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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' MOTION *IN LIMINE* TO PRECLUDE EVIDENCE CONCERNING RECKLESSNESS AND NEGLIGENCE AND TO REQUIRE THE DIVISION TO PROVE INTENTIONAL MISCONDUCT

GIBSON, DUNN & CRUTCHER LLP
200 Park Avenue
New York, NY 10166
Telephone: 212.351.4000
Fax: 212.351.4035

BRUNE LAW P.C.
450 Park Avenue
New York, NY 10022

Counsel for Respondents

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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 brief in support of their motion *in limine* to preclude the introduction of evidence concerning recklessness or negligence and to require the Division of Enforcement (the "Division") of the U.S. Securities and Exchange Commission (the "Commission") to prove intentional misconduct to prevail on any of the claimed violations in this matter, consistent with the allegations of the Order Instituting Proceedings ("OIP").

INTRODUCTION

The OIP alleges that Respondents committed a deliberate and "intentional[]" fraud, motivated by a desire to obtain illicit profits in the form of improper fees and other payments. *See infra* Pt. I. Indeed, the OIP begins: "Since 2003, Respondents have defrauded three Collateralized Loan Obligation ('CLO') funds they manage and these funds' investors . . . ." OIP ¶ 1. Respondents are preparing their defense accordingly. Your Honor should hold the Division to the "scope of the charges" authorized by the Commission in the OIP, *Pierce v. S.E.C.*, 786 F.3d 1027, 1036 (D.C. Cir. 2015) (citing Rule 200(b)(3) of the SEC Rules of Practice, 17 C.F.R. § 201.320 *et seq.* (the "Rules")), and should not permit the Division to introduce, or prevail on, a new theory of liability at this late stage. It would be highly prejudicial to Respondents, and contrary to case law addressing similar bait-and-switch maneuvers, to leave open the door for a finding of liability on a non-intentional misconduct theory—a wholly different level of scienter that implicates distinct "matters of fact and law,"—not alleged in the OIP. Rule 200(b)(3). The Division should therefore be precluded from introducing any evidence that is not relevant to its allegations of intentional misconduct—including evidence relating to, or in support of, recklessness or negligence standards of liability. *See infra* Pt. II.

Instead, Respondents' conduct should be assessed according to the theory of liability articulated by the Commission in the OIP.[1]

Finally, if Respondents' motion is denied and the Division is permitted to try, and proves, only negligent conduct, the available sanctions would be severely limited. For example, it would be inappropriate under those circumstances to permanently bar Respondents from the industry or to impose the significant financial penalties the Division seeks. *See infra* Pt. III. It is critical that Your Honor decide the issues raised in the instant motion prior to trial; doing so will clarify the parameters for the hearing and allow the parties to tailor and narrow their presentations of the evidence. Respondents therefore respectfully request a ruling and guidance on the issues raised in the instant motion as soon as possible.

LEGAL STANDARDS

The ALJ "may only admit 'new matters of fact or law that are within the scope of the original order instituting proceedings.'" *Pierce*, 786 F.3d at 1036 (quoting Rule 200(d)(2)) (emphasis added). Consistent with that directive, Rule 320 mandates that the hearing officer "shall exclude all evidence that is irrelevant, immaterial or unduly repetitious," as measured by the allegations of the OIP. Rule 300 dictates that "[a]ll hearings shall be conducted in a fair, impartial, expeditious and orderly manner."

ARGUMENT

I. The Division's OIP Alleges Intentional Misconduct, Not Mere Recklessness or Negligence.

The Division's OIP alleges that Respondents' supposed violations were intentional, not merely reckless or negligent. The OIP's central allegation is that, despite her awareness that

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[1] Respondents deny the charges in the OIP in their entirety.

assets' value had declined, "Tilton has *intentionally* and consistently directed that nearly all valuations of these assets be reported as unchanged." OIP ¶ 4 (emphasis added). The OIP similarly emphasizes Ms. Tilton's purported intent when it alleges that "instead of following the definitions set forth in the indentures, Tilton has consistently *and intentionally* used her own discretion" to categorize assets. OIP ¶ 40 (emphasis added). One cannot *un*-intentionally "use[] . . . discretion." The OIP alleges an intent to knowingly violate the terms of the indentures, and such allegations cannot be interpreted as alleging mere recklessness or negligence.

The OIP further emphasizes its theory of intentional misconduct by repeatedly stressing Respondents' alleged *motive* for violating the law—namely, a supposed desire to "Improperly Collect[] the Subordinated Fee and Other Payments." OIP ¶¶ 29-51. In other words, the OIP alleges that Respondents' violations were the product of a conscious design and intent to obtain illicit profits through fraudulent misrepresentations and omissions. The OIP never so much as hints that the violations it alleges—which it repeatedly describes as "intentional" and repeatedly emphasizes were the product of a desire to obtain illicit profits—were anything less than intentional.

Securities case law, unsurprisingly, makes clear that "intentional" does not mean merely negligent, and that "intentional" and non-intentional conduct such as negligence are mutually exclusive. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), for example, the Supreme Court distinguished between cases that "proceed[] on a theory of liability premised on negligence," on the one hand, and cases alleging "fraud or intentional misconduct," *id.* at 215—which, the Court noted, is "quite different from negligence," *id.* at 199. The Court in fact prohibited the plaintiff from shifting from one theory to the other during the course of litigation. *See id.* at 215.

This distinction between fraudulent intent and negligence is consequential in the securities context. Most obviously, where the Division alleges intentional violations, the Division must actually *prove* scienter—a higher bar than mere negligence. *See, e.g.*, *Marini v. Adamo*, 995 F. Supp. 2d 155, 177 (E.D.N.Y. 2014) (considering Exchange Act section 10(b) and Rule 10b-5 claims, noting that "plaintiffs must prove by a preponderance of the evidence that defendants acted with *scienter, also known as intent*") (emphasis added). In contrast, where the Division alleges negligence, intent is no longer relevant. *Cf. S.E.C. v. Ginder*, 752 F.3d 569, 576 (2d Cir. 2014) (finding that evidence SEC introduced as to defendant's intentional conduct was insufficient to sustain finding of negligence and granting defendant's motion for judgment as a matter of law). Instead, in a negligence case, the key question is the standard of care against which the respondent's conduct must be judged, proof of which often entails submission of evidence and expert testimony on industry standards. *See, e.g.*, *Thomas R. Delaney II*, Administrative Proceedings Release No. 755, 109 S.E.C. Docket 962, at *44 (ALJ Mar. 18, 2015) (considering, in making findings on negligence claim, testimony from "experts and fact witnesses with expert knowledge of compliance" who "testified at length concerning the standard of care").

As a result, courts place great weight on the use of the word "intentional" in a securities complaint, understanding it to mean with scienter. *See, e.g.*, *Novak v. Kasaks*, 216 F.3d 300, 311-12 (2d Cir. 2000) (holding that there was "no doubt that [plaintiff's] pleading satisfies the standard for scienter" where pleading alleged that defendants acted "'intentionally and deliberately'" to inflate financial results); *cf. S.E.C. v. Sayegh*, 906 F. Supp. 939, 946-47 (S.D.N.Y. 1995) ("Scienter may be established by proving conduct that was knowing, *intentional*, or reckless, *as opposed to merely negligent*.") (emphasis added). So too here: the

use of the word "intentionally" in the OIP—the equivalent of the complaint here—means that Respondents are charged with acting with scienter, and specifically with intentional wrongdoing.

Moreover, the OIP's repeated invocation of "intentional[]" misconduct, and its silence as to factual allegations of recklessness or negligence, put Respondents on notice that the Division will attempt to prove *only* intentional wrongdoing. Where, as here, the OIP alleges only intentional misconduct, the Division must prove it to prevail, as discussed below. Respondents must be able to rely on the theory set forth in the charging document in preparing their defense.

II. The Division Should Be Precluded from Proceeding on a New Theory of Liability on the Eve of Trial.

"[T]he SEC's Rules of Procedure make it clear that the OIP—and not any motion, brief, or other filing by the Division—establishes the scope of the charges in SEC enforcement proceedings." *Pierce*, 786 F.3d at 1036 (citing Rule 200(b)(3)). It is the Commission, not the Division, that authorizes the prosecution of a case after reviewing the investigative record, and it is the OIP that constitutes its instructions to the Division and to the ALJ as to the "matters of fact and law to be considered." Rule 200(b)(3). The Division is bound by the Commission's charging decisions, including its decision as to which theories of liability the Division may—or may not—pursue. And "[i]t is well-established that respondents in administrative proceedings are entitled to be sufficiently informed of the charges against them so that they may adequately prepare their defense." *W. Pacific Capital Mgmt. LLC*, Administrative Proceedings Release No. 681, 103 S.E.C. Docket 3633, at *1 (ALJ Feb. 7, 2012). As a result, the Division may not supplement its case with new allegations or theories that are not alleged in the OIP, *see Gregory M. Dearlove, CPA*, Administrative Proceedings Release No. 315, 88 S.E.C. Docket 1603, at *41-42 (July 27, 2006), and the ALJ "may only admit 'new matters of fact or law that are within the

scope of the original order instituting proceedings.'" *Pierce*, 786 at 1036 (quoting Rule 200(d)(2)) (emphasis added).

Here, the allegations in the OIP charge intentional fraud, and Respondents are preparing for trial accordingly. The Rules do not permit the Division to alter the theory of liability set forth in the OIP—one that is premised on Respondents' alleged intentional misconduct—and instead attempt to prevail on a showing of recklessness or negligence. Nor may Your Honor expand the case in this manner to effectively "amend an order instituting proceedings to include new matters of fact or law" outside the scope of the OIP. *See* Rule 200(d)(1) (expressly granting and limiting this authority to "the Commission" alone).

The Division has previously been precluded from shifting from a scienter-based to a negligence-based theory of liability in circumstances similar to those presented here. In *Albert Glenn Yesner, CPA*, Administrative Proceedings Release No. 42030, 70 S.E.C. Docket 2076 (Oct. 19, 1999), the Division had "told [respondent] early in [the] proceeding that it would attempt to prove that [respondent] engaged in misconduct that was intentional, knowing, or reckless." *Id.* at *2. Respondent expressed concern "that he [could not] rely on the staff's litigation assurances and that the Division might . . . argue that [respondent's] misconduct was negligent." *Id.* The Commission "disagree[d]," and assured respondent that the Commission would "judge [respondent's] conduct . . . against the . . . standard articulated by the Division" in its communications with him. *Id.*[2] Here, where Respondents are relying on the standard

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[2] The U.S. Supreme Court in *Ernst & Ernst* similarly barred a plaintiff from shifting from one theory of liability to another—in that case, from negligence to intentional misconduct—where, "[t]hroughout the long history of th[e] case [the plaintiff] proceeded on a theory of liablity premised on negligence, specifically disclaiming that [the defendant] had engaged in fraud or intentional misconduct." 425 U.S. at 215.

articulated by the Commission in the OIP—and not merely on post-OIP statements made by the Division—the Division should certainly be required to prove intentional misconduct to prevail.

This issue is far from a technicality. At this late date, if the Division were to assert for the first time that it will attempt to prove recklessness or negligence, and evidence concerning a recklessness or negligence standard of care were to be admitted at the administrative hearing, Respondents would be severely prejudiced in their ability to mount a defense. Unlike an intentional misconduct theory, a negligence claim, for example, raises questions of "the appropriate industry standard, whether [defendant] complied with that standard and, more importantly, whether he complied with the more expansive and controlling standard of reasonable prudence." *SEC v. Dain Rauscher, Inc.*, 254 F.3d 852, 859 (9th Cir. 2001). To meet a negligence case, Respondents might need to introduce extensive evidence concerning the relevant standards of care, and Respondents' policies and procedures meeting that standard. Such evidence might include, for example, multiple expert witnesses who could testify to standard industry compliance procedures generally, and accounting, valuation, and reporting procedures more specifically. *See, e.g.*, *Thomas R. Delaney II*, 109 S.E.C. Docket 962, at *44; *Ginder*, 752 F.3d at 576; *Dain Rauscher*, 254 F.3d at 859. Such evidence might also include both expert and fact witnesses comparing Respondents' conduct to the standard of care established by expert testimony.

Respondents are preparing a defense to meet the intentional misconduct theory of liability that is alleged in the OIP, not a recklessness or negligence theory. It would be fundamentally unfair to require them to now scramble to defend against an entirely different theory that would turn on a different set of facts, documents, and witnesses. *See Albert Glenn Yesner*, 70 S.E.C. Docket 2076 at *2; *see also* Rule 300 (mandating that "[a]ll hearings shall be conducted in a fair

. . . manner"). The prejudice to Respondents would be particularly pronounced given the lateness of the hour, with amended trial witness and exhibit lists already submitted.

The Division should therefore be precluded from introducing any evidence that relates to anything other than the intentional misconduct theory alleged in the OIP, and it should be expressly foreclosed from prosecuting or prevailing on a recklessness or negligence theory not alleged in the charging document.

III. If This Motion Is Denied and the Division Proves Only Negligence, Sanctions Would Be Severely Limited.

In addition to notice and Respondent's ability to prepare a defense, the Division's scienter allegations are highly relevant to the question of what sanctions would be available and appropriate were the Division to prove its case, "as the availability of remedies differs with reference to each culpable mental state." *S.E.C. v. Merchant Capital, LLC*, 311 Fed. App'x 250, 252 (11th Cir. 2009) (summary order) (remanding and ordering court to impose "the appropriate remedies in light of its determination whether the defendants acted with scienter or only negligently"); *see also, e.g.*, *Terry T. Steen*, Administrative Proceedings Release No. 107, 64 S.E.C. Docket 196 (ALJ Mar. 7, 1997) (Foelak, J.) (respondent's "state of mind is highly relevant in determining the remedy to impose") (citing *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981)). Indeed, the Investment Advisers Act itself directs the Commission to consider "whether the act or omission for which [a] penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement" in determining whether the penalty sought "is in the public interest." Investment Advisors Act of 1940, 15 U.S.C. § 80b-3(i)(3) (2015).

In the event this motion is denied and the Division is permitted to proceed on a negligence theory of liability, that theory would not, for example, support a permanent bar of

Respondents from the industry. *See, e.g.*, *Steadman*, 603 F.2d at 1141 ("It would be a gross abuse of discretion to bar an investment adviser from the industry on the basis of isolated negligent violations."); *In re Valicenti Advisory Services, Inc.*, Administrative Proceedings Release No. 111, 64 S.E.C. Docket 2281, at *19 (ALJ July 2, 1997) (Foelak, J.) (finding that where respondents had acted without scienter, "revocation and suspension" sanctions would be "excessively harsh"), *rev'd on other grounds by* Release No. 1774, 68 S.E.C. Docket 1762, (Nov. 18, 1998).[3] Nor would it be appropriate to award a significant monetary sanction on a finding of negligence. *See, e.g.*, *Terry T. Steen*, 64 S.E.C. Docket 196, at *11-12 (denying Division's "request[] that the Respondent be ordered to pay a 'significant' money penalty" where respondent's "lack of scienter" "weigh[ed] against imposition of a penalty").

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[3] As Your Honor noted *Valicenti*, 64 S.E.C. Docket 2281, at *15-16, "willful[ness]" under the Investment Advisers Act relates to the availability of certain sanctions pursuant to Sections 203(e) & (f) of the Act and is distinct from the issue of scienter. Accordingly, the OIP's allegations of "willful" violations, OIP ¶¶ 74-76, are not relevant to the instant motion.

CONCLUSION

For the foregoing reasons, Respondents respectfully request that the Division be precluded from introducing evidence concerning recklessness or negligence, and that it be required to prove intentional misconduct to prevail on any of the claimed violations in this matter. Respondents respectfully request a ruling and guidance on the issues raised in the instant motion as soon as possible, in order to clarify the parameters for the hearing and allow the parties to tailor and narrow their presentations of the evidence.

Dated: New York, New York
August 26, 2016

GIBSON, DUNN & CRUTCHER LLP

By: _____
Randy M. Mastro /AS
Reed Brodsky
Barry Goldsmith
Caitlin J. Halligan
Mark A. Kirsch
Monica Loseman
Lawrence J. Zweifach
Lisa H. Rubin

200 Park Avenue
New York, NY 10166-0193
Telephone: 212.351.4000
Fax: 212.351.4035

Susan E. Brune
BRUNE LAW P.C.
450 Park Avenue
New York, NY 10022

Counsel for Respondents