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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of, LYNN TILTON, PATRIARCH PARTNERS, LLC, PATRIARCH PARTNERS VIII, LLC, PATRIARCH PARTNERS XIV, LLC and PATRIARCH PARTNERS XV, LLC Respondents.	Administrative Proceeding File No. 3-16462 Judge Carol Fox Foelak

MEMORANDUM OF LAW IN SUPPORT OF RESPONDENTS' MOTIONS *IN LIMINE* TO STRIKE AS INADMISSIBLE, IN WHOLE OR IN PART, THE DIVISION OF ENFORCEMENT'S EXPERT REPORTS, AND TO PRECLUDE TESTIMONY ON THE STRICKEN SUBJECTS

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Respondents Lynn Tilton, Patriarch Partners, LLC, Patriarch Partners VIII, LLC, Patriarch Partners XIV, LLC, and Patriarch Partners XV, LLC (collectively, "Patriarch" or "Respondents"), respectfully submit this memorandum of law in support of their motions *in limine*: (1) to strike as inadmissible in whole or in part the reports (*i.e.*, written direct testimony) of Security and Exchange Commission ("SEC") Division of Enforcement's (the "Division") expert witnesses Ira Wagner, Dr. Steven L. Henning, and Michael G. Mayer; and (2) to preclude those witnesses from giving live testimony on the stricken subjects and related topics.[1]

INTRODUCTION

Three years ago, a respected federal judge excoriated the Division for proffering written expert testimony from Ira Wagner that was "problematic and not admissible." *SEC v. Tourre*, 950 F. Supp. 2d 666, 681 (S.D.N.Y. 2013) (Forrest, J.). Mr. Wagner, the Court wrote, was attempting to act as a "conduit for a factual narrative," purporting to "'find[] facts' that [we]re in contention," and opining on "legal conclusion[s]" that were "not proper expert testimony." *Id.* at 681-82.

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[1] Respondents file this omnibus brief in support of three separate motions *in limine* directed, respectively, at each of the Division's experts. These motions seek to strike the following reports, respectively, in whole or in part: Expert Report of Ira Wagner, July 10, 2015 ("Wagner Report"), attached as Exhibit 2 to the Declaration of Lawrence J. Zweifach, Aug. 26, 2016 ("Zweifach Decl."); Rebuttal Expert Report of Ira Wagner, Aug. 31, 2015 ("Wagner Rebuttal"), attached as Exhibit 3 to the Zweifach Declaration; Expert Report of Michael G. Mayer, July 10, 2015 ("Mayer Report"), attached as Exhibit 5 to the Zweifach Declaration; Rebuttal Expert Report of Michael G. Mayer, Aug. 31, 2015 ("Mayer Rebuttal"), attached as Exhibit 6 to the Zweifach Declaration; Expert Report of Steven L. Henning, July 10, 2015 ("Henning Report"), attached as Exhibit 8 to the Zweifach Declaration; and Rebuttal Report of Steven L. Henning, Aug. 31, 2015 ("Henning Rebuttal"), attached as Exhibit 9 to the Zweifach Declaration.

For Your Honor's convenience, the attached expert reports are annotated to catalogue Respondents' objections. Moreover, index tables cataloguing the same objections are attached as Exhibits 1, 4, and 7 to the Zweifach Declaration, referring to the reports of Wagner, Mayer, and Henning, respectively.

The Division and Mr. Wagner have apparently learned the wrong lesson from the *Tourre* episode. In the instant action, the Division again will attempt to rely on the expert testimony of Mr. Wagner, but it has again failed to limit that testimony to opinions that comply with the basic precepts of admissibility. Rather, the Division and Mr. Wagner once again are attempting to introduce into evidence the same kind of "[im]proper expert testimony" that was rejected by Judge Forrest in *Tourre*. And the Division is engaging in the same ploy with the reports of its other purported experts, Messrs. Mayer and Henning. This time, however, rather than run the risk of having their improper expert reports closely scrutinized and dissected by a United States District Judge, the Division has brought this action as an administrative proceeding on its home turf. The Division, Mr. Wagner, and the other purported experts apparently are hoping that they can get away with their "[im]proper expert testimony" gambit in a forum that has relaxed procedural and evidentiary rules.

Tourre is not only compelling authority; it is also consistent with what other courts around the country have regularly held: that experts may not testify as to legal conclusions, engage in fact-finding, introduce hearsay pre-trial testimony through their expert reports, speculate about irrelevant matters, or otherwise inject improper testimony into the trial record. *See, e.g.*, *United States v. Scop*, 846 F.2d 135, 140 (2d Cir. 1988) (government expert's opinions were "legal conclusions" that inappropriately "invade[d] the province of the court to determine applicable law"); *United States v. Cruz*, 981 F.2d 659, 663 (2d Cir. 1992) ("manifestly erroneous" to admit expert testimony that merely "bolster[s]" a party's factual narrative); *see also infra* Pts. I-V (citing cases). Those same rules should and do apply in this proceeding.

Yet Mr. Wagner's 120-plus pages of expert reports—which, pursuant to Your Honor's May 7, 2015 Prehearing Order, are to serve as his direct testimony—are replete with legal

conclusions (*e.g.*, whether Respondents committed fraud), improper fact-finding (*e.g.*, Respondents' practices with respect to loan categorization), and wholly inappropriate "factual narrative[s]" (*e.g.*, wholesale recitation of hearsay investigative testimony)—exactly the same infirmities that rendered his proffered testimony in *Tourre* defective. For these and other reasons detailed below, Your Honor should strike the improper sections of Wagner's reports, just as the court in *Tourre* precluded him from testifying about those topics.

In one regard, however, Mr. Wagner's proffered testimony is even more egregiously inappropriate than what was proposed in *Tourre*. Here, Mr. Wagner has submitted a purported "rebuttal" expert report that goes well beyond the scope of his initial report and the bounds of proper rebuttal. The rebuttal report is wholly inappropriate and should be stricken altogether.[2]

The Division's other experts fare no better. Dr. Steven L. Henning, the Division's accounting expert, repeatedly purports to opine on the legal conclusion of whether Respondents' financial statements were "false and misleading." Michael G. Mayer, who purports to calculate the amount of fees received by Respondents, rests his entire analysis on his fact-finding about whether the SEC's "allegation[s] [are] true," Mayer Report 20, and on the legal conclusions that flow from that improper fact-finding. Fundamental fairness requires that Your Honor grant the same relief that the court did in *Tourre*: strike the defective sections of these experts' reports.

As Your Honor is well aware, the very legitimacy and fairness of this forum are the subject of intense scrutiny in the courts and elsewhere. Allowing the Division, Mr. Wagner, and the Division's other two experts to employ the same improper tactics that have been soundly rejected by federal courts—which led to the sharp rebuke of the Division and its go-to expert Mr.

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[2] Mr. Wagner's "rebuttal" report is 50% longer than his opening report and introduces wholly new theories regarding whether Ms. Tilton was amending loans.

Wagner in *Tourre*—would exacerbate the perception and concern that SEC administrative proceedings are fundamentally unfair and deny respondents due process. It is therefore imperative that this tribunal be particularly sensitive to such perceptions and concerns, as the Commission has instructed. *See In re Clarke T. Blizzard*, Investment Advisers Act Release No. 2032, 2002 WL 714444, at *2 (Apr. 24, 2002) ("Even the appearance of a lack of integrity could undermine the public confidence in the administrative process upon which our authority ultimately depends."). The Division's abuse of the right to offer expert testimony should come to a halt, and the instant case presents Your Honor with an opportunity to do so.

Therefore, Respondents respectfully request that Your Honor: (1) strike Mr. Wagner's rebuttal report in its entirety; (2) strike Mr. Mayer's opening and rebuttal reports in their entirety; (3) strike the portions of the reports highlighted in Exhibits 2, 8, and 9 to the Zweifach Declaration; and (4) preclude the Division's experts from testifying as to stricken subjects or related topics. Specifically, as detailed below, the Division's experts should be precluded from testifying as to legal conclusions, purported findings regarding disputed facts, improper factual narratives, "rebuttal" opinions that exceed the scope of the original reports, hearsay investigative testimony, unreliable speculation, and irrelevant material.[3]

LEGAL STANDARDS

The SEC Rules of Practice, 17 C.F.R. pt. 201 ("Rules of Practice"), mandate that "the hearing officer . . . shall exclude all evidence that is irrelevant, immaterial or unduly repetitious,"

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[3] Respondents will also seek relief via a separate *Daubert* motion because the Division's experts' opinions and methodologies, in whole or in part, do not comply with the relevant standards of reliability. *See In re Ralph Calabro*, Securities Act Release No. 9798, 2015 WL 3439152, at *11 & n.67 (May 29, 2015) (evaluating whether the expert's testimony comported with the "spirit" of *Daubert v. Merrell Dow Pharms.*, 509 U.S. 579 (1993), and adopting the principle that unreliable expert testimony "has no more place in administrative proceedings than in judicial ones").

Rule 320, and that the hearing "shall be conducted in a fair, impartial, expeditious and orderly manner." Rule 300. Moreover, Congress has required that evidence in administrative proceedings be "reliable," "probative," and "substantial" to support any order that issues after a hearing. 5 U.S.C. § 556(d). The mandatory language of these provisions creates a duty for the hearing officer to exclude irrelevant and otherwise inappropriate evidence, including expert testimony, in order to safeguard the fairness of the hearing and any resulting decision. The prejudice that flows from the SEC's well-documented abuse of expert testimony and reports is not eliminated because these proceedings are conducted in front of a judge rather than a jury, as the many decisions discussed herein rendered in bench trials make clear. *See, e.g., In re Stephen Michael Sohmer*, Exchange Act Release No. 49052, 2004 WL 51681, at *8 n.34 (Jan. 12, 2004); Hearing Transcript, *In re John J. Aesoph*, SEC Administrative Proceeding File No. 3-15168 (Oct. 28, 2013).

ARGUMENT

In accordance with the procedures established for this proceeding, each expert's report or reports will serve as his direct testimony. Yet the reports submitted by the Division's experts—Ira Wager, Michael G. Mayer, and Steven L. Henning—are riddled with improper testimony. The reports should be stricken in whole or in part, and the Division's experts should be precluded from testifying about such matters at the hearing.

I. Legal Conclusions Contained In The Expert Reports Should Be Excluded.

Courts and agencies alike recognize the inadmissibility of an expert's testimony on issues of law. *See, e.g., United States v. Scop*, 846 F.2d 135 (2d Cir. 1988); *see also, e.g., SEC v. Tourre*, 950 F. Supp. 2d 666, 678 (S.D.N.Y. 2013) ("No party would doubt—one hopes—that an expert cannot testify as to whether the specific information at issue in a case is or is not 'material.'"). Yet the Division's experts have littered their reports with legal conclusions far

outside the scope of their expertise. By doing so, they improperly seek to supplant the role of the ALJ as arbiter of the law.

Courts have time and again excluded improper legal conclusions couched as expert opinions. For example, in *Scop*, the Second Circuit held that testimony by the government's expert was inappropriate because his "opinions were legal conclusions" that "went well beyond his province as an expert in securities trading," and were "calculated to invade the province of the court to determine applicable law . . . ." 846 F.2d at 140. (internal quotation marks omitted). In *Marx & Co. v. Diners' Club Inc.*, 550 F.2d 505 (2d Cir. 1977), the court similarly held that the district court erred in admitting expert testimony that opined on the meaning of the contract underlying the case. *Id.* at 509 (explaining that the testimony "did not concern practices in the securities business, on which Friedman was qualified as an expert, but were rather legal opinions as to the meaning of the contract terms at issue"). Legal opinions have no more place in expert testimony before an ALJ than before a district court judge. The Commission has therefore rejected an expert's testimony as outside the witness's purview "to the extent that [the expert's] testimony might be construed to express opinions" that are "about the ultimate legal issues in this proceeding." *In re Stephen Michael Sohmer*, Exchange Act Release No. 49052, 2004 WL 51681, at *8 n.34 (Jan. 12, 2004) (Op. of the Comm'n). Even before *Sohmer* confirmed this principle, the Division itself opposed expert testimony on the ground that "the issues are purely legal" and "expert testimony is therefore inappropriate." *In re Morgan Stanley & Co., Inc.*, Administrative Proceedings Release No. 391, 1991 WL 417850, at *1 (June 13, 1991).

A. Wagner

Wagner reveals at the outset of his opening report that he is intent on offering legal conclusions, explaining that he was tasked with, in part, determining whether Respondents' categorization of Zohar Funds' assets "was consistent with the Zohar governing documents" and

whether that categorization "was consistent with the standard of care and fiduciary duties required of Respondents." Wagner Report 2. The former depends on Wagner's interpretation of the indentures, a pure issue of law—contract interpretation—on which his opinion can represent nothing other than a legal conclusion; the latter explicitly turns on (and calls upon Wagner to delineate) the legal standard that determines the ultimate issue as to the alleged breach of fiduciary duty.

Wagner's interpretation of the Zohar Funds' governing documents is evident throughout the report. *See, e.g.*, Wagner Report 4 (describing "objective and clear criteria set out in the Indenture"); *id.* at 5 (concluding that "the Indentures required" Wagner's preferred categorization, and that Respondents' categorization "is in violation of the Zohar CLO Indentures"); *id.* at 6 (calling Respondents' alleged conduct "a clear violation of the plain language of the Indenture" and "provisions of the Collateral Management Agreement"); *id.* at 26-27 (setting forth "my read of the Zohar CLO Indentures"); *id.* at 34-39 (declaring, "I have carefully read the Indentures and Collateral Management Agreements" and "also carefully read the Zohar III Offering Memorandum," and then dedicating several pages to legal interpretations); *id.* at 44 (describing what "behavior is required and expected" under the indentures). Wagner purports to opine not just on the interpretation of the indentures—itself inappropriate—but on the ultimate legal issue of whether Respondents complied with the indentures. All of these legal conclusions are inadmissible.

Similarly, the entire section of Wagner's report concerning Respondents' asset categorization should be excluded because it takes as its premise Wagner's legal conclusion that Respondents categorized assets differently than required by the indentures. *See* Wagner Report 30-39. If it is not excluded, then, at a minimum, the portions that most explicitly offer legal

conclusions should be stricken. *See, e.g., id.* at 30 (interpreting "the respective transaction's Indenture"); *id.* ("discretion . . . does not exist in the Indenture or the Collateral Management Agreement"); *id.* at 31 (responding to Ms. Tilton's investigative testimony by concluding that "[n]one of [her] explanations or interpretations is based on the language in the Indenture or Collateral Management Agreement").

Further, Wagner's so-called opinions as to fiduciary duties are, in fact, bald recitations and applications of purported legal standards. *See, e.g.*, Wagner Report 5 (describing Respondents' conduct as "adverse to the interests of the Zohar CLO funds and the investors and beneficial to Tilton"); *id.* at 6 (opining as to the issue of liability by stating that Respondents' "actions violated Patriarch's fiduciary duty"); *id.* at 47 ("[A]s a Registered Investment Advisor, Patriarch has a fiduciary duty to its advisory clients."); *id.* at 50 (concluding there was "a significant undisclosed conflict of interest").

Wagner also opines inappropriately as to the purported materiality of specific disclosures. *See, e.g.*, Wagner Report 6 (explaining that "[i]nvestors carefully monitor" certain reported data and interpret changes in that data as "a signal that the investment may not be performing"); *id.* at 16 (concluding which statistics are "important considerations for CDO investors"). In other words, he offers more unadorned legal conclusions. All such conclusions should be stricken.

B. Mayer

Mayer's reports should be excluded in their entirety, and Mayer excluded from offering any live testimony, because his opinions are based on a foundation of inappropriate legal conclusions and fact-finding masquerading as expert opinions. Mayer begins his opinions by revealing that he views his role as more akin to judge than witness, and his task as determining liability. He first states his "understanding that, among other things, the Respondents are accused of" misconduct alleged in the OIP, and that "the Division has asked" him to apply his

expertise "[i]n order to determine if the allegation is true." That is not an expert's role. Mayer Report 20.

The crux of Mayer's report is an inappropriate legal conclusion as to loans' current or not current status, and the consequences that flow therefrom. The current status of a loan hinges on an interpretation of the indenture and therefore a legal conclusion inappropriate for an expert report under *Marx & Co.* Mayer essentially concedes that he is construing the indenture when he determines current status of a loan. *See, e.g.*, Mayer Report 23 (reciting indenture definition of non-current loans and then offering his own gloss "[i]n other words"), 26 (same). In isolation, Mayer's explanation of the loan data might have been fair game; however, he crosses the line and offers a legal conclusion when he pronounces "this loan is not current" under the indenture. *E.g.*, Mayer Report 35 figs.26-27. Mayer commits this offense passim, taking each analysis beyond the outer limits of his methodology into the realm of legal conclusion based on language of the indentures.[4]

Based on his legal conclusions at steps One and Two, Mayer proceeds to his "Step Three," which applies only "for a loan that is not current." *Id.* at 44. Mayer's "Step Three" inappropriately incorporates Mayer's determination of current or non-current status, so the result of Step Three is also a legal conclusion and is beyond Mayer's charge as an expert witness. Indeed, the first words of Mayer's application of Step Three—"Since the loan is not current," *id.* at 46—betray the inadmissibility of the entirety of his analysis. Every step in Mayer's OC Ratio analysis after Step Three compounds this violation, by incorporating and building upon it. Steps

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[4] Mayer Report 37 ("loan is not current"), 40 (same), 41 ("loan . . . should have been classified as not current"), 41 ("loan was not current"), 42 ("loan . . . should have been classified as not current"), 43 ("this loan was not current"), 44 ("loan . . . should have been classified as not current").

Four, Five, Six, and Seven, each dependent on Step Three, turn on the legal conclusion that a loan was not current under the language of the indenture. *Id.* at 49-55. The upshot is that there is no way to redact the legal conclusions from Mayer's report; every opinion is a legal conclusion or is inextricably intertwined with one.

Mayer's rebuttal report continues his metamorphosis from expert witness to legal commentator. There, Mayer disputes Respondents' expert's calculation regarding disgorgement. Mayer Rebuttal 3. Mayer faults Respondents' expert for basing his analysis on a "but-for world"—a premise that Mayer criticizes based on *legal principles* as "flawed," noting that any "but-for approach is speculative." *Id.* at 4. But-for analyses are, in fact, standard in many areas of law, and Mayer's reflexive dismissal of that measure reveals the folly of his opinions, premised as they are on inappropriate legal conclusions.

C. Henning

Henning's report inappropriately interprets the Investment Advisers Act of 1940, even citing an SEC-authored report on the legislation to support his statutory interpretation. Henning Report 7 n.16. If this accounting expert's detour into statutory construction is not excluded, the Division will have bootstrapped its disputed legal interpretation of a statute at issue into evidence. Worse still, after Henning's summary of the statute's purported standard for adequate supervision—a naked legal opinion—he adds the one-sentence lawyerly capstone: "That is not the case in this matter." *Id.* at 7.

Henning does not stop at interpreting the statute; he also argues vociferously for the application of his proffered legal standard, "false and misleading." Specifically, he opines that any inconsistency between GAAP principles and Respondents' accounting conventions renders their financial statements "false and misleading." *E.g.*, *id.* at 19. Even if Henning's supposed expertise allows him to interpret GAAP, this leap from GAAP standards to fraud-based legal

standards is an inappropriate legal conclusion. In fact, Henning uses the phrase "false and misleading" *nineteen times* in his reports, articulating the legal standard even more frequently than one may expect in a legal brief.

Henning also construes the legal documents underlying this case, like the expert did in *Marx & Co.* Henning Report 6 ("Under the terms of the Indentures . . ."), 8 (interpreting the legal effect of "signing the certifications"); Henning Rebuttal 9 (interpreting a prose footnote in a financial statement as "implying" a certain analysis). In addition, Henning opines inappropriately about the legal relationship between Respondents and the Zohar Funds, a pure question of law, by asserting that Respondents "bore responsibility for the Funds' financial statements." Henning Report 6.

Henning even opines as to whether particular disclosures would have been material to investors—another bold attempt by a Division expert to act as judge applying a legal standard. Henning Rebuttal 11-12 (pronouncing with explanation that a disclosure "render[ed] the financial statements false and misleading *regardless of whether the amounts stated in the financial statements would have been different*" without it (emphasis added)); 13 (finding fair value reports false and misleading to investors "regardless of whether the fair value would have differed from the amount stated in the financial statements had Patriarch actually performed a fair value analysis").

Finally, Henning's opinion that the facts discussed by Respondents' expert are "not relevant to this case" is unambiguously a legal conclusion inappropriate in an expert report. Henning Rebuttal 13.

II. Purported Fact-Finding By The Experts Should Be Excluded.

The Division's experts violate the fundamental rule that no witness—and particularly no expert—may invade the province of the jury, or the judge in a bench trial, by engaging in fact-

finding. Courts following this precedent in the securities context have excluded expert opinions that: contain "factual narrative of events giving rise to th[e] action," *Highland Capital Mgmt., L.P. v. Schneider*, 551 F. Supp. 2d 173, 180 (S.D.N.Y. 2008); state facts of which the witness "has no personal knowledge," *id.*; or "simply assemble the record evidence and opine on what it means," *Tourre*, 950 F. Supp. 2d at 678 . This rule is so critical that it is "manifestly erroneous" to admit expert testimony that merely "bolster[s]" a party's fact evidence. *United States v. Cruz*, 981 F.2d 659, 662-63 (2d Cir. 1992). On all of the points discussed below, there are factual disputes. It is not an expert's role to resolve them.

The Division's experts do not even attempt to justify their findings of fact as appropriate opinion testimony. Wagner, for example, repeatedly identifies which facts he "find[s]" and which facts he "do[es] not find." Wagner Report 23, 34, 36. Mayer views it has his role to "determine if the allegation is true." Mayer Report 20. Parts of Henning's reports do no more than offer long block quotations and then characterize the quotations just recited. *E.g.*, Henning Rebuttal 4-5.

A. Wagner

Wagner engages in fact-finding without support in his methodology. He describes what "the Zohar CLOs are" and "the general structure and terms of the Zohar CLOs." Wagner Report 3. He announces that investors "carefully monitor" various financial data and "expect that the Collateral Manager" act in a specific way. *Id.* at 6. He also insists that the Zohar Funds "would be familiar" to a CLO investor. *Id.* at 22. He even suggests that CDO investors "monitor their CDO investments in an efficient manner" and "efficiently manage their portfolios," an unsupported fact-finding that conveniently allows Wagner to state as fact generalizations that conflict with common-sense notions about sophisticated investors and that are even more convenient to the Division: that investors rely heavily on "aggregate data in Trustee Reports and

rely on its accuracy," and that investors "do not expect to be in an active role." *Id.* at 19-20; *see also id.* at 44 ("Typically, investors in CLOs monitor the OC Ratios" and "it would be unreasonable to expect investors to undertake [a greater] level of analysis . . . ."). By announcing facts in his report, Wagner seeks to enter in evidence a depiction of CLO investors as unsophisticated. To the extent assertions are generalized and do not pertain to the Zohar Funds' investors, they are irrelevant, and to the extent they pertain to these investors, the statements are bald-faced fact-finding.

Wagner characterizes Ms. Tilton's testimony, which should speak for itself; and based on his interpretations of the testimony, he also—taking on the role of an ALJ—finds facts relating to Respondents' conduct. Wagner Report 31-34. Additionally, an entire section of the report should be stricken as it does no more than restate and characterize other evidence. *Id.* at 40-43; *see also id.* at 49 (reciting Mayer's conclusions and summarizing "[t]he magnitude of the misallocation" as "significant").

Wagner presents other facts without basis or knowledge as well. *See, e.g.*, Wagner Report 43 ("funds that should have been paid to investors . . . were instead allocated to lower priorities in the waterfall"); *id.* at 44 ("the categorization of assets is essentially the only information available to investors"); *id.* ("investors cannot accurately assess the risk in their investments"); *id.* at 48 (stating as fact that Respondents used a "subjective approach to categorizing assets" and "did not disclose this approach"); *id.* at 49 (stating that Respondents "benefited by receiving approximately $200 million," without considering any other factors, such as recommitment of those monies to the Zohar Funds). These portions of his report are all inappropriate and should be excluded.

B. Mayer

Mayer's report contains an entire section (titled "Relevant Parties and Entities") dedicated to reciting extrinsic evidence unrelated to his purported area of expertise. Mayer Report 9-12. He also purports to find numerous facts without any explanation or methodology. *See id.* at 57 (explaining that one would "have to maintain, update, and analyze over a thousand pieces of data each month in order to replicate the OC Ratio tests"), 60 (same), 60-61 (introducing a "time consuming" process of "hand enter[ing]" data into cumbersome spreadsheets, and supposing that there is no more efficient process available); Mayer Rebuttal 7 (stating as fact that "it is impossible or extremely difficult at best for an investor to replicate the OC Ratio test"). In Mayer's discussion of preference share distributions, the fact-finding is so obviously detached from any expert opinion that a footnote reads: "Source Needed." Mayer at 64 n.193. Whether intentional or inadvertent, this note confirms the non-opinion fact-finding nature of the section.

When Mayer states that "[a]n investor could not calculate . . . OC Ratios for the many dates the electric files are missing from the trustee's website portal," he is doing nothing more than purporting to find a fact. Mayer Rebuttal 8. Worse still, he comes close to admitting the spuriousness of the assumption underlying this factual assertion, when he explains that he simply "reviewed the zipped files on a the trustee's website portal and assumed that when a zipped file existed it contained all . . . of the electronic files," which "may not be the case." Mayer Rebuttal 10 nn.29, 31.

Mayer's backup position—that even if investors could find the data, they were incapable of analyzing it—is naked and flawed fact-finding. Mayer Rebuttal 12-13. He provides three factually unsubstantiated or erroneous reasons to criticize Respondents' position "that the calculation of the OC ratio could easily be determined by an investor or automated," namely:

(1) the data occupies "numerous electronic files" with "a large number of columns," though Mayer provides no reason to think the investors could not easily consolidate and synthesize data; (2) the "loan identifier" sometimes differs between files, although again Mayer does not explain why this is problematic; and (3) the "formats" of the electronic files change over time, apparently under the unsubstantiated assumption that investors are incapable of dealing with multiple formats. Mayer Rebuttal 12-13. This purported fact-finding, and the conclusions that flow from it, should be stricken.

C. Henning

Henning, too, engages in rampant fact-finding. He lapses into explanations of the supervisory relationships among Respondents, and between them and the Zohar Funds, citing various potential witnesses' testimony. Henning Report 7 & n.15. Henning's purported accounting expertise gives him no basis to opine on, for example, whether one individual "had the ability and authority to affect the conduct" of other individuals. *Id.* at 7; *see also id.* at 8 (opining that Ms. Tilton "did not defer responsibility" for accounting decisions, citing a fact witness's testimony).

Henning also inappropriately testifies to the content of documentary evidence; for example, after a long block quotation from the financial statements, he characterizes those statements in his own words. *See* Henning Rebuttal 5 ("Thus, by their own disclosures . . ."). Relatedly, Henning states without citation or explanation that "Patriarch did not disclose or acknowledge the use of its equity method or the consolidation of any of the portfolio companies." Henning Rebuttal 14.

Your Honor should strike the portions of Henning's report that opine on an accounting firm's role in ensuring the financial statements' compliance with GAAP, because Henning admits that this opinion is based upon two pieces of evidence that are not appropriate subjects of

expert testimony or interpretation: "the engagement letters and the testimony of Peter Berlant, the Anchin partner." Henning Report 8-9. His opinion is not saved by Henning's "experience with" retention letters, *id.*, or else any professional in the world whose work includes engagement letters would be qualified to educate Your Honor about the letters' meaning. Henning also includes a paragraph recapitulating and characterizing Berlant's testimony and then simply agreeing with it—first saying that "Berlant characterized his review as ministerial," and then agreeing (as though it were an expert opinion) that the work did not rise to the level of an audit. *Id.* at 9-10; *see also* Henning Rebuttal 15-16 (recapping Mercado's testimony).

The fact-finding in Henning's report is so unabashed that he recites several pages of fact witnesses' transcribed *investigative* testimony, unattached to any opinion. This is pure bolstering. Henning Report 14-17; *see also id.* at 23. These transcript passages are broken up only by other evidence that Henning cherry-picks to make the same points, *id.* at 16 (quoting an email exchange among Respondents), and by Henning's interpretation of the evidence—not as an accounting expert but as an advocate, *id.* ("This evidence makes clear . . ."). In rebuttal, he again recites witnesses' testimony (adding lengthy quotations from Respondents' expert) as an argument, and immediately follows with his summary of the words he has just transcribed. *See* Henning Rebuttal 6-7 ("In short, Dietrich and Tilton are both referring to a hypothetical value . . .").

As a conclusory statement of fact, Henning states that "there were several indicators of impairment that should have been evaluated," and although he then presumes to show indicators of impairment, he never even purports to explain why those indicators required evaluation. Henning Report 16. Henning states as fact that loans were "modified by Patriarch based what [sic] Tilton believed the portfolio companies could pay" citing investigative testimony, and he

argues that Respondents requested an "extension of the maturity on the notes of Zohar I" citing only the OIP itself. *Id.* at 18. Moreover, Henning attempts to rebut Ms. Tilton's past testimony with his characterization of other evidence—rather than with any opinion based on his expertise. *Id.* ("Tilton testified" one way, but Henning's "review of evidence produced in this matter" leads him to disagree.). Admission of these statements would allow out-of-hearing testimony and the OIP itself to become evidence with the imprimatur of an expert opinion.

Similarly, Henning discusses that "Tilton reviewed financial information . . . on a regular basis" and speculates as to whether "she used this information to consider impairment." *Id.* at 19. He opines that Respondents "had no basis to make the fair value disclosures that they did," and that "there is no evidence that any analysis was prepared to determine the fair value" based on other evidence (including a bolstering recapitulation of transcript) rather than on his own opinions. Henning Report 22-23; *see* Henning Rebuttal 3, 10 ("[T]here is no evidence that Patriarch ever performed any impairment analysis"). He even argues about the evidence explicitly. Henning Rebuttal 12 ("Dietrich . . . ignores the evidence . . . .").

Finally, Henning engages in shameless and entirely speculative fact-finding when he asserts that Respondents' changes to the language in their financial statements concerning accounting conventions constituted "an acknowledgment . . . that the prior reporting departed from GAAP." Henning Report 4; *see id.* at 25-26; Henning Rebuttal 2, 16. Betraying the gap between any expert analysis and this opinion, Henning ultimately defends the opinion with the

statement "logic dictates"—logic, not any principle of accounting—"that the financial statements . . . did not comply with GAAP." Henning Rebuttal 16.[5]

III. Wagner's Rebuttal Report, Which Lies Far Outside The Scope Of The Report To Which It Purports To Respond, Should Be Stricken Altogether.

A rebuttal report is meant to rebut. If it does more than that, by opining on issues not discussed in the opening report or in an opposing report, then it is merely a belated opening opinion, timed to sandbag. The legal principle is uncomplicated: "A rebuttal expert report is not the proper place for presenting new arguments, unless presenting those arguments is substantially justified and causes no prejudice." *Ebbert v. Nassau Cnty.*, 2008 WL 4443238, at *13 (E.D.N.Y. Sept. 26, 2008) (internal quotations omitted). Nor is the rebuttal report permitted to simply repeat statements already outlined in the opening report. *Scientific Components Corp. v. Sirenza Microdevices, Inc.*, 2008 WL 4911440, at *3 (E.D.N.Y. Nov. 13, 2008).

Wagner's rebuttal report should be stricken in its entirely as a thinly veiled attempt at sandbagging. At the eleventh hour in this litigation, Wagner introduces a wholly new theory of liability, which is the centerpiece of his rebuttal report. The rebuttal, consequently, is 50% longer than his opening report. Whereas Wagner's opening report opines that amendments do not affect loan categorization and are therefore immaterial, his rebuttal report opines at length

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[5] This opinion also represents improper argumentation. It is neither a proper opinion nor reasoning in support of any proper opinion. If Henning were correct that a person in litigation with the SEC could not modify the conduct that the SEC claims is improper while disputing such allegations, then the result would be an absurd Hobson's choice. Faced with the Division's argument of an ongoing violation, a respondent would be put in the unjust position of choosing between, on the one hand, continuing the underlying conduct that the Division views as improper, thereby risking an increased penalty if ultimately found liable, or on the other hand, ceasing the underlying conduct, thereby allowing an argument that the change is an admission of wrongdoing. Respondents must be permitted to change their conduct while still disputing the legal necessity of doing so. In any event, arguments such as this by the SEC's expert demonstrate that he is irreparably biased, wholly unreliable, and should not be permitted to testify at all.

"that Tilton was not amending the loans." Wagner Rebuttal 3. Having said nothing on the topic in his opening report, and without explaining how the issue may have been raised by any of Respondents' experts, Wagner suddenly views it as his charge in rebuttal to "assess whether Tilton was 'amending' loan terms." *Id.* at 13. The effect of Wagner's late-stage epiphany is highly prejudicial to Respondents, who have not been afforded an opportunity to submit a sur-reply report; Wagner has given himself the first and last word on the topic by fiat. The prejudice is compounded in this case, where the expert reports are serving not merely as notice of future testimony—but as the testimony itself.

IV. Investigative Testimony Introduced Through Expert Reports Should Be Excluded.

The prohibition against hearsay is fundamental to any full and fair adversarial hearing. This principle applies more broadly than the Federal Rules of Evidence; the prohibition is "that most characteristic role of the Anglo-American law of evidence—a rule which may be esteemed, next to the jury trial, the greatest contribution of that eminently practical legal system to the world's methods of procedure." 5 Wigmore on Evidence § 1364, at 28 (Chadbourn rev. 1974). "The whole purpose of the Hearsay rule" is to ensure fundamental ingredients of a full and fair adversarial hearing: witness testimony in person, under oath, and subject to cross-examination. *California v. Green*, 399 U.S. 149, 155 (1970) (quoting 3 Wigmore § 1018).

Hearsay is inadmissible in an administrative proceeding to the extent it deprives a party of its right to a full and fair hearing, *see* Rule 300 (requiring "fair" and "impartial" hearings), or to the extent the hearsay is unreliable, *compare Consolidated Edison Co. v. NLRB*, 305 U.S. 197, 230 (1938) ("Mere uncorroborated hearsay" in administrative hearing "does not constitute substantial evidence."), *with* 5 U.S.C. § 556(d) (prohibiting agencies from issuing any order on the basis of an administrative hearing "except . . . supported by and in accordance with . . . substantial evidence"). Moreover, prior sworn statements of witnesses who are available to

testify are generally inadmissible. *See* Rule 235(a). True, the Federal Rules of Evidence do not apply in administrative hearings and therefore do not operate to prohibit hearsay in this case, *see, e.g.*, *In re Joseph Abbondante*, Exchange Act Release No. 53066, 2006 WL 42393, at *7 (Jan. 6, 2006), but that does not diminish the necessity of a fair hearing based on reliable evidence, and does not take away from the letter and spirit of Rule 235(a).

Worse than mere hearsay is an attempt by the Division to import vast amounts of investigative testimony into the administrative record. The Division's attempts to do so have been rejected in the past, yet it brazenly tries again here. In *In re Del Mar Financial Services, Inc.*, the Division had taken investigative testimony from one of the respondents, and then sought to admit the testimony at the hearing. *See* Release No. 188, 2001 WL 919968, at *4 (Aug. 14, 2001) (Foelak, ALJ). The ALJ rejected this evidence, writing:

> There is no doubt that the investigative testimony of [respondent] should not be admitted against [other respondents] because it would be fundamentally unfair to do so. It would cast doubt on whether they were accorded due process in this proceeding. These Respondents did not have the opportunity, and were forbidden by the Commission's Rules, to confront [the testifying respondent] and to cross-examine him.

Id. (citing 17 C.F.R. § 203.7(b)). The Division appealed this ruling to the Commission, which affirmed the ALJ's exclusion of the investigative testimony. *See In re Del Mar Fin. Servs., Inc.*, Securities Act Release No. 8314, 2003 WL 22425516, at *8-9 (Oct. 24, 2003) (Op. of the Comm'n).

Ten years later, the Division tried again to inject administrative testimony into an administrative hearing. *See* Hearing Transcript, *In re John J. Aesoph*, File No. 3-15168 (Oct. 28, 2013) (Foelak, ALJ).[6] The ALJ "reject[ed] their offer of admitting that into evidence" because

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[6] The relevant pages of the *In re Aesoph* transcript are attached as Exhibit 10 to the Zweifach Declaration.

the Division sought to admit such large swaths of testimony. *Id.* at 1494:18-24. The ALJ expressly cited footnote 22 of the Commission's *Del Mar Financial Services* opinion, in which the Commission refers to its order as "disapproving of practice of depositing entire investigative transcripts into record." 2003 WL 22425516, at *9 n.22.

It is troubling that the Division is once again attempting to introduce long passages of investigative testimony through expert reports in this case, even though the Commission and federal district judges have informed the Division on multiple occasions that this practice is improper. The hearsay that the Division seeks to admit here, through experts' recitations, is especially unreliable and undermines basic principles of fairness. The experts quote at length—sometimes reprinting several pages of transcript—from testimony given to the Division during the course of its investigation. This testimony was untested by cross-examination, and was given in an investigative setting that may well have been influential or coercive. If the Division can enter investigative testimony through expert witnesses as hearsay (and worse—as hearsay with the stamp of an expert's rigor) then the administrative hearing will lose any adversarial character it can claim. Unlike the Division, Respondents did not have the benefit of a five-year-long investigation with subpoena power, so one side would have the unfair advantage of eliciting, reporting, curating, and admitting as evidence the testimony of its choosing.

This hearsay is also prejudicial and time-wasting because it seeks to move wholesale fact testimony into the record through experts. This strategy represents an inappropriate evasion of, or hedge against, in-person testimony. The Division's experts transact in the testimony of witnesses who will be called at the hearing, whose hearsay is thus nonsensical to admit (not to mention inadmissible as unduly repetitious, *see* Rule 320). Your Honor will hear from these

witnesses, or else Your Honor would hear from them but for the Division's choice not to call them.

Your Honor should send a clear message to the Division that it should cease and desist from this improper practice of attempting to shore up weak cases by filling the record of a hearing with highly prejudicial investigative testimony.

A. Wagner

Wagner acknowledges that his opinions are based on his "review . . . of investigative testimony in this matter." Wagner Report 2. He does not merely internalize this testimony, he recapitulates it as fact, including an entire section (titled "Investor Testimony and Documents Support My Conclusions on Asset Categorization") dedicated to reciting hearsay. Wagner Report 40-43. The hearsay in this section includes testimony from representatives of MBIA and other financial institutions, all presented as truthful and thus as confirming Wagner's opinions. Wager also uses "[i]nvestor testimony" to establish the materiality of the OC ratio, quoting the witnesses' testimony at length to show subjective reactions to the OC ratio, and then bolstering the hearsay through the conclusory statement that "the expectations and opinions expressed" in the testimony "are entirely consistent with what a sophisticated participant . . . would expect." *Id.* at 45-46.

B. Mayer

Whole sections of Mayer's report do no more than restate hearsay statements. Twenty-one consecutive footnotes are citations to investigative testimony. Mayer Report 9-12 nn.30-50. Out of the 37 footnotes in two adjacent sections of Mayer's report, 33 are citations to investigative testimony. *Id.* at 9-14 nn.30-66. These valueless pages should be stricken as incompatible with a full and fair hearing.

C. Henning

Henning quotes and summarizes large swaths of investigative testimony, Henning Report 23, including Berlant's self-serving investigative testimony, *id.* at 9-10. He also states facts for which his only cited support is investigative testimony. *Id.* at 18 & n.53.

V. Irrelevant And Immaterial Opinions Should Be Excluded.

An ALJ is required by the Rules of Practice to exclude irrelevant evidence. Rule 320. There is no exception to this rule, which derives from a binding statute. *See* 5 U.S.C. § 556(d) ("[T]he agency as a matter of policy shall provide for the exclusion of irrelevant, immaterial, or unduly repetitious evidence.").

Expert opinions that generalize about the "conduct of unrelated persons" are widely recognized as irrelevant. *See United States v. Cruz*, 981 F.2d 659, 663 (2d Cir. 1991). This principle applies in SEC administrative hearings. *See In re F.B. Horner & Assocs., Inc.*, Exchange Act Release No. 30884, 1992 WL 160028, at *3 n.11 (July 2, 1992) (Op. of the Comm'n) (rejecting "generalized testimony given by [an] expert witness" as failing to shed light on "the markups at issue here").

A. Wagner

A major component of Wagner's report centers on his discussion of "[w]hether and how Tilton's categorization of assets affected investors." Wagner Report 2. All opinions and testimony on this topic are irrelevant; the effect on investors of Ms. Tilton's alleged conduct is not an element of any claim charged in the OIP. Therefore, Wagner's statements that: Respondents' conduct "was adverse to the interests of . . . the investors," *Id.* at 5; any alleged errors "harmed investors," *id.* at 6; "[t]he actions taken by [Respondents] did . . . adversely affect the interests of the CLO investors," *id.*; "[t]he impact of Tilton's categorization of assets is clearly disadvantageous to the . . . investors," *id.* at 48; and "investors were improperly denied

the benefits," *id.*, are all irrelevant. Accordingly, the entire section titled "The Impact of Improper Asset Categorization on Investors" should be stricken as irrelevant. *Id.* at 43-46.

Wagner offers other irrelevant opinions as well. For example, he opines on the structure and behavior of other CLOs, referring to "virtually all cash flow CLOs." Wagner Report 3. Even if an expert were permitted to opine on the conduct of others, these opinions would be only "virtually" relevant, because Wagner does not provide any more clarity on the category of CLOs to which he is referring. His irrelevant generalizations continue as he describes, for example, what "investors commonly" do and what statistical changes "would be seen as a sign" by investors, *id.* at 3-4; "features typical of [CLO] transactions," *id.* at 11; the ordinary structure of indentures and the "generally . . . long maturity" of CDOs, *id.* at 13; what "[i]nvestors in CDOs expect" as a general matter, *id.* at 13; and how "[v]irtually all CDOs" measure collateral, *id.* at 15. These are illustrative of irrelevant conclusions that insinuate throughout the Wagner reports. The only CDOs that matter presently are the Zohar Funds.

The irrelevancy and immateriality of the opinions are so comprehensive that Wagner's entire section generalizing about CDOs is irrelevant and immaterial, because it merely hypothesizes about funds that have nothing to do with this matter. Wagner Report 13-21. Even more patently irrelevant are Wagner's assertions about how "other CLOs," *besides* the Zohar Funds, operate. *Id.* at 24.

B. Mayer

Mayer opines generally as to other CLOs and the private equity market, without specific reference to Respondents or the Zohar Funds. Mayer Report 4-5 (describing what conduct "is common for CLOs"), 5 (explaining "a typical CDO," the compliance tests that "CDO's frequently have," and whom "[a] typical CLO employs"), 6 fig.2 ("Typical CLO Structure"),

8 & fig.3 (describing and illustrating "flow of funds for a typical CLO"), 15 (comparison to "a typical CDO"), 17 (same), 19 (same). These are irrelevant opinions about unrelated parties.

Mayer's rebuttal makes much of an irrelevant point, namely that Respondents' expert "has not produced an automated program" to calculate the OC Ratio—a feat that Mayer regards as difficult or impossible. Mayer Rebuttal 7. The fact that an expert did not undertake an action is irrelevant to that action's feasibility.

Mayer also opines on the availability of data for Zohar I's investors to calculate the OC Ratio, *see* Mayer Rebuttal 8-9 & fig.4, 11-12—a point that is plainly irrelevant to the allegations in the OIP. The OIP does not allege that Zohar I ever failed an OC Ratio test, nor that Zohar I's OC Ratio was ever miscalculated. *See* OIP ¶ 44 ("Had Respondents appropriately classified the Zohar Funds' assets, Zohar II and Zohar III would have failed the OC ratio test . . . ."). Mayer's opinion about this data therefore has no bearing on the truthfulness of any allegation against Respondents.

C. Henning

Finally, Henning offers irrelevant and immaterial opinion on the conduct of unrelated parties when he explains that some individuals who review financial information use that information "to estimate cash flows," and that some individuals who estimate cash flows use those estimates "in a loan impairment analysis." Henning Report 19.

CONCLUSION

The Division has only four witnesses on its "will call" witness list—its three purported experts and Ms. Tilton. Although the Division has a right to submit expert testimony, it may not abuse that right by proffering legal conclusion, factual narratives, irrelevant speculation, and other improper evidence under the guise of expert testimony. And it especially cannot be permitted to do so when, plainly, it has brought this case in an administrative forum to attempt to

avoid the boundaries on permissible expert testimony that the federal courts have imposed on the Division and Mr. Wagner previously. Your Honor should not permit the Division to employ such win-at-all-costs tactics. Accordingly, Respondents respectfully request that Your Honor: (1) strike Mr. Wagner's rebuttal report in its entirety; (2) strike Mr. Mayer's opening and rebuttal reports in their entirety; (3) strike the portions of the reports highlighted in Exhibits 2, 8, and 9 to the Zweifach Declaration, submitted herewith; and (4) preclude the Division's experts from testifying on the stricken subjects and related topics.

* * *

Rule 154(c) Certification: Undersigned counsel certifies that this omnibus brief in support of three motions contains 8,021 words and therefore complies with the length limitations set forth in Rule 154(c).

Dated: New York, New York
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CERTIFICATE OF SERVICE

I hereby certify that I served true and correct copies of 1) Respondents' Motion *In Limine* to Strike in Its Entirety the Rebuttal Report of Division of Enforcement Expert Ira Wagner, to Strike Portions of Wagner's Opening Report, and to Preclude Testimony on the Stricken Matters and Related Topics, 2) Respondents' Motion *in Limine* to Strike in Their Entirety the Reports of Division of Enforcement Expert Michael G. Mayer and to Preclude His Testimony, 3) Respondents' Motion *in Limine* to Strike Inadmissible Portions of the Reports of Division of Enforcement Expert Steven L. Henning and to Preclude Testimony on the Stricken Matters and Related Topics, 4) Memorandum of Law in Support of Respondents' Motions *in Limine* to Strike as Inadmissible, in Whole or in Part, the Division of Enforcement's Expert Reports, and to Preclude Testimony on the Stricken Subjects, and 5) Declaration of Lawrence J. Zweifach in Support of Respondents' Motions *in Limine* to Strike as Inadmissible, in Whole or in Part, the Division of Enforcement's Expert Reports, and to Preclude Testimony on the Stricken Subjects, and accompanying exhibits on this 26th day of August, 2016, in the manner indicated below:

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