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 POST HEARING BRIEF**

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Respondent Laurie A. Bebo, by and through her counsel, Reinhart Boerner Van Deuren s.c., hereby respectfully submits this Post Hearing Brief and requests that the Court conclude that the claims set forth in the December 3, 2014 Order Instituting Proceedings ("OIP") filed by the Securities and Exchange Commission's ("SEC" or the "Commission") Division of Enforcement (the "Division") be dismissed in their entirety.

INTRODUCTION

After four weeks of testimony in this matter, what is most clear is that the Commission should never have charged Ms. Bebo with securities fraud and the Division's allegations set forth in the OIP are unsupported. But in the search for "broken windows," the Commission did charge Ms. Bebo, and the Division brought the case in this forum because it is the only forum where it could craft the facts, in many cases out of whole cloth, as it needed to fit a pre-established theory of liability. However, like a worn out sweater, when the Division's presentation of facts were tested by cross-examination and presentation of the documentary evidence contradicting it, pulling on the frayed edges of its case caused it to fall apart.

Indeed, the Division failed to meet its burden of proof in this prosecution for a simple and troubling reason: it never conformed a theory of liability to the actual facts presented. Rather it transparently crafted the facts through rehearsed witness testimony (indeed rehearsing the "cross examination" of many witnesses), and where the testimony and documentary evidence were not malleable enough—or when they were exculpatory—the Division simply chose to ignore them. As a result, the Division's evidence is unreliable and grossly contradictory.

In the end, the Division's case is nothing more than scripted theater—written over the Division's two-year investigation that in hindsight was nothing more than a one-sided trial preparation period—divorced from the true facts. This became clear whenever the Division's witnesses' memories were tested or they were forced to go "off script." For example, when

former Ventas employee, Joseph Solari, was asked on re-direct by the Division what the "one important instruction" he was told by the Division with respect to his testimony, Mr. Solari froze on the stand and could not recall it. Mr. Solari was obviously confused whether the Division's attorney was talking about the answer written for him by the Division that he recited nearly a dozen times to the effect of: "I would never agree to such a thing, and I did not have the authority to agree to it." (*See, e.g.,* Solari, Tr. 416, 417, 418, 419, 420, 422, 423.)[1]

Numerous other Division witnesses could conveniently only remember certain facts favorable to the Division's case, but their memory was an empty slate with respect to everything else pertinent to the case. The two starkest examples in this regard are Assisted Living Concepts, Inc.'s ("ALC") in-house lawyers, Eric Fonstad and Mary Zak-Kowalzcyk. For example, Mr. Fonstad claims that he never knew that ALC had even started to use room rentals related to employees to meet the covenant calculations under the lease with Ventas, because he could not recall it. (Fonstad, Tr. 1508.) Yet, Mr. Fonstad participated in the call with Mr. Solari, prepared the follow-up e-mail to him, received (and printed) both the final e-mail and Ventas' response, chaired disclosure committee meeting days later where this "correspondence" regarding clarification of "census" for purposes of calculating the lease covenants was discussed, and chaired each subsequent meeting where the same subject was repeatedly discussed.[2] (Fonstad, Tr. 1570-72, 1592-1604.) He could remember *no facts* about any of these circumstances.

Ms. Zak-Kowalczyk on direct examination testified at the insistence of the Division that she had "no responsibility" at all for securities law compliance. Yet Ms. Zak-Kowalczyk was the

[1] Ms. Bebo will cite the hearing transcript by identifying the witness, followed by the transcript page.

[2] Notably, Mr. Fonstad met with counsel for the Division off-the-record on at least four different occasions, two being prior to his investigative testimony. At no point in time was Mr. Fonstad shown certain of the key disclosure committee minutes. Mr. Fonstad also did not remember basic things about ALC, such as its key occupancy tracking system called the TIPS system.

chair of ALC's disclosure committee, whose principal purpose was securities law compliance. She also testified on direct examination that she had no role whatsoever in preparation of ALC's response to an SEC comment letter, but on cross examination was again shown this to be untrue as she reviewed and edited ALC's response. Then on direct examination the Division had her testify that she had never retained a particular outside counsel to perform legal work related to the Ventas facilities (and thus would not have a reason to go there). However, on cross examination her memory was refreshed that, in fact, the lawyer did represent ALC in relation to a personal injury matter that occurred at one of the facilities. Finally, Ms. Zak-Kowalczyk could not remember a single detail about any meeting that she was asked about if it was not contained in some notes of the meeting. Thus, her testimony that she could not recall the issue of employee leasing[3] being discussed at the August 2011 board meeting carries no weight. Her testimony is based solely on the fact that her half-page of notes about a 45 minute conversation did not contain particular reference to that subject.

But beyond these questions of evidence reliability that infects the entire Division case, the four weeks of testimony revealed other critical deficiencies in the Division's evidence. First, there is an overwhelming void of evidence regarding materiality. The uncontradicted evidence is that the lease with Ventas was not a material contract in the first place (*see, e.g.,* the uncontradicted testimony of Ms. Bebo's expert, David B.H. Martin). And while the Division and SEC routinely use event studies to prove the materiality of false statements or omissions, they chose not to do so here because of the inevitability of the outcome, as Ms. Bebo's financial economist expert, Professor David Smith, so eloquently presented. Realizing the total lack of

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[3] As used herein, reference to "employee leasing," "employee leasing program" 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.

evidence to support the required element of materiality, the Division made an 11th hour, desperate attempt to back-fill evidence by obtaining a false declaration from one of ALC's board members, Derek Buntain. A declaration which, even if true, would have no relevance to what a public investor might conclude was material information.

Second, the Division's presentation of evidence contained virtually nothing about the so-called "false statement" made in connection with the purchase or sale of securities. It elicited virtually no testimony and put in virtually no evidence about who prepared the statement, why it was prepared, or views of the relative importance of the statement in ALC's financial reporting process. That is no doubt because the alleged false statement was specifically reviewed and approved by Mr. Fonstad in the days immediately following the agreement with Ventas approving the use of room rentals related to employees in the covenant calculations. And it was reviewed and approved by many other senior executives with critical roles in ALC's financial reporting process—including the CFO, director of financial reporting, and internal auditor—all with knowledge of all of the pertinent facts of ALC's covenant compliance practices. The statement was reviewed each reporting period by ALC's independent auditors, Grant Thornton, who had knowledge of the basic facts (though admittedly not every detail) about the employee leasing practice. No wonder that the Division chose not to call any witnesses from Grant Thornton. It knew their testimony would (and did) undercut the entirety of their scienter case.

And knowing that it could not meet the scienter element of its fraud allegations if Ms. Bebo also disclosed pertinent facts to ALC's Board of Directors and Audit Committee regarding ALC's payment of apartments for employees to meet the Ventas covenants, they attempted to demonstrate the Board members' lack of knowledge through strained and patently incredible testimony from those Board members. Their testimony, however, was directly

contradicted by other Division witnesses as well as some of the Board members themselves. This attempt failed to bolster an already extremely weak scienter case where all the evidence indicates that Ms. Bebo acted in good faith towards investors and had no financial or other motive to commit the alleged fraud.

Given there are no facts to support a securities fraud disclosure case, the Division presented weeks of testimony supporting a breach of contract claim dressed up as a securities fraud case. And it's a breach of contract action that the counter-party to ALC never brought when it sued ALC over other issues, or otherwise seemed to care about. The Division's attempt to stand in the shoes of Ventas and assert a breach of contract action fails as a matter of law and fact. With regard to the facts of the Division's breach of contract action, it failed to prove the absence of a mutual understanding between Ventas and ALC regarding ALC renting units for people with a reason to go to the facilities. Ventas representatives have no recollection of the call Ms. Bebo had with them discussing the matter or what they did with the confirming e-mail she sent following the call. Suggesting that Ventas had no knowledge of any use of employees in connection with the covenant calculations (as the Division does in the OIP), is contradicted by the very correspondence confirming the arrangement which was indisputably reviewed by at least four Ventas executives and asset managers. Tim Doman's bizarre testimony that Ventas simply disregarded the confirmation because it was not a "formal request" lacks credibility. More fundamentally, however, even if this is true, Ventas never told Ms. Bebo they were simply disregarding the e-mail and so it was certainly reasonable for ALC and Ms. Bebo to rely on their silence in reaching the conclusion that Ventas had no issues or concerns with ALC's rental of rooms related to employees. In fact, the Division's lead-off witness, Mr. Doman, could not recall a single event of default declared by Ventas based on a tenant tripping the financial covenants.

And another of Ms. Bebo's experts, John Durso, presented uncontradicted evidence that industry conventions would never have led to a default or enforcement of remedies under the circumstances of this case, that the accommodation provided by Ventas was typical in the context of the crashing U.S. economy, and that Ms. Bebo acted consistent with industry standards in relying on the phone call and e-mail with Ventas.

To try and cover all of these deficiencies with respect to scienter and the clear facts that there was an understanding with Ventas, the Division made a final attempt to further mold the facts to conform to their false narrative by relying on John Buono. But hours of off-the-record discussions, interviews, and preparation with the Division (about 60 hours combined) cannot overcome the cognitive dissonance, failed recollections, and stunning self-contradictory testimony of Mr. Buono. Mr. Buono's new-found understanding of the "facts" would require the Court to credit his hearing testimony that *today* he realizes that there was no agreement with Ventas when *for three years* he acted fully consistent with the agreement reached on the call with Mr. Solari and confirmed in the follow-up e-mail (that he helped prepare) where the parties reached an understanding about ambiguous lease terms. And in 2012 and 2013 he staunchly defended ALC's employee leasing practice to the Board, to ALC's auditors, and to Milbank. To incent Mr. Buono to change his view of the reality that there was an understanding, the Division told him on a break in the middle of his investigative testimony that Ms. Bebo "threw him under the bus." And he was apparently permitted to read everyone's investigative testimony but Ms. Bebo's.[4] But even Mr. Buono was incapable of supporting the Division's theory that ALC's

[4] This is improper conduct by the government. The prosecutor's job is not just to win, but to win fairly. *See, e.g., U.S. v. Reyes*, 600 F.3d 454, 462 (9th Cir. 2011). Accordingly, "it is improper for the government to present to the [trier of fact] statements or inferences it knows to be false or has very strong reason to doubt." *See id*. And when clear defects in a trial make it clear that the process itself lacked fundamental fairness, the court should remedy that misconduct in order to "vindicate the accused's constitutional right to a fair trial, a fundamental right for which the prosecution shares responsibility with the courts." *See Commonwealth of Northern Mariana Islands v. Bowie*, 243 F. 3d 1109, 1111 (9th Cir. 2001). Respondent, however, continues to have faith that the government will do the right

general counsel was unaware of how ALC was meeting the lease covenants, or that Board members were unaware of the practice. His testimony demonstrated the opposite.

Moreover, the Division's notion that ALC overpaid for the Ventas properties because it was supposedly in default of the financial covenants is dishonest and unsupported by the facts. The record is clear that, to the extent any default drove the purchase of the buildings, it was the actions by state regulators to revoke ALC's licenses to operate three of the eight properties. Also, the record is replete with discussions with Ventas to buy the properties at comparable prices long before the contest of the license revocation notices and regulatory compliance pressures arose. The $100 million purchase price is consistent with those prior proposals, and Ventas did not even increase its price demands after litigation over the license problems was commenced. Finally, when the deal was announced ALC's share price went up. Investors must have concluded what Mr. Buono and ALC's then-CEO Chip Roadman concluded in late June—that the acquisition would likely add significant value (approximately $2.40 per share) to the company. All this is even before considering Mr. Durso's expert testimony that the price was reasonable and that the appraisals used by ALC were unduly low.

In sum, the Division's prosecution fails on the facts and law as set forth more fully below, and for that reason, this Court should find for Respondent on all counts.

* * *

The remainder of this memorandum is organized in three parts. Part one explores the factual and legal deficiencies in the Divisions case in more detail. In summary, the Division has failed to demonstrate any actionable violation of the federal securities laws of Commission rules.

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thing—that it will not present arguments or inferences that it knows to be false or has a very strong reason to doubt. And in that spirit Respondent reserves judgment on whether to pursue the remedies available her based upon the positions set forth in the government's opening brief.

Part two of this memorandum demonstrates that these administrative proceedings violate the United States Constitution. They are both facially infirm and Ms. Bebo's constitutional right to due process has been violated as applied in this particular case.

Part three of this memorandum sets forth Ms. Bebo's view of what remedy can be imposed if the Court were to somehow conclude that any violations of the federal securities laws or rules occurred.

PART ONE - THE DIVISION FAILED TO PROVE ANY SECURITIES LAW VIOLATIONS

STATEMENT OF FACTS

I. SUMMARY OF THE EVIDENCE DEMONSTRATING THE UNFOUNDED ALLEGATIONS AND UNSUPPORTED REPRESENTATIONS IN THE OIP AND THE DIVISION'S PREHEARING BRIEF.

The Division made unsupported allegations and key omissions in its OIP and in the Division's Prehearing Brief (the "Prehearing Brief") that resulted in a gross overstatement of its case against Ms. Bebo. This section, in summary format, demonstrates the Division's failure to support the allegations of the OIP, and highlights some of the Division's false accusations and over-promises contradicted by the documentary evidence, its own witnesses, and other non-party witnesses.[5] Put another way, even putting aside Ms. Bebo's highly consistent and credible testimony that rebuts all of the OIP allegations, the documentary evidence and testimony of non-party witnesses disproved the Division's allegations.

[5] Several exhibits and prior statements (*e.g.*, proffer statements and investigative testimony) that refuted the Division's allegations were available to the Division before the OIP and Prehearing brief were written. In fact, in some instances, the Division even elicited and then subsequently ignored exculpatory facts or statements in its filings.

A. False statements or allegations by the Division in its Prehearing Brief and OIP.

The Division failed to substantiate its OIP allegations and evidentiary promises in its Prehearing Brief. The following chart identifies false allegations and overstatements by the Division (on the left side of the table) and provides the correct or contrary evidence as well (on the right side of the table):

Allegations or Statements From the Division's OIP or Prehearing Brief	Evidence Contradicting the Division's Allegations or Statements
The Division's allegations or statements about ALC's agreement with Ventas and, additionally, Ventas's, ALC's Board of Directors, and Grant Thornton's knowledge of the agreement: • "Instead, [Bebo] offers two primary excuses for her misconduct. First, she argues that Ventas somehow agreed to allow an unlimited number of ALC personnel to be included in the covenant calculations, so long as Bebo could manufacture — on a *post hoc* basis after the quarter had ended — some business-related reason for that person to stay at the facilities (even if they never actually travelled or stayed there). Second, Bebo claims that her scheme was fully disclosed[6] to and approved by a slew of ALC attorneys, board members, and auditors. At the hearing, the Division will	Ventas Agreement: Division witness John Buono's testimony corroborated Ms. Bebo's "alibi" or "excuse" that ALC had an agreement with Ventas regarding ALC's rental of units for employees or others with a reason to go, and including those units in covenant calculations: • (Buono, Tr. 2487 (Mr. Buono testified that his prior view was that ALC "requested that employees would be in the houses and that, quite frankly, there would be no other reason to put them in the houses other than to put them in the calculations, but I can't testify that they agreed to include them in the covenant calculations." Buono also clarified that **"it is now my opinion that Ventas did not approve it per covenant calculations."**) (emphasis added).) • (Buono, Tr. 2487-88 (Mr. Buono testified that he had previously made the assumption from the [February 4, 2009 Solari call] that Ventas agreed to have employees included in the covenants and, more specifically, he testified "why would we do it otherwise is the question.").) • (Buono, Tr. 2489-90 (Mr. Buono testified that "[i]n 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

[6] Respondent Bebo expects the Division to argue that the employee leasing practice was not fully disclosed to certain individuals. Although there is information in this table that the Board was aware of specific key details of the employee leasing program, the notion that the Board was at all aware of the program rebuts the Division's attempt to characterize employee leasing as a hidden practice and supports Respondent's argument that the board knew details of the employee leasing program.

show that Bebo's account is both nonsensical and internally inconsistent. **Beyond Bebo's story not making any sense, not a single percipient witness or document will corroborate Bebo's alibis. To the contrary, the three individuals Bebo claims were witnesses to her purported agreement with Ventas will all deny that an agreement existed to include *any* employees in the covenant calculations."** (Prehearing Brief, p. 2 (emphasis added).) • "Again, no document exists corroborating Bebo's account of what she disclosed to, or was approved by, Ventas, the attorneys, the board, and auditors." (Prehearing Brief, p. 2.) • "The heart of Bebo's defense is her self-serving claim that Ventas agreed to the inclusion of employees in the covenant calculations, and that she fully disclosed the practice to various attorneys, auditors, and ALC's board. **Notably, there is no documentary evidence to support Bebo. And more importantly, each of the percipient witnesses will testify that Bebo is not telling the truth."** (Prehearing Brief, p. 19 (emphasis added).) • "Bebo's efforts were unsuccessful, and ALC sought a release from Ventas expressly relating to the inclusion of employees in the covenant calculations and the quarterly certifications ALC sent to Ventas. This was the first time	that -- those employees, we would only do that -- a reasonable person would only think we'd do that in order to meet covenants.").) • (Buono, Tr. 2490 (Mr. Buono testified that he is struggling with his prior understanding *today* because his understanding has changed based on pressure and influence by Division lawyers); *see also* Buono Tr. 2490 (when discussing prior language in Disclosure Committee minutes he testified that "that there was correspondence whereby the covenant calculations have been clarified. *Now it's been pointed out to me that we never mentioned the covenant calculations. We mentioned employee leasing . . .It means during the course of reviewing materials and having questions from the SEC and others, they pointed out that the phrasing covenant calculations is not there in our correspondence to Ventas, and I don't recall it being discussed on the call with Ventas."*) (emphasis added).) • (Buono, Tr. 2781 (Mr. Buono testified that he did not believe it was necessary to clarify the meaning of the agreement with Mr. Solari and that "vague was fine.").) • (Buono, Tr. 4632-33 (Mr. Buono testified that employee leasing being discussed in the context of using it in covenant calculations is the only context, in his mind, that it would be taken in).) • Despite Mr. Buono's change of heart, it is clear that he viewed and still views the January 20, 2009, call with Solari as an agreement (*See* Buono Tr. 4645 (Mr. Buono testified that he wouldn't use the term "agreement" to describe the February 2009 call, but also stated that "it was confirmation of the conversation that we had with Joe Solari that we would be including -- we would allow employees to reside in our -- in our residences." Tellingly, Mr. Buono concluded by stating that "[s]o there's been additional information **after that time that would lead me to believe that maybe this wasn't as good of an *agreement* as we would have hoped."**) (emphasis added).)

Ventas learned that ALC was including employees in the covenant calculations." (Prehearing Brief, p. 18.) • "Solari and Buono both participated on the January 20, 2009 phone call on which Bebo claims Ventas approved the inclusion of employees in the covenant calculations. **Both witnesses will deny that Ventas ever agreed to the practice, on that phone call or otherwise.**" (Prehearing Brief, p. 19 (emphasis added).) • "Bebo further violated the antifraud provisions by orchestrating the scheme to hide ALC's breach of the Ventas covenants from ALC's board and attorneys, Ventas, and Grant Thornton, by including employees and other non-residents in the covenant calculations." (Prehearing Brief, p. 23.) • "Similarly, six members of ALC's board of directors, as well as other ALC personnel who attended board meetings, refute Bebo's story that the board approved, and were provided the details regarding the scope and extent of, Bebo's fraudulent scheme." (Prehearing Brief, p. 19.) • "And Bebo's scienter is confirmed by the fact that she continues to falsely claim, to this day, that she fully disclosed her scheme to, and received approval from, Ventas, attorneys, the board, and Grant Thornton." (Prehearing Brief,	• (Buono, Tr. 4648 (Division witness Buono stated that it was his understanding that employee leasing was for the purposes of covenant calculations and, more specifically, he testified "[w]hy else would we do it?").) • (Buono, Tr. 4649-50 (Mr. Buono testified that it was reasonable that he might have said to Grant Thornton, "look, Amy, we've been through this; *we have an agreement with Ventas.*") (emphasis added); *see also* Ex. 2119, p. 6 (Division's proffer notes containing Mr. Buono's prior statement to Amy Henslin).) • (Buono, Tr. 4656-57 (Mr. Buono testified that based on the call with Mr. Solari, he understood that employees would be staying at the properties in lieu of hotels and that the apartments would be paid directly by ALC).) Board Knowledge: Division witness John Buono also corroborated Ms. Bebo's testimony that ALC's directors, namely David Hennigar and Mel Rhinelander, approved the employee leasing practice *at its inception*: • (Buono, Tr. 2393-96 (Mr. Buono corroborated Ms. Bebo's testimony about Mel Rhinelander and the David Hennigar approving the employee leasing program prior to the February 2009 board meeting, except that Buono mistakenly testified that this meeting occurred earlier than February 2009); Buono, Tr. 2746-47 (Mr. Buono confirmed that Mel Rhinelander was Ms. Bebo's main point of contact with the board).) Board Knowledge: Grant Thornton corroborated Ms. Bebo's testimony that ALC's Board was aware of the employee leasing program: • Grant Thorton partner Melissa Koeppel discussed the employee leasing program with the board on multiple occasions and, according to Grant Thornton, nobody was surprised to hear about the program. (Koeppel, Tr. 3328-30 (Ms. Koeppel stated that the whole Board of Directors typically attended the Audit Committee meetings and she first brought up employee leasing in 2009. She also commented

p. 24.) • "Bebo also lied to Grant Thornton when she told its personnel that Ventas had agreed to the inclusion of employees in the covenant calculations." (Prehearing Brief, p. 26.) • "ALC's landlord never agreed to the inclusion of such individuals in the covenant calculations. In addition, ALC's landlord never knew that ALC was including such individuals in covenant calculations . . ." (OIP, ¶ 5.) • "Ventas never agreed to, and was unaware of, ALC's inclusion of such nonresidents in the financial covenant calculations." (OIP, ¶ 27.) • "At the time it filed the lawsuit, Ventas was still unaware that ALC had been including employees in the covenant calculations." (Prehearing Brief, p. 17.) • "ALC also recognized revenue associated with the fake occupants in the financial materials ALC provided to Ventas. Ventas knew none of this." (Prehearing Brief, p. 2.)	that "management had entered into an arrangement with Ventas to include in the covenant calculations employees who had stayed at the properties for a business purpose." According to Koeppel, the board was engaged and sort of acknowledged her conversation); Koeppel, Tr. 3335-37 (Ms. Koeppel brought up the topic of employee leasing again in 2010 after the number of individuals used in the covenant calculations increased); Robinson, Tr. 3440 (Grant Thorton partner Jeff Robinson testified that he was informed that employee leasing was discussed during the third quarter of 2010 Audit Committee meeting); Koeppel, Tr. 3337-38 (Ms. Koeppel's practice would have been to discuss the employee leasing program with Malen Ng before the Audit Committee meeting).) • Jeff Robinson, another Grant Thornton partner, also discussed employee leasing and the use of employees to meet covenant calculations with ALC's Board of Directors. (Robinson, Tr. 3430-31 (Mr. Robinson discussed employee occupancy with the Audit Committee in 2011. More specifically, Mr. Robinson testified that, "we did inform them that the company was utilizing these -- you know, the employee count for purposes of meeting the covenants and that it was our understanding that this was in accordance with an agreement that management had with Ventas." According to Mr. Robinson, nobody was surprised and it confirmed his belief that "they had been previously informed by . . . our previous audit teams on this topic."); Robinson, Tr. 3432 (Mr. Robinson discussed revenue with regard to consolidated financial statements and employee leasing with the Audit Committee); Robinson, Tr. 3514 (Mr. Robinson informed the Audit Committee that ALC would fail covenants without employees); Robinson, Tr. 3435-36 (Mr. Robinson discussed employee leasing with Malen Ng prior to the Audit Committee meeting); Ex. 1913; Ex. 1913A (agenda for Malen Ng call includes "Caravita covenants"); Robinson, Tr. 3516-17 (Mr. Robinson confirmed he spoke with the Audit Committee about employee leasing, even though the discussion is not reflected in the minutes); Robinson, Tr. 3520-3521

	(reconfirming the same); *see also* Robinson Tr. 3438-39; Robinson Tr. 3449-50.) Board Knowledge: The Division's own witnesses corroborate Ms. Bebo's testimony that ALC's Board was well aware of the employee leasing program: • Testimony of Division witnesses Derek Buntain and Mr. Buono, in addition to management presentations and other materials, indicate that employee leasing was discussed at a Board meeting for the third quarter of 2009. (*See* Section XIII, *infra*); Buntain, Tr. 1372-77 (Mr. Buntain's comments corroborate Ms. Bebo's testimony that employee leasing was discussed at the Board meeting for the third quarter of 2009, when considered with Buono's testimony and other exhibits); Buono, Tr. 2392-93 (Mr. Buono recalling a comment by Mr. Buntain "to the effect that if we're adding employees to the calculation, why don't we add more because the covenants that we presented at that meeting were close to the -- close to the edge of failing.").) • Employee leasing was also discussed with the Board in August of 2011, when ALC was responding to the SEC comment letter. (*See* Section XIII, *infra*); Buntain, Tr. 1452-54 (Mr. Buntain testified about the Board's discussion of the comment letter in August of 2011 and he also testified that management explained why they were comfortable with the occupancy at the Cara Vita properties. More specifically, Mr. Buntain testified "[t]hey justified their use of the employees." Mr. Buntain also testified that "[w]ell, the memo to Mr. Solari by Ms. Bebo said something. When she didn't hear anything back, she took that as an approval." Mr. Buntain was asked if management "justified the reasons for being in compliance by referencing *the agreement with Ventas regarding the use of employees for covenant calculations*" and he replied, "*[w]ell, that's one of the ways they justified it, yes.*") (emphasis added); Buono Tr. 4629-32 (Mr. Buono testified that employee leasing was discussed at the August 2011 Board meeting. Further, he testified that "[t]he substance of the conversation was that essentially -- I mean, there was discussion about the employee leasing, if I remember correctly, but I

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<td>don't remember the specifics of talking about it being used in covenant calculations. I don't recall it being used in terms of magnitude of how many employees were involved. I just recall we didn't introduce or discuss the concept of employee leasing.").)

• Mr. Buono also provided credible testimony that ALC's Board of Directors was aware of employee leasing. (Buono, Tr. 4633-34 (Mr. Buono testified that several directors, including Mr. Buntain and Mr. Rhinelander, understood that employees were used in the covenant calculations); Buono, Tr. 2417-18 (Division Witness Buono testified that "[Malen Ng] knew about employee leasing" and he also testified that during a call he had with Malen Ng that she "mentioned that Mr. Robinson had discussed employee leasing, that we were renting rooms to employees, and that was part of how the covenants were being made"); Ex. 1115; Buono Tr. 2523-24; Buono, Tr. 4639-40 (Mr. Buono is asked whether his memory was refreshed that Ms. Ng. responded to him by stating "we knew about the employee leasing plan" and he testified "[m]y recollection of what I said, and I don't recall if I said -- if she said "we" or "I," and then this is incomplete, "I knew about the leasing plan," and then she said, "[b]ut I didn't know it was that many."); Ex. 2117, p. 5 (Division's notes containing Mr. Buono's prior statement); Ex. 1179, p. 4 (November 6, 2009 Audit Committee Meeting Minutes where Mr. Buono "presented specific information regarding compliance with the CaraVita covenants" and that information was discussed by the Audit Committee members).)

Board Knowledge: Milbank, independent investigators, concluded that the employee leasing program was not concealed from the board:

• (Robinson, Tr. 3461-62 (Mr. Robinson confirmed that Milbank relayed to Grant Thornton the fact that the "consideration that this practice was concealed from the board is incorrect."); Ex. 3460 (Grant Thornton notes of call with Milbank; "[b]ased on their initial discussions, they believe the consideration that this practice was concealed from</td>
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	the board is incorrect.").) • And after its full investigation, Milbank concluded that the Board was aware of the practice of ALC paying for rooms to be included in the covenant calculations, and then learned of the broader arrangements in 2012. (*See* Ex. 1879, p. 9 (Grant Thornton notes of December 17, 2012 call with Milbank; "[b]oard believed that the rooms were to be used and paid for by ALC. Board learned of the broader arrangements in 2012."); *see also* Robinson, Tr. 3473 (identifying notes from December 17, 2012 call).) Exhibits contradicting the Division's assertions about the existence of documentary evidence to support Ms. Bebo's theory (*e.g.*, "The heart of Bebo's defense is her self-serving claim that Ventas agreed to the inclusion of employees in the covenant calculations, and that she fully disclosed the practice to various attorneys, auditors, and ALC's board. Notably, there is no documentary evidence to support Bebo"): • (Ex. 1230 (E-mail confirming/notifying Ventas of ALC's room rentals related to employees).) • (Ex. 1335 (February 4, 2009, e-mail from Joe Solari[7] replying to ALC's e-mail confirming/notifying Ventas of ALC's room rentals related to employees and stating that Bill Johnson from Ventas will "be following up with [Laurie] and/or John with any questions or requests for further information regarding this matter.").) • (Ex. 1343 (February 13, 2009 e-mail from Bill Johnson[8] at Ventas requesting to set up a meeting and replying to Joe Solari's response to ALC's e-mail confirming/notifying Ventas of ALC's room rentals related to employees).) • Many Disclosure Committee minutes indicate that ALC was monitoring the Ventas covenants and that there had been correspondence between ALC and

[7] William Johnson from Ventas was carbon copied on the e-mail.

[8] Bill Johnson included other senior Ventas officials in the e-mail (*e.g.*, Tim Doman and Joe Simms).

	Ventas whereby the covenant calculations had been clarified as to census. (Ex. 1130; Ex. 1130A; Ex. 125; Ex. 1091; Ex. 1159B.) • (Ex. 1913; Ex. 1913A (agenda for call between Mr. Robinson and Malen Ng, where Mr. Robinson discussed employee leasing).) • (Ex. 1115 (November 5, 2009, e-mail from Buono to Malen Ng informing her that the Winterville EBITAR looks out line with occupancy for several reasons, including the fact that Winterville has employees with rooms. This e-email also informs Malen, the head of the Audit Committee, that ALC makes adjustments "top side" to pay for employee rooms).) • (Ex. 3460 (Grant Thornton notes of call with Milbank; "[b]ased on their initial discussions, they believe the consideration that this practice was concealed from the Board is incorrect.").) • (Ex. 1879, p. 9 (Grant Thornton notes of December 17, 2012 call with Milbank; "[b]oard believed that the rooms were to be used and paid for by ALC. Board learned of the broader arrangements in 2012.").) • (Ex. 1553 (e-mail from Jeff Robinson to John Buono containing a statement from Amy Henslin as to when Grant Thornton discussed the issue of employee occupancy with ALC's Board).) • All of the management representation letters signed by Mr. Buono substantiate the fact that his belief was consistent with Ms. Bebo's that ALC had an agreement with Ventas, because several of the letter's had specific representations about complying with contractual obligations. (*See e.g.*, Exs. 61-72.) In fact, one representation letter signed by John Buono had a specific representation relating to the Ventas covenants. (Ex. 63 ("We have calculated the Caravita lease covenants in accordance with the corresponding lease agreement and as understood by us after conferring with the lessor.").) • Mr. Buono signed several of the management

	representation letters which specifically acknowledge and approve of the employee leasing process. (*See* Ex. 73, p. 1 ("We also note that, as publicly disclosed , the Company's Audit Committee is still investigating possible irregularities relating to the Company's lease with Ventas Reality, Limited Partnership ("Ventas") . . . Management is aware that units leased to employees at facilities subject to the Ventas lease were treated as bona fide rentals by third parties; however, management does not believe that this practice or management's or employee's involvement in such practice involve irregularities.") (emphasis added); *see also* Exs. 1627-28, 1895A (additional management representation letters with similar language).) • Importantly Mr. Buono was still signing management representation letters long after Ms. Bebo left ALC. (Ex. 1627 (November 8, 2012 management representation letter); Ex. 1628 (August 8, 2012 management representation letter); Ex. 1895A (March 14, 2013 management representation letter).) • There are several documents indicating that Division witness John Buono objected to Mr. Bell's memorandum that called into question ALC's employee leasing practice. (*See* Ex. 1071(e-mail from Mr. Buono to ALC's Board, which discussed Bell's critical comments of ALC's employee leasing practice and Mr. Buono wrote "[i]t is my assumption that the consensus of the Board was that it continues to believe the previous certifications [that were called into question by Bell's memorandum] were accurate or the Board would have instructed management to take appropriate steps to correct."); *see also* Exs. 1081, 1081A (Mr. Buono sends a draft e-mail to Quarles and Brady, addressed to Alan Bell, where he wrote "[a]s you are aware, external counsel has advised management that in fact the Feb 4, 2009 email from Laurie Bebo to Joe Solari does provide proper notice and that the certificate re patient revenue is proper."); Buono, Tr. 2427-28 (regarding the same issue, Mr. Buono testified that he ultimately signed management representation letters because "I believed at the time that all of the directors did not share Alan's opinion based on the

	conversation with them.").)
The Division's allegations or statements about what details of the employee leasing program were disclosed to ALC's Board in 2012: • "When the board confronted Bebo, she failed to come clean about many details of her scheme, including the fact that ALC was including in the covenant calculations non-employees, family members of employees, employees who weren't actually staying at the properties, and employees at multiple properties during the same time period. **Indeed, Bebo would never disclose this information to the board."** (Prehearing Brief, p. 17 (emphasis added).)	ALC's Board was made aware of the details of the employee leasing program: • The above response includes evidence that Ms. Bebo disclosed employee leasing to the Board, which further corroborates her testimony that she discussed the details of the employee leasing program with the Board as well. • (Ex. 329, pp. 14-16 (March 20, 2012 e-mail from Mr. Buono to Alan Bell, with Laurie Bebo carbon copied, containing several attachments that are the CaraVita calculations; these lists of employees that were presented to the Board clearly contain Laurie Bebo's family members (*e.g.*, Nick Welter, Gale and Bill Paremski) that the Board or at least some Board members were aware of; the lists also contain the same individuals at multiple properties).)
The Division's allegations or statements about ALC's attorneys' understanding and knowledge of the agreement with Ventas: • "In fact, Bebo utterly disregarded the legal advice from the one attorney she consulted on the issue — Fonstad —who expressly advised her to disclose to Ventas her proposal to include employees in the covenant calculations and to obtain Ventas' signed approval." (Prehearing Brief, p. 19.) • "Moreover, each attorney Bebo claims approved the practice **will deny knowing that ALC was including employees in the covenant calculations, let alone approving the practice."** (Prehearing Brief, p. 2 (emphasis	Mr. Buono informed the Division that Eric Fonstad approved the employee leasing practice: • Although Eric Fonstad provided input about the possibility of establishing the employee leasing program prior to the January 20, 2009, call with Ventas, it is clear that his final legal opinion was that the practice was allowed. (Buono, Tr. 4651-53 (Mr. Buono states that he believes that he informed the SEC that at some point he "received advice from [Fonstad] that ALC['s] rental of rooms to employees or individuals for use in covenant calculations was allowed" or "kosher").) The Division's statement that "Quarles & Brady will testify that they never approved, or were made aware of, the inclusion of employees in covenant calculations" is false: • (Davidson, Tr. 2292 (Quarles and Brady attorney Bruce Davidson became aware that ALC was including employees as occupants at these facilities to meet the covenant requirements in 2012; Mr. Davidson's testimony and documents also

added).) • "According to Bebo, Ventas's silence confirmed its agreement that ALC could include in the covenant calculations an unlimited number of employees who did not actually stay at the Ventas facilities, as long as those employees had "a reason to go." **Bebo's interpretation is not only at odds with Buono's and Solari's accounts of the January 20 call and her summary of the call contained in the February 4 email, but ignores the advice she received from Fonstad: that ALC disclose in writing its intent to include employees in the covenant calculations and Ventas's written approval was needed for ALC to do so."** (Prehearing Brief, p. 10 (emphasis added).) • "At the hearing , **two former ALC in-house counsel and multiple attorneys from Quarles & Brady will testify that they never approved, or were made aware of, the inclusion of employees in the covenant calculations."** (Prehearing Brief, p. 19 (emphasis added).)	indicate that Mr. Morrison, another Quarles attorney, was aware that 70-90 employees were being used in covenant calculations and ALC paid for the apartment).) ALC's in-house counsel, Mary Zak Kowalczyk knew about the employee leasing practice because she was at several meetings where the practice of including employees for covenant calculations was discussed: • Employee leasing was discussed with the Board in August of 2011 when ALC was responding to the SEC comment letter and Mary Zak Kowalczyk. (*See* section XIII *supra* ; Buntain, Tr. 1452-54 (Mr. Buntain testified about the Board's discussion of the comment letter in August of 2011 and he also testified that management explained why they were comfortable with the occupancy at the Cara Vita properties. More specifically, Mr. Buntain testified "[t]hey justified their use of the employees." Mr. Buntain also testified that "[w]ell, the memo to Mr. Solari by Ms. Bebo said something. When she didn't hear anything back, she took that as an approval." Mr. Buntain was asked if management "justified the reasons for being in compliance by referencing *the agreement with Ventas regarding the use of employees for covenant calculations*" and he replied, "*[w]ell, that's one of the ways they justified it, yes.*") (emphasis added); Buono, Tr. 4629-32 (Mr. Buono testified that employee leasing was discussed at the August 2011 Board meeting. Further, he testified that "[t]he substance of the conversation was that essentially -- I mean, there was discussion about the employee leasing, if I remember correctly, but I don't remember the specifics of talking about it being used in covenant calculations. I don't recall it being used in terms of magnitude of how many employees were involved. I just recall we didn't introduce or discuss the concept of employee leasing.").) • As discussed above, Grant Thornton presented at several Audit Committee or Board meetings and Mary Zak Kowalczyk was present for these meetings. (Exs. 113-115, 119 (2011 Audit Committee minutes indicating Ms. Zak Kowalczyk

	was present).) • Mary Zak-Kowalczyk testified that she was present for several conversations where employee leasing was discussed. (Kowalczyk, Tr. 4357 (Ms. Zak-Kowalczyk testified, "I believe that we contacted Quarles & Brady to ask them to assist us in -- to provide a letter or an opinion on whether it was reasonable for us to have relied upon the e-mail from Mr. Solari as evidence of the landlord's consent to -- to including employee rental in the covenant calculations -- the occupancy calculations."); Kowalczyk, Tr. 4360-61 (Ms. Zak-Kowalcyzyk discussed her understanding of employee occupancy based on her initial conversation with Ms. Bebo in March, 2012—including the fact that some rooms were being used in the covenant calculations).) Exhibits contradicting the Division's misstatements and false assertions: • (Ex. 1048 (Mary Zak-Kowalczyk's handwritten notes from August 4, 2011 meeting).) • (Ex. 1037 (reasonableness opinion from Quarles & Brady certifying that ALC acted reasonably with regard to employee leasing).) • (Ex. 3683 (e-mail from ALC to Quarles & Brady indicating that 70-90 employees were being used in covenant calculations).)
The Division's overstatements or false allegations about Ms. Bebo concealing the employee leasing practice from Ventas: • "To that end, Bebo restricted Ventas from visiting certain facilities at particular times, such as meal times when Ventas might be able to identify the actual number of occupants based on the number of people dining." (Prehearing Brief, p. 14.) • "Bebo went so far as to direct that	The Division overstated its case with regard to Ms. Bebo taking certain acts to conceal the employee leasing program: • (Butora, Tr. 946-47 (Ventas employee Ms. Butora indicating that Ventas did not count heads or check rooms for occupants during site visits nor did Ventas intend to do these things).) • (Doman, Tr. 200 (Mr. Doman from Ventas testified that the average time for a site visit varies, "but in general, [Ventas] like[s] to spend at least a couple hours on each property.").) • (*See* Houck, Tr. 1476, 1496 (The Division's only

resident name tags be removed from their doors during Ventas's inspections, such that Ventas could not manually count the number of occupied rooms." (Prehearing Brief, p. 14; *see also* OIP, ¶ 39.)	witness to speak on the nametag issue, Jared Houck, indicated that he only recalled one instance where Ms. Bebo requested that name tags be removed at a Cara Vita facility, but he did not recall the reason and he did not recall whether her request had anything to do with a Ventas visit).) Exhibits contradicting the Division's statement: • (Ex. 1389 (August 5, 2009, e-mail chain where Laurie Bebo confirms that it is okay that Debra Cafaro (Ventas's CEO) stop by a Cara Vita property anytime between 12:00 p.m. to 5:00 p.m.).) • (Ex. 1505 (e-mail chain indicating that Laurie Bebo was comfortable with Ventas visiting at 9 a.m. for a visit that would likely last into lunchtime).)
The Division's overstatements or misrepresentations about Ms. Bebo's representations to ALC's auditors: • "Moreover, in connection with the audit of ALC's financial statements for the year ending December 31, 2011, Bebo and Buono signed a representation letter addressed to ALC's auditors that represented that Bebo and Buono had no knowledge of any allegations of fraud or suspected fraud by any ALC employee. Bebo and Buono either knew, or were reckless in not knowing, that such statement was false and misleading, given that in approximately November 2011, **an ALC employee confronted Bebo and Buono with concerns that the inclusion of employees in the Ventas financial covenant calculations was fraudulent**." (OIP, ¶ 50 (emphasis added).)	Testimony contradicting the Division's statement: • (Grochowski, Tr. 119-91 (Division witness Grochowski testified that his November 2011 meeting with Ms. Bebo was the first time he spoke with her in person about his concerns with the covenant calculations. He also testified that he did not allege that *anyone, including Laurie Bebo and John Buono*, was committing fraud nor did he use that language during the conversation).)

B. The Division's omission of exculpatory facts from its Prehearing Brief or OIP.

In addition to overstating its case, the Division also omitted key exculpatory facts from its OIP and Prehearing Brief. The Division's decision to omit key facts from the factfinder is a disappointing act of gamesmanship that ultimately undermines the integrity of the SEC administrative hearing process. The following chart again provides some of the more egregious omissions by the Division:

Allegations or Statements From the Division's OIP or Prehearing Brief	**Omitted Material Known to the Division When its Statement or Factual Allegation was Made**
• "On January 20, 2009, Bebo and Buono spoke with Solari via telephone." (Prehearing Brief, p. 8.) • "Solari and Buono both participated on the January 20, 2009 phone call on which Bebo claims Ventas approved the inclusion of employees in the covenant calculations." (Prehearing Brief, p. 19.)	The Division chose to ignore several prior statements by John Buono—a Division witness—and Laurie Bebo, in concluding that Eric Fonstad was not on the January 20, 2009, call. Additionally, the Division chose to base its conclusion on Mr. Buono's recent choice not to remember Mr. Fonstad's presence, instead of his prior statements, and Mr. Fonstad's inability to recall whether he was present: • (Buono, Tr. 2781-82 (Mr. Buono testified that he once testified that Eric Fonstad was present during the January 20, 2009 call with Joe Solari, but also stated that his current recollection is that he cannot remember if Eric Fonstad was present).) • (Buono, Tr. 2782 (when Mr. Buono was asked about the subsequent statement he made four months after his initial testimony confirming Mr. Fonstad's presence for the January 20 call, Mr. Buono testified **"[n]o matter what you do or say, I'm not going to remember if Eric was in that room."**) (emphasis added).) • (Buono, Tr. 4666 (Mr. Buono was asked, "[w]ould you agree that Mr. Fonstad, based on your experiences working with him, did not consistently demonstrate a good memory?" and he answered, "I would say in the latter stages of [Eric Fonstad's] career, he did not.").) Other witnesses also placed Mr. Fonstad in Ms. Bebo's

	office during the January 20, 2009 call with Joe Solari: • Ms. Bucholtz was in Ms. Bebo's office just prior to the call and she witnessed Mr. Buono and Mr. Fonstad go into Ms. Bebo's office, when she left around the time that the call with Mr. Solari was scheduled to begin. (Bucholtz, Tr. 2939-40.) • Joy Zaffke, Ms. Bebo's administrative assistant also observed Mr. Fonstad being present for the call. (Zaffke, Tr. 3217-18.) Exhibits addressing the Division's omissions: • (Ex. 2122, p. 2 (The Division's notes of its proffer session with Mr. Buono, which occurred after he already testified that Mr. Fonstad was present for the January 20, 2009 call; the notes state "Bebo talked with Joe Solari the next day. It was very informal. JB was with Bebo on the call and Eric was in the room during the call. Bebo told Joe that ALC wanted to rent to employees consistent with the arrangements the prior lessor had but it would be less formal. . . *Eric[Fonstad] never expressed any discomfort with JB the about employee leasing arrangement.*").)
• "Following the end of each quarter, after ALC calculated the number of nonresidents to include in the covenant calculations, Bebo personally determined the identities of the non-residents that ALC would include in the calculations." (Prehearing Brief, p. 13; *see also* OIP, ¶ 32.) • Also, "Bebo admits that she was the one who selected the names of employees to be provided to Grant Thornton." (Prehearing Brief, p. 26.)	The Division failed to mention that other individuals, including Mr. Buono, removed names or otherwise altered the lists of names: • (Buono, Tr. 2775-76 (Mr. Buono testified, "I don't recall removing names, but I'm not saying that I didn't…I could have, but I don't specifically remember… I'll give the example of over 100 percent, that I might have removed a name.").) • (Buono, Tr. 4661-62 (Mr. Buono testified about whether names were removed without consulting Ms. Bebo and he stated, "[i]t's not something I did." However, when asked about his statement to the Division about removing names without consulting with Ms. Bebo, he testified "[t]hat is a possibility if the situation was where having those names on there would have made occupancy 120 percent.").) Exhibits addressing the Division's omissions:

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<tr><td></td><td>(Ex. 2117, p. 3 (the Division's notes of its proffer session with Mr. Buono, which state "JB said that Bebo always provided the names of the employee occupants to be added into the covenant calculations but that names were sometimes removed from the list without consulting with Bebo.") (emphasis added).)
(Ex. 2122, p. 5 (the Division's notes of its proffer session with Mr. Buono, which state "JB said he probably didn't go back to Bebo to get a name for one person. He said he probably added the person himself. JB said he might have asked Mark (Mark Hall?) if he was at both places.").)
(Ex. 1374 (May 5, 2009 e-mail from Mr. Buono where he wrote, "[w]e needed 7 more names for Winterville. We have filled in 4 with regional or above people (Io, Paula, Jared, and KB).").)</td></tr>
<tr><td>"Moreover, in summer 2011, ALC was exploring a sale of the company, and was preparing due diligence materials to be reviewed by potential buyers, one of which was Ventas. Bebo directed ALC's investment bankers not to provide Ventas with actual occupancy figures at the Ventas facilities but permitted the investment bankers to provide such information to other interested buyers." (Prehearing Brief, p. 14; see also OIP, ¶ 38.)</td><td>The Division failed to mention that ALC's Board members agreed with Ms. Bebo's decision to not provide information to Ventas and, additionally, that she ultimately left it up to the Board (i.e., Mel Rhinelander) to do so:

Exhibits addressing the Division's omissions:
(Ex. 3714 (Laurie Bebo's e-mail to Citibank, which stated "Mel and I had an opportunity to talk earlier and we agreed that it is our preference not to send the facility listing with occupancy numbers in this early round if we don't have to. . . Mel and I do not want the individual facility listing and occupancy sent to Ventas at this time. This is something Mel may choose do in the future if we get further down a particular path.").)
(Ex. 292 (Laurie Bebo's e-mail to Citibank, which states, "[t]his is the attachment that lists the individual facilities and their respective occupancy. Please maintain this separately and do not release it to Ventas without Mel's specific approval.").)</td></tr>
</table>

• "Robin Herbner and Sean Schelfout — the first two accounting personnel responsible for performing the covenant calculations — both quit ALC at the earliest opportunity as a result of their discomfort with including employees in the calculations." (Prehearing Brief, p. 15.)	The Division did not disclose that these employees never expressed any concern to Mr. Buono and that Sean Schelfout was already looking for a different job prior to working on the employee leasing program: • (Buono, Tr. 2775 (Mr. Buono testified that "neither Robin Herbner nor Sean Schelfout ever came to [him] to say that they were uncomfortable with the employee occupants being included in the covenant calculations.").) • (Schelfout, Tr. 1062 (Mr. Schelfout testified that he began looking for a new job in 2008, which predated his involvement with the Ventas covenant calculations).)
• "In response, on January 19, 2009, the general counsel wrote Bebo and Buono an email advising them that for such a practice to be permissible under the Ventas lease, ALC needed to fully disclose the practice to Ventas and obtain Ventas's approval in writing." (OIP, ¶ 23.)	As mentioned in the chart above, Division witness Buono has provided prior testimony that Eric Fonstad signed off on the employee leasing process—a fact that the Division chose not to address in its OIP or Prehearing Brief: • (Buono, Tr. 4651-53 (Mr. Buono states that he believes that he informed the SEC that at some point he "received advice from [Fonstad] that ALC['s] rental of rooms to employees or individuals for use in covenant calculations was allowed" or "kosher").)
• "In March 2012, Bebo tried to convince ALC's board not to disclose the inclusion of non-residents in the Ventas financial covenant calculations to the remaining potential bidders interested in purchasing ALC." (OIP, ¶ 40.)	The Division's statement fails to account for prior correspondence between ALC's management and the Board, where management offered to disclose ALC's use of employees to potential bidders: • (Exs. 1594, 1594A (In preparation for meetings between bidders for ALC and management, management suggested including the following language in their explanation of the $2 million revenue account: "*[t]he intercompany transaction is taken for the dual purpose of accurately reflecting the Company's audited consolidated financial statements and an e-mail provided to Ventas as the Cara Vita landlord regarding the treatment of rooms reserved for employees at the Cara Vita residences which are paid for by the Company.*").) • (Ex. 325 (e-mail where Bell and subsequently Rhinelander provided management with a different

	explanation of the $2 million revenue account, however, the Board members removed the language management inserted about employee leasing).)
• "In connection with related settlement negotiations with Ventas, Bebo tried to convince ALC's board not to disclose to Ventas ALC's inclusion of employees and other nonresidents in the Ventas financial covenant calculations. Bebo actively lobbied against a director's demand that ALC include in any settlement proposal specific language whereby Ventas would release claims arising from ALC's inclusion of employees in the financial covenant calculations." (OIP, ¶ 52.)	The Division omitted several key facts about the Ms. Bebo's position with regard to the settlement language. For example, external counsel and internal counsel both agreed with her position about omitting specific language about employee leasing: • (Exs. 1068, 1068A (Quarles and Brady letter addressed to Ms. Bebo that stated, "[y]ou asked us to review a proposed letter to Ventas Properties conveying certain proposals regarding the various Ventas facilities. Included in the proposed letter is a sentence stating that ALC 'has placed employees in the facilities to meet the occupancy thresholds.' *In our view, this language should be deleted from the letter for the reasons discussed below*.") (emphasis added).) • (Kowalczyk, Tr. 4390-91(In house counsel for ALC, Mary Zak Kowalczyk reviewed Exs. 1068 and 1068A, and testified that she agreed with Quarles's advice to delete reference to the employee leasing language in the Ventas settlement negotiations).)

II. RELEVANT PERSONS AND ENTITIES.

A. ALC.

1. ALC's Business.

From November 2006 to July 2013 ALC was a publicly traded company, with shares traded on the New York Stock Exchange. 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 in the United States totaling 9,398 units. (2009 Form 10-K, Ex. 5, p. 3.) ALC operated about the same number of facilities and units throughout the relevant time period, with 211 facilities as of the end of 2011. (2011 Form 10-K, Ex. 13, p. 3.)

ALC preferred to own most of its facilities, but it also leased many of its facilities in the ordinary course of its business. (Bebo, Tr. 3876-77; Rhinelander, Tr. 2856) Owning the facilities provided ALC with much greater flexibility in terms of operating the facility. ALC could make changes to the physical plant of the facility by adding on units to well-performing buildings, renovating facilities or portions of facilities, and refurbishing facilities. (Bebo, Tr. 3879-77; Buono, Tr. 4600-01.) It could also have much greater flexibility with respect to interactions with state regulators and licensing of the buildings. (*Id.*) There were different business models that could be pursued without a formal license if ALC owned the buildings, that could not be pursued if the buildings were leased. (Bebo, Tr. 3879-80; Ex. 13, p. 4-5.)

Thus, ALC owned most of the facilities it operated - 161 of the 211 as of the end of 2011. However, it also leased numerous facilities in the ordinary course of its business. (Martin Report, Ex. 2187, p. 6.) It leased the other 50 facilities as of the end of 2011. (2011 Form 10-K, Ex. 13, p. 4.)

ALC's facilities typically contained about 40 to 60 units, and the company offered residents a supportive, home-like setting, and assistance with the activities of daily living. (*See* Ex. 5, p. 4.) The assistance includes general services like meals, activities and laundry. (*Id.*) Support services like assistance with medication, monitoring health status, transportation coordination, and coordination with the resident's doctor. (*Id.*) Assisted living is a kind of intermediate step for seniors. Those that live there do not need the 24-hour medical care provided in skilled nursing facilities, but for a variety of reasons elect not to live alone in their homes or regular apartments. (*Id.*)

During the 2009 to 2011 time period, ALC generated revenues of approximately $230 million and net income of $16-$24 million, and cash flows from operating activities of approximately $44 million to $55 million. (Ex. 377, pp. 6-7, n. 6.)

ALC's financial performance was largely driven by company-wide private pay occupancy.[9] (*See* Roadman, Tr. 2570-71; Bebo, Tr. 3834; Ex. 13, pp. 20-21, 24.) Residents pay ALC rent and may purchase the other services from ALC described above (although not all residents purchase services). (*See* Ex. 13, p. 23.) Consequently, ALC monitored occupancy closely. Every night, senior management, divisional personnel, regional personnel, and others would receive a nightly occupancy snapshot for the entire Company. (Bucholtz, Tr. 2959-61; Ex. 2133.) The reports were broken out by region and by facility. (Ex. 2133.) They were passed out at Board meetings. (Rhinelander, Tr. 2868-70; Bucholtz, Tr. 2959-61.) The same data was available to board members, management and other employees on the Company's Intranet. (Bucholtz, Tr. 2963-64.) None of the data included units related to employee leasing. (*Id.*; Houck, Tr. 1484.)

ALC tracked occupancy in its facilities based on the number of units occupied, even if there were more than one person occupying the unit. (Bebo, Tr. 4105-06.) For all purposes, ALC considered a unit "occupied" if there was a commitment to pay for the unit from the resident or other party committing to pay on the resident's behalf. (Herbner, Tr. 512-13; Buono, Tr. 2414; Houck, Tr. 1482; Bebo, Tr. 4105-06.) ALC never tracked whether a resident was actually living in or staying at its facilities for occupancy purposes. (*See* Buono, Tr. 2414; Houck, Tr. 1483; Bebo, Tr. 4105-06.) Indeed, many residents did not stay in the unit they rented

[9] ALC had embarked on a strategy of eliminating its reliance on payment through state-run Medicaid programs. (Ex. 13, p. 21.)

for extended periods of time. Yet, ALC always counted those units as occupied for purposes of tracking occupancy and financial reporting. (*See* Bebo, Tr. 4105-06.)

Occupancy at the facility level increased and decreased significantly over short periods of time. It was volatile for two principle reasons. (Bebo, Tr. 3852-53) First, typically the agreements with the senior residents permitted the resident to terminate the agreement on 30-days' notice. Also, even if a resident signed up a one or two year lease, state laws effectively make it a month-to-month tenancy. (Bebo, Tr. 3853-54) Second, seniors moved into the facilities at the end of their lifetime cycle and so ALC and other assisted living companies are constantly losing residents when they pass away. (*Id.*)

Most of ALC's facilities possessed licenses issued by the state in which they operated, particularly those that contain assisted living units or memory care units, which involve a higher level of care and supervision of residences. (*See* Ex. 5. p. 6; Doman, Tr. 316-19; Bebo, Tr. 3877-81, 3889-91.) Independent living units are generally not subject to the same licensing and oversight by the state. (Bebo, Tr. 3879-80; Durso, Tr. 3156.)

2. ALC's Origins: David Hennigar Decides To Spin ALC Out From Extendicare In 2006.

In 2006, Assisted Living Concepts, Inc. ("ALC") was spun off from a company called Extendicare Health Services, Inc., with ALC becoming a new publicly-traded company. (Ex. 5, p. 3.) Shares of ALC thereafter were traded on the New York Stock Exchange. (Bebo, Tr. 1767, 2067, 3821.) However, although ALC was a public company, it still was controlled by its Chairman, David J. Hennigar, and his family through a company called Thornridge Holdings Limited, a Canadian company. Hennigar and his family are from Canada.[10] (*See* Bell, Tr. 553-54, 694-96; Buntain, Tr. 1391-93.)

[10] The Hennigars also majority owned and controlled Extendicare.

Mel Rhinelander, then Extendicare's Chief Executive Officer, devised the strategy for separating the senior living facilities from the skilled nursing facilities as a way of generating more value for Mr. Hennigar and his family - the largest Extendicare shareholder - and Extendicare's other public shareholders. (Rhinelander, Tr. 2797-98; Bell, Tr. 694-96.) Hennigar agreed with this strategy and decided to spin ALC out of Extendicare because the majority of Extendicare's assets consisted of skilled nursing facilities. (Bebo, Tr. 3818-19.) ALC's business model would be to own and operate senior living facilities, typically assisted and independent living. (*Id.*)

Upon completion of the spin-off, ALC's ownership structure consisted of two classes of stock. (Bebo, Tr. 3821; Ex. 5, pp. 3, 14; Ex. 2073, pp. 14-19.) The Class A stock was listed and traded on the New York Stock Exchange, and held by the public. The Class B stock was not listed. (*Id.*) Nearly all of the Class B stock was held by Thornridge. (*Id.*) The holders of Class B Common Stock - Mr. Hennigar and his family - were entitled to ten votes per share held with respect to each matter presented to ALC's shareholders. (*Id.*) The holders of Class A Common Stock were entitled to only one vote per share held with respect to each matter presented to ALC's shareholders. (*Id.*) Thus, due to its combined ownership of Class A Common Stock and nearly all of the Class B Common Stock, Mr. Hennigar (through Thornridge) controlled the voting power of ALC's shareholders and therefore controlled the company. (Bebo, Tr. 3821; Ex. 2072; Ex. 2080.)

3. ALC's Board.

Upon completion of the spin-off, Hennigar acted as ALC's Chairman of the Board of Directors and exercised ultimate control over the strategic direction of the company. No strategic considerations affecting ALC were done without his awareness and if he disapproved, it did not get done. (*See* Buntain, Tr. 1393.)

Mr. Rhinelander, the former CEO of Extendicare and resident of Canada, was appointed by Mr. Hennigar as the Vice Chairman of the Board of Directors of ALC. (Rhinelander, Tr. 2796-98.) Rhinelander had worked at Extendicare for about 36 years, and had a lengthy business relationship with Mr. Hennigar. (*Id.*) When ALC was spun out from Extendicare, Mr. Rhinelander retired from his role as CEO of that company. (Rhinelander, Tr. 2799.) However, at the request of Mr. Hennigar he took on a more significant role in the management of ALC, beyond that of a typical member of the board of directors. (Rhinelander, Tr. 2801.) Mr. Rhinelander had initially suggested that he serve as ALC's CEO for two years before turning the reins over fully to Ms. Bebo. (Rhinelander, Tr. 2800.) She would serve as the Chief Operating Officer and report to him during this two year period, after which she would assume the role as CEO. (*Id.*) Mr. Hennigar believed that Ms. Bebo was ready for the CEO role, and wanted to save the salary expense of a COO, so she assumed the role of CEO on day one. (Bebo, Tr. 3819-20; Rhinelander, Tr. 2800-01.)

However, Mr. Rhinelander remained actively involved in the management and operations of ALC. (Rhinelander, Tr. 2801; Bebo, Tr. 3827-30.) He anticipated that he would be compensated for his efforts, testifying that "There was an agreement between myself and the board that for two years that I would act as a sounding board and help Laurie create a structure and create a company under public structure. Then in exchange for that, I would be paid a sum of money to charities of my choice." (Rhinelander, Tr. 2801.)

From the time of the spin off and through the time period relevant to the OIP, the rest of the ALC board consisted of Mr. Hennigar's friends and business associates, many of whom also served on the Extendicare board as well. Thus, for example, Alan Bell became an ALC board member and member of the Audit Committee. Mr. Bell was a Canadian lawyer that represented

Mr. Hennigar personally and his family in relation to their various business ventures. (Bebo, Tr. 3826; Bell, Tr. 544-45.) The other three members of ALC's Audit Committee - Charles H. Roadman, Derek H.L. Buntain and Malen Ng, had been members of the Extendicare board of directors. (Bebo, Tr. 3818-19; Buntain, Tr. 1371.) Mr. Buntain has known Mr. Hennigar for about 50 years. (Buntain, Tr. 1372.) The remaining members of the board included Jesse Brotz (2007-2010), who was appointed to the ALC board soon after the spin-off from Extendicare. (Ex. 2073, p. 10.) Mr. Brotz is Mr. Hennigar's nephew. (Bebo, Tr. 3827.) Michael Spector, a retired lawyer at the law firm ALC used for outside counsel, Quarles & Brady, was appointed to the board in 2007 and died in 2014.

At all times, all members of ALC's board of directors were appointed and served only with the approval of Mr. Hennigar. (*See* Buntain, Tr. 1392-93; Bebo, Tr. 3824-25; Bell, Tr. 694-95.)

4. Ms. Bebo's Becomes CEO of ALC, But Effectively Reports To Mr. Rhinelander.

Ms. Bebo started at Extendicare in 1999 as the Vice President of Sales and Marketing. (Bebo, Tr. 3813.) She interviewed with and was hired by Mr. Rhinelander. (*Id.* at 3815.) She had prior experience in the health care field in sales, marketing, and operations. (*Id.* at 3806-12.) She had no finance or accounting background at the time of her hiring. (*Id.*) Ms. Bebo was subsequently promoted to Senior Vice President of Sales and Marketing for Extendicare, and took on significant additional responsibilities for operations of that company's assisted and independent living facilities (assets later spun out to ALC). (Bebo, Tr. 3814-18.) By 2006, she had been promoted by Mr. Hennigar and Mr. Rhinelander to the role of Chief Operations Officer for Extendicare's senior living business unit (someone else was COO for the skilled nursing facilities). (*Id.*)

During her work at Extendicare, Mr. Rhinelander took on a mentor relationship for Ms. Bebo. It became a very close, trusting professional relationship that continued after ALC was spun out of Extendicare. (*Id.* at 3814-18, 3827-30, 3832-33.)

Although Mr. Hennigar determined that Ms. Bebo should be the CEO of ALC, he also valued Mr. Rhinelander's involvement and input in the operations of the company. Thus, he approved the governance structure where Ms. Bebo worked closely on operational and strategic matters with Mr. Rhinelander. Ms. Bebo spoke with Mr. Rhinelander on a weekly basis, if not more often, related to the business, operations and strategic direction of ALC. (*See* Bebo, Tr. 3827-30, 4476-78; Rhinelander, Tr. 2851-53; Exs. 2138, 2139, 2147, 2201.) He was more than a sounding board, and had authority to veto decisions Ms. Bebo wanted to make with respect to ALC although it was a good working relationship because Ms. Bebo and Mr. Rhinelander "typically agreed with each other pretty easily" (Bebo, Tr. 3832-33.) Ms. Bebo testified that:

Q	Would you consider him a sounding board only?
A	No.
Q	With respect to the testimony that he gave in these proceedings regarding his role at the company, do you agree with that characterization?
A	No.
Q	In what respect do you disagree with it?
A	Mr. Rhinelander acted as a mentor, as a sounding board, as a decision maker with regard to changes, or proposed changes, or perhaps a different direction that we may have contemplated, strategic planning and perhaps bigger-picture items that would maybe have a longer term impact. Mr. Rhinelander worked in -- worked through discussions with me; and then ultimately if he and I would disagree, he would make the decision as to whether it was -- he was still fine with my decision, and then he would -- he would direct me to go ahead with my decision, or if he felt strongly about it the other way, then he would tell me that I needed to go the direction that he had asked or that he had determined.

	And with regard to his other roles, he was the conduit between myself and the board, also myself and Mr. Hennigar to some extent. Over time I did learn what I should just go right to Mr. Hennigar with, and so I would still let Mel know those things, but I would go right to Mr. Hennigar.

(*Id.* at 3828-29.)

Consequently, given Mr. Hennigar's controlling ownership interest in ALC, his active role in decisions made at the Company, and Mr. Rhinelander's active role in managing the day-to-day operations of the Company, Ms. Bebo vetted large and small decisions with Messrs. Hennigar and/or Rhinelander prior to implementing them. For example, Ms. Bebo could not incur even marginal increases in ALC's cost structure without Mr. Hennigar's approval. Mr. Hennigar had to approve any salary increases, even those for direct reports to Ms. Bebo. (*Id.* at 3843.) Mr. Hennigar dictated that there would be no Chief Operating Officer at the company given Ms. Bebo's ability to focus on the operations with the involvement and assistance of Mr. Rhinelander. (*Id.* at 3837-38.) Mr. Hennigar dictated cost controls for salaries and wages, including how much Ms. Bebo could pay in salary for the company's line staff through executives. (*See id.* at 3842-43.)

In addition, Messrs. Rhinelander and Hennigar were Ms. Bebo's liaison to the rest of ALC's Board of Directors. Mr. Rhinelander shaped the agenda for the matters to be considered by the Board, and Ms. Bebo typically sought approval from Mr. Hennigar or Mr. Rhinelander with respect to company matters prior to addressing those matters with the rest of the Board. (Buono, Tr. 2747, 4613-14.) Ms. Bebo testified that

A	...And then in discussions with Mr. Rhinelander, he would let me know what I was to take to the board. We would plan the agendas together for the meetings, the committee meetings and the board meeting. I would also then review those same agendas and obtain approval from Mr. Hennigar.

	Sometime there were items that Mr. Rhinelander would say, you know, this will just need to go to Mr. Hennigar. He wouldn't make a decision on it. And with regard to other communication pieces, he would make a decision as far as what would be shared at the board meetings or the committee meetings.

(Bebo, Tr. 3829-30.)

5. As A CEO With No COO, Ms. Bebo Was Deeply Involved In ALC's Operations.

With Mr. Rhinelander and Mr. Hennigar being so actively involved in the strategic decision-making for the Company, and with Mr. Hennigar's decision that ALC not hire a Chief Operating Officer, Ms. Bebo handled the duties that would have been typically handled by a COO in addition to her duties as CEO. Consequently, she was very involved and had "daily interactions" with employees operating ALC's facilities, the sales and marketing personnel, and the clinical specialists. (*Id.* at 3837-38.) She was also heavily involved in any regulatory issues from a state licensing perspective with regard to policies and procedures for resident care and safety at the properties. (*Id.* at 3845-47.) In all, Ms. Bebo had approximately 18 to 20 people directly reporting to her, including the CFO, four divisional vice presidents, the vice president of sales and marketing, the vice president of human resources, two national directors of business development, the director of information technology, the director of facilities management, vice president of clinical services, and the senior in-house attorneys at the company. (*Id.* at 3847-49.)

Many of the operational policies and procedures that Ms. Bebo established at ALC in the various departments reporting to her required her inputs or reviews. (*Id.* at 3837-38.) Operationally, she acknowledges that she held a lot of responsibility and provided a lot of oversight, which some may characterize as micromanagement:

Q	So it's been suggested in these proceedings that you are akin to a micromanager. Do you agree with that characterization?
A	I think that there are people that definitely would characterize it that way.

	I look at it, I guess, in a more positive, proactive way, but I think we probably come to the same -- we'd probably come to identify the same practices. From my perspective, it's oversights, but I was definitely involved on a daily basis with the operations and sales and clinical pieces in the company, as well as the facilities management piece. So from my perspective, I was either a part of specific systems that were overseeing those things, and I would tap people and check in on what was going on or review information, or I might just get involved because I was interested in an opportunity or a concern that's been raised with me.

(*Id.* at 3849.)

As CEO, Ms. Bebo was in charge of working with Messrs. Hennigar and Rhinelander to implement the strategic plan of the Company. That plan included growing "private-pay" occupancy organically at facilities owned or operated by ALC as well as growing the company through acquisitions, if new units could be acquired at a price below the per unit value based on ALC's market capitalization. (*See id.* at 3834-35.) In the end, Ms. Bebo viewed her overarching duty at ALC to successfully manage the company in a way that continually enhanced the value of the company to all shareholders.

6. ALC's CFO, John Buono, Oversaw The Accounting Department And Financial Reporting Process.

As ALC's Chief Financial Officer, John Buono was principally responsible for the company's accounting and finance departments. (*See* Ex. 1655.) Mr. Buono is and was a Certified Public Accountant licensed in the State of Wisconsin. (Buono, Tr. 2310.) Others serving the accounting and finance function at ALC were Controller Wally Levonovich, Assistant Controller Tony Ferreri, the Internal Auditor, David Hokeness, the Director of Financial Reporting John Lucey, the Treasury and Tax Manager Dan Grochowski, Field Accounting Manager Robin (Birr) Herbner and Treasury Manager Sean Schelfout. All of these personnel were licensed Certified Public Accountants, except for Mr. Schelfout. (Ferreri,

Tr. 1220-21; Hokeness, Tr. 3040; Lucey, Tr. 3680-82; Grochowski, Tr. 1086-87; Herbner, Tr. 857-58.) Although he reported to Ms. Bebo, Mr. Buono acknowledges that Ms. Bebo was far less involved in the management of the accounting and finance functions of the company when compared to the operations of ALC. (*See* Buono, Tr. 2397.)

(a) ALC's Accounting Systems.

ALC tracked occupancy through a database called the TIPS system. (Herbner, Tr. 512-13.) Once a resident took financial responsibility for a unit, the unit would be deemed occupied in the TIPS system. (*Id.*) Information would flow from the TIPS system to the occupancy data reported in ALC's financial statements and SEC filings. (*See id.* at 519.) There is no dispute that the occupancy reported by ALC in its financial statements, quarterly, and annual reports filed with the Commission were correct and accurate.

Once there was a commitment to pay for a unit, ALC deemed it sufficient to recognize revenue from the unit. ALC maintained two databases of financial information within its accounting system. (Ferreri, Tr. 1238-39.) Operational revenue and expenses were recorded on the "house" database in ALC's electronic accounting software. (*See id.*) This would consist of revenue generated from the rent charged to residents and revenue from the services provided to residents, all at the facility level. The operational expenses would consist of things like salaries and wages of those that worked at the facilities, and costs to purchase food, linens, and similar items. (*See* Ex. 250, pp. 10-14.)

The corporate database within ALC's accounting system included all of ALC's overhead expenses, such as regional, divisional, and corporate salaries. (Ferreri, Tr. 1238-39.) It would also include any revenue earned at the corporate level such as through interest or investments. For purposes of tracking the profitability of each of its facilities, ALC would allocate regional,

divisional, and corporate expenses to the various facilities by division, based on the number of units in each division. (*See* Buono, Tr. 2316.)

Within the corporate database, there was an entity or a "reserve center" account containing the number "997" (hereafter the "997 Account"). (Ferreri, Tr. 1238-39; Grochowski, Tr. 1117-18; *see also* Buono, Tr. 2770-71; Ex. 399.) As discussed below, the 997 Account was used to ensure that the revenue related to ALC's rental of units related to employees at the various CaraVita Facilities was eliminated in consolidation. However, the 997 Account was also utilized to reconcile other intercompany and consolidating transactions. (*See* Exs. 1727, 1727A.)

ALC had the ability to prepare facility level financial statements for its own internal tracking and profitability analysis. (*See* Ferreri, Tr. 1284-85.) However, the only facilities where ALC had to provide facility-level financial reports to third parties was the CaraVita Facilities. (Grochowski, Tr. 1118-19.)

(b) ALC's Financial Reporting Process.

ALC had "extensive" policies and procedures for meeting its financial and SEC reporting obligations. (Ex. 1655; Lucey, Tr. 3684-93.) The process involved a significant number of high-level executives, all of whom were aware that ALC corporate was paying for apartments at the CaraVita Facilities for rooms allocated for employees to stay at the facilities and including those units in the covenant calculations. (*See infra*.) John Lucey and John Buono were primarily responsible for ALC's financial reporting process, and Mr. Buono, Mr. Lucey, and ALC's Controller, Wally Levonovich, were responsible for ensuring that ALC's financial information was in compliance with GAAP. (Ex. 1655, pp. 1-2.)

Mr. Lucey prepared all of the initial drafts of ALC's quarterly filings on Form 10-Q and annual filings on Form 10-K. (*See* Lucey, Tr. 3684.) He was the primary contact to ALC's external auditors, Grant Thronton LLP ("Grant Thornton"), with respect to their quarterly

reviews of ALC's quarterly financial statements and SEC filings and Grant Thornton's audit of ALC's annual financial statements and 10-K's. (Lucey, Tr. 3678-79.) Once Mr. Lucey prepared the initial draft of the financial statement and disclosure document, the draft was provided to other senior executives in ALC's finance/accounting department, including Mr. Buono and ALC's Director of Internal Audit, David Hokeness. (Lucey, Tr. at 3684.)

ALC's disclosure committee would meet to review the filings, and discuss any needed changes to the disclosures contained in the SEC filings. (*See* Lucey, Tr. 3687, 3690.) The ALC disclosure committee was chaired by the lead attorney at ALC. (*See* Hokeness, Tr. 3075.) During 2009 and 2010, Eric Fonstad was the chairperson of the disclosure committee. (*Id.*) When Mr. Fonstad retired, Mary Zak Kowalczyk took over as the lead in-house attorney at ALC and the chairperson of the disclosure committee. (*Id.*) Personnel from the finance and accounting departments, including Mr. Buono, Mr. Levonovich, Mr. Hokeness, and Mr. Lucey generally attended the disclosure committee meetings. (*See*, *e.g.*, Ex. 124, p. 1.) But personnel from other departments at the company also attended the meetings at times, such as the head of human resources. Ms. Bebo was not a member of the disclosure committee, and did not attend the meetings. (Hokeness, Tr. 3075.)

The disclosure committee had several purposes and functions, which were described in the disclosure committee charter. (Ex. 1919.) One function was to assist ALC in its disclosure obligations to investors. (*Id.* at 3; Fonstad, Tr. 1567-68.) Specifically, the disclosure committee was tasked with identifying and reviewing potential disclosure matters and make recommendations to the senior officers like Ms. Bebo, who was not a member of the committee, regarding public disclosure of such matters. (Ex. 1919, p. 3; Fonstad, Tr. 1567-68.)

In addition to review, analysis and comment by the disclosure committee, ALC provided draft SEC filings to the company's outside legal counsel for SEC compliance matters, Quarles & Brady. (*See, e.g.*, Lucey, Tr. 3687, 3690; Ex. 1655, p. 3.) ALC also provided copies of the draft filings to its external auditors, Grant Thornton, for review and comment. (*Id.*)

ALC's Board and Audit Committee also reviewed and approved ALC's SEC filings. (*See id.*) In particular, the Audit Committee had "oversight responsibility for the quality and integrity of the financial reporting, disclosure controls and procedures, and internal control and procedure practices of ALC." (*See* Ex. 2072, p. 4.) And ALC reported to shareholders that the Audit Committee reviewed the audited financial statements of ALC contained in its annual reports with management and Grant Thornton, and each reporting period recommended that the financial statements and reports be filed with the SEC. (*See id.*) Each reporting period, the board reviewed the reports and approved them for filing with the SEC.

B. Ventas.

At all times relevant, Ventas was a large, publicly-traded healthcare real estate investment trust based in Chicago, Illinois. In 2008, at the time the Lease with ALC was executed, Ventas owned a portfolio of 513 senior housing and healthcare-related properties. (Ex. 2106, p. 83, Ventas Form 10-K for the year ended December 31, 2008.) These included 440 "senior housing communities" and skilled nursing facilities. (*Id.*) A number of these properties were in the same markets as ALC facilities, so that Ventas was a direct competitor to ALC. (*See*, *e.g.*, Doman, Tr. 299.) As Ventas grew between 2008 and 2012, the number of markets where it competed with ALC also grew. (*See* Rhinelander, Tr. 2831; Bebo, Tr. 4138-39; Doman, Tr. 261-62.)

Ventas had two types of portfolios within its senior housing community properties—a "triple-net lease portfolio" and an operating or "shop" portfolio. (Doman, Tr. 163-64, 260-61,

284-88; Ex. 2109, p. 7.) With respect to the triple-net lease portfolio, the properties are leased out to unaffiliated operators and Ventas earns revenue and income by collecting rent. (Doman, Tr. 163-64, 286-87.) They are typically leased on a long term basis, approximately 7 to 15 years with multiple renewal options. (Doman, Tr. 163.) The lessee gets to keep the cash flow generated by the property above the rent payments. (Doman, Tr. 164.)

In Ventas' operating portfolio, Ventas owns the properties and contracts with a management company at a fixed fee. (Doman, Tr. 163-64.) In this way, Ventas basically owns all of the revenue, the expenses, and the net operating income generated by the properties. (*Id.*) Because Ventas owned the net operating income generated by the properties, it had both more risk and a more significant opportunity to generate greater profits from the operating portfolio. (*Id.*, Doman, Tr. 287-88.) Consequently, Ventas was a direct competitor of ALC in the assisted living space with respect to its operating portfolio.

With respect to the senior housing operating portfolio, Ventas contracted with a company called Sunrise Senior Living, Inc. to run those operations. (Ex. 2106, p. 83.) Sunrise also operated other assisted living facilities in markets where ALC also operated. Consequently, Sunrise was also a direct competitor of ALC.

Ventas had critical business relationships with three entities: Sunrise Senior Living, Inc.; Brookdale Senior Living, Inc.; and Kindred Healthcare, Inc. (*See* Ex. 2106, p. 83.) Sunrise and Brookdale were two of ALC's largest direct competitors in the assisted living industry at the time. In 2008 and 2009, Sunrise managed the operations of 79 of Ventas' senior housing communities. (Ex. 2106, p. 83; Ex. 2107, p. 11.) Ventas leased approximately 203 of its properties to Kindred (largely skilled nursing facilities) and approximately 83 of its properties to Brookdale. (Ex. 2016, p. 83; Ex. 2107, p. 84.)

Ventas has an acquisitions group that works hand-in-hand with its asset management group. The acquisitions group closes a deal and then gives it to the asset management group. (Doman, Tr. 167.) Further, asset managers monitor a facility's performance and address issues that may arise, whereas the acquisitions group tries to discover ways to do "future business" with tenants. (*See* Solari, Tr. 408-09.) However, acquisitions individuals would stay involved with relationships and also do other tasks that were not customary for the acquisitions department. (*See id.*) Mr. Solari was the Managing Director-Acquisitions at Ventas. (Solari, Tr. 399.) In that position, Mr. Solari was a senior executive of Ventas who reported directly to Ray Lewis, Ventas' Chief Investment Officer. Mr. Lewis reported directly to Ms. Cafaro. (Solari, Tr. 442-43.)

III. ALC ENTERS THE LEASE WITH VENTAS AND ACQUIRES THE OPERATIONS OF OLD CARAVITA.

In 2007, Ms. Bebo was approached at an industry conference by the CFO of the entity that operated the eight CaraVita Facilities at the time (referred to herein generally as "Old CaraVita"). (Bebo, Tr. 3868.) He inquired whether ALC would be interested in purchasing the operations of the CaraVita Facilities. (Bebo, Tr. 3868-69.) The company that operated them through an existing lease with Ventas was small—it owned no other buildings other than the eight facilities. (Bebo, Tr. 3868-70.) Old CaraVita was owned by two individuals, Josh Coughlin and the CEO of the company, although Mr. Coughlin was ALC's primary point of contact. (*Id.*) Old CaraVita was a small "mom-and-pop" operation. (*See* Doman, Tr. 304.) Thus, the operation of the buildings was required to support the rent payments since there was no significant financial backing behind the facilities. (*See id.*)

For a variety of reasons the proposal was attractive to Ms. Bebo, including the fact that all of the residents were private pay. (Bebo, Tr. 3874-75.) It would also be a relatively small

cash outlay for ALC, which Ms. Bebo knew would make it attractive to Mr. Hennigar, who had the ultimate decision-making authority. (*See* Bebo, Tr. at 3827; *see also* Bebo, Tr. 3881-82.) Thus, in late summer 2007, Ms. Bebo brought the potential opportunity to Mr. Hennigar and Mr. Rhinelander. (Bebo, Tr. 3871-73.) After discussing the matter with them, it was clear that Mr. Hennigar wanted to do the deal—buy the operations from Old CaraVita and enter into a lease with Ventas—provided that ALC would have flexibility to exit the one facility that was located in Florida. (*Id.*) Mr. Hennigar had highly negative views of the litigation climate in Florida based on his experience with Extendicare. (*Id.*) Consequently, Ms. Bebo was instructed to find a solution for the Florida property and to pursue the acquisition. (Bebo, Tr. 3882-83) Mr. Hennigar instructed her to "get this done." (*Id.*)

A. Negotiations of the Lease With Ventas.

John Buono and Eric Fonstad took the lead in negotiating the terms of the lease with Ventas. (Bebo, Tr. 3884; Fonstad, Tr. 1535-47.) Negotiations with Ventas over the terms of the lease took place over an extended period of time. They started in the Summer of 2007, when ALC provided Ventas with a mark-up of the lease, and did not conclude until the lease was executed in January 2008. (*See* Ex. 1564; Ex. 1564A; Fonstad, Tr. 1535-47.)

Mr. Fonstad testified on direct examination that when he first reviewed the lease, he was concerned because it "contained a lot of reporting requirements that would make it very difficult for the company to comply with." (Fonstad, Tr. 1298.) Consequently, he and Mr. Buono went through the lease and made a number of edits to the lease that they thought would make it more favorable to ALC. (Fonstad, Tr. 1299.) He testified on direct that, in response to this first set of changes, Ventas told ALC that "they would not accept any changes to the lease and that the lease would have to be accepted as-is." (*Id.*) Thus, he was concerned about ALC entering the lease. (Fonstad, Tr. 1299-1300.)

On cross-examination two things became clear. First, that Mr. Fonstad's concerns upon initial review of the Lease had nothing to do with the occupancy and coverage ratio covenants at issue in this case. Indeed, Mr. Fonstad's initial mark-up of the Lease, sent to Ventas in July 2007, contains no substantive edits to the occupancy and coverage ratio covenants whatsoever. (Fonstad, Tr. 1535-1543; Ex. 1564; Ex. 1564A, p. 28.) Mr. Fonstad did not request that the covenants be eliminated or that the thresholds be reduced in any way. (Fonstad, Tr. 1535-1543; Ex. 1564; Ex. 1564A, p. 28.) Second, Mr. Fonstad testified incorrectly that Ventas told ALC that they had to accept the Lease "as-is." Although the parties did not start from scratch on the Lease, the negotiations were prolonged, particularly related to the issues with ALC's request to have an exit strategy on the Florida property (as dictated by Mr. Hennigar), and lasted until the end of the year. Moreover, the Division elicited testimony from another of their witnesses flatly contradicting Mr. Fonstad. (Solari, Tr. 403-04.) Mr. Solari's correspondence shows that the Lease terms were heavily negotiated. (*Id.*) By the time of ALC's Board meeting to consider the transaction in November 2007, Ventas told ALC that the Board needed to approve the transaction and the Lease without further modification or negotiation. (*Id.*)

B. ALC's Board Approves The Transaction And Entry Into The Lease.

Ultimately, ALC was able to obtain appropriate terms that gave the company flexibility in exiting the Florida property, which were the only reasons not to do the transaction from Mr. Hennigar's perspective. (Bebo, Tr. 3881-85.) Ms. Bebo was comfortable with the anticipated return on the transaction, the due diligence the team at ALC had done, and did not think that the financial covenants would be problematic. (Bebo, Tr. 3884-88.) There had been no major changes in the marketplace that would have given her concern about ALC's ability to operate the buildings at a level comparable to Old CaraVita. (Bebo, Tr. 3888, 92-93.)

Knowing that Mr. Hennigar wanted to pursue the transaction and Mr. Rhinelander agreed, and given her comfort level with the economics of the transaction, Ms. Bebo presented a positive view of the transaction at a meeting of ALC's Board in November 2007. (Bebo, Tr. 3887.) She believed that there were likely better acquisitions available to ALC in terms of owning facilities, and she presented these other acquisitions to Mr. Hennigar from time-to-time. (*See* Bebo, Tr. 3881-87.) But those acquisitions required a greater cash outlay and the per unit price of the acquisition target would, in most instances, be greater than the per unit price based on ALC's market price and capitalization. (*See* Bebo, Tr. 3834-36, 3881-87.)

Upon presenting the opportunity to acquire the operations of Old CaraVita and enter into the Lease with Ventas to the Board, Mr. Bell raised several concerns about the Lease with Ventas, stating that it was structured for a different entity, that it had provisions more akin to a sale-leaseback transaction, and noting concerns with the wide variety of covenants in the Lease. (Bebo, Tr. 3896-97.) Ms. Bebo does not recall Mr. Bell specifically raising a concern about the occupancy or coverage ratio covenants, but he does. (Bell, Tr. 550-51.) Mr. Bell did not inform Ms. Bebo or the Board while she was present that he had obtained a legal analysis of the lease from an outside law firm. (Bebo, Tr. 3897-99.) ALC did not retain the law firm, or pay for any legal work Mr. Bell described. (*See* Bebo, Tr. 3899.)

Mr. Bell and Mr. Buntain, who shared Mr. Bell's concerns, abstained from the vote on the transaction. (Bebo, Tr. 3890, 3899-3900.) Ms. Bebo thought that Mr. Bell made some valid points for the Board to consider in voting on the transaction, but did not share his concerns. (Bebo, Tr. 3900.) Mr. Rhinelander expressed surprise at the Board meeting about the concerns Mr. Bell was raising. (Rhinelander, Tr. 2804) He also spoke in favor of the transaction. According to Ms. Bebo, he stated he did not have the same concerns as Mr. Bell:

> At the board meeting itself, he indicated that he had -- as far as a response to Mr. Bell, [Mr. Rhinelander] indicated that he had, you know, experience in this area as well and that, you know, he did not have the same level of concern. He indicated that this was an attractive, you know, price for the company and something that would -- something that would add to our growth that we've talked about as far as a strategic plan for ALC.

(Bebo, Tr. 3902.) According to Mr. Rhinelander, he asked Ms. Bebo whether "she felt comfortable that [ALC] could meet the requirements" and she indicated she did. (Rhinelander, Tr. 2804.)

Outside of the board room, Mr. Rhinelander was furious that Mr. Bell had raised these concerns at the Board meeting instead of ahead of time in discussions with Mr. Rhinelander and Mr. Hennigar. (*See* Bebo, Tr. 3901-03.) He told Mr. Bell that he was "disappointed that this came up at the last minute" and "didn't feel that that was an appropriate way for directors to interact." (Rhinelander, Tr. 2806.) Mr. Rhinelander indicated that Mr. Bell had plenty of time before the Board meeting to review the documents and raise any issues he had with Mr. Hennigar outside of the Board meeting. (*See* Rhinelander, Tr. 2804-06; *see also* Bebo, Tr. 3901-02.) Both Mr. Rhinelander and Mr. Bell offered to resign from the board, but ultimately remained on the board. (Bell, Tr. 553-54; Rhinelander, Tr. 2806-07.)

IV. ALC ENTERS INTO THE LEASE WITH VENTAS.

Following approval at the board meeting, and effective January 1, 2008, various subsidiaries[11] of ALC entered into an Amended and Restated Master Lease Agreement (the "Lease") with a subsidiary of Ventas whereby ALC rented eight senior living facilities located in several states in the Southeast United States (referred to herein as the "CaraVita Facilities").

[11] Those subsidiaries are referred to as "Tenants" in the Lease and this brief. References to ALC with respect to the Lease in this submission includes the Tenants unless the context indicates another meaning.

A. The Lease Terms Generally Are Ambiguous And Suited To A Sale-Leaseback Transaction For Skilled Nursing Facilities, Which Offered ALC Flexibility In Compliance With It.

Probably due to the small portfolio of eight buildings, Ventas and Old CaraVita signed a lease that appears to have been modeled on one of Ventas' standard skilled nursing facility leases. (*See* Bebo, Tr. 3888-89). It contains a host of provisions that have no applicability whatsoever to assisted and independent living facilities, and also contains a host of provisions relating to Medicare and Medicaid reimbursement, when none of the CaraVita Facilities were ever contracted to participate in Medicare or Medicaid. (*See id.*; Exs. 1564, 1564A.) They were all private pay. (Bebo, Tr. 3870-71.)

As John Durso—Ms. Bebo's expert in the senior living industry—testifies, the Lease is "ambiguous, with numerous provisions that do not apply to ALC's operations (that is, operating market rate rentals of units to 'private pay' persons). Many of the Lease provisions are immaterial to the leased facilities and more akin to leasing or managing skilled nursing facilities ('SNFs') participating in, and receiving funds from, Medicare and/or Medicaid." (Ex. 2185, p. 7; *see also* Ex. 2185, pp. 11-12.) Entire sections of the Lease are missing (Section 5 is listed in the table of contents but missing from the document). (Ex. 2185, p. 7.)

In general, the Lease is suited for a management agreement for an SNF that receives Medicare and/or Medicaid payments, and contains a host of internally inconsistent provisions that are inapplicable to leased facilities that receive no government payments. (Ex. 2185, pp. 11-12.) For example, it contains a host of limitations on ALC's actions and a host of reporting obligations, including things such as precluding ALC from changing its organizational status, or issuing equity interests. (*Id.*) And the Lease requires ALC to provide information about any need to increase its reserves for expenses relating to malpractice or professional

liability claims or any material increase in the costs for insurance. (*Id.*) Mr. Durso opines much of the Lease has:

> ...little or nothing to do with ALC's operation of the facilities; they relate to ALC's financial circumstances and ability to pay the rent under the Lease.
>
> Though some of the above restrictions and obligations might be useful to a landlord to monitor a tenant's resources to continue to pay rent, they are of little importance here, particularly when ALC's ability to pay its rent was never in question, it timely made all of its rent payments, and its financially strong parent organization guaranteed those payments.

(Ex. 2185, p. 12.)

Despite the fact that the Lease appeared to be suited for a different situation—a small operator with limited financial means; skilled nursing facilities participating in government payor programs—Ms. Bebo did not think there was anything harmful in those provisions to ALC, just that a lot of it was not pertinent to the current situation. (*See* Bebo, Tr. 3891-92.) In addition, the prior operator had indicated that Ventas had been flexible in terms of working together with them on different issues that came up. (Bebo, Tr. 3892-93.) Finally, at the time the Lease was approved, Ms. Bebo felt that the ambiguity evident in the Lease could actually benefit ALC—it had imbedded flexibility in terms of ALC's compliance. (*See* Bebo, Tr. 3893-95; Ex. 2185, pp. 12-14.)

B. The Parties' Failure To Spend Time and Expense To Re-write The Lease From Scratch Makes Sense Because The CaraVita Facilities Were A Small Part Of Both ALC's And Ventas' Business.

1. The CaraVita Facilities constituted a small part of ALC's business.

The relative insignificance of the CaraVita Facilities to the rest of ALC's business overall is summarized well in the expert report of David B.H. Martin:

> Here, ALC would have had a reasonable basis to conclude that as a general matter the Lease was not material. At the time ALC entered into the Lease, it operated 208 assisted and independent living residences in 17 states in the United States. ALC operated about the same number of facilities for all of the

> periods covered by the ALC Reports, with 211 facilities in 20 states as of the end of 2011. At the time it signed the Lease, ALC owned the majority of the facilities it operated (153), but it also leased a substantial number (63). Thus, the eight properties covered by the Lease when it was signed accounted for only 3.8% of ALC's overall facilities and only 12.7% of its leased facilities.
>
> In terms of units, the properties covered by the Lease when it was signed had 541 units. As a result, ALC operated over 9,076 units at this time, and the eight properties covered by the Lease comprised less than 6.0% of ALC's total units at the time it entered into the Lease.
>
> From a revenue standpoint, ALC generated over $228 million in revenue per year throughout the relevant time period. It also reported income from operations ranging from $29.8 million in 2008 to a high of $43.6 million in 2011. The properties covered by the Lease represented a small portion of that revenue and operating income. In 2011, the eight properties covered by the Lease had revenues of $13.3 million and operating loss of $(1.7) million. Thus, in 2011, the properties covered by the Lease represented 5.6% of ALC's revenues but a reduction of its operating income.

(Ex. 2187, pp. 6-7.) (footnotes omitted).) Put another way, by 2011 ALC was actually losing money by operating the CaraVita Facilities.

2. The CaraVita Facilities constituted an even smaller part of Ventas' Business.

As noted above, the CaraVita Facilities constituted yet an even smaller portion of Ventas' portfolio of property. The eight facilities ALC leased from Ventas was a relatively small group of facilities in Ventas' triple-net lease portfolio. (Doman, Tr. 296-97.)

In fact, according to Ventas' First Quarter 2009 Supplemental Data, Ventas' combined triple-net lease and operating portfolio generated revenue of $859 million. (Ex. 2112, p. 8; Doman, Tr. 297-98, 301.) By contrast, the revenue derived from the rent paid by ALC was insignificant. The fixed rent paid by ALC was approximately $5 million. Thus, the rent from

ALC constituted *only 0.58% of Ventas overall revenue* from its triple-net lease and operating portfolio.[12] (*See* Ex. 2112, p. 8 (rounding up to 1%).)

V. IN 2008, ALC AND VENTAS REACH A NUMBER OF INFORMAL UNDERSTANDINGS WITH RESPECT TO AMBIGUOUS LEASE TERMS AND LEASE COMPLIANCE.

Throughout the first year of the Lease, 2008, ALC and Ventas reached a number of informal agreements or understandings with respect to how the occupancy and coverage ratio calculations should be processed in light of the ambiguity contained within the terms of the Lease.

A. ALC And Ventas' 2008 Informal Agreement With Respect To Interpretation Of The Occupancy Covenant.

Section 8.2.5(d) of the Lease contains the minimum average occupancy covenant. It states:

> As of the end of each fiscal quarter, the minimum average occupancy rate (i) for the quarter then ended for each Facility shall be greater than or equal to 65%, (ii) for the trailing 12 months then ended (1) for each Facility shall be greater than or equal to 75% and (2) for all Facilities in aggregate shall be greater than or equal to 82%.

(Ex. 1986, p. 28.)

Notably, despite seventeen pages of definitions for key terms in the Lease (located at Exhibit B to the Lease), neither "occupancy" nor "occupant" are defined in the lease. The Lease <u>could have defined</u> the term with reference to, for example, units occupied by patients or residents or the ratio of patients or residents paying rent to the number of units or beds. The Lease does make similar references along these lines in one of the provisions of the Lease that has no applicability to the CaraVita Facilities. Section 8.2.3(d) requires operator and actuarial

[12] ALC's rent was even more insignificant by 2011 because Ventas had grown significantly through acquisitions and mergers. By the end of 2011, Ventas had 1,378 properties, and reported $1.765 billion in revenue, including $652 million in rent revenue from its triple-net leased assisted living and skilled nursing facilities. Ventas Form 10-K filed for the period ending December 31, 2011 at pp. 1, 97.

reports that are submitted for Medicare or Medicaid purposes, including "any and all of the census information concerning the number of licensed beds occupied by residents or patients…."[13] (Ex. 1986, pp. 27-28.) But in Section 8.2.5(d) there is no limiting definition of occupancy or occupant.

ALC calculated occupancy under the Lease in a different manner than Old CaraVita calculated occupancy. (Doman, Tr. 325.) Old CaraVita utilized a calculation of the number of residents, or occupied beds, over the number of available units. (Doman, Tr. 329-30; Ex. 1988; Exs. 2002, 2002A.) In contrast, ALC used a calculation of the number of units occupied over the number of available units (Doman, Tr. 325; Ex. 1988), i.e., same Lease terms, but entirely different method of calculating occupancy.

Because many of the approximately 540 units in the CaraVita Facilities could house multiple residents, this difference in calculation methodologies made a significant difference in the occupancy percentage, and caused Old CaraVita to report occupancy over 100% for numerous months. (*See* Doman, Tr. 329-30; Ex. 2002A.) Ventas noted this in their evaluation of ALC's occupancy reports. (*See* Exs. 2002, 2002A, 1988.)

In a May 6, 2008 e-mail, a Ventas personnel noted that ALC's reporting of occupancy based on "units occupied/available" resulted in a calculation about 6% lower than Ventas' calculations based on how Old CaraVita had prepared the calculations. (Ex. 1988.) Later in a September 4, 2008 e-mail from William Johnson, a Ventas Asset Manager, to Tim Doman, the Senior Vice President for Asset Management, Mr. Johnson analyzed ALC's occupancy trend for

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[13] The inclusion of language in one section of the contract while excluding it in Section 8.2.5(d) means that "occupancy" in Section 8.2.5(d) must be interpreted as being broader under the doctrine of *expressio unius est exclusio alterius*, which means "expressing one item of [an] associated group or series excludes another left unmentioned.". *See Chevron USA, Inc. v. Echazabal*, 536 U.S. 73, 80 (2002) (internal quotations omitted); *see also Chi. Bd. Of Options Exchange v. Conn. Gen. Life Ins. Co.*,
713 F.2d 254, 258 (7th Cir. 1983).

the first six months of 2008, stating, "YOY [Year-Over-Year] is horrible but it's partly due because Josh was using beds[;] we now have ALC using units." (Exs. 2002, 2002A.) Exhibit 2002A demonstrates that the calculation differences between the Old CaraVita method and ALC's method could cause an occupancy difference of as much as 10%-12%. (*See* Ex. 2002A, "Winterville YOY" tab.)[14]

Tim Doman explained the Lease's ambiguity with respect to calculating occupancy:

Q	Did you ever object to ALC calculating occupancy different from how old CaraVita calculated occupancy?
A	No. Because back at that time of the industry, there -- no one really had a set -- you know, had a set method. Some people -- I mean, the way the resident beds, you know, sort of calculation came about was because it came from sort of the skilled nursing environment, where you were focused on beds, so some people were using beds and then were treating it like multifamily commercial real estate and doing occupancy on units. So back at that time you had a mix of some people doing it on beds and some people doing it on units. So we -- we would do it either way as long as we did it consistently over the period of time.
Q	And if you had a problem with ALC calculating it differently, you would have had Ventas object to that calculation, wouldn't you?
A	We would have had a discussion with them, but we had operators that were calculating it both ways.

(Doman, Tr. 331-32.)

Thus, Mr. Doman concedes that it was appropriate for ALC to rely on Ventas' lack of objection to an informal disclosure about ALC's interpretation of the ambiguous language of the Lease with respect to the occupancy covenant. It is undisputed that ALC never made a "formal request" to calculate occupancy in this manner. It is undisputed that ALC and Ventas never entered into any formal agreement or understanding with respect to whether ALC's changed

[14] Comparing April 2007 data under Old Caravita with April 2008 calculation under ALC, the revenue is essentially the same: $157,589 in April 2007 and $154,745 in April 2008. Yet occupancy varies from 100.6% in April 2007 under Old CaraVita to 88.3% in April 2008 under ALC method of calculating occupancy. (*Id.*)

method of calculating occupancy was permissible under the terms of the lease. Ventas acknowledges that no formal amendment or notification was required. (Doman, Tr. 332-34.)

B. ALC And Ventas' 2008 Informal Agreement With Respect To Interpretation Of The Coverage Ratio Covenant.

There was similar ambiguity, flexibility, and discretion regarding compliance with the Lease, including calculating the financial coverage ratios. In 2008, ALC and Ventas reached informal agreements through e-mail with respect to how the coverage ratio covenant should be applied—no different from a process standpoint than when ALC and Ventas reached an understanding through a phone call and an e-mail about calculating the covenants in February 2009.

The Lease required ALC to maintain a Coverage Ratio with respect to each Facility for the trailing twelve month period of 0.8 to 1.0 and for the total portfolio of the eight CaraVita Facilities at 1.0 to 1.0. (Ex. 1986. p. 28.) Unlike "occupancy," which is nowhere defined in the Lease, "Coverage Ratio" is a defined term. It is defined as the ratio of "Cash Flow" to fixed rent payments on the facilities plus any debt service for each particular facility. (Ex. 1986, p. 131.) Effectively, the ratio was meant to confirm that the cash flow generated from the operations of the properties was sufficient to cover the rent payments. In Ventas' words, the covenant was an "early warning signal." (Doman, Tr. 176.)

Because the rent was effectively set based on the payments and escalators set forth in the Lease, the key metric in the calculation is the amount of "Cash Flow." Cash Flow is also a defined term under the Lease, but it permits a lot of flexibility to ALC in calculating cash flow, particularly with respect to what constitutes regional, divisional, and corporate expenses that get added back to the net income reported on the facility financial statements. (Doman, Tr. 336-37; Bebo, Tr. 3984-85.)

The definition of Cash Flow in the Lease results in the following equation:

Cash Flow =

- Net Income (Line "C" below)
- **plus** Provision for Depreciation and Amortization (Lines "D" & "E" below)
- **plus** Provision for Management Fees (Line "F" below)
- **plus** Provision for Income Taxes (Line "G" below)
- **plus** Provision for rent payments and interest (Line "H" below)
- **minus** Imputed Management Fee based on 6% of revenues (Line "M" below)
- **minus** replacement reserve of $300 per bed. (Line "N" below)

(Ex. 1986, p. 130.)

Below is a snapshot from the first covenant compliance worksheet provided by ALC to Ventas for the first quarter of 2008, which shows the calculation in practice:

1			3100	3101	3102	3103	3104	3105	3106	3107	
2	TTM December 31, 2007		Winterville Retirement	Greenwood Gardens	Highland Terrace	Peachtree Estates	Tara Plantation	The Inn at Seneca	CaraVita Village	Sanctuary at Northstar	Portfolio TTM Total
8	Net Income	C	23,676.00	126,762.00	39,505.00	108,030.00	209,455.00	(46,899.00)	435,176.00	68,476.00	964,181.00
9											
10	*Additions to Net Income*										
11	plus Depreciation[2]	D	35,749.00	20,798.00	12,253.00	9,130.00	13,699.00	14,615.00	54,547.00	14,352.00	175,143.00
12	plus Amortization[2]	E	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
13	plus Management Fee	F	125,821.00	132,783.00	106,586.00	135,507.00	173,902.00	91,299.00	312,259.00	140,662.00	1,218,819.00
14	plus Income Tax	G	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
15	plus Fixed Rent	H	734,184.00	384,403.00	402,472.00	574,457.00	924,112.00	299,135.00	962,954.00	669,908.00	4,951,625.00
16	plus Loss on Sale of Assets / One Time Loss	K	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
17	*Additions Subtotal*	*L = Sum of D : K*	895,754.00	537,984.00	521,311.00	719,094.00	1,111,713.00	405,049.00	1,329,760.00	824,922.00	6,345,587.00
18											
19	*Subtractions to Net Income*										
20	less Imputed Mgmt Fee	*M = B * 6%*	115,111.38	111,477.30	93,376.14	116,804.52	164,751.24	73,441.20	243,693.48	132,131.88	1,050,787.14
21	less Replacement Reserve	*N = A * 300.00*	14,907.00	17,889.00	13,119.00	18,186.00	20,571.00	11,925.00	49,500.00	14,907.00	161,004.00
22	*Subtractions Subtotal*	*O = M + N*	130,018.38	129,366.30	106,495.14	134,990.52	185,322.24	85,366.20	293,193.48	147,038.88	1,211,791.14
23											
24	Cash Flow	*P = C + L - O*	789,411.62	535,379.70	454,320.86	692,133.48	1,135,845.76	272,783.80	1,471,742.52	746,359.12	6,097,976.86
25											

(Ex. 1992A (native) at "Covenant" Tab.)

As set forth in the example above, the provision for management fee added back to net income exceeds the 6% imputed management fee.[15] Consequently, the more expenses that ALC characterizes from the income statement as regional, divisional, or corporate expenses—all of which were included in the management fee provision added back to net income—the greater the reported Cash Flow on a dollar-for-dollar basis.[16] And the greater the numerator for purposes of calculating the Coverage Ratio.

When ALC took over the operations of the CaraVita Facilities, the provision for management fee that was added back to net income increased, in part due to an extra layer of expense due to divisional oversight. This increased ALC's coverage ratio. The following is again from ALC's initial compliance submission to Ventas:

56	Other Expense								
57	6600 · Management Fees Expense	27,406	28,366	28,624	29,320	113,716	17364	103,674	
58	9960 · Depreciation and Amort. Expens	7,715	10,998	11,860	12,104	42,677	787	35,749	
59							14754	14,754	
60	Non lease rent	178,798	184,380	183,268	183,268	729,714	183268	734,184	
61	Total Other Expense	213,919	223,744	223,752	224,692	886,107	216173	888,361	
62	Net Other Income	-213,919	-223,744	-223,752	-224,692	-886,107	-216173	-888,361	
63	Pre Tax Income	-3,068	4,424	4,657	17,659	23,672	-3064	23,676	
64									
65	Division Office Expenses						22147	22,147	Divisional Office expenses - included in Total Expenses above but represents management fee

(Ex. 1992A (native) at "Winterville" Tab.)

Because of the amount of expenses that ALC was adding back to the provision for management fee based ALC's re-allocation of expenses from the facility financial statement to the division expense/management fee, there was a disagreement in 2008 about how that should be handled under the ambiguous terms of the Lease. Ventas noted that ALC's calculation of the management fee provision was in some cases as high as 12%, more than twice the percentage of

[15] The management fee added back to net income is $1,218,819 while the 6% imputed management fee that was subtracted is only $1,050,787.

[16] Thus, Mr. Buono was simply wrong when he testified, at the behest of the Division, that the amount of expenses that ALC considered regional, divisional, or corporate would have no effect on the coverage ratio calculation.

the imputed management fee. (Ex. 1993.) On May 30, 2008, Ventas wrote to ALC the following:

> *Per your definition of Division Office Expense (*"Division Office Expense is an allocation of expenses related to regional and divisional oversight. It includes items like salaries, travel costs, and participation in ALC's worker's comp and general and professional liability insurance programs"*), we are not seeing how that would be classified as a management fee to be added back to net income in the covenant calculation. From our viewpoint, we should not add this back to Cash Flow unless you see otherwise.

(Ex. 1989.)

On behalf of ALC, Mr. Buono responded that the expenses that were included in the provision for management fee was appropriate:

> Joe,
> We disagree with your assessment that divisional expense items should not be added back to Cash Flow. These items represent divisional oversight similar to what the Cara Vita entity would have incurred and added back to the individual houses. The salaries and travel costs relate specifically to people outside of the individual houses to provide corporate oversight. Because we are self insured in workers comp and general and professional liability insurance programs, these amounts do not result in incremental costs to the individual houses and as a result should not be included as an expense on that level. What differs here from the Cara Vita model is that we essentially have two layers of management expenses, one at a regional level and one at a corporate level.
>
> John Buono
> Sr. V.P., Chief Financial Officer and Treasurer
> Phone 262-257-8999

(*Id.*) Ventas and ALC traded additional e-mails to resolve the issue of how the coverage ratio covenant, and the definition of management fee, should be interpreted. (Exs. 1992-94.) In an e-mail from a Ventas asset manager, Ventas indicated it agreed with certain aspects of ALC's interpretation of the management fee provision. (Ex. 1992.)

Mr. Doman acknowledged that Ventas' statement of agreement in an e-mail was sufficient to reach an understanding about how to interpret and apply the ambiguous definitions related to the coverage ratio covenant. (Doman, Tr. 341.) However, Ventas continued to disagree with ALC about other aspects of the interpretation and sought more information about what specifically ALC was including as a divisional expense component to the management fee added back to net income. In this regard, ALC told Ventas to simply "get past this allocation" issue and implicitly told Ventas that their interpretation and request for further information was

irrelevant. (Ex. 1994; Doman, Tr. 343-45.) Mr. Doman does not recall Ventas ever challenging Mr. Buono's direction to "get past the allocation" dispute, and there is no evidence that Ventas ever responded. (Doman, Tr. 344-46.) Consequently, ALC continued to calculate the coverage ratio consistent with its interpretation of the covenant based on Ventas' silence in response to Mr. Buono's e-mail - just as they would with respect to the calculation using unit rentals related to employees.

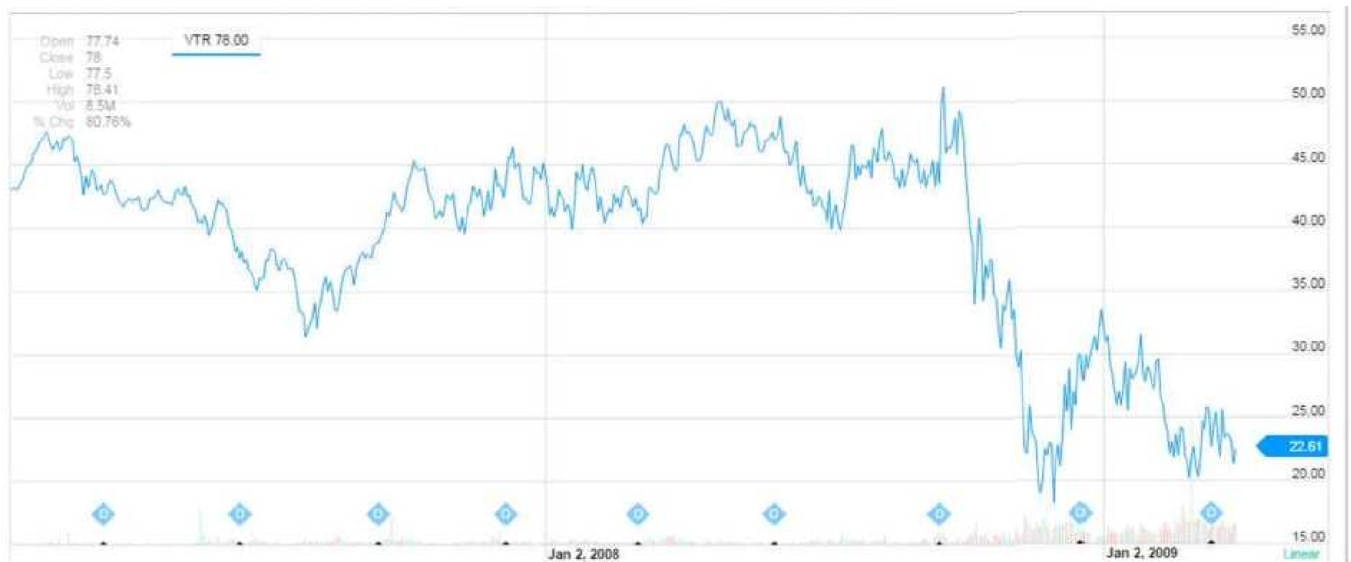
VI. THE U.S. ECONOMY CRASHES, NEGATIVELY AFFECTING BOTH ALC AND VENTAS' BUSINESS.

Not long after ALC assumed the operations of the CaraVita Facilities, the U.S. economy significantly worsened in the second half of 2008, culminating with the worst recession in decades and the worst financial crisis since the Great Depression. (*See, e.g.,* Durso Report, Ex. 2185.) This affected the businesses of both ALC and Ventas in a number of ways.

A. Ventas Was Severely Affected By The Recession; As A Result It Modified Its Business To Conserve Cash Flows And Laid Off 10% Of Its Workforce.

In a March 2009 letter to shareholders, Ventas' CEO and Chairwoman Debbie Cafaro described the 2008 economic climate in which Ventas was operating as "an unprecedented global financial meltdown," where Ventas adjusted its business to keep its "single-minded focus on building liquidity and enhancing [Ventas'] financial strength and flexibility." (Ex. 2109, p. 4.) Looking to 2009, Ms. Cafaro indicated that Ventas expected 2009 to be another humbling year, marked by high unemployment, negative GDP growth and deteriorating fundamentals in most businesses. (Ex. 2109, p. 7.) And in Ventas' annual report filed in late February 2009, Ventas indicated that its principal business strategy at that time was to maintain a strong balance sheet and conserve liquidity (i.e. stable cash flow and earnings). (Ex. 2106.) Mr. Doman confirmed that this accurately described the business climate and strategy for Ventas and his department during at the time. (Doman, Tr. 285, 289-92.)

Ventas share price was crashing in late 2008 and early 2009, and Ventas was at risk of being frozen out of the capital markets and unable to pay off debt coming due because of its cratering share price. (Ex. 2106, pp. 40, 45; Ex. 2070; Doman, Tr. 292-94.) Ventas' stock chart, reflecting its share price crash in late 2008 and early 2009, is set forth below:



(Ex. 2070.)

In this economic climate, Ventas touted the stable cash flows of its triple-net portfolio of which the CaraVita Facilities were a part. The leased properties were a source of stability as long as Ventas was able to collect rent from tenants like ALC. (Doman, Tr. 286-87.) Put another way, the leased properties are a source of stability because "no matter how the operations perform [in the difficult economy], the tenant owes us rent." (*Id.*)

Of course, those operations were only a source of stability if the tenants were capable of paying the rent. Ventas witnesses acknowledged that ALC was never a risk for not making rent payments to Ventas, and always made timely rent payments. (*See* Doman, Tr. 304, 315; Solari, Tr. 459; Butora, Tr. 950.)

Ventas also acknowledged that there would be significant risks to the on-going cash flow and liquidity that Ventas coveted during the height of the economic crisis, if it were to take the step of defaulting a well-funded tenant for a covenant violation. (Doman, Tr. 311-14.) If Ventas had defaulted ALC (or any other tenant), it recognized that it could lose rent payment streams in the time it was seeking a replacement tenant, and once a new operator was located, the ability to reposition the properties to a new operator could be significantly delayed by state requirements to transfer assisted living licenses. (Doman, Tr. 312-14; Ex. 2106, p. 32-33.) For assisted living facilities, this takes about three to six months. (Bebo, Tr. 3957-58.) And during this time period Ventas could have to fund expenses and obligations of the properties that had been previously paid by ALC. (Doman, Tr. 313; Ex. 2106, p. 33.)

In the middle of 2008, a operator/tenant of approximately 70 or 80 Ventas senior care facilities went bankrupt. (Bebo, Tr. 3960-61.) Ventas was forced to take over the operations of those properties and the former operator, a company called Sunwest, ceased paying rent to Ventas. (*Id.*)

As the economy got worse into early 2009, things got so bad for Ventas that they took the drastic step of eliminating approximately 10% of the company's work force in April 2009. (Solari, Tr. 460-61.) And with respect to Ventas' business, the economic conditions did not even start to "turn around" until sometime between September 2009 and September 2010. (Doman, Tr. 295-96.)

Importantly, based on Ms. Bebo's participation in the industry and the fact that she periodically reviewed Ventas' (and other important industry players) SEC filings, she was aware of Ventas' situation and believed there would be opportunity to work together through trying economic times. (Bebo, Tr. 3962-63.) She thought Ventas might be open to flexibility with

respect to the covenants if there was a mutual desire to try and work together on other projects that could be mutually beneficial. (Bebo, Tr. 3985-87.)

This was consistent with how many players in the industry were acting during the recession, as set forth in John Durso's expert report:

> Importantly, these [recessionary] conditions affected senior care facilities industrywide and demanded flexibility between the landlords and tenants of the facilities. The alternative would have been disastrous. ALC's and Ventas' actions and conduct in addressing and clarifying the Financial Covenants were consistent with the actions taking place between landlords and tenants of senior care facilities nationwide, as they all reacted and adjusted to the consequences of the Great Recession.

(Ex. 2185, p. 11.)

B. ALC Business Is Also Affected, Causing Occupancy Rates To Decline At The CaraVita Facilities.

As noted above, ALC's business was also adversely affected by the Great Recession, and upon taking over the operations of the CaraVita Facilities, the financial performance of the facilities declined. Although occupancy was declining, as a company, ALC remained financially strong, flush with cash, and presented no solvency risk or risk of non-payment of rent. (Bebo, Tr. 3961, 3986; Doman, Tr. 315 (stating in November 2008 that ALC was "well enough capitalized to make the rent payments"); Solari, Tr. 459; Butora, Tr. 950.) At no time, was anyone at Ventas concerned about ALC's ability to make the rent payments on the CaraVita Facilities. (Butora, Tr. 950.)

The factors described above, along with ALC's own operational issues with running the CaraVita Facilities, resulted in questions at the August 5, 2008 meeting of the ALC Audit Committee about the implications of non-compliance with the Lease covenants. (Ex. 1204.) Mr. Buono prepared a memorandum outlining the decline in occupancy since the acquisition of the portfolio and the trends at the CaraVita Facilities. In particular, Mr. Buono noted the adverse

trends at Peachtree Estates and Greenwood Gardens and the potential for breaching the occupancy and/or coverage ratio covenants in the coming quarters if conditions and operations of these Facilities did not improve, or other options were not pursued. (*Id.*)

VII. VENTAS' WORDS AND ACTIONS DEMONSTRATED TO ALC AND MS. BEBO THAT THE COVENANTS WERE OF LITTLE IMPORTANCE BECAUSE THERE WAS NO RISK OF NON-PAYMENT OF RENT.

Particularly after the Great Recession impacted Ventas' business, Ventas conveyed through its words and actions to ALC and the public at large that the occupancy and coverage ratio covenants were of little importance, provided that the tenant was paying rent. Indeed, Ventas' head of asset management during 2009 to 2012 could not identify a single instance where Ventas had defaulted a tenant and asserted its remedies under a lease where the sole basis for the default was an occupancy or coverage ratio covenant violation. (Doman, Tr. 379-81.) This is consistent with Ms. Bebo's recollection based on her knowledge of and participation in the industry during that time period. (Bebo, Tr. 4050-51.) She was not aware of *any* instance where *any* landlord pursued a default and remedies solely as a result of a financial covenant violation. (*Id.*)

In public presentations filed with the Commission in January 2008 as an attachment to a Form 8-K, Ventas touted the financial covenants contained in its leases as protection against non-payment of rent. (Ex. 2069, p. 5; Doman, Tr. 309.) Specifically, Ventas indicated that unique covenants, and cash flow coverage in master leases "enhance[] rent reliability." (Ex. 2069, p. 5.) Ventas touted the financial covenants in their leases as a basis for asserting there is "strong credit support" for the rent payments. (Ex. 2069, p. 7.)

Ms. Bebo always understood, based on her knowledge of the industry and based on her interactions with Ventas specifically, that Ventas' primary concern with respect to the financial

covenants was with respect to the ability of the tenant to meet the rent payments. (Bebo, Tr. 4048-49.) Ms. Bebo testified:

Q	I'd like to talk about your impressions of Ventas' level of concern for financial covenants in the lease. What, if any, view do you have on whether Ventas was concerned with the financial covenants in the lease?
A	Given my history of working with a number of different companies, interacting with a number of CEOs and COOs from the industry, and knowing that I track the industry information, the idea that -- the idea that Ventas cares about financial covenants, in and of itself, I think, doesn't make any sense. The fact that Ventas is going to care about receiving their rent payment, that that rent payment is an important piece to them. The financial covenants are put into the lease to help them -- help Ventas identify things before they would -- before they would become too difficult for a tenant to pay the rent. So the financial covenants have -- you know, provide for an opportunity for the landlord to determine if there's going to possibly be a problem with the tenant paying the rent. I think that it's a box to check for Ventas. I think that, you know, it's something that is going to -- it's something that is perhaps going to encourage them to have more contact with a tenant if there's a triggering of a financial covenant.
Q	Do you -- did you speak with anyone at Ventas or did anyone at Ventas make any statements to you that would also corroborate what you just said?
A	In several discussions with people from Ventas, certainly the interest level was always about ALC as a whole, the guarantor entity. There were a lot of questions about the liquidity for ALC, the current cash position, the ability for ALC to continue to make rent payments. Those were things that were always asked by folks at Ventas. Mr. Solari, in particular, had said to me that, you know, Ventas cares about the rent payment. Again, given my experience with things in the industry, the idea that a triggering of a financial covenant, in and of itself, is going to cause a landlord with a tenant that's paying rent to do anything negative just doesn't make sense.

(Bebo, Tr. 4047-49.) Similarly, Mr. Buono testified (after being impeached) that he understood Ventas' number one priority with respect to the Lease was receiving its rent payments, and that

the second priority was that the buildings remain in good physical condition and "running well." (Buono, Tr. 4653-55.)

Ventas' asset manager acknowledged that she is not aware of Ventas ever indicating to ALC that the financial covenants were particularly important to Ventas, or that they were important for any reason other than as an indicator of the tenant's ability to pay the rent owed to Ventas. (Butora, Tr. 950-51.)

Because ALC was never a risk for non-payment of rent, Ventas never exercised its audit rights under the Lease despite recognizing in e-mails that ALC could be "playing with the numbers." (*See* Doman, Tr. 346-47; Butora, Tr. 948; Ex. 215.) In fact, according to Ventas' long-time asset manager, the only time Ventas had *ever* exercised its audit rights was in a situation where the tenant was asking for relief on the rent payments. (Butora, Tr. 948-49.)

The most glaring illustration of the effect that the recession had on covenant compliance is reflected in Ventas' determination to do nothing to assert remedies for default when ALC received a notice of revocation on one of the CaraVita Facilities in November 2009. At that time, the effects of the recession on Ventas' business had not yet started to subside, and Ventas took no action to enforce a default under the Lease. This can be contrasted to 2012, when things had turned around for Ventas and it had become a much larger company. At that time, as described in more detail below, Ventas did assert that ALC had breached the Lease when it received license revocation notices, and sued ALC on that basis.

In September 2009, ALC received a license revocation notice from the State of Alabama for the CaraVita Village property in Alabama. (Bebo, Tr. 3964-65; Ex. 2148, 2149.) ALC provided Ventas notice of the license revocation. (Bebo, Tr. 3964-65.) In February 2010, ALC provided Ventas notice of the consent agreement that ALC reached with the State to resolve the

notice of revocation and cure the poor inspection results that prompted the revocation notice. (Ex. 1169.) Pursuant to the consent agreement, the facility was placed on a probationary license status, which resolved the license revocation notice provided that ALC complied with the consent agreement. (Doman, Tr. 376-77; Ex. 2039.)

Ventas issued a notice of an event of default (Ex. 1231), but took no further action. It did not sue ALC or otherwise attempt to enforce any remedies for a default under the Lease. Ventas simply sought additional information about the survey inspection that lead to the license revocation and consent agreement, and for any other survey reports that had been issued in relation to the other CaraVita Facilities.

Though the notice of default was issued formally under the Lease, it was concluded in an informal manner just like the 2008 understandings reached in relation to the interpretation of the terms of the occupancy and coverage ratio covenants. After ALC provided the survey materials, Ms. Butora simply informed ALC by telephone that the Lease terms had been satisfied and the notice of default withdrawn. No formal action was required. (Ex. 2034; Doman, Tr. 375-76.)

VIII. AT THE MEETING WITH MS. CAFARO, SHE TOLD MS. BEBO THAT JOE SOLARI SHOULD BE HER POINT OF CONTACT TO DISCUSS IMPORTANT MATTERS RELATED TO THE CARAVITA FACILITIES.

In late November 2008, Ms. Bebo and Mr. Buono set up a meeting with the CEO of Ventas, Ms. Cafaro, to begin a conversation about ways in which ALC and Ventas could work together through the difficult economic times, which might include relief from the covenants or other flexible arrangements regarding the covenants in the Lease. Ms. Bebo and Mr. Buono traveled to Ventas' headquarters and met with Ms. Cafaro and Mr. Solari.

A. Ms. Bebo's approach to the meeting with Ms. Cafaro.

Given the economic conditions and given that she was unaware of any landlord in the industry evicting a tenant over a financial covenant breach, Ms. Bebo was not going down to

Ventas with "hat-in-hand" regarding any negotiations over the Lease covenants.[17] At the time, Ms. Bebo believed that in a *worst-case scenario* if ALC violated the occupancy or coverage ratio covenants, it would be forced to pay a "toll" of a million dollars. (Bebo, Tr. 3959.) However, the more likely scenario, Ms. Bebo concluded at the time, would have been increased monitoring by Ventas and possibly requiring ALC to submit formal plans for improvement. (Bebo, Tr. 3961-62.)

This is entirely consistent with Mr. Doman's testimony. He testified that he recalled that ALC had actually tripped the occupancy covenant early in the relationship with ALC. (Doman, Tr. 265-67, 281-82.) In response, *Ventas took no formal action to assert remedies under the Lease; it simply monitored the situation:*

Q	Now, in response to ALC tripping the occupancy covenant, you simply focused on ALC more closely; is that correct?
A	I think we generally focus more closely on all of our operators once they have come near or tripped covenant.
Q	And in response to ALC tripping the occupancy covenant, at some point in time, you monitored the situation to get a level of comfort that they were sort of out of the woods; is that correct?
A	We wanted to monitor them more closely to see if they would remedy the issue and have more variance on the covenant so they weren't close to tripping, that is correct.
Q	And so you monitored them to get a level of comfort that they were out of the woods; is that fair?
A	Fair.

(Doman, Tr. 282.) Similarly, in a discussion in late February with respect to proposed temporary relief from the coverage ratio covenants in connection with the purchase of two Ventas properties in New Mexico, Ventas indicated that the only remedy it might seek if ALC breached the coverage ratio was requiring ALC to deposit money in an escrow account to secure rent

[17] This was a different strategy than Mr. Buono anticipated. He wanted to go into the meeting and request covenant relief right away, and offer to increase rental payments on the properties in exchange. (Buono, Tr. 2332-33; Ex. 156.) Ms. Bebo believed that this was not in ALC's best interest, and that positioning potential covenant relief with relationship building or other proposals would be better for ALC in light of the economic conditions at the time.

payments or purchase a lower performing building out of the portfolio.[18] (Fonstad, Tr. 1614-15, Ex. 197.)

Ms. Bebo also was aware at the time that there was flexibility contained in the terms of the Lease with respect to calculating the occupancy and coverage ratio calculations. She was aware that the Lease permitted ALC to remove 10% of the operational beds from the denominator of the occupancy calculation, along with a comparable number of units.[19] In addition, she was aware that ALC could calculate occupancy as the ratio of the number of people at the Facilities to the number of reduced units. As it turns out, this change in methodology for calculating occupancy would have largely solved any potential violations of the occupancy covenant from 2009 to 2011. (*See* Ex. 2199.)

With respect to the coverage ratio, based on the terms of the Lease and ALC's interactions with Ventas in 2008 regarding the disputes about how to calculate coverage ratio, Ms. Bebo believed that there was flexibility in determining what expenses at the building could be deemed facility expenses that remained in the calculation and reduced the coverage ratio and what expenses could be deemed regional, divisional, and corporate expenses that could be added back to net income and increase the coverage ratio.[20]

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[18] In early 2009, ALC, led by Eric Fonstad and John Buono, was involved in negotiations with Ventas about the potential acquisition of two Ventas properties that were located in New Mexico. (Buono, Tr. 2497-98.) As part of these negotiations, ALC sought relief from Ventas' coverage covenants. (Buono, Tr. 2497-505; Bebo, Tr. 4053-56.) ALC sought relief from the coverage covenants and not the occupancy covenants because, despite ALC's agreement with Ventas about employee leasing, there was still a possibility that ALC could fail the coverage covenants. (Bebo, Tr. 4053-56.) Ultimately, ALC did not purchase the New Mexico properties. (Bebo, Tr. 1980-81.)

[19] Because there are slightly more operational beds than units, the Lease actually permitted ALC to remove slightly more than 10% of the units from the denominator of the occupancy calculation.

[20] As it turns out, ALC did remove certain residence sales manager expenses from the Facility expenses at certain Facilities and allocated them to a corporate level expense.

This was another reason why Ms. Bebo was not desperate to address covenant relief at the meeting with Ms. Cafaro and why her approach to the meeting was in the best interests of ALC.

B. In the brief, high-level discussion, Ms. Cafaro tells Ms. Bebo and Mr. Buono to work with Mr. Solari.

The meeting was relatively short, but generally involved discussions about high-level thoughts and questions about things each party could do to help the other through tough times. They discussed the effect of the recession on ALC, such as plans for weathering the economic downturn, ALC's financial position, liquidity, and whether ALC had any debt coming due. (Bebo, Tr. 3991.) ALC asked similar questions about Ventas' businesses and they specifically discussed the financial trouble that Ventas' biggest and most important operator, Sunrise, was in. (Buono, Tr. 2333.) They discussed the possibility of ALC taking over the operations of some of the Sunrise properties, through a new lease. (*Id.*)

At the time of the meeting, Ms. Cafaro was well-aware of the occupancy and coverage ratio trends in the ALC portfolio at the time. (*See* Ex. 147, 154.)[21] Mr. Solari was also aware at the time that ALC's covenant calculations were trending south toward a potential tripping of the covenant. (Solari, Tr. 448.) Neither Ms. Cafaro nor Mr. Solari raised any concerns about the covenant trends or brought up the covenants at all. The Division's assertion that Ms. Bebo was somehow being deceptive by not bringing up the covenants in this meeting simply cannot be squared with reality.

The meeting did not last long because Ms. Cafaro politely and professionally conveyed that she would not be meeting with Ms. Bebo again. (Bebo, Tr. 3992.) She really had no interest

[21] Division Exhibit 147 is a September 16, 2008 e-mail to Ms. Cafaro that contains a detailed chart reflecting the decline in occupancy and coverage ratio coverage at the ALC-operated facilities. In Division Exhibit 154, Mr. Doman tells Ms. Cafaro in anticipation of the meeting that ALC had some "slippage in occupancy and coverage" and referred her back to the September 16 e-mail update.

in a substantive dialogue with ALC about lease covenants or any other topic, presumably because of ALC's insignificance to Ventas' business (as described above). Instead, she told Ms. Bebo and Mr. Buono that Mr. Solari should be their point of contact for important matters in the relationship between the two companies. (Bebo, Tr. 3992; Buono, Tr. 2741-42.) Mr. Buono stated that he understood that, coming out of that meeting, Mr. Solari was supposed to be ALC's point of contact for all items pertinent to the Lease at the time, that he was in charge of the CaraVita portfolio, and that "everything" was supposed to go through Mr. Solari. (Buono, Tr. 2741-42.)

This was confirmed by Mr. Solari, who testified that after Ventas and ALC executed the Lease, and around the time of Ms. Bebo's meeting with Ms. Cafaro, he served as ALC's "relationship officer." (Solari, Tr. 445.) He acknowledged he was responsible for the future business relationship with ALC. He acknowledged he was ALC's point of contact at Ventas for anything that might come up relating to important asset management subjects, and if ALC was displeased with any response it received from Mr. Johnson, ALC could call him. (Solari, Tr. 444-45.)

Thereafter, in late December 2008 or early January 2009, Ms. Bebo had a telephone conversation with Mr. Solari where they discussed similar topics, like the effect of the economy on their respective businesses. Ms. Bebo specifically recalls telling Mr. Solari during that call that there could be challenges for ALC in the future with meeting some of the Lease covenants. (Bebo, Tr. 4000-01.)

IX. VENTAS AGREES TO PERMIT ALC TO PAY FOR ROOMS FOR PERSONNEL WITH A REASON TO GO TO THE CARAVITA FACILITIES.

A. ALC learns that Old CaraVita had employees living at the CaraVita Facilities.

ALC learned in 2008 that Old CaraVita had permitted a handful of employees to live at the CaraVita Facilities. Ms. Bebo recalls discovering this in late 2008, after ALC terminated the employment of one of these employees. (Bebo, Tr. 1883, 3993-94.) The home office received an inquiry from the staff at the Facility about what should be done with respect to the employee's arrangement to live at the Facility, i.e. should the employee be permitted to remain living at the Facility, be evicted, or should some other course of action be taken.[22] (*Id.*)

Ms. Bebo was told that there were several employees that were or had been living at the CaraVita Facilities. ALC and Ms. Bebo understood that these employees were included in both the occupancy and financial coverage ratio calculations in the covenant reporting by ALC and in past reporting by Old CaraVita. (Bebo, Tr. 1884-86.)

After learning about these employees that had been living at the Facilities, Ms. Bebo consulted with Mr. Buono and Mr. Fonstad about the effect of employee leasing under the Lease. (Bebo, Tr. 1888-89.) In December 2008 or January 2009, Ms. Bebo, Mr. Buono and Mr. Hokeness (ALC's informal auditor) met with ALC's general counsel, Mr. Fonstad, to discuss whether they can include employees in the covenant calculations since the predecessor (Old CaraVita) had done that. (Hokeness, Tr. 3046-47; Fonstad, Tr. 1307; Bebo, Tr. 1888-89.)

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[22] Ms. Bebo did not know whether there was a formal, signed written lease with the employees. (Bebo, Tr. 1883-84.)

B. Mr. Fonstad's January 19 E-mail Regarding ALC Renting To Employees And Family Members, And His Incredible Testimony That This Was The End Of His Participation And Advice.

1. Mr. Fonstad's advice in the e-mail was consistent with how ALC subsequently proceeded.

As ALC's general counsel, Mr. Fonstad was asked to review the Lease and provide legal advice regarding whether ALC had to disclose the practice that Old CaraVita had started, and which continued after ALC took over the operations of the CaraVita Facilities, whereby the facilities permitted employees to live at the facilities and pay rent. There were also discussions with Mr. Fonstad about whether ALC could pay for apartments for employees that were travelling to the CaraVita Facilities. Mr. Fonstad provided his preliminary analysis in a January 19, 2009 e-mail.

With respect to Mr. Fonstad's January 19, 2009 e-mail, a number of important points support Ms. Bebo's position in this case. *First*, Mr. Fonstad's e-mail refers to Section 42.6 of the Lease with respect to "modifications" of the Lease but then informs Ms. Bebo and Mr. Buono that that provision is not directly on point. (Ex. 1046.) Mr. Fonstad never advises that the then-contemplated arrangement of renting to employees would require a formal modification pursuant to Section 42.6. (*See id.*) Rather, in both his e-mail and the template letter accompanying it, Mr. Fonstad advised Ms. Bebo that ALC seek "confirmation of [ALC's] interpretation of the lease" or to send a letter "confirm[ing] the understanding we reached about the interpretation of certain terms of the [Lease]." (*Id.*)

Second, there is no reference at all to Section 33 of the Lease with respect to providing a "notice" that would be required under the Lease. (*See id.*) Section 8.1.3 of the Lease prohibits any of the Tenants from entering into any transaction with any shareholder or affiliate of the Tenant, "except in the ordinary course of business and on terms that are fully disclosed to

Landlord in advance and are no less favorable to any Tenant than would be obtained in a comparable arm's-length transaction with an unrelated third party." (Ex. 1986, p. 22.) By its plain terms, Section 8.1.3 of the Lease does not require "notice" under the Lease. In fact, it does not even specify that disclosure to Ventas be in writing. Given the lack of any requirement of notice or even written communication for the disclosure required by Section 8.1.3, a court would interpret the provision as not requiring formal notice under the Lease. Indeed, by putting the disclosure in writing, ALC went beyond the requirements of Section 8.1.3 for disclosure of affiliated transactions.

Consequently, although he included a template letter with a place for Ventas to counter-sign, the advice contained in the e-mail reflects no requirement for this formality, and it is clear the Lease does not require it. Thus, the February 4 e-mail confirmation and acknowledgement of receipt of the e-mail accompanied by no objection on Ventas' part achieved the same result as the contemplated template letter (as Mr. Fonstad no doubt agreed since, as described below, Ms. Bebo sent him both the February 4 letter and the Ventas response).

Third, provided there was disclosure of the practice to Ventas, Mr. Fonstad concluded that having employees stay at the facilities and including employees in the covenant calculations would not violate the primary intended use provisions of the Lease. Section 7.2.1 of the Lease requires that each CaraVita Facility be used "solely for its Primary Intended Use (and shall not change, or consent to or acquiesce in the change of, such Primary Intended Use)." (Ex. 1986, p. 20.) Schedule 1.3 of the Lease designates each Facility for use as an independent living, assisted living, or Alzheimer's care facility. (Ex. 1986, p. 99.) Notably, there was flexibility imbedded in the Lease with respect to the Facilities' Primary Intended Use, given that the designations for seven of the eight facilities included Alzheimer's care, but those facilities never

held licenses or certificates to provide Alzheimer's care. Moreover, any facility licensed to provide assisted living could also house independent living residents, without any age restriction.

There is no dispute that ALC never changed the use of any of the Facilities from its "primary" use as an independent or assisted living facility and nothing related to the employee leasing arrangements resulted in ALC losing any required licenses or authorizations necessary to run those Facilities as required for their primary intended uses.

Section 7.2.1 also addresses the operations of the CaraVita Facilities more broadly. It states that ALC "shall operate each Facility in a manner consistent with its current operation as a quality healthcare facility…." (Ex. 1986, p. 20.) Sending employees to stay at the CaraVita Facilities in order to improve their operations, whether it be for sales, facility improvement, care improvement, evaluation of operations through mystery shopping, or evaluation of staffing needs, was consistent with the Facility operating as a "quality healthcare facility" and its primary intended use as an assisted or independent living facility. Indeed, ALC had employees routinely stay at all of its facilities - which is also a common industry practice.

Fourth, Mr. Fonstad clearly understood that the contemplated employees and family members would not be paying "rent," and the language of his January 19 e-mail and the subsequent e-mail to Mr. Solari must be viewed through this lens. Mr. Fonstad acknowledged that prior to preparing the e-mail, "there was a discussion where the idea was brought up that - of having employees stay at the facilities—if employees stayed at the facilities, they should be able to be included in the covenant calculations." (Fonstad, Tr. 1307.) Mr. Fonstad understood that ALC had a policy of having employees stay at their facilities when they travelled to them on business. This would be no different, except the rooms for the employees would be included in the covenant calculations. (Fonstad, Tr. 1550-51.) He understood that employees from various

different areas of the company were staying at the CaraVita Facilities, including regional management staff, marketing personnel, information technology personnel, finance personnel, facilities management. (Fonstad, Tr. 1306, 1551.) During this same conversation, Mr. Fonstad indicated that they discussed the possibility of including relatives of employees in the covenant calculations, and specifically he recalls "Laurie mentioning that her mother might stay at one of the facilities, in which case she thought that we should be able to include her in the calculations too." (Fonstad, Tr. 1318.) There is no evidence that Mr. Fonstad or anyone else at this time believed or understood that Ms. Bebo's mother or the other ALC employees travelling to the facilities would be paying rent in order to be included in the covenant calculations.

2. Mr. Fonstad's testimony that the January 19 e-mail was the end of his advice and involvement is not credible on its face.

The Division puts great emphasis on this e-mail - asserting Ms. Bebo disregarded his advice - but this assertion is based on Mr. Fonstad's false testimony that this was the end of his involvement. Rather, as demonstrated below, his January 19, 2009 e-mail was only the very beginning of his involvement. Based on voluminous documents and testimony from multiple witnesses, it was clearly established at the hearing that Mr. Fonstad, ALC's general counsel, was involved at every stage of the formation of the agreement and in many aspects of the implementation of ALC's use of units related to employees in the Ventas covenant calculations.

There are two possibilities with respect to Mr. Fonstad's inaccurate testimony, but what probably best explains Mr. Fonstad's incredible testimony is that it is not in his self-interest to remember any details about his involvement with respect to the inclusion of rooms related to employees in the Ventas covenant calculations. After all, this case involves a prosecution by the government alleging that ALC's disclosure about a legal matter for which Mr. Fonstad was responsible was false or misleading. Others at ALC relied on Mr. Fonstad being present for

discussions about the subject of including employees in the covenant calculations, including Mr. Lucey and Mr. Hokeness. As Mr. Lucey stated:

Q	It wasn't a specific provision that you thought [in-house counsel] knew best in the section in the 10-K or 10-Q?
A	Well, when it came to the financial numbers, they didn't really -- they weren't necessarily -- they didn't have any of the understanding, I guess, of the financial numbers as much, but all the other -- the transactions, covenants, a lot of it was language sometimes that appropriate -- appropriate language in certain cases, but that -- and then just overall, you know, just also an overall review of the document.
Q	In your opinion, would compliance with contractual agreements be one of the topics that in-house counsel would know best?
A	I would agree with that.
Q	And what about debt covenant compliance?
A	Yeah, I would say -- I would think that would be an area that -- that they would have knowledge in.
Q	And what about lease covenant compliance?
A	I would -- I would think that area as well.

(Lucey, Tr. 3689-90.)

First, he really cannot remember anything accurately, and has only remembered those facts that the Division wants him to remember, at the Division's insistence during the two meetings he had with Division attorneys prior to his investigative testimony and the two meetings after his investigative testimony but prior to his trial testimony. Second, he does remember the true facts that place him at the center of this case, but is lying because it is in his self-interest to do so. In either case, Mr. Fonstad (like most of the Division's other witnesses) was crafted by the Division itself and should not be credited.

Every other witness to testify in the case establishes that Mr. Fonstad was well-aware of ALC's use of employees to meet the covenant calculations:

- Mr. Hokeness:

Q	Does this refresh your recollection at all that based on your interactions with Mr. Fonstad between 2008 and the time he retired in 2010, it was your understanding that Mr. Fonstad knew ALC was including employees

	in the occupancy covenant calculations?
A	It's my understanding that Eric was present at some of the other meetings and discussions. I don't know what he -- he knows or didn't know at the time. I would have thought he had some knowledge, but I don't -- I can't point to a conversation.

(Hokeness, Tr. 3054-55.)

- Mr. Lucey:

Q	Just to be clear, were you comfortable with Mr. Buono's statement that ALC had an agreement with Ventas and that Ventas was fine with [including employees in the covenant calculations]?
A	I guess I just felt there were more people involved -- more people that knew more about the subject than I, so I let -- I was fine with Mr. Buono's comment. Other people knew more about it than I, so I didn't -- I guess I didn't object to the -- or didn't go further with that.
Q	When you say "other people," what people are you referring to?
A	You know, just the people in the -- other people in the room or on the [disclosure] committee. I guess I thought other people -- I assumed other people knew. I don't know that they did, but that was my -- that's what I thought.
Q	Did the presence of legal counsel at the disclosure committee meetings provide you with comfort regarding this?
A	In my mind, I thought people, you know, were generally aware, but I couldn't -- I guess couldn't be certain what they were aware of.
Q	My question specifically was, in your mind, did having legal counsel present in the room provide you some sort of comfort about this issue?
A	Yes.

(Lucey, Tr. 3703-04.)

- Mr. Fonstad was on the January 20, 2009 call with Mr. Solari (Buono, Tr. 2343); helped draft the February 4, 2009 e-mail to Mr. Solari (Buono, Tr. 2354, 2468); and advised Mr. Buono in discussions during 2009 or 2010 that rental of rooms to employees or individuals for use in the covenant calculations was "kosher." (Buono, Tr. 4651-53.)

- Kathy Bucholtz testified that Mr. Fonstad was present for the call with Mr. Solari, and assisted in drafting the follow-up e-mail to Mr. Solari. (Bucholtz, Tr. 2939-41, 2951.)

- Joy Zaffke testified that Mr. Fonstad was present for the call with Mr. Solari. (Zaffke, Tr. 3217-18.)

C. Mr. Solari agrees that ALC could pay for apartments for people with a reason to go to the CaraVita Facilities during a January 20, 2009 telephone call.

ALC scheduled a call for January 20, 2009 with Mr. Solari. As described above, Mr. Solari acted as the principal relationship manager for the Ventas/ALC relationship, and it was reasonable for ALC to rely on his authority in connection with the Lease. (Solari, Tr. 444-45.) He had at least "apparent" authority to bind Ventas. Ms. Bebo believed she had a good working relationship with Mr. Solari. (Bebo, Tr. 4001.)

Based on discussions among Ms. Bebo, Mr. Buono, Mr. Fonstad, and Mr. Hokeness, Ms. Bebo had decided to discuss two principal matters during the January 20 call with Mr. Solari: the opportunity to partner with a hospice company at the Peachtree Estates Facility, and ALC paying for apartments for employees or others with a reason to go to the CaraVita Facilities. Ms. Bebo, Mr. Buono and Mr. Fonstad met prior to the call to discuss their approach, and Mr. Fonstad provided some handwritten talking points to Ms. Bebo. (Bebo, Tr. 3997-99.) Just prior to the call, Ms. Bebo was in a meeting in her office with ALC's Vice President of Sales and Marketing, Kathy Bucholtz, to make occupancy calls to various regions in the company. (Bucholtz, Tr. 2939-40.) Ms. Bucholtz left Ms. Bebo's office around the time that the call with Mr. Solari was scheduled to begin, and Mr. Buono and Mr. Fonstad went into Ms. Bebo's office for the call. (*Id.*) Joy Zaffke, Ms. Bebo's administrative assistant also observed Mr. Fonstad being present for the call. (Zaffke, Tr. 3218.)

Ms. Bebo testified extensively about her recollection of the call with Mr. Solari, which is only summarized here. (*See* Bebo, Tr. 4002-07.) The call took place on January 20, 2009 by teleconference on a speakerphone in Ms. Bebo's office. (Bebo, Tr. 4002.) Ms. Bebo, Mr. Buono and Mr. Fonstad participated from Ms. Bebo's office. (Bebo, Tr. 1902.) Mr. Solari was the only participant from Ventas. It lasted approximately 30 minutes. (*Id.*)

During the call, Ms. Bebo told Mr. Solari that ALC had identified a few employees who had been renting units at the CaraVita Facilities that carried over from Old CaraVita. (Bebo, Tr. 1903.) Mr. Solari indicated he had no issue with the fact that employees had been living at the Facilities and included in the covenant calculations. (Bebo, Tr. 1903-04.) Mr. Solari indicated he was not aware of that, but did not think it was a problem. (*Id.*)

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

Ms. Bebo asked Mr. Solari a question to the effect of, "Do you care how many?" And Mr. Solari indicated he did not care. (Bebo, Tr. 1909.) Ms. Bebo asked if Ventas wanted these apartments broken out separately in the reporting, and Mr. Solari indicated Ventas did not. (Bebo, Tr. 1912-13.) Ms. Bebo's hand-written notes of the telephone call indicate Mr. Solari did not impose a cap on the number of units ALC would rent for employees that could be included in the covenant calculations. (G. Bebo, Tr. 3273-74.)

They discussed the rate at which ALC should pay for the apartments. Ms. Bebo testified: "I asked Mr. Solari what rate ALC should pay for the apartments. And he indicated that it should be, like, an arm's-length, third-party transaction, and it would be at the market rate." (Bebo, Tr. 1908-09.) Mr. Solari asked about the types of people covered by the arrangement,

and Ms. Bebo indicated that the arrangement would be permissible as long as it was in the ordinary course of business, which Ms. Bebo was told by Mr. Solari meant that ALC should charge regular market rates and it should be limited to employees or other people whose backgrounds were familiar to ALC and who ALC was comfortable being present at the Facilities. (Bebo, Tr. 4004.)

1. Mr. Buono's testimony corroborated the existence of an agreement reached during the January 20 phone call.

Mr. Buono's version of events has evolved from the time of his testimony in the investigation phase of this case, after the Division lawyers inappropriately told Mr. Buono that Ms. Bebo had "thrown him under the bus" while simultaneously depriving him of the ability to review her transcript. (Buono, Tr. 2434-35, 2490-91.) It is also clear that the approximately sixty hours of meetings with the Division staff have inappropriately colored his memory of the facts, his perception of what understanding ALC reached with Ventas, and the scope of his role in the process.

For example, in his sworn investigative testimony, Mr. Buono testified that Mr. Fonstad was present for the call with Mr. Solari on January 20. (Buono, Tr. 2343, 2781-82.) Later, after seeking to enter the SEC's cooperation program where he understood he would answer the Division's questions truthfully and "offer things to help them" (*See* Buono, Tr. 2432-33) and participating in hours of sessions where the Division crafted his trial testimony, Mr. Buono could no longer remember Mr. Fonstad being present on the call with Mr. Solari as described in the following discourse:

Q	I want to talk a little bit about your recollections of Mr. Fonstad being in the January 20 -- being present in the room for the January 20, 2009 call with Mr. Solari. You once testified that you believed he was there; correct?
A	Yes.

Q	And now your recollection is that he was not there; is that correct?
A	My recollection is I can't remember if he was there or not.
	JUDGE ELLIOT: Three more questions, Mr. Cameli.
	BY MR. CAMELI:
Q	Now, would it help you -- your recollection if I told you that approximately four months after your testimony, you told the SEC that Mr. Fonstad was present during that call?
A	I've told you that I told him. I agree that I told him, but I just do not recall.
Q	That does not refresh your recollection?
A	*No matter what you do or say, I'm not going to remember if Eric was in that room.*

(Buono, Tr. 2781-82 (emphasis added).)

With respect to what was discussed on the call with Mr. Solari, Mr. Buono was inconsistent. On cross-examination, he acknowledged that, based on the phone call, it was his understanding that Mr. Solari agreed that employees could stay at the CaraVita Facilities in lieu of staying at hotels in the area, and that ALC would pay for apartments to be used by those employees:

Q	Now, based on the January 20, 2009 call with Mr. Solari, you understood that employees would be staying at the properties in lieu of hotels; is that right?
A	Yes.
Q	And also that the apartment at the property would be paid directly by ALC; is that right?
A	Yes.

(Buono, Tr. 4656-57.) Mr. Solari was not concerned about this type of arrangement. (Buono, Tr. 4657, 4658-59.) Of course, Mr. Buono could only have that understanding based on the phone call if those matters were discussed. Yet, Mr. Buono then took the incredible position that those matters somehow were not discussed, and he was impeached with his prior testimony. (Buono, Tr. 4658-59.)

Other than these facts, Mr. Buono appears to have almost no recollection of the details of what was discussed during the approximately thirty minute phone call. The sum and substance of his recollection of the call is the following statement on direct:

Q	What was discussed on that phone call?
A	We discussed the hospice situation and the -- our desire to modify the lease to allow us to include leasing to a hospice company and discussed the fact that the prior operator had employees staying at the facilities and that we desired to do the same.

(Buono, Tr. 2344.)

Mr. Buono continued, testifying that, at the time, he believed that ALC did have an agreement with respect to how they subsequently proceeded, but that it changed after his numerous meetings with the Division:

Q	Okay. So let's start with an understanding that Ventas is aware of this treatment and has so approved. Was that your understanding in 2009?
A	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.
Q	And that is not your -- today your understanding is different, though.
A	Today I'm struggling with that for a few reasons. One is that we never set covenant calculations. I believe I read Joe Solari's testimony from the SEC from back -- I don't know when -- and he doesn't agree that that's it, and he's the guy who needs to agree; and the other issue is we got beyond employees that were staying there as discussed in the previous paragraph.

(Buono, Tr. 2489-90.) Similarly, in response to questions from the Court about the follow-up e-mail sent to Mr. Solari, Mr. Buono acknowledged that from 2009 to 2012 it constituted an agreement with Ventas governing how ALC proceeded during that time period, but his impression has changed based on his interaction with the Division attorneys: "So there's been additional information after that time [May 8, 2012] that would lead me to believe that maybe this [Solari e-mail] *wasn't as good of an agreement as we would have hoped*." (Buono, Tr. 4645.)

2. Mr. Solari cannot remember the substance of the call, and his other testimony, scripted by the Division, was not credible.

For Mr. Solari's part, he has no recollection of the substance of the January 20 call, at least that is what he stated several times in response to various different inquiries prior to the hearing. For example, in connection with ALC's 2012 internal investigation conducted by Milbank, Mr. Solari was asked by Ventas' lawyer what he could remember from the call. Mr. Solari told Ventas' counsel - as relayed to Milbank - that he could not dispute Ms. Bebo's recollection of it. (Robinson, Tr. 3480; Ex. 1879, p. 4 ("He was unable to deny the Bebo representation of his approval.").) Similarly, when Ms. Bebo's counsel interviewed Mr. Solari in the Fall of 2013, and when Mr. Solari testified under oath in the Division's investigation of these matters, he stated he simply could not recall any detail of the call and therefore could not dispute her recollection of it. (Solari, Tr. 449-52.) And when shown Ms. Bebo's February 4, 2009 e-mail during the investigation, Mr. Solari testified that it did not refresh his recollection. (*See* Solari, Tr. 449-50.)

At trial, Mr. Solari asserted that he now remembered the following with respect to the thirty minute phone call:

A	I don't recall a lot of specifics about that phone conversation, but I do recall discussing two general topics with Ms. Bebo and Mr. Buono and that was the leasing of certain units at one of the facilities to a hospice company, a hospice provider, and the other topic was whether certain corporate employees from Assisted Living Concepts, while traveling to those facilities on business, could stay in vacant units rather than in a hotel.

(Solari, Tr. 414.) He acknowledged that he was primarily in "listening mode," while Ms. Bebo did most of the talking. (Solari, Tr. 450.)

In light of Mr. Solari's failed memory of this telephone conversation and virtually every other pertinent discussion with ALC personnel,[23] his recitation of the scripted denials with respect to various aspects of Ms. Bebo's recollection of the call is inadmissible and should be given no weight. On at least ten occasions during his direct examination, Mr. Solari recited the answer written for him by the Division to the effect of: "I would never agree to such a thing, and I didn't have the authority to agree to it." (*See, e.g.,* Solari, Tr. 416, 417, 418, 419, 420, 422, 423.) What he "would" have done based on Ventas' routine practice is irrelevant, as this Court ruled before trial with respect to the subpoena served on Ventas. And whether Mr. Solari had actual authority to agree to something is also irrelevant where all of the witnesses testified that Mr. Solari was a senior executive with apparent authority to negotiate leases and lease terms.

It is not surprising that Ms. Bebo has a much greater recollection of the call than Mr. Solari. She had to explain what occurred on the call numerous times from 2009 to 2012—to board members, to other ALC employees, to ALC's independent auditors, and others. And, as outlined below, she reviewed her notes of the call in 2012.

D. Ms. Bebo sends a confirmatory e-mail to Mr. Solari regarding employee leasing and Ventas makes no objection to the arrangement.

1. Internal ALC discussions immediately following the call.

After hanging up with Mr. Solari, Ms. Bebo, Mr. Buono and Mr. Fonstad discussed what had transpired during the call and how ALC should proceed. (Bebo, Tr. 1924.) During this meeting Mr. Fonstad "agreed that [the parties] had come to an understanding of ambiguous terms

[23] Indeed, Mr. Solari's memory is lacking with respect to a number of ALC-related matters: he acknowledged his initial recollection of the lease negotiations being short was erroneous (Solari, Tr. 458-59); he could not recall substance of meeting he attended with the CEO of Ventas, Ms. Bebo, and Mr. Buono in November 2008 (Solari, Tr. 413, 446-47); he did not recall internal discussions at Ventas about ALC having occupancy issues in the Fall of 2008 (Solari, Tr. 447-48); Mr. Solari also could not recall an earlier call in January with Mr. Buono about some other properties (Solari, Tr. 449); he does not recall the February 25, 2009 call with Ms. Bebo to discuss potential acquisition of New Mexico properties (Solari, Tr. 456-57); and he also could not recall what he said during his 2013 interview with Reinhart (Solari, Tr. 450-51).

within the lease, and that Mr. Solari was agreeable to us including apartments that ALC would pay for people that have a reason to go in the covenant calculations." (Bebo, Tr. 1925.) Specifically, Mr. Fonstad agreed that the practice of ALC paying for apartments for people with a reason to go would be appropriate under the lease and that ALC had met its obligations to provide notice of an affiliate transaction. (Bebo, Tr. 1924-25.) In the words of Mr. Buono, Mr. Fonstad agreed that including employees in the covenant calculations was "kosher." (Buono, Tr. 4651-53.)

The mood among the group was very positive coming out of the call. (Bucholtz, Tr. 2941.) They felt that they had obtained a very flexible agreement that would make it very easy for ALC to comply with the financial covenants. (*See* Bebo, Tr. 4028-29.) Specifically, they "talked about the fact that it was pretty amazing that Mr. Solari wasn't going to put a limit on the number of apartments that ALC would pay for," and which could therefore be utilized in the covenant calculations. (Bebo, Tr. 1926-27, 1928-29.) When the group left Ms. Bebo's office, they discussed the call with ALC's head of sales and marketing, Kathy Bucholtz. (Bucholtz, Tr. 2940-41; Bebo, Tr. 4027-29.) They informed Ms. Bucholtz that Mr. Solari had agreed that ALC could "count employees in the occupancy." (Bucholtz, Tr. 2940-41.) They also indicated that they would consult with the Board of Directors, and seek the Board's approval. (Bucholtz, Tr. 3014-16.)

2. Preparation of the Solari e-mail.

During the call, the parties agreed that ALC would send a follow-up e-mail to Mr. Solari. (Bebo, Tr. 1930-31.) Ms. Bebo, Mr. Buono and Mr. Fonstad decided that this e-mail would also include a discussion of employee leasing. (Bebo, Tr. 1931-32.) In addition, Mr. Fonstad no longer felt it necessary to send the more formal letter appended to his January 19 e-mail. (Bebo, Tr. 1936.) Rather, a confirmatory writing by e-mail would suffice.

Ms. Bebo was supposed to prepare the draft e-mail for Mr. Buono and Mr. Fonstad to review, but she became involved in other operational issues. (Bebo, Tr. 1930-32; Ex. 1319; Ex. 1328.) Mr. Buono and Mr. Fonstad instead took the lead in preparing the draft e-mail to Mr. Solari. (Buono, Tr. 2354, 2468, 2756-57; Bebo, Tr. 1931-32; Ex. 1320 and 1320A.) They prepared the draft, sent it to Ms. Bebo, and then discussed among themselves and with Kathy Bucholtz. (Bebo, Tr. 1931-32; Bucholtz, Tr. 2951-52.) In discussing the draft, the group talked about their understanding of the scope of the agreement with Mr. Solari. Ms. Bucholtz indicated that they discussed:

> Joe Solari -- as I understood it, Joe Solari, and Laurie, and John had agreed that employees and family members could stay in our respite apartments. They just had to be -- have a -- you know, be good people, not put any of our residents in jeopardy, just -- you know, we couldn't just let any old person stay there. *It had to be a person that had a reason to go to the property*.

(Bucholtz, Tr. 2952-53 (emphasis added).)

3. Disclosure of ALC "rentals related to employees" in the February 4, 2009 Solari e-mail.

Consistent with the January 20 call, Ms. Bebo's February 4 e-mail mostly covered the hospice proposal. (*See* Bebo, Tr. 1914 more time spent on hospice discussion); Ex. 1334.) One paragraph addressed the employee leasing arrangement. (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 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.*)

The Division contends that the e-mail is deficient because it fails to specifically state that room rentals related to employees would be included in the covenant calculations. Placed in the appropriate factual context, however, this is irrelevant. As Mr. 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 Mr. Solari], that they wouldn't -- why would we do it otherwise is the question." (Buono, Tr. 2487-88.) And Ventas' head of asset management testified that, going back to August of 2008, Ventas was in a "heightened state of alert on the ALC portfolio" with respect to covenant compliance. (Doman, Tr. 258.)

The Division also complains that the e-mail refers to rentals *to* employees instead of rentals *for* employee use. The Division's own witnesses dispel the importance of this minute distinction. First, Mr. Buono, the person who principally drafted the e-mail along with Mr. Fonstad, testified that he would not make a distinction between a statement describing rentals to employees versus rentals for employees. (Buono, Tr. 2469.) Second, as described below, Ventas was not confused about the confirmation contained in the e-mail, but unbeknownst to Ms. Bebo and ALC, simply "disregarded" the confirmation because it was not a "formal request" under Section 33 of the Lease. (*See* Doman, Tr. 254.) Moreover, the Division's position ignores the broader language describing "rentals related to employees," and ignores the fact that everyone associated with the Milbank investigation continued to describe ALC's process in management representation letters and elsewhere as treating rentals *to* employees as bona fide rentals to third parties. (Ex. 1627, 1628.)

4. Ventas acknowledges receipt of ALC's written confirmation of unit rentals related to employees, but otherwise fails to object or respond.

Upon receiving the e-mail, Mr. Solari forwarded it to Mr. Doman, the senior executive in charge of Ventas' asset management function, Mr. Johnson, an asset manager assigned to ALC's account, and Joseph Sims, an analyst assigned to the ALC account. (Ex. 3376; Solari, Tr. 452-53; Doman, Tr. 191-92 (describing roles and responsibilities).) *Thus, every senior executive and key Ventas employee with direct responsibility for the CaraVita Facilities and the Lease was aware of ALC's confirmation of the company leasing rooms related to employees as*

occupants. Mr. Solari also responded back to Ms. Bebo's e-mail indicating Bill Johnson would be following up on any issues related to it. (Ex. 1335.) Mr. Solari raised no concern with any part of its content. (*Id.*)

The February 4, 2009 e-mail clearly put Ventas on notice regarding employee leasing by ALC. The e-mail states that it is "confirming" ALC's "notification" of employee leasing. From the text of the e-mail, it should have been clear to Ventas that ALC was notifying it of actual employee leasing rather than a proposal to further discuss the topic. The text of the February 4, 2009 e-mail is not inconsistent with ALC paying for rooms that were available for employees. It is described as "our rental" of rooms to employees as occupants of the Tenant and "rentals related to employees." Other than ordinary course terms, there is no limit on the scope or operation of employee leasing in the e-mail. (Ex. 1334.)

From Ventas' perspective, it should not have mattered whether employees paid the rent to lease units or ALC paid the rent to have units used by or available to employees. In either case, these units would not continue to be occupied at the end of the lease term or if Ventas otherwise took over operation of the properties. If Ventas was really concerned about employee leasing, the Solari call and February 4 e-mail were sufficient to trigger questions.

And in Mr. Solari's view, it did trigger some concerns. He testified that the e-mail appeared to be broader in terms of ALC renting rooms related to employees (Solari, Tr. 426-27; Ex. 184)—*with the obvious implication that any rentals would be counted in the covenant calculations*—than his recollection of the discussion on the phone call. It "confused" him a little bit. (Solari, Tr. 426.) However, he acknowledges he did not object or respond to Ms. Bebo in any fashion about this issue because he "wanted to bring the asset management department into the conversation." (Solari, Tr. 427.) He did not know whether anyone from asset management

actually followed-up, and he never discussed the issue or the January 20 telephone call with anyone at Ventas. (Solari, Tr. 428-29, 453; Doman, Tr. 215.)

Unbeknownst to ALC, Mr. Doman and his asset management team appears to have entirely disregarded this aspect of the e-mail because it was not a "formal request," although his testimony is inconsistent in this regard as well. At first, Mr. Doman indicated he ignored that part of the e-mail because "it did not meet the lease provisions for doing what Laurie was requesting that she wanted to do." (Doman, Tr. 252-53.) On the same page of the transcript, Mr. Doman then concedes that the e-mail could be construed as a "formal request," but "if it was a formal request, I would have expected it to be in compliance with the lease and probably stated in a different e-mail" separate from the hospice discussion.[24] (Doman, Tr. 253.) Mr. Doman was essentially unable to answer simple questions about what he did in response to receiving the e-mail:

Q	...So either you read the e-mail and you just missed this paragraph, or you read the paragraph of the e-mail about rentals related to employees, and you just didn't care because it wasn't a formal request that you thought was required under the lease. That's my understanding of your testimony. Is that fair?
A	Can you restate?
Q	Yes. Either you read the paragraph of the e-mail and you missed it, or you read the paragraph of the e-mail rentals related to employees, and you just didn't care because it wasn't a formal request?
A	No, it's not that I didn't care is that it's the tenant's responsibility to comply with the lease and give us a formal request for things that they need approved under the terms of the lease.
Q	So you disregarded that part of the e-mail; is that fair?

[24] On direct examination, Mr. Doman indicated that thought he read the e-mail but does not specifically recall reading it. (Doman, Tr. 212.) Then he claimed that the e-mail was deficient because it did not comply with the provisions of the Lease governing affiliated transaction disclosure. He provided a (wrong) legal opinion that what is proposed in the e-mail does not count as ordinary course and was not arm's length. (Doman, Tr. 212-14.) Mr. Doman never sought legal advice on this issue apparently, and his interpretation of the Lease is simply incorrect. ALC was notifying Ventas of rentals at the properties related to employees, and confirming the terms of those rentals would be comparable to other arm's length, ordinary course transactions. (*See* Buono, Tr. 2470.) That is all the Lease requires, and was the basic advice provided by Mr. Fonstad to ALC and Ms. Bebo.

A	I did not take that as a formal request under the -- as she laid it out in the e-mail for what we required under the terms of the lease.

(Doman, Tr. 254.) Mr. Doman could provide no explanation for why Mr. Johnson, Mr. Sims, and Mr. Solari did not respond or take any other action with respect to ALC's confirmation of its rental of units related to employees. (Doman, Tr. 255-56.) He does not know whether, they too disregarded the e-mail because it was not a formal request, whether they missed the part of the e-mail about ALC's rental of rooms to employees, or some other reaction. (*Id.*)

About one week later, on February 12-13, 2009 two things happened. First, Ventas had received ALC's 2008 fourth quarter compliance package. (Ex. 32.) On February 13, the asset manager, Bill Johnson, tells Mr. Doman and others that he anticipates that ALC would default on the covenants during the first quarter. (Doman, Tr. 217-18; Ex. 194) And so Mr. Doman stated that Ventas was on "a more heightened state of alert" in terms of monitoring ALC and the covenants. (Doman, Tr. 218-19.) Again, it is obvious in this context that ALC was confirming rentals related to employees so they could include them in the covenant calculations. As John Buono testified: Why else would they be doing it?

The very same day, Mr. Doman received a copy of Mr. Johnson's response to Ms. Bebo's February 4, 2009 e-mail confirming ALC's notification of rentals related to employees at the CaraVita Facilities. (Ex. 1343.) This is the third time that Mr. Doman received a copy of that disclosure. The e-mail sets forth no objection to the employee leasing subject (it is totally silent on the subject) and states Ventas would like to set up a call to discuss the hospice opportunity. (Ex. 1343; 3377.)

Subsequently, there was a call set up with Mr. Johnson in response to his February 13 e-mail, involving multiple representatives from ALC and Ventas. (Bebo, Tr. 4044-45.) During the call, the parties essentially went through Ms. Bebo's February 4 e-mail to Mr. Solari

point-by-point with respect to the hospice issue. (*Id.*) However, Ventas again raised no questions, issues, or concerns about ALC's confirmation of its notification of rentals at the properties related to employees. (*Id.*) Ms. Bebo described her thinking following that conversation:

Q	Did you receive, either in writing or any other way, any information from Ventas objecting to or raising issues with your February 4 e-mail to Mr. Solari?
A	No, we never did. And the fact that the e-mail, you know, that comes back from Mr. Johnson obviously includes other people at Ventas gives myself, Mr. Buono, Mr. Fonstad reassurances that, well, nobody else is raising any issue about this either. Mr. -- we certainly felt that Mr. Solari had obviously briefed his team members about it, and the fact that we were getting an e-mail back that showed other people that were on the Ventas team with Mr. Solari as having seen the e-mail correspondence, and that then we had a follow-up call about this hospice situation, and all these team members are on a call and we're going through an e-mail -- we're going through the e-mail that we sent to them, the follow-up e-mail, you know, item by item, they clearly have the e-mail, you know, they clearly have the e-mail in front of them, we're going through this, nobody even asks about, and what did you mean by this second last paragraph? I feel that they were informed, that they had talked with Mr. Solari about it. Mr. Doman, as an example, is just not very shy about asking questions, and nothing comes up.

(Bebo, Tr. 4044-45.)

In the end, from the perspective of ALC and Ms. Bebo, numerous Ventas executives with direct responsibility for management of the portfolio and compliance with the Lease received the e-mail, *yet none asked any questions or raised any issues about it at that time or any other time*. (Doman, Tr. 353-54; Solari, Tr. 427-29.) In discussing this February 13 response to ALC, Mr. Doman testified as follows:

Q	Now, if we could go to the second page of Exhibit 3377. So that's Ms. Bebo's e-mail to Mr. Solari on February 4th, 2009. That includes that disclosure of rentals related to employees, correct?

A	In the second-to-last paragraph, that's what she is stating.
	…
Q	And then in the e-mail -- the final e-mail that Mr. Johnson sends with a copy to you, he indicates, Laurie and/or John, can we schedule a call next week for our group to hear more about this opportunity that ALC would like to pursue at Peachtree Estates? Please provide a few different dates, times, and I'll coordinate our team. Is that what he writes there?
A	Yes, he's talking about the sublease opportunity.
Q	Okay. And so he doesn't respond to the other issue of rentals related to employees; is that right?
A	Not that I'm aware.
Q	To your knowledge, Ventas never responded to ALC with respect to their confirmation of notification of rentals of rooms to employees; is that right?
	…
A	It wasn't a permitted request, so I don't think we responded to it.

(Doman, Tr. 352-54.)

Mr. Doman's explanation defies common sense. First, there was no request with respect to the rentals related to employees—the e-mail states that ALC was confirming the prior notification on the phone call of ALC's rentals of rooms related to employees. Second, any reasonable person in Ventas' shoes would have objected to ALC's confirmation of room rentals related to employees if it did indeed think such a practice would be improper. Silence in response to a notice confirming a conversation or practice is generally construed as assent. Rather, Ventas' actions in failing to question or object to the practice are entirely consistent with providing flexibility on the covenants in light of the fact that there was no risk of ALC's non-payment of rent and the fact that Ventas' primary focus in operating its business at this time was on generating liquidity and cash coming into the company (as stated in their SEC filings at the time and in statements to ALC). (*See, e.g.*, Ex. 2109, p. 4 (Ventas Chairman's letter: "We kept our single-minded focus on building liquidity and enhancing our financial strength and

flexibility.").) It would be contrary to that operational focus to pull the plug on an operator that was flush with cash and liquidity and presented no risk of non-payment.

In any event, what Ventas personnel thought, but did not express to ALC, and how they "would have" viewed the e-mail had they focused on it is irrelevant. The fact is that any reasonable person in management at ALC would have concluded that ALC and Ventas had an understanding regarding the effect of the employee leasing arrangement under the Lease. Ms. Bebo genuinely and reasonably believed the same, as her testimony confirmed:

Q	And you took the fact that Ventas never responded to your notification of renting rooms to employees as a sign that Ventas had agreed to allow ALC to include employees in the covenant calculations.
A	…With regard to the understanding with Ventas, that takes place on the call with Mr. Solari. If I understand your question, I was not -- I was not further asking for their approval with regard to ALC paying for apartments and including it in the covenant calcs. I did notify them of that understanding that we came to on the phone. They did not respond back with any questions, comments, or disagreement as it relates to that understanding that Mr. Solari and I had on the call.
Q	And you took the fact that [Ventas] didn't respond to confirm your understanding of the agreement you had reached with Mr. Solari.
A	I believe that since Mr. Solari forwarded this to other people within Ventas, that it certainly indicated that he had a discussion with them, and no one else had any other concerns about it as well.

(Bebo, Tr. 1937-38.) As set forth below, Ms. Bebo's subsequent conduct and statements while at ALC were consistent with that belief.

E. Mr. Fonstad approves ALC's disclosure about Ventas lease compliance in February 2009.

It is indisputable that Mr. Fonstad continued to be involved in every step of ALC's decision to pursue the employee leasing practice. At 3:31 p.m. on February 5, 2009, Ms. Bebo forwarded the e-mail she had sent to Mr. Solari the day before which confirmed ALC's rental of rooms related to employees at the CaraVita Facilities. (Ex. 1171, p. 2.) Mr. Fonstad read the

e-mail and considered it important enough to print the e-mail for his files. (Fonstad, Tr. 1558-59; 1530-31.) One minute later, Ms. Bebo forwarded Ventas' response to her e-mail. (Ex. 1171, p. 1.) Mr. Fonstad read this e-mail and decided it was important enough to print the e-mail for his files. (Fonstad, Tr. 1558-60 (would read e-mails from CEO in the normal course); 1530-31.) He did not have a printer in his office, so he had to get up and retrieve the e-mails off the printer in the hallway. (Fonstad, Tr. 1529 (he maintained a paper copy file related to Ventas issues); 1530-31 (he printed important e-mails, not all his e-mails); 1559 (printers outside Mr. Fonstad's office).)

Despite knowing he received these e-mails, Mr. Fonstad falsely testified that he had no idea one way or another whether the phone call on January 20th ever occurred. (Fonstad, Tr. 1507, 1555-56.)

Around this same time period, Mr. Fonstad participated in a meeting with Ms. Bebo, Mr. Buono and Mr. Hokeness. (Bebo, Tr. 4046-47.) Mr. Hokeness prepared a memorandum to Mr. Fonstad, Mr. Buono, and Ms. Bebo based on his understanding of the current status of the inclusion of rentals related to employees in the Ventas covenant calculations. (Hokeness, Tr. 3048-49; Ex. 1129 (February 9, 2009 memorandum).) Ms. Bebo described the circumstances that resulted in Mr. Hokeness' preparation of the memorandum:

Q	Excuse me, of the memo [Ex. 1129]? I believe it's a memo.
A	Yes.
Q	And who did you receive it from?
A	Mr. Hokeness. After Mr. Fonstad, Mr. Buono, Mr. Hokeness and myself had a discussion about the Solari call and the understanding that we had come to, we talked about the fact that for the fourth quarter of 2008, I was not looking for board approval to utilize the employees that had actually stayed at the property and that this was a process that we're going to go through for the fourth quarter of 2008. I told Mr. Hokeness that I would still be following up with Mr. Rhinelander and working through a process for Mr. Hennigar and/or

	the board to, you know, weigh in on this practice. That we explained to Mr. Hokeness, if the board does approve, that we'll have a different practice for the 2009 forward time frame. Mr. Hokeness had done this piece of write-up for the audit for fourth quarter for 2008, and he told me that, here is a copy of it, if I had any changes, he indicated that he was going to give a copy to Mr. Fonstad and Mr. Buono, gave me a copy, said if we had any changes, to get back with him, or this was, you know, part of the audit files.

(Bebo, Tr. 4046-47.)[25]

Then on February 13, 2009—only five days after the date of Mr. Hokeness' memorandum, and only eight days after Ms. Bebo sent Mr. Fonstad her e-mail to Mr. Solari and his response—the ALC disclosure committee met to discuss the disclosures in ALC's 2008 annual report on Form 10-K. (Ex. 124.) As with all disclosure committee meetings from 2009 to 2010, Mr. Fonstad acted as chairman of the meeting and Mr. Hokeness acted as secretary and prepared the minutes. (*Id.*)

During that meeting, the minutes indicate that Mr. Buono reported that "Ventas lease covenants continue to be monitored and correspondence between ALC and Ventas has occurred whereby the covenant calculations have been clarified as to census." (Ex. 124, p. 3.) Mr. Fonstad testified that he can recall "nothing" about what was discussed and claimed he did not know what the reference to correspondence with Ventas meant (Fonstad, Tr. 1570-71), but in context, it is indisputably a reference to the Solari e-mail and the ability to include rooms rentals related to employees in the covenant calculations.

Mr. Fonstad's testimony on direct that he was never told that ALC had started using employees to meet the Ventas lease covenants and that employees were being used to meet the

[25] Mr. Hokeness does not believe that he circulated the memorandum, and Mr. Buono and Mr. Fonstad do not recall receiving it. (Hokeness, Tr. 3052; Buono, Tr. 2358; Fonstad, Tr. 1512.) Mr. Hokeness acknowledged that, although it was his typical practice to circulate memoranda by e-mail, he did circulate paper hard copies of memoranda from time to time. (Hokeness, Tr. 3052-53.)

occupancy and coverage covenants (Fonstad, Tr. 1508.) is also demonstrably false. As set forth in more detail below, Mr. Fonstad was told these exact things by Mr. Buono at this disclosure committee meeting and at every subsequent disclosure committee meeting in 2009 and early 2010.

On February 19, 2009—six days after the disclosure committee meeting where the Solari e-mail and the inclusion of employees in the covenant calculations was discussed—Mr. Lucey sought Mr. Fonstad's legal advice with respect to the exact disclosure that the Division contends was false or misleading in ALC's 2008 10-K and in every subsequent disclosure:

Eric,

Please review this new paragraph on the CaraVita lease in the 10-K

I'm sure I do not have the correct legal entity for Ventas

Thanks

Lease agreement with Ventas

On January 1, 2008, ALC acquired the operations of eight assisted and independent living residences consisting of a total of 541 leased units for a purchase price including fees and expenses of $14.8 million. The lease has an initial term expiring in March 2015 with four five-year renewal options. The aggregate minimum rent payments for the remaining initial lease term with Ventas for the calendar years 2009 through 2015 are $5.1 million, $5.2 million, $5.3 million, $5.5 million, $5.6 million, $5.7 million and $1.4 million (three months), respectively. The minimum rent will increase by 2.5% over the prior year's minimum rent for each of the calendar years 2009 through 2015. Annual minimum rents for the first, second and third renewal terms will increase by X%, X% and X%, respectively. The final 5 year renewal increase is subject to negotiation. In accordance with FASB Technical Bulletin 85-3, ALC accounts for the effect of scheduled rent increases on a straight-line basis over the lease term.

In connection with the assumed lease, the Company guarantees certain quarterly minimum occupancy levels and are subject to net worth, minimum capital expenditure requirements per residence, per annum and minimum fixed charge coverage ratios. Failure to comply with these covenants could result in an event of default under the lease. <u>At December 31, 2008, ALC was in compliance with all covenants.</u>

(Ex. 1057 (emphasis added).) Like Mr. Lucey, Ms. Bebo specifically asked Mr. Fonstad to advise ALC whether any disclosures in ALC's 10-K's or 10-Q's needed to be changed in light of the changing circumstances. He indicated no changes were necessary. (Bebo, Tr. 1929-30.)

Mr. Fonstad, of course, does not have any recollection of what advice he gave ALC, Mr. Lucey, or Ms. Bebo. (Fonstad, Tr. 1580.) However, he testified that he believed that the

statement that ALC was in compliance with the covenants was appropriate under the circumstances, and he never advised Mr. Lucey or anyone else at ALC to modify its disclosures about the Ventas lease as a result of the February 4th e mail to Mr. Solari about rentals related to employees, or ALC's communications with Ventas about requests for covenant relief. (Fonstad, Tr. 1580-82.)

X. ALC'S IMPLEMENTATION OF THE EMPLOYEE LEASING ARRANGEMENT.

After the January 20 call and the February 4 e-mail, ALC took steps to implement the understanding reached with Mr. Solari on the call. ALC did not proceed with other options for compliance with the occupancy and coverage ratio covenants in the Lease, including unilaterally removing 10% of the units from the count or calculating the occupancy rate using the ratio of people to units, because ALC believed it had an agreement with Ventas regarding employee leasing. (*See, e.g.*, Bebo, Tr. 4560-61, 3985-86.)

A. Ms. Bebo discusses the Solari call with Mr. Rhinelander and ALC begins including a small number of rooms paid for by ALC in the compliance information provided to Ventas in February 2009.

Before implementing the employee leasing arrangement, Ms. Bebo discussed the arrangement with Mel Rhinelander, Vice Chairman of ALC's Board of Directors, on at least two occasions. First, Ms. Bebo called Mr. Rhinelander on January 21, 2009—the day after she, Mr. Buono, and Mr. Fonstad had the call with Mr. Solari. (Bebo, Tr. 1955, 4029-30; Ex. 2138, p. 4; Exs. 2092, 2094.) She spoke with Mr. Rhinelander for 47 minutes. (Ex. 2138, p. 4.) During that call she relayed to him what had been discussed on the call with Mr. Solari, and she indicated that ALC should consider this as a potential route with regard to the covenant calculations. (Bebo, Tr. 4032.) Mr. Rhinelander was open to proceeding this way and they agreed he would speak with Mr. Hennigar. (*Id.*)

Thus, starting on January 22, Ms. Bebo, Mr. Buono and Ms. Herbner began identifying "employees that have occupied a room at one of the houses" in the Southeast Region (which included seven of the eight CaraVita Facilities) to complete the fourth quarter covenant calculations. (Ex. 176.) Ms. Bucholtz and others also participated in this process. (*See, e.g.*, Ex. 177.) In the following week or two, ALC identified several employees that had stayed at Greenwood Gardens, Peachtree Estates, and CaraVita Village. (*See, e.g.*, Ex. 130.)

ALC included rooms that it rented related to these employees in the occupancy and coverage ratio covenant calculations for the fourth quarter of 2008. (Ex. 17, p. 5.) Notably, although those employees only stayed at the facilities for limited time periods (Exs. 177, 180, 182), ALC paid for the apartments for entire monthly periods with respect to four of the five units that were utilized for employee use (Ex. 17, p. 5.).[26] As noted earlier, this was consistent with how ALC calculated occupancy and payment for units at the rest of the company.

The compliance certification documents relating to the fourth quarter of 2008 were sent to Ventas on February 12, 2009. (Ex. 32.) As described below, after approval of employee leasing by Mr. Hennigar, Mr. Rhinelander, and the full-board on February 23, ALC fully implemented the "reason to go" standard discussed on the call with Mr. Solari. ALC thus stopped collecting information about actual stays by employees for the first quarter 2009, and tracked employees that had a reason to travel to the Facilities. (Bebo, Tr. 4076-80.)

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[26] For example, Sue Martin reportedly stayed at the Greenwood Gardens facility for two and a half weeks in October, three weeks in November, and one week in December. (Ex. 182.) However, ALC paid for a unit for the entire months of October, November, and December. (Ex. 17, p. 5.) Similarly, Pamela Ondercin reportedly stayed thirteen days at the Peachtree Estates facility in November and December. (Ex. 180.) But ALC paid for a unit for the entire months of November and December. (Ex. 17, p. 5.)

B. ALC Implements Practice Of Including Rooms For People With A Reason To Go In The Ventas Covenant Calculations After Obtaining Direction From The Board.

Ms. Bebo revisited this issue with Mr. Rhinelander on the morning of the ALC Board meeting on February 23, 2009. (Bebo, Tr. 1958-59, 1962.) In a meeting in her office also attended by Mr. Buono and Ms. Herbner, Ms. Bebo briefly recapped the call with Mr. Solari. (Bebo, Tr. 1958, 1964-65.) She informed Mr. Rhinelander that ALC had an agreement with Ventas whereby ALC could pay for apartments for people who have a reason to go to the CaraVita properties, and that the apartments paid for by ALC could be used in the covenant calculations. (Bebo, Tr. 1964-65.) They provided Mr. Rhinelander a copy of the Solari e-mail. (Bebo, Tr. 4204.) She told Mr. Rhinelander that the phone call and e-mail constituted notice of an affiliate transaction (the use of rentals for employees), and an understanding of ambiguous terms in the lease. (Bebo, Tr. 1963.) Ms. Bebo also gave Mr. Rhinelander a second option to consider—going back to Ventas to try to open up the Lease. (Bebo, Tr. 1959.)

After hearing both options, Mr. Rhinelander went to the room next door to consult with Mr. Hennigar, the Chairman of the Board of Directors. (Bebo, Tr. 1965.) When Mr. Rhinelander returned, he indicated that Mr. Hennigar had chosen to go with the employee leasing option. (Bebo, Tr. 1965-66.) And then later that day, during the Board meeting, Mr. Hennigar indicated that the Board had already discussed the employee leasing program, and management did not need to go into any more detail on it. (Bebo, Tr. 1968.) With the Board's approval, ALC used the employee leasing program to meet the covenant calculations. (*See* Bebo, Tr. 1970-71.)

Mr. Buono's testimony corroborates Ms. Bebo's, except that he testified that the meeting and approval happened earlier than February 2009, although he is likely confused with respect to the timing of the meeting:[27]

Q	And you mentioned Mel Rhinelander. Other than Ms. Bebo telling you that Mr. Rhinelander knew about this, you had discussions with Mr. Rhinelander whereby you could independently conclude that he knew about employee leasing, correct?
A	The first conversation, when we were entering into the -- or discussing the possibility of using employee leasing, Mel, Laurie and I and Robin Herbner were in the room, and Mel made a statement to the effect of, well, if the lease doesn't say you can't include employees, let's include employees, something to that effect.
Q	This is all the way back in 2008.
A	That is in 2008 at that -- I believe I place it at the December 2008 meeting.
Q	And so all of you were gathered in this room discussing this as a -- as a way -- as a tool to ensure that covenants weren't missed with respect to occupancy and coverage, correct?
A	When you say all of us, that's who?
Q	Yeah, the people you just mentioned. Why don't you just for the Court tell us again who was all there.
A	Laurie Bebo, Robin Herbner, myself, and Mel Rhinelander.
Q	And then what happened after that? Did Mr. Rhinelander go into a room and meet with Mr. Hokeness about it -- or excuse me, Mr. Hennigar?
	…
A	THE WITNESS: Okay. Mr. Rhinelander left the room and went into the board room.

(Buono, Tr. 2393-95.)

Mr. Buono's testimony continued:

Q	Okay. So it's possible that he went into a room that was empty, or it's possible that he went into a room that may have had all the board members in it. You don't know.
A	I don't know who was in and who wasn't.
Q	Did he come back out of the room?
A	Yes.

[27] There is no evidence that the issue of ALC paying for rooms for employees or others had been discussed at all prior to the December 2008 board meeting. In addition, Ms. Herbner did not become involved with respect to including rooms for employee use in the covenant calculations until after the call with Mr. Solari on January 20, 2009. (*See* Herbner, Tr. 754, 756-57, 796-97; Ex. 176.)

Q	Okay. And what did he say when he came back out of the room?
A	That we would do the employee leasing program.
Q	And is that all he said? Did he say he consulted, that people signed off? Did he say anything like that?
A	Well, I don't remember anything other than him saying that this was what he wanted to do.
Q	But did I understand you to say that he went into the room where the board ordinarily meets?
A	Yes.
Q	And he went into that room at or about the time that the board ordinarily was meeting that day?
A	Correct.
Q	Do you know if any of the board members had arrived at the office that day for the board meeting?
A	I believe they all had arrived at that point in time. It was very close to the time of the start of the board meeting.

(Buono, Tr. 2395-96.)

C. ALC accounting staff sets up procedures for employee leasing arrangement.

After the call with Mr. Solari, ALC's accounting staff, supervised by Mr. Buono and Mr. Levonovich, established the process by which the revenue related to the apartments that ALC corporate would pay for at the CaraVita Facilities for people with a reason to go would be recorded at the facility level and then eliminated in consolidation. (*See* Buono, Tr. 2771-72; Herbner, Tr. 807-810; Ex. 1337; Ex. 176.) At that time, ALC's assistant controller, Tony Ferreri, was called into a meeting with Mr. Levonovich and Ms. Herbner to discuss the journal entry process they had developed. (Ferreri, Tr. 1226-27, 1264-66; Herbner, Tr. 861.) Although Ms. Bebo was aware that ALC was allocating units for ALC to pay for people with a reason to go to the CaraVita Facilities, was generally aware that revenue was being recorded at the Facilities for covenant purposes, and was generally aware that this revenue was being eliminated in consolidation through a corporate consolidating account so that it would not be reported in ALC's Commission filings, Ms. Bebo did not participate in establishing the processes. (Bebo, Tr. 4128-30, 4133-34.) For example, she was not aware it was referred to as the 997 Account at

the time. (*Id.*; Buono, Tr. 2727 (indicating he provided her additional information about the accounting in 2012).)

1. The journal entry process.

The process established by Mr. Buono, Mr. Levonovich and Ms. Herbner started with one of the members of the accounting staff—Ms. Herbner in 2009, Sean Schelfout in 2010, and Dan Grochowski in 2011. (Herbner, Tr. 845-46; Schelfout, Tr. 971; Buono, Tr. 2374-75.) On a monthly basis, they would determine the number of units ALC would need to satisfy the covenants, typically based on reviewing occupancy trends and making projections. (Schelfout, Tr. 974-75, 983-84.) Next, they would allocate or set aside the rooms that ALC corporate would pay the ALC entity that operated the Facility through the journal entry process described below. (Schelfout, Tr. 977.) The units would be reserved for the entire month, consistent with the practice with respect to residents throughout the rest of the company, and revenue would be calculated based on a standard daily rate multiplied by the number of days in the month for each corporate unit that was allocated for employees or others to use. (Grochowski, Tr. 1115; Schelfout, Tr. 991.)

Each month, journal entries were initiated by Ms. Herbner or the other staff member preparing the calculation, e-mailed to Mr. Buono for his approval, and then submitted to ALC's assistant controller Tony Ferreri. (Ferreri, Tr. 1234-37; Schelfout, Tr. 1022; Ex. 387.) As new corporate rooms were set aside, revenue was recorded not based on a particular employee or other "occupant," but based on the fact they were corporate unit rentals (*i.e.*, often times there was no employee identified with a particular room at the time the journal entry was recorded). (*See* Exs. 381, 384, 386, 387, 394, 395 (Journal Entry Materials).) The revenue described above was recorded in line 3010 on the general ledger of the applicable CaraVita Facility. (*See* Ferreri, Tr. 1237-39; Ex. 399; Buono, Tr. 2350.) A corresponding reduction to revenue was recorded in

the same line of the general ledger of a corporate level account, referred to as the "997 Account." (*See id.*) It would thus be eliminated in consolidation, preventing the intercompany revenue from flowing through to ALC's financial statements reported to investors. (Ferreri, Tr. 1230-31, 1240-41, 1244-45.) Other consolidating transactions and expense reclassifications (including those related to the CaraVita Facilities) were also recorded in the 997 Account as well. (Bebo, Tr. 4133-34, 4134-35.) Put another way, the 997 Account was not created simply to account for the Ventas covenant transactions.

2. The occupancy reconciliations, with lists of people with a reason to go to the CaraVita Facilities.

Mr. Buono and the accounting staff under his supervision set up the procedures for implementing employee leasing. (*See e.g.* Buono, Tr. 2349-50; Bebo, Tr. 4070-72.) Although not necessary for Lease compliance because Mr. Solari specifically indicated he did not want ALC to separately report rentals related to employees, these procedures included quarterly lists of people who went or had a reason to go to the CaraVita Facilities on behalf of ALC. (Bebo, Tr. 4005, 4070-72, 4076-77, 4152, 4554.)

The principal reason the accounting staff maintained the list of employees was for purposes of internal tracking, and reporting to Grant Thornton. (*Id.*; Bebo, Tr. 1993-94.) This began with the 2009 first quarter occupancy calculations that ALC was preparing in the April to May, 2009 time period. On May 4, 2009, Grant Thornton sent a request to ALC for information on how to reconcile the compliance information provided to Ventas with ALC's regular house financial statements for the CaraVita Facilities. (Ex. 1377, p. 2.)

The next day, on May 5, 2009, Mr. Buono sent an e-mail to Ms. Bebo (copying Ms. Herbner) indicating that Grant Thornton was requesting information about the inclusion of rooms for ALC employees in the Ventas covenant calculations. (Ex. 1375.) It stated:

> GT is looking for support on our occupancy in the Cara Vita properties. During their review of these properties they compare our occupancy report to the numbers. The employees staying at the house are not included in that report. So, to complete their work, we are going to give them the letter in which we informed Ventas of our intention to have employees living at our residences. They have not yet requested names, but they may. This is where you come in. We needed 7 more names for Winterville. We have filled in 4 with regional or above people (Io, Paula, Jared, and KB). As you know these four are doubled up which really didn't overly concern you since they were at both buildings, however we need three more.

(Ex. 1375.) After discussing the request with Ms. Bebo, ALC did not try to hide any information from Grant Thornton. Later on May 5th, Ms. Herbner provided a copy of an occupancy reconciliation report, which included the number of rooms related to employees included in the calculation.[28] (Exs. 1377, p. 1, 1377A.) Ms. Herbner also provided Grant Thronton with a copy of Ms. Bebo's February 4 e-mail to Mr. Solari. (Ex. 3053.)

That first quarter following the February 2009 board meeting is representative of how the process of preparing the list of names played out for the following three years. The accounting staff and Mr. Buono would periodically ask Ms. Bebo to add names to the lists or replace names that they had removed, typically once for each quarterly reporting period. (*See, e.g.*, Bebo, Tr. 4076-77.) Although Ms. Bebo provided most of the names, there were many occasions where others at ALC would add names to the occupancy reconciliation reports being prepared. (*See* Bebo, Tr. 4091-92, 4120-21.) This is reflected in Mr. Buono's May 5 e-mail, among other exhibits: "We needed 7 more names for Winterville. *We* have filled in 4 with regional or above people (Io, Paula, Jared, and KB)." (Ex. 1375 (emphasis added).)

Ms. Bebo would supply names of employees or others based on the understanding from the January 20, 2009 call with Mr. Solari that these people would be limited to those with a

[28] In almost every subsequent quarter, ALC provided the full occupancy reconciliation report that included the full listing of names. (*See, e.g.*, Ex. 3076.)

reason to go to a CaraVita Facility and whom ALC would be comfortable with staying at the facilities from a resident safety perspective. (*See* Bebo, Tr. 4003-05.) Since unoccupied units were made available by the facilities to ALC for such purposes, there was no need to track actual days stayed by any such employees or other people. If during a quarter it was determined that an employee had or would have a reason to go to a CaraVita Facility, such employee could go on the list for the entire quarter and remain on the list for subsequent periods.

Although Ms. Bebo would occasionally remove a name from the list where she noticed that a person on the list would no longer have a reason to go to a property (e.g., a former employee), she did not review the list for this purpose and understood that other employees had been doing so as they had brought discrepancies to her attention from time to time. (Bebo, Tr. 4092-93, 4094-95.) Grant Thornton also, on occasion, told ALC that an employee should be removed from the list because he or she no longer worked there. (Bebo, Tr. 4092-93, 4096.)

3. The occupancy reconciliation reports were not meant to reflect actual days spent overnight by individuals at the facilities.

One of the false narratives propagated by the Division in the OIP and during the hearing was that the occupancy reconciliations prepared for Grant Thornton were supposed to reflect the number of days that a particular individual occupied a room or stayed at a particular CaraVita Facility. Anyone reviewing the occupancy reconciliations would reach the immediate conclusion that those spreadsheets did not serve the purpose of tracking actual nights stayed at the Facilities. For example, this was immediately apparent to Mr. Grochowski when he became responsible for preparing the Lease covenant calculations in early 2011. He recognized "right off the bat" that names were listed at multiple facilities, and that they did not track his

observations of when people at the corporate office were traveling.[29] (Grochowski, Tr. 1097-98.)

Mr. Buono clearly understood this at the time as well. When Mr. Grochowski asked him about a non-employee on the list and whether he stayed at the properties for the number of days that he appeared on the occupancy reconciliation, Mr. Buono said the number of days did not matter, as set forth in Mr. Grochowski's testimony:

Q	I believe you testified that you're familiar with the name Kevin Schewer?
A	Correct.
Q	And he was included as an occupant at the Ventas facilities for purposes of determining compliance with the covenants?
A	Correct.
Q	Do you recall hearing Mr. Buono tell a story to colleagues at ALC involving an accident involving Mr. Schewer?
A	Yes, I do.
Q	And according to Mr. Buono's story, the accident took place in northern Wisconsin?
A	Correct.
Q	And Mr. Buono told that story either before or after a weekly finance department staff meeting?
A	Correct.
Q	After the meeting, once people cleared out, you told Mr. Buono that he shouldn't have told that story?
A	Correct.
Q	You thought it was bad to tell the story because Mr. Schewer was identified as an occupant at one of the facilities in Georgia?
A	Correct.
Q	By your reasoning, if Mr. Schewer was identified as an occupant in Georgia, he shouldn't be involved in a car accident in northern Wisconsin?
A	Correct.
Q	Mr. Buono did not think there was a problem with the story?
A	No, he did not.
Q	He corrected you and stated just because a person's name was on the list did not mean the person was staying at the facility?
A	Correct.

[29] Having no knowledge of the agreement with Ventas, this raised concerns for Mr. Grochowski. (*Id.*)

(Grochowski, Tr. 1179-80.) Similarly, a former ALC employee and current Wisconsin State Patrol Trooper named Jason Dengel testified that Mr. Buono understood that the occupancy reconciliation lists were meant to track people with a reason to go:

Q	During the course of working late and being in her office, did you have an occasion to witness and hear a conversation between her and anyone at ALC regarding employees who travel or have a reason to go to the CaraVita properties in the southeast?
A	Yes.
Q	When did that occur?
A	Probably fourth quarter 2011. It was shortly after I had started at ALC.
Q	Will you explain what happened.
A	I was in Ms. Bebo's office going over some questions I had on admission packets, and John Buono came into the room and told Laurie that he needed some names from the list, and I asked the question on what -- what that was, and *it was said that these are people that have a reason to go to that particular building*, and Ms. Bebo asked John if this list was correct and current, and John had said, yes, it was. And I had asked what that was all about, and it was pointed out to me that at one point in the past, that that list is supposed to be audited by our internal accounting department, and some of the names were missed that were no longer employed with ALC, that there were some names on there that were missed and an outside firm had found those names.

(Dengel, Tr. 3912-13 (emphasis added).)

Grant Thornton also recognized that the listing of names was not intended to track actual nights stayed at the CaraVita Facilities by those listed on the occupancy reconciliation reports that they received each quarter, and did not find that troublesome:

Q	…Based on your understanding of the arrangement with Ventas, could ALC reserve rooms for the same person at multiple properties for the same time period for purposes of the covenant calculations?
A	And so you're asking me if that was -- if that practice would be consistent with my understanding of the arrangement with Ventas?
Q	Right.
A	Well, I would have believed at that point in time that an individual might spend time at various of the locations because of the geographical proximity these locations had to each other, and that they may have needed to have rooms available to them at various locations.

(Robinson, Tr. 3404.) Grant Thornton understood, based on discussions with Mr. Buono that "as rooms are reserved in these houses, revenue is automatically booked" (Ex. 1696, p. 4), and that "the employee adjustment relates to extra rooms at each facility that are not currently occupied by ALC residents, but are set aside for ALC employees to improve the overall performance of each facility." (Ex. 1685, p. 5.)

Ms. Bebo acknowledged at the hearing that, in hindsight, the processes and procedures for maintaining internal lists of employees used to confirm that ALC had enough employees traveling or with a reason to travel to the CaraVita Facilities to support the corporate allocations were not as robust as they should have been. Checks and balances between her and the financial office within ALC failed to catch mistakes of employees or family members that should not have been on the list. (*See, e.g.*, Bebo, Tr. 4099-4102.) Not a lot of time was spent on the internal process, but this was a very small part of ALC's business. But it is a different matter entirely to imply, as the Division does, that there was little employee travel to the CaraVita Facilities.

It is impossible to reconstruct employee travel and stays at the CaraVita Facilities in hindsight. The records do not exist in these proceedings to reconstruct it, and they may not exist at all because Ms. Bebo specifically chose the "reason to go" standard in the call with Mr. Solari so that ALC would not have to track the travel and stays of employees in connection with covenant compliance:

Q	Throughout your testimony here and your investigative testimony, you've used the term "people with a reason to go." Why -- why did you -- why did you use that? Why was that part of this agreement as opposed to people who would stay -- actually stay at these units?
A	I specifically developed that verbiage before I got on the phone with Mr. Solari, because -- a couple reasons. One, to work through this and to come to an understanding with Ventas about these ALC set-aside apartments, and including them in the calculations would be something

	that would be fairly flexible. You know, that would be -- it would be a good deal for ALC. And what I didn't want to do is I didn't want to make more work, though, for ALC in going this route. I don't want to have to have some system where I've got to keep track of and ensure that people's flights make it or that somebody actually stays at a house that night or those three nights. One of the things that had recently been an issue is that we would have team members that we expected were staying at the houses, and for personal reasons, they maybe chose not to, and ALC had awkwardly become involved in different personal discussions and personal situations with employees, and I didn't want to go there any more. And so the idea of a reason to go is so that I don't have to ask everybody, did you actually stay here, or did you sleep somewhere else and -- and/or what constitutes staying at the residence. Are you there for two hours and you take a shower, or do you have to sleep there? I don't want to get into all that. I don't want to have to be involved in people's personal lives. I don't want to have to keep track of a system where, you know, we've got a lot of personal information then coming through the accounting department, et cetera. And so I specifically asked for people with a reason to go.

(Bebo, Tr. 4008-10.)

But anecdotal evidence indicates there was a significant amount of travel by ALC employees to the eight CaraVita Facilities throughout the 2009 to 2011 time period to support the employee leasing program. Exhibit 3507 is an analysis of expense reports for certain ALC employees. It identifies the particular facilities that the employee visited during a trip based on the expense report. (Ex. 3507.) A review of that exhibit indicates the following number of rooms would be needed to accommodate the number of employees traveling to the CaraVita Facilities each quarter:[30]

[30] This is based on employees traveling to one or more of the CaraVita Facilities during the quarter. Some employees are included at multiple Facilities because the expense reports confirm they visited multiple Facilities during the quarter, and so would need rooms to stay at multiple Facilities. This was common, based on a review of the expense reports.

2009		Number of Visits Per Exhibit 3507
Q1		53
Q2		59
Q3		88
Q4		78
2010		
Q1		41
Q2		57
Q3		18
Q4		18
2011		
Q1		27
Q2		34
Q3		25
Q4		45

(*See id.*) There was also a significant amount of testimony and exhibits reflecting the various initiatives of which Ms. Bebo was aware that involved sending many different employees to the CaraVita Facilities. (*See* Bebo, Tr. 4116-20, Ex. 2099, 2103, 2104; Houck, Tr. 1486-90, 1492-93; Bucholtz, Tr. 2939, 2943, 2964, 2968-73.)

4. Listing non-employee family members does not indicate a fraudulent scheme, but just the opposite.

Much of the Division's case is premised upon the fact that contractors and family members of employees are set forth on the occupancy reconciliations. However, this does not support the allegations of fraud for two reasons. First, Ms. Bebo listed these individuals based on advice of counsel, Mr. Fonstad. (*See, e.g.*, Bebo, Tr. 2007-08, 2050.) This is not surprising because Ms. Bebo had discussed the issue of including rooms for family members with Mr. Fonstad at the beginning of the process back in late 2008 and early 2009, before the call with Mr. Solari and subsequent e-mail. (*See* Bebo, Tr. 1893-94.) She testified about revisiting the

issue of family members with Mr. Fonstad after Ventas had agreed to including ALC-paid apartments for people with a reason to go:

Q	Now, I notice that you state on May 5, in your e-mail [Ex. 1378], Also, you can put my mom and dad in at Peachtree, Gale and Bill Bebo. Is there a reason that you did that?
A	Yes. My mom and dad had gone to Peachtree and physically actually did stay there overnight, and I had discussions with Mr. Fonstad about that situation, and he indicated that they should be put on the list.
Q	Did he say why?
A	He indicated that they meet the expectation of a reason to go, and particularly, he was interested in including outside people as far as -- it's easy for us to know who's the regional at that time or it's easy for us to know who the residence director is at that time. But if we had outside people that would have a reason to go, it would be more difficult for us to find that, or if they had been at the building and we needed to -- or there was an investigation, or something like that, called for, and we needed to understand who was in the building at that time, I think that was part of his idea, that this would be a place we might be able to obtain that information.

(Bebo, Tr. 4084-4085.)

Second, people trying to commit fraud with respect to the lists of individuals on the occupancy reconciliations that were reviewed by multiple employees internally and by the company's external auditors would not put their mothers and fathers on the list. They certainly would not list other couples like Dan and Patty Rodwick or Jane and Todd Rodwick, as Ms. Bebo did, if they were trying to legitimize a fraudulent practice. These names would stick out like a sore thumb to any third party reviewing the lists. And Ms. Bebo knew they would be reviewed by Grant Thornton and others in the finance department responsible for financial reporting. No one trying to commit fraud would put names of parents or couples on these lists.

5. **Mr. Buono was responsible for providing officer certificates and compliance information to Ventas without the employee lists, and for determining any GAAP compliance issues**.

As noted above, during the call with Mr. Solari the parties discussed whether Ventas wanted the units ALC rented for people with a reason to go reported separately from the other units in the covenant reporting. Mr. Solari indicated he did not want it broken out separately. Thus, Ms. Bebo was generally aware that ALC was not providing lists of employees or specifically breaking the employee occupancy out separately in their reporting to Ventas. (Bebo, Tr. 2087-88.)

Mr. Buono testified that it was his understanding that Ventas did not want the reporting to change after the call with and e-mail to Mr. Solari:

Q	You suggested that ALC provide the quarterly covenant information to Ventas without the number of employee occupants included in the calculations; isn't that correct?
A	I have no recollection of providing -- of saying that.
Q	Let's go to Respondent's Exhibit 2117, page 2. Let's see if this refreshes your memory. Second-to-last paragraph, "JB suggested." Please read that and see if that refreshes your memory.
A	Okay.
Q	Does this refresh your memory?
A	Yes, but what I meant by that was they didn't want to know -- we didn't want to break out what was employees and what was non-employees.
Q	And specifically, it's because -- and I think you're quoted here -- Ventas did not want the detail; isn't that what you said?
A	They only wanted it in their form, and we gave it to them in their form. I don't recall what exactly I was referring to when I said, "They did not want the detail." They didn't want a lot of detail.
Q	But you provided the information that they wanted in their form.
A	Correct.

(Buono, Tr. 4655-56.) During that testimony, Mr. Buono was shown the notes from his proffer session with the Division, which stated:

> JB suggested that ALC provided the quarterly covenant information to Ventas in the form that Ventas had requested and that the number of employee occupants

included in the covenant calculations was not provided as part of the quarterly covenant information because "Ventas did not want the detail."

(Ex. 2117, p. 2.)

Although ALC did not provide any of the employee lists or the specific number of employees to Ventas, as noted above, all of the revenue ALC corporate paid to the CaraVita Facilities was contained on "3010 Rent Revenue-Private" line of the financial statements. (Grochowski, Tr. 1149-50.) It would have been evident to Ventas that this category of revenue was increasing substantially throughout 2009:

Assisted Living
Wk Ventas Rolling Twelve Month Income Statement
For The Year to Date December 31, 2009
Ventas

Revenue		Jan 2009	Feb 2009	Mar 2009	Apr 2009	May 2009	Jun 2009	Jul 2009	Aug 2009	Sep 2009	Oct 2009	Nov 2009	Dec 2009	TTM	YTD
3010	Rent Revenue-Private	(501)	800	4,066	70,152	67,042	68,888	120,902	176,631	194,372	271,458	265,193	266,344	1,505,347	1,505,347
3404	R & B - Companion Studio	61,158	51,061	33,738	30,466	25,508	25,188	25,637	32,630	23,356	23,935	18,570	13,297	364,564	364,564
3405	R & B - Deluxe	7,130	6,440	7,130	4,370	3,565	3,450	3,565	5,750	6,900	6,510	6,300	6,510	67,620	67,620
3409	R & B - Bedroom	110,812	97,007	102,506	102,144	104,361	100,915	93,935	92,751	89,162	99,076	85,303	89,236	1,167,209	1,167,209
3410	R & B - Second Resident	13,459	12,306	11,629	12,575	12,529	14,465	10,789	12,589	12,425	13,459	12,715	13,748	152,685	152,685
3411	R & B - Studio	513,666	449,285	676,452	473,709	507,125	470,546	453,655	424,468	382,372	385,337	377,482	404,835	5,518,930	5,518,930
3412	R & B - Studio Deluxe	148,456	139,765	155,172	154,658	157,757	156,038	153,102	155,307	114,920	104,844	97,360	102,178	1,639,577	1,639,577

(Ex. 36, p. 10.) This revenue line was the second largest of any category of revenue reported to Ventas for 2010. (Ex. 41, p. 11.)

Mr. Buono signed every officer certificate that accompanied the Ventas covenant compliance information. (*See* Exs. 32-45.) He and his staff were responsible for providing financials to Ventas. (Buono, Tr. 2451.) Ms. Bebo did not review the officer certificates, the compliance information, or the financial statements, prior to that information being sent to Ventas. (*See* Bebo, Tr. 2087-88.) And it is unclear whether she was even aware that the Lease referred to a requirement that financial statements for the Facilities comply with generally accepted accounting principles ("GAAP"). In any event, she relied on Mr. Buono and others on ALC's accounting and finance staff to make determinations of whether certain accounting treatment complied with GAAP. (Bebo, Tr. 3809, 4184-85.)

XI. MS. BEBO WAS COMFORTABLE WITH THE AGREEMENT REACHED WITH MR. SOLARI, AND DID NOT THINK IT WAS IN ALC'S BEST INTEREST TO REVISIT THE AGREEMENT.

After the January 20 call and the February 4 e-mail, Ms. Bebo believed that employee leasing under the Lease was settled and did not see any reason to subsequently re-open the issue with Ventas. (*See* Bebo, Tr. 4074-75.) As set forth above, Ms. Bebo and others at ALC all realized that they had obtained a very favorable deal with Mr. Solari and Ventas. As Ventas was a contractual counter-party and a competitor of ALC, ALC and Ms. Bebo had no obligation to revisit the issue or otherwise highlight the number of ALC set-aside apartments included in the covenant calculations (even though the revenue from those apartments was separately recorded on the financial statements for Ventas). The Division's attempt to act as a proxy for Ventas—asserting contractual claims in this matter that Ventas never even asserted when it sued ALC (as described below)—is improper. To paint Ventas as being owed some kind of fiduciary duty of on-going disclosure is similarly improper, and contradicted by the Division's own witnesses.

Mr. Solari testified that in all his dealings with ALC he was trying to get the best outcome for his employer, Ventas, and he recognized that Ms. Bebo had the same obligation to ALC. (Solari, Tr. 454-56.) There was no fiduciary duty that would entail ongoing disclosure obligations between the two:

Q	In exchange for the prices you proposed on the two New Mexico properties and the Peachtree Estates property, Ventas was willing to provide a waiver of the facility coverage covenant until March 31 of 2011; isn't that correct?
A	That's correct.
Q	You thought that it was appropriate to try and get ALC, understandably so, to pay as high of a price as you could for what was really a severely underperforming Peachtree Estates property, right?
A	Correct.
Q	And, of course, in doing so, you didn't feel that you owed ALC some sort of a fiduciary duty to make sure they didn't overpay for something.
A	Correct.

Q	Your allegiance, your loyalty was to your company, Ventas.
A	Correct.
Q	And that was to get the best -- your obligation was to get the best deal for Ventas and its shareholders with respect to your negotiations.
A	Correct.
Q	And that was true with respect to really all of Ventas' dealings with ALC.
A	Correct.
	…
Q	...And so you would agree that the folks at ALC did not owe Ventas any fiduciary duty in negotiations, correct?
A	Correct.
Q	And Ms. Bebo, Mr. Buono, they owed a fiduciary duty to their shareholders at ALC just as you did to yours at Ventas, correct?
A	Right.
Q	And their obligation was to get the best deal for ALC's shareholders in all of their dealings with Ventas, right?
A	Correct.

(Solari, Tr. 454-56.)

Another of the Division's witnesses, Ms. Herbner testified that Ventas did not ask for information about the employees in connection with the covenant calculations while she was involved with them:

Q	In your communications with Ventas representatives, did you ever indicate that ALC was including employees in the covenant calculations?
A	I did not.
Q	Why not?
A	*They didn't ask.* I -- and I was, you know, told that it was an approved process. I had no reason to believe that they weren't notified.

(Herbner, Tr. 832-33 (emphasis added).)

Ms. Bebo described her general approach to subsequent communications with Ventas after reaching the agreement in late January and early February:

Q	...After Joe Solari left Ventas, did you ever speak to anyone else at Ventas about employees -- the use of employees for covenant calculations?
A	Not that I recall.
Q	Why not?
A	I think early on, why not is because when we're on a conference call with Mr. Solari and other team members from Ventas just a short time after the call with Mr. Solari, and we're going through the e-mail regarding

	hospice, and it's not brought up or discussed, we have the expectation at ALC that everybody's fine with it and that there isn't a reason for additional discussion with them. I think that as with any agreement with a third party, a contractual agreement, an agreement that you come to, you don't go back and revisit it for no reason. So given that they haven't brought it up again, we don't bring it up. The only time that -- the only time that I can recall bringing it up, not verbally speaking about it, but bringing it back up with Ventas, is in 2012, and that's during the purchase and sale time period. But prior to that, I don't think it's ALC's responsibility to bring up and point out the beneficial agreement that's been reached or have it revisited.

(Bebo, Tr. 4074-75.)

A. From the inception of the Lease in 2008, Ms. Bebo was guarded in all communications with Ventas about ALC's operations because Ventas, a large competitor, constantly sought highly sensitive information about ALC.

Ventas regularly communicated with ALC on matters relevant to the Lease and the CaraVita Facilities starting early in the relationship. (*See* Doman, Tr. 200-201.) And many of Ventas' information requests went beyond the Lease, inquiring about market conditions, ALC's business strategy and sales efforts, and ALC's operations outside of the CaraVita Facilities. (Bebo, Tr. 4144-45.) Consequently, from 2008—long before there was any issue with ALC including rentals related to employees in the covenant calculations—Ms. Bebo wanted to generally provide Ventas as little information about ALC as possible. (*See* Exs. 1254, 1118; Buono, Tr. 2742; Bebo, Tr. 4146-47.)

In July 2008, only seven months after ALC and Ventas entered into the Lease relationship, Ventas sought highly sensitive information about ALC's operations purportedly so it could use that information in highly public calls with Ventas' own investors. (Doman, Tr. 355-58; Ex. 1996, 1995, 1549.) Ventas sought information about things like traffic at ALC's facilities, conversion rates reflecting how effective ALC was at turning that traffic into residents,

discounting programs, and margins. (*Id.*) Because of these intrusive requests and the fact that ALC was a public company, Ms. Bebo and Mr. Buono sought advice from Mr. Fonstad with respect to compliance with Regulation FD, and what non-public information could be disclosed to Ventas. (*See* Ex. 1254, 1549; *see* Bebo, Tr. 4146-47.) This type of mining for competitive information continued throughout the relationship. (*See* Ex. 2029.)

In 2008 and 2009, Ventas had its own "shop portfolio" of facilities that were operated under a management contract with Sunrise. (Doman, Tr. 287.) During the same time period, Ventas was touting the 70-90 Sunrise-managed buildings as the high-growth area of Ventas' business. (Doman, Tr. 762-63, 283, 286-87, 297; Ex. 2109.) Many of those buildings were in the same markets as ALC facilities. When ALC entered into the Lease with Ventas, Mr. Doman immediately recognized that ALC's margins of about 50% were significantly higher than the margins for the Sunrise properties and he wanted to help contribute to that growth area of the business. (Doman, Tr. 283, 288.) Ventas' "shop portfolio" grew significantly when it acquired Atria in 2011. (*See* Doman, Tr. 303, 363.) Many of Ventas' other tenant-operators were direct competitors of ALC in other markets as well. (*See e.g.*, Doman, Tr. 299-300.) These operators managed a significantly greater number of Ventas buildings than ALC, and were much more important to Ventas' financial performance. (*See* Doman, Tr. 296-97, 300-302.)

Ms. Bebo was aware of Ventas' industry position and relationships with these competitors at the time, and had significant concerns about sharing information with Ventas. (*See* Bebo, Tr. 4138-39.) Indeed, there were meetings that she and Mr. Buono had with Ventas where Ventas openly discussed what these other competitors were doing operationally. (Buono, Tr. 2742.) As reflected above, from the beginning of the relationship, Ms. Bebo understood Ventas would use the information for its own general business purposes, not necessarily to

compete directly with the CaraVita Facilities but to use or share with Sunrise or its other tenant-operators. This would, of course, allow those operators to compete better with ALC's other facilities.

Consequently, ALC's practice was to give general, standard answers to Ventas questions to avoid competitive harm, focusing on high-level marketing/operational developments that would not include sensitive information. (Bebo, Tr. 4146-48.) For example, when Ventas asked about occupancy changes, ALC would typically respond by discussing changes in marketing personnel and general statements about sales initiatives. (Bebo, Tr. 4148-52.)

This is not to say that Ms. Bebo and ALC did not revisit the employee leasing arrangement with Ventas in subsequent years or quarters because they felt it would be divulging competitive information. But it is important for two reasons. First, it reflects the lens through which Ms. Bebo viewed the subsequent interactions with Ventas in the quarterly meetings and calls. Second, it is important that these were two sophisticated businesses that competed in the same marketplace. Neither party owed a fiduciary duty to the other, and ALC and Ms. Bebo acted quite properly in what they believed was the best interests of their own company. They felt they had an agreement with respect to an interpretation of ambiguous lease terms that was very favorable to ALC, and they were not going to kick the sleeping bear.

B. ALC's response to Ventas' July 2009 inquiry (Ex. 212).

An example of an alleged misleading communication with Ventas that the Division focused on at the hearing was Exhibit 212. In the July 28, 2009 e-mail, a Ventas analyst asks Ms. Herbner for some "color" about increases in occupancy at a number of CaraVita Facilities from the fourth quarter of 2008 to the first quarter of 2009. (Ex. 212.) Although the changes in occupancy from quarter to quarter were impacted significantly by the number of rooms that ALC allocated at those Facilities for use by employees, ALC responded by providing general

information about sales personnel changes, performance plans and other information consistent with ALC's typical answers to such questions.[31] (*Id.*; Bebo, Tr. 4150-52.) Consistent with these requests being for additional "color," Ventas accepted ALC's answers without further inquiry. Ms. Herbner confirmed that the information provided to Ventas in response to the inquiry was truthful, but incomplete by not mentioning unit rentals related to employees. (Herbner, Tr. 839-40.)

Moreover, with respect to this particular communication, ALC had just months before discussed the employee leasing with Mr. Solari and provided the confirmatory e-mail that went to three employees in Ventas' asset management function. (Bebo, Tr. 4151-52.) Thus, ALC reasonably concluded that Ventas was not looking for a discussion of employee leasing—they knew there were employees included in the counts and Mr. Solari had indicated that he did not want them separately reported. (*Id.*) The responses to Ventas addressed the types of business details that Ms. Bebo believed Ventas was generally interested in. (*Id.*) Ms. Bebo took a similar approach on those occasions when she participated in subsequent quarterly conference calls with Ventas. (Bebo, Tr. 4148-52.)

C. The Division's other assertions of deceptive behavior toward Ventas are unsupported and false.

In its pre-hearing brief, the Division made a number of assertions with respect to how Ms. Bebo allegedly "actively sought to prevent Ventas from learning of the non-residents in the covenant calculations." (Div. Prehearing Br., p. 14.) The Division attempted, but utterly failed to support these assertions as set forth in the table below.

[31] Similarly, referring to the quarterly conference calls that Ventas conducted with ALC and its other operators, Mr. Doman indicated that the purpose of the calls and Ventas' questions were to just get some more color on the numbers that were being provided to Ventas. (*See* Doman, Tr. 244.)

Division Allegation	The Truth
"Bebo additionally required that Buono or she personally accompany Ventas on the site visits, such that Ventas would not have unfettered access to employees working at the facilities (who were not aware of the scheme) and ask them questions about occupancy." (Div. Prehearing Br., p. 14)	This was a requirement for Ventas from the beginning of the relationship in 2008, before ALC began including room rentals related to employees in the covenant calculations. (Bebo, Tr. 4147-48.) And it was a requirement for visits by outsiders to other ALC facilities. (Bebo, Tr. 4142-43.) On one occasion, Ms. Bebo encouraged a visit by Ventas' CEO, with no concern that she be accompanied. (Ex. 1389.) Others also attended Ventas site visits, like Jared Houck. (Houck, Tr. 1473.)
"Bebo went so far as to direct that resident name tags be removed from their doors during Ventas's inspections, such that Ventas could not manually count the number of occupied rooms." (Div. Prehearing Br., p. 14)	There is no evidence that any removal of name tags coincided with a Ventas site visit. (Houck, Tr. 1476.) Mr. Houck had no recollection whether removing name placards at one of the CaraVita Facilities on the one occasion coincided with a site visit by Ventas. (*Id.*)
"Bebo restricted Ventas from visiting certain facilities at particular times, such as meal times when Ventas might be able to identify the actual number of occupants based on the number of people dining." (Div. Prehearing Br., p. 14)	Documents indicate Ms. Bebo did not care what time Ventas visited particular facilities. (Ex. 1389.) Moreover, this allegation is nonsensical since Ventas never attempted to conduct head counts on any of its site visits. (Butora, Tr. 946-47.)

XII. PERSONNEL INVOLVED IN ALC'S DISCLOSURE PROCESS CONSIDERED THE LEASE DISCLOSURE IN LIGHT OF THE EMPLOYEE LEASING ARRANGEMENT, AND NO ONE SUGGESTED A DIFFERENT DISCLOSURE.

The central clearinghouse for key disclosure items in the filings was ALC's disclosure committee, chaired by Mr. Fonstad, and that was no different with respect to compliance with the Lease and employee leasing. Ms. Bebo had no role in or influence on the disclosure committee, as she was not a member of it. (Lucey, Tr. 3704-05.) Thus Messrs. Buono and Fonstad must have reached the same understanding as Ms. Bebo of the contours of the employee leasing arrangement based on their participation in the call with Mr. Solari and the February 4 e-mail.

At every subsequent meeting in 2009 following the February 13, 2009 meeting described above, the disclosure committee discussed employee leasing in connection with the disclosure in

ALC's SEC filings regarding compliance with the Lease. Mr. Buono presented on this subject matter at each meeting. (Lucey, Tr. 3702.) Convenient for the Division, none of the four members of the disclosure committee, including ALC's CFO, general counsel, director of financial reporting, and internal auditor remember anything with respect to what was discussed at these disclosure committee meetings. Of course, the Division met with all of these witnesses off the record for over one hundred hours combined. Their testimony is either reflective of those meetings shaping their testimony, or an indication of how immaterial everyone understood the Ventas lease to be.

Nonetheless, the minutes of the meetings are quite clear that the matter of ALC meeting the Lease covenants through its rental of rooms related to employees was discussed at each meeting:

Meeting Minutes	Reference to Employee Leasing to Meet Covenants
4/22/2009 (Ex. 125, p. 4)	"Lease covenants continue to be monitored. With respect to Ventas lease[,] correspondence between ALC and Ventas has occurred whereby covenant calculations have been clarified as to census. No lease covenants violated."
7/30/2009 (Ex. 126, p. 4)	"Lease covenants continue to be monitored. Adjustments to calculations for Ventas covenant continue to be processed. There has been no relief in covenants and currently there are no on-going negotiations. With respect to Ventas lease[,] correspondence between ALC and Ventas has occurred whereby the covenant calculations have been clarified as to census. The Company affirmatively asserts compliance for Q2. No lease covenants violated."
10/29/2009[32] (Ex. 1159B, p. 4)	"Lease covenants continue to be monitored. Adjustments to calculations for Ventas covenant continue to be processed. There has been no relief in covenants and currently there are no on-going negotiations. With respect to Ventas lease[,] correspondence between ALC and Ventas has occurred whereby the covenant calculations have been clarified as to census. The Company affirmatively asserts compliance for Q3. No lease covenants violated."

[32] Mary Zak-Kowalczyk also received these minutes, and so was aware that Lease covenant calculations were being conducted based on correspondence that clarified census by February 2010 when she received the minutes.

Put simply, consideration of the inclusion of employees in the covenant calculations for the Lease was a focus of repeated discussion at the disclosure committee. No one, including Mr. Fonstad, raised a concern about the practice or a need to modify ALC's disclosure about the Ventas Lease in its Commission filings. (Fonstad, Tr. 1592-95.) Mr. Lucey and Mr. Hokeness did not raise any concerns about the disclosures in their respective roles of director of financial reporting and internal auditor. (Lucey, Tr. 3699-3704, 3707, 3711; Hokeness, Tr. 3100-04.)

Most significantly, no one involved in the disclosure committee (or any of the accounting staff) raised any concern about ALC's disclosure with Ms. Bebo.

XIII. THROUGHOUT THE REST OF 2009 THROUGH 2011, THE USE OF EMPLOYEE LEASING WAS A COMMON TOPIC OF DISCUSSION WITH ALC'S BOARD, WHICH REVIEWED AND APPROVED THE PROCESS.

Despite their failing memories and current claims of lack of awareness, the weight of the reliable evidence establishes that the Board was fully aware of and approved the use of the employee leasing program to satisfy the covenant calculations from the start.

A. The employee leasing program is discussed again during the Board meeting for the third quarter of 2009.

During the Board meeting for the third quarter of 2009, the Board again heard about ALC's agreement with Ventas to include apartments ALC rented for non-residents in the covenant calculations. (Bebo, Tr. 2023-24.) Ms. Bebo informed the Board that non-residents could be included in the covenant calculations as long as they have a reason to go to the properties. (Bebo, Tr. 2024.) In fact, Ms. Bebo fielded a number of questions about the process and discussed a number of different scenarios in response to a question from Derek Buntain regarding the margin (or lack thereof) with which ALC was meeting the covenants. (Bebo, Tr. 2024-26.) Ms. Bebo also informed the Board of the range of the number of employees included in the covenant calculations. (*Id.*)

Mr. Buntain himself admits that he commented on how the occupancy numbers and the "threshold" numbers were the same, looking "like it might be a plugged number," during the third quarter 2009 Board meeting. (Buntain, Tr. 1372.) Mr. Buono similarly recalls Mr. Buntain making a comment "to the effect that if we're adding employees to the calculation, why don't we add more because the covenants that we presented at that meeting were close to the -- close to the edge of failing." (Buono, Tr. 2392-93.) Mr. Rhinelander testified that Mr. Buntain commented at a Board meeting in late 2011 that we should "fill all the facilities up with employees" (which implies he knew about employee leasing prior to that time). (Rhinelander, Tr. 2816-17, 2871.) Mr. Buntain even testified that he made a "sarcastic" comment, in 2012, about adding more employees when Mr. Buono mentioned that they were going to fail the next quarter. (Buntain, Tr. 1377.) While Mr. Buono was not clear on the timing of the comment, and Mr. Buntain asserts he made the comment in 2012, it could only have happened in late 2009, because ALC was not on the edge of failing the covenants in 2011 or 2012.

Indeed, consistent with Ms. Bebo's testimony, several parts of ALC's Board materials indicate that Mr. Buntain's comment about adding additional employees occurred at the third quarter Board meeting in 2009. (*See* Bebo, Tr. 4130-33.) First, as ALC's Board materials reflect, ALC gradually started adding additional employees after the third quarter of 2009 Board meeting to avoid resting on the 82% occupancy threshold for the CaraVita portfolio over the last twelve months ("LTM"). The following chart exemplifies ALC's change in philosophy about barely meeting the CaraVita occupancy covenants after Mr. Buntain's comment:[33]

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[33] Ms. Bebo testified that after Mr. Buntain made his comment during the third quarter Board meeting, Mr. Buono changed its occupancy numbers following the meeting and sent different numbers to Ventas than what was contained in the management presentation. (Bebo, Tr. 4130-32; *see* Ex. 1014, p. 45 (third quarter of 2009 management presentation indicating that the LTM occupancy calculation for the Cara Vita portfolio was 82%); Ex. 0035, p. 6 (materials sent to Ventas for the third quarter of 2009 indicating that the LTM occupancy calculation for the Cara Vita portfolio was 82.1%).)

Exhibit	Document	Occupancy Calculation for the CaraVita Portfolio—**Quarter**	Occupancy Calculation for the CaraVita Portfolio—**LTM**	Threshold Occupancy Requirement for **LTM**	Difference Between the CaraVita Occupancy Calculation and the Threshold Requirement
Ex. 77, p. 37	Q1 2009 Board materials	84%	83.4%	82%	1.4%
Ex. 3064, p. 41	Q2 2009 Board materials	80.9%	82.6%	82%	.6%
Ex. 1014, p. 45	Q3 2009 Board materials	80.3%	82%	82%	0%
After Derek Buntain's comment about adding additional employees to the Cara Vita covenant calculations, so ALC would not be right on the Cara Vita Covenants					
Ex. 3005, p. 44	Q4 2009 board materials	82.6%	82.1%	82%	.1%
Ex. 0084, p. 80	Q1 2010 board materials	85.3%	82.5%	82%	.5%
Ex. 3204, p. 48	Q2 2010 board materials	87%	83.9%	82%	1.9%
Ex. 1027, p. 48	Q3 2010 board materials	87.9%	83.5%	82%	1.5%
Ex. 1022, p. 50	Q4 2010 board materials	83%	84.7%	82%	2.7%
Ex. 1023, p. 45	Q1 2011 board materials	81.8%	83.9%	82%	1.9%
Ex. 1026, p. 45	Q2 2011 board materials	84.5%	83.4%	82%	1.4%
Ex. 89, p. 49	Q3 2011 board materials	87.9	83.5%	82%	1.5%
Ex. 1028, p. 51	Q4 2011 board materials	87.4%	85.6%	82%	3.6%

The second indication in the Board materials that Mr. Buntain made his comment during the third quarter 2009 Board meeting is that the Board materials changed in response to his comment. More specifically, the management report (the slideshow presented to the Board of Directors) included a slide about the CaraVita properties and that slide had an asterisk, which indicated there was a CaraVita building very close to falling below the covenant thresholds. (*See* Bebo, Tr. 4133.) That asterisk disappeared after Mr. Buntain's comment during August 2009 Board meeting, because ALC started including additional employees to create a cushion. (*Compare* Ex. 0077, p. 37 (Q1 2009 Board materials—the slide about the CaraVita covenants has an asterisk at the bottom of the slide), Ex. 3064, p. 41 (Q2 2009 Board materials—the slide

about the Cara Vita covenants has an asterisk at the bottom of the slide), *and* Ex. 1014, p. 45 (Q3 2009 Board materials—the slide about the Cara Vita covenants has an asterisk at the bottom of the slide), *with* Exs. 3005, 3204, 1027, 1022, 1023, 1026, 1028, and 89 (all other Board materials after Q3 2009, but before 2012; the slide about the CaraVita covenants does not have an asterisk at the bottom of the slide in any of these presentations).) Thus, Ms. Bebo's testimony and the Board materials support the conclusion that Mr. Buntain's comment was made during the third quarter 2009 Board meeting.

B. Grant Thornton discussed employee leasing with the Audit Committee in 2009, 2010, and again in 2011.

In addition to management, Grant Thornton's engagement partners—Melissa Koeppel and Jeff Robinson—discussed the employee leasing program with the Audit Committee on multiple occasions; not one of the Audit Committee members was surprised to hear about it:

Q	Now I want to switch gears a little bit and talk about your interactions with ALC's board or Audit Committee on this subject. During 2009 and 2010, did you generally attend Audit Committee meetings?
A	Yes.
Q	And would you attend the whole meeting or just parts of it?
A	I would attend the entire Audit Committee meeting, except when we would be dismissed and they would have conversations with management.
Q	And for those Audit Committee meetings, did only the Audit Committee members attend, or were other members of the board of directors typically in attendance?
A	It was typical that the entire board would be there. The committee meeting would be a subset of the board meeting, and all would just stay.
Q	In 2009 or 2010, do you recall ever bringing up the inclusion of employees in the covenant calculations before the board?
A	Yes, I believe I brought it up twice.
Q	When was the first time that you brought that subject to the board's attention?
A	My recollection is when I first became aware of it. So it would have been in connection with a quarter in 2009.
Q	And at that time, what do you recall telling the board?

A	My recollection was that I commented that management had entered into an arrangement with Ventas to include in the covenant calculations employees who had stayed at the properties for a business purpose.
Q	And do you recall -- do you recall anything else about what you told the board?
A	No.
Q	And did you get any questions from the board members about that?
A	No.
Q	What do you recall, if anything, about their reaction to your presentation about this issue?
A	You know, that they were engaged in the conversation. You know, their body language didn't express any surprise. In talking with them across the table, they seemed to kind of acknowledge it, and then we moved on to other subjects.

(Koeppel, Tr. 3328-30.)

Ms. Koeppel brought up the topic again in 2010, after the number of employees being included in the covenant calculations had increased; again, none of the Audit Committee members expressed any surprise. (Koeppel, Tr. 3335-37; *see also* Robinson, Tr. 3440 (Mr. Robinson testified he was informed that topic was discussed during the third quarter 2010 Audit Committee meeting).) Ms. Koeppel also testified that it would have been her practice to discuss this issue with the Chair of the Audit Committee—Malen Ng—during their "pre-call" before the meeting. (Koeppel, Tr. 3337-38.)

Similarly, Mr. Robinson discussed the topic—the fact that the company was using employees to meet the covenant calculations—with the Audit Committee during the meeting for the first quarter of 2011; again, no one was surprised:

Q	Prior to March 2012, what, if any, discussions did you have with the board about ALC including employees in the covenant calculations?
A	Are you asking about conversations with the board as a whole?
Q	Yeah, let's -- let's talk about just, yeah, at board meetings -- board or Audit Committee meetings.
A	So we actually had a conversation with the Audit Committee during the closing of the first quarter review of 2011 regarding the existence of the practice of utilizing employees to fulfill the covenant calculations with those leases. That was an Audit Committee meeting. There were other

	members of the board that were in attendance at that Audit Committee meeting, as frequently happened.
Q	Do you know whether all of the other board members were in attendance?
A	I don't remember if all of them were in attendance.
Q	And what -- what do you remember about that discussion with the Audit Committee?
A	What I remember about the conversation was that we -- again, as I mentioned, we did inform them that the company was utilizing these -- you know, the employee count for purposes of meeting the covenants and that it was our understanding that this was in accordance with an agreement that management had with Ventas.
Q	At that time, did any of the board members ask you any questions about that?
A	Not to my recollection.
Q	What, if any, impression did you get with respect to whether they knew about this subject matter already?
A	The impression -- the impression I received in that meeting was that there didn't seem to be any surprises when we told them that. So it confirmed my belief that they had been previously informed by our -- that they had been informed by our previous audit teams on this topic.

(Robinson, Tr. 3430-31.)

Mr. Robinson also told the Audit Committee that there was "no net impact on revenue to the consolidated financial statements" from the revenue related to the employees. (Robinson, Tr., 3432.) He told the Committee that ALC would have failed the covenants without the employees. (Robinson, Tr. 3514 ("Q Well, did you inform the Audit Committee that without the inclusion of these employees, ALC would fail the covenants? A Yes, we did. Q You indicated that to the Audit Committee. A Yes, we did.").) Mr. Robinson also discussed the matter with Ms. Ng, during his call with her prior to the Audit Committee meeting; again, she did not express any surprise that ALC was utilizing employees to meet the covenant calculations. (Robinson, Tr. 3435-36; Exs. 1913, 1913A (agenda for call includes "Caravita covenants"); Robinson, Tr. 3516-17 (Mr. Robinson confirmed he spoke with the Audit Committee about employee leasing, despite topic not specifically noted in the minutes; "the agenda that we used for Malen was the same agenda we used for our Audit Committee discussion"; other items they

discussed not in the minutes either); Robinson, Tr. 3520-21 (reconfirming the same); *see also* Robinson, Tr. 3438-39 (Mr. Robinson testified that he was not surprised in April 2012 that Mr. Buono believed Board was aware of this); Robinson, Tr. 3449-50 (Mr. Robinson was surprised by tenor of Bell memo).)

And, again, Mr. Buono's testimony corroborates this: "[Malen Ng] knew about employee leasing." (Buono, Tr. 2417-18 ("Before board meetings and Audit Committee meetings, there would be a call set up. It would be Mr. Robinson and whoever the manager was speaking with Ms. Ng as the head of the Audit Committee. There would be Ms. Ng speaking with David Hokeness and Ms. Ng speaking with me, three separate calls. During one of the calls with me, Ms. Ng mentioned that Mr. Robinson had discussed employee leasing, that we were renting rooms to employees, and that was part of how the covenants were being made."); Ex. 1115 (November 5, 2009 email correspondence from Mr. Buono to Ms. Ng regarding, inter alia, employee leasing); Buono, Tr. 2523-24 (after reviewing Ex. 1115, Mr. Buono clarifies that it was third quarter 2009 when discussions with Grant Thornton and Ms. Ng occurred; "It was most likely the discussion associated with the third quarter of 2009 that I talked about earlier where I have discussion with Malen, Grant Thornton has a discussion with Malen, and Dave Hokeness has a discussion with Malen. She probably had a few questions, and I was providing answers.").) In fact, Mr. Buono himself "presented specific information regarding compliance with the CaraVita covenants[, and t]he members of the Committee discussed [that] information." (Ex. 1179, p. 4 (November 6, 2009 Audit Committee Meeting Minutes).)

C. Management discusses the employee leasing program with the Board again in 2011 when evaluating ALC's response to the SEC comment letter.

Management discussed the employee leasing program with the Board again in August 2011 when the Board was considering ALC's response to the SEC comment letter—in particular,

management discussed with the Audit Committee and the Board why it was comfortable with meeting the occupancy covenants for the remainder of the lease. (Bebo, Tr. 2108 (discussed response to comment letter in August 2011); Bebo, Tr. 4246, Ex. 1048 (Mary Zak Kowalczyk's handwritten notes from August 4, 2011 meeting); Ex. 86, p. 46 (slide from August 4, 2011 meeting presentation); Bebo, Tr. 4249-52.) That is, ALC had the flexibility of the employee leasing program to meet the covenants. (*Id.*) Among other things, management discussed different scenarios, how they have flexibility under the agreement, and the fact that ALC had a large number of people with a reason to go to the CaraVita properties. They discussed how they did not see the economy getting any worse than it had been, and therefore, there was no need to rethink the flexibility of the agreement. (Bebo, Tr. 4249-52.)

Despite maintaining on direct examination that he did not learn about the employee leasing program until March 2012, Mr. Buntain testified on cross-examination that management did indeed discuss employee leasing while the Board evaluated its response to the SEC comment letter, in August 2011:

Q	Just so you know, I'm not suggesting that that was given to you physically. But you do recall that management explained to the board why and how they were comfortable with the occupancy and coverage covenants that relate to the Ventas properties, correct?
A	Yeah. They justified their use of the employees.
Q	Yeah. And they justified -- they did that by saying, look, there was an agreement with Mr. Solari at Ventas, and we could use employee allocations.
	…
A	THE WITNESS: Well, the memo to Mr. Solari by Ms. Bebo said something. When she didn't hear anything back, she took that as an approval.
Q	That's right.
A	He didn't approve it back in writing.
Q	But that was -- what I'm saying is that was gone over with you and the board with respect to their justification for why they were meeting the occupancy and coverage covenants.
	MR. HANAUER: Can we get a time frame on this, Your Honor?

	JUDGE ELLIOT: Yes. Yes. I'll sustain that. You'll have to be more specific time wise. MR. CAMELI: Absolutely.
Q	That would be -- let's pull this up. That would be -- this would be August of 2011 when this comment letter was discussed.
A	Um-hum.
Q	Okay. Now, let me go back to what I was just talking about. They justified the reasons for being in compliance by referencing the agreement with Ventas regarding the use of employees for covenant calculations, didn't they?
A	*Well, that's one of the ways they justified it, yes.*

(Buntain, Tr. 1452-54 (emphasis added).)[34]

[34] Despite the Division's attempts to "rehabilitate" Mr. Buntain, and get him back in line with the Division's theory that it was March 2012, not August 2011, when management discussed this issue with the Board, Mr. Buntain's testimony is clear that he was referencing the discussion of the response to the SEC comment letter:

> Q When management said that, was that in August 2011 or March 2012?
> MR. CAMELI: It's asked and answered, Your Honor. I object.
> JUDGE ELLIOT: Overruled. You can answer.
> THE WITNESS: Well, they definitely said it in 2000 -- March 12th. March 7th, I guess. *But there were some comments along the way. I can't recall the specific date when they said it, but that's what they used.*
> *And quite frankly, the letter was prepared by Laurie and John Buono that went to the SEC. We had some input into it, but I never saw the final draft.*
> MR. HANAUER: And I think we have some very muddled testimony here, Your Honor.
> JUDGE ELLIOT: Yeah. I'm baffled. I'm completely confused. Let's try to clear this up.
> BY MR. HANAUER:
> Q When was the first time you were aware of the -- you learned of the Solari letter?
> A Well, that was after the fact. There was reference to it at the time of the March 6th meeting.
> Q Okay. And prior to the March 6th meeting, did management ever tell the board that Ventas had agreed to allow ALC to include employees in the covenant calculations?
> A Not to my knowledge.

And although Mr. Buono's memory of the events contains less detail than Ms. Bebo's, he confirms that they did discuss the employee leasing program at the August 2011 Board meeting while discussing the response to the SEC comment letter. (Buono, Tr. 4629-631.) Of course, the only reason employee leasing would come up in the context of the response to the SEC comment letter would be in the context of meeting the covenants. (*See* Ex. 295, p. 5 (response to SEC comment letter: "[b]ased upon current and reasonably foreseeable events and conditions, the Company does not believe that it has a reasonably likely degree of risk of breach of the CaraVita Covenants").)

D. The Board had all of the information it needed to evaluate the scope of the employee leasing program at every Board meeting.

In February or March 2009, Mr. Bell asked management to provide information, on a quarterly basis, about the status of the CaraVita covenants. (Bebo, Tr. 2036-037 ("Specifically, the request was to show the board the overall covenant calculations as they go to Ventas, because the board already had the information with--without employees. So there was a brief discussion about, well, how will they know the difference? And so I don't remember if Mr. Buono offered it, exactly how it came about, but that is correct, that that request was made from Mr. Bell. And subsequent to that request, which either took place at the end of the February 23rd, 2009 board meeting or the conference call board meeting that we had in March of 2009, that slide with the overall covenant calculations on it show up in the PowerPoint presentation, I believe, from April of 2009 forward.").) For every meeting thereafter, the Board was given all of the information it needed to evaluate the scope of the employee leasing program. That is, in each Board package

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(Buntain, Tr. 1454-55) (emphasis added). As ALC submitted its response in August 2011, that conversation discussing it also occurred in August 2011. Indeed, notes of the August 2011 Board meeting confirm as much. (*See* Ex. 1048 (Mary Zak Kowalczyk's handwritten notes from August 4, 2011 meeting; "CaraVita Covenants … Reviewed covenants … Management reviewed how it has come to its confidence levels -- Reviewed in light of SEC comment letter and comments in #2 of our response to SEC comment letter").)

provided in advance of the quarterly meetings, the Board was given two sets of occupancy numbers—one with the employees included in the calculations, and one without. (*See, e.g.,* Ex. 81 (November 2009 Board package), Ex. 86 (August 2011 Board package).) This information was readily available at every Board meeting, including the two meetings discussed above, when the CaraVita covenants were a topic of discussion.

In the November 2009 Board package—for the meeting at which Ms. Bebo addressed the employee leasing program—the following information was available, for example:

1. A presentation detailing ALC's performance in Q3 2009 compared to previous quarters, on a region by region basis, including the South East region, which included all but one of the CaraVita properties (Ex. 81, pp. 23-26);

2. Information showing the South East region had declining occupancy from Q3 2008 through Q3 2009, with 331 units occupied out of 495 total, for an occupancy rate of 66.87%, in Q3 2009 (Ex. 81, p. 24.);

3. Information relating to ALC's compliance with the CaraVita covenants showing the quarterly occupancy on a per facility basis ranging from 73.9% - 96.4% (significantly higher than the 66.87%) (Ex. 81, p. 54); and

4. Information showing no cushion between the actual portfolio occupancy and the threshold requirement—an 82% occupancy rate for the last twelve months, exactly the same as the occupancy rate required by the covenant (Ex. 81, p. 54).

Similarly, in the August 2011 Board package—for the meeting during which the SEC comment letter and the proposed response were discussed—the following information was available, for example:

1. An operations analysis, dated June 30, 2011, including a Profit Contribution by House spreadsheet and a column listing the occupancy percentages, listing 59% occupancy for CaraVita Village (Ex. 86, pp. 56, 63-66); and

2. An Appendix, dated June 30, 2011, including information labeled "CaraVita Acquisition," listing 76.3% occupancy for CaraVita Village (Ex. 86, pp. 68, 83).

That is a difference of over 15%, and information readily available to the Board.

Again, Mr. Buono corroborates this fact:

Q	Isn't it true that you provided the board the CaraVita occupancy numbers both with and without the inclusion of employee occupants?
A	In the board book.
Q	You did that?
A	In the board book, yes.

(Buono, Tr. 2755.) Mr. Buono believes this was done because the Board wanted the numbers as provided to Ventas and without the apartments ALC paid for so that they could compare those Facilities' performance to the other ALC properties. (Ex. 2117, p. 2.)

Similarly, Mr. Hokeness confirmed that with the information provided to the Board, he was able to calculate the occupancy percentages with and without employees, and did so on a copy of the Board materials. (Hokeness, Tr. 3141 ("JUDGE ELLIOT: So then is it -- can I infer from this that both the occupancy percentages with employees and the occupancy percentages without employees were provided to the board? THE WITNESS: If my recollection is correct, the highlighted material in yellow was -- went to the Audit Committee, but in addition to an Audit Committee package, there was Appendix A, B, C, 1, 2, 3. They received a lot of materials. I believe where it says, 'Board package at June 30,' I just extracted that from one of the exhibits that the board also received. JUDGE ELLIOT: So if someone had looked through the materials going to the board, they could have reproduced your numbers here; is that right? THE WITNESS: Except for the 'At 7/27.' But you're correct. 'At the board package,' I believe that's from materials that the board also had."); *see also* Ex. 293, p. 17 (Board materials with Mr. Hokeness's handwritten calculations); Ex. 293A.)

Pursuant to ALC's Corporate Governance Guidelines, board materials were distributed in writing to Board and Committee members in advance of a meeting to allow directors "to properly review and understand" the materials. (Ex. 1016, p. 8.) But, shockingly, the members

of the Board and the Audit Committee contend that they did not review the detailed financials provided to them. (*See, e.g.*, Buntain, Tr. 1369; Roadman, Tr. 2566; Rhinelander, Tr. 2820-21.) This was proven false as well; other witnesses confirmed that these materials were reviewed at Board meetings. (Bucholtz, Tr. 2959-60.) Indeed, Ms. Bucholtz reviewed the occupancy percentages at the specific CaraVita Facilities at the March 2011 board meeting. (*Id.*)

E. Finally, Milbank concluded that the employee leasing program was not concealed from the Board.

In addition to all of the evidence showing that the Board was aware of the employee leasing program used to satisfy the CaraVita covenants, Milbank quickly reached the same conclusion during its internal investigation. On May 14, 2012, Milbank informed Grant Thornton that allegations that it was concealed from the Board were incorrect. (*See* Ex. 3460, p. 2 (Grant Thornton notes of call with Milbank: "Based on their initial discussions, they believe the consideration that this practice was concealed from the Board is incorrect."); *see also* Robinson, Tr. 3461-62 (confirming Milbank relayed that conclusion).) And after its full investigation, Milbank concluded that the Board was aware of the practice of ALC paying for rooms to be included in the covenant calculations, and then learned of the broader range in 2012. (*See* Ex. 1879, p. 9 (Grant Thornton notes of Dec. 17, 2012 call with Milbank: "Board believed that the rooms were to be used and paid for by ALC. Board learned of the broader arrangements in 2012."); *see also* Robinson, Tr. 3473 (identifying notes from Dec. 17, 2012 call).) Of course, the Board was aware of the broader practice before 2012, after having discussed it on more than one occasion and having regular access to all of the occupancy information showing the scope of the practice, *see supra*, but, nonetheless, any Board member's testimony that he knew nothing of the employee leasing program before 2012 is simply not credible.

XIV. GRANT THORNTON—ALC'S AUDITOR—WAS AWARE OF THE EMPLOYEE LEASING PROGRAM AND SIGNED OFF ON ALL AUDITS.

Grant Thornton was aware of the employee leasing program from the outset. Grant Thornton's engagement partners discussed the employee leasing program with management and the Audit Committee. Every time Grant Thornton's engagement team asked for information about the CaraVita covenant calculations, ALC provided it to them. They were provided with a copy of the February 2009 Solari email, documenting the clarification of the lease reached by ALC and Ventas, and felt that it was sufficient confirmation of the agreement. Every quarter they were given a spreadsheet calculating the CaraVita covenants, and they had access to all of the information needed to evaluate those calculations. Grant Thornton understood that ALC would fail the covenants without the inclusion of employees. And with all of this information, during the life of the Ventas lease, Grant Thornton signed off on every audit.

A. Grant Thornton discussed the employee leasing program with ALC at least once every year.

Grant Thornton's engagement partners—Melissa Koeppel and Jeff Robinson—discussed the employee leasing program with members of management, the Chair of the Audit Committee, and/or the Audit Committee at least once every year from 2009 through 2011. (*See, e.g.,* Koeppel, Tr. 3328-30 (discussion with the Audit Committee in 2009); Koeppel, Tr. 3335-37 (discussion with Audit Committee in 2010); *see also* Robinson, Tr. 3430-31 (Mr. Robinson testified he was informed that topic was discussed during the third quarter 2010 Audit Committee meeting); Koeppel, Tr. 3337 (Ms. Koeppel's practice to discuss with Chair of Audit Committee during pre-call); Robinson, Tr. 3430-31 (Mr. Robinson "had a conversation with the Audit Committee during the closing of the first quarter review of 2011 regarding the existence of the practice of utilizing employees to fulfill the covenant calculations with those leases");

Robinson, Tr. 3435-36 (2011 call with Chair of Audit Committee); Exs. 1913, 1913A (agenda for April 2011 call includes "Caravita covenants").)

In fact, Grant Thornton was aware of the agreement from the outset. Ms. Koeppel first learned that ALC was including employees in the covenant calculations in either the second or third quarter of 2009. (Koeppel, Tr. 3312-13.) The engagement team informed her of the arrangement and confirmed that there had been written documentation supporting the inclusion of employees in the calculations, expressing no concern. (*Id*. at 3313-14.) After learning about this from the engagement team, Ms. Koeppel spoke with Mr. Buono, who confirmed that there had been a clarification of the covenant calculation, agreed to by both Ventas and ALC. (*Id*. at 3315-17.) Mr. Buono discussed with Ms. Koeppel that these were unusual economic times, and these were "unique circumstances addressing a unique situation." (*Id*. at 3321-22.) She also spoke with Ms. Bebo and Mr. Hokeness, to confirm that there was an agreement with Ventas. (*Id*. at 3322-23, 3327.)

And although there may have been some confusion on Grant Thornton's part regarding the precise scope of the employee leasing program and exactly what information Ventas was receiving over the course of the engagement, all of that confusion was cleared up by the time of the 2012 audit (*see, e.g.,* Robinson, Tr. 3406-07 (full spreadsheet not sent to Ventas)[35]) and ALC never withheld any information from Grant Thornton.

B. Every time Grant Thornton's engagement team asked for information about the CaraVita covenant calculations, ALC provided it to them.

Grant Thornton had a team of five to eight people working on the ALC engagement. (Koeppel, Tr. 3308; Robinson, Tr. 3382-83.) That is, multiple people asked for or evaluated the

[35] Grant Thornton learned that Ventas was not receiving the employee-specific information by February 20, 2012. (Robinson, Tr. 3414.)

information ALC was providing to Grant Thornton. Every quarter, ALC provided Grant Thornton a spreadsheet detailing the CaraVita covenant calculations. (*See, e.g.,* Ex. 3315 (email from Daniel Grochowski to Stephanie Liebl enclosing covenant calculation speadsheets); Robinson, Tr. 3398.) When Grant Thornton asked for documentation of the agreement with Ventas, ALC provided it, and Grant Thornton was satisfied with it. (Exs. 1379, 1379A.) When Grant Thornton asked for a list of names for the employee additions to the occupancy calculations, ALC provided lists. (Koeppel, Tr. 3341-42.) After Grant Thornton learned that Ventas was not receiving the employee-specific information, they asked for documentation of the agreement with Ventas, again, and were satisfied with the sufficiency of the Solari email, again. (Robinson, Tr. 3418-20; Exs. 1824, 1824A (internal Grant Thornton email, dated March 5, 2012, attaching Solari email: "FYI - for ALC file to support Caravita lease using employees. We'll want to roll this from year to year."); Robinson, Tr. 3421-22 ("We concurred that this documentation, in addition to the fact that the company had been continuing to provide -- or include employees in their calculations for a number -- for a number of years, and that we had been told by management that this arrangement existed for a number of years, that there was adequate -- that that was adequate documentation.").) And neither ALC nor Mr. Bebo ever refused to provide information or answer questions about the employee leasing program. (Koeppel, Tr. 3360-61.)

C. Grant Thornton had all the information it needed to evaluate the covenant calculations and the employee leasing program.

During the course of its audit work, Grant Thornton made site visits to several of the CaraVita properties, including in 2010. (Koeppel, Tr. 3338-40.) ALC provided lists of names for the covenant calculations, and part of Grant Thornton's general practice would be to review the detail and look for unusual items. (Koeppel, Tr. 3342.) Many of those lists included the

same employees at multiple locations for the same quarter. (*See* Ex. 3315.) And Grant Thornton did not find that troublesome:

Q	Yeah. Based on your understanding of the arrangement with Ventas, could ALC reserve rooms for the same person at multiple properties for the same time period for purposes of the covenant calculations?
A	And so you're asking me if that was -- if that practice would be consistent with my understanding of the arrangement with Ventas?
Q	Right.
A	Well, I would have believed at that point in time that an individual might spend time at various of the locations because of the geographical proximity these locations had to each other, and that they may have needed to have rooms available to them at various locations.

(Robinson, Tr. 3404.) Grant Thornton also understood that the employees were not paying rent, and instead, ALC was paying the rent. (Robinson, Tr. 3404-05.) Indeed, Grant Thornton tested the journal entries associated with the employee leasing program; the engagement team knew the purpose of and tested "the 997 activity in the elimination of intercompany revenue." (Koeppel, Tr. 3351-52; Ex. 1679 (Grant Thornton work paper on 997 revenue activity.))

Koeppel confirmed as much:

Q	And so -- just so we're straight with what the note says after the entry revenue was automatically booked, it goes on to say, As the amounts are technically intercompany, they need to be eliminated, which is done through Entity 997 in the southeast region interco line in the schedule below, paren, highlighted in blue. The intercompany revenue by house is calculated monthly by Dan Grochowski, treasury, and John Buono. It is based on charges per day times the number of ["]employee occupants["] times the number of days in the month. GT agreed selected months to journal entries to get comfortable with the revenue amount being booked and subsequently eliminated. Did I read that correctly?
A	Yes.
Q	Is that note meant to reflect the audit team's understanding of what's going on with this 997 account?
A	Yes.

(Koeppel, Tr. 3352-53.)

Grant Thornton also reviewed ALC's 10-Ks and 10-Qs, and was aware of the disclosures related to the CaraVita covenants. (Koeppel, Tr. 3359-60.) In fact, Ms. Koeppel did not believe it was necessary to disclose anything more about how ALC was meeting the covenants under the circumstances, as that would not be a typical disclosure. (*Id.*)

Indeed, Grant Thornton's understanding of the program was noted in the work papers:

> Consistent with PY testing, the employee adjustment relates to extra rooms at each facility that are not currently occupied by ALC residents, but are set aside for ALC employees to improve the overall performance of each facility. This adjustment is made quarterly along with the other adjustments described above. While this is consistent with the approach taken in prior quarters, in order to determine if this adjustment is reasonable, GT reviwed the Ventas lease agreement to gain a better understanding of the term "occupancy" as defined in this calculation. Per review, GT noted nothing in the agreement which defines "occupancy" in greater detail. Each quarter the Company sends Ventas this detailed occupancy spreadsheet which displays all adjustments being made to occupancy on a monthly basis. Since Ventas receives this spreadsheet, they have the opportunity to disagree with the calculation and adjustments being made. When considering this and the fact that Ventas has not openly disagreed with the calculation, GT considers the adjustments being made to be reasonable. See further work performed at <Reserve Center Analysis>.

(Ex. 1685, p. 5; Ex. 1696.)

Q	..So we're looking at pages 7 and 8 of Exhibit 1696, and it indicates under revenue activity, ALC passing these lease covenants thus GT wanted to confirm this was acceptable. GT reviewed an e-mail from Laurie Bebo, CEO of ALC to Joe Solari Ventas REIT, lessor of CaraVita properties on February 4, 2009, at 3:10 p.m.
	Did I read that correctly?
A	Yes, you did.
Q	And it states, Within the e-mail it was noted that Laurie confirms ALC's notification to Ventas that they will be renting rooms to employees. She confirmed room rentals related to employees that are in the ordinary course of business and on terms no less favorable than would be obtained in a comparable arm's-length transaction with a third party. The rep letter includes a representation that ALC is in compliance with its covenants. As such, GT will PFR.
	Did I read that correctly?
A	Yes.
Q	What does PFR stand for?
A	Pass further review.

(Robinson, Tr. 3428-29.) Grant Thornton also understood that ALC would have failed the covenants without the employees (and informed the Audit Committee of the same). (Robinson, Tr. 3514.)

XV. EVENTS IN 2012 CONFIRM THAT MS. BEBO ALWAYS ACTED IN THE BEST INTEREST OF ALC'S SHAREHOLDERS, ALWAYS BELIEVED ALC APPROPRIATELY MET THE LEASE COVENANTS, AND THAT VENTAS DID NOT CARE ABOUT VIOLATION OF THE FINANCIAL COVENANTS.

A. Mr. Hennigar's decision to put ALC up for sale drove his and the Board's decision-making about the company in late 2011 and 2012.

In the summer of 2011, Ms. Bebo learned from Mr. Rhinelander that Mr. Hennigar wanted to explore selling ALC. (Bebo, Tr. 4324; *see also* Buono, Tr. 2371-72.) Around that time, ALC hired an investment banking firm, Citibank, to assist in locating parties that would be interested in bidding on ALC and to help facilitate the sale. (Rhinelander, Tr. 2829.) Ms. Bebo realized that this strategic focus would take a substantial amount of her time, and take time away from her duties running the day-to-day operations of ALC. (Bebo, Tr. 3837-38.) In trying to keep up with the significant additional responsibilities required by the sale process Ms. Bebo began working approximately 100 hours per week. (Bebo, Tr. 3838.) She pleaded with Mr. Hennigar and Mr. Rhinelander to let her hire a Chief Operating Officer, but Mr. Hennigar did not want to increase the company's expenses in the middle of the process.[36] (Bebo, Tr. 3839.) Instead, he and Mr. Rhinelander instructed Ms. Bebo to focus on the sale process and try and get it completed on an expedited basis. (*Id.*)

Ms. Bebo foresaw potential problems manifesting in ALC's operations due to this decision, and realized that operationally there was a potential for things to fall through the cracks

[36] Ms. Bebo had requested permission to hire a COO on previous occasions, but Mr. Hennigar refused those requests because philosophically Mr. Hennigar was "interested in maintaining a low cost model and for us at ALC to be able to drive high margins and high cash flow." (Bebo, Tr. 3837; *see also* Rhinelander, Tr. 2915.)

without her involvement in the operational systems that she had developed over the previous five years. (Bebo, Tr. 3839-40.) She told Mr. Buono that, "we are either going to get the company sold fast enough or there was going to be some implosion…." (Bebo, Tr. 3840.)

A window into how the sale process affected Ms. Bebo's responsibilities and workload at ALC is also reflected in an April 3, 2012 e-mail to Mr. Rhinelander:

> The time constraints are horrendous and at least 8 of us are not getting to the normal things we need to do. I do not complain about the hours I work and I know you like to tell me that some of what I do is unnecessary but it is obvious there are problems brewing because of our inability to do our regular work. Physicall Mel, I cannot work more hours. Since this process has started in November or December I have gone to the extreme for work. At least two nights a week I stay up all night at the office working. The other days I work as much as I physically can and get 4-6 hours of sleep. Weekends I am working either at home or the office. I have not taken a vacation day for over 18 months.

(Ex. 1595, p. 1.)

B. The Division falsely asserts that Ms. Bebo attempted to hide facts about employee leasing from bidders and Ventas during the sale process.

In another failed attempt to try to demonstrate deceptive conduct, the Division attempted to show that Ms. Bebo improperly sought to (a) hide occupancy data without employees from bidders early in the process; and (b) prevent bidders from receiving a disclosure about the reason for the negative revenue in the 997 Account. (*See* Div. Prehearing Br., pp. 14-15.) Neither assertion is supported by the evidence.

The first assertion is based on two e-mails Ms. Bebo sent to Citibank in July 2011 related to uploading ALC occupancy data for all of its facilities into the data room that bidders could access and review. (*See* Exs. 287, 292; Rhinelander, Tr. 2903-04.) Ms. Bebo and Mr. Rhinelander discussed whether granular information about ALC's occupancy should be provided to bidders generally at this point, early in the process. (Rhinelander, Tr. 2831, 2903-04; Bebo Tr. 4434.) They concluded that they would prefer that none of the bidders receive access

to this information at the time. (Rhinelander, Tr. 2830-31.) In particular, they discussed not providing company-wide granular occupancy information to Ventas. (*Id.*) Ventas was the only bidder that was a competitor with ALC. (Bebo, Tr. 2120.) Mr. Rhinelander and Ms. Bebo agreed that Ventas should not receive the information. (Rhinelander, Tr. 2831, 2903-04.)

Mr. Rhinelander described how Ms. Bebo was very concerned about *any* competitive information that could go to *any* of the bidders, the disclosure of which could harm ALC:

Q	Why did you make the decision -- or why did you make the decision not to circulate the occupancy numbers to Ventas?
A	Laurie didn't want the information circulated for a number of reasons. I think I've made the statement previously that one major reason was that they used a company called Atria to manage many of their facilities, that Atria was a direct competitor of ALC, that she felt if they had that data and were not the successful buyer, that that data could be harmful to ALC. Also, Ventas at that point had not signed a confidentiality agreement. There was a whole number of things that Laurie didn't want to do at different stages. So did this one just jump out as the only one? No. She restricted and wanted to confine the site visits by potential buyers, the times you could come. There were a number of things that she requested or asked to do that would have been in conjunction with protecting her competitive advantage.

(Rhinelander, Tr. 2911.)

The Division's entire argument on this point is based solely on the fact that Ms. Bebo first raised the concern about how ALC could be harmed by the disclosure of highly sensitive occupancy data to numerous third parties early on in the sale process, many of whom could be participating for the sole purpose of getting access to this type of sensitive information. The Division's argument cannot be supported by so slender a reed.

Moreover, it is contradicted by the true facts, based on Mr. Rhinelander's own testimony and the e-mails themselves. The e-mails to the investment banker both specifically state that Mr. Rhinelander had the final decision about whether to disclose the occupancy data being

provided to the bidders generally and specifically with respect to Ventas. (Exs. 284, 292.[37]) And Mr. Rhinelander agreed that *he was the ultimate decision-maker about whether to disclose the information and he made the decision not to disclose the information to Ventas*. (Rhinelander, Tr. 2905, 2911, 2914.)

The Division's assertion that Ms. Bebo attempted to prevent disclosure to bidders about the negative revenue build-up in the 997 Account is similarly unfounded. First, Ventas was no longer involved in the bidding process at all. (*See* Bebo, Tr. 4435-36.) Second, the true facts are that Ms. Bebo and Mr. Buono prepared a draft disclosure to bidders that more fully disclosed the employee leasing arrangement than the draft prepared by Mr. Bell. Mr. Bell's draft contained no reference to the use of rooms related to employee stays in the covenant calculations. (Exs. 1076, 1076A.) It was a vanilla disclosure that stated:

> The reserve is taken for the dual purpose to accurately reflect the consolidated numbers for the Company's audited financial statements and in management's view an arrangement with Ventas as the Cara Vita landlord for the treatment of the Company's income and occupancy obligations under the leases.

(Ex. 1076A.) In contrast, the draft disclosure *prepared by Mr. Buono* stated the following:

> no effect on the consolidated financial statements of the Company. The intercompany transaction is taken for the dual purpose of accurately reflecting the Company's audited consolidated financial statements <u>and an email provided to Ventas as the Cara Vita landlord regarding the treatment of rooms reserved for employees at the Cara Vita residences which are paid for by the Company.</u> The intercompany transaction has been discussed with the auditors

(Exs. 1594, 1594A.) Mr. Rhinelander and Mr. Bell rejected the broader disclosure about the "treatment of rooms reserved for employees" and instructed Ms. Bebo to use a disclosure that

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[37] Exhibit 287 states: "Mel and I do not want the individual facility listing and occupancy sent to Ventas at this time. *This is something Mel may choose to do in the future if we get further down a particular path.*" (Emphasis added.) Exhibit 292 states: "Please maintain this [list of per-facility occupancy data] separately and do not release it to Ventas *without Mel's specific permission*." (Emphasis added.)

eliminated the language referring to "management's view [of] an arrangement with Ventas." (*Compare* Ex. 1076A *with* Ex. 325; *see also* Bebo, Tr. 4433.)

Third, the Division's sole focus on Exhibit 326 is improper and again ignores the actual facts of the case. In the e-mail Ms. Bebo indicates that the one bidder that asked a question about the reserve in the 997 Account had dropped out of the bidding, so it may not be necessary to discuss the issue in meetings with the other bidders. Twisting this into some attempt at deception ignores the above conduct and the fact that Ms. Bebo did provide specific information about the reserve to the final bidders. (Bebo, Tr. 4436.)

C. Ms. Bebo's concerns about operational issues caused by Mr. Hennigar's refusal to hire a COO are realized, when state regulators take action to revoke licenses at the CaraVita Facilities and other facilities.

On February 13, 2012, the State of Georgia issued a notice of intent to revoke the license of one of the eight CaraVita Facilities, the Tara Plantation Facility, after investigating a complaint and conducting a survey. (Ex. 1194, p. 207.)

By letter dated March 21, 2012 Ventas provided notice to ALC that the notice of revocation constituted an event of default under the Lease, and reserved its rights to exercise any and all rights and remedies under the Lease. (Ex. 1194, p. 224.)

ALC also received notices of revocation from state regulators related to two more CaraVita Facilities. First, the State of Alabama issued a notice of revocation for CaraVita Village on March 27, 2012. (Ex. 1194, p. 227.) The notice was accompanied by about 90 pages of alleged violations of regulations governing resident care and safety, among other regulations. A few days later, on March 30, 2012, the State of Georgia issued a notice of revocation for Peachtree Estates Facility, accompanied by 41 pages of alleged violations. (Ex. 1194, p. 317.) By letter dated April 5, 2012, ALC provided notice to Ventas of these two additional actions against Facility licenses. (Ex. 1194, pp. 359-60.)

Ventas' reaction to ALC breaching the Lease covenant related to holding the licenses for the Facilities was far different than its reaction when it believed ALC tripped the occupancy covenant earlier in the relationship. This is because losing the license could prevent new resident admissions or the ability of the Facility to operate entirely. (Butora, Tr. 953.) This is far different from a technical default under a financial covenant. Ventas even took the fairly drastic step of hiring undercover security officers to surreptitiously enter the CaraVita Facilities and observe the operations and how the staff of those Facilities was caring for residents. (Doman, Tr. 351.)

D. The March 6, 2012 Compensation Nomination and Governance ("CNG") Committee meeting.

In late February and early March 2012, Mr. Buono was preparing some documents for Mr. Hennigar with respect to the potential opportunity for ALC to purchase the CaraVita Facilities from Ventas. (Buono, Tr. 2388.) Given that ALC had just received a license revocation notice for one of the buildings and because the Board was well-aware of the occupancy and operational issues that ALC was having in the Southeast Region, Mr. Hennigar asked Mr. Buono to explain the justification for the purchase to the other members of the Board that had come to the Menomonee Falls headquarters the day prior to the scheduled Board and Audit Committee meetings on March 7. (*See* Buono, Tr. 2388.) Before meeting with these other board members, Mr. Buono also told Mr. Hennigar that one of the reasons to purchase the properties was "because we got an employee leasing program that may not be recognized and the whole due diligence question would come up." (Buono, Tr. 2388.)

Mr. Buono was brought into the office where Mr. Hennigar, Mr. Bell, Mr. Buntain, and one other board member had convened for an impromptu CNG Committee meeting (one had not been actually scheduled for that day and time). (Buono, Tr. 2388; Bebo, Tr. 2196-97, 4436-37.)

To Mr. Buono's surprise, he was peppered with questions about the employee leasing program. This surprised him because he believed, based on his prior interactions with the board, that they were well-aware of the nature of the use of corporate rooms for employees to meet the covenants. He recalls a conversation with the chair of the Audit Committee, Ms. Ng, around this time where he said to her "how come everybody has amnesia now, and she said, well, I knew about the program, but I didn't know it was that many." (Buono, Tr. 2392.) He was angry about their feigned lack of knowledge and sent Ms. Bebo an e-mail that day with the subject "I hate everyone." (Ex. 2101.) Mr. Buono sent the e-mail because he was "upset" and "felt like we were being, for lack of a better term, hornswoggled by the board and the CNG committee." (Buono, Tr. 2779.)

Ms. Bebo was then brought into the CNG meeting, and also discussed the units ALC rented for employees. She also thought that the way board members were phrasing questions implied that they were unaware of the practice. (Bebo, Tr. 4436-37.) Ms. Bebo answered their questions about the Solari e-mail and the arrangement with Ventas. She did not directly confront their apparent amnesia, but she did refer to Mr. Buntain's cushion comment at the third quarter 2009 board meeting, and explained that the board had made the decision. (Bebo, Tr. 4437-38.)

Ms. Bebo was similarly disturbed and angered by the board members pretending that they did not know about how ALC had been meeting the Ventas Lease covenants. (*See* Bebo, Tr. 4254-55; Zak-Kowalczyk, Tr. 4391-92 (explaining that both Mr. Buono and Ms. Bebo were upset following the meeting).) Those feelings were amplified when she received a cryptic e-mail from her mentor, Mr. Rhinelander, that stated, "You had mention to the board previously about the way you were meeting the lease covenants no?" (Ex. 1039.) She sought to discuss the matter with Mr. Rhinelander, and put the call on speaker so that her mother could listen in.

(Bebo, Tr. 4440-41.) During the call, Mr. Rhinelander indicated he was just kidding in his e-mail and told Ms. Bebo to calm down. (Bebo, Tr. 4443.) He reassured her that the rest of the board had the pertinent information about how ALC was meeting the covenants and Mr. Bell just wanted some more details about the process so he could work with Citibank to discuss the issue with bidders. (*Id.*) They agreed that the board would discuss the matter further at the board meeting the following day. (Bebo, Tr. 4443-44.)

The following day, on March 7, the board met as scheduled. Ms. Bebo sought to discuss with the full board the matters that came up at the CNG committee meeting the day before, but she was prevented from doing so. (Bebo, Tr. 4256.) Mr. Rhinelander instructed her not to bring the subject up because Mr. Bell and Mr. Hennigar did not want to discuss the issue at the board meeting.[38] (Bebo, Tr. 4444-45.) Instead, following the meeting Mr. Bell began collecting additional information about ALC's compliance with the Ventas Lease covenants. (Bell, Tr. 588-89; Ex. 327.) He requested Mr. Buono re-calculate the covenants for each quarter of 2011 without the ALC rented units included. Mr. Buono provided him with the re-calculation of the covenants on March 20, which included a copy of the occupancy reconciliation portion of the spreadsheets that had been used to calculate the covenants previously. (Ex. 329.) Thus, Mr. Bell had copies of all of the lists of employees and other non-residents at that time for all of 2011.

Mr. Bell then prepared a memorandum about the license revocation issues and ALC's rental of units for employees, and circulated it to the Board of Directors on April 4, 2012. (Exs. 1098, 1098D; Ex. 333.) In the memorandum, he alleged it was "[h]ighly unlikely that Feb.4/09 Bebo email re employees is a legal basis for inclusion of employees to meet their

[38] Unbeknownst to her, the Board did discuss the matter without her in executive session. (Roadman, Tr. 2598-99.)

residence occupancy/income covenant in the leases" and "J. Bono [*sic*] compliance certificate re patient revenue is clearly wrong." (*Id.*)

Mr. Buono was irate with Mr. Bell's memorandum. He told ALC's auditor, Jeff Robinson of Grant Thornton, that he thought Mr. Bell was "trying to cover his backside by putting this phrase within the memo." (Robinson, Tr. 3447-48.) He certainly disagreed with Mr. Bell's assertions about his conduct with respect to the certifications of patient revenue being "wrong." (Buono, Tr. 2717-18; Robinson, Tr. 3448.) For the next several weeks, he sought to have Mr. Bell formally withdraw his assertions in the memorandum, and he sought clarification from the rest of the Board members that they did not agree with those two assertions with respect to ALC's compliance with the financial covenants in the Ventas Lease. (Buono, Tr. 2427.) The Board members were equivocal, and based on their lack of responsiveness and his disagreement with Mr. Bell's conclusions, Mr. Buono prepared to resign his position at ALC. (Buono, Tr. 2428-29; Exs. 1156, 1156A.)

Ms. Bebo shared Mr. Buono's concerns and similarly believed that the conclusions contained in Mr. Bell's memorandum were wrong. Since Mr. Bell had only sent it to members of the Board, she sent a copy to Ms. Zak-Kowalczyk, Quarles & Brady, Grant Thornton, and Mr. Buono. (Bebo, Tr. 4456, Ex. 1098.) She discussed the memorandum with Mr. Bell and Mr. Rhinelander, asking Mr. Bell to substantiate his opinion or withdraw it. (Bebo, Tr. 2216-18.) Mr. Bell refused to do either or really discuss the memorandum with Ms. Bebo at all. (*Id.*) Instead, he told her it was not a legal opinion and instructed her to get a reasonableness opinion from ALC's outside counsel, Quarles & Brady. (*Id.*)

Over the course of the next several weeks various personnel at ALC had communications with lawyers at Quarles & Brady about the employee leasing arrangement. (Bebo, Tr. 4286-91; Ex. 347.)

E. Ventas files a lawsuit on regulatory problems but does not bring claims against ALC for unit rentals related to employees.

On April 26, 2012, a few weeks after Ventas received the April 5 notice that state regulators were taking actions against the licenses of two more CaraVita Facilities, it filed a lawsuit against ALC in federal district court in Chicago, Illinois. (Ex. 2075.) The lawsuit alleged that the regulatory notices identified numerous deficiencies with the respective CaraVita Facility's operations which are "jeopardizing the health, safety, and welfare of the residents." (Ex. 2186, p. 9.)

In April and May, ALC and Ventas began discussing a potential negotiated resolution of the disputed event of default and the lawsuit. During those negotiations, Mr. Bell sought to append additional language onto an otherwise broad and general release of claims as part of the settlement. The additional language would have sought a specific release with respect to the use of rooms related to employees to meet the financial covenants in the Lease.

By letter dated April 18, 2012, Quarles & Brady advised against including this in the draft settlement correspondence. (Exs. 1068, 1068A.) ALC's lead internal legal counsel, Mary Zak-Kowalczyk, agreed with that advice and approach. (Zak-Kowalczyk, Tr. 4390-91.) Ms. Bebo also believed that the additional language should not be included, and indeed it was not included at that time.

However, ALC sent another settlement proposal on April 27. Mr. Bell again sought to include specific language with respect to the use of rentals to employees in the covenant calculations. (Bell, Tr. 612-13.) He convinced Mr. Rhinelander of this approach (*id.*), and

Ms. Bebo included the language in the settlement proposal. (Exs. 1535, 1535A.) Specifically, the proposal included the statement: "Without limiting the generality of the foregoing [general release], any claims against Tenants, their employees, officers or directors based upon Tenant renting rooms on the Properties to certain of its employees and including those employees in certificates and covenant calculations would be covered by the above release." (Exs. 1535, 1535A, p. 2.)

On May 9, 2012 Ventas sent another default notice to ALC asserting a host of new alleged breaches of the Lease. (Ex. 355; Doman, Tr. 347-50.) This included allegations that:

- ALC defaulted under the Lease because it attempted to surrender its license for CaraVita Village in Alabama. (Ex. 355, p. 5; Doman, Tr. 348.)
- The revocation of licenses at multiple facilities was an independent default under the Lease. (*Id.*)
- ALC defaulted under the Lease by failing to give timely notice of a fire at Highland Terrace in Florida. (Ex. 355, p. 6, Doman, Tr. 349.)
- ALC defaulted under the Lease by starting fire restoration work at Highland Terrace without providing advanced notice. (*Id.*)

Ventas also included in this default notice the following allegation:

> Tenant has submitted fraudulent information to Landlord in respect of Tenant's compliance with Section 8.2.5 of the Lease and Tenant may have failed to comply with Section 8.2.5 of the Lease by failing to mainain required occupancy and coverage ratios. Such fraud has included treating units leased to employees as bona fide rentals by third parties. Such actions constitute Events of Default under Section 17.1.5 of the Lease.

(Ex. 355, p. 5.)[39]

[39] Interestingly, when this letter was received by ALC Mr. Robinson had a discussion with Ms. Ng and Mr. Bell about the allegations related to the financial covenants. In that conversation those board members told Mr. Robinson that ALC's "position is that this letter is posturing. Quarles & Brady has drafted a letter in response. Statements are false and misleading but has not been mailed yet due to ongoing negotiations." (Robinson, Tr. 3459-60; Ex. 1880, p. 4.)

The next day, Ventas filed a motion to amend its complaint against ALC. (Ex. 2186, p. 10.) The amended complaint was filed on May 14, and Ventas included all of the allegations from the May 9 letter described above, *except* for the allegation that ALC had breached the Lease by submitting fraudulent information to Ventas with respect to the covenant calculations. (Ex. 1194 (amended complaint); Ex. 2076 (ALC's 8-K describing the letter and amended complaint allegations); Division Pre-hearing Br. at 18 n. 5.)

F. Neither the board nor outside counsel recommends changing ALC's disclosure about lease compliance in late April and early May.

The same day that Ventas filed its lawsuit, Quarles & Brady provided an opinion letter that concluded that Ms. Bebo and ALC had acted reasonably in including employees in the covenant calculations. (Ex. 1037.) Mr. Buono prepared a letter to Mr. Bell about his April 4 memorandum and sent it to a Quarles attorney. The draft reflects his view of the Quarles opinion, stating, "As you are aware, external counsel has advised management that in fact the February 4, 2009 e-mail from Laurie Bebo to Joe Solari does provide proper notice and that the certificate regarding patient revenue is proper." (Ex. 1081A; Buono, Tr. 2424-26.)

Quarles & Brady also recommended that ALC file an 8-K disclosing the fact that Ventas had initiated litigation with respect to the alleged defaults under the Lease based on ALC's receipt of license revocation notices from state regulators. (Bebo, Tr. 4482.) They advised that the 8-K needed to be filed by May 2, 2012. (*Id.*)

Neither Quarles & Brady nor any other third party recommended at this time that ALC should modify its disclosure in its first quarter Commission filings or otherwise disclose how it was meeting the financial covenants through the use of apartments that ALC paid for employees and others to use. (Bebo, Tr. 4483-84; Lucey, Tr. 3723-26; Ex. 2058, 2058A, p. 18.) By the time of the reasonableness opinion and preparation of these draft filings, Quarles & Brady

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.)

G. Ms. Bebo urges disclosure of additional information to prevent ALC's May 3 announcement postponing their earnings call from misleading investors.

ALC was scheduled to file its Form 10-Q, hold an earnings call with analysts, and have its annual general meeting of shareholders after the market close on May 3, 2012. (*See* Bebo, Tr. 4485-87.) Ms. Bebo and Mr. Buono, however, had been isolated by the board, with little communication about whether the 8-K recommended by Quarles & Brady would be filed, and what was planned with the other filings, earnings release, and shareholder meeting. (*Id.*; Buono, Tr. 2717-18.) Quarles & Brady was also not responding to Ms. Bebo and Mr. Buono's requests to discuss these issues with them. (Bebo, Tr. 4485-86.)

In the mid-afternoon of May 3, Ms. Bebo went into the room where the rest of the board was meeting to try and find out what they planned to do. Up to that point, Ms. Bebo and Mr. Buono had been effectively frozen out of the loop and they waited in Ms. Bebo's office along with Ms. Zak-Kowalczyk. (Bebo, Tr. 4485.) Members of the board indicated that ALC may not be releasing the earnings information and filing the 10-Q as planned, and would potentially cancel the annual meeting of shareholders. (Bebo, Tr. 4486.) But they were again equivocal and non-committal. (*Id.*) Ms. Bebo was told to leave the meeting, and sometime later she and Mr. Buono were summoned from her office by Mr. Rhinelander to come back to the board room. (*Id.*)

Ms. Bebo and Mr. Buono were told by the board that they had decided to pull the plug on the earnings release, 10-Q filing, and shareholder meeting. (*Id.*) They wanted to put out a one-line press release announcing the delay, without an explanation. (*Id.*) This troubled both Ms. Bebo and Mr. Buono. (Bebo, Tr. 4486-87; Buono, Tr. 2720-21.) The board refused to

reconsider the nature of the press release, and Ms. Bebo urged the board to wait until after the market closed. (Bebo, Tr. 4487.)

She and Mr. Buono explained to the board members that market participants already were aware that the company had been put up for sale - there had been articles in industry press about it - and that "everybody's going to think that there's a sale, and they're going to think that, you know, we're going to delay a day or so here because we want to have some sort of a signed … purchase and sale agreement" to announce. (*Id.*) The board members refused Ms. Bebo's pleas in this regard, and approximately ten minutes before market close issued the following press release:

> Assisted Living Concepts, Inc. announced that it will delay its previously announced May 3, 2012 earnings release and conference call discussion regarding its 2012 first quarter financial results. ALC has not determined a new date for the release and associated conference call.

(Ex. 2081, p. 2.) Mr. Buono and Ms. Bebo left the room and went back to Ms. Bebo's office to see what the market reaction would be.

Ms. Bebo and Mr. Buono were correct about the market mis-interpreting the announcement as a precursor to an impending sale of the company. The stock price shot up immediately. (Buono, Tr. 2720; Smith report, Ex. 2186-0039; Bebo, Tr. 4488-90.) Mr. Buono testified that the "market was speculating that the company was being bought and the stock was trading far in excess of the volume, and clearly, that was not the reason why we were holding the earnings report." (Buono, Tr. 2720.) They rushed back to the board room, bringing Mr. Buono's laptop computer back into the room to show them what was transpiring. (Bebo, Tr. 4489-90.) Ms. Bebo told the Board "this is horrible" and suggested they should put out a corrective press release; Mr. Buono agreed. (*Id.* at 4490; Buono, Tr. 2721.) But there was not enough time because the earlier press release was issued so close to market close. (*Id.*)

In response to the concerns raised by Ms. Bebo and Mr. Buono, board member Derek Buntain said something to the effect that "boy, it looks like someone's going to get rich today," and according to Mr. Buono "he was commenting on the activity and was almost happy about it." (Buono, Tr. 2721-22; *see also* Bebo, Tr. 4490.)

Ms. Bebo was so concerned and despairing about these events, including the potential that investors and shareholders may have been misled with respect to the press release the board directed they issue, that throughout the day on May 3 and May 4 she prepared detailed notes of what was transpiring. (Bebo, Tr. 4491-92; Ex. 354.) She wrote that she feared for her safety, and at the insistence of her mother, locked the notes from those two days in a safe at her home. (Ex. 354, p. 21.) As noted above, Mr. Buono prepared to resign from ALC on May 3.

H. ALC purchases the CaraVita Facilities from Ventas for a reasonable price that added value to ALC.

As noted earlier, ALC had a strong preference for owning their facilities instead of leasing them. Thus only eight months into the Lease relationship with Ventas, ALC first made overtures to Ventas about purchasing the CaraVita Facilities. However, they provided a very low offer to Ventas. Mr. Buono proposed buying the eight Facilities for $52.5 million. (Ex. 3248; Buono, Tr. 4594-95.) This was only $2.5 more than the $50 million Ventas had paid for them a few years earlier. (*See* Ex. 2112, p. 8 (reflecting Ventas investment in the ALC portfolio of $50 million).) Ventas informed ALC that this is "very far from a break-even point" for them. (Ex. 3248.)

In July, 2011, ALC again approached Ventas about their interest level in selling the CaraVita Facilities to ALC. (Ex. 1486; Buono, Tr. 4596-97.) Ventas expressed potential interest in selling if ALC would offer $85 million for the eight Facilities. In an e-mail relaying the discussions with Ventas, Mr. Buono indicated that, at this price, the acquisition would increase

ALC's cash flow by about $2.7 million per year. (*Id.*) In about January of 2012, Mr. Buono again discussed buying the eight CaraVita Facilities, plus four other facilities that Ventas had acquired from a company called NHP (the "NHP Facilities") and which were subject to a different lease with ALC. In a follow-up e-mail, he proposes ALC buying all twelve properties for $88 million. (Ex. 1514; Buono, Tr. 4597-99.)

By early March, 2012, Ms. Bebo and Mr. Buono had concluded there would be significant benefit to ALC to purchase the eight CaraVita Facilities and the four NHP Facilities for a price up to $99 million, particularly in light of the on-going sale process. Thus, Mr. Buono prepared a memorandum that could be shared with bidders, and Ms. Bebo sent it to Citibank. (Ex. 317.) Among the benefits to owning the buildings identified in the memorandum, Mr. Buono identified that ALC could construct additions to the well-performing buildings, and could change the license status of the under-performing buildings, which would increase ALC's earnings by at least $1.8 million each year. (*Id.* at p. 2.) This is in addition to the approximate $39 million that ALC could save over the life of the Lease by owning and paying interest on a line of credit versus the rent they paid Ventas. (Buono, Tr. 4601-02.)

Not surprisingly, when this option was presented to the potential bidders, they thought it would be very favorable to ALC. As Mr. Rhinelander, chair of ALC's special committee in charge of leading the sale process (Rhinelander, Tr. 2903), testified:

Q	...So do you believe that that [the acquisition adding to ALC's earnings] was the case?
A	I don't remember. I do know that we talked to potential buyers to ask them if they would see the acquisition as favorable or not in the context of a potential buyer buying the company, and they affirmed that they would like to see it purchased.
Q	I'm sorry?
A	The buyers that we talked to said that they thought us buying Ventas would be positive to their perception of the company in considering buying us.

(Rhinelander, Tr. 2922-23.)

Consequently, the facts establish that an acquisition of the 12 properties for $99 million was attractive to ALC for many reasons weeks before Ventas ever asserted an event of default with respect to the licensing issues ALC was having at the CaraVita Facilities, and two months before Ventas ever raised allegations about covenant calculations.

But the Division's attempt to tie losses recorded on ALC's financial statements in connection with the acquisition of the 12 properties from Ventas to the May 9 letter's allegations that ALC submitted "fraudulent information" is further unsupported for several additional reasons. (*See* Ex. 1543A.) First, there is no *evidence* tying the losses recorded as part of the acquisition to the financial covenant allegations. All of the evidence demonstrates that the licensing default issues may have played a role in driving the settlement, but the financial covenant allegations did not, including:

- The purchase was part of a settlement of the Ventas lawsuit which never involved allegations related to the financial covenants. (Ex. 364; Ex. 2186, pp. 7-8.)

- ALC's outside counsel provided two separate legal opinions. In one opinion, they concluded that ALC had virtually no defense to the lawsuit alleging that ALC breached the Lease due to the actions taken against the Facility licenses. (Ex. 1050.) In the other, it concluded that ALC acted reasonably in paying for units for use by employees. (Ex. 1037.)

- ALC's in-house counsel similarly testified that she basically ignored any issues relating to the covenant calculations during this time because she had to prioritize the "major significant issues from a regulatory standpoint" which were a potential event of default under the Lease. (Zak-Kowalczyk, Tr. 4393-94.)

- When the board approved the transaction, the meeting minutes note that Ventas' position in the lawsuit with respect to the alleged default as a result of license revocation notices "had merit." (Ex. 1093, pp. 2-3.) The minutes make no reference to any financial covenant issues or allegations driving the purchase. (*Id.*)

In addition, the Division presented scant evidence that the purchase price was unreasonable or even above market value for the properties. The Division focuses on the appraisals that ALC received months after the transaction. By that time - and indeed at the time of the transaction announcement - ALC had already determined that any difference between the appraised value and the purchase price would be written off for tax purposes. (Buono, Tr. 4609-10 (agreeing to the assertion that the lower the appraised value, the greater the tax write-off); 4610-11 (Buono learned right away that GAAP prevented booking goodwill).) In addition, the lower appraised valued would set the "basis" for the value of the properties. (Buono, Tr. 4609-10.) Consequently, by the time ALC obtained the appraisals they were incentivized to obtain the lowest appraisal possible for the properties. (Buono, Tr. 4609-10.)

Moreover, Mr. Durso provided expert testimony with respect to why there were factors that were not considered in the appraisals, that would have led ALC to conclude that the properties were worth much more than the appraised value. These were some of the same factors identified by Mr. Buono earlier in March. In addition, Mr. Durso testified that the appraisers used a very high cap rate that caused the value established for the appraisals to be very conservative. (Durso, Tr. 3154.) Merely substituting a slightly lower cap rate that was more typical of transactions in the industry during this time period would imply a value of around $80 million. (Durso, Tr. 3150-51.) But this still would not take into account the extra value that ALC could obtain by owning the properties instead of leasing them, such as adding on to well-performing buildings, changing licensure status, and cost savings from acquiring buildings in an entire region or integrating the buildings into the rest of the company. (Durso, Tr. 3155-57.)

Also, Ventas confirmed that the properties were worth what ALC paid for them (Doman, Tr. 366), and ALC's board concluded in May that $100 million was market value, but at the high end of the range of market value. (Ex. 1093, p. 2.)

Finally, Mr. Buono conducted a financial analysis of the transaction after ALC acquired the properties. (Ex. 1108; Ex. 1108A.) His analysis demonstrated that the acquisition of the properties would add approximately *$2.40 per share of value to ALC* (and increase ALC's stock by that amount) based on the generation of $2.8 million in free cash flow and the ability to add on units to well-performing properties. (*Id.*; Buono, Tr. 4605-08.) He noted that investors focused on the cash flow metric when evaluating the value of ALC. (Buono, Tr. 4605.)

I. Dan Grochowski's whistleblower letter prompts an investigation by Milbank.

In the Fall of 2011, Mr. Grochowski approached his boss, Mr. Buono, and said he "was not comfortable with the employee leasing program," and requested not to perform the covenant calculations anymore. (Buono, Tr. 2376.) Mr. Buono set up a meeting to discuss his concerns with himself and Ms. Bebo. (*See* Buono, Tr. 2376.)

In that meeting with Ms. Bebo and Mr. Buono, which occurred in November 2011, Mr. Grochowski, said he was "uncomfortable" with the process. (Grochowski, Tr. 1153.) At no time did Mr. Grochowski make an allegation that the practice was "fraudulent," and the primary focus of his concerns was questioning the basis and scope of the understanding or agreement reached with Ventas. (Grochowski, Tr. 1209.) Mr. Grochowski asked a number of other questions, and Ms. Bebo responded truthfully and remarkably consistent with how she has testified in these proceedings. (Grochowski, Tr. 1155-57, 1161-62.) He also questioned the accounting at the facility level regarding whether it complied with GAAP, although he acknowledged he was no GAAP expert. (Grochowski, Tr. 1154.)

Disagreeing with Mr. Grochowski's GAAP characterization, Mr. Buono took over the covenant calculations going forward. (Buono, Tr. 2376-77; Grochowski, Tr. 1162-63.) At the end of the meeting, Ms. Bebo said that Mr. Grochowski did not have to be involved in the calculations if he was not comfortable with it, having not been involved with striking the initial agreement with Ventas. (Grochowski, Tr. 1162.) Ms. Bebo never sought to silence Mr. Grochowski or ask him not to share his concerns with others. (Grochowski, Tr. 1209.)

Several months later, after researching the Commission's whistleblower bounty program, Mr. Grochowski wrote a letter directed to the Chair of the Audit Committee that is far different in tone than the issues he expressed in the meeting with Ms. Bebo and Mr. Buono the previous November. (Ex. 1132.) Mr. Grochowski's May 2, 2012 "whistleblower letter" uses language like "sham" and "accounting misconduct" - language and concerns that were not expressed at all in the earlier meeting. (Ex. 1132.) In response to receiving the letter, ALC's Audit Committee retained Milbank to conduct an internal investigation. (*See* Roadman, Tr. 2613.)

J. Based on Milbank's findings, ALC's board takes no action and Grant Thornton affirms ALC's financial statements and internal controls.

Milbank began its internal investigation around May 4, 2012. (*See* Roadman, Tr. 2613; Bell, Tr. 741.) Milbank periodically kept ALC's auditors, Grant Thornton, updated on the investigation and ultimately reported detailed findings of its investigation in early 2013. During a call on May 10 or 11, Milbank reported to the auditors that it was hired by the Audit Committee to investigate issues relating to ALC "leasing space for employees that travel to the facility and use them," and whether that was "vetted" with Ventas. Milbank also reported that some rooms were also set aside for family members. (Robinson, Tr. 3456.)

Milbank reported its findings to ALC's board by a telephone conference on September 21, 2012. (Bell, Tr. 622-23.) From approximately May 2012 when the investigation

began until September 2012, when Milbank presented its findings to ALC's board, the lawyers had collected computers and e-mails from approximately 23 company personnel, interviewed approximately 16 employees, executives and board members, and conducted their legal analysis. (*See* Ex. 1873, pp. 4-5; 1879.) Milbank also collected and searched back-up tapes. (*Id.*) Based on Milbank's report to the board, ALC and the board took no action at all. It did not restate its financial statements. (*See* Roadman, 2623.) It did not disclose a material weakness in its internal controls during 2012 or prior periods. It did not terminate Mr. Buono, who was the hub of the Ventas covenant calculation process. (Roadman, Tr. 2619-20.) Although Ms. Bebo had already been terminated at the end of May, ALC would later revoke that termination, accept her resignation, and pay most of what she was owed for severance under her employment agreement. (*See* Bebo, Tr. 4513.)

After Milbank reported to the board, it gave a brief summary of its findings to Grant Thornton. (*See* Ex. 1918.) Milbank told Grant Thornton that, based on their investigation, they did not believe that ALC needed to restate any of its prior Commission filings and that they "have not reached a conclusion that there is an identifiable inaccuracy" in those filings. (Ex. 1918; Robinson, Tr. 3464.) With respect to the "[i]ntegrity of the CFO, VP finance, CEO and attorney," Milbank indicated they could not conclude that any prior representations were false. (Ex. 1918; Robinson, Tr. 3464-65.)

When Grant Thornton attended the next regularly scheduled board meeting on November 1, 2012, it sought confirmation from the board that no restatements, modifications, or revisions to previously filed financial statements needed to be made. They obtained that confirmation. (Robinson, Tr. 3467-71; Ex. 1701, 1035.) Specifically, at the Audit Committee meeting, the members made the following representation:

> Mr. Robinson reported that the independent public accountants had conducted their initial fieldwork and that their quarter-end review was substantially complete. In response to questions he directed to members of the Committee, the members of the Committee stated that they were not aware of any indications of fraudulent activities or illegal acts or of any significant deficiencies, material weaknesses, or modifications that the independent public accountants are not aware of relating to the financial statements of the Company for the period ended September 30, 2012 and prior financial statements of the Company as filed with the SEC.

(Ex. 1035, p. 3 (emphasis added).) Mr. Robinson indicated this representation was particularly important in light of the Milbank investigation; it had "more significance because of the communications between Milbank and the board, and the need to just close the loop in terms of the thought process that members of the Audit Committee had gone through." (Robinson, Tr. 3470.)

Milbank presented a more detailed review of its investigation and findings to Grant Thornton during two telephone conference calls, one on December 17, 2012 and one on February 13, 2013. (Robinson, Tr. 3472-73; Ex. 1873, p. 2.) Milbank described the scope of their investigation as trying to determine whether any misrepresentations had been made to Ventas and the public about compliance with the Lease covenants. (Robinson, Tr. 3477; Ex. 1879, p. 1.) Milbank then reported the following findings to Grant Thornton:

- "Determined that ALC had used employee use units to calculate minimum occupancy covenants under Ventas lease. Without recourse to units for employee use, ALC would not have been in compliance from during 2009 through 2012." (Robinson, Tr. 3478-79; Ex. 1879, p. 3.)

- "However, not able to determine that units for employee use to calculate minimum occupancy was done without the knowledge and approval of Ventas." (Robinson, Tr. 3479; Ex. 1879, p. 3.)

- "Understanding of ALC senior management that this had been addressed by and approved by Ventas." (Robinson, Tr. 3479; Ex. 1879, pp. 3-4.)

- "Communicated -- communicated with Ventas counsel on this topic. They, Ventas, were unable to say they, Ventas, had not agreed to the employee use.

Current management had no knowledge about whether it was authorized by Ventas or not." (Robinson, Tr. 3480; Ex. 1879, p. 4.)

- "Ventas' counsel to reached out -- Ventas' counsel reached out to Joe Solari, a Ventas liaison to ALC, terminated in 4/2009 due to downsizing after he received the February 4th, 2009 e-mail on employee leasing arrangements. This was the person who had the reported arrangement. He was unable to deny the Bebo representation of his approval." (*Id.*)

- "[February] 4th, 2009 e-mail which details subleasing to a hospice provider. Towards the end of the e-mail, she confirms the agreement with Solari, the leasing of the employee use. This e-mail was distributed to Solari's supervisor at Ventas. A follow-up e-mail to Laurie to set a meeting to discuss the hospice, but it was silent on the employee leasing issue, which indicates confirmation of Bebo's assertion that the agreement had been confirmed by Ventas." (Robinson, Tr. 3481; Ex. 1879, pp. 4-5.)

- "No one, including those spoken to at Ventas, could testify that the Bebo employee leasing inclusion was not accurate." (Robinson, Tr. 3482; Ex. 1879, p. 5.)

- "February 4th, 2009 e-mails could lead to ALC leases for employee use -- employees for use. However, ALC leased from lessors for use by potential employees when traveling to the unit. Employees were not actually at the premises but potentially could have been at the premises." (Robinson, Tr. 3483; Ex. 1879, p. 6.)

- "Senior management open and transparent to auditors on this topic which units were set aside for which employees. Both Bebo and Buono were open and forthcoming on the documentation. Suggests no intent -- no ill intent by management." (Robinson, Tr. 3483-84; Ex. 1879, p. 6.)

- "Sham, in quotes, dash, A process was -- A process was -- something -- on a monthly basis to develop the list of employees. Concern by whistleblower that Bebo's parents were on the list of employees. At least one or more indicated that they were listed because the individuals would do some mystery shopping, in quotes, in the areas to investigate competition and pricing. Some rooms were occupied, parenthetically, particularly in 2009, after the facilities were taken over by ALC due to changes in the operations post acquisition. In addition, employees were required to stay in facilities if available. It is clear that rooms set aside were not used by employees in many instances. Were able to ascertain that T&E records of employees were not on premises. However, ALC leased at arm's-length prices units for potential employee use." (Robinson, Tr. 3484-85; Ex. 1879, pp. 6-7.)

- "Back into rooms. Purpose to ensure covenant compliance. Proposed this to Solari in order to get through tough times, so no ambiguity. This would have been allowed under the arrangements." (Robinson, Tr. 3485-86; Ex. 1879, p. 7.)

In addition, when Grant Thornton asked specifically about Mr. Buono's knowledge and involvement in the covenant calculations, Milbank - presumably based on statements provided to them by Mr. Buono during his interview - conveyed the following to Grant Thornton:

A	...[T]here was an understanding by senior management that the rooms were going to be used to meet the covenant and not occupied…. However, the board believed that the rooms were to be used and paid for by ALC. Board learned of the broader arrangements in 2012. This was disclosed in a discussion between Buono and chairman approximately March or April of 2012. *Buono was aware of true purpose of the practice prior to 2012*. He was involved in creation of internal documentation, and he participated in the conversation…. between Bebo and Solari, but Buono was not involved in which employees were listed.

(Robinson, Tr. 3487-88 (emphasis added); Ex. 1879, p. 9.)

Soon after receiving this report from Milbank, Grant Thornton issued its audit opinion on ALC's internal controls throughout 2012. (Ex. 1866; Robinson, Tr. 3490.) Grant Thornton identified no material weaknesses or significant deficiencies in ALC's internal controls over financial reporting. (*Id.*)

XVI. EXPERT TESTIMONY REGARDING MATERIALITY.

A. David B. H. Martin, the former Director of the SEC Division of Corporate Finance, concluded that the Lease was not material and that ALC did not omit material information about covenant compliance.

For the past 32 years, Mr. Martin has been advising public companies on their disclosure obligations under the federal securities laws. (Ex. 2187, p. 1.) Prior to that, Mr. Martin worked for the SEC, including serving as the Director of the Division of Corporate Finance. (Ex. 2187, p. 1.) As the Court is no doubt aware, the Division of Corporate Finance is responsible for administering the SEC's disclosure system for public companies, including the review of filings

made by companies to the SEC. (Ex. 2187, p. 2.) Mr. Martin also held positions at the SEC as an examiner of company filings, as a lawyer in the chief counsel's office of the Division of Corporate Finance, and as a special counsel to the Chairman of the SEC. (Ex. 2187, pp. 1-2.)

Mr. Martin set forth two opinions in his report, neither of which were rebutted by any other testimony.[40] First, Mr. Martin concluded that the Commission's rules did not require that ALC identify and file the Lease as a "material contract" or a "material definitive agreement" at the time that ALC entered into the Lease with Ventas.[41] (Ex. 2187, p. 3.) ALC nonetheless chose to voluntarily disclose and file the Lease as an exhibit, but this "does not mean that ALC had arrived at a judgment that the Lease was a material contract requiring disclosure" (*Id.*), and no evidence has been presented that ALC actually reached a conclusion through some kind of deliberative process in early 2008 that the Lease was material. As Mr. Martin testified in his report, it is common for public companies to disclose agreements under these regulations even though they do not qualify as material contracts if they want to take a conservative approach or there is a possibility that the contract could become "material or otherwise significant at a later date." (Ex. 2187, pp. 3-4.)

Mr. Martin reasoned that a reasonable person could have concluded, consistent with the securities regulations, that the Lease was not material at its inception. (Ex. 2187, pp. 3-9.) After analyzing how the CaraVita Facilities subject to the Lease were such a small part of ALC's business overall (*see, supra*, Sec. III.B.1.), Mr. Martin concluded that "I am of the opinion that ALC would have had a reasonable basis to conclude that information about the Lease as a general matter would not be significant to a reasonable investor's investment decision or

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[40] The Division did not offer any expert testimony with respect to public company disclosure obligations, and the Division did not object when the Court precluded cross examination of Mr. Martin.

[41] The specific regulations are Item 1.01 of Form 8-K and Item 601(b)(10) of Regulation S-K. (Ex. 2187, p. 3.)

significantly alter the total mix of information that was available about ALC." (Ex. 2187, p. 7.) In addition, Mr. Martin reasoned that none of the other factors in the regulations would require disclosure of the Lease at its inception. (Ex. 2187, p. 7-9.)

Mr. Martin's second opinion is that ALC and Ms. Bebo could have reasonably concluded that ALC was not omitting material information in its quarterly and annual reports filed with the Commission when it decided not to add any additional information about how it was meeting the Ventas Lease covenants from 2009 through 2011. (Ex. 2187, pp. 9-14.) Mr. Martin reached this opinion for the following reasons:

- Shareholders had full information as to the existence and language of the financial covenants because ALC filed the Lease (though it was not required to do so).
- ALC disclosed the full magnitude of the impact of being deemed in breach of the financial covenants by a court. Consequently, "shareholders had information of the worst case scenario regarding any potential default under the Lease for failure to meet the Covenants, without any equivocation regarding the enforceability of the liquidated damages provision of the Lease or conditionality regarding the likelihood that Ventas would assert a default if ALC were in breach of the Covenants."
- "ALC disclosed various factors that could challenge its compliance with the Covenants, thereby putting shareholders on notice of this potential risk."
- Asserting compliance is a judgment call and "[i]n any event, only Ventas could affirm compliance with the Covenants, and ALC's disclosure does not represent that Ventas made such an affirmation."

(Ex. 2187, p. 11-14.)[42]

B. The Division's Expert, John Barron.

In contrast to Mr. Martin, who is an expert on SEC disclosure practices, the Division chose to submit an expert report from an accountant, John Barron.[43] Mr. Barron has significant

[42] Grant Thornton's lead auditor for 2009 and 2010 testified they never considered recommending that ALC disclose that they were meeting the covenants through the ALC room rentals related to employees, stating that would not be typical or necessary. (Koeppel, Tr. 3359-60.)

expertise on auditing standards and compliance with GAAP. This is a curious decision given that the Division's fraud allegations do not involve any allegation that ALC's financial statements filed with the Commission and provided to investors were misstated or otherwise failed to comply with GAAP.[44] (*See* OIP.) The Division's Section 10(b) case involves an allegation that, as a matter of disclosure, ALC omitted material disclosures from its Commission filings, and Mr. Barron has no expertise and can provide no support for those claims. (*See* OIP.)

1. Mr. Barron's materiality opinion relies on a false assumption.

Mr. Barron's first opinion is that, from the perspective of ALC's financial statements, any event of default would be material without regard to whether any consequences could or would actually flow from an event of default. (Barron, Tr. 1629-30.) As Mr. Barron acknowledged on cross examination, this is a conclusion that any investor reviewing ALC's financial statements could have reached. (Barron, Tr. 1633-34, 1649-52, 1654-56.)

In reaching this conclusion, Mr. Barron spends pages conducting calculations that any investor could have done with ALC's SEC filings, and reaches the same conclusion that ALC provided to investors: a default of the financial covenants *could* be material. (Barron, Tr. 1655-56):

Q	So ALC told investors [in their SEC filings] that there was a risk that breaches of certain lease covenants could adversely affect its financial condition and capital structure; is that right? That's what you note in paragraph 37?
A	Yes. It's just informing investors that if there's a breach, it could result in the prepayment of future lease payments, the write-off of assets, loss of right to operate the properties, and that if that happened, it could have a material or -- sorry, it could have an adverse effect.

[43] About 75% of Mr. Barron's work for the last 12 years has involved expert consulting and testimony. (Barron, Tr. 1623-24.) And virtually all of Mr. Barron's work in this area has been in support of the government, including two other matters in support of the Division of Enforcement. (Barron, Tr. 1624.)

[44] Mr. Barron offered no opinions with respect to whether ALC's Commission filings complied with GAAP. (Barron, Tr. 1629, 1634.)

(Barron, Tr. 1656.)

ALC's disclosure of risk, of course, parallels almost the exact opinion that Mr. Barron reaches in this case, as he effectively acknowledged on cross examination.

Q	And at the end of the day, you didn't consider whether any of these factors could negate the potential losses in whole or in part; is that right?
A	I looked at it from the standpoint of, you know, the potential effects of an event of default. I wasn't trying to predict or assume what the events might -- you know, the ultimate resolution might be. I was looking at it from the standpoint of would the potential effects of an event of default be material, would it -- would it be considered important to investors, and I get into that in my report.

(Barron, Tr. 1662.) At the end of the day, Mr. Barron's testimony on materiality essentially boils down to the tautology that because ALC disclosed that an event of default could be material, that it automatically is material. That is because there is no evidence to support Mr. Barron's further conclusion that every event of default of any nature—from loss of the ability to operate a facility on the one hand to the failure to timely report a fire at a facility by one day—is necessarily material, even if no consequences would or could flow from the event of default:

Q	In your view, an event of default that the failure to give timely notice of a fire by even one day is the same for materiality purposes as the state revoking the license of a building that would prevent it from operating entirely?
A	My opinion is that an event of default, no matter the reason, I'm looking at the potential consequences, the financial consequences of an event of default, and I'm not really distinguishing between -- I mean, I'm not saying -- it's really any event of default has those potential consequences to the company.

(Barron, Tr. 1670.)

Put another way, Mr. Barron's assumption - his only bridge from ALC's statement that breaches of Lease covenants could be material to his opinion that every event of default is necessarily material - is not only unsupported by anything in his report, but has been proven false

both during his own cross examination and through the testimony of many other witnesses. That evidence, described above, is summarized below:

- In the fall of 2009, ALC received license revocation notices from the State of Alabama, which constituted an event of default. This is the same event of default that prompted Ventas to initiate litigation in 2012. However, in 2009, when the economy was far worse, Ventas did nothing to assert its remedies. (Barron, Tr. 1677-79.)

- In early 2010, Ventas issued a notice of event of default to ALC for the failure to provide required survey reports under the Lease. (Ex. 1231.) No adverse consequences took place. (Barron, Tr. 1680-83.)

- Ventas officials could not testify to any instance where Ventas defaulted another tenant between 2009 and 2012 for a financial covenant violation where the tenant was still making rent payments. (Doman, Tr. 379-80.)

- In May 2012, Ventas asserted that ALC's treatment of rentals of units to employees as bona fide rentals to third parties was a default under the Lease, *but never added those allegations to its lawsuit and took no action to enforce any remedies due to that alleged event of default*. (Ex. 364.)

- Three Grant Thornton auditors testified that in the real world, financial covenant breaches of leases or debt instruments almost always get worked out without material consequences to the breaching party. (Trouba, Tr. 3568.)

- Ms. Bebo's expert, David Smith, has conducted extensive research which shows that debt covenant breaches almost always get resolved without the bank calling a default and asserting the full scope of its remedies under the contract. (*See* Smith, Tr. 3634-35, 60-63.)

- ALC's outside counsel on securities matters at Quarles & Brady testified that events of default do not necessarily have to be disclosed. That each event of default must be evaluated based on the facts and circumstances at the time. (Davidson, Tr. 2298-99.)

- With respect to acceleration of future rent payments, Mr. Barron failed to consider whether that provision of the Lease is even enforceable. (Barron, Tr. 1683.) And as a legal matter, it is clear that the provision with respect to 75% of the rent acceleration would be an unenforceable liquidated damages provision. That is because Georgia courts have invalidated an early rent acceleration provision. (*See, infra*, Argument Sec. II.D.2.)

Given that the bridge to his ultimate opinion is wholly unsupported and collapses under the weight of the undisputed evidence presented at the hearing, Mr. Barron's materiality opinion carries no weight.

2. Mr. Barron's opinion that financials provided to Ventas failed to comply with GAAP is unreliable.

Almost as an after-thought, Mr. Barron included a brief opinion in his report that the financial information provided to Ventas failed to comply with GAAP because the revenue attributable to the units that ALC rented for use by employees was improperly recognized. (Ex. 377, pp. 27-29.) Mr. Barron's opinion as to why the intercompany revenue recorded at the facility level failed to comply with GAAP boils down to two assertions. First, it failed to comply with GAAP because ALC recorded a debit to revenue on the parent company's financial statements instead of a rental expense.[45] (Barron, Tr. 1701-02.) Second, he concluded that there was no evidence of an oral or written arrangement between ALC and the tenant entities to support the revenue recognition. (Ex. 377, p. 28.)

With respect to the first point, Mr. Barron's opinion is unsupported for a number of reasons. First, it takes an improper formalistic approach to recognition of revenue in an intercompany setting. Based on his cross-examination, he concluded that ALC could not recognize revenue because its accounting systems did not have separate general ledgers for each facility. (Barron, Tr. 1702-04, 1706-07.) Thus, it could not record an account receivable at the facility level. (*Id.*) Put another way, ALC could *never* recognize intercompany revenue at the facility level unless it changed its entire accounting system. Mr. Barron also acknowledged there is nothing in GAAP that would require separate ledgers or indicates that intercompany revenue

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[45] Mr. Barron acknowledged that the fact that no cash was exchanged between the tenant entity and the ALC parent corporation was irrelevant in the intercompany setting. (Barron, Tr. 1701-02.)

cannot be recognized where there are no separate ledgers for subsidiary entities. (Barron, Tr. 1703.) In the end, Mr. Barron stakes out the implausible position that intercompany revenue could not be recognized unless ALC modified its entire financial reporting system.

Moreover, Mr. Barron's opinion is contrary to the testimony of other Division witnesses who testified that recording a debit to revenue in the corporate-level 997 Account to offset the revenue recognized at the facility revenue simply short-cut a two-step process into one step and had no impact with respect to GAAP. In particular, Mr. Buono in response to questioning from the Court stated:

Q	[JUDGE ELLIOT:] Negative revenue is a concept that has been mentioned before in the hearing. Do you have an understanding of what negative revenue is?
A	Yes.
Q	JUDGE ELLIOT: What is negative revenue, in your mind?
A	Negative revenue would be a contra account to eliminate intercompany revenues.
Q	JUDGE ELLIOT: And was negative revenue used in connection with the 997 account or some other sort of booking?
A	It was used with the 997 account.
Q	JUDGE ELLIOT: Why was the decision made to use negative revenue as opposed to, for example, a rental expense?
A	Even if you used a rental expense in the consolidation, you would have to eliminate the revenue that we posted from intercompany transactions.
Q	JUDGE ELLIOT: So it didn't make any difference?
A	*Didn't make any difference.*
Q	JUDGE ELLIOT: In your mind, do you have a view as to whether using negative revenue with the 997 account is more or less consistent with GAAP or the same than booking it as rental expenses?
A	*We shortcutted it a bit, but it gets to the same result. The end result has to have the consolidated revenue properly recorded without the benefits of intercompany transactions.* *So if we had recorded it as intercompany revenue in Ventas and intercompany expense on corporate, we would have eliminated the revenue on 997, and we would have to eliminate expense also. We did it through the intercompany accounts. It's just a shortcut way to do it.*
Q	JUDGE ELLIOT: And who -- either one person or multiple people, who came up with the idea of using the 997 account and negative revenue to account for the -- to recognize revenue for the stays?

A	I don't remember specifically who came up with it. It was probably a member of my staff, but it -- I mean, what they would have gotten from me is that they should eliminate the revenue. So how they did it wasn't important to me. It was that it was eliminated so then my consolidated financial statements were not overstated.

(Buono, Tr. 2770-72 (emphasis added).)

Grant Thornton auditors also testified that other clients had accounted for intercompany transactions in a similar manner, and their main concern with respect to the intercompany transactions was assuring that the intercompany revenue was being eliminated in consolidation. (Koeppel, Tr. 3346-48.) They were not concerned that the intercompany transactions were being recorded with a debit to revenue in the 997 Account. (Koeppel, Tr. 3344-45.)

Mr. Barron's assertion that there was no oral or written arrangement between ALC corporate and the tenant entities is similarly unfounded. As he was forced to concede on cross-examination, there need not be a specific writing to establish an arrangement—there need only be persuasive evidence of an arrangement. (Barron, Tr. 1716-17.) In this instance there was clear evidence of an arrangement whereby the tenant entities would make any vacant rooms available for ALC employees and others to stay in while traveling to the facilities. The price was established at the same daily rate as other residents. And the rooms would be rented by the month similar to how ALC rented rooms for all of its other residents. Mr. Barron's consistent reference to the requirement for a written instrument or other writing to establish the terms is not supported by the accounting literature upon which he relies. (Barron, Tr. 1718-20.)

In summary, Mr. Barron's claims of GAAP non-compliance with respect to revenue recognition was unsupportable; the real issue in terms of GAAP with respect to these intercompany transactions was whether it would need to be disclosed in the notes to the financial statements that GAAP would generally require. However, the Lease specifically indicates that

the financial statements would be provided without any notes or similar disclosures that GAAP would otherwise require. (Ex. 1986, p. 150.) It is in the notes where the nature of the intercompany revenue in line "3010 Rent Revenue - Private" would have been described. As Mr. Doman testified:

Q	…So do you have an understanding as to why Ventas did not require notes to the [tenant] financial statements for the quarterly financial statements?
A	Not specifically.
Q	Do you have an understanding of whether notes to financial statements are generally required under GAAP?
A	Generally, yes.
Q	Generally they are required under GAAP?
A	They are.
Q	And why is that?
A	So it gives the reader clarification on specific points that they would like to draw the investor communities' attention to. *Related party transactions, things like that, that might be meaningful to the financial statements*.

(Doman, Tr. 320 (emphasis added); *see also* Barron, Tr. 1708-11 (describing how notes and disclosures are integral to financial statements under GAAP because "they just have to go together").)

The fact that this is a disclosure issue under GAAP as opposed to a revenue recognition issue became clear when Mr. Barron was asked about the other category of intercompany transactions that appear on the Ventas financial statements—divisional office expense allocations:

Q	And can you identify what [Ex. 3384, p. 10] is?
A	Well, it's a -- it's an annual statement of income for [2009] -- let's see, I guess this is all of the facilities combined of all the tenant entities.
Q	This is for the whole [CaraVita] portfolio?
A	Yeah, that's what it looks like.
Q	And then there were separate income statements for each facility?
A	Yes.
Q	And in your review, there are no descriptions of all significant accounting policies set forth in these financial statements, as would be required by

	GAAP; right?
A	That's right.
Q	And there's no notes; right?
A	I don't recall seeing any notes. Notes to the financial statements, no, I don't recall seeing those.
Q	And any reader of these financial statements would recognize that there's no notes to them?
A	Yes.
Q	And that there's no descriptions of all significant accounting policies?
A	That's right.
Q	If I could direct your attention to page 14 of Exhibit 3384, which is part of this portfolio income statement. Do you see the line under EBITARM called "division office expense"? Do you know what kind of expenses are included in division office expense?
A	No, I don't.
Q	Can you tell that from the financial statements?
A	No, I cannot.
Q	You can't tell what's included in division office expense; right?
A	Well, I mean, in looking at it now, I -- obviously, it just conveys that there is a division with office expenses that have been included in these financial statements. I would assume the Division has some relationship to these entities.
Q	Do you have an understanding of what are division office expenses and intercompany expense allocated to the tenant entity?
A	I don't know. I don't know from reading this.
Q	And in your review of ALC's financial records with respect -- did you see anything with respect to division office expense in terms of whether or not there were accounts receivable or accounts payable recorded at either the corporate level or the tenant entity level?
A	No.

(Barron, Tr. 1713-15.)

3. Mr. Barron's internal controls opinion is similarly deficient given there was no misstatement of ALC's financials.

Finally, Mr. Barron opines that ALC lacked internal controls over financial reporting, but the weakness of his opinion is that he concedes there was no issue with ALC's *financial reporting*. Put simply, ALC had the key control for financial reporting purposes—it eliminated

the intercompany revenue in consolidation and none of the employee-related occupancy was ever included in the occupancy data reported to investors. (Buono, Tr. 2351.)

The baseless nature of his opinion is established by the events transpiring after the Milbank investigation. Milbank conducted an extensive investigation, collecting a significant amount of documents and interviewing approximately 16 individuals. (Ex. 1873, pp. 4-5.) ALC spent approximately a million dollars or more on the investigation. (Bell, Tr. 671.) One purpose of the investigation was to provide information to the Board and Grant Thornton to determine whether there were any internal control deficiencies in 2012. Grant Thornton had to issue an opinion on internal controls in connection with the audit of ALC's 2012 financials, which included the first quarter financials where ALC had supplied covenant calculations to Ventas with unit rentals related to employees included in them.

After the investigation, the Board, ALC's executives (including Dr. Roadman), and Grant Thornton all concluded that ALC's internal controls were effective for 2012. (Barron, Tr. 1723-25; Ex. 2183.) Given Grant Thornton's far superior knowledge of the issues based on the fact that they audited ALC for many years, and given that they and Milbank devoted substantially greater time and resources into evaluating the internal control issues than Mr. Barron, who spent about 220 hours total on his assignment and relies on the government for future work, the opinions of Grant Thornton carry far greater weight than those of Mr. Barron. This is particularly true because Mr. Barron relied on Grant Thornton in relation to other aspects of his report. (Barron, Tr. 1641-43.)

C. David Smith prepared an event study that demonstrated that financial covenant violations were not material.

Professor David Smith is a professor of commerce at the University of Virginia and a Director of the MicIntire Center for Financial Innovation. (Ex. 2186, p. 3.) He earned his

doctorate degree of philosophy in finance at the Kelley School of Business at Indiana University. (*Id.*) Prior to becoming a professor at the University of Virginia he was an economist in the International Finance Division of the Federal Reserve Board in Washington, D.C. and, before that, an assistant professor of finance at the Norwegian School of Management in Oslo, Norway. (*Id.*)

Professor Smith's qualifications to conduct the event study, and the methodologies used in his statistical analysis utilized in his report and testimony, are unchallenged. The Division provided no expert testimony of any kind to challenge his opinions.

An event study is a well-established method used by financial economists to determine whether public release of new, firm-specific information is important to market participants—*i.e.*, investors—and whether it is important in a positive or negative way. (Ex. 2186, pp. 10-11.) It is based on the economic theory that stock prices rapidly adjust to reflect new and unexpected information relevant to the value of the stock. (*Id.* at 13-14.) If the new information is, in the eyes of investors, positive for the value of the company, the market will cause the price of the stock to increase in a statistically significant manner. (*Id.* at 13.) If the new information is, in the eyes of investors, negative for the value of the company, then the market will cause the price to decline in a statistically significant manner. (*Id.*)

Professor Smith concluded that disclosure of allegations of improper calculations of occupancy rates and coverage ratios under the Ventas Lease (referred to by Professor Smith as the "Financial Covenant Allegations") in ALC's Form 8-K on May 14, 2012 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.) This is the first time that investors learned that ALC may have "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."[46] (*Id.*; *see also* Ex. 2076, p. 2.)

Following the disclosure of the Financial Covenant Allegations for the first time on May 14, 2012, "ALC's stock price declined $0.37 or 2.26%. Measured relative to the benchmark based on the returns of the NYSE and Peer Group, the abnormal return on ALC stock on this day was -0.40% and was not statistically significant." (Ex. 2186, p. 16.) Consequently, "the lack of a statistically significant price impact is inconsistent with the market interpreting the Financial Covenant Allegations as negative news." (*Id.*) And Professor Smith "conclude[d] that there is no evidence that the information disclosed on May 14, 2012, including the Finacial Covenant Allegations, had an impact on the ALC stock price." (*Id.* at 17.)

D. Professor Smith's event study further confirms the lack of merit in Mr. Barron's materiality opinion.

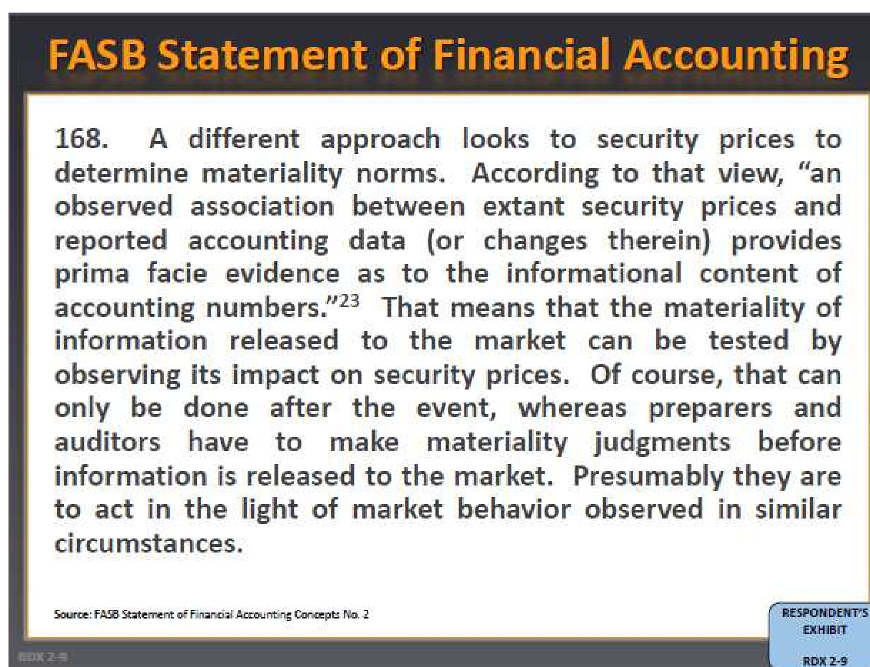
As described above, Mr. Barron's report on materiality focused on the purported impact on ALC's financial statements that could potentially be caused by an event of default. In paragraph 77 of his report, he writes, "[a]s it turned out, ALC's settlement of Ventas' lawsuit in 2012 confirms the materiality of a default of the lease covenants." (Ex. 377, p. 22; Barron, Tr. 1725-26.) In this paragraph of his report, Mr. Barron was looking back with hindsight with respect to the one-time "losses" that ALC actually booked when it purchased the eight CaraVita Facilities and the four NHP Facilities.

On June 21, 2012, ALC issued an 8-K announcing the acquisition and disclosing the anticipated one-time charges to net income it would be taking as a result of the transaction. (Ex. 2186, p. 24; Ex. 2077.) Mr. Barron acknowledged this was the "first time that [ALC]

[46] Mr. Barron confirmed that, in his review of the materials in this case, this is the first time he observed this allegation by Ventas about ALC fraudulently treating units leased to employees as bona fide rentals to third parties. (Barron, Tr. 1666.)

disclosed the amount of losses that they would … be suffering as a result of this agreement [to purchase the properties]." (Barron, Tr. 1727.)

The accounting literature regarding materiality that Mr. Barron relied upon in his report (Ex. 377, p. 16 n. 61.) states:



Thus, Mr. Barron's own accounting literature states that if materiality is viewed in hindsight, the proper approach is to analyze the impact on the price of ALC's stock—which is exactly what Professor Smith did through his event study. He found that ALC's stock *increased* in response to the June 21 disclosure, although not in a statistically significant manner. (Ex. 2186, p. 24.) However, as with the May 14 disclosure of the Financial Covenant Allegations, it was clear investors *did not* interpret the new information as being negative to ALC, contrary to Mr. Barron's supposition in his report. This demonstrates the lack of materiality of the purported financial harm that could be caused by an event of default.

ARGUMENT

I. THE DIVISION HAS THE BURDEN OF PROVING SECURITIES LAW VIOLATIONS BY A PREPONDERANCE OF THE EVIDENCE.

The OIP charges Ms. Bebo with violations of (1) Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (the "Exchange Act") and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 which prohibits fraud in connection with the purchase or sale of securities; (2) causing ALC's violation of Section 13(a) of the Exchange Act and rules promulgated thereunder, including alleged Sarbanes-Oxley certification violations, which generally prohibits companies from filing false or misleading periodic reports with the Commission; (3) Section 13(b)(5) of the Exchange Act and rules promulgated thereunder, which generally prohibits knowing circumvention or failure to implement internal controls or knowing falsification of books and records; and (4) Rule 13b2-2, which prohibits misleading auditors in connection with audits or reviews of company financial statements.

The Division has the burden of proving the alleged violations by a preponderance of the evidence, which means that the Division must prove that it is "more likely than not" that Ms. Bebo committed the violations. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 329 (2007). Put another way, the Division must prove more than an "equality of evidence," and if the evidence of both parties is "in balance or equally probable, then [it] has failed to sustain [its] burden." 4-73 Modern Fed. Jury Instructions-Civil, ¶ 73.01 (Matthew Bender). The Division failed to meet its burden here.

II. THE DIVISION FAILED TO ESTABLISH A VIOLATION OF SECTION 10(b) AND RULE 10b-5.

In order to prove a claim against Ms. Bebo under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, the Division was required to prove that Ms. Bebo, with fraudulent intent to deceive investors, made a material misstatement, or omitted to disclose

material information that she had a duty to disclose.[47] *See Aaron v. SEC*, 446 U.S. 680 (1980); *Pugh v. Tribune Co.*, 521 F.3d 686, 693 (7th Cir. 2008).

The OIP alleges a single statement—asserting compliance with the Ventas Lease—out of those thousands of pages of financial statements and disclosure documents was false or misleading because it failed to provide additional information about *how* ALC was meeting the lease requirements. (OIP, ¶¶ 2, 6, 41-45.) The Division failed to prove this violation for the following reasons. First, ALC's judgment that it was in compliance with the Lease was reasonable, and therefore it was not false or misleading to represent that ALC was in compliance with the financial covenants of the Lease. Second, there was no duty to disclose the manner in which ALC was meeting with the covenants. Third, the unrebutted expert testimony of David Smith demonstrates as a matter of law that the manner in which ALC was meeting the financial covenants was not material to investors. Fourth, the Division failed to prove scienter - which under these circumstances, is whether Ms. Bebo had actual knowledge of the falsity of the statement - even if it could establish that ALC's statement of compliance with the occupancy and other covenants of the Lease was materially false or misleading.

A. The Standard for Proving Falsity of ALC's Opinion That It Was In Legal Compliance With the Lease Covenants.

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

[47] The Division refers to a purported "scheme" throughout the OIP and its Prehearing Brief, although it is unclear if it is invoking so-called scheme liability under Rule 10b-5(a) or 10b-5(c). Liability under these sections reaches broader conduct than Rule 10b-5(b), because it reaches conduct of persons that do not "make" misstatements to investors, but assist in preparing them or in preparing false financial statements that *are provided to investors*. *In re John P. Flannery*, Release No. 3981, 2014 WL 7145625, at *12 (Dec. 15, 2014) (stating "we conclude that primary liability under Rule 10b5(a) and (c) *also* encompasses the 'making' of a fraudulent misstatement to investors, as well as the drafting or devising of such a misstatement"). But liability under Rule 10b-5(a) or (c) must involve a scheme to deceive or defraud *investors* (not some third party), and so the Division must still establish a material false or misleading statement *to purchasers or sellers of ALC's securities*. *Id.* at *10-12. Because Ms. Bebo signed ALC's 10-K's and 10-Q's scheme liability adds nothing and does not apply to this case.

covenants - are only actionable under limited circumstances. *See Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318, 1327 (2015); *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1095-96 (1991); *Fait v. Regions Fin. Corp.*, 655 F.3d 105, 111 (2d Cir. 2011). Because a claim based on an opinion turning out to be incorrect would be impermissibly based on hindsight, the Division has the heavy burden of proving (1) that the opinion stated was unreasonable; and (2) that the speaker of the opinion knew that the opinion was incorrect or did not believe it was accurate herself. *See id.*

In the Supreme Court's recent *Omnicare* decision, the Court considered whether certain alleged misstatements of opinion were false under Section 11 of the Securities Act - a strict liability statute. The Court held that statements of opinion can be false only if the speaker did not hold the belief she professed.[48] *Omnicare*, 135 S. Ct. at 1326-27. The Court reasoned that a sincerely held statement of opinion cannot be an untrue statement of material fact, *even if the opinion ultimately proves to be incorrect*:

> [A]s we have shown, a sincere statement of pure opinion is not an 'untrue statement of material fact,' regardless of whether an investor [or the Division] can ultimately prove the belief wrong. That clause, limited as it is to factual statements, does not allow investors [or the Division] to second-guess inherently subjective and uncertain assessments. In other words, the provision is not … an invitation to Monday morning quarterback an issuer's opinions.

Id. at 1327; *see also Nakkhumpun v. Taylor*, 782 F.3d 1142, 1159 (10th Cir. 2015) (holding that, under *Omnicare*, "[a]n opinion is considered false if the speaker does not actually or reasonably hold that opinion" and dismissing a complaint because no facts were alleged "that would cast doubt on the sincerity or reasonableness of [defendant's] statement of his opinion").

[48] The Court also concluded that, because Section 11 was a non-scienter-based claim, that a company could be liable for omissions of material facts about "the issuer's inquiry into or knowledge concerning a statement of opinion [in a registration statement]," if the omitted facts "conflict with what a reasonable investor would take from the statement itself." *Omnicare*, 135 S. Ct. at1329. Because Section 10(b) requires scienter, the Division must demonstrate Ms. Bebo did not subjectively believe and acted with intent to deceive and consequently this aspect of the opinion does not apply, and so that effectively supersedes the "omissions" aspect of the *Omnicare* decision. *See id.* n.11.

As set forth below, the Division in this case has attempted to do exactly what the Supreme Court in *Omnicare* held was forbidden—second-guessing ALC's and Ms. Bebo's assessment that the telephone call and subsequent e-mail with Mr. Solari was sufficient basis to conclude that they were in compliance with the financial covenants when ALC rented apartments at the Facilities for use by employees and others. The Division's entire case is premised upon proving that ALC was not in compliance with the Lease covenants. It attempted (but failed) to prove that ALC's belief was wrong or unreasonable, but it has presented *no evidence* to demonstrate that Ms. Bebo ever subjectively believed that ALC was not in compliance with the Lease covenants. Because this analysis in many ways overlaps with an assessment of scienter, we address them together in Section III below.

B. ALC's statement that it was in compliance with Lease covenants is a statement of opinion.

As part of its analysis, the *Omnicare* court first discussed what distinguishes between a statement of "fact" and a statement of "opinion." The Court stated that statements of fact are certain and objective while statements of opinion are uncertain and subjective, often (though not always) signaled by words like "I believe" or "I think." *Omnicare*, 135 S. Ct. at 1325. With respect to opinions, the Court quoted the following definition: "an opinion 'rest[s] on grounds insufficient for complete demonstration." *Id.* at 1325 (quoting 7 Oxford English Dictionary 151 (1933).)

In the months following the *Omnicare* decision, lower courts have applied its reasoning to various statements that are not preceded by the type of "I believe" signaling language referred to in the opinion. For example, the *Omnicare* standard governing opinions has been applied to judgments about the interpretation of clinical trial results. *In re Merck & Co., Inc. Sec., Derivative & "ERISA" Litig.*, 2015 WL 2250472, at *19-20 (D.N.J. May 13, 2015) (concluding

that the statement "that the cardioprotective effect of naproxen was the 'best interpretation of the data'" was an opinion to which *Omnicare* applied); *Corban v. Sarep Therapeutics, Inc.*, 2015 WL 1505693, at *6 (D. Mass. Mar. 31, 2015) (holding that "many of the challenged statements consist of interpretations of the company's data, which constitute non-actionable expressions of opinion" unless plaintiffs could meet the *Omnicare* standard).

In this case, there can be no question that ALC's statement that it was in compliance with the Lease covenants was a statement of opinion. 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 is undeniably a "matter of judgment."[49] An assertion of legal compliance cannot be definitively true or false at the time it is made except in the rare case in which a court has already definitively ruled on the legality of the issuer's actions. The ultimate accuracy of the stated belief hinges on future events and the decisions of counterparties, judges, juries, and regulators. Assessing legal compliance thus calls for an exercise of judgment about unknowable future events.

C. ALC's Opinion of Compliance With the Lease Was Objectively Reasonable.

The Division was required to prove that ALC would have no reasonable basis to defend against subsequent assertions by Ventas that ALC's use of rooms it rented for employees was in violation of the Lease. This it failed to do. Based on the evidence presented, Ms. Bebo is the only participant to the call with Mr. Solari that has a specific recollection of what was discussed. ALC would at least have a basis to have a jury decide the issue in any hypothetical litigation between Ventas and ALC. Thus, it is baseless to contend that there was no reasonable basis to assert ALC's compliance with the financial covenants. Indeed, this is exactly what the Milbank

[49] The Restatement (Second) of Torts § 538A (Am. Law Inst. 1977) defines a statement of opinion as a statement of "the belief of the maker, without certainty, as to the existence of a fact" or of "his judgment as to quality, value, authenticity, or other matters of judgment." (emphasis added).

firm and the board concluded based on Milbank's thorough internal investigation. Quarles and Brady reached the same conclusion when its litigators reviewed the matter in April 2012. Thus, two major law firms reviewed the covenant compliance practices and found them to be reasonable under the Lease.[50]

But not only was ALC's judgment reasonable, it was also objectively correct for two additional reasons. *First*, as set forth above, the Lease was ambiguous with respect to what constituted "occupancy" or an "occupant" or what constituted the "census" for purposes of calculating the occupancy rate. ALC had discretion for how to calculate the occupancy rate. Section 8.2.5(d) of the Lease simply stated the required thresholds for the "minimum average occupancy rate." Other key terms used in the Lease were defined, but not occupancy. The Lease certainly did not expressly preclude counting units paid for by ALC for employees who stayed or had reason to stay at the CaraVita Facilities.

In fact, it was common for seniors to themselves pay for rooms at the CaraVita Facilities and other ALC buildings, even though those customers lived elsewhere during substantial periods of time. No one is suggesting that, despite their failure to actually "occupy" the units, that these units could not be counted toward the calculation of the occupancy covenant and the financial coverage ratios. And, there is nothing in the Lease that prevented ALC from doing the same in order for ALC's employees to use the units for ALC's own purposes.

ALC internally tracked and publicly reported occupancy based on rented units (i.e., commitments to pay for a unit for an applicable period), and ALC generally did not have a reason to track the days a resident actually stayed in a unit for purposes of reporting occupancy.

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[50] In addition, Ms. Ng and Mr. Bell in mid-May 2012 told Grant Thornton that Ventas' allegations in their May 9, 2012 default notice were false and unfounded.

Ms. Bebo approached employee leasing under the Lease with the same mindset, focusing on ALC's payment of rent for the unit as the determining factor.

The practice was also not prohibited by the "Primary Intended Use" covenant in Section 7.2.1 because the units were being used to improve the operations of the CaraVita Facilities and further their purpose of providing assisted living services. And, finally, ALC provided both verbal and written disclosure of the tenant's transactions with affiliates as part of the employee leasing arrangements.

Second, the evidence demonstrates that Ms. Bebo obtained clarification of an ambiguous Lease term and effectively disclosed how ALC intended to proceed with respect to including ALC apartments for employees in the covenant calculations. With potential ambiguity in the Lease, Ms. Bebo and Mr. Buono first consulted with Mr. Fonstad, ALC's general counsel, and then spoke with Mr. Solari, a senior Ventas executive whom she was told was to be ALC's relationship manager, to confirm Ventas' agreement as to ALC's understanding of the effect of employee leasing under the Lease. During this call on January 20, 2009, Mr. Solari agreed to the relevant aspects to the employee leasing arrangement.

On February 4, 2009, Ms. Bebo sent an e-mail to Mr. Solari, which was drafted by Mr. Buono and Mr. Fonstad, to confirm the understanding of ALC and Ventas regarding the employee leasing arrangement. This e-mail was forwarded to other key decision-makers at Ventas regarding the Lease, including Messrs. Johnson, Doman and Sims. Although this e-mail did not cover every point from the January 20, 2009 call with Mr. Solari, it clearly notified Ventas of a broad arrangement whereby ALC have rentals "related to" employees. There was no limit or cap on the number of rentals related to employees. It was not phrased as a proposal, but rather as a confirmation of something ALC would do, and indeed had been doing. And in

context, no one in Ventas' position could conclude anything other than ALC intended to include those rentals in the covenant calculations.

Moreover, nothing in the Lease required a "formal request," whatever that means, and ALC and Ventas had reached numerous similar understandings regarding the covenants by e-mail or telephone conversations. Mr. Fonstad never advised that the Lease needed to be amended, formally modified, or notice given pursuant to Section 33 of the Lease.

Thus, through the phone conversation and e-mail, ALC had a valid understanding with Ventas that the employee leasing arrangement complied with the Lease as written and units available for employee use could be counted toward compliance with the occupancy and coverage ratio covenants in the Lease. If Ventas were to have challenged employee leasing at any time, ALC could have referenced the potential ambiguity in the Lease and held Ventas to the parties' mutual understanding that occupancy was broad enough to cover employee leasing under the terms discussed between Mr. Solari on behalf of Ventas and Ms. Bebo, Mr. Buono and Mr. Fonstad on behalf of ALC. At a minimum, therefore, ALC would have had a reasonable defense in litigation related to any default alleged by Ventas. Under the relevant authority, this ends the inquiry and the Court should conclude that it was reasonable to assert compliance under these circumstances.

D. ALC's Statements Of Opinion Concerning Compliance With The Lease Are Not Actionable Because They Were Not Material.

The materiality requirement protects investors or shareholders from being buried in an "avalanche of trivial information—a result that is hardly conducive to informed decisionmaking." *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.,* 426 U.S. 438, 448 (1976)). The Supreme Court explained "to fulfill the materiality requirement 'there must be a substantial likelihood that the disclosure of the omitted

fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.'" *Id.*

1. The lack of any statisticaly significant decline in ALC's stock upon disclosure of the alleged fraud demonstrates immateriality.

The best indicator of 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) (noting drop in stock price is widely used as evidence of materiality when the market is efficient); *SEC v. Mangan*, 598 F. Supp. 2d 731, 735 (W.D.N.C. 2008) (same). That is because the market "is the most accurate and unbiased measure of whether reasonable investors found the information to be material." *Mangan*, 598 F. Supp. 2d at 735.

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." *Id.* A disclosure of the alleged fraud or the information the Division alleges was undisclosed that has no appreciable impact on the price of stock is immaterial as a matter of law. *See Oran v. Stafford*, 226 F.3d 275, 282-83 (3d Cir. 2000); *Grimes v. Navigant Consulting, Inc.*, 185 F. Supp. 2d 906, 914 (N.D. Ill. 2002) (finding disclosure that resulted in stock increase made failure to disclose immaterial as a matter of law); *Greenhouse v. MCG Capital Corp.,* 392 F.3d 650, 660-61 (4th Cir. 2004) (where "it is *not* substantially likely that reasonable investors would devalue the stock knowing [the undisclosed information]," it is not material).

The Third Circuit Court of Appeals explained the rationale as follows:

> Ordinarily, the law defines "material" information as information that would be important to a reasonable investor in making his or her investment decision. In the context of an "efficient" market, the concept of materiality translates into information that alters the price of the firm's stock. This is so because efficient markets are those in which information important to reasonable investors (in effect, the market) is immediately incorporated into stock prices. Therefore, to the extent that information is not important to reasonable investors, it follows that its release will have a negligible effect on the stock price.

In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1425 (3d Cir. 1997) (citations omitted).

The SEC and Department of Justice often use analysis of share price movement in response to corrective disclosures to prove materiality in securities fraud cases, using event studies like the one that David Smith performed for Ms. Bebo. *See Schiff*, 602 F.3d at 171-72; *Mangan*, 598 F. Supp. 2d at 734-35; *SEC v. Berlacher*, 2010 WL 3566790, at *8 (E.D. Pa. Sept. 13, 2010); *SEC v. Leslie*, 2010 WL 2991038, at *29 (N.D. Cal. July 29, 2010) ("SEC offers the expert report of Mr. Davis" who "performed an event study and concluded" a statement "was material because there was a statistically significant decrease in the share price"). Here, the Division failed to provide any expert testimony about the reaction of ALC's share price to the news disclosing the allegation that ALC was in breach of the financial covenants due to the employee leasing arrangement. That silence speaks volumes. *See Mangan*, 598 F. Supp. 2d at 736 (granting summary judgment where SEC's expert did not dispute defense expert that, during the appropriate event window, there was no statistically significant decline in share price in response to disclosure of previously undisclosed information).

In this case, the undisputed evidence submitted through the expert testimony of Professor Smith was that, when it disclosed for the first time the Financial Covenant Allegations - that Ventas alleged that ALC had been fraudulently calculating the covenants by treating units rented to employees - there was no statistically significant price reaction in ALC's stock. Consequently, the Division's fraud claim is deficient as a matter of law and should be dismissed.

2. There Was No Duty To Disclose Immaterial Information Forming The Basis Of The Opinion Or Predictions About Behavior Of Its Contractual Counter-Party.

In evaluating whether "soft" information related to a company's opinions or beliefs about a matter need to be disclosed, courts have found that the company does not need to disclose

information that forms the basis of the company's opinion or judgment on the matter.[51] Requiring this type of detailed disclosure ensures that corporations are not subject to second-guessing in disclosure suits founded on opinions, which would prompt companies to "deluge investors with marginally useful information…." *Zaluski v. United Am. Healthcare Corp.,* 527 F.3d 564, 572 (6th Cir. 2008); *see also Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 514, 518 (7th Cir. 1989).

Consequently, where an issuer has a reasonable defense to an asserted breach of a contract or to assertions of non-compliance with laws or regulations, there is no actionable claim under the securities laws where the issuer asserts it is in compliance with such laws or contract. *See Anderson v. Abbott Labs.*, 140 F. Supp. 2d 894, 906-07 (N.D. Ill. 2001) *aff'd at Gallagher v. Abbott Labs.,* 269 F.3d 806 (7th Cir. 2001). In *Anderson*, a regulatory body had already asserted that the company had breached regulations critical to the ongoing profitability of the business, but the company asserted in its public filings that it was in substantial compliance with the regulations. In dismissing the claim, the court stated:

> Abbott's maintenance of its innocence is not fraud. SEC rules do not create a duty to confess contested charges…. Where there exists a good faith dispute as to facts or an alleged legal violation, the [law] only requires disclosure of the dispute. There are good reasons for this limitation. A tender offeror should not be placed in a position of being forced to either admit liability, while he or she disputes it, or violate the securities law by failing to disclose the alleged and disputed violation. As long as the tender offeror discloses to the target shareholders that a good faith dispute exists as to an alleged violation of law, a shareholder has sufficient information to make a rational and informed decision. This same reasoning applies to proxy disclosures and should extend to 10(b) as well.

[51] Hard information is factual or historical information that is objectively verifiable. *City of Monroe Emps. Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 669 (6th Cir. 2005). Soft information, by contrast, includes a company's subjective analysis, predictions and matters of opinion. *See City of Livonia Emps'. Ret. Sys. v. Boeing Co.*, 711 F.3d 754, 758 (7th Cir. 2013) ("The law does not require public disclosure of mere *risks* of failure. No prediction - even a prediction that the sun will rise tomorrow - has a 100 percent probability of being correct."); *In re Donald J. Trump Casino Sec. Litig.-Taj Mahal Litig.*, 7 F.3d 357, 369 n.11 (3d Cir. 1993) ("soft information" is "statements of subjective analysis or extrapolation, such as opinions, motives, and intentions, or forward looking statements, such as projections, estimates, and forecasts").

Id. (citations omitted); *see also Arazie v. Mullane*, 2 F.3d 1456, 1466-67 (7th Cir. 1993) (disclosures about compliance with gaming regulations were not misleading where there was "no document, meeting, or transaction which could or should have alerted [the company] that the [Gaming] Commission objected…"); *Kushner v. Beverly Enters., Inc.*, 317 F.3d 820, 831 (8th Cir. 2003) (allegations of non-compliance with Medicare regulations were dismissed because the "hard fact is that no regulatory action was initiated during the Class Period" and there was no duty to disclose the basis for asserting compliance) (quotation omitted). Here there was not even a dispute to disclose, and ALC had a good faith basis to conclude that its practice was in compliance with the Lease.

The *Zaluski* case, however, is the case that is most directly on point. There, the court held that a healthcare company called United American Healthcare Corporation ("UAHC") was not liable for securities fraud as a matter of law based on allegations that it failed to disclose factual circumstances indicating that it may have breached a contract with a state agency *that represented the source of nearly all of its revenue*. *Zaluski*, 527 F.3d at 574-75. UAHC's contract with the State of Tennessee provided it was subject to immediate termination and imposition of a penalty if it made direct or indirect payments to a state employee. *Id.* at 568.

Despite these potential consequences, for approximately four years, UAHC retained and made monthly payments to a Tennessee state senator in violation of the contract. *Id.* The breach subjected UAHC to immediate loss of virtually its only source of revenue, and penalties of up to $4.2 million. *Id.*

When the payments to the state senator came to light, UAHC issued a press release claiming, falsely, that the payments were made for out-of-state consulting, which could arguably be construed as not violating the contract. UAHC's stock lost more than half of its value in a

single day of trading when it later was announced that it had received an order of supervision from the state for violations of its agreement. *Id.* at 569.

In affirming dismissal of the complaint, the court reasoned that (1) UAHC's periodic filings with the SEC were not misleading for describing the company's key contract but failing to disclose the payments in violation of the contract because there was no duty to disclose the basis for the conclusion that the company was in compliance with the contract or a prediction with respect to how their counter-party would react to a disclosure to it of the payments; and (2) UAHC's press release mischaracterizing the payments to the state senator was not actionable because the undisclosed information that rendered the press release misleading related to UAHC's opinions and predictions about the *consequences* of the payment, not the payment itself.

The reasoning of the *Zaluski* court on both of these points are highly instructive in evaluating the present situation.

(a) There was no duty to disclose facts related to employee leasing as the basis for ALC's opinion that it complied with the Lease covenants.

In *Zaluski*, Plaintiffs argued that UAHC's quarterly and annual filings were false and misleading for failing to disclose the facts that constituted the breach of the agreement. *Id.* at 569. The filings discussing UAHC's contract with the state, as described by the court, were quite similar to ALC's disclosures about the Lease:

> UAHC referred to the existence of the TennCare contract, the terms of the contract, and the length of the renewed contract…. These statements contained a paragraph that disclosed that the license with Tennessee was subject to "denial, limitation, suspension or revocation if there is a determination that the plans are" not complying with the contract or statutes, or failing to provide the care expected under the contract.

Id. at 574. Plaintiffs alleged it was misleading to describe the contract that accounted for nearly 100% of the company's revenue, implicitly certifying it was in compliance with the contract,

while failing to disclose the fact that it was making payments to a state senator that could constitute a breach of the contract.

The court dismissed the action and found that the consequences of the payments by the company were "the type of predictions and soft information that do not give rise to a duty of disclosure." *Id.* at 574. In contrast to a duty to disclose data contrary to a belief based on "objective fact" that does "not turn on decisions made by external parties," in *Zaluski* the "complained-of omission … is that payments made to [the Senator] could have resulted in Tennessee's decision to void the contract or fine the company. There is no evidence that [defendant] believed either of these actions to be forthcoming." *Id.* at 576; *see also City of Livonia Emps.' Ret. Sys. v. Boeing*, 711 F.3d 754, 758-59 (7th Cir. 2013) (holding there was no duty to disclose potential problems with meeting the predicted deadline for first flight of the Boeing 787 because "[t]here is no duty of total corporate transparency - no rule that every hitch or glitch, every pratfall, in a company's operations must be disclosed in 'real time,' forming a running commentary, a baring of the corporate innards, day and night."); *In re Bank of Am. AIG Disclosure Sec. Litig.*, 980 F. Supp. 2d 564, 575-76 (S.D.N.Y. Nov. 1, 2013).

ALC's statements in its SEC filings concerning compliance with the Lease were statements of opinion regarding a legal contract. As set forth in the uncontradicted expert testimony of Mr. Martin, there was no duty to disclose the basis for ALC's conclusion.[52] None of the various witnesses involved in ALC's disclosure process and who were indisputably aware that ALC was meeting the financial covenants through rooms ALC paid for employees to use at the Facilities believed that additional disclosure about the practice was necessary. Both the judgment that it was in compliance with the covenants and the related opinion that the employee

[52] Ms. Koeppel also testified Grant Thornton never believed that it was necessary for ALC to disclose how it was meeting the Lease covenants.

leasing was compliant with the Lease were inextricably intertwined with predictions about decisions made by an external party, Ventas. The predictive and forward-looking nature of the disclosures is amplified by the fact that the statement is included under the heading "*Future* Liquidity and Capital Resources." As in *Zaluski*, and in light of all the evidence, the statement is therefore not actionable.

But Ms. Bebo and ALC actually have a stronger argument that there was no duty to disclose information that may have contradicted their opinion that the company was in compliance with the covenants. Unlike the contract in the *Zaluski* case where UAHC's contract clearly prohibited direct or indirect payments to state employees, the Lease here did not define occupancy and did not clearly address whether employee lessees could be counted as occupants for purposes of the occupancy covenant, whether such employees paid rent themselves or ALC paid the rent to make units available for their use on company business.

Moreover, disclosure of the information in ALC's case was immaterial to its operations and financial condition, unlike in *Zaluski*. There, the company faced the loss of nearly all of its revenue if the state agency terminated the agreement; ALC would suffer minor, if any, losses in comparison. Any losses would be one-time, and not affect on-going cash flows that investors focused on in evaluating the value of ALC. The fact that ALC would incur no losses (or minimal losses) is reflected by the fact that when ALC did trip the occupancy covenant, Mr. Doman testified that Ventas simply monitored the situation until ALC was "out of the woods."

Also, the acceleration of rent clause in the Lease would be unenforceable in the State of Georgia. *See, e.g. Nobles v. Jiffy Mkt. Food Store Corp.*, 579 S.E.2d 63, 66 (Ga. Ct. App. 2003), (holding accelerated rent provision in a commercial lease provided the landlord with "payment

potentially bearing no reasonable relation to actual damages" because it contained no assessment of future market conditions or the probability of reletting the premises, and did not require that the landlord try to relet the premises); *Peterson v. P.C. Towers, L.P.*, 426 S.E.2d 243, 247 (Ga. Ct. App. 1992) (holding that "acceleration provision was in the nature of an unenforceable penalty, rather than a provision for liquidated damages."); *Jones v. Clark*, 249 S.E.2d 619, 620 (Ga. Ct. App. 1978) ("We find the acceleration provision to be a penalty provision rather than a liquidated-damages provision and thus affirm the denial of summary judgment."). This is where five of the eight CaraVita Facilities were located. (Ex. 1986-0144) Thus approximately 75% of the rent could not be subject to acceleration. (*Id.*)

Finally, although ALC disclosed the worst case scenario in terms of the one time losses that could be caused by Ventas fully enforcing its remedies under the lease, it believed that would not be the case as set forth in the response to the Commission's comment letter. (Ex. 295, at pp. 4-5; Roadman, Tr. 2608-09; Zak-Kowalczyk, Tr. 4282-83.) ALC also may have been able to negotiate some other resolution to any assertion of default by Ventas, such as having ALC advancing a portion of the rent, escrowing funds, outright paying Ventas a fee, or purchasing the buildings so that ALC could convert them to more profitable independent living facilities. (*Id.*) And Ventas had already told ALC in February 2009 that it would probably only seek to have ALC deposit rent money into an escrow account if it breached the coverage ratio covenant.

(b) There was no duty to disclose even if the Division could establish that employee leasing was not in compliance with the Lease.

As noted above, in *Zaluski* the court found that UAHC made an affirmatively misleading statement when it claimed payments to the senator complied with the contract because he was compensated for work outside of the state. Nonetheless, the court concluded that the materiality

of the misleading statement derives solely from the predictions regarding the actions of the UAHC's contractual counter-party. Thus it was not actionable. *Zaluski*, 527 F.3d at 575-76.

As with the contention that the company's periodic filings were misleading for its failure to disclose the payments to the state senator, the court found that the "affirmatively misleading" press release would only be materially misleading to the extent that the company predicted that its counter-party would take a certain action. *Id.* There, UAHC did not need to qualify its statements concerning its payments or the order of supervision because the consequence of its payments turned on decisions outside the control of the company. *Id.* If UAHC's payments constituted a breach of the agreement the state could terminate or impose a penalty, but there was no evidence that UAHC believed that either of those events were soon to occur. *Id.* Notably, the court reached this conclusion even though a potential breach of contract that exposed it to a loss of virtually all of its revenue and additional penalties.

Consequently, under *Zaluski*, even if one assumes that the employee leasing arrangement breached the Lease, there is no duty to disclose because the materiality of the information turned upon matters of opinion and prediction on a number of complex issues that were entirely outside of ALC's control, including (1) whether Ventas would have elected to enforce the covenants, in a manner contrary to the understanding previously reached with ALC, or negotiated some other resolution; (2) what remedies and damages Ventas would have chosen; and (3) the enforceability of Ventas' liquidated damages remedy as noted above.

There are additional reasons (aside from those in the immediately preceding section) supporting the reasonable belief on ALC's part to not assume the worst case scenario. For example, Ventas had publicly disclosed that the purpose of its review process with its tenants was to monitor credit risk, and it is preposterous to think that Ventas would have terminated a

lease where rent was guaranteed by a financially sound and highly liquid ALC, particularly at the height of the recession. In addition, Ventas personnel could recall no example of *ever* having defaulted a tenant for a financial covenant violation during the 2009 to 2012 time period. Ms. Bebo was also not aware of any situation in the *entire industry* where that had occurred between *any* landlord and *any* tenant.

In the end, the cases like *Zaluski* recognize that the securities laws should prevent investors from being deluged with marginally useful information. This would be required if companies had to disclose minutiae about the basis for every opinion held by the company. For an allegation of fraud in this context, the Division is essentially asserting that Section 10(b) required that ALC had to disclose not only that it believed it complied with the covenants by including employees in the relevant occupancy and coverage ratio covenant calculations; the legal reasoning for why it believed employees could be counted; details about the specific communications with Ventas whereby it reached its conclusion that it had an understanding about the ambiguous language in the occupancy covenant; its subjective predictions about what Ventas might do if it disputed ALC's interpretation of the Lease and characterization of the communications with Ventas; and finally the basis for any prediction on what remedies Ventas may or may not assert and whether they are enforceable. As Mr. Martin testified, none of this type of information needs to be disclosed under the circumstances.

Such forward-looking opinions and subjective conclusions cannot and should not support securities fraud claims. Indeed in *Boeing*, the Seventh Circuit rejected a duty to disclose minutiae about the circumstances that raised questions about the company's date for a predicted first flight. It stated:

> A more plausible inference than that of [securities] fraud is that the defendants, unsure whether they could fix the problem by the end of June, were reluctant to

> tell the world "we have a problem and maybe it will cause us to delay the First Flight and maybe not, but we're working on the problem and we hope we can fix it in time to prevent any significant delay, but we can't be sure, so stay tuned." There is a difference, famously emphasized by Kant, between a duty of truthfulness and a duty of candor, or between a lie and reticence.

711 F.3d at 758-89.

III. THERE IS NO EVIDENCE THAT MS. BEBO ACTED WITH THE REQUISITE LEVEL OF SCIENTER TO SUPPORT A SECTION 10(b) CLAIM.

The evidence shows that Ms. Bebo genuinely and reasonably believed that the employee leasing arrangement implemented by ALC complied with the terms of the Lease. Her conduct and statements while at ALC were consistent with that belief and there is no evidence that effectively contradicts it.

The Supreme Court has held that scienter is required for a violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 213-14 (1976). This requirement applies to SEC enforcement actions as well as private actions. *Aaron*, 446 U.S. at 695. In *Hochfelder*, the Supreme Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud" purchasers or sellers of securities. 425 U.S. at 193 n.12.[53]

Although reckless conduct may suffice to meet the element of *scienter* in some circumstances, not so here. In this case, the Division was required to prove that Ms. Bebo knowingly lied about her belief that ALC was in compliance with the Lease covenants and that there was not a reasonably likely degree of risk of default in the future, and that she did so to deceive or defraud purchasers or sellers of ALC's stock. Because the Division's claims in this

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[53] Some lower federal courts have held that this standard can be met by a showing of "extreme recklessness," although it is a lesser form of intent rather than a heightened form of negligence. For example, the Seventh Circuit has held that scienter requires "recklessness so severe that it is the functional equivalent of intent." *Searls v. Glasser*, 64 F.3d 1061, 1066 (7th Cir. 1995), (citing *Ambrosino v. Rodman & Renshaw, Inc.*, 972 F.2d 776, 789 (7th Cir. 1992)); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977).

matter relate to opinions of legal or contractual compliance contained in a forward-looking statement, the Division must meet the heightened standard of showing that "the speaker does not genuinely and reasonably believe them." *In re Donald Trump*, 7 F.3d at 368; *see also Boeing*, 711 F.3d at 759 (holding that plaintiffs must plead and prove that defendants made predictions knowing they were false in order to be actionable); *Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund v. Omnicare, Inc.*, 583 F.3d 935, 945-46 (6th Cir. 2009) (explaining actual knowledge of falsity of statement required to establish misrepresentation claim based on statement of legal compliance).

This is a high standard that is particularly hard to prove in connection with disclosures about compliance with ambiguous terms of a long, complex contract where the evidence demonstrated that the two parties, ALC and Ventas, reached numerous informal understandings about how the Lease should be applied. Ms. Bebo's actions in connection with ALC's employee leasing do not show negligence much less the far higher standard of scienter.

A. Ms. Bebo's actions taken in implementing employee leasing were not consistent with any intent to deceive, manipulate or defraud.

The evidence does not show that Ms. Bebo implemented employee leasing under the Lease with any fraudulent intent. In fact, Ms. Bebo took all reasonable actions for an executive in her position when implementing the employee leasing practice in early 2009 and in utilizing the practice to meet the financial covenants in the subsequent two years.

1. Ms. Bebo consulted with and relied on the advice of counsel.

Generally, consulting with legal counsel and involving legal counsel at every step of the process is inconsistent with the intent to deceive. Moreover, seeking and relying on the advice of counsel as to whether a contemplated course of action is legal can negate the mental state element of scienter or willfulness. *See United States v. Benson*, 941 F.2d 598, 614 (7th Cir.

1991) (tax case). To demonstrate the reliance on counsel, a defendant need show that she disclosed the material facts to counsel, requested counsel's advice as to the legality of the contemplated action, and relied on the advice in good faith. *SEC v. e-Smart Techs., Inc.*, 2015 WL 583931, at *6 (D.D.C. Feb. 12, 2015) (emphasis added)(citing *Zacharias v. SEC,* 569 F.3d 458, 467 (D.C. Cir. 2009); *see also SEC v. Harwyn Indus. Corp.*, 326 F. Supp. 943, 955 (S.D.N.Y. 1971) (dismissing claims because "defendants at all times relied on advice of counsel"). As for what constitutes full disclosure, the Supreme Court has suggested that the advice of counsel requires that a person "fully and honestly lay[] all the facts before his counsel, and in good faith and honestly follows such advice, relying upon it and believing it to be correct…." *Williamson v. United States,* 207 U.S. 425, 453 (1908).

That is no doubt what happened here. From the very beginning, Ms. Bebo consulted with Mr. Fonstad, ALC's general counsel. Mr. Fonstad was involved from the beginning of discussions on employee leasing in late 2008 and through each of the key steps in January and February 2009, including the call with Mr. Solari on January 20; the drafting of the e-mail sent to Mr. Solari on February 4; receiving, reviewing and printing the final e-mail from Ms. Bebo on February 5; receiving, reviewing and printing Ventas' response on February 5; being involved in follow-up meetings with Ms. Bebo, Mr. Buono and others to discuss the implementation of the practice; and chairing the disclosure committee meetings where the agreement based on the e-mail to Mr. Solari was discussed in some depth over-and-over. Finally, Ms. Bebo, Mr. Lucey and others at ALC relied on Mr. Fonstad's advice as to whether the disclosure about the Ventas Lease covenants continued to be appropriate. He advised that it was. Thus Mr. Fonstad was aware of all the material facts and Ms. Bebo appropriately relied on Mr. Fonstad's legal advice as to compliance with the terms of the Lease.

2. Ms. Bebo was aware the disclosure committee never urged different disclosures.

There is no evidence to suggest that *anyone* ever advised Ms. Bebo to disclose any of the information that the Division alleges was omitted. In fact, ALC had a formal process created for the purpose of facilitating discussion of concerns or issues with the Company's financial statements or disclosures, including specifically the Company's disclosure committee. None of the scores of senior managers and other key accounting, finance and legal personnel involved in the process ever brought to Ms. Bebo's attention any issue with the disclosures regarding Ventas Lease compliance.

The undisputed lack of any other person in the company raising any concerns about either the practice of employee leasing or whether the manner in which ALC was meeting the covenants should be disclosed is highly relevant, and dooms the Division's securities fraud claim here. *See, e.g., Durgin v. Mon*, 659 F. Supp. 2d 1240, 1256 (S.D. Fla. 2009) (plaintiff failed to adequately plead scienter where there were no allegations that "anyone advised Defendants or expressed concern to Defendants that the Company was engaging in fraud"); *SEC v. Coffman*, 2007 WL 2412808, at *14 (D. Colo. Aug. 21, 2007) (SEC failed to establish scienter where there was "no evidence that anyone suggested to [the defendant] that … assets were impaired").

3. Ms. Bebo discussed ALC's plan with Ventas.

Ms. Bebo set up the January 20 call with Mr. Solari, a senior executive with the counterparty to the Lease, to confirm his understanding of the effect of employee leasing under the Lease. Ms. Bebo has a clear recollection of the matters discussed on this call, which covered all of the relevant features of the employee leasing practice as ALC would implement it, including having rooms available in the CaraVita Facilities for people who would have reason to go there and charging ALC regular market rates. Mr. Solari agreed that such employee leasing

was permitted under the Lease and would count toward the occupancy and coverage ratios in the lease. He did not express a need to impose a cap or limit the number units.

Mr. Solari was a high level Ventas executive and the principal relationship manager for the Ventas/ALC relationship. He obviously possessed "apparent" authority to bind Ventas. ALC's reliance on Solari's authority was reasonable and certainly did not show any fraudulent intent sufficient to support a Section 10(b) claim.

4. Ms. Bebo sent a confirming e-mail to Ventas (which was prepared with the assistance of counsel) and Ventas did not object.

Mr. Buono and Mr. Fonstad prepared the e-mail to confirm the matters discussed during the January 20 call. It was not meant to set forth everything that was discussed, but to confirm in writing the notice that had been provided on the call. And although the part of this e-mail addressing employee leasing was not as detailed as the discussion during the January 20 call, it was consistent with the employee leasing practice as ALC would implement it.

The e-mail was certainly clear enough to put Ventas on notice that ALC would include rentals related to employees in the covenant calculations. In the e-mail, ALC stated that it was "confirming" its "notification" of employee leasing. From that language, it was clear that ALC was notifying Ventas of actual room rentals related to employees rather than a proposal to further discuss the topic. From Ventas' perspective, it should not have mattered whether employees paid the rent to lease units or ALC paid the rent to make units available for employees. In either case, these units would not continue to be occupied at the end of the lease term or if Ventas otherwise took over operation of the properties. Regardless of the particular terms governing the periphery of the arrangement, Ventas knew that unit rentals to or for employees would terminate with the conclusion of the ALC-Ventas relationship. If Ventas was really concerned about employee

leasing, the January 20 conference call and February 4 e-mail were more than sufficient to raise questions.

The Division's focus on the fact that the e-mail makes no reference to the covenant calculations is a straw man. As the Division's own witness, Mr. Buono, stated: Why would ALC do it if not for purposes of covenant calculations? In addition, the Division paints Ventas as diligent, scrutinizing the covenant calculations with a fine-tooth comb. But somehow the Division wants the Court to also believe that Ventas would not understand that a new practice of rentals related to employees -- proposed at a time when Ventas was supposedly on "high alert" because occupancy in the portfolio was trending toward a default -- was begun for the specific reason of including those rentals in the covenant calculations. These two positions are totally inconsistent.

But the Division's position suffers from a more fundamental problem -- its witnesses from Ventas do not even support it. Mr. Doman *did not* testify that he was confused about the e-mail or that he thought the rentals related to employees confirmed in the e-mail would not be included in the covenant calculations. Rather, he testified he and Ventas disregarded that part of the e-mail because it was not a "formal request." For his part, Mr. Solari cannot recall what he did in response to receiving the e-mail.[54] In fact, Mr. Solari cannot recall the substance of the call itself.

In any event, Ventas' own subjective interpretation of the e-mail, which indisputably was not provided to Ms. Bebo, is irrelevant. What is relevant is Ventas' words and actions conveyed

[54] Is it reasonable to believe that Ventas and Mr. Doman simply disregarded the e-mail confirmation/notification because it was not a formal request? Of course not. On its face, the e-mail was not a request at all. Is it reasonable to believe that Ventas was meticulous and careful of details in managing its relationship with ALC and the CaraVita Facilities, yet somehow at least four Ventas senior executives and employees with responsibility for the lease relationship failed to notice and ask questions about the employee lease notification in the February 4 2009 e-mail? That strains credibility. The more reasonable explanation is that Mr. Solari had in fact agreed to employee leasing as Ms. Bebo recalls during the January 20 call and none of the other Ventas executives objected to it.

to Ms. Bebo. Here, she had a detailed conversation about ALC paying for apartments for people with a reason to go to the CaraVita Facilities, and including those rentals in the covenant calculations. She observed the e-mail go from Mr. Solari to the head of Ventas' asset management department (Mr. Doman) and two other asset management personnel. *None* of them objected, raised a concern, or asked a question about the confirmation of rentals related to employees. It was certainly reasonably to conclude -- as Ms. Bebo did -- that Mr. Solari had briefed the asset management team about the call. Then, Ms. Bebo attended another conference call attended by some of the same Ventas asset management personnel. They walked through the hospice portion of the e-mail again. Again Ventas did not object, raise any concerns, or ask any questions about the confirmation of rentals related to employees contained in the e-mail. It was certainly reasonable and proper for her and Mr. Buono (and for Mr. Fonstad, to whom Ms. Bebo forwarded the e-mail) to conclude that counting rooms for employees toward the covenants was agreeable to Ventas. From these facts, at most there was a misunderstanding between ALC and Ventas about the effect of employee leasing under the lease. Such a misunderstanding cannot form the basis of a violation of Section 10(b).

Ms. Bebo's genuine belief that Mr. Solari, and the others at Ventas, had agreed to employee leasing on behalf of Ventas is further shown by ALC's decision to implement employee leasing rather than other alternatives.

The terms of the Lease contained options to avoid defaulting under the occupancy covenant in the first part of 2009. Section 8.1.11(c) permitted ALC to remove from service up to 10% of the beds in each facility. Such an action would have removed all the units containing those beds (there were slightly greater number of operational beds than units) from the occupancy covenant count. Ms. Bebo, Mr. Buono and Mr. Fonstad were clearly aware of this

provision at the time as it is mentioned in the February 4, 2009 Solari e-mail with reference to the hospice proposal. ALC also could have and calculate occupancy based on the ratio of people to units instead of units to units. In fact, ALC was aware that the prior tenant had calculated occupancy in based on people to units without any objection from Ventas. Ms. Bebo's summary exhibit demonstrated that these calculation changes alone would have permitted ALC to meet the occupancy covenant.

5. Ms. Bebo consulted with ALC's board before implementing employee leasing and it was commonly discussed at board meetings in the subsequent three years.

After the January 20 call with Mr. Solari, Ms. Bebo discussed the call and the incredibly flexible understanding ALC obtained during the call with Mr. Rhinelander on January 21. Mr. Rhinelander liked the option of pursuing along the lines discussed on the call with Mr. Solari and said he would speak with Mr. Hennigar about it. Before proceeding with the full employee leasing practice under the Lease, on February 23, 2009, Ms. Bebo and Mr. Buono revisited the issue with Mr. Rhinelander, in a meeting also attended by Ms. Herbner. After Mr. Rhinelander consulted with David Hennigar, he told Ms. Bebo and Mr. Buono that they should proceed with the practice of ALC renting units for employees or others with a reason to go to the Facilities. Ms. Bebo was also led to believe that the entire Board had endorsed the practice at that time.

Following that approval, the evidence conclusively demonstrated that the inclusion of employees in the Ventas covenant calculations was discussed at numerous Board or Audit Committee meetings, including in presentations by Grant Thornton. The Division's own witnesses, Mr. Buono and Mr. Rhinelander, both testified that Mr. Buntain commented prior to March 2012 that management should add more employees in the calculations. On cross examination, Mr. Buntain conceded that the inclusion of employees in the covenant calculations

was discussed at the August 2011 board meeting in connection with ALC's response to the SEC comment letter.

The scope of employee leasing was also clear from the materials in packages management provided to the Board on a quarterly basis, and which management reviewed with the Board at meetings. (Buono, Tr. 2524-25; Roadman, Tr. 2584-85; Ex. 1017, Ex. 108.) ALC Board members may claim that they were not aware of employee leasing before March 2012, but such a claim is contrary to the facts and in any event the information was there if they cared to listen during meetings or review Board materials. Ms. Bebo did not attempt to hide anything from the ALC Board regarding employee leasing.

6. Ms. Bebo and ALC were open with ALC's auditor and provided the basic details of the employee leasing practice to them.

In *SEC v. Snyder*, the Fifth Circuit found no meaningful distinction between the reliance on counsel and the reliance on accountant defense, explaining that under both theories the defendant is offering an explanation for the conduct that tends to negate the element of scienter. *SEC v. Snyder*, 292 F. App'x 391, 406 (5th Cir. 2008); *see also SEC v. Caserta*, 75 F. Supp. 2d 79, 94 (E.D.N.Y. 1999) ("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.") That is because disclosure of the material facts to the company's independent auditors negates an inference of scienter.

ALC informed Grant Thornton of employee leasing in April or May of 2009 during its first quarterly review of a period including the employee leasing practice. Ms. Bebo spoke with Melissa Koeppel about employee leasing at that time and Grant Thornton was provided with a copy of the February 4, 2009 Solari e-mail. During its quarterly reviews, Grant Thornton had access to documents, including the list of employees, that clearly showed the scope of and

procedures for employee leasing. Grant Thornton audited the journal entry process and the 997 Account. Ms. Bebo is not aware of Grant Thornton ever raising any issues with the practice.

As the Milbank firm concluded (and the Grant Thornton witnesses effectively confirmed on the stand): "Senior management open and transparent to auditors on this topic which units were set aside for which employees. Both Bebo and Buono were open and forthcoming on the documentation. Suggests no intent -- no ill intent by management."

7. Ms. Bebo relied on the finance department for the process and accounting determinations.

Ms. Bebo relied on Mr. Buono and his staff with respect to the accounting treatment of employee leasing, quarterly certifications to Ventas and regular communications with Grant Thornton. Ms. Bebo is not an accountant, and was not in a position to question the accounting treatment of employee leasing, such as the effect of employee leasing on the coverage ratio calculations in the Lease under GAAP. Ms. Bebo recalls that she rarely, if ever, spoke directly with Grant Thornton about employee leasing after her initial conversation with Melissa Koeppel in April or May of 2009. Ms. Bebo does not recall being directly involved in the Ventas compliance certification process at any time.

The first time that anyone at ALC raised concerns about the propriety of the employee leasing was when Mr. Grochowski questioned the practice in November 2011. To the extent that Mr. Grochowski raised concerns about the accounting for the financial statements provided to Ventas, Mr. Buono, the company's CFO and GAAP expert, was in the room. He obviously disagreed with Mr. Grochowski's assessment, as he continued to calculate the covenants and prepare the financial statements himself. He also expressly disagreed with Mr. Barron's GAAP opinion at trial.

Moreover, the second time that anyone raised any kind of concern about the covenant compliance practices was when Mr. Bell circulated his hastily prepared "solicitor-client" memorandum in April 2012. When she received this correspondence, Ms. Bebo herself distributed the memorandum to outside counsel at Quarles & Brady and provided it to ALC's auditors. Even then, Grant Thornton raised no concerns about the employee leasing arrangement with Ms. Bebo.

These are not the actions of a person with any intent to deceive or defraud investors. Instead, these actions were entirely consistent with an executive reasonably and in good faith attempting to comply with the terms of a contract and support the conclusion that she genuinely and reasonably believed that ALC was in compliance with the Lease covenants.

8. The occupancy reconciliations do not support a finding of fraud, and in fact support the opposite conclusion.

The Division's almost exclusive reliance on the occupancy reconciliation lists as evidence of fraud collapses under its own weight. If Ms. Bebo was trying to commit fraud or deceive the various multiple people that reviewed the lists both internally at ALC and externally at Grant Thornton, she did an extremely poor job of it. No one trying to pass off as supposed "fictitious employee occupants" lists multiple couples with the same last names on the same lists, as she did. If Ms. Bebo was trying to commit fraud she would have never identified Dan and Patty Rodwick as an "employee occupant" on any list. She would never have identified Jane and Todd Rodwick on the same list (which occurred), or any list at all. Such names would so obviously stick out as non-employees. Consequently, this conduct actually demonstrates that Ms. Bebo had no intent to deceive in preparing the lists, and was following Mr. Fonstad's advice to include on the list of names non-employees that were going to travel to the Facilities.

9. Ms. Bebo's actions on May 3 reflect her good faith toward shareholders and continued belief that ALC was in compliance with the financial covenants.

When Ventas did file a lawsuit against ALC alleging that ALC defaulted under the Lease when state regulators took action against the licenses of three of the CaraVita Facilities, Ms. Bebo followed the advice of counsel who advised to disclose it in a Form 8-K. Notably, no one at Quarles & Brady or anyone internally at ALC thought that the company needed to disclose any additional information about the financial covenants at this time. On May 3, she urged the Board to disclose the Ventas lawsuit so that public investors would not be misled that the press release postponing ALC's earnings release portended an impending sale of the company. Her actions of May 3 are consistent with someone who acted in good faith towards investors and entirely inconsistent with someone who would intentionally deceive them. This is contrasted with the Board's decision to ignore her pleas to disclose this news along with the earnings delay, and in particular Mr. Buntain's remark that evinced a total lack of concern about the potential impact that the Board's course of action had on public investors.

10. The reasonableness of Ms. Bebo's reliance on the propriety of the employee leasing practice is corroborated by the board's inaction upon learning of the Milbank findings.

As described in section XIV.J. of the statement of facts, the Milbank law firm conducted an extensive internal investigation into the very issues that are before the Court for its consideration. The Milbank firm concluded -- as reported to the board and to Grant Thornton --that there was no evidence that ALC's prior representations of compliance with Lease covenants were false. In addition, Milbank found there was no basis to conclude that prior disclosures about compliance with the Ventas lease were false or misleading, that Ventas could not dispute Ms. Bebo's recollection of the call (which was confirmed at the hearing), and that

Ms. Bebo's openness with the board, with Grant Thornton and in the investigation demonstrated "no ill intent."

The board, after receiving Milbank's report and having the opportunity to review and inform themselves of all the relevant facts (if they so chose), concluded 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 Mr. Buono. Instead, they represented to Grant Thornton at the November 2012 Audit Committee meeting that they were not aware of any "indications of fraudulent activities" related to the 2012 time period. The Board also gave Mr. Buono raises and bonuses following the investigation. (Buono, Tr. 2782-83; Roadman, Tr. 2620.)

B. Ms. Bebo had no motive to commit the alleged fraud.

One way to establish scienter is to demonstrate that the defendant received a personal substantial benefit from the fraud. *See, e.g. Plumbers & Pipefitters Local Union 719 Pension Fund v. Zimmer Holdings, Inc.*, 679 F.3d 952, 956 (7th Cir. 2012). Conversely, where there is a lack of any personal benefit from the alleged fraud, it undermines an inference of scienter. *Id.* As the Seventh Circuit stated in dismissing a private securities complaint in *Zimmer*:

> If, as plaintiffs maintain, [defendants] told a series of lies during the first half of 2008 about … one product that together produced less than 10% of the firm's income … and affected earnings by only 15¢ a share, they were putting their fortunes and careers at stake in exchange for very little in return. This aspect of plaintiffs' arguments thus undermines, rather than strengthens, the inference of scienter.

Id.

In this case, Ms. Bebo also had no personal financial interest in devising a fraudulent scheme to meet the Lease covenants. In fact, she received no personal benefit from the employee leasing arrangement at all. She sold no stock during 2009 to 2011. Stock option grants/stock appreciation rights were granted based on on targets for private-pay occupancy at

ALC facilities, as reported in the company's public filings.[55] It is undisputed that the employee leasing arrangement had no impact on the publicly reported occupancy data. There is no evidence that Ms. Bebo's cash incentive compensation would have been affected by a covenant compliance issue under the Lease. Indeed, by 2011 ALC was losing money on operating the CaraVita Facilities (after paying over $5 million in rent to Ventas) and so losing those operations would have actually benefitted Ms. Bebo's compensation.[56]

Finally, just as in *Zimmer*, the CaraVita Facilities were also an immaterial part of ALC's business, constituting less than 6% of ALC's revenue and 2.1% of ALC's operating income for the year ended 2011. The Lease was immaterial, and investors concluded that allegations of violations of the financial covenants were immaterial as well. *See also Fire & Police Pension Ass'n of Colo. v. Abiomed, Inc.*, 778 F.3d 228, 241 (1st Cir. 2015) (stating "[i]f it is questionable whether a fact is material or its materiality is marginal, that tends to undercut the argument that defendants acted with the requisite intent or extreme recklessness in not disclosing the fact.").

IV. THE DIVISION HAS FAILED TO ESTABLISH THAT MS. BEBO VIOLATED THE EXCHANGE ACT'S BOOKS AND RECORDS AND INTERNAL CONTROLS PROVISIONS.

In addition to its failure to establish fraud claims against Ms. Bebo, the Division has failed to prove that Ms. Bebo directly violated section 13(b)(5) of the Exchange Act and Rule 13b2-1 promulgated thereunder, or that she caused ALC to violate sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act. Section 13(b) outlines some of the financial reporting

[55] The base price of Ms. Bebo's stock appreciation rights that were awarded in 2009 were set based on the price of ALC's stock on February 22, 2009. Thus, it would have been in her personal interest to get any news that could potentially be perceived as bad for the company out prior to that time. (Bebo, Tr. 4170-73.)

[56] Payments under ALC's cash incentive compensation program were determined based on Adjusted EBITDAR and Adjusted EBITDAR margin, which excluded transaction costs and non-cash, non-recurring gains and losses such as impairment of goodwill or other long-lived assets. This measurement would have excluded one-time costs related to a purchase, buy-out or other expenses relating to the resolution of a default under the Lease. (*See* Bebo, Tr. 4169-71.)

requirements for corporations that issue securities. Specifically, these provisions provide for liability where a defendant knowingly falsifies company accounting records, causing the company's records not to fairly reflect its transactions, or circumvents internal accounting controls.

A. Neither the Journal Entries for the 997 Account Nor the Quarterly Compliance Certification Documents ALC Provided to Ventas Were False.

Section 13(b)(2)(A) requires an issuer of registered securities to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." 15 U.S.C. § 78m(b)(2)(A). Rule 13b2-1 prohibits the falsification of any books, records, or accounts that an issuer is required to make and keep pursuant to section 13(b)(2)(A). *See* 17 C.F.R. § 240.13b2-1.

Congress enacted section 13(b)(2) to ensure that financial statements filed with the Commission are correct and accurate. *See SEC v. World-Wide Coin Invs., Ltd.*, 567 F. Supp. 724, 747 (N.D. Ga. 1983) (noting the purpose of the provision is to "promote the reliability and completeness of financial information that issuers are required to file with the Commission or to disseminate to investors pursuant to the Exchange Act") (citing *Promotion of the Reliability of Fin. Info.*, Exchange Act Release No. 15570, 1979 WL 173674 (Feb. 15, 1979); SEC Release Notice No. 17500, 1981 WL 36385 (Jan. 29, 1981); SEC Release Notice , 123 Cong. Rec. 519, (daily ed. Dec. 6, 1977) (remarks of Sen. Harrison Williams).[57] The recordkeeping provision, which is "intimately related to the requirement for a system of internal accounting controls," has among its objectives the establishment and maintenance of records "of

[57] *See also Promotion of the Reliability of Financial Information and the Prevention of the Concealment of Questionable or Illegal Corporate Payments and Practices*, 44 Fed. Reg. 10964 (Feb. 23, 1979). The SEC's adopting release also states the following with respect to the scope of the Rule: "This provision is designed, not only to provide a more reliable basis for the preparation of financial statements, but also, among other things, for the purpose of confirming the Commission's authority "effectively to prevent off-the-books slush funds' and to assure that 'there is proper accounting of the ***use*** of corporate funds…." *Id.* at 10966 (emphasis added).

sufficient accuracy" to prepare financial statements in accordance with GAAP. *See* Exchange Act Release No. 17500.

Although the exact basis for the books and records claim against Ms. Bebo remains unclear, the Division's prehearing brief indicates that it relates, at least in part, to ALC's journal entries for the 997 Account as well as the compliance certification documents ALC provided to Ventas on a quarterly basis.[58] *See* Div. Prehearing Br., p. 25. With the clear intent of section 13(b)(2) in mind, there is no question that the employee leasing practice—including the journal entries and the compliance certification documents provided to Ventas—had no effect whatsoever on the integrity of the financial statements that ALC reported to the Commission. In fact, the Division has never challenged the accuracy any financial information or the occupancy data in the Company's financial statements. Indeed, the journal entries were the key mechanism for assuring that ALC's reported financial statements were accurate.

Putting that aside, the Division's claim fails for additional, independent reasons. Neither the journal entries for the 997 Account nor the quarterly compliance certification documents were false in any material way in violation of section 13(b)(2)(A). The employee leasing transactions that ALC recorded in the journal entries for the 997 Account as well as the quarterly documents provided to Ventas were based on criteria that Ms. Bebo and Mr. Solari agreed upon during their January 20, 2009 telephone conversation. (*See* Bebo, Tr. 1904-05, 1907-08.) This included employees and other non-residents affiliated with ALC who had a reason to go to a CaraVita Facility. (Bebo, Tr. 1908.)

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[58] To the extent relevant to the Division's books and records claim against Ms. Bebo, none of the lists relating to employee leasing that Ms. Bebo participated in preparing constitutes books or records in violation of section 13(b)(2)(A). Specifically, the lists do not constitute records that "reflect the transactions and dispositions of assets" of ALC. *See* Exchange Act § 13(b)(2)(A). They merely reflected days that employees and other non-residents affiliated with ALC stayed or had reason to stay at any of the CaraVita Facilities for purposes of calculating covenants under the Lease.

Finally, any contention by the Division that the journal entries and quarterly compliance certification documents reflected revenue associated with employees who remained on the lists when they were no longer employed by ALC, or who were included on the list for a full quarter when they were hired mid-quarter, is immaterial. Although the Division need not prove that Ms. Bebo acted with scienter, section 13(b)(2) is not a strict liability statute that converts any misstatement, no matter how small, into a securities violation. *See SEC v. Todd*, 642 F.3d 1207, 1219 (9th Cir. 2011) (stating "[t]he SEC acknowledges that the rules does not create a 'strict liability' regime"); *SEC v. Espuelas*,
905 F. Supp. 2d 507, 525-26 (S.D.N.Y 2012) (holding that violation requires unreasonable conduct, not strict liability). In contrast, liability under this provision is predicated on standards of reasonableness. *Espuelas*, 905 F. Supp. 2d at 526. Further, an inadvertent mistake cannot form the basis of a violation under the books and records provision. *See United States v. Reyes*, 577 F.3d 1069, 1080 (9th Cir. 2009) (noting that violations under the books and records provision should not be imposed for "insignificant or technical infractions or inadvertent conduct"); *see also* Exchange Act Release No. 17500, 1981 WL 36385, at *2. ("[I]nadvertent recordkeeping mistakes will not give rise to Commission enforcement proceedings; nor could a company be enjoined for a falsification of which its management, broadly defined, was not aware and reasonably should not have known.").

As stated above, ALC's accounting staff, under the supervision of Mr. Buono, set up the procedures to implement employee leasing as had been agreed upon by Ventas. These procedures included the creation of quarterly lists of employees who went or had a reason to go to the CaraVita Facilities on behalf of ALC and whom ALC would be comfortable with staying at the facilities from a resident safety perspective. The accounting staff maintained the list of

employees for purposes of internal tracking and reporting to Grant Thornton. While Ms. Bebo added names of employees or others to the list where appropriate, she did not review the lists for the specific purpose of removing names of people who no longer had a reason to go to a property (*e.g.*, former employees). Ms. Bebo understood that other employees vetted the lists, because they brought discrepancies to her attention from time to time. Further, on occasion, Grant Thornton told ALC that an employee should be removed from the list because he or she no longer worked there.

These quarterly employee lists then provided support for the journal entries to the 997 Account as well as the quarterly compliance certification documents provided to Ventas. Ms. Bebo relied upon Mr. Buono and the accounting staff to handle the accounting treatment of the employee leasing, and Ms. Bebo knew that Mr. Buono reviewed and signed every officer certificate that accompanied the Ventas covenant compliance information. Ms. Bebo did not review the officer certificates, the compliance information, or the financial statements, prior to that information being sent to Ventas. (Bebo, Tr. 2087-88.) Any inadvertent mistakes relating to the journal entries or the compliance documents cannot be seen as unreasonable conduct on the part of Ms. Bebo. As such, the Division cannot demonstrate that Ms. Bebo caused violations of section 13(b)(2)(A).

B. The 997 Account Served as ALC's Key Internal Control to Ensure Employee Leasing Did Not Affect ALC's Public Accounting.

Section 13(b)(2)(B) of the Exchange Act requires any company that issues securities to "devise and maintain a system of internal accounting controls" over financial reporting. *See* 15 U.S.C. § 78m(b)(2)(B). Specifically, issuers must have internal accounting controls that provide "reasonable assurances" that (1) transactions are executed in accordance with management's authorization; (2) transactions are recorded as necessary to permit preparation of financial

statements in conformity with GAAP and to maintain accountability for assets; (3) access to assets is permitted only in accordance with management's authorization; and (4) the recorded assets reasonably equal existing assets. *See* 15 U.S.C. § 78m(b)(2)(B)(i)-(iv).

The Division contends ALC lacked internal accounting controls such that falsified transactions relating to employee leasing could be recorded in ALC's general ledger. (*See* Div. Pre-Hearing Br.,25). However, nothing related to employee leasing that ALC utilized for meeting the Ventas Lease covenants had anything to do with the internal control issues identified in the statute. As with section 13(b)(2)(A), the purpose of the internal controls provision is to provide "reasonable, cost-effective safeguards against the unauthorized use or disposition of company assets and reasonable assurances that financial records and accounts are sufficiently reliable for purposes of ***external reporting***." *World-Wide Coin*, 567 F. Supp. at 750 (emphasis added). In other words, the clear intent of the internal controls provision is to provide reasonable assurances regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. Here, accounting personnel performed the employee leasing transactions in accordance with management's instructions; there is no dispute that ALC's financial statements were GAAP compliant; and ALC appropriately reported all asserts of the Company in its financial statements. Consequently, there can be no violation of section 13(b)(2)(B) or Rule 13b2-1.

Nonetheless, ALC had sufficient internal controls in place to ensure that intercompany revenue associated with employee leasing did not flow through to ALC's financial statements reported to investors. The key control that served this function was the 997 Account. Although utilized to reconcile other intercompany and consolidating transactions, the 997 Account eliminated in consolidation the employee leasing transactions between ALC corporate and the

subsidiary lessees of the CaraVita Facilities, so the transactions would not affect ALC's public reporting. (Ferreri, Tr. 1230-31, 1240-41, 1244-45.) Importantly, the 997 Account was effective in its purpose, as the Division has never disputed the accuracy of the Company's financials reported to the Commission, or that ALC's financial statements were GAAP compliant.

To further support the sufficiency of ALC's internal accounting controls, Grant Thornton audited them and issued a clean opinion at 2012 year-end, after receiving a full report from the Milbank firm based on its internal investigation. Specifically, armed with information from Milbank's investigation relating to employee leasing, Grant Thornton stated in its audit of ALC's 10-K for the year ended December 31, 2012, that the Company, in all material respects, had effective internal control over financial reporting. (Ex. 2183; *see also* Barron, Tr. 1722:17-24.) Put another way, even after learning that ALC booked revenue not only for employees who went to the CaraVita Facilities, but also those who had a reason to go -- *but did not actually go* --- Grant Thornton still did not make the determination that ALC's internal controls were deficient as a result of employee leasing.

For all of these reasons, the Division cannot demonstrate that Ms. Bebo caused violations of section 13(b)(2)(B).

C. The Division Has Not Established the Requisite Mental State for a Violation of Section 13(b)(5) or Rule 13b2-1.

Section 13(b)(5) of the Exchange Act provides that "[n]o person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account" as are described in section 13(b)(2)(A). 15 U.S.C. § 78m(b)(5). Similarly, Rule 13b2–1 prohibits the falsification of any "book, record or account." 17 C.F.R. § 240.13b2-1. Given the plain language of section 13(b)(5), the Division is required to make a showing of scienter. *See SEC v. Retail Pro, Inc.*, 2010 WL 1444993, at *3-4

(S.D. Cal. Apr. 9, 2010); *SEC v. Leslie*, 2010 WL 2991038, at *17. And although most courts have found that scienter is not required to establish a violation of Rule 13b2-1, it does require a showing that the defendant acted unreasonably. *SEC v. Delphi Corp.*, 2008 WL 4539519, at *5 (E.D. Mich. Oct. 8, 2008). Courts have equated unreasonableness with reckless conduct. *Espuelas*, 905 F. Supp. 2d at 525-26. For the reasons previously stated, the Division has not demonstrated that Ms. Bebo acted with scienter or recklessly with respect to the employee leasing practice. Consequently, Ms. Bebo did cause violations of section 13(b)(5).

V. THERE IS NO BASIS FOR A CLAIM AGAINST MS. BEBO UNDER SECTION 13(a) OF THE EXCHANGE ACT.

The OIP also alleges that Ms. Bebo directly violated Section 13(a) of the Exchange Act or caused ALC to violate Section 13(a) and Rules 12b-20, 13a-1 and 13a-13. To establish violations of these provisions, the SEC must show that ALC's public filings contained material misstatements or omissions. In addition, the Staff alleges Ms. Bebo submitted false Sarbanes-Oxley certifications in violation of Rule 13a-14 because the public filings she certified contained false or misleading statements. These claims fail for three independent reasons.

First, as demonstrated above there is no basis to conclude that ALC's public filings contained any material misstatements or omissions. Because the OIP's claims under Section 13 are based on the same allegations of falsity, the Section 13(a) claim and related claim of false certifications would fail for the same reasons. *See, e.g., SEC v. Cedric Kushner Promotions, Inc.*, 417 F. Supp. 2d 326, 336-37 (S.D.N.Y. 2006). And because there there was no underlying falsity in the filings, 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. As one court has found in the context of private securities litigation, "there is nothing in either the [Exchange Act] or the Sarbanes-Oxley Act and implementing regulations that authorizes

plaintiffs to base a claim for securities fraud on an alleged misstatement in a Sarbanes-Oxley certification." *In re Silicon Storage Tech., Inc., Sec. Litig.*, 2007 WL 760535, at *17 (N.D. Cal. Mar. 9, 2007). Rather, courts have found that Sox certifications themselves are <u>not</u> actionable. *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).

The rule is the same when an action is brought by the SEC. *See SEC v. Black*, 2008 WL 4394891, at *17 (N.D. Ill. Sept. 24, 2008).[59] In *Black*, the Commission attempted to persuade the court to create an exception for Sarbanes-Oxley certification claims in cases brought by the SEC, but the court flatly rejected such a special rule. *Id.* at *16-17. The court pointed out that the cases cited by the SEC, in which claims brought under Rule 13a-14 were allowed to proceed, dealt only with the sufficiency of factual allegations in a complaint and did not address "whether a false certification can stand as an independent claim." *Id.* at *16 (citations omitted). Thus, the court held, "[c]onsistent with the SEC Release and the two cases that have addressed the issue [i.e., *Silicon Storage* and *Intelligroup*] … a false Sarbanes-Oxley certification does not state an independent violation of the securities law."[60] *Id.* at *17.

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[59] Other courts outside of the Seventh Circuit have concluded that there is an independent cause of action under Rule 13a-14. *See SEC v. Brown*, 740 F. Supp. 2d 148, 164-65 (D.D.C. 2010).

[60] The SEC Release upon which the *Black* court relied, states:

> An issuer's principal executive and financial officers <u>already</u> are responsible as signatories for the issuer's disclosures under the Exchange Act liability provisions and can be liable for material misstatements or omissions under general antifraud standards and under our authority to seek redress against those who cause or aid or abet securities law violations. An officer providing a false certification potentially could be subject to Commission action for violating Section 13(a) or 15(d) of the Exchange Act and to both Commission and private actions for violating Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5.

Certification of Disclosure in Cos.' Quarterly & Annual Reports, SEC Release No. 8124, 2002 WL 31720215, at *9 (Aug. 28, 2002) (emphasis added).

PART TWO - THIS ADMINISTRATIVE PROCEEDING IS UNCONSTITUTIONAL AND MUST BE DISMISSED.

INTRODUCTION

Instead of defending herself before an impartial judge in a federal court with basic procedural and constitutional safeguards—including the right to a trial by jury and the right to conduct depositions and other discovery under the Federal Rules of Civil Procedure—Ms. Bebo has been forced to defend herself against ruinous financial penalties in this administrative proceeding where the SEC is the prosecutor, judge, and initial appeals court. This proceeding is unconstitutional on several accounts.

First, this proceeding was instituted pursuant to a law that provides the SEC unguided authority arbitrarily to choose whether its enforcement targets will receive the procedural and constitutional benefits of a federal court proceeding. That law, Section 929P(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, violates Ms. Bebo's rights to equal protection and substantive due process under the Fifth Amendment.

Second, the inferior officer overseeing the proceeding, the Administrative Law Judge ("ALJ"), was hired by someone other than the President, a Department head, or the judiciary in violation of Article II of the U.S. Constitution. He is also insulated from termination by dual-layers of tenure protection, thus impairing the President's ability to ensure that the laws are faithfully executed in violation of Article II.

Third, in addition to the facial defects in the enabling legislation and the ALJ's authority, the conduct of this proceeding violated Ms. Bebo's right to procedural due process because it denied her the opportunity to cross examine certain key witnesses, among other reasons.

Because this proceeding was instituted pursuant to an unconstitutional law, is overseen by an ALJ whose appointment and retention are unconstitutional, and has not afforded Ms. Bebo adequate process, the proceeding must be dismissed.

ARGUMENT

I. THE FEDERAL LAW ENABLING THIS PROCEEDING, SECTION 929P(A) OF DODD-FRANK, IS UNCONSTITUTIONAL ON ITS FACE UNDER THE FIFTH AMENDMENT GUARANTEES OF EQUAL PROTECTION AND DUE PROCESS.

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. Rather, the SEC was limited to seeking injunctions of on-going fraud or disgorgement 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 (describing state of remedies available to the government, and noting SEC did not have authority to obtain civil penalties in federal court until 1984). In addition, the SEC could bar securities professionals like broker-dealers and investment advisors (or their firms) from the industry in administrative proceedings. *Id.* at 966 n.43. But if a citizen was forced to pay a fine as a result of violating the federal securities laws, Congress required the Department of Justice to bring those claims in federal court. *See id.* at 960-63. Of course, the citizen would have all of the Constitutional protections provided to a citizen being prosecuted by her government, including the requirement that the government prove guilt beyond a reasonable doubt. *Id.*

In 1984, Congress first granted the SEC authority to obtain civil penalties in federal district court, but it was limited to insider trading cases and the penalty was limited to three times the amount of profit gained or losses avoided as a result of the insider trading. *Id.* (citing Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264). The SEC continued to have

no authority to assert civil penalties in administrative proceedings against even regulated entities and persons.

Six years later, in the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Congress granted the SEC authority to obtain civil monetary penalties in administrative proceedings only against regulated entities and persons like brokers and investment advisors. Pub. L. No. 101-429, 104 Stat. 931, §§ 202, 301 (1990). In addition, Congress broadened the SEC's authority to obtain civil penalties in federal district court against citizens otherwise unregulated by the Commission. *Id.* §§ 201, 302.

For the next twenty years, the remedies the SEC could obtain against an ordinary citizen were much like the remedies available under the enforcement authority of other federal agencies; Congress provided for additional, more severe and punitive remedies in federal court where the defendant is entitled to robust procedural safeguards.[61] Thus, like other federal agencies with enforcement powers, the level of due process afforded the citizen tracked the punitive gradient of the remedy sought. This legal regime set a delicate balance—a balance that in various decisions from the Supreme Court evaluating similar agency adjudication frameworks was held constitutionally permissible. *See, e.g. Atlas Roofing Co. v. Occupational Safety & Health*

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[61] For example, under the Clean Water Act ("CWA"), the Environmental Protection Agency ("EPA") can enforce its orders through administrative actions or judicial actions. With respect to administrative actions, Section 309(g) of the CWA, 33 U.S.C. § 1319(g), prescribes two classes of penalties that the EPA can levy against violators. Based on a finding that a person has violated a permit condition, the EPA Administrator may assess either a Class I or Class II civil penalty. *See* 33 U.S.C. § 1319(g). Class I penalties, for less egregious conduct, may not exceed $16,000 per violation, with a maximum of $37,500. Violations that are more serious invite Class II penalties, which may not exceed $16,000 for each day the violation continues, with a maximum of $187,500. *Id.* (The EPA adjusts the penalties as necessary for inflation according to a formula prescribed by the Debt Collection Improvement Act of 1996.) Section 309(d) of the CWA also authorizes the EPA to bring federal judicial enforcement actions seeking civil penalties. A court can assess a civil penalty not to exceed $37,500 per day for each violation. Unlike for administrative actions, the CWA does not identify any total maximum penalty amount for the court. *See* 33 U.S.C. § 1319(d). Similarly, under the FTC Act, the Federal Trade Commission ("FTC") can enforce requirements of consumer protection law through either administrative or judicial processes. *See* 15 U.S.C. §§ 45(b), 53(b). In administrative proceedings, the FTC cannot levy civil penalties for unfair or deceptive acts or practices; however, if the FTC files suit in federal court, the court can award monetary equitable relief (including restitution or rescission of contract), among other relief, against violators. *Id.*

Review Comm'n, 430 U.S. 442 (1977) (holding no Seventh Amendment jury trial right in OSHA administrative proceeding).[62]

Section 929P(a) of Dodd-Frank destroyed that delicate balance when it granted the SEC authority to obtain civil penalties against any citizen in the country in an administrative proceeding. In granting the SEC this authority, the remedies that the SEC can seek administratively are now functionally identical to the remedies that it can obtain in federal district court.[63] In fact, the legislative history regarding Section 929P(a) of Dodd-Frank confirms that this was Congress' intent:

> *Section 211. Authority to impose civil penalties in cease and desist proceedings*
>
> This section streamlines the SEC's existing enforcement authorities by permitting the SEC to seek civil money penalties in cease-and-desist proceedings under Federal securities laws. The section provides appropriate due process protections <u>by making the SEC's authority in administrative penalty proceedings coextensive with its authority to seek penalties in Federal court.</u> As is the case when a Federal district court imposes a civil penalty in a SEC action, administrative civil money penalties would be subject to review by a Federal appeals court.

H.R. Rep. No. 111-687, at 78 (2010) (emphasis added).

By granting this parity of remedy, Congress threw off the delicate due process balance that the Supreme Court had approved and in a manner not permitted by the Constitution. The

[62] The Occupational Health and Safety Administration does not have the option to try to impose civil penalties in federal court. Indeed, it has no authority to bring cases in federal court, except to restrain "any conditions or practices in any place of employment which are such that a danger exists which could reasonably be expected to cause death or serious physical harm immediately or before the imminence of such danger can be eliminated through the enforcement procedures...." 29 U.S.C. § 662.

[63] The SEC's enforcement director acknowledged that the remedies available in either forum are on par: "Ceresney responded to the view by some that the SEC will bring more cases administratively to avoid losses in court. He noted that the SEC won eight out of its last 10 court cases. Congress gave the SEC the authority to obtain the <u>same remedies as in federal court</u>, he explained, and administrative proceedings offer a streamlined procedure in which cases can be brought much more quickly, while the evidence is still fresh." *Officials discuss administrative proceedings and more at PLI conference*, Fed. Sec. L. Rep. (CCH) No. 2655, at 2 (Nov. 20, 2014) (emphasis added). Although there are minor, immaterial differences in the remedies that can be achieved in federal court or district court, as set forth in the Enforcement Director's comments, the remedies are functionally equivalent.

fundamental Constitutional deficiency of the structure is that it places in the hands of the government prosecutor, in the form of the SEC, the sole power to provide or withhold a citizen's Seventh Amendment right to a jury trial for the same conduct and remedies. More problematic, the government will only grant the citizen her Constitutional right to a jury trial when the Commission, in consultation with the Division of Enforcement attorneys who conducted the investigation, concludes that, on balance, it is to the government's advantage to permit the citizen her right to a jury. Indeed, in a recent speech, the only factors that the SEC's enforcement director identified with respect to how the Commission, in consultation with Division of Enforcement attorneys bringing the case, will decide to file in district court is whether it would be advantageous as a litigation tactic to file there. *See* Andrew Ceresney, Remarks to the American Bar Association's Business Law Section Fall Meeting (Nov. 21, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370543515297#.VJ25mV4AA.

As set forth in more detail below, the legal scheme established by Congress through Section 929P(a) of the Dodd-Frank Act impermissibly affords SEC prosecutors the unguided discretion to choose whether a respondent will have a right to be tried by a jury.[64] Such a law

[64] The SEC's decision to bring its enforcement actions in one forum as opposed to the other is not guided by any reasoned direction from Congress. *See* Pub. L. No. 111-203 §§ 929P(a)(1), (a)(2)(E), (a)(3)(e), and (a)(4)(e). The relevant legislative history is also silent on this matter. *See* H.R. Rep. No. 111-517, at 870-71 (2010) (Conf. Rep.); H.R. Rep. No. 111-687, pt. 1, at 78 (2010). SEC attorneys have acknowledged the lack of *any* congressional principal guiding the SEC's selection of a forum in which to bring an enforcement action. When asked last year by a federal district court to articulate "the criteria that the SEC uses to determine whether a matter is referred to court, criminally or civilly, versus referred for administrative proceeding," an SEC attorney responded: "To start with, Congress gave the SEC two distinct paths that it can follow in pursuing a civil action: You can go into Federal District Court; you can bring it in an administrative proceeding. *It did not provide any criteria as to when the Commission would or should do one versus the other.* It's entirely left to the Commission's discretion. The Commission decides— does not have formal criteria. The Commission decides on a case-by-case basis, based on everything before it, which route it might want to follow." Tr. of Mot. for TRO at 66-67, *Jarkesy v. S.E.C.*, No. 1:14-cv-00114-BAH (D.D.C. June 11, 2014) (ECF No. 22) (emphasis added). Although the Division of Enforcement has since issued purported "guidelines" for the selection of forum in its enforcement actions, *see* U.S. Securities and Exchange Commission, *Division of Enforcement Approach to Forum Selection in Contested Actions*, https://www.sec.gov/divisions/enforce/enforcement-approach-forum-selection-contested-actions.pdf (last visited July 30, 2015), the non-exhaustive list of four factors described therein does not include any direction from Congress. The Division also made clear that the circumstances of each particular case will ultimately govern where the case is brought, and it disclaimed any kind of set formula used to make the forum determination.

violates the equal protection and due process guarantees of the Fifth Amendment, and is therefore facially unconstitutional.

The remedy for a litigant injured by a facially unconstitutional statute "is necessarily directed at the statute itself and must be injunctive and declaratory." *Ezell v. City of Chi.*, 651 F.3d 684, 698 (7th Cir. 2011). A successful "facial attack means the statute is wholly invalid and cannot be applied to anyone." *Id*. Because Section 929(P)(a) of Dodd Frank is unconstitutional on its face, the proceeding instituted pursuant to it must be dismissed immediately.

A. Section 929P(a) of Dodd-Frank violates the Fifth Amendment's guarantee of equal protection, and is therefore unconstitutional on its face.

The Constitution's promise of equal protection guarantees that similarly situated individuals will be similarly treated. Laws that create classifications that "affect some groups of citizens differently than others" implicate the concerns of equal protection and are struck down unless they can survive judicial scrutiny. *McGowan v. Maryland*, 366 U.S. 420, 425 (1961); *see also Pers. Adm'r of Mass. v. Feeney*, 442 U.S. 256, 279 (1979). This constitutional safeguard is offended if the government's classification rests on grounds irrelevant to the achievement of a legitimate government objective. *McGowan,* 366 U.S. at 425.[65]

A statutory scheme that, for no legitimate purpose, affords some litigants a jury trial while denying the same to similarly situated litigants violates the equal protection guarantee of the Fifth Amendment. The Supreme Court's consideration in *Baxstrom v. Herold,* 383 U.S. 107 (1966), of such a statutory scheme is instructive. The petitioner in *Baxstrom,* a prison inmate in New York at the end of his sentence, challenged the New York statutory scheme that allowed for

[65] While the Fifth Amendment does not contain the words "equal protection" as does the Fourteenth Amendment, which applies only to the states, the United States Supreme Court has interpreted the Due Process Clause of the Fifth Amendment to include an equal protection guarantee enforceable against the federal government. The Court's approach to Fifth Amendment equal protection claims "has always been precisely the same as to equal protection claims under the Fourteenth Amendment." *Weinberger v. Wiesenfeld*, 420 U.S. 636, 638 n.2 (1975).

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 in that state. *Id.* at 110. Under New York law at that time, "[a]ll persons civilly committed . . . other than those committed at the expiration of a penal term, [were] expressly granted the right to de novo review by jury trial of the question of their sanity . . . ." *Id.* at 111.

Applying rational basis scrutiny, 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 was the same—whether the person before it was mentally ill—the Equal Protection Clause required that all people facing that determination be given the same protections. *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.

Almost a decade later the Supreme Court again considered the equal protection implications of a state's commitment laws, this time in Wisconsin. *Humphrey v. Cady,* 405 U.S. 504 (1972). Though the Court remanded before finding a constitutional violation, the Court noted in strong language the constitutional problem with denying a jury to one class of commitment candidates but not another when the determination to be made (mental illness warranting institutionalization) and the potential outcome (commitment) was the same for both classes.

The petitioner in *Humphrey* challenged on equal protection grounds the constitutionality of Wisconsin's disparate treatment of people committed for treatment under the state's Mental Health Act and its Sex Crimes Act. *Id.* at 508. A person committed under Wisconsin's Mental

Health Act at that time had a statutory right to have a jury determine whether he met the standards for commitment, but a person facing commitment under Wisconsin's Sex Crimes Act, like the petitioner, was not afforded a jury determination. *Id.*

Before remanding for an evidentiary hearing, the Court observed that under its reading of the two Acts, the *same conduct* could warrant commitment proceedings under either Act. If it developed on remand that the "petitioner 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 rather than the other," the Court stated, "[t]he equal protection claim would seem to be especially persuasive . . . ." *Id.* at 512.

Thus, *Baxstrom* and *Humphrey* stand for the proposition that when the alleged wrongful conduct and the remedy sought are the *same*, a statutory scheme 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 Section 929P(a) of Dodd-Frank, which grants the SEC authority to obtain civil penalties against any citizen in the country in either district court, where the defendant can elect to be tried before a jury, or an administrative proceeding, where she cannot.

Moreover, with its passage of Section 929P(a), Congress provided no guidance to SEC prosecutors as to when and for what reasons it would be appropriate for them to choose to bring their charges in an administrative proceeding rather than in district court. And the SEC's exercise of that authority is no different than the grant of arbitrary and unbridled discretion to withhold the right to a jury or other procedural protections found constitutionally infirm in *Baxstrom* and *Humphrey*. If the "arbitrary decision of the State to seek . . . commitment under

one statute rather than the other" was viewed with such judicial ire in *Humphrey*, so must be the SEC's authority arbitrarily to select its forum, one with a jury and one without. *Id.*

Here, the government's unequal treatment under Section 929P(a) of unregulated people accused of securities violations is *at best* arbitrary. Recent statements made by the SEC's enforcement director demonstrate that the unequal treatment of defendants under this scheme is actually a litigation tactic put in place to give the government its best opportunity to win. *See* Ceresney, *supra*. Even under the least stringent form of constitutional scrutiny, a discriminatory law that has an *illegitimate* purpose must be struck down.

B. Section 929P(a) of Dodd-Frank violates the Fifth Amendment's guarantee of substantive due process, and is therefore unconstitutional on its face.

Where 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). And "[t]o punish a person because he has done what the law plainly allows him to do is a due process violation of the most basic sort…." *Bordenkircher v. Hayes*, 434 U.S. 357, 363 (1978). Courts have on many occasions invalidated statutory provisions that penalize citizens for possessing or exercising their constitutional rights.

The Supreme Court's decision in *United States v. Jackson*, 390 U.S. 570 (1968) is instructive. There, the Court held that the capital punishment provision of the federal anti-kidnapping law was unconstitutional because it penalized a defendant for exercising his right to a jury trial. The problem with the statutory regime in *Jackson* was that the defendant would be exposed to a death sentence if he exercised his right to have a jury determine the outcome of his case. *Id.* at 570-71. By waiving his right to have a jury determine his guilt, and

instead agreeing to have his case heard by a federal judge, the maximum sentence he could receive, if found guilty by the judge, would be life in prison. *Id.*

In striking down the penalty provision, the Court stated that "[w]hatever might be said of Congress' objectives, they cannot be pursued by means that needlessly chill the exercise of basic constitutional rights." *Id.* at 582. And the Court held that "Congress cannot impose … a penalty in a manner that needlessly penalizes the assertion of a constitutional right." *Id.* at 583.

Relying on *Jackson*, the court in *Wymelenberg v. Syman*, 328 F. Supp. 1353 (E.D. Wis. 1971), struck down a Wisconsin statute that forced new residents coming into the state to wait two years before they could obtain a divorce. The court stated "the instant statute must clearly fail as it is impermissible for a state to attempt to chill an individual's constitutional right to travel to and settle in the state of his choice." *Id.* at 1355.

Similarly, the Supreme Court has also found violations of due process where the government retaliates against the exercise of constitutional rights. For example, in *Blackledge v. Perry*, 417 U.S. 21 (1974), the Supreme Court found unconstitutional the prosecutorial discretion authorized by a state statutory regime because of the risk that the prosecutor's actions would be motivated by the goal of penalizing a defendant's assertion of his right to a jury trial. There, North Carolina charged Perry with a misdemeanor assault. *Id.* at 22. State law provided that such misdemeanors could be tried initially in a court without a jury, and then appealed at the option of the defendant for a trial before a jury *de novo*. *Id.* However, North Carolina law also permitted the prosecutor to obtain a new felony indictment for the same conduct, which the prosecutor did after Perry exercised his right to have a jury determine his original misdemeanor charge. *Id.* at 23.

The Court held that risk of punishment for the exercise of Perry's right to appeal and have a jury determine the charges against him violated due process. *Id.* at 28-29. The Court reasoned that no actual evidence of bad faith or foul motive need be established because the statute itself permitted the potential for an improper motive to enter the government's decision-making.[66] *Id.*; *see also Marshall v. Jerrico, Inc.*, 446 U. S. 238, 249 (1980) (citations omitted) ("In appropriate circumstances the Court has made clear that traditions of prosecutorial discretion do not immunize from judicial scrutiny cases in which the enforcement decisions of an administrator were motivated by improper factors or were otherwise contrary to law.").

This same reasoning provides the foundation for the Supreme Court's jurisprudence with respect to the Fifth Amendment right against self-incrimination. *See Griffin v. California*, 380 U.S. 609 (1965); *Miranda v. Arizona*, 384 U.S. 436 (1966). Thus, in *Griffin* the Court held that a defendant could not be penalized by the prosecution impeaching the defendant at trial with his pre-trial custodial silence. In reaching this conclusion, the Court reasoned that the Constitution cannot condone "a penalty imposed by courts for exercising a constitutional privilege." *Griffin*, 380 U.S. at 614. Citing *Griffin*, the *Miranda* Court explained that "it is impermissible to penalize an individual for exercising his Fifth Amendment privilege when he is under police custodial interrogation." 384 U.S. at 468 n.37.

In this case, Congress has gone beyond simply imposing a penalty on a person for asserting her constitutional right. Rather, the Act affects a wholesale transfer of Ms. Bebo's constitutional right to a jury trial *to the government itself*. Because the remedies that the SEC may obtain in either forum are functionally equivalent, the sole consideration for the government

[66] Notably, the Court recognized the government's interest in streamlining prosecutions and conserving resources as potentially driving the decision to retaliate against persons that exercised their right to have a new *de novo* trial in front of a jury and impermissibly injecting "the opportunities for vindictiveness" into the decisions. *Perry*, 417 U.S. at 27-28. Expediency, of course, is the same factor that creates the opportunity for vindictiveness in the SEC's selection of forum under Dodd-Frank.

in exercising its discretion of where to bring the case is where it is more likely to be successful. Consequently, the government can and will conclude that there are circumstances where the defendant would be unsympathetic to a jury. In those cases, the government will penalize the citizen and bring the case in federal court. In other instances, such as in this case, the government may conclude that a jury may view the defendant as sympathetic or credible, and thus determine that the defendant should be stripped of her right to a jury and forced to proceed administratively. Either way, the government is penalizing the citizen for possessing the Seventh Amendment jury right in way that is inimical to the Constitution.

Dodd-Frank, on its face, also permits the SEC to file a case in district court and wait to see if the defendant asserts her right to a jury trial. The SEC has the option to then voluntarily dismiss the case and obtain the same remedy administratively. It is beyond cavil that such a practice, which is permissible under Dodd-Frank, runs afoul of the dictates of *Jackson*, *Perry*, and their progeny. It makes no difference, from a constitutional perspective, that Dodd-Frank sets up a mechanism whereby the Commission, in confidential consultations with its staff attorneys who will prosecute the case, assumes that a citizen will assert her jury trial right if the case is filed in district court and then concludes that the benefit to the government of proceeding in that forum does not outweigh the perceived "cost" of the citizen's right to a jury trial (and other procedures that govern district court actions). Just because the government's actions are a preemptive punishment of the citizen's exercise of her constitutional rights makes it no less penal and no less a constitutional violation. *See United States v. Alvarado-Sandoval*, 557 F.2d 645, 645-46 (9th Cir. 1977).

II. THE SEC'S CHOSEN FORUM VIOLATES TWO SEPARATE CLAUSES OF ARTICLE II OF THE U.S. CONSTITUTION.

Administrative proceedings do not afford respondents the opportunity to have their case heard by a jury. Instead, an SEC ALJ presides over the proceedings, acting as the factfinder and deciding matters of law. A constitutional defect in the authority of a presiding judge, such as the SEC ALJ presiding over this proceeding, affects the validity of the proceeding itself. *Freytag v. Comm'r.*, 501 U.S. 868, 879 (1991).

The appointment and retention of the SEC ALJ presiding over this proceeding is constitutionally defective in two ways. First, the ALJ's appointment violates the Appointments Clause of Article II because he was not appointed by the President, a court of law, or a department head as is required by that clause. U.S. Const. art. II, § 2. Second, the ALJ's multiple-layer tenure protection impedes the President's ability to exercise executive power over him, an inferior officer, in violation of the Take Care Clause of Article II. *Id.* at § 3.

A. The Appointment of SEC ALJs Violates Article II.

The Appointments Clause of Article II of the Constitution prescribes the method by which "officers" and "inferior officers" of the United States are appointed to their posts. U.S. Const. art. II, § 2, cl. 2. Principal "officers" are selected by the President with the advice and consent of the Senate, and "inferior officers" can be appointed by the President alone, or by the heads of departments, or by the judiciary. *Id.*; *see also Buckley v. Valeo*, 424 U.S. 1, 132 (1976).

The Appointments Clause applies to all agency officers, including those whose functions are "predominately quasi judicial and quasi legislative." *Buckley*, 424 U.S. at 133 (quoting *Humphrey's Ex'r v. United States*, 295 U.S. 602, 625-26 (1935)). "[A]ny appointee exercising significant authority pursuant to the laws of the United States is an 'Officer of the United States,'

and must, therefore, be appointed in the manner prescribed by § 2, cl. 2, of [Article II]." *Freytag*, 501 U.S. at 881 (quoting *Buckley*, 424 U.S. at 126).

Indeed, Justice Scalia has observed: "Today, the Federal Government has a corps of administrative law judges numbering more than 1,000, whose principal statutory function is the conduct of adjudication under the Administrative Procedure Act (APA), see 5 U.S.C. §§ 554, 3105. They are all executive officers." *Id.* at 910 (Scalia, J., concurring) (emphasis omitted).

Because SEC ALJs are inferior officers, their appointment must conform to the prescriptions of Article II. On-the-record discussion by ALJ Elliot himself confirms that his hiring was not conducted in compliance with Article II requirements.

1. SEC ALJs are Inferior Officers as Contemplated by Article II.

SEC ALJs are "inferior officers" whose appointment *must* be made by the President, the head of a department (such as the Commission itself[67]), or the judiciary. *See Hill v. S.E.C.*, No. 1:15-CV-1801, 2015 WL 4307088, at *16 (N.D. Ga. June 8, 2015) (holding that SEC ALJs are inferior officers and that the method of their hiring likely violates Article II).

Their status as constitutional *officers* of the Executive Branch is evidenced by, among other things, the statutory authority creating their position; their career appointments by heads of an Executive Branch department; the statutory and regulatory requirements prescribing their duties, appointment, and salary; the significant authority and discretion they exercise; and their power, in certain cases, to issue the final decision of the SEC. Simply, SEC ALJs exercise the requisite "significant authority pursuant to the laws of the United States" and are therefore officers. *Freytag*, 501 U.S. at 881.

[67] The SEC is a "Department" of the Executive Branch. *Free Enterprise Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 511 (2010) ("Because the Commission is a freestanding component of the Executive Branch, not subordinate to or contained within any other such component, it constitutes a 'Departmen[t]' for the purposes of the Appointments Clause."). The Commissioners are the "heads" of the Department. *Id.* at 512-13.

SEC ALJs' positions are analogous to those of the Tax Court's special trial judges ("STJ"), which the Supreme Court has already concluded are "inferior officers" for purposes of Article II. *Id*. In *Freytag*, the Commissioner argued that because STJs simply assisted the Tax Court judge in taking evidence and preparing an opinion and lacked authority to enter a final decision of their own, they were merely "employees," not officers. *Id.* The Supreme Court rejected that argument, instead focusing on the significant discretion STJs exercise in concluding that they are not merely "employees":

> [T]his argument ignores the significance of the duties and discretion that special trial judges possess. The office of special trial judge is "established by Law," Art. II, § 2, cl. 2, and the duties, salary, and means of appointment for that office are specified by statute. These characteristics distinguish special trial judges from special masters, who are hired by Article III courts on a temporary, episodic basis, whose positions are not established by law, and whose duties and functions are not delineated in a statute. Furthermore, special trial judges perform more than ministerial tasks. They take testimony, conduct trials, rule on the admissibility of evidence, and have the power to enforce compliance with discovery orders. In the course of carrying out these important functions, the special trial judges exercise significant discretion.

Freytag, 501 U.S. at 881-82.

The Supreme Court agreed with the Tax Court and the Second Circuit, which both "considered the degree of authority exercised by the special trial judges to be so 'significant' that it was inconsistent with the classifications of 'lesser functionaries' or employees." *Freytag*, 501 U.S. at 881.

Here, too, the SEC ALJs exercise significant authority and discretion (they "take testimony, conduct trials, rule on the admissibility of evidence, and have the power to enforce compliance with discovery orders[,]" among other things). *See id.* at 881-82. And the office of the SEC ALJs is "established by law," with the ALJs' "duties, salary, and means of appointment for office … specified by statute." *See id.* at 881.

(a) SEC ALJs exercise considerable discretion and significant authority.

SEC ALJs exercise considerable discretion and significant authority in these administrative proceedings, which makes them officers as contemplated by Article II of the U.S. Constitution.

The SEC ALJs' authority is delegated to them by the Commission. *See* 15 U.S.C. § 78d-1(a) (the SEC "shall have the authority to delegate … any of its functions to …an individual Commissioner, an administrative law judge, or an employee …"); 17 C.F.R. § 200.14(a) ("…the Office of Administrative Law Judges conducts hearings in proceedings instituted by the Commission."); 17 C.F.R. § 200.30-9 (the Commission "hereby delegates ... to each [ALJ] the authority … [t]o make an initial decision …"). The SEC ALJs, also referred to as "hearing officers," are given significant authority by regulation:

> The [ALJs] are responsible for the fair and orderly conduct of the proceedings and have the authority to:
> (1) Administer oaths and affirmations;
> (2) Issue subpoenas;
> (3) Rule on offers of proof;
> (4) Examine witnesses;
> (5) Regulate the course of a hearing;
> (6) Hold pre-hearing conferences;
> (7) Rule upon motions; and
> (8) … prepare an initial decision containing the conclusions as to the factual and legal issues presented, and issue an appropriate order.

17 C.F.R. § 200.14(a); *see also* 17 C.F.R. § 201.111 (ALJs have power to, inter alia, revoke, quash or modify subpoenas; receive relevant evidence and rule upon admission of evidence; consider and rule upon all procedural and other motions; regulate the conduct of the parties and their counsel; reopen any hearing prior to the filing of an initial decision, etc.).

Under the SEC Rules of Practice ("RoP") an SEC ALJ is given the power to perform the following, among other things: amend the SEC's OIP (RoP 200(d)(2)), and require amended

answers to be filed (RoP 220(b)); require the SEC to file a more definite statement of specified matters of fact or law to be considered or determined (RoP 220(d)); grant or deny leave to amend an answer (RoP 220(e)); grant or deny leave to move for summary disposition, if necessary, and rule on motions for summary disposition (*see* RoP 250(a), (b)); stay proceedings pending Commission consideration of offers of settlement (RoP 161(c)(2)); express views on offers of settlement (RoP 240(c)(2)); grant extensions of time (RoP 161); find a party in default and set aside a default (RoP 155); reject filings that do not comply with the SEC's Rules of Practice (RoP 180(b)); enter default, dismiss the case, decide a particular matter against a party, or prohibit introduction of evidence when a person fails to make a required filing or cure a deficient filing (RoP 180(c)); order that scandalous or impertinent matter be stricken from any brief or pleading (RoP 152(f)); order production of documents pursuant to subpoena (RoP 230(a)(2), 232); order depositions, and act as the "deposition officer" (RoP 233, 234); regulate the SEC's use of investigatory subpoenas after the institution of proceedings (RoP 230(g)); modify the Rules of Practice with regard to the SEC's document production obligations (RoP 230(a)(1)); require the SEC to produce documents it has withheld (RoP 230(c)); issue protective orders governing confidentiality of documents (RoP 322); certify issues for interlocutory review, and decide whether to stay proceedings after an application for or grant of review (RoP 400(c), (d)); direct the parties to meet for prehearing conferences, and preside over such conferences as the ALJ "deems appropriate." (RoP 221(b)); order any party to furnish prehearing submissions (RoP 222(a)); allow the use of prior sworn statements when, in its discretion, it would be desirable, in the interests of justice, to do so, and limit or expand the parties' intended use of the same (RoP 235(a), (a)(5)); take "official notice" of facts not appearing in the evidence in the record (RoP 323); determine the scope of cross-examination (RoP 326); order that hearings not be recorded or

transcribed (RoP 302(a)); issue orders specifying corrections to the transcript (RoP 302(c)); rule on motions to correct errors in the initial decision (RoP 111(h)); impose sanctions on parties for contemptuous conduct (RoP 180(a)); disqualify himself or herself from considering a matter (RoP 112(a)); consolidate proceedings (RoP 201(a)); regulate appearance of amici (RoP 210(d)); modify the rule regarding the participation of intervening parties and amici, among others (RoP 210(f)).

(b) SEC ALJs have the power to issue the final decision of the Commission under certain circumstances.

After the hearing, the SEC ALJ issues an "initial decision," which includes: "findings and conclusions, and the reasons or basis therefore, as to all the material issues of fact, law or discretion presented on the record and the appropriate order, sanction, relief, or denial thereof." RoP 360(b); *see also* 17 C.F.R. § 200.14(a). The ALJ's initial decision becomes the final decision of the Commission if no timely petition is filed, and the Commission does not review the decision on its own initiative. *See* RoP 360. With certain exceptions inapplicable here, the Commission's decision to review is discretionary. In determining whether to grant review, the Commission considers whether "a prejudicial error was committed in the conduct of the proceeding; or … the decision embodies: (A) a finding or conclusion of material fact that is clearly erroneous; or (B) a conclusion of law that is erroneous; or (C) an exercise of discretion or decision of law or policy that is important and that the Commission should review." RoP 411(b)(2).

If the Commission does not review the matter (either by petition or on its own accord), the decision becomes final, and "the action of [the] administrative law judge . . . shall, for all purposes, including appeal or review thereof, be deemed the action of the Commission." 15 U.S.C. § 78d-l(c). The Commission issues an order, and "[t]he decision becomes final upon

issuance of the order[, which] shall state the date on which sanctions, if any, take effect." RoP 360(d)(2).[68]

Because SEC ALJs exercise significant authority pursuant to the laws of the United States, and because their powers are not appreciably different than those of STJs, which were held to be inferior officers of the Tax Court, they are inferior officers for the purpose of Article II. *See Butz v. Economou*, 438 U.S. 478, 513 (1978) ("There can be little doubt that the role of the . . . administrative law judge . . . is 'functionally comparable' to that of a judge. His powers are often, if not generally, comparable to those of a trial judge: He may issue subpoenas, rule on proffers of evidence, regulate the course of the hearing, and make or recommend decisions."); *see also Edmond v. United States,* 520 U.S. 651, 663 (1997) ("[W]e think it evident that 'inferior officers' are officers whose work is directed and supervised at some level by others who were appointed by Presidential nomination with the advice and consent of the Senate.").

2. SEC ALJs are not appointed by the President, a department head, or the judiciary.

Because they are "inferior officers" as contemplated by Article II, the SEC ALJs, including the ALJ presiding over this proceeding, must be appointed by the President, the head of a department, or the judiciary. They are not.

As ALJ Elliot explained on the record during these proceedings, there are two ways SEC ALJs are appointed. (June 19, 2015 Hearing Tr. 4472.) The first method is overseen by the U.S. Office of Personnel Management ("OPM"), which administers the competitive examination for

[68] In *Landry v. FDIC*, 204 F.3d 1125 (D.C. Cir. 2000), the Unites States Court of Appeals for the District of Columbia Circuit held that FDIC ALJs were not inferior officers. *See id.* at 1133-34. Attempting to distinguish *Freytag*, the court noted that, unlike the special trial judges in Tax Court, "the [FDIC] ALJs … can never render the decision of the FDIC. Final decisions are issued only by the FDIC Board of Directors." *Id.* at 1133 (citation omitted). Notwithstanding the disputed premise that the *Freytag* decision turned upon the special trial judges' ability to render a final decision under certain circumstances, the facts in *Landry* are distinguishable from those here. That is, unlike FDIC ALJs, SEC ALJs can issue final decisions under certain circumstances.

selecting all ALJs across the federal government. (Notice of Filing, *In re Timbervest, LLC*, SEC File No. 3-15519 (June 4, 2015), https://www.sec.gov/litigation/apdocuments/3-15519-event-139.pdf (citing 5 U.S.C. §§ 1104, 1302; 5 C.F.R. § 930.201(d)-(e)).)[69] Under the OPM process, the SEC's Chief ALJ obtains from OPM a list of eligible candidates, and a selection is made from the top three candidates on that list. *Id.* (citing 5 U.S.C. §§ 3317, 3318; 5 C.F.R. §§ 332.402, 332.404, 930.204(a)). The Chief ALJ and an interview committee then make a preliminary selection from among the available candidates, and their recommendation is subject to final approval and processing by the Commission's Office of Human Resources. *Id.* Importantly, the SEC Commissioners are not involved in this method of hiring SEC ALJs.

The other method by which SEC ALJs are hired is used when the candidate is already an ALJ for a different federal agency. (June 19, 2015 Hearing Tr. 4472.) This is the way ALJ Elliot was hired to the SEC, as he explained on the record at the hearing in this proceeding. (*Id.* at 4472-73.) At the time ALJ Elliot applied for a position as an SEC ALJ, he was serving as a Social Security ALJ. (*Id.*) He responded to a job posting on the USA Jobs website, submitted his resume, was interviewed by the SEC's Chief ALJ and a representative from SEC Human Resources, and was hired for the position. (*Id.* at 4472-74.) As with the first method of SEC ALJ appointment, described above, this method also does not involve any participation by the SEC Commissioners. ALJ Elliot confirmed as much: "I was not appointed by the Commission. The Commission, as far as I know, did not issue any sort of order appointing me as an ALJ." (*Id.* at 4474.)

Because the appointment of SEC ALJs is not made by the President, the head of a department (such as the Commission itself), or the judiciary, their appointments are

[69] In explaining this method of ALJ appointment, ALJ Elliot referenced a filing made by the SEC in a different enforcement action, *In re Timbervest, LLC*. Information related to the OPM's hiring process comes directly from that filing.

constitutionally defective. This administrative proceeding, overseen by an ALJ without proper constitutional authority, is void and must be dismissed.

B. The Multiple-Layer Tenure Protection Enjoyed by SEC ALJs Violates Article II.

In addition to the constitutional defect in their appointment, there is another constitutional problem with the SEC's ALJs: their two-layer tenure protection violates the Take Care Clause of Article II.

Article II of the U.S. Constitution vests "[t]he executive Power . . . in a President of the United States of America," who must "take Care that the Laws be faithfully executed[.]" U.S. Const. art. II, § 1, cl. 1; *id.* § 3. "In light of '[t]he impossibility that one man should be able to perform all the great business of the State,' the Constitution provides for executive officers to 'assist the supreme Magistrate in discharging the duties of his trust.'" *Free Enterprise Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 483 (2010) (quoting 30 Writings of George Washington 334 (J. Fitzpatrick ed. 1939)). Nonetheless, under *Free Enterprise*, pursuant to Article II's vesting of the executive power in the President, executive officers—such as the SEC ALJs, as described above—cannot be separated from the President by multiple levels of protection from removal. *Id.* at 484. "The President cannot 'take Care that the laws be faithfully executed' if he cannot oversee the faithfulness of the officers who execute them." *Id.* (citation omitted).

That is, Article II is violated when an executive officer can only be removed for good cause, and the power to remove that officer is held by another officer who can only be removed for good cause. *See id.* SEC ALJs enjoy at least two levels of good-cause protection, with the result being ALJs who are "not accountable to the President, and a President who is not responsible for the" ALJs. *Id.* at 495.

SEC ALJs are protected from removal except for "good cause" as determined by the Merit Systems Protection Board ("MSPB"). 5 U.S.C. § 7521(a). Similarly, the SEC Commissioners, who have the power to remove the ALJs, cannot be removed by the President from their position except for "inefficiency, neglect of duty, or malfeasance in office." *See Free Enterprise*, 561 U.S. at 487, 495 (citations omitted) ("none of [the Commissioners] is subject to the President's direct control"); *MFS Sec. Corp. v. SEC*, 380 F.3d 611, 619-20 (2d Cir. 2004) ("the power to remove Commissioners belongs to the President, and even that is 'commonly understood' to be limited to removal for 'inefficiency, neglect of duty or malfeasance in office.'") (citations omitted). Further, members of the MSPB can "be removed by the President only for inefficiency, neglect of duty, or malfeasance in office." 5 U.S.C. § 1202(d).

In sum, because SEC ALJs cannot be removed except for "good cause," the Commissioners are similarly protected from removal but for "inefficiency, neglect of duty, or malfeasance in office," and the MSPB members (who determine whether good cause exists to remove an ALJ) are also protected from removal but for "inefficiency, neglect of duty, or malfeasance in office," SEC ALJs are protected by multiple layers of protection from removal in violation Article II. Under this multilevel protection scheme:

> [T]he President cannot remove an officer who enjoys more than one level of good-cause protection, even if the President determines that the officer is neglecting his duties or discharging them improperly. That judgment is instead committed to another officer, who may or may not agree with the President's determination, and whom the President cannot remove simply because that officer disagrees with him. This contravenes the President's 'constitutional obligation to ensure the faithful execution of the laws.'

Free Enterprise, 561 U.S. at 484 (quoting *Morrison v. Olson*, 487 U.S. 654, 693 (1988)).

Because the President cannot oversee SEC ALJs in accordance with Article II, SEC administrative proceedings are governed by SEC ALJs in violation of the Constitution.

III. THIS ADMINISTRATIVE PROCEEDING HAS DEPRIVED MS. BEBO OF HER RIGHT TO PROCEDURAL DUE PROCESS.

In addition to the facial defects explained above that render this proceeding invalid under the Fifth Amendment and Article II, the SEC's administrative procedures as applied in Ms. Bebo's case have deprived her of the procedural process due to her.

A. Factual Background.

1. Ms. Bebo was not given adequate time to prepare a defense.

For over two years, the Division of Enforcement of the SEC has been investigating whether there had been any violations of the federal securities laws in relation to certain periodic financial reports filed with the Commission by ALC. The Division issued forty-three (43) subpoenas for testimony or documents, collected millions of pages of documents (approximately 270 gigabytes of data), and took a cumulative total of fifty-five (55) days of on-the-record testimony from thirty-three (33) witnesses. On the Monday after Thanksgiving, December 3, 2014, the Division issued an Order Instituting Public Administrative and Cease-and-Desist Proceedings ("OIP"), initiating administrative proceedings against Ms. Bebo.

Respondent twice asked for an extension of time to prepare. At the outset of the proceedings, Ms. Bebo moved for an extension of the hearing date, as the Court set a hearing date in April 2015, which provided Ms. Bebo just four months to prepare her defense, even though the Division had been investigating the matters that resulted in the allegations contained in the OIP for over two-and-one-half years and had plenty of time to prepare its case for the anticipated hearing. Ms. Bebo cited the nature of the claims at issue, which involve complex legal and factual circumstances; the scope of the factual circumstances—the OIP's allegations span five years; the massive investigative file containing millions of pages of documents, and the technical difficultly accessing the critical documents; the number of witnesses; and the need for

multiple expert witnesses. Ms. Bebo renewed her motion as the hearing date approached. Both times the request was denied

Indeed, the substantive allegations contained in the OIP span over a period of five years, with January 2009 to May of 2012 being the critical time period relevant to Division's allegations that Ms. Bebo caused ALC to file false or misleading periodic filings with the Commission. There are more than 100 witnesses with relevant information, based on the allegations and theory of the Division, as reflected in the OIP's allegations. Those witnesses are spread throughout the United States and even internationally—principally in Canada. As noted above, during the course of its two-year investigation the Division took a cumulative total of fifty-five (55) days of on-the-record testimony from thirty-three (33) witnesses. The Division interviewed at least sixteen (16) other witnesses, from whom it obtained written statements.

The Division also collected millions of pages of documents from various persons and entities relevant to the claims in the case, and Division staff have represented to Ms. Bebo's counsel that they have reviewed every single one of those documents during their lengthy investigation. The investigative file, excluding documents collected in the course of the investigation, is approximately 5 gigabytes of information. Including the various document productions, the amount of information produced by the Division beginning on December 9, 2015 was over 250 gigabytes of information. This was all amassed by the Division in an investigation that began in the summer of 2012, over two and a half years prior to filing the OIP on December 3, 2014.

The size of the investigative file and number of documents produced beginning on December 9, 2014 alone would have made it prejudicial to force Ms. Bebo to a hearing within four months. However, the format and manner in which the Division provided the information

prevented Ms. Bebo and her counsel from meaningfully accessing the critical documents for over a month. On December 9, 2014, the Commission provided an internal hard drive with 265 gigabytes of electronic data and gave access to a 5 gigabyte production via a secure File Transfer Protocol (FTP). The volume of documents exceeded 1.5 million pages. The letter enclosing the internal hard drive explained that the material was being provided electronically to "avoid any delay and unnecessary cost," but had the opposite effect.

First, the information was contained on an internal hard drive that had to be mounted and integrated into another computer. An external hard drive would have been much easier and quicker to access. Next, the size of the data was so large that counsel could not begin processing the data on the 265 gigabyte internal hard drive, without first upgrading its server capacity.

Once this process was complete, counsel learned that the databases related to the documents were produced in a format that made it extremely difficult for Ms. Bebo and her counsel to process and review the documents in a meaningful way and in a timely manner. As set forth in the affidavit of William K. Boren, Reinhart's head Litigation Support Project Manager, the Division's production was contained in 9 Concordance databases, a program for which Ms. Bebo's counsel does not maintain a license. (Affidavit of William Boren dated Jan. 2, 2015, (hereinafter "Boren Aff.") ¶¶ 1-8.) To work with the underlying documents, a litigation technology specialist worked in the accompanying .dat files which are accessible through a text editing program. The.dat files were unnecessarily large because the text from every page from the respective production was incorporated in the .dat file instead of providing a path to the text contained in a separate.txt file, a method routinely used by law firms and e-discovery companies. (Boren Aff. ¶ 9).

As a result, a single .dat file contained text from tens of thousands of pages of documents, which rendered the file incredibly large—5 gigabytes for ALC's production alone. (Boren Aff. ¶ 11). This decision created innumerous delays as the litigation technology specialist modified the text files to include header information that had been omitted from the .dat files, but which was needed for a meaningful review of metadata in Relativity, the program used by Ms. Bebo's firm to review documents.[70] (*See* Boren Aff. ¶¶ 11-17). Since the Division did not include headers in the .dat file, the litigation technology specialist had to refer to a separate file identifying the headers and then incorporate those references for each of the nine .dat files. The nine databases had different header information and one databases alone had more than 70 headers. While the "find and replace" function automates much of the text editing process within a single database, each separate search function took significantly longer than necessary because the text from each document was included in a single file. Much of the delay could have been avoided had the Division clicked a different option when making its production through Concordance. (Boren Aff. ¶ 18).

Based on the problems with Division's production format, Ms. Bebo's counsel only gained access to the seven smaller databases after Christmas 2014 and requested that the Division reproduce the two largest databases, those containing documents produced by ALC and Grant Thornton—the most important documents in this case—in a usable format so that those databases could be imported without further delay or expense. Nonetheless, Ms. Bebo was not granted any additional time to prepare her defense.

[70] According to marketing materials available from the kCura, the provider of Relativity, Relativity is used by all of the Am Law 100 firms and is also used by government agencies including the Department of Justice. Relativity, kCura, Inc., https://www.kcura.com/relativity/ (last visited July 30, 2015).

2. The Division's investigative methods, chosen forum, and access to witnesses prejudiced Ms. Bebo's defense.

Nearly all of the thirty-one (31) witnesses who testified at Ms. Bebo's hearing met or spoke with the Division, at least once, in advance. Many met with the Division for hours or over the course of multiple days. (*See, e.g,* Doman, Tr. 250-51; Solari, Tr. 440-42; Bell, Tr. 661-62; Fonstad, Tr. 1524-25; Hokeness, Tr. 3033-35.) Most met with the Division during the investigation and then again prior to their hearing testimony. (*Id.*) Only three of those witnesses, other than Ms. Bebo herself, agreed to speak with Respondent's counsel—Ms. Bebo's mother and two former colleagues who the Division never contacted during its investigation.

The fact that the Division spoke with the witnesses during the course of and after the investigation is not the problem—that is their job. Instead, it is the manner in which the Division approached and interviewed these witnesses, the manner in which testimony was preserved, and the manner in which the witnesses were prepared for testimony—all with an eye towards the initiation of, if not during, these administrative proceedings—that is problematic. Ms. Bebo did not have access to these witnesses or sufficient opportunity to challenge their credibility, both things she would have had in federal district court.

3. The Division of Enforcement influenced witnesses with suggestions of criminal prosecution and finger pointing, resulting in a lack of credibility.

In its communications with counsel for ALC and individual witnesses, the Division of Enforcement referenced criminal referrals and 5th amendment privileges before taking depositions and completing its investigation. Before a single deposition was taken in its investigation, the Division suggested that ALC's counsel and witnesses take note of the criminal referral provisions in its Enforcement Manual and indicated that witnesses should consider taking advantage of the cooperation tools available. (*See* Ex. 1967 (in email correspondence,

Division counsel states "…I'm sure you're aware of this but in case you haven't started considering it yet, I would like to refer you to Section 5 of our Enforcement Manual…"); *see also* Securities and Exchange Commission, Division of Enforcement, Enforcement Manual, Section 5 (addressing, *inter alia*, criminal referrals).) Similarly, before issuing a subpoena for a witness's deposition, the Division asked his counsel whether the witness would testify or "take the 5th." (*See* Ex. 1970 (September 2013 email correspondence between the Division and witness's counsel).)

While veiled and inherent threats would have a tendency to influence witnesses' testimony, even more troubling was the Division's representation to co-respondent John Buono, on the day of his investigative testimony, that Ms. Bebo had "thrown him under the bus[,]" which she had not done. (Buono, Tr. 2434-35.)

Q	You mentioned earlier -- we talked about this testimony about a concern over Ms. Bebo throwing you under the bus. Did you ever come to think that she did throw you under the bus?
A	I didn't know.
Q	I mean, to this day do you know?
A	To this day, I -- you're asking me if the SEC lied to me by saying she threw me under the bus?
Q	Well, that's -- did the SEC tell you that she threw you under the bus?
A	They gave me the impression that she implied -- or she blamed things on me.
Q	And when did they give you that impression?
A	They would have given it to me at that -- probably at that meeting. When was that testimony?
Q	Which -- the one here on February 26th or the last one?
A	The last one -- the testimony, not the proffers. There's only one testimony.
Q	November 19th, the one that we just talked about?
A	Yes.

What is more, Mr. Buono was not provided with Ms. Bebo's transcripts during the investigation. (Buono, Tr. 2490-91; *see also* Buono, Tr. 2491 ("Q: Well -- so earlier when you had a belief that she had thrown you under the bus in her testimony, that was based not on what

you read, but on what someone told you? A: It was based on what someone had told me. I had not read Laurie's testimony.").) While the Division of Enforcement's mission is "to protect investors and the markets by investigating potential violations of the federal securities laws and litigating the SEC's enforcement actions," *see* Enforcement Manual, Section 1.4.1, they are not cops, and the Division's attorneys must abide by the same rules of professional conduct as all other attorneys.[71]

Not surprisingly, Mr. Buono's version of the critical events has changed over time through his cooperation with the SEC—he admitted as much in his testimony—compromising his credibility:

Q	And let's look at 1130A for a minute. These are the minutes from the year-end meeting that was attached; is that correct? …
A	It is a meeting of the disclosure committee in reference to the fourth quarter annual report, 2008, yes. …
Q	Yeah. And let's go to page 3, please. And now I want to go to (g), if you can enlarge (g). So this is -- this part of the report appears to be from Financing/Treasury, John Buono for Wally Levonowich. Does that mean that you were providing the bulleted information for -- in Wally's place?
A	Appears to be, yes.
Q	I'm interested in, as you might imagine, the fourth bullet point. Ventas lease covenants continue to be monitored, and correspondence between ALC and Ventas has occurred whereby the covenant calculations have been clarified as to census. Now, would you have written that bullet point?

[71] Prior to the hearing in this matter, the Division also submitted a now admittedly untruthful, sworn declaration of Derek Buntain, and included it on its exhibit list. (Buntain, Tr. 1437-40.) In it, Mr. Buntain falsely asserted that he exercised some options and purchased some stock; that never occurred. The Division could have easily discerned the untruthfulness of the declaration by merely checking the trading records Mr. Buntain filed with the Commission itself. Those records, which also appear on the Division's exhibit list, demonstrate that Mr. Buntain's initial declaration included on the Division's exhibit list was false, unless the declarant had, himself, committed a securities law violation by failing to file the required forms to disclose the exercise of stock options he purports to have made.

On April 2, 2015, the Division submitted a second "supplemental declaration" of Mr. Buntain in attempt to explain this untruthful statement. In short, Mr. Buntain has not only falsely represented that he used the stock options to purchase ALC shares, he also misrepresented that knowing whether or not ALC was in compliance with covenants (which he did know) would have been an "important factor" in deciding whether to purchase or hold his shares in the company.

Given the declaration was obtained at the instance of the Division—at the same time that Mr. Buntain's counsel was refusing to acknowledge requests for an interview or testimony from Ms. Bebo's counsel—this is a particularly troubling misrepresentation.

A	No. Dave Hokeness would have written all of minutes. …
Q	Do you recall putting -- trying to -- let's first talk about whether you believe this is accurate. Is this your belief at the time that this was written back in 2009?
A	I have no reason to believe it's not accurate.
Q	And do you believe it's -- today, as you sit here, that it's still accurate?
A	That there was correspondence whereby the covenant calculations have been clarified. Now it's been pointed out to me that we never mentioned the covenant calculations. We mentioned employee leasing.
Q	All right. So when you say it's been pointed out to you, what do you mean by that?
A	It means that during the course of reviewing materials and having questions from the SEC and others, they pointed out that the phrasing covenant calculations is not there in our correspondence to Ventas, and I don't recall it being discussed on the call with Ventas. …
Q	I'd like for you to tell me the basis for your belief that the statement whereby the covenant calculations have been clarified is no longer true as you sit here today.
A	Because we did not in our correspondence to Ventas mention covenant calculations. We merely mentioned employees will be staying at the locations. My interpretation was that Ventas would realize they could be put in the covenant calculations.
Q	Why did you have that interpretation?
A	Because why else would we -- why else would we do it? It doesn't make any sense to book journal entries for the sake of booking journal entries.

(Buono, Tr., 2492-96.) The Division's methods of investigation and communication in this case have compromised the credibility of the witnesses and the fundamental fairness of these proceedings.

4. **The hearing testimony of witnesses, reflecting significant preparation with the Division, lacks credibility**.

While refusing to speak with Ms. Bebo's counsel, nearly every witness who testified during Ms. Bebo's hearing spent time with the Division of Enforcement prior to his or her testimony. Over the course of the investigation and hearing, one witness—John Buono—spent between forty-five and sixty hours with the Division. (Buono, Tr. 2420.) Although the evolution of his story and testimony is discussed above, he is one example of how the testimony of many of these witnesses lacks credibility:

Q	Can you go to Exhibit 152, please. And I'll ask you to go to the memo on the

	second page. And can you just blow up the first half of the memo, please. There you go. Did you draft that memorandum?
A	Yes.
Q	And in the third paragraph of the memo, it says, ALC is contemplating an arrangement with Ventas whereby scheduled lease payments will be accelerated, perhaps three years, and prepaid. In exchange, ALC would receive a modification or waiver of certain lease covenants. What caused you to draft a memo about that proposal?
A	Something that Alan Bell said to me after the board meeting. He said you guys, before you're out of compliance with the covenants, should go down to Ventas and discuss ways to modify it, and he suggested that prepaying rent would be possibly a way to get modifications.
Q	And so I believe I may have misspoken. You didn't draft that memorandum, did you?
A	Oh, no, I did not. That was from David.
Q	But you received it?
A	I'm sorry. I'm thinking of the wrong memo.
Q	You never received this memorandum?
A	I never received this memorandum, no.
Q	Pardon me?
A	Give me a second, please.
Q	Right.
A	Yes.
Q	And I believe I --
A	Yes.
Q	I believe I misspoke and I asked if you drafted it.
A	Yes. I did not draft it. I received it from Dave Hokeness.
Q	And to what extent do you know if Ms. Bebo was aware of this proposal?
A	I believe she was.

(Buono, Tr. 2330-31.)

Similarly, testimony was elicited by the Division from Joe Solari, the Ventas representative who participated in the January 20, 2009 phone call with Ms. Bebo and Mr. Buono, that significantly deters from his credibility. Apparently have rehearsed his testimony with the Division prior to the hearing, Solari uttered the phrase "I would never agree to such a thing, and I didn't have the authority to agree to it" nearly verbatim ten different times in response to the Division's questioning. (*See*, *e.g.*, Solari, Tr. 416-23.)

While the Division was able to effectively rehearse its cross-examinations with witnesses, Ms. Bebo was not permitted to treat many as adverse witnesses, despite their unwillingness to

meet with Ms. Bebo's counsel and their adverse interests. For example, Dr. Charles Roadman replaced Ms. Bebo as CEO of ALC, and played a part in terminating her employment, yet, the Court did not consider Dr. Roadman to be an adverse witness. (Roadman, Tr. 2563.)

5. Ms. Bebo was denied access to crucial evidence and witnesses by virtue of the nature of these proceedings.

By proceeding administratively, the Division also stripped Ms. Bebo of the ability to secure the testimony at the hearing, much less at a deposition, of key witnesses in the case, including ALC's chairman of the board and the chair of ALC's Audit Committee—David J. Hennigar and Malen S. Ng.

During the time period 2009 to 2012, ALC had two classes of stock. ALC's Class A Common Stock was listed and traded on the New York Stock Exchange under the symbol "ALC." ALC's Class B Common Stock was neither listed nor publicly traded. The holders of Class B Common Stock were entitled to ten votes per share held with respect to each matter presented to ALC's shareholders. The holders of Class A Common Stock were entitled to only one vote per share held with respect to each matter presented to ALC's shareholders. Due to its combined ownership of Class A Common Stock and nearly all of the Class B Common Stock, Thornridge Holdings Limited controlled the voting power of ALC's shareholders and therefore controlled the company. (*See* Bebo, Tr. 3831-32.)

Mr. Hennigar was President of Thornridge and that company's chairman of the board. Thus, Mr. Hennigar possessed *de facto* control over ALC through Thornridge. In addition, Mr. Hennigar acted as ALC's Chairman of the Board and exercised ultimate control over the strategic direction of the company. Mr. Hennigar is a citizen of Nova Scotia, Canada. Ms. Ng was a member of ALC's Board of Directors and the Chairperson of the Audit Committee of ALC's Board. Ms. Ng is a citizen and resident of Ontario, Canada. Ms. Bebo was unable to

subpoena either witness for deposition, discovery or testimony at the hearing in the administrative proceeding. Both were deposed by the Division during the investigation, outside the presence of Ms. Bebo's counsel.

In late summer of 2014, the Division interviewed Mr. Hennigar and Ms. Ng, among others, off the record in preparation to take their testimony on the record. Thereafter, the Division was able to obtain their on-the-record testimony through an investigative cooperation program with the Canadian securities agencies. That on-the-record testimony was conducted as a *de facto* direct examination of those witnesses rather than for the purpose of investigation and fact-finding. The Division sought to introduce the one-sided investigative testimony at the hearing in this matter, but ultimately withdrew the request.[72] Nonetheless, Ms. Bebo was precluded from eliciting any testimony from these two key witnesses, as they were outside the subpoena power of the SEC.

And the Court did admit the deposition testimony of Mr. Hennigar from unrelated litigation, over the objection of Ms. Bebo. While Ms. Bebo's counsel did question the witness, the deposition was taken in the course of an employment dispute between Ms. Bebo and ALC, not in regard to the Division's allegations of securities fraud. Ms. Bebo never had an opportunity to examine Mr. Hennigar in connection with the allegations in this case, because the Division opted to initiate these administrative proceedings, instead of litigation in federal district court, where testimony could have been compelled. The admission of this testimony is fundamentally unfair for the same reasons noted above. Further, testimony from those unrelated proceedings is

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[72] ALJ Elliot, the finder of fact, read both transcripts. (Tr. 106-07 (JUDGE ELLIOT: Very well. Well, it does -- it looks to me like it's probably a board member, based upon -- *at least based upon Mr. Hennigar's and Ms. Ng's transcripts, which I've read* but have not admitted.).)

irrelevant and immaterial to this proceeding for any purpose other than impeachment. But, of course, Mr. Hennigar did not testify. That the SEC's Rules of Practice contemplate admission of prior sworn statements does not make the admission of any deposition transcript fair or just as a matter of course.

6. Despite Ms. Bebo's lack of access to witnesses, the SEC was permitted to admit declarations in lieu of live testimony.

Notwithstanding Ms. Bebo's lack of access to substantially all of the relevant witnesses in this case, the Division was permitted to admit declarations from sixteen witnesses obtained over a more than six-month period—more time than Ms. Bebo is allowed to prepare her entire defense—without having to subpoena the witnesses or make them available at trial for cross-examination. The Division did not allege that any one of these witnesses was dead or outside the subpoena power. Nor did the Division suggest that it was unable to secure the witnesses' attendance by subpoena. Quite the opposite, the Division itself did not want to procure the attendance of the witnesses by subpoena and preferred to shortcut due process by admitting the prior sworn statements of witnesses, most of which were made without respondent's participation.[73]

Among the many advantages held by the Division in the administrative proceeding is its ability to conduct a full investigation before commencing administrative proceedings, which includes the ability to compel deposition testimony. The Court allowed the Division to further tip the scales in its favor by introducing sworn statements obtained during the investigation from available witnesses, while Ms. Bebo would have been precluded from compelling sworn testimony from a witness unless she could identify specific reasons why she "believes the

[73] The Division sought to introduce nineteen prior statements, but Ms. Bebo's counsel only observed the deposition testimony of three witnesses. The three depositions all took place in Milwaukee, Wisconsin and the Division offers no explanation why these witnesses could not testify orally in the open hearing that took place in Milwaukee, Wisconsin.

witness will be unable to attend or testify at the hearing…" Rule 233(a). In short, under the Rules of Practice, Ms. Bebo would have been precluded from obtaining the type of evidence from available witnesses that the Division was allowed to introduce without live testimony.

Even if the facts contained in the prior sworn statements are not ultimately in dispute, those witnesses may have evidence that Ms. Bebo could use in her defense. The problem with the admission of prior sworn statements is that they lack the information known by the witnesses that was not elicited by the Division. Without the right to discovery that is available to a defendant in a civil action, Ms. Bebo was unable to determine what relevant information is known by the witnesses without voluntary cooperation. Since Ms. Bebo's attorneys were not present for any meetings or discussions involving the Division and the sixteen witnesses who have provided sworn declarations, Ms. Bebo is without knowledge of the facts disclosed to the Division that were omitted from the final sworn statement or questions not asked by the Division. Given the manner in which the Division obtained its sworn statements, it has cherry picked the facts included into the sworn statement, thereby preventing Ms. Bebo from obtaining other potentially relevant information.

While the Division preferred to avoid inconveniencing the witnesses by calling them to give live testimony, it merely shifted the onus to Ms. Bebo. During the investigatory phase of the its action, the Division obtained the facts it believes are required to prove its case and sought to admit those facts—and only those facts—through these declarations. Due process and fundamental fairness require that the Division be required to make its case in an open hearing, rather than through the admission of sworn statements obtained outside the presence of Ms. Bebo's counsel and, in most instances, before the proceeding was commenced against her.

7. Evidentiary rulings, through the admission of irrelevant, speculative, or unreliable evidence to the lack of uniform application of (any) evidentiary rules, prejudiced Ms. Bebo's defense.

Without the protection of the Federal Rules of Evidence or the Federal Rules of Civil Procedure, irrelevant, speculative, and unreliable evidence was admitted, and the application of any evidentiary rules uneven, at best. Ms. Bebo was denied access to relevant evidence when the Court quashed subpoenas it previously issued and denied the ability to use the witnesses' and the Division's own language when cross-examining and attempting to impeach witnesses. These evidentiary rulings were fundamentally unfair, and prejudiced Ms. Bebo's defense.

8. The Court allowed Ventas representatives to provide speculative testimony, while prohibiting Ms. Bebo from collecting documents to challenge that testimony.

The OIP set forth various allegations with regard to Ms. Bebo's purported knowledge of and/or reckless indifference to the accuracy of ALC's statements in its periodic filings with the Commission that it was in compliance with certain (unspecified) operating and occupancy covenants set forth in ALC's lease with Ventas. To prepare her defense to these allegations, Ms. Bebo sought production of documents from several third parties, including Ventas. The Ventas subpoena sought information that would support Ms. Bebo's defense that her statement that ALC was in compliance with the covenants in the Ventas lease was accurate and reasonable due to how Ventas has addressed similar situations with other lessees. For certain requests, the Court required Ms. Bebo to establish why the information requested in the subpoenas was relevant to the proceedings and proper in scope. (Order on Request for Issuance of Subpoenas, Release No. 2247 (Jan. 23, 2015).) Upon doing so, the Court issued supplemental subpoenas, including one to Ventas, on February 5, 2015. (Subpoena to Produce Docs. to Ventas, Inc., Feb. 5, 2015.) Ventas moved to modify the subpoena (which, in reality, was a request to quash the better portion of the subpoena). (Ventas's Mot. to Modify Subpoena, Mar. 3, 2015.) Ms. Bebo

filed a response establishing the relevance of her requests to her defense to the allegations in the OIP. (Resp't Laurie Bebo's Resp. to Ventas's Mot. to Modify the Subpoena, Mar. 9, 2015.)

Despite having issued the subpoena after requiring Ms. Bebo to establish the relevance of the requested information and documents, on March 11, 2015, the Court issued an order granting Ventas' motion, effectively quashing the bulk of the subpoena. (*See* Order on Mot. to Modify Subpoena, Release No. AP-2410 (the "Order").) In the Order, the Court held that the documents sought by the subpoena documents were irrelevant, stating:

- How Ventas treated Old CaraVita in the course of their business relationship is not at issue, and Bebo is incorrect that it is a relevant line of argument that Ventas would have accepted the alleged way ALC, under Bebo's leadership, reported under the Ventas lease agreement – including by including ALC employees as tenants of facilities leased from Ventas (Order at 1.);

- The OIP's charges of violations of Exchange Act Sections 10(b), 13(a) and 13(b), and related Exchange Act Rules, are concerned with alleged dishonest actions and statements by ALC, allegedly caused by Bebo, and not whether Ventas agreed with those statements. *What might be relevant to Bebo's defense is evidence of Bebo's knowledge and understanding of what Ventas would or would not have accepted in terms of reporting*. Documents responsive to Requests 1-3 would not fall into this category of evidence; that evidence would instead be found in documents Bebo viewed and that have already been produced to her by ALC and/or Ventas – for example, emails between Bebo or other ALC employees and Ventas – and in the testimony of Bebo or her colleagues at ALC about what Ventas had indicated was acceptable reporting (Order at 2.) (emphasis added);

- It is irrelevant what approach Ventas took as to lessees other than ALC; *what is relevant is what Bebo understood Ventas' approach as to ALC to be*. Evidence supporting that is found in documents that Bebo saw when she was with ALC; if such documents exist, they would have already been produced by ALC and/or Ventas (*Id.*); and

- As discussed above, the only relevant aspect of that theory is Bebo's knowledge or understanding of what Ventas sanctioned (Order at 3.) (emphasis added).

The Order makes clear, on four separate occasions, that the only relevant information regarding Ventas, as it relates to these proceedings, is Ms. Bebo's knowledge or understanding of Ventas' treatment of ALC. The Order prevented Ms. Bebo from conducting discovery on Ventas'

treatment of other lessees (including ALC's predecessor, referred to in the briefings as "Old CaraVita") or Ventas' leasing and covenant practices generally.

Nonetheless, despite quashing Ms. Bebo's subpoena seeking information to challenge Ventas's expected testimony about Ventas' general leasing and covenant practices, the Court allowed Ventas witnesses to testify about what they would or would not have done, their policies, their practices, and internal communications notwithstanding their failure to either communicate them to Ms. Bebo or recall the contents of their conversations with her. (*See, e.g.*, Solari, Tr. 414-17 (Mr. Solari permitted to testify about what he would or would not have done or agreed to despite having no recollection of the specifics of the call except that they discussed "whether certain corporate employees from Assisted Living Concepts, while traveling to those facilities on business, could stay in vacant units rather than in a hotel").)

9. The Court prohibited Ms. Bebo from using the Division's or the witnesses' own language when cross-examining and attempting to impeach witnesses.

Through the course of its investigation, the Division used the term "employee leasing" in more than fifty questions while taking the testimony of Ms. Bebo and Mr. Buono. The term was used more than on hundred times by the parties and witnesses. The Division used it during its examination of witnesses during the hearing in roughly thirty-five different questions. Witnesses used the term during their testimony. Yet, when Respondent's counsel attempted to use the language to either question or impeach witnesses, it was often met objections from the Division and derision from the Court.

John Buono used the term "employee leasing" five times during his direct examination. On cross-examination, John Buono testified that one of the Board members "knew about employee leasing":

Q	Now, you mentioned earlier, and I think maybe the judge had asked you a

	question about -- or maybe it was something I had asked about Mr. Robinson, and you said it in the context of Ms. Ng. And it was in the context that you believed Ms. Ng knew about the arrangement with Ventas and Mr. Solari, correct?
A	She knew about employee leasing.

(Buono, Tr. 2417.) Moments later, Respondent's counsel asked Mr. Buono whether another Board member knew about "employee leasing," and was met with objection:

Q	Yeah. With respect to the employee leasing arrangement that you've just -- we've just been talking about, the agreement with Mr. Solari to use employees, do you have any basis to believe that Mr. Hennigar knew about that?
MR. HANAUER:	Objection. Vague. Use employees for what?
JUDGE ELLIOT:	Mr. Cameli, you're going to get -- you get one more bite at the apple. Okay? You've got to be specific. You get one more bite at the apple, and I'm shutting you down.

(Buono, Tr. 2421-22.) The Division objected to the term when it was to the Division's strategic advantage to stifle Respondent's ability to effectively cross-examine the witness and elicit testimony favorable to the defense:

Q	Mr. Buono, do you agree that you have testified in the past that you were informed by Mr. Fonstad that employee leasing was okay?
MR. HANAUER:	Objection to the term "employee leasing," Your Honor. We've been through this --
JUDGE ELLIOT:	Sustained.
MR. CAMELI:	I'm using the witness's own language.
JUDGE ELLIOT:	Mr. Cameli, you're down to nine minutes.

(Buono, Tr. 2745.) The Division's protestations are particularly disingenuous given that the Division itself used the term "employee lease" as shorthand while taking investigative testimony:

Q	But this whole practice that we've been talking about today where you put in lists of employees or other folks who you believe had a reason to stay at the CaraVita properties, that was, that, I'm just going to call it *employee lease*, you understand that?
A	Okay, sure.

(Ex. 500, (Bebo Investigative Test., Apr. 8, 2014, p. 846 (emphasis added)).)

10. **Ms. Bebo was unable to properly prepare her defense because she was denied discovery opportunities regarding the spoliation of evidence caused by a third party**.

Ms. Bebo does not believe the SEC is responsible for spoliation of evidence that would have assisted her defense in this matter. However, the SEC's administrative proceeding denied Ms. Bebo the opportunity—both procedurally and because of the inadequacy of time—to explore the party responsible for spoliation. And this proceeding further denied her an opportunity to explore either retrieval of the evidence or a secondary manner of procuring its substance (*i.e.*, deposing others with potential knowledge). If the SEC had commenced these proceedings in district court, those opportunities would have been afforded Ms. Bebo and the fruits of those efforts may have dissuaded the government from pursuing an enforcement action and/or assisted Ms. Bebo greatly in her defense.

Moreover, while the government may not have been responsible for the spoliation, it was aware of Ms. Bebo's claims of the same and, by choosing to prosecute administratively, denied her the ability to fully investigate the facts and circumstances surrounding her missing materials. Likewise, while the SEC may not have been a spoliation culprit, its prosecution relied heavily upon witnesses who certainly may have been responsible for the destruction or concealment of such evidence and with whom the government chose nevertheless to align.

Evidence of spoliation exists in this case both circumstantially and directly. First and foremost, Ms. Bebo's notes—which are relevant to **any** facts concerning her agreement with Ventas and her communications with board members, auditors and others regarding employee leasing as it relates to occupancy census and covenant calculations—are nonexistent. The utter absence of these notes is implausible based on the evidence at trial. Likewise, Ms. Bebo's maintenance of her original board materials and accompanying notes is consistent with her management style and the testimony of third parties. But without the benefit of discovery

attendant to a district court proceeding, Ms. Bebo was left with the fact of this destroyed or concealed evidence and nothing more.

(a) Ms. Bebo Took and Maintained Copious Notes and Maintained Copies of all Her Board Materials.

Ms. Bebo stated that while CEO at ALC, and with respect to activities outside of the board of directors meetings, she took notes for all of the meetings she attended (even those in her office) with business associates both internal and external. (Bebo, Tr. 3857-58.) This included conference calls. (*Id.*) If the subject of those meetings was business or follow-up items, it was her practice to take notes. (*Id.*) In fact, if a matter was business-related, she would probably have some notes on even trivial matters. (*Id.*) Ms. Bebo further testified that she would have a date on the first page of her notes for a particular topic, meeting or conference call. (Bebo, Tr. 3859.) Her notes identify names of those in attendance on calls or at meetings, as well as the subject of the meeting. (*Id.*) In general, those notes were taken on 8½ x 11 inch yellow or white pads, but on some occasions she used legal-sized pads as well. (Bebo, Tr. 3859-60.)

Importantly, Ms. Bebo would not take pages out of a notepad on which she was writing and often had more than one notepad in use at one time, sometimes color-coding them for different agendas or types of meetings. (Bebo, Tr. 3860.) When the pads were full (some might have blank pages but no pages removed) Ms. Bebo or an assistant would file them in a lateral drawer behind Ms. Bebo's desk to her right. (Bebo, Tr. 3860-61.) At the time Ms. Bebo left ALC in May of 2012, she approximates that she had accumulated more than 200 notepads. (Bebo, Tr. 3861.)

Likewise, during board of directors meetings, Ms. Bebo would bring specific notes and additional presentation materials that she might use for the meeting. (Bebo, Tr. 3861.) She would then take notes in her board book and on the board materials themselves that she had

brought in to the meeting. (*Id.*) It was her practice always to take enough notes that she could produce the minutes of a board meeting in the event somebody did not write them down or was not able to get them completed. (Bebo, Tr. 3861-62.) Board meeting attendees received half-sized lined paper pads, and Ms. Bebo would use that for notes and then place it in a pocket of her board book, a three-ring binder. (Bebo, Tr. 3862.) Her board binders and the notes contained therein were stored in a particular way in Ms. Bebo's office. (Bebo, Tr. 3862.) The binders were placed in a specific cabinet with frosted doors and shelves behind the doors. (*Id.*) The binders would be placed on those shelves in the order for each of the board meetings at ALC. (*Id.*) When Ms. Bebo left the company in May 2012, those notepads and binders were still in her office. (*Id.*)

Immediately upon leaving ALC, Ms. Bebo attempted to obtain her notepads or copies thereof and nothing was forthcoming. (Bebo, Tr. 3862-63.) It was not until after her arbitration proceedings had concluded that she was permitted access to any notepads, and on that occasion, approximately 40 notepads were provided to her at ALC's attorney's offices in Chicago. (*Id.*) When she examined those notepads at the ALC attorney's offices, Ms. Bebo observed that there were a number of pages scattered throughout that were torn out with "chunks" missing in the front, middle or back of the notepads. (Bebo, Tr. 3863-64.) The notes that were present were missing numbers of pages—typically, large numbers of pages. (*Id.*) And virtually none of the remaining pages related to discussions with Mr. Henninger and Mr. Rhinelander for operational items. (*Id.*) Rather, the notepads mostly retained discussions about regulatory items, a few specific resident issues, and a substantial amount regarding ALC occupancy development calls. (*Id.*)

When Ms. Bebo was permitted to go to ALC to pick up personal items more than a month after her departure, there were no notepads in any of the boxes presented to her or otherwise located within her line of sight. (Bebo, Tr. 3864-65.) She was permitted to take things from Extendicare or from Highliner, a different company from that of ALC. (*Id.*) She was also permitted to review and take matters of a personal nature, such as books or gifts, or materials from a conference or training of some sort, not ALC-type materials. (*Id.*) The materials to which she was given access at ALC were not orderly in any way. Her materials were not in the boxes in a way that they would have been in her office, or in other words, the items in a box were from three different places in her office. (*Id.*) At the time she was at ALC, approximately a month after her departure, the materials provided to her contained no notepads and there were no board books. (*Id.*) The only place Ms. Bebo ever saw an item from a board book is when she had an opportunity in the instant proceedings to go to Ropes & Gray in Chicago, meet with attorneys for ALC, and examine a box that had "a lot of different remnant" separate papers that were rubber-banded together or clipped together. (Bebo, Tr. 3865-66.) In that process, she came across one page that was ripped from one of her board books that contained her handwriting; specifically, it contained her notes from a discussion about the topic on that page. (*Id.*)

Ms. Bebo's testimony regarding her note-taking and storage of notes and board books was corroborated by other credible witnesses. (*See generally* Trs. of Dengel, Zaffke, Bucholtz, G. Bebo, and Houck.) Even John Buono corroborates evidence regarding her note-taking habits.

Specifically, Jason Dengel, a former ALC employee and current state law enforcement officer, testified that he observed probably 100 or 200 legal pads with notes in Ms. Bebo's office. (Dengel, Tr. 3916.) Officer Dengel observed that Ms. Bebo took notes diligently—"she was always taking notes." (*Id.*) While Officer Dengel was unable to confirm that her notes were

maintained intact, he testified that he had never seen Ms. Bebo tear pages out of a notepad and that she "pretty much saves everything." (Dengel, Tr. 3916-17.) Officer Dengel further testified that he observed a series of three-ring binders maintained in Ms. Bebo's office from board meetings, and he approximated that she maintained probably 15 or 20 binders. (Dengel, Tr. 3917.)

Likewise, Joy Zaffke, Ms. Bebo's executive assistant and someone with whom she worked closely for a four-year period, observed Ms. Bebo's note-taking habits. (Zaffke, Tr. 3209.) She testified that she was able to see into Ms. Bebo's office, given the location of her desk, and could observe notepads on her desk or in front of her while Ms. Bebo was in a meeting or speaking with someone casually. (*Id*.) Ms. Zaffke testified that Ms. Bebo always had a notepad in hand and that was "always taking notes, no matter what situation she was in." (*Id*.) Among other settings, such note-taking occurred during meetings with other ALC employees in her office as well as meetings in other conference rooms or boardrooms in the building. (Zaffke, Tr. 3209-10.) Ms. Zaffke testified that at any given time in her desk area, Ms. Bebo had approximately 20 notepads. (Zaffke, Tr. 3210.) Additionally, a table in Ms. Bebo's office contained another pile of notepads and the credenza behind her desk had various notepads as well. (*Id*.) Ms. Zaffke also testified that Ms. Bebo never used partially full notepads and that typically she would go through them from start to finish chronologically. (Zaffke, Tr. 3211.) Ms. Zaffke had no recollection of Ms. Bebo ever tearing a sheet out of her notepad and stated that if she ever needed to pass a note to someone she would not use something from a notepad. (*Id*.) Also, Ms. Zaffke observed that the filing cabinets in Ms. Bebo's office contained board binders, and the notepads used during the board meeting would be in those board binders in a

separate filing cabinet in Ms. Bebo's office. (*Id.*) Ms. Bebo was never observed to discard any of her notepads or remove any pages out of her notepads. (Zaffke, Tr. 3212.)

With respect to board binders, Ms. Zaffke testified that Ms. Bebo's board binders were in a shelving unit and that after a board meeting it was Ms. Zaffke's responsibility to clear the contents of all of the board binders except Ms. Bebo's. (Zaffke, Tr. 3212.) Except to move the binder from the boardroom and put it on Ms. Bebo's shelf, Ms. Zaffke would not have otherwise touched Ms. Bebo's board binder. (Zaffke, Tr. 3213.) In addition to board materials, Ms. Bebo's board binders also contained notes written on pages of the board materials and also on a smaller notepad that would fit inside the cover of the binder. (*Id.*)

Gale Bebo, Ms. Bebo's mother and at times executive assistant, corroborated the testimony of others on this topic, noting that Ms. Bebo always kept her board materials intact and in a cabinet. (G. Bebo, Tr. 3248.) Likewise, contained in the pocket within the binder were Ms. Bebo's notes from the board meeting and her little notepad of notes from the board meeting, all of which were filed in a cabinet in Ms. Bebo's office. (G. Bebo, Tr. 3248-49.) Gale Bebo further corroborates that Ms. Bebo had at least a couple hundred notepads in a drawer within her office. (G. Bebo, Tr. 3261-62.) She also stated that Ms. Bebo never ripped pages from the notepads, but in many cases, the pads were filled up. (G. Bebo, Tr. 3262.) Critically, Gale Bebo testified that she was asked to retrieve notes pertaining to the Solari call and that they contained information relevant to these proceedings; specifically, they contained documentation memorializing the Ventas agreement and the board's approval of the same. (G. Bebo, Tr. 3272-74.)

Like other witnesses, Kathy Bucholtz was also familiar with Ms. Bebo's note-taking habits and described them as "copious." (Bucholtz, Tr. 2953.) At every meeting involving

Ms. Bucholtz and Ms. Bebo, Ms. Bucholtz observed that Ms. Bebo "always had a pad of paper and was taking notes." (*Id.*) Like others, Ms. Bucholtz testified that Ms. Bebo saved her notes and one of her credenzas had "stacks of pads" in it. (*Id.*) Ms. Bucholtz did not think that Ms. Bebo wrote on pads that were only partially full pads and she did not know Ms. Bebo to have ever torn pages out of her legal pads. (Bucholtz, Tr. 2954.) With respect to board materials, Ms. Bucholtz testified she was familiar with how Ms. Bebo stored them and that they were maintained in a cabinet—each one of her binders was in a particular cabinet and when an annual conference (meeting) occurred, the board binders were in another cabinet. (Bucholtz, Tr. 2954.) According to Ms. Bucholtz, Ms. Bebo was a "bit of a packrat." (Bucholtz, Tr. 2954-55.) Ms. Bucholz confirms that inside the binders were the board agenda and notes regarding the meetings. (Bucholtz, Tr. 2955.)

Corroborating her mother's testimony, Ms. Bebo testified that she last saw her notes from the Solari call in April 2012 in connection with the reasonableness letter from Quarles & Brady. (Bebo, Tr. 4022.) In addition to this occasion, Ms. Bebo also saw those notes on other occasions shortly after the Solari call, in early 2009, during discussions about the Solari agreement and the new understanding with Ventas; she would have had her notes with her for reference. (Bebo, Tr. 4022-23.) Ms. Bebo also testified that her notes would have reflected her conversations between Mr. Rhinelander and herself regarding the specifics of the Ventas employee leasing arrangement. (Bebo, Tr. 4199-4200.) Mr. Rhinelander did not want to have a lot of written communication with Ms. Beo, but instead communicated more by phone. (Bebo, Tr. 4200.)

Jared Houck also testified that he frequently attended meetings with Ms. Bebo and other members of the senior leadership team, that he had an occasion to notice that Ms. Bebo would

take extensive notes during meetings and calls, and that she saved those notes in her office. (Houck, Tr. 1478-79.)

Mr. Buono's specific recollection about the location of the notes and binders is unclear. However, while he does not recall exactly whether Ms. Bebo took notes during her call with Mr. Solari, "it wasn't uncommon for her to take notes." (Buono, Tr. 2465.) Mr. Buono would generally agree that it was Ms. Bebo's habit and routine to take notes during telephone conversations with counterparties. (Buono, Tr. 2465.)

(b) The current state of Ms. Bebo's notes and board books suggests spoliation has occurred.

Despite all of this corroborating evidence about Ms. Bebo's note-taking habits and her preservation of such notes, when the current state of Ms. Bebo's notes and binders were physically presented in court, they bore no resemblance to the form or substance described by multiple witnesses. (*See* Ex. 2200 A-X and Aff. of Mark A. Cameli Regarding Notepads and Board Materials Produced at Hearing.) Specifically, this Court will recall that the documents produced in court and made part of the record photographically and testimonially were very different than the state of the notes and board binders described in the testimony of these witnesses. (*See* generally Bebo, Tr. 3929-54.)

In short, the nature of these administrative proceedings have made it impossible for Ms. Bebo or her counsel to properly investigate the disposition of those critical documents and the parties responsible for their destruction and/or concealment, all of which are highly relevant and exculpatory for Respondent.

B. The Division's Decision to Bring its Enforcement Action in a Forum That Would Not Allow Ms. Bebo to Effectively Prepare Her Defense Deprived Her of Procedural Due Process.

"Procedural due process imposes constraints on governmental decisions which deprive individuals of 'liberty' or 'property' interests within the meaning of the Due Process Clause of the Fifth or Fourteenth Amendments." *Mathews v. Eldridge*, 424 U.S. 319, 332 (1976). In determining whether governmental action has violated procedural due process, courts first consider whether plaintiffs will be deprived of a liberty or property interest, and then must determine "what process is due." *Cooper v. Salazar*, 196 F.3d 809, 813 (7th Cir. 1999).

In this case, it is indisputable that Ms. Bebo has a property interest at stake in the administrative proceeding. *See Cooper*, 196 F.3d at 814 (finding property right in a discrimination claim being evaluated by a governmental body); *Wisconsin v. Constantineau*, 400 U.S. 433, 437 (1971) (recognizing a property interest in "a person's good name, reputation, honor, or integrity"); *Goldberg v. Kelly*, 397 U.S. 254, 264 (1970) (loss of a person's livelihood); *Collins Sec. Corp. v. SEC*, 562 F.2d 820, 825 (D.C. Cir. 1977), *overruled on other grounds by Steadman v. SEC*, 450 U.S. 91 (1981) (stating "[Commission] proceedings do often culminate, as here, with the imposition of severe sanctions on those found to have violated the statute").

Consequently, the question becomes what procedural mechanisms are required in order for the administrative proceeding to satisfy due process. For this question, the Supreme Court has established a three-factor balancing test. *Mathews*, 424 U.S. at 335. The first factor involves an assessment of "the private interest that will be affected" by the action of the government. *Id.* at 334. The second factor involves evaluating "the risk of an erroneous deprivation of such interest through the procedures used" in the administrative proceeding and "the probable value, if any, of the additional or substitute procedural safeguards." *Id.* The third factor involves a review of the "Government's interest, including the function involved and the fiscal and administrative

burdens that the additional or substitute procedural requirement would entail." *Id.*at 335; *see also Cooper*, 196 F.3d at 814. As set forth below, these factors weigh heavily in favor of Ms. Bebo under the circumstances of this case.

1. The private interest involved is significant.

As Supreme Court Justices Powell and Stewart recognized in their dissent in *Steadman v. SEC*, a finding of fraud by the SEC along with the "harsh penalties" that may be imposed, such as industry employment bars, result in "serious stigma and deprivation." 450 U.S. at 106; *see also Collins*, 562 F.2d at 825-26. And the Supreme Court recognized the significant private interest at stake in administrative proceedings that adjudicate issues that could also constitute criminal law violations, finding a potential for substantial injury in an administrative proceeding resulting from "the personal and economic consequences alleged to flow from" an adverse finding that the respondent violated the law. *Jenkins v. McKeithen*, 395 U.S. 411, 424 (1969).

Ms. Bebo is facing allegations that she defrauded investors. The SEC seeks a fraud finding and a potential permanent bar from her acting as an officer or director of a public company. In addition, Ms. Bebo faces the potential imposition of substantial civil penalties. Consequently, the private interest at stake in this administrative proceeding is significant.

2. The risk of an erroneous deprivation of Ms. Bebo's property interest is high because, among other things, she was unable to call or cross-examine certain critical witnesses.

It is axiomatic that "[t]he right to present evidence is, of course, essential to the fair hearing required by the Due Process Clause." *Jenkins*, 395 U.S. at 429. Related to the right to present evidence, due process generally requires that a citizen who is the subject of an administrative adjudication of the sort presented by this case have the right to confront or cross-examine witnesses. *Id.*; *see also Goldberg v. Kelly*, 397 U.S. at 269 ("In almost every setting where important decisions turn on questions of fact, due process requires an opportunity

to confront and cross-examine adverse witnesses."); *Texas-Capital Contractors, Inc. v. Abdnor*, 933 F.2d 261, 269 (5th Cir. 1990) ("Although evidentiary procedures are somewhat relaxed in administrative proceedings, cross-examination of witnesses is basic to due process of law.").

In *Jenkins*, the Court struck down a state statute governing administrative proceedings before the Louisiana Labor-Management Commission of Inquiry (the "Commission"). The Commission possessed statutory authority to investigate and make factual findings with respect to whether companies or individuals violated certain criminal laws in the field of labor-management relations. 395 U.S. at 414. The findings were in the nature of a probable cause determination that would be passed along to other authorities for potential prosecution, and also had the collateral effect of branding the person subject to its decisions as a criminal. *Id.* at 416-17. In the proceedings, the targets of the investigation had severe limits on the ability to cross-examine or confront other witnesses. *Id.* at 428-29. The respondents in the administrative proceedings also had severely limited ability to present evidence on their own behalf. *Id.* at 429.

The Supreme Court was troubled by the fact that "[t]he right to present oral testimony from other witnesses and the power to compel attendance of those witnesses may be denied in the discretion of the Commission." *Id.* "We do not mean to say that the Commission may not impose reasonable restrictions on the number of witnesses and on the substance of their testimony; we only hold that a person's right to present his case *should not be left to the unfettered discretion of the Commission*." *Id.* (emphasis added).

Similarly, in cases involving a claimant's rights to social security benefits, courts have consistently found that it would be a deprivation of due process to prevent the claimant from subpoenaing witnesses to the hearing on critical issues in the case. *See Lonzollo v. Weinberger*, 534 F.2d 712 (7th Cir. 1976); *Gullo v. Califano*, 609 F.2d 649 (2d Cir. 1979); *Treadwell v.*

Schweiker, 698 F.2d 137 (2d Cir. 1983); *Lidy v. Sullivan*, 911 F.2d 1075 (5th Cir. 1990). For example, in *Lonzollo*, a claimant was denied social security disability benefits in an administrative proceeding. In the proceeding, the administrative law judge relied on a report of a treating physician in denying disability benefits. The judge also denied the claimant the ability to subpoena and cross-examine the treating physician. The Seventh Circuit held that this violated the claimant's right to procedural due process because "the claimant has a right to subpoena the physician and cross-examine him concerning the report." 534 F.2d at 714.

The *Treadwell* case also involved an administrative proceeding regarding a claim to social security disability benefits, although the issue in that case was whether the claimant could prove that she worked long enough to secure a benefit under the program. In her administrative proceeding, Treadwell requested that subpoenas be issued to the claimant's former employers for testimony at the hearing. 698 F.2d at 138. The administrative law judge precluded Treadwell from subpoenaing her former employers for testimony at the hearing and also refused to enforce certain document subpoenas that he did allow to issue. The witnesses and evidence Treadwell sought by her subpoenas were critical in establishing Treadwell's work history, the key issue in the case.

The Second Circuit held that preventing the claimant from compelling testimony from witnesses about critical issues in the case violated her right to procedural due process. The court reasoned: "The question whether Treadwell had been employed [by the subpoenaed party] was crucial to her claim. Further, her ability to challenge [other evidence] depended upon issuance of the subpoena. Treadwell was clearly unable to present evidence rebutting [other witnesses'] assertions." *Id.* at 143. Consequently, the proceeding lacked fundamental fairness and denied Treadwell her right to procedural due process. *Id.* at 143-44.

In this case, the SEC's decision to bring charges against Ms. Bebo in an administrative proceeding impaired her ability to present critical evidence in her defense of the charges—evidence that would have been available and adduced if the action had been brought in district court instead. Importantly, the deprivation of her ability to obtain and submit this evidence cannot be cured by any procedural mechanism in the administrative proceeding.

In the OIP, the Division alleges that Ms. Bebo made or caused ALC to make false or misleading statements about the Company's compliance with a lease for eight of its assisted living facilities. In addition, in order to prove a claim for fraud under Section 10(b) of the Securities Exchange Act, the Division must prove that Ms. Bebo acted with scienter. Scienter, or intent to deceive investors, is the critical inquiry in most securities fraud cases. During the hearing, Ms. Bebo put on, to the extent she could within limited procedures available to her, evidence that she lacked requisite scienter because she disclosed to ALC's Board of Directors and its Audit Committee that oversaw the company's investor disclosures the employee leasing practice that is at the heart of the Division's allegations. Disclosure of the alleged fraudulent conduct to the company's Board of Directors (among other personnel inside and outside of the company) is obviously inconsistent with intent to deceive the company's investors.

Yet, due to the fact that the Division brought its charges against Ms. Bebo in an administrative proceeding, she was unable to secure the presence of key members of the company's Board of Directors for the hearing or obtain any discovery from those witnesses as part of the proceedings. Specifically, Ms. Bebo could not compel testimony from Mr. Hennigar, the chairman of the board, and Ms. Ng, the chairwoman of the Audit Committee. Mr. Hennigar and Ms. Ng are Canadian citizens who cannot be subpoenaed as part of the administrative proceeding because the Securities Exchange Act only authorizes the "attendance of witnesses

and the production of any such records…. *from any place in the United States* or any State …." *See* 15 U.S.C. § 78u(b) (emphasis added). In other words, an ALJ's subpoena power is restricted to U.S. territorial boundaries. *Id.*; *see also* 17 C.F.R. § 201.232. Further, even if an ALJ issued an order to serve a subpoena on a third party outside U.S. borders, federal courts would not have the power to enforce the subpoena. *See, e.g.*, *Commodity Futures Trading Comm'n v. Nahas*, 738 F.2d 487, 491, 496 (D.C. Cir. 1984).

The Division chose to deny Ms. Bebo the procedural and other protections of the Federal Rules of Civil Procedure applicable in federal district court, where she would have been able to obtain deposition and document discovery from each of these witnesses.[74] While crafting a means to deny access to these critical witnesses, the SEC nevertheless procured their testimony *ex parte* and offered it into evidence at the hearing.

3. There is no significant governmental interest in depriving Ms. Bebo of the right to call witnesses in her defense.

The final factor of the test courts use to discern the risk of a procedural due process violation is based on an assessment of the fiscal or administrative burdens that an additional or substitute procedural requirement would entail. *Mathews*, 424 U.S. at 335. In this case, the Division could have filed (and can re-file if this administrative proceeding is dismissed) its claims in federal court. Such a procedure (which was the *only* procedure available prior to the 2010 enactment of Dodd-Frank and remains one of two prosecutorial routes available for securities enforcement actions) would constitute a minimal burden, given that for the first

[74] Canada is not a signatory to the Hague Convention, so litigants use letters rogatory—a formal written request from one court to another for assistance—to compel Canadian witnesses to produce documents and be examined under oath. After receiving a request from a U.S. court, Canadian courts have broad discretion under the *Canada Evidence Act*, R.S.C. 1985, c. E-5, pt. II (and equivalent provincial legislation) to enforce letters rogatory and generally do so unless the request is determined to be contrary to public policy. *See Gulf Oil Corp. v. Gulf Can. Ltd.*, (1980) 2 S.C.R. 39, 57 (Can.) (noting that it is a "rare occasion, certainly in relations with the United States" where letters rogatory are determined to run counter to Canadian public policy, and thus are not enforced). The resulting evidence can then be used in the court proceedings.

seventy-five years of the SEC's existence that is the forum where claims such as this one would have been brought. *See Cooper*, 196 F.3d at 814 (affirming district court preliminary injunction that required government to return to procedural mechanism in place prior to statutory amendment).

Indeed, the government has no significant interest in depriving Ms. Bebo of her ability to call witnesses and obtain evidence in her defense.[75] The Supreme Court prophetically noted, near in time to the SEC's creation, that:

> The v[a]st expansion of this field of administrative regulation in response to the pressure of social needs is made possible under our system by adherence to the basic principles that the Legislature shall appropriately determine the standards of administrative action and that in administrative proceedings of a quasi-judicial character the liberty and property of the citizen shall be protected by the rudimentary requirements of fair play.

Morgan v. United States, 304 U.S. 1, 14-15 (1938).

Due process requires that Ms. Bebo be afforded the rudimentary elements of fair play. In selecting its forum for this enforcement action, the Division knew that Ms. Bebo's ability to prepare her defense would be significantly disadvantaged in administrative court as opposed to federal district court for reasons specific to her case. Instead of choosing the only forum that would allow for compulsion of testimony from two of the most important witnesses in the case, the Division chose to prosecute Ms. Bebo where it knew that evidence could not come to light. This is simply not compatible with the basic requirements of due process.

[75] In apparent recognition of the due process problems presented by the unavailability of key foreign-based witnesses in an administrative proceeding, the SEC recently dismissed an administrative proceeding for this reason. *See In re Jordan Peixoto*, Release No. 2133 (Dec. 15, 2014), http://www.sec.gov/alj/aljorders/2014/ap-2133.pdf; Ed Beeson, *SEC Hits Limits In Collapsed Herbalife Insider Case*, Law360 (Dec. 19, 2014), http://www.law360.com/articles/606128/sec-hits-limits-in-collapsed-herbalife-insider-case.

Even in administrative proceedings, where the rules of procedure are relaxed, a respondent is entitled to fundamental fairness in the conduct of the proceeding. For the numerous reasons described above, Ms. Bebo has not received a fair hearing.

PART THREE - REMEDIES

If the Court somehow determines that these proceedings are both Constitutional and that Ms. Bebo violated certain provisions of the securities laws or rules promulgated by the Commission thereunder, Ms. Bebo asserts that beyond the cease-and-desist order that would be issued the Division has established no basis for a finding of disgorgement, that civil monetary penalties are not warranted, and a director and officer bar is unwarranted because, among other reasons she has effectively had a "time out" for the past three years.

I. THERE IS NO BASIS FOR DISGORGEMENT.

The Commission is authorized to order violators of the federal securities laws to disgorge the value of the proceeds they obtained by virtue of their wrongdoing. *SEC v. Fishbach Corp.*, 133 F.3d 170, 175 (2d. Cir. 1997). Disgorgement is an equitable remedy designed to deprive a wrongdoer of his unjust enrichment; it is not a punitive remedy. *Zacharias,* 569 F.3d at 471. (An order of disgorgement "is not a punitive measure; it is intended primarily to prevent unjust enrichment") (citation omitted).

Accordingly, in order to establish a basis for disgorgement, the Division must show a direct nexus between Ms. Bebo's conduct and the "ill-gotten gains" it seeks to disgorge. *See SEC v. Todd*, 2007 WL 1574756, at *18 (S.D. Cal. May 30, 2007), aff'd in part and rev'd in part on other grounds, 642 F.3d 1207 (9th Cir. 2011) (rejecting SEC's claim for disgorgement where there was no "requisite nexus between the supposed ill-gotten gains and the requested disgorgement.") Indeed, the measure of disgorgement in securities cases must be strictly limited

to the gains reaped from the misconduct alleged. *See SEC v. Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1978) ("[D]isgorgement extends only to the amount with interest by which the defendant profited from his wrongdoing."); *SEC v. McCaskey*, 2002 WL 850001, at *11 (S.D.N.Y. Mar. 26, 2002) (denying request for disgorgement where court was unable to determine amount of profits causally connected to violations); *SEC v. First City Fin. Corp., Ltd.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989) (holding SEC has the burden of showing that the amount sought is a "reasonable approximation of profits causally connected to the violation.") Thus, a court may only order disgorgement of the amount of profits causally related to the wrongdoing. Here, the Division has not established—and cannot establish—that the amounts it seeks to disgorge are in any way connected, let alone causally related, to the conduct it attributes to Ms. Bebo. The Division's request for disgorgement should therefore be rejected.

A. There is No Causal Link Between the "Misconduct" the Division Alleges and Ms. Bebo's Compensation.

In this case, the Division seeks disgorgement of the entire amount of base salary and bonuses Ms. Bebo received between 2009 and 2011. The Division does not contend that Ms. Bebo received this compensation as a direct result of her supposed misconduct, but rather theorizes that "[h]ad ALC's board of directors known the truth about her fraudulent scheme, she would have been terminated and not awarded a discretionary bonus" and thus, *any compensation she received* constitutes an ill-gotten gain. (Div Prehearing Br. at 28.) This argument is absurd.

The Division does not suggest—and has never suggested—that the base compensation and bonuses Ms. Bebo received between 2009 and 2011 were specifically tied to the "fraudulent scheme" the Division alleges she pursued. To order disgorgement of all compensation, without any evidence that such compensation was attributable specifically to the misconduct alleged in this case would allow the Division to circumvent its obligations to establish a causal connection

between the misconduct alleged and supposed ill-gotten gains. The Division could simply declare in every case that the discovery of any violation of the securities laws, no matter how egregious, would have resulted in an executive's termination, and that as a result, any compensation received after the date of the alleged misconduct is an ill-gotten gain, whether or not actually attributable to the violation it alleges.

The Division's disgorgement theory has been rejected before. *See S.E.C. v. Razmilovic*, 822 F. Supp. 2d 234 (E.D.N.Y. 2011) *aff'd in part, vacated in part on other grounds*, 738 F.3d 14 (2d Cir. 2013). In *Razmilovic*, the Court rejected the SEC's request for disgorgement of the defendant's entire base compensation and bonuses during the fraud period, which was based on a theory that his employment "should have (and would have) been terminated based upon his participation in the fraud scheme and, therefore, he should not have received any compensation." *Id.* at 253. The Court found that the SEC had not satisfied its burden of demonstrating that the entire base salary was linked to the defendant's fraudulent conduct because it was unreasonable to infer any causal connection between the fraud and the defendant's continued employment. Instead, the Court ordered disgorgement of only those portions of the defendant's base compensation and bonuses which could specifically be attributed to his fraudulent scheme.

In this case, there is no direct connection between the misconduct the SEC alleges and Ms. Bebo's continued employment at ALC, much less the compensation she received as a result of that continued employment. Ms. Bebo's compensation was not in any way related to the Ventas lease or covenant compliance, and there is no evidence that the employee leasing practice inflated the compensation she received in any way. And perhaps more importantly, the Division's theory that discovery of the employee leasing practice would have resulted in Ms. Bebo's termination is belied by the fact that Mr. Buono, who the Division named as a

respondent in these proceedings and maintains was as integral to the alleged "fraudulent scheme" as Ms. Bebo, was not terminated by the Board after a full investigation by the Milbank firm. Instead, the Board determined to retain him, provide him salary increases, *and bonuses* in 2013.

Without such evidence of a direct causal link between the misconduct alleged and the compensation Ms. Bebo received, there is no basis for disgorgement of those amounts. *See SEC v. Kelly*, 765 F. Supp. 2d 301, 325-26 (S.D.N.Y. 2011) (rejecting request for disgorgement of defendants' entire yearly compensation and bonuses because there was no evidence that they were linked to the company's financial performance or were otherwise causally connected to the alleged wrongdoing); *SEC v. Resnick*, 604 F. Supp. 2d 773, 783 (D. Md. 2009) (rejecting request for disgorgement of the defendant's salary where there was no evidence that the defendant's salary was causally linked to his unlawful conduct); *SEC v. Savino*, 2006 WL 375074, at *17 (S.D.N.Y Feb. 16, 2006) ("Because Savino's guaranteed salaried payment of $750,000 in 1998 was not in fact commissions generated by the fraud, however, this Court will not order disgorgement of his 1998 salary.") Indeed, because the Division's proposed measure of disgorgement does not reasonably approximate any profits gained by Ms. Bebo as a result of her alleged misconduct, it is an improper request for punitive relief and must be rejected. *See SEC v. Wills*, 472 F. Supp. 1250, 1276 (D.D.C. 1978) ("When the amounts to be disgorged cannot be related with sufficient certitude to defendants' securities law violations, the SEC's disgorgement request takes on the character of a plea for punitive relief."); *Todd*, 2007 WL 1574756, at *18 ("SEC's position that Defendants should give up their salaries for the time at issue is untenable -- it is basically a statement that because of several business decisions or errors, nothing else they did during that period matters. This is punitive.")

B. The Division's Disgorgement Theory Would Undermine the Limits on the SEC's Authority Crafted by Congress.

In effect, the Division is asking the Court to dispense of its obligation to establish a causal link between the misconduct it attributes to Ms. Bebo and the compensation she received over a three-year period. To do so, however, would expand the Division's authority far beyond the limits on that authority imposed by Congress. In enacting Sarbanes-Oxley, Congress already saw fit to relieve the SEC of its obligation to establish a causal link between alleged misconduct and executive compensation in *certain limited circumstances not present here*, and the Division should not be permitted to unilaterally expand the scope of that authority. The Division's disgorgement theory should be rejected for this reason too.

Section 304 of the Sarbanes-Oxley Act authorizes the SEC to bring an action against a corporation's CEO or CFO to claw back incentive-based earnings and bonuses following the corporation's issuance of accounting restatements. It provides in relevant part that:

> If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the CEO and CFO of the issuer shall reimburse the issuer for (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement . . .

15 U.S.C. § 7243(a).

In other words, under section 304(a), if a company is required to issue an accounting restatement due to misconduct, the CEO and CFO may be required to reimburse the company for any bonuses and incentive-based compensation they received during the 12-month period immediately following the publication of the misstated financials, regardless of whether the restatement is attributed to misconduct on the part of the executive in particular or whether or not the compensation was causally connected to the misconduct alleged. There is no requirement

that the SEC establish a nexus between the misconduct and the compensation subject to disgorgement under section 304(a).

Similarly, with the 2010 passage of Dodd-Frank, Congress expanded the SEC's authority to clawback executive compensation. Section 954 of Dodd-Frank requires issuers to adopt a policy providing that:

> in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement. . .

15 U.S.C. § 78j-4(b)(2).

In other words, section 954 of Dodd-Frank provides for the clawback of any incentive-based compensation paid to "current or former officers" during a three-year period prior to a required restatement caused by material noncompliance with financial reporting requirements. Like section 304(a), there is no requirement that the SEC establish a nexus between the alleged material noncompliance and the executive compensation subject to disgorgement under Dodd-Frank.

But the Division does not invoke section 954 of Dodd-Frank or SOX section 304(a) as a basis for its disgorgement theory in this case. Nor could it. Disgorgement under both Dodd-Frank or section 304(a) is only available where a company actually filed a restatement. *See S.E.C. v. Shanahan*, 624 F. Supp. 2d 1072, 1078 (E.D. Mo. 2008) (holding that "the ordinary, contemporary, common meaning of Section 304 is that, before penalties may be imposed, an issuer must be compelled or ordered to prepare a financial restatement, and must actually file the restatement."); *In re Cree, Inc. Sec. Litig.*, 2005 WL 1847004, at *15 (M.D.N.C. Aug. 2, 2005) (dismissing section 304 claims where plaintiffs failed to demonstrate that

corporation issued a restatement of its financial reports). Here, as in *Shanahan*, the Division could not raise any claim for disgorgement under section 304(a) (or under Dodd-Frank) because ALC has never been compelled to issue (and has never issued) a restatement of its financials. Yet, the Division still seeks an order of disgorgement that in effect, would automatically require reimbursement of all compensation paid to Ms. Bebo, despite the fact that no restatement was issued (as required by section 304(a) and Dodd-Frank) and no causal link has been established (as required under the SEC's traditional disgorgement authority). Acceptance of the Division's theory would eliminate any limitations on the disgorgement remedy and render Section 954 of Dodd-Frank and section 304(a) irrelevant.

If the Division's disgorgement theory is legally viable (which it is not), there would never have been a need for Congress to enact section 304 or section 954 of Dodd-Frank in the first place. Indeed, why would Congress need to provide the SEC these additional tools for combating corporate fraud if it already had carte blanche to seek disgorgement of any amounts earned by any executive (not just a CEO or CFO in the case of section 304(a)), for any period of time (not just the 12-month period covered by section 304(a) or the three-year period covered by Dodd-Frank), by simply claiming that earlier discovery of the alleged misconduct would have resulted in their termination (whether or not the company was ever required to issue a restatement)? If the Division is to be believed, section 304(a) and section 954 of Dodd-Frank did nothing to expand the SEC's authority to address corporate wrongdoing, because the Division had the ability to do everything Congress said it could do under those statutes and more, under the guise of equitable disgorgement. This too demonstrates the absurdity of the Division's disgorgement theory.

Acceptance of the Division's disgorgement theory would not only evade the limits on the SEC's disgorgement authority established by Congress, but it would eviscerate those limitations in every instance and render section 304(a) of Sarbanes-Oxley and section 954 of Dodd-Frank entirely superfluous. The request for disgorgement should therefore be rejected.

II. MONETARY PENALTIES ARE NOT WARRANTED IN THIS CASE.

Section 21B(a) of the Exchange Act authorizes the Commission to assess civil money penalties in any proceeding instituted pursuant to Sections 15(b) against any person, after notice and an opportunity for an administrative trial, if it finds that such person has willfully aided, abetted, counseled, commanded, induced, or procured a violation of any provision of the Securities Act, the Exchange Act, or the Advisers Act. *See* 15 U.S.C. § 78u-2(a)(2).

Section 21B(b) of the Exchange Act specifies a three-tier system for assessing the maximum amount of a penalty. 15 U.S.C. § 78u-2(b). The Commission is authorized to impose a first-tier penalty of no more than $7,500 for an individual for "each act or omission" violating the securities laws. 15 U.S.C. § 78u-2(b)(1); 17 C.F.R. § 201.1004. For violations that involve "fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement" the Commission is authorized to impose maximum second-tier penalties of $80,000 for a natural person for each violation. 15 U.S.C. § 78u-2(b)(2); 17 C.F.R. § 201.1004. And in the third tier, the maximum amount is $160,000 for an individual if the act or omission (1) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, and (2) directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the person who committed the act or omission. 15 U.S.C. § 78u-2(b)(3); 17 C.F.R. § 201.1004.

In addition, before assessment of any penalty pursuant to Section 21B of the Exchange Act the Commission must find that such an assessment is in the public interest. Section 21B(a) of

the Exchange Act requires that the public interest finding support the amount of a particular assessment, not merely the overall decision to assess a penalty. *See* 15 U.S.C. § 78u-2(b)(3).

In this case, neither the statutory factors nor the public interest supports imposition of any monetary penalties, let alone the drastic third-tier sanctions the Division seeks.

A. The Facts of This Case do not Support the Imposition of Third-Tier Penalties.

To impose third tier monetary penalties, the Division must prove that the offense "involved fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement" *and* caused "substantial losses or created significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the person who committed the [offense]." *Id.*

As discussed above, the Division has not shown—and cannot show under the facts of this case—that Ms. Bebo's conduct amounted to fraud, deceit, manipulation or deliberate or reckless disregard of the SEC's regulatory requirements or her responsibilities as CEO of a public company. The drastic third-tier sanctions the Division seeks are unavailable for this reason alone. Indeed, even the lesser second-tier sanctions, which likewise require a showing of fraud, deceit, manipulation, or recklessness, are unavailable for this reason as well.

But the Division has failed to establish a basis for the third-tier sanctions it seeks in this case for another reason as well: third-tier penalties are available only where the respondent's misconduct risked or caused a substantial loss to investors. 15 USC § 78u(d)(3)(B)(iii); 17 C.F.R. § 201.1003. There is no evidence supporting such a finding here.

If the Division claims a substantial loss to investors, a blanket accusation of risk will not suffice. To the contrary, to warrant third-tier penalties, the Division must show that there is a causal link between the respondent's alleged violation of federal securities laws and the

substantial losses it claims were caused (or risked) by those violations. *See, e.g., SEC v. Platforms Wireless Int'l Corp.*, 2007 WL 1238707, at *14 (S.D. Cal. Apr. 25, 2007) *vacated in part on other grounds*, 559 F. Supp. 2d 1091 (S.D. Cal. 2008) ("Contrary to the SEC's conclusory argument, there is no evidence that the violations here resulted in substantial losses or created a risk of substantial loss to other persons, and therefore third tier penalties are not appropriate."); *SEC v. Pattison*, 2011 WL 723600, at *5 (N.D. Cal. Feb. 23, 2011) (refusing to impose requested third-tier penalties where SEC failed to prove any actual losses to others such as shareholders that were "proximately caused" by misstatements in financial statements); *see also Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 343 (2005) (holding that private plaintiffs alleging losses from securities fraud must establish a causal connection between the material misrepresentation alleged and the loss; "To touch upon a loss is not to *cause* a loss, and it is the latter that the law requires.")

Here, the Division has failed to demonstrate that the misconduct it attributes to Ms. Bebo resulted in any loss, much less the substantial loss or risk of loss required to sustain the third-tier penalties it seeks. Indeed the only thing the Division cites in support of its requested third-tier penalties is the fact that "after Ventas learned of ALC's inclusion of employees in the covenant calculations, ALC settled Ventas's lawsuit by purchasing the Ventas facilities for more than $30 million in excess of their appraised value." (Div. Prehearing Br. at 29.)

But that assertion fails on a number of levels. First, there is ample evidence establishing that ALC paid fair market value for the properties. Ventas testified the properties were worth that amount, ALC's board concluded $100 million was market value, and the purchase price is consistent with ALC offers and Ventas' expressions of interest in selling the properties long before the licensing issues that prompted the lawsuit arose. Second, there is ample evidence that

ALC's accounting for the transaction was based on unduly conservative appraisals. This was purposeful so that ALC could write off for tax purposes the difference between the appraised value and the purchase price. Third, Ventas never sued ALC for breach of the covenant violations and there is no evidence that decision-makers at either Ventas or ALC considered the financial covenant allegations important to the settlement of the lawsuit. That underlying litigation involved a multitude of allegations and claims entirely unrelated to the subject of this case, and the record is clear that the far more serious circumstances of ALC losing licenses and the ability to operate the Facilities in their entirety drove the settlement of claims.

Finally, the purchase of the CaraVita Facilities actually *increased* the value of ALC, as determined by Mr. Buono and ALC's interim CEO Chip Roadman. Mr. Buono's analysis indicated it would increase ALC's value on a per share basis by $2.40. Not surprisingly, when investors learned about the transaction, ALC's stock increased.

Because the Division cannot show that the misconduct it attributes to Ms. Bebo caused or risked any "substantial loss" to others, there is no basis for imposing the drastic third-tier remedies the Division seeks here.

B. The Public Interest Does Not Weigh in Favor of Any Sanctions.

Although the tier determines the maximum penalty, "each case 'has its own particular facts and circumstances which determine the appropriate penalty to be imposed'" within the tier. *SEC v. Opulentica, LLC*, 479 F. Supp. 2d 319, 331 (S.D.N.Y. 2007) (quoting *SEC v. Moran*, 944 F. Supp. 286, 296-97 (S.D.N.Y. 1996)). Accordingly, in addition to the statutory factors cited above, the Commission must consider whether the penalty (and the penalty amount) is in the public interest.

In considering whether a penalty is in the public interest, the Commission may consider six factors: (1) whether the act or omission for which the penalty is assessed involved fraud,

deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) the harm to other person(s) resulting either directly or indirectly from such act or omission; (3) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior; (4) whether the respondent previously has been found by the Commission, another regulatory agency or a self-regulatory organization to have violated federal or state securities laws or the rules of a self-regulatory organization or has been enjoined or convicted by a court of competent jurisdiction of violations of such laws or rules; (5) the need to deter respondent and others from committing such acts or omissions; and (6) such other matters as justice may require. *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979); *In re New Allied Dev. Corp.*, Exchange Act Release No. 37990, 1996 WL 683705, at *8 n.33 (Nov. 26, 1996); *In re. First Sec. Transfer Sys., Inc.*, Exchange Act Release No. 36183, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,700 (Sept. 1, 1995).

As discussed above, the conduct at issue in this case did not involve scienter, and there is no evidence that any harm resulted to investors or any other person as a direct or indirect result of that conduct. In addition, the evidence in this case shows that Ms. Bebo has no personal financial interest in the "fraud" the Division attributes to her; she received no personal benefit from the employee leasing arrangement at the center of the Division's allegations, as her annual performance compensation was not affected by compliance or noncompliance with the Ventas lease covenants, and the CaraVita facilities represented only a negligible portion of ALC's business and operating income (by the end ALC was losing money by operating the properties under the Lease). Moreover, Ms. Bebo has never before been found (or even accused) to have violated state or federal securities laws. And finally, because the allegations of securities fraud are tied so closely to the particular facts of this case, and the interpretation and meaning of the

specific contract provisions at issue here, any sanctions imposed here will have little, if any, deterrent effect beyond this case.

The imposition of monetary penalties on these facts will not advance the public interest.

C. Ms. Bebo's Reliance on the Advice of Counsel Further Mitigates any Otherwise Appropriate Sanctions.

"Reliance upon advice of counsel is a fact that may be taken into account in determining what sanctions are appropriate. . ." *In re Coxon*, Initial Decision Release No. 140, 1999 WL 178558, at *10 (Apr. 1, 1999); *see also Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099, 1109 (D.C. Cir. 1988) ("As to sanctions, the *extent* to which petitioners sought the advice of counsel, the *clarity* of the advice, and the petitioners' reasons for following or disregarding it, in whole or in part, are highly relevant, *even though the reliance on counsel may not have been sufficient to discharge petitioners from the underlying liability for statutory violations*.") (citation omitted); *Howard v. SEC*, 376 F.3d 1136, 1147-48 (D.C. Cir. 2004). The extent to which Ms. Bebo relied on the advice of counsel is relevant to the determination of whether sanctions are in the public interest.

The record in this case demonstrates that Ms. Bebo relied in good faith on the advice of counsel with respect to the Ventas lease covenant calculations in general and employee occupancy in particular. ALC's general counsel, Eric Fonstad, was involved in the discussions concerning employee leasing from the beginning, and was present for and involved in each of the key steps that allowed Ms. Bebo and ALC to conclude that the employee leasing practice was appropriate. Mr. Fonstad was aware of all the material facts concerning the arrangement and participated in the January 20, 2009 call during which Mr. Solari approved that arrangement on behalf of Ventas. Ms. Bebo appropriately relied on Mr. Fonstad's legal advice concerning the

employee leasing practice and ALC's compliance with the terms of the Ventas lease, and any sanctions imposed against Ms. Bebo should reflect this fact.

D. At most, Ms. Bebo should be subject to a minimum first-tier penalty for the entire course of conduct.

For the reasons discussed above, the facts of this case do not justify the imposition of any monetary penalty, much less the substantial third-tier penalties the Division seeks to impose. However, even if the Court were to disagree, only a single, minimal first-tier penalty should be imposed based on Ms. Bebo's entire course of conduct.

Although the statute "provides that a penalty may be imposed for 'each act or omission' it leaves the precise unit of violation undefined." *In re Raymond J. Lucia Cos., Inc. & Raymond J. Lucia, Sr.*, Initial Decision Release No. 540, 2013 WL 6384274, at *59 (Dec. 6, 2013). Nonetheless, in the vast majority of prior cases where the SEC has sought civil penalties for violations of the federal securities laws, whether in an administrative action or federal court, maximum civil penalties have been calculated based on a defendant's entire course of conduct, rather than an overly literal application of the statute. *See, e.g., SEC v. Rabinovich & Assocs., LP*, 2008 WL 4937360, at *6 (S.D.N.Y. Nov. 18, 2008) (imposing single penalty even though defendants made fraudulent statements about firm's investment performance to 150 investors over a two-year period, because "*they all arose from a single scheme or plan*.") (emphasis added); *SEC v. Save the World Air, Inc.*, 2005 WL 3077514 (S.D.N.Y. Nov. 15, 2005) (determining that a single penalty was appropriate where defendant violation violated securities laws by making a series of fraudulent misstatements about a product over a year and a half); *SEC v. Robinson*, 2002 WL 1552049 (S.D.N.Y. July 16, 2002) (ordering a single third-tier penalty where defendant violated section 10(b) of the Exchange Act and section 17(a) of the Securities Act, rather than imposing $22 million penalty requested by the SEC); *In re Fundamental*

Portfolio Advisors, Inc., Release No. 2146, 2003 WL 21658248, at *18 (July 15, 2003) (Division requested that Respondents pay third-tier civil penalties for two violations, the sale of shares in connection with 1993 prospectus, and the filing and distribution of a 1994 prospectus, rather than viewing each sale of Fund shares as a separate violation); *SEC v. Lawbaugh*, 359 F. Supp. 2d 418 (D. Md. 2005) (ordering single third-tier penalty of $120,000 despite allegations that defendant committed a series of fraudulent transactions resulting in individual and corporate losses in excess of $4 million); *In re Raymond J. Lucia Cos.*, 2013 WL 6384274, at *59, & 59 n.41 (assessing one tier-three penalty because although respondents "technically violated the statute hundreds of times," assessing penalties on that basis "would plainly be disproportionate and unreasonable.")

The Court should not depart from this long line of precedent here. Any penalty assessed should be calculated in light of the fact that the representations at issue in this case were unchanged in every public filing at issue here and the product of a single course of conduct, rather than multiple independent violations of securities laws.

III. A PERMANENT (OR ANY) DIRECTOR AND OFFICER BAR IS NOT WARRANTED UNDER THE FACTS OF THIS CASE.

The Division also seeks an order permanently barring Ms. Bebo from serving as an officer or director of a public company, arguing that Ms. Bebo's conduct "was egregious and involved scienter" and, as a result, a permanent bar is warranted. (Div. Prehearing Br. at 30.) But here, again, the Division is mistaken. Simply declaring conduct "egregious" or saying it "involved scienter" does not make it so. Just as monetary penalties are not warranted in this case, a permanent (or any) director and officer bar is not appropriate either. The Division's request for such a bar should be rejected.

In determining whether to order a director and officer bar (and the duration of such a bar), the Commission should consider: (1) the "egregiousness" of the underlying securities law violation; (2) the respondent's status as a "repeat offender"; (3) the respondent's role or position when she engaged in the fraud; (4) the respondent's degree of scienter; (5) the respondent's economic stake in the violation; and (6) the likelihood that misconduct will recur. *SEC v. Bankosky*, 716 F.3d 45, 48 (2d Cir. 2013); *SEC v. Patel*, 61 F.3d 137, 141 (2d Cir. 1995).

Moreover, "before imposing a permanent bar, a court should also consider whether a conditional bar (e.g. a bar limited to a particular industry) and/or a bar limited in time (e.g. a bar of five years) might be sufficient, especially where there is no prior history of unfitness." *Patel*, 61 F.3d at 142.

Consideration of these factors does not warrant imposition of any director and officer bar in this case, much less the permanent bar sought by the Division. As discussed above, the Division has not shown—and cannot show—that Ms. Bebo knowingly or intentionally violated any securities laws in her capacity as CEO of ALC; there is no evidence of scienter on these facts. And if any violation occurred, it does not rise to the level of "egregious" conduct warranting a director and officer bar. *SEC v. Robinson*, 2002 WL 1552049, at *5 (S.D.N.Y. July 16, 2002) (finding defendant's conduct "egregious" where he lied about having a product to market, ties to established telecommunications companies, and expectation of billions of dollars in sales revenue, because defendant's actions "constituted nothing but a polite form of theft").

Nor is there any evidence that Ms. Bebo is a "repeat offender." Throughout the course of her tenure at ALC, and indeed throughout her entire career, Ms. Bebo has never before been accused of any violation of securities laws, much less found liable for such a violation. This too weighs against the imposition of any D&O bar. *See SEC v. Stanard*, 2009 WL 196023, at *33

(S.D.N.Y. Jan. 27, 2009) ("The Court finds particularly relevant Stanard's lack of previous securities law violations and the fact that the injunctive relief already granted will provide a significant deterrent, greatly reducing the likelihood that Standard, who has had an otherwise unblemished career, will engage in future securities violations as an officer or director.") Indeed, even if the Division could establish that Ms. Bebo acted with scienter (it cannot), there is no evidence that she is the kind of repeat offender a D&O bar is intended to address. That alone weighs against such a ban, let alone the drastic permanent ban sought by the Division. *See SEC v. Dibella*, 2008 WL 6965807, at *11 (D. Conn. Mar. 13, 2008) (although defendant "acted with scienter, he is not the type of 'repeat offender' for whom an officer/director bar is especially appropriate. The conduct at issue in this case constitutes his first and only violation of the securities law.")

Similarly, there is no likelihood of recurrence in this case, not only because any violation (if there were one) stemmed from the highly particularized circumstances surrounding the Ventas lease during the time period in question, but also because Ms. Bebo is not in a position to commit any similar violations in the future. *See SEC v. Brown*, 878 F. Supp. 2d 109, 119 (D.D.C. 2012) ("The SEC has failed to demonstrate that there is a reasonable likelihood that Brown will engage in future violations of the securities laws. Most significantly, the SEC has neither alleged nor adduced evidence that Brown is currently seeking employment in securities-related positions or that she is currently or prospectively capable of committing any securities violations. It is undisputed that Brown has not been employed by Integral since 2008, that she does not work for a publicly traded company, and that she has no legal reporting obligations to the SEC.")

And as discussed above, Ms. Bebo did not receive any financial gain or personal profit as a result of ALC's employee leasing practices, as there is no evidence that she benefitted through

bonuses, salary, or stock sales as a result of those practices. Even the Division's convoluted theory of financial gain based on Ms. Bebo's continued employment at ALC is not enough to support a director and officer bar. *See SEC v. Shanahan*, 2010 WL 173819, at *14, 16 (D. Minn. Jan. 13, 2010) (finding that "Defendants' economic stake in the misstatements was minimal in that their only financial benefit was job retention," which weighed against an officer and director bar).

The only factor that could conceivably support the imposition of any officer and director bar is based on Ms. Bebo's role within ALC at the time the alleged misconduct occurred. But the fact that Ms. Bebo held a prominent position in the company alone cannot justify such a bar. *See SEC v. Nocella*, 2014 WL 4105945 (S.D. Tex. Aug. 11, 2014). The *Nocella* case is instructive. There, the SEC sued a bank for violating securities regulations, and sought to bar two of the bank's executives from working as directors or officers of a publicly traded company. The SEC alleged that amidst financial unrest of the mid-2000s, the defendant bank officers sent letters to borrowers who were four or more payments past due on their home loan payments. If the borrower made his next payment, the bank would then consider the loan current, and as a result did not list the modified loans as impaired on disclosures. The District Court dismissed the SEC's request for a D&O bar on summary judgment, finding that the defendants were fit to serve as directors or officers of a publicly traded company. In doing so, the court noted that while the defendants "held prominent positions in the bank" and were therefore "accountable for the actions of the company," they did not create or implement the programs on their own." According to the court, the loan modifications were "a good-faith attempt to manage a floundering bank during a recession" and the defendants should not be subject to the requested bar merely by virtue of their roles within the company, particularly where the violations were not

egregious, they were first-time offenders, their financial gain was minimal, and neither officer was in a position to violate securities laws in the future (one was retired and the other worked for a private bank). *Id.* at *2. Much like the defendants in *Nocella*, Ms. Bebo did not design or implement the ALC employee leasing practices on her own. Those practices were, at worst, a good faith effort to manage a struggling aspect of ALC's business during a recession, and Ms. Bebo should not be subject to a D&O bar merely because she led the company when those practices were implemented.

For these reasons, there is no basis for any director and officer bar in this case, much less the permanent bar the Division seeks. Ms. Bebo has already been effectively barred from her profession for years as a result of the Divisions accusations against her, and any further bar would be unwarranted. *See SEC v. Schroeder*, 2010 WL 4789441, at *2 (N.D. Cal. Nov. 17, 2010) ("Further, because it appears that Defendant has had difficulty obtaining regular employment since October 2006 when KLA made public the allegations against Defendant, the Court finds that he has already been effectively barred from his profession for four years.")

Dated this 31st day of July, 2015.

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