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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	:	Administrative Proceeding File No. 3-16462 Judge Carol Fox Foelak
Respondents.	:	

MEMORANDUM OF LAW IN SUPPORT OF RESPONDENTS' MOTION *IN LIMINE* TO EXCLUDE THE EXPERT TESTIMONY OF STEVEN L. HENNING

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August 31, 2016

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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 motion *in limine* to exclude the expert testimony of SEC Division of Enforcement ("the Division") expert witness Dr. Steven L. Henning.

INTRODUCTION

The Division and its expert Dr. Henning have been repeatedly rebuked and precluded from giving the very same kinds of inappropriate testimony Dr. Henning attempts to proffer here, including purported legal conclusions on ultimate issues in the case, improper fact-finding, speculation, and other fundamental defects.[1] Most egregiously, Dr. Henning's report[2] opines *19 times* that Respondents' representations were "false and misleading"—even though a federal court has previously prohibited the Division and Dr. Henning from providing *precisely* that testimony because "[q]uestions of whether or not disclosures or omissions were material and/or misleading are ultimate questions for the jury," not proper subjects of expert testimony. *SEC v. Das*, 2011 WL 4375787, at *10 (D. Neb. Sept. 20, 2011) ("[Dr. Henning] will not . . . be permitted to opine as to whether such disclosures or omissions were *materially* false or *misleading*.") (italics in original).

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[1] *See* 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 (Aug. 26, 2016) (the "Motion to Strike"). The memorandum of law in support of that motion is cited herein as "MTS."

[2] The Expert Report of Steven L. Henning, July 10, 2015 ("Henning Report") is attached as Exhibit 1 to the Declaration of Akiva Shapiro, Aug. 31, 2016 ("Shapiro Decl."). The Expert Rebuttal Report of Steven L. Henning, Aug. 31, 2015 ("Henning Rebuttal") is attached as Exhibit 9 to the Shapiro Declaration.

Two years later, Dr. Henning was excluded altogether for virtually the same reasons that Respondents have moved to strike his testimony here: the court held that Dr. Henning's testimony "impermissibly reaches legal conclusions, usurps the role of the Court in instructing the jury, and usurps the role of the jury in interpreting the governing [agreements]," *Levinson v. Westport Nat'l Bank*, 2013 WL 3280013, at *1 (D. Conn. June 27, 2013), and that he merely restated contractual terms, other witnesses' testimony, and regulatory requirements, *id.* at *7-9.

The *Daubert* line of cases—applicable to SEC administrative proceedings, *see In re Ralph Calabro*, Release No. 9798, 2015 WL 3439152, at *11 (May 29, 2015)—imposes "exacting standards of reliability" that expert testimony "must meet." *Weisgram v. Marley Co.*, 528 U.S. 440, 455 (2000). Both in administrative agencies and in the federal courts, *Daubert* and its progeny require the judge to "perform a gatekeeping function," *In re H.J. Meyers & Co.*, Release No. 211, 2002 WL 1828078, at *45 (Aug. 9, 2002), and exclude as "inadmissible" the testimony of any expert whose "analysis [is] unreliable under the *Daubert* factors" at "*any* step," *Amorgianos v. Nat'l R.R. Passenger Corp.*, 303 F.3d 256, 267 (2d Cir. 2002) (internal quotation marks omitted) (quoting *In re Paeoli R.R. Yard PCB Litig.*, 35 F.3d 717, 745 (3d Cir. 1994)).

Your Honor should perform that "gatekeeping function" and exclude the testimony of Dr. Henning for a number of independent reasons. *First*, the flaws highlighted in Respondents' Motion to Strike alone are sufficient to disregard Dr. Henning's reports in their entirety. *Second*, Dr. Henning's report veers far afield from expert opinion into the realm of pure advocacy. In 2015, the Zohar Funds' financial statements eliminated, *at the SEC's request*, their reference to being GAAP-compliant. Dr. Henning purports to render an "expert opinion"—without any citation to any authority whatsoever—that the absence of a representation that the statements were GAAP-compliant proves that the earlier statements were false and misleading. This

"expert opinion" provides no citation to any accounting literature or accounting practices. It is simply Dr. Henning's spin, as an advocate, on contested facts. "Where an expert report amounts to written advocacy akin to a supplemental brief, a motion to strike is appropriate because this evidence is not useful" to the judge. *McPhail v. First Command Fin. Planning, Inc.*, 247 F.R.D. 598, 604-05 (S.D. Cal. 2007) (internal quotation marks and alteration omitted).

Third, Dr. Henning's methodology is unreliable. He repeatedly asserts that Respondents made "false and misleading" statements, Henning Report 4, 7, 8, 19, 20, 22, 24; Henning Rebuttal 2, 11, 12, 13, 14, 15, but GAAP does not define "false and misleading," and it is not an accounting standard. Dr. Henning asserts that Respondents' valuation techniques were not consistent with their representation that they used the present value method, but he completely ignores the representation that the financial statements were based on "present value . . . *or other valuation techniques*." Henning Report 22-23. Dr. Henning cannot simply ignore language inconsistent with his preordained conclusion under the guise of an expert opinion. Dr. Henning also asserts that the ASC 310 accounting standard applies, but he never explains whether or why that standard would apply to the unique structure of the Zohar Funds. *See id.* at 10, 11, 12, 13; Henning Rebuttal 4, 5, 7, 9, 10, 11, 14.

In short, Dr. Henning's proffered testimony fails to come close to satisfying the *Daubert* standard. The Division and Dr. Henning know this from their prior experiences together, in which Dr. Henning's testimony on these very topics was barred—as was the testimony of the Division's other go-to expert, Ira Wagner, for similar reasons. But the Division is apparently hoping to capitalize on the more relaxed evidentiary standards and procedural protections in this administrative proceeding to mask the deficiencies in Dr. Henning's proposed testimony. In fact, the Division's experts are the only witnesses on its "will call" list other than Respondent Lynn

Tilton herself—and their reports will be admitted wholesale as their direct testimony, if Respondents' Motions to Strike and the instant motion are denied. The Division and Dr. Henning should not be permitted to succeed in this gamesmanship. Consistent with *Daubert*, SEC precedent, due process, and fundamental fairness, Your Honor should preclude Dr. Henning from testifying in this case. And because the Division has proffered *no other evidence* regarding the financial statement and accounting allegations, it should be precluded from offering any further evidence on those points. The Division and Dr. Henning should not be given "a second chance should their first try fail." *Weisgram*, 538 U.S. at 455.

LEGAL STANDARD

Any proffered expert testimony must "rest[] on a reliable foundation and [be] relevant to the task at hand." *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579, 597 (1993). Therefore, a judge must "make certain that an expert, whether basing testimony upon professional studies or personal experience, employs in the courtroom the same level of intellectual rigor that characterizes the practice of an expert in the relevant field." *Kumho Tire Co. v. Carmichael*, 526 U.S. 137, 152 (1999).

Unreliable expert testimony "has no more place in administrative proceedings than in judicial ones." *In re Calabro*, 2015 WL 3439152, at *11. Accordingly, the "spirit" of *Daubert* applies to SEC administrative proceedings. *Id.* In both administrative agencies and the Federal Courts, *Daubert* requires the trial judge to "perform a gatekeeping function" to determine the admissibility of expert testimony. *In re H.J. Meyers & Co.*, 2002 WL 1828078, at *45.

The Administrative Procedure Act ("APA") and the SEC's own Rules of Practice confirm that unreliable expert testimony is inadmissible in an administrative proceeding. The APA requires agencies to issue orders after hearings that are "supported by and in accordance with the *reliable* . . . evidence." 5 U.S.C. § 556(d) (emphasis added). Indeed, the Commission

recently adopted an amendment to Rule 320—which applies to this case—adding "unreliable" evidence to the list of evidence that the hearing officer *must* exclude. SEC, Amendments to the Commission's Rules of Practice, 81 Fed. Reg. 50,212, 50,226 (July 29, 2016) ("We are adopting the amendments to Rule 320 as proposed" "to add 'unreliable' to the list of evidence that shall be excluded.").

It is well established that "*reliability*," as articulated by *Daubert* and Rule 702 and endorsed by the Commission in amended Rule 320, "is the touchstone for expert testimony." *Elliott v. Commodity Futures Trading Comm'n*, 202 F.3d 926, 933 (7th Cir. 2000) (emphasis added). As an ALJ has held in another administrative hearing context, "expert opinion must be credible; and, to be credible, expert opinion must be reliable. In order for expert opinion to be reliable, it must meet the same standards set forth [in *Daubert* and Rule 702] for the admissibility of expert testimony." *In re Universal Yacht Servs., Inc.*, 2004 WL 1330136 (May 24, 2004) (Armed Services Board of Contract Appeals).

Opinions are unreliable when they are supported "only by the *ipse dixit* of the expert," or where "there is simply too great an analytical gap between the data and the opinion proffered." *Gen. Elec. Co. v. Joiner*, 522 U.S. 136, 146 (1997). Expert testimony is, moreover, "not the product of reliable principles or methods" when based on "assumptions . . . that lack[] a foundation in the record." *In re WSF Corp.*, Release No. 204, 2002 WL 917293, at *4 (May 8, 2002).

Because none of the arguments below implicates a "battle of the experts," and Dr. Henning's reports are facially defective on their own terms, Your Honor can and should grant this motion without a hearing. *See Colon ex rel. Molina v. BIC USA, Inc.*, 199 F. Supp. 2d 53, 71 (S.D.N.Y. 2001) ("Nothing in *Daubert,* or any other Supreme Court or Second Circuit case,

mandates that the district court hold a *Daubert* hearing before ruling on the admissibility of expert testimony, even where such ruling is dispositive of a summary judgment motion."); *see also Nelson v. Tenn. Gas Pipeline Co.*, 243 F.3d 244, 249 (6th Cir. 2001) ("The district court is not required to hold an actual hearing to comply with *Daubert*."); *Oddi v. Ford Motor Co.*, 234 F.3d 146, 151–55 (3d Cir. 2000) (same).

ARGUMENT

Henning's proffered expert testimony should be precluded for three independent reasons. First, significant portions of Henning's report are defective and therefore inadmissible; second, Henning's report underscores his bias against Respondents; and third, Henning's opinions are unsupported by accounting principles.

I. Henning's Improper Expert Testimony Should Be Stricken From The Record.

As detailed in Respondents' Motion to Strike, Dr. Henning's expert reports suffer from a number of deficiencies that render his reports defective and inadmissible.

Dr. Henning is well aware of this fact. Five years ago, the SEC put up Dr. Henning as its expert in a fraud case in federal court. In response to a motion by the defendants to limit Dr. Henning's testimony, the court held:

> Henning may testify about generally accepted accounting principles ("GAAP") and the accuracy and completeness of disclosures made on Info's Forms 10–K and 10–Q, and proxy statements. He will not, however, be permitted to opine as to whether such disclosures or omissions were *materially* false or *misleading*. Questions of whether or not disclosures or omissions were material and/or misleading are ultimate questions for the jury. [FN 7] Nor will he be allowed to testify as to the Defendants' legal duties and obligations; summarize the law, or the policies behind the law; or offer opinions as to the Defendants' state of mind or intent. It is the responsibility of the Court to advise the jury of the law, and it is the province of the jury to determine whether the Plaintiff has met its burden of demonstrating that the Defendants breached their duties under the law.
>
> [FN 7:] Dr. Henning's testimony would not aid the jury in making these determinations because his deposition reveals that he does not claim to have any expertise or training in determining what factors are significant to investors.

Das, 2011 WL 4375787, at *10.

The Division and Dr. Henning evidently are not heeding the judge's admonition. Dr. Henning repeatedly asserts legal conclusions throughout his reports, using the phrase "false and misleading"—*the very phrase* he and the Division were informed was inappropriate—*19 times* in his reports. Henning Report 4, 7, 8, 19, 20, 22, 24; Henning Rebuttal 2, 11, 12, 13, 14, 15. At one point, Dr. Henning drops all pretense about rendering an accounting opinion; he engages in statutory interpretation and cites as his source an SEC-authored white paper about the Investment Advisers Act. Henning Report 7 & n.16. And in his Rebuttal report, Dr. Henning opines that "the financial statements [were] false and misleading *regardless of whether the amounts stated in the financial statements would have been different*" under his preferred approach. Henning Rebuttal 11-12 (emphasis added). That, of course, is no more than an opinion on materiality.

Second, Henning engages in extensive purported fact-finding and inappropriately testifies to the content of documentary evidence, characterizing financial statements in his own words. *See* Henning Rebuttal 5 ("Thus, by their own disclosures ..."). Relatedly, he states without citation or explanation that "Patriarch did not disclose or acknowledge the use of the equity method or the consolidation of any of the portfolio companies . . . ." *Id.* at 14.

Third, Henning introduces extensive hearsay into the record, reciting several pages of fact witnesses' transcribed *investigative* testimony, unattached to any opinion. Henning Report 9-10, 14-17; *see also id.* at 23-24. Henning also states facts for which his *only* cited support is investigative testimony. *See id.* at 18 & n.53. "Henning may not proffer opinions which do not draw on his expertise but merely restate otherwise properly admitted evidence such as his recitation of the terms of the [agreement] as well as the testimony of" other witnesses. *Levinson*, 2013 WL 3280013, at *7.

The Division and Dr. Henning know full well, from *Das*, *Levinson*, and their extensive experience working together, that Dr. Henning's proffered testimony is wholly inappropriate. Accordingly, Dr. Henning should be precluded from testifying altogether.

II. Dr. Henning's Report Betrays His Bias Against Respondents.

In certain circumstances, as here, "a showing of bias [is] so extreme that exclusion is appropriate under *Daubert*." *In re Welding Fume Prods. Liab. Litig.*, 534 F. Supp. 2d 761, 766 (N.D. Ohio 2008). Indeed, even an otherwise qualified expert may be excluded from testifying if it appears that his or her opinion is "irreparably tainted by litigation bias and unreliable." *McClellan v. I-Flow Corp.*, 710 F. Supp. 2d 1092, 1125 (D.Or. 2010); *see also Conde v. Velsicol Chemical Corp.*, 804 F. Supp. 972, 984 (S.D. Ohio 1992) ("[W]here an expert becomes an advocate for a cause, he therefore departs from the ranks of an objective expert witness, and any resulting testimony would be unfairly prejudicial and misleading.").

Dr. Henning's report substantially "departs from the ranks of an objective expert witness." In 2015, the Zohar Funds' financial statements eliminated the representation that the statements were GAAP-complaint. Dr. Henning opines—with no citation to any authority whatsoever—that the modification is "an acknowledgement by the Respondents that the prior reporting was not in accordance with GAAP and the changes were made in order to correct those disclosures." Henning Report 25; *see also* Henning Rebuttal 16.[3] "Where an expert report amounts to written advocacy akin to a supplemental brief, a motion to strike is appropriate

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[3] Unsurprisingly, Dr. Henning makes no mention of the fact that Respondents removed "in accordance with GAAP" from its 2015 financial statements because the SEC by that point had conveyed to Respondents that it believed Respondents were effectuating a violation by continuing to use that terminology. Of course, Respondents disagreed (and continue to disagree) that the language was ever problematic. But the critical point is that the removal came at the SEC's request and was not intended to be, and is not, an admission of any kind.

because this evidence is not useful" to the judge. *McPhail v. First Command Fin. Planning, Inc.*, 247 F.R.D. 598, 604-05 (S.D. Cal. 2007) (internal quotation marks and alteration omitted). That is the case here.

III. Henning's Opinions Are Unsupported by Accounting Guidance.

Even if Henning is not deemed to be so biased that his testimony should be excluded on that basis, he nevertheless should not be permitted to testify because his analysis is fundamentally unreliable and wholly unsupported by accounting guidance. It is axiomatic that an expert's analysis must be reliable "at every step," and "'*any* step that renders the analysis unreliable under the *Daubert* factors *renders the expert's testimony inadmissible.*'" *Amorgianos*, 303 F.3d at 267 (quoting *In re Paoli R.R. Yard PCB Litig.*, 35 F.3d 717, 745 (3d Cir. 1994)). Where an expert's testimony fails to meet this standard, the expert should be excluded. A trial judge is

> not obligated to prune away all of the problematic [elements of an expert's analysis] in order to preserve [the expert's] testimony . . . . Requiring judges to sort through all inadmissible testimony in order to save the remaining portions . . . would effectively shift the burden of proof and reward experts who fill their testimony with as much borderline material as possible.

Bricklayers & Trowel Trades Int'l Pension Fund v. Credit Suisse Sec. (USA) LLC, 752 F.3d 82, 96 (1st Cir. 2014).

Fundamentally, Dr. Henning's so-called "methodology" is unreliable because his opinions about financial statements, accounting, and GAAP-compliance are not rooted in accounting guidance. Dr. Henning repeatedly opines that Respondents' statements were "false and misleading." But GAAP does not define "false and misleading," and that term is not a recognized accounting standard. Dr. Henning surely knows this; that is why he does not even suggest that the "false and misleading" label is an accounting standard. Dr. Henning's legal opinion is irrelevant, and he offers no *accounting* opinion on that point.

Dr. Henning's other opinions fare no better. For example, he asserts that Patriarch "does not estimate the cash flows expected to be collected on the loans." Henning Report 24. Henning is referring there to the "income approach" to estimate fair value. Patriarch's disclosures clearly state that "fair values are based on estimates using present value of anticipated future collections *or other valuation techniques*." *See* Zohar CDO 2003-1, Ltd. ("Zohar I"), Financial Statements, Aug. 8, 2013, Shapiro Decl. Ex. 6, at 6. Henning ignores the italicized portion of Patriarch's disclosures. And he never accounts for the accounting guidance that allows for multiple valuation techniques for estimating fair value. *See* ASC 820-10-35-24A (referring to the market approach, cost approach, and income approach).

Dr. Henning's opinion that the Zohar Funds' balance sheets did not "present fairly in conformity with GAAP" the balance sheets of the Funds is unsupported because he does not consider whether (much less establish that) the accounting principles he references, ASC 310, are appropriate to the Funds' circumstances—a required component of assessing conformity with GAAP. Dr. Henning simply assumes that the Zohar Funds' assets should be accounted for as loans. But even the Division's own experts recognize that the Zohar Funds contain features of collateralized loan obligations. Because Dr. Henning claims no experience in structured finance, he provides no explanation for why ASC 310, which applies to traditional loans, should apply in the structured finance context. "[T]here is simply too great an analytical gap between the data and the opinion proffered." *Gen. Elec. Co. v. Joiner*, 522 U.S. 136, 146 (1997). Dr. Henning's analysis is not "rooted in the principles and methodology of accountancy," *SEC v. Lipson*, 46 F. Supp. 2d 758, 764 (N.D. Ill. 1998), and it should therefore be excluded.

CONCLUSION

For the foregoing reasons, Respondents respectfully request that Your Honor exclude the expert reports and testimony of Steven L. Henning.

Dated: New York, New York
August 31, 2016

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