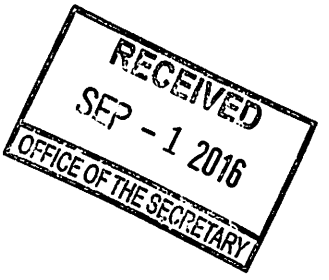
HARD COPY



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 EXCLUDE THE EXPERT TESTIMONY OF MICHAEL G. MAYER AND IRA WAGNER, AND TO PRECLUDE THE DIVISION OF ENFORCEMENT FROM SEEKING DISGORGEMENT

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

August 31, 2016

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Statutes

Other Authorities

Rules

Regulations

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* to exclude the expert testimony of SEC Division of Enforcement ("the Division") expert witnesses Michael G. Mayer and Ira Wagner, and to preclude the Division from seeking disgorgement as a remedy in this proceeding.[1]

INTRODUCTION

The Division seeks to deprive Respondents of over $200 million in so-called "disgorgement"—an unprecedented sum—based solely on the fundamentally unreliable reports by its purported experts Michael G. Mayer and Ira Wagner. Such startling overreach cannot be countenanced in *any forum*: Both in federal courts and in front of administrative tribunals, *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993), and its progeny require the trial 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); *see*

---

[1] Respondents file this omnibus brief in support of three separate motions *in limine*: Respondents' Motion *in Limine* to Exclude the Expert Testimony of Michael G. Mayer; Respondents' Motion *in Limine* to Exclude the Expert Testimony of Ira Wagner; and Respondents' Motion *in Limine* to Preclude the Division of Enforcement from Seeking Disgorgement. The Expert Report of Ira Wagner, July 10, 2015 ("Wagner Report") is attached as Exhibit 1 to the Declaration of Akiva Shapiro, Aug. 31, 2016 ("Shapiro Decl."). The Rebuttal Expert Report of Ira Wagner, Aug. 31, 2015 ("Wagner Rebuttal") is attached as Exhibit 2 to the Shapiro Declaration. The Expert Report of Michael G. Mayer, July 10, 2015 ("Mayer Report") is attached as Exhibit 3 to the Shapiro Declaration. The Rebuttal Expert Report of Michael G. Mayer, Aug. 31, 2015 ("Mayer Rebuttal") is attached as Exhibit 4 to the Shapiro Declaration.

also In re Ralph Calabro, Securities Act Release No. 9798, 2015 WL 3439152, at *11 (May 29, 2015) (asserting applicability of *Daubert*'s principles in SEC proceedings). Nowhere is the *Daubert* principle more important than in an administrative proceeding—like this one—that deprives respondents of key rights and protections that are otherwise guaranteed in federal court.

Your Honor should perform that "gatekeeping function" and exclude the testimony of Messrs. Mayer and Wagner for three independent reasons. *First*, as already detailed in Respondents' pending Motions to Strike, the Mayer and Wagner reports are replete with legal conclusions, improper fact-finding, speculation, and other fundamental defects.[2] Those flaws alone should compel Your Honor to exclude Messrs. Mayer and Wagner under *Daubert*—in addition to providing a basis for striking both of Mr. Mayer's reports, and Mr. Wagner's rebuttal report, for the reasons discussed in the Motions to Strike. *Second*, Messrs. Mayer and Wagner are unqualified to render the opinions offered: neither witness possesses relevant knowledge, training, or experience concerning the operational roles and responsibilities of the various parties involved with CLOs—a topic central to their purported expert opinions. Their history as professional witnesses on the Division's speed dial does not somehow qualify them as "experts" here. *See, e.g.*, *Thomas J. Kline, Inc. v. Lorillard, Inc.*, 878 F.2d 791, 800 (4th Cir. 1989) ("[I]t would be absurd to conclude that one can become an expert simply by accumulating experience in testifying.") (pre-*Daubert*); *Katt v. City of New York*, 151 F. Supp. 2d 313, 356 (S.D.N.Y. 2001) (Lynch, J.) ("*Daubert* requires more . . . than a sterling resume to permit opinion testimony by a professed expert.").

---

[2] *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 "Motions to Strike"). The memorandum of law in support of that motion is cited herein as "MTS."

Third, Mayer and Wagner rely on patently unreliable methodologies. Mayer's calculations regarding the Zohar Funds' Class A Overcollateralization Ratios (the "OC Ratios") and allegedly overpaid subordinated collateral management fees and preference share distributions fail to take into account the actual operations of the Zohar Funds. Wagner, for his part, bases the vast majority of his report on Mayer's unreliable report, and thus his opinions suffer from the same fatal flaws. In addition, Wagner's purportedly "overwhelming evidence" that Respondents were not amending loans (a rebuttal opinion that is independently improper because it is outside the scope of his opening report) is based on an analysis of *one loan* out of over 350. "[A] sample size of one is rarely, if ever, sufficient." *Am. Honda Motor Co. v. Allen*, 600 F.3d 813, 818 (7th Cir. 2010).

Recognizing that the federal courts would never "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), the Division apparently hopes to capitalize on the looser evidentiary standards and procedural protections in this administrative proceeding to excuse the stark deficiencies in the Mayer and Wagner reports and to introduce almost its entire case through purported expert 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. Your Honor must not countenance such transparently manipulative tactics. Consistent with *Daubert*, SEC precedent, due process, and fundamental fairness, Your Honor should preclude Messrs. Mayer and Wagner from testifying in this case. The Division should not be given "a second chance should their first try fail." *Weisgram v. Marley Co.*, 528 U.S. 440, 455 (2000).

And as the experts fall, so too does the Division's theory of, and purported support for, disgorgement: the Division has no basis upon which to seek disgorgement other than its purported experts' unreliable reports. Moreover, apart from the issues that pervade the Division's theory of disgorgement in this particular case, serious concerns have been raised about the Division's use of disgorgement, more generally. Many legal commentators have criticized the Division for abusing its statutory power by seeking remedies that are legal in nature, under the guise of the equitable remedy of "disgorgement." Therefore, particularly in the context of administrative proceedings, where the Division is afforded sweeping authority and respondents are denied fundamental procedural safeguards, it is of paramount importance that Your Honor limit the Division to its statutorily delegated powers and strictly hold it to its burden of proof. Here, because its defective expert reports are the sole support for its disgorgement request, the Division cannot, as a matter of law, satisfy its burden; under these circumstances, disgorgement of the subordinated collateral management fees or preference share distributions would be an improper and unsupported penalty, and the Division should be precluded from seeking this relief.

LEGAL STANDARDS

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 n.67. Accordingly, the "spirit" of

Daubert applies to SEC administrative proceedings. *Id.* at *11. 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.,* Release No. 211, 2002 WL 1828078, at *45 (Aug. 9, 2002).

The Administrative Procedure Act ("APA") and the SEC's own Rules of Practice, 17 C.F.R. pt. 201, 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, an "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"—the Division's experts' 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) ("[T]he 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).[3]

ARGUMENT

The proffered expert testimony of Messrs. Mayer and Wagner should be precluded. For the reasons described in the Motion to Strike, their reports are replete with inadmissible material, and it is not Your Honor's or Respondents' obligation to sift through the muck in search of a nugget of admissible testimony. *See infra* Pt. I. Independently, neither Mr. Mayer nor Mr. Wagner is qualified to render the opinions contained in their reports, *see infra* Pt. II, and their methodologies are unreliable, *see infra* Pt. III. Finally, because *Daubert* requires exclusion of

---

[3] There are myriad other defects with the expert reports which Respondents would explain at any hearing in this matter. Again, though, the pervasive facial defects warrant striking the reports and precluding the experts from testifying altogether, without a hearing.

Messrs. Mayer's and Wagner's testimony, and because their testimony is the only support for the Division's request for disgorgement, the Division should be precluded from seeking this relief. *See infra* Pt. IV.

I. Messrs. Mayer And Wagner Must Be Excluded On the Basis Of Their Improper Expert Reports

Respondents' pending Motions to Strike identify the tremendous volume of inadmissible material that makes up the expert reports of Messrs. Mayer and Wagner. The reports—which, in accordance with Your Honor's May 7, 2015 order, are the witnesses' direct testimonies—are shot through with legal conclusions, improper fact-finding, speculation, and other fundamental defects, rendering them inadmissible in full. MTS 5-25.

The Division attempts, through the reports of Messrs. Mayer and Wagner, to introduce the same kind of "[im]proper expert testimony" that Judge Forrest of the Southern District of New York disregarded three years ago as "problematic and not admissible." *SEC v. Tourre*. 950 F. Supp. 2d 666, 681 (S.D.N.Y. 2013). Messrs. Mayer and Wagner's "testimony stating ultimate legal conclusions" and "[m]ere [factual] narration," among other problems, "thus fails to fulfill *Daubert*'s most basic requirements" and "provid[es] a separate basis for exclusion." *Id.* at 675.

It is not Respondents' or the ALJ's obligation "to sort through all inadmissible testimony in order to save the remaining portion." *Bricklayers & Trowel Trades Int'l Pension Fund v. Credit Suisse Sec. (USA) LLC*, 752 F.3d 82, 96 (1st Cir. 2014). A contrary rule "would effectively shift the burden of proof and reward experts who fill their testimony with as much borderline material as possible." *Id.* 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.

Id. Respondents' Motions to Strike identify large swaths of the experts' reports—including the entire Wagner Rebuttal Report and both of Mr. Mayer's reports—that must be stricken as inadmissible, leaving little or no salvageable testimony. Accordingly, the proffered testimony should be stricken altogether.

II. Messrs. Mayer And Wagner Are Not Qualified To Render The Opinions In Their Reports.

Even if the expert reports were not defective for the reasons described in the Motions to Strike, Messrs. Mayer and Wagner should be excluded under *Daubert* because they are unqualified to render the opinions they purport to provide. *See Zaremba v. Gen. Motors Corp.*, 360 F.3d 355, 360 (2d Cir. 2004) (stating that, where the witness lacked qualifications, an analysis of the remaining *Daubert* factors "seems almost superfluous"). The inquiry is not limited to a perusal of the expert's academic credentials; "*Daubert* requires more . . . than a sterling resume to permit opinion testimony by a professed expert." *Katt v. City of N.Y.*, 151 F. Supp. 2d 313, 356 (S.D.N.Y. 2001) (Lynch, J.). The mere fact that Messrs. Mayer and Wagner have testified time and again—including repeatedly for the Division—is immaterial; "it would be absurd to conclude that one can become an expert simply by accumulating experience in testifying." *Thomas J. Kline, Inc. v. Lorillard, Inc.*, 878 F.2d 791, 800 (4th Cir. 1989) (pre-*Daubert*).[4]

---

[4] Mr. Mayer has served as an SEC expert in at least five matters. *See SEC v. McGinnis,* District of Vermont, No. 5:14-CV-6 (Expert Report); *SEC v. Goldstone,* District of New Mexico, No. 12-257 (Deposition Testimony, Mar. 27, 2014); *SEC v. Quan,* District of Minnesota, No. 11-cv-ADM-JSM (Deposition and Trial Testimony, Jan. 29, 2014, Feb. 4–5, 2014); *SEC v. Berrettini,* Northern District of Illinois, Case No. 10-cv-01614 (Affidavit, Apr. 17, 2012); *SEC v. Dunn,* District of Nevada, No. 2:09-cv-02213 (Deposition Testimony, Apr. 28, 2011). Two of Mr. Wagner's seven expert engagements have been as an expert for the

[Footnote continued on next page]

A. Michael G. Mayer

Despite Mr. Mayer's long history of testifying on behalf of the Division, he is unqualified to provide an expert opinion about the operation of CLOs or related topics. Nothing in Mr. Mayer's statement of qualifications indicates that he has any professional experience with CLOs. *See* Mayer Report 3; *see also* Shapiro Decl. Ex. 7 (curriculum vitae of Mayer). Indeed, much of the description of CLOs in his expert report is lifted wholesale from a consulting firm's white paper on the subject, underscoring Mr. Mayer's lack of first-hand knowledge or experience on the topic. *Id.* at 4-7 nn.2, 3, 6, 8, 13, 15, 16-20.

That lack of experience undermines the entirety of Mr. Mayer's analysis. Mr. Mayer ignores the operational aspects of CLOs: he focuses on Respondents' role in the Zohar Funds, but his report is devoid of analysis about the roles and responsibilities of the other participants in a CLO structure, including the trustee, collateral administrator, custodian, and loan administrator. In sum, Mr. Mayer's total lack of experience with CDOs and CLOs renders him unqualified to opine on the structure and operations of the complex investment structures at issue here.

B. Ira Wagner

Mr. Wagner's report makes clear that he has experience with CDOs and CLOs as an investment banker. But Respondents were involved with the Zohar Funds as collateral managers, *see* Order Instituting Administrative Cease-and-Desist Proceedings ("OIP") ¶ 11, and as noted above, third parties were involved in the operation and monitoring of the Zohar Funds as well. Given Mr. Wagner's lack of experience in critical daily operations of a CLO, central to this dispute, he is unqualified to opine on the functions of those third parties, including, for

---

[Footnote continued from previous page]

SEC, including *U.S. v. Tourre,* 950 F. Supp. 2d 666 (S.D.N.Y. 2013) (Forrest, J.), where Mr. Wagner's written testimony was excluded as "problematic and not admissible." *Id.* at 681.

example, the roles and responsibilities of various players in calculating the OC Ratio, preparing financial statements, and conducting other tasks that are at the heart of the Division's allegations against Respondents. *See, e.g.*, OIP ¶¶ 29-36 (OC Ratio test), ¶¶ 57-73 (financial statements)

Mr. Wagner's experience as an investment banker working on CLOs might qualify him, for example, to opine on the role of an investment banker in other, similar structured products. Mr. Wagner's *lack* of experience with the day-to-day operations of CDOs and CLOs renders him unqualified to opine on the propriety of those functions at the Zohar Funds.

Mr. Wagner's reports demonstrate his lack of qualification. Because he has no operational experience with CLOs, he ignores the roles and responsibilities of various third parties, and baldly concludes that Respondents acted improperly. *See, e.g.*, Wagner Report 5 (opining that "the subjective categorization methodology utilized by Tilton is in violation of the Zohar CLO Indentures".) And despite his extensive opinions regarding loan modification, *see, e.g.*, Wagner Report 32, 34-36, Mr. Wagner does not claim to have any practical experience with such practices. Indeed, his report is entirely silent on the topic of loan administration functions, which are, of course, critical in a case where loan administration—including the nature, existence and extent of repayments—is at the heart of the case.

III. Messrs. Mayer and Wagner Employ Unreliable Methodologies.

Even if Messrs. Mayer and Wagner had the qualifications to render their opinions, their methodologies are fundamentally unreliable. It is black letter law 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 v. Nat'l R.R. Passenger Corp.*, 303 F.3d 256, 267 (2d Cir. 2002) (emphasis in original, quoting *In re Paoli R.R. Yard PCB Litig.*, 35 F.3d 717, 745 (3d Cir. 1994)).

A. Michael G. Mayer

Mr. Mayer renders three principal opinions. His first opinion is that the Zohar II and Zohar III CLOs failed their monthly OC Ratio tests starting in July 2009 and June 2009 respectively. *See* [ ]. His third opinion is that the Zohar II and Zohar III CLOs paid $208 million in subordinated collateral management fees and preference share distributions during periods in which the CLOs failed their OC Ratio tests. Both of these conclusions rest on categorically speculative and unreliable methodology.[5]

The fundamental flaw in Mr. Mayer's analysis is that he assumes a static world. In other words, the failure of the OC Ratio test in a given month is assumed to be independent of any failure in prior months. Mr. Mayer then aggregates his results for each (independent) period to conclude that Respondents improperly received $208 million in fees and preference shares. But Mr. Mayer's starting assumptions are demonstrably false.

Mr. Mayer ignores the consequences that an alleged OC Ratio test violation would trigger. Because Mr. Mayer calculates the OC Ratio for each valuation date independently, he fails to take into account the changes that alleged previous OC Ratio test violations would cause. As a result, Mr. Mayer does not even attempt to fully analyze how the cash flows and proceeds would be distributed and diverted by the CLO waterfall after the first alleged violation and failure of the OC Ratio test. Mr. Mayer simply assumes that if the OC Ratio test fails, no payments would be made to Subordinated Collateral Management Fees and Preference Share

---

[5] Mr. Mayer's second opinion is that investors would have had to analyze a large amount of data to determine whether the Zohar Funds passed their OC Ratio tests. *See* Mayer Report 57-61; Mayer Rebuttal 8, 10, 12-13. That opinion is flawed for the reasons discussed in the Motion to Strike. *See* MTS 14-15. Mayer's second opinion is not independently the subject of this motion.

Distributions, even though it is quite likely that any OC Ratio test failure would be cured in subsequent months.

An example illustrates the problem with Mr. Mayer's approach. Assume a $100 loan with interest payable quarterly, initially scheduled to repay the $100 principal at maturity. Mayer calculates the OC Ratio for each period using the Zohar Funds' equivalent of the $100 principal outstanding. The flaw in Mr. Mayer's analysis is that if the OC Ratio test fails for any period, one of the likely consequences is an early paydown of principal. To continue the loan example, suppose that the consequence of a missed interest payment was that the borrower would be required to pay down $20 of principal, leaving an $80 principal balance. Now, the borrower would only owe $80 at maturity. Yet Mr. Mayer's analysis assumes that the $100 in principal outstanding continues indefinitely. In the context of the Zohar Funds, Mr. Mayer ignores the principal paydown (among many other scenarios) that would be triggered if the OC Ratio test actually failed, as opposed to the hypothetical failure Mr. Mayer posits. *See, e.g.*, Indenture of Zohar II 2005-1 ("Zohar II"), Jan. 12, 2005, Shapiro Decl. Ex. 9, at § 11.1(a)(i)(H) ("[I]f any Class A Coverage Test was not satisfied on the related Determination Date . . . an amount equal to the . . . Principal Sharing Percentage of . . . Note Reduction Amount will be applied to the payment of the principal of Class A[] Notes until the outstanding principal of the Class A[] Notes has been repaid in full . . . .").

This error is fatal. Mr. Mayer's entire analysis hinges on the Zohar Funds allegedly failing the overcollateralization test. The test is, by definition, a function of the Funds collateral relative to the Funds' outstanding Class A Notes. If the first failure of the OC Ratio test could trigger consequences, including a paydown of principal and commensurate reduction in the outstanding amount of the Class A Notes (from $100 to $80, in the example above), then Mr.

Mayer's calculations for every subsequent period after the initial failure are unreliable. At most, Mr. Mayer's calculation may inform the first time when the OC Ratio test was purportedly breached. But his methodology cannot establish that the Funds would have continued to fail their OC Ratio tests in each and every subsequent quarter, because it does not even attempt to account for the dynamic (not static) consequences in a failure of the OC Ratio test.

In his rebuttal report, Mr. Mayer asserts that it is incorrect to "assum[e]" that, upon a failure of the OC Ratio Test, "cash flow would be directed to pay down principal on investor notes when the OC Ratio test failed." Mayer Rebuttal 3. But these additional principal payments are dictated by the indentures and are not an assumption. *See* Indenture of Zohar CDO 2003-1 ("Zohar I"), Nov. 13, 2003, Shapiro Decl. Ex. 8, at § 11.1; Indenture of Zohar II 2005-1 ("Zohar II"), Jan. 12, 2005, Shapiro Decl. Ex. 9, at § 11.1; Indenture of Zohar III, Apr. 6, 2007, Shapiro Decl. Ex. 10, at § 11.1.[6]

Mr. Mayer concludes in his third opinion that Patriarch received improper Subordinated Collateral Management Fees and Preference Share Distributions. But that conclusion is linked to the incomplete (at best) calculation of the OC Ratio. Mr. Mayer ultimately alleges that as long as the OC Ratio test would be violated and failed to comply with its threshold, no payments (at all) would be made for payment of Subordinated Collateral Management Fees and Preference Share Distributions. That conclusion is simply wrong and demonstrates Mr. Mayer's lack of familiarity with the CLO structure. As explained above, the failure of the OC Ratio test would trigger principal redemptions of outstanding Class A Notes sufficient to cure the violation, and

---

[6] Indeed, there are myriad ways the collateral manager could and did avert a failure of the OC Ratio test, including deferring fees and reinvesting assets that Mr. Mayer does not account for in his opinion.

additional distributions in the structure could continue so long as the OC Ratio test was brought back into compliance. Mr. Mayer's complete lack of accounting for this basic feature of the Zohar Funds renders his entire analysis unreliable.

B. Ira Wagner

The aforementioned problems with Mr. Mayer's analysis also infect Mr. Wagner's analysis. The centerpiece of Mr. Wagner's report is his opinion that the "failure to properly categorize the loans was adverse to [investors'] interests." Wagner Report 5. But Mr. Wagner repeatedly relies on Mr. Mayer's analysis to further his opinion. *See id.* at 5, 5 n.1, 30, 43, 44, 44 n.34, 45, 45 n.35, 48, 49. Mr. Wagner's entire discussion under the heading "Tilton's Categorization of Assets," *see id.* at 30-39, is based on his "understanding from [his] review of the Mayer Report." *Id.* at 30. And the concluding sections of the Wagner Report—which opine on investor impact and Respondents' obligations as collateral manager—contain *six* references to Mr. Mayer's report (not including footnotes) over just eight pages. *Id.* at 43-50. Because, as described above, Mr. Mayer's opinions are entirely unreliable, so too are Mr. Wagner's. *Rink v. Cheminova, Inc.*, 400 F.3d 1286, 1294 (11th Cir. 2005) (finding that experts were properly excluded where they relied on the findings of another expert, which were found to be unreliable).

Mr. Wagner also purports to opine that Respondents acted improperly in managing the Zohar Funds. As explained above, this opinion is inappropriate as a threshold matter because Mr. Wagner lacks the qualifications necessary to render such an opinion, and because this so-called "opinion" is a legal conclusion. But at any rate, Mr. Wagner cherry-picks evidence and uses an unreliable methodology to opine as to Respondents' activities with regard to loan modification. *See Barber v. United Airlines, Inc.*, 17 F. App'x. 433, 437 (7th Cir. 2001) (stating that a "selective use of facts fails to satisfy the scientific method and *Daubert*"). Mr. Wagner claims in his rebuttal report that there is "overwhelming evidence that Tilton was not amending

the loans." Wagner Rebuttal 10. In support of that sweeping statement, Mr. Wagner provides analysis of just *one loan's* interest payments, out of approximately *364* total loans (roughly 41 in Zohar I, 160 in Zohar II, and 163 in Zohar III as of late 2009).[7] Needless to say, "a sample size of one is rarely, if ever, sufficient," *Am. Honda Motor Co. v. Allen*, 600 F.3d 813, 818 (7th Cir. 2010), especially when purporting to draw generalizations about investment vehicles with as diverse holdings as the Zohar Funds. Mr. Wagner's assertion that a sample size of one-third of one percent (0.3%) constitutes "overwhelming evidence" serves to show just how far Mr. Wagner will go to arrive at the result he and the Division have preordained.

* * *

In sum, the opinions of Messrs. Mayer and Wagner are unreliable and must be excluded. They are replete with "[im]proper expert testimony," containing legal conclusions, improper factual narratives, and other fundamental defects. *See Tourre,* 950 F. Supp. 2d at 682. Neither is qualified to opine on the subjects of their expert reports. Both employed unreliable methodologies to reach their conclusions. Independently, each offense requires an expert be excluded. Taken together, the opinions of Messrs. Mayer and Wagner "ha[ve] no . . . place in administrative proceedings," *In re Ralph Calabro*, Securities Act Release No. 9798, 2015 WL 3439152, at *11 n.67 (May 29, 2015), and it is the duty of the ALJ as gatekeeper to exclude their

---

[7] Mr. Wagner purports to undertake an analysis of one "exemplar loan to American LaFrance ('ALF')." Wagner Rebuttal 3. That analysis spans 20 pages. *See id.* at 13-33. Then, in a conclusory paragraph, Mr. Wagner claims he reviewed 13 other loans and came to a conclusion "[s]imilar to the ALF loan." *Id.* at 33, 33 n.32. To the extent that paragraph—devoid of any detail whatsoever—can be considered an analysis in any meaningful sense of that term, it should be wholly disregarded. And in any event, Mr. Wagner does not demonstrate that 14 loans out of 364 are representative.

opinions, *In re H.J. Meyers & Co.*, Release No. 211, 2002 WL 1828078, at *45 (Initial Decision) (Aug. 9, 2002).

IV. The Division Should Be Precluded From Seeking Disgorgement.

In this action, the Division is seeking disgorgement of hundreds of millions of dollars from Respondents. *See* OIP ¶¶ 6, 44. The Division's OIP, expert reports, witness lists, and exhibit lists demonstrate that the *only* evidentiary basis for the Division to obtain disgorgement is the expert reports of Messrs. Mayer and Wagner. *See* OIP ¶¶ 6, 44, Section III.B. (seeking "remedial action . . . including, but not limited to, disgorgement and civil penalties"); *see generally* Mayer Report; Mayer Rebuttal 2-4 & n.6; Wagner Report 5-6, 43, 48–49; Wagner Rebuttal 6-7, 66; Division's August 22, 2016 Amended Witness List (identifying Ms. Tilton and Messrs. Mayer, Wagner, Henning as the only "will call" witnesses). The slender reed of Mr. Mayer's and Mr. Wagner's deficient expert reports, however, cannot bear the weight of the Division's unprecedented bid for a monetary ransom.

Given the relaxed procedural rules that apply in an SEC administrative proceeding and the perception that such proceedings are fundamentally unfair, it is critical that Your Honor scrutinize the legal, evidentiary, and causal basis for the Division's draconian disgorgement request with great care to ensure that it is reliable. As explained above, the Mayer and Wagner reports are completely unreliable. For example, Mr. Mayer claims in his rebuttal report that he does not have to correct his analysis because he is calculating an amount for "disgorgement." Mayer Rebuttal 3. This statement by Mr. Mayer suggests that, in his view, when he is called upon to calculate an amount for disgorgement in an SEC administrative proceeding, standards of reliability and accuracy go out the window. But the setting for this proceeding does not absolve the Division's experts of their obligation to provide reliable testimony, using reliable methods.

In short, by any standard, the testimony of Messrs. Wagner and Mayer should not, and cannot, support the relief that the Division is seeking. OIP ¶ 44.

A. The Disgorgement Request Must Be Scrutinized Closely In Light Of The Sweeping Powers Afforded To The Division in Administrative Proceedings, Which Are Unchecked By Fundamental Procedural Safeguards.

Today, the Division can "obtain through internal administrative proceedings nearly everything it might obtain by going to court." Jed. S. Rakoff, PLI Sec. Regulation Institute Keynote Address, *Is the S.E.C. Becoming a Law unto Itself?*, at 5 (Nov. 5, 2014). Alarmingly, however, the procedural safeguards available to respondents in administrative proceedings have not kept pace with the Division's rapidly expanding power. *See generally* Alexander I. Platt, *SEC Administrative Proceedings: Backlash and Reform*, 71 Bus. Law. 1 (2015); *see also* Commissioner Michael S. Piwowar, *Remarks to the Securities Enforcement Forum 2014* (Oct. 14, 2014) (remarking that certain "due process concerns have heightened since the enactment of [Dodd-Frank]"). Respondents in administrative proceedings are, accordingly forced to defend themselves against sweeping charges and the specter of staggering liability without the most basic procedural protections that would be available in federal court.[8]

---

[8] For example, unlike in a federal proceeding, respondents in an administrative hearing generally are precluded from taking depositions, restricted to limited discovery, and may be found liable based on hearsay and other evidence that would be inadmissible in federal court. Moreover, even where respondents would be guaranteed the Seventh Amendment right to a jury trial in a federal trial, they are denied that right in an SEC administrative proceeding. These fundamental inequities are exacerbated by stringent timing rules that govern administrative proceedings. While the Division is free to conduct investigations over the span of several years, during which time it frequently amasses "evidentiary records spanning millions of pages and testimony gathered over several years"—just as it did here—respondents do not have access to those materials until *after* the Division institutes proceedings, at which point respondents have a woefully inadequate period of four months to prepare for trial. William McLucas & Matthew Martens, *How to Rein in the SEC*, Wall St. J. (June 2, 2015), *available at* http://www.wsj.com/articles/how-to-rein-in-the-sec-1433285747.

[Footnote continued on next page]

Given the startling absence of key procedural safeguards, it is no wonder that judges, commentators, government officials, and respondents alike have concluded that administrative proceedings raise "serious fairness issues." U.S. Chamber of Commerce, Ctr. for Capital Markets Competitiveness, *Examining U.S. Securities and Exchange Commission Enforcement: Recommendations on Current Processes and Practices*, at 17 (July 2015); *see also, e.g.*, Rakoff, *supra*, at 7. Indeed, when the Office of the Inspector General asked ALJs and other SEC staff "if they thought the system was slanted against defendants," some ALJs (including Your Honor), "identified possible systemic causes, including *de novo* review of decisions by the Commission," "the rules of practice," "limited access by respondents to discovery and the investigative file," and "truncated timelines." Memorandum from Carl W. Hoecker, Inspector Gen., to Mary Jo White, SEC Chair, Transmittal of Rep. of Investigation: Case No. 15-ALJ-0482-1, at 20 (Jan. 21, 2016).[9]

[Footnote continued from previous page]

As one commentator has noted, this process is akin to a 200-meter-race between two runners "where one of the runners—the SEC Enforcement Division—starts only fifty meters from the finish line while the other—the defense—is at the starting line." Ryan S. Stippich, *Constitutional and Strategic Considerations Regarding SEC Enforcement Actions Following Dodd-Frank*, Aspatore, 2016 WL 2989433, at *3 (Apr. 2016). The SEC's decision to finally amend its Rules of Practice "suggest[s] that the agency has, at long last, come to the recognition that is has overreached." Platt, *supra*, at 40. But the amendments, which will become effective on September 27, 2016, are "too little, too late." *Id.*

9 Given the exceedingly uneven playing field, it is unsurprising that the Division enjoys a much more favorable rate of success in administrative proceedings than in federal court—both in the initial proceeding and on appeal to the Commission. *See, e.g.*, Jean Eaglesham, *SEC Wins with In-House Judges*, Wall St. J. (May 6, 2015), *available at* http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803. Equally unsurprising, many respondents choose to settle rather than subject themselves to a proceeding in which the deck is stacked. *See, e.g.*, Bryan Mahoney, *SEC Could Bring More Insider Trading Cases In-House*, Law 360 (June 11, 2014), *available at* http://www.law360.com/articles/547183/sec-could-bring-more-insider-trading-cases-in-house (quoting SEC Director of Enforcement Andrew Ceresney as stating, "'there have been

[Footnote continued on next page]

In light of these procedural deficiencies, it is critical that Your Honor scrutinize the legal, evidentiary, and causal basis for the Division's massive disgorgement request in this case with great care. The disgorgement sought in this proceeding cannot stand up to this scrutiny.

B. The Division Should Be Precluded from Pursuing Legal Remedies Beyond The Scope Of Its Express Statutory Authority Under The Guise Of "Disgorgement."

The Division uses the façade of an "equitable disgorgement" to obtain what are, in substance, *legal* remedies: monetary penalties and restitution at law, as critics have noted. *See, e.g.*, Russell G. Ryan, *The Equity Façade of SEC Disgorgement*, 4 Harvard Bus. L. Rev. Online 1, 5-12 (2013). In doing so, it exercises its authority in a manner that exceeds Congressionally-delineated bounds. Your Honor should not permit this charade to continue in this case.

The equitable remedy of disgorgement is not subject to a statutory cap. In contrast, monetary penalties are subject to express maximums. 15 U.S.C. § 78u-2(b). If the Division obtains monetary penalties under the guise of "disgorgement," it is able to sidestep this critical statutory restraint on its authority. ALJs must therefore look beyond the Division's "labels" and analyze whether the remedy sought is equitable or punitive in substance. *See Collins Sec. Corp. v. SEC*, 562 F.2d 820, 825 (D.C. Cir. 1977) ("[O]ur sister circuits have repeatedly used language to the effect that orders issued by the Commission are intended to be remedial, not punitive. Such labels are likely to reflect conclusions rather than analyses."); *see also, e.g., SEC v. Jones*, 476 F. Supp. 2d 374, 386 (S.D.N.Y. 2007) ("[B]ecause disgorgement is remedial and not punitive, a court cannot order disgorgement above the amount wrongfully acquired."). If the amount of "disgorgement" sought is not tied to—or exceeds—a respondent's profits, the remedy

---

[Footnote continued from previous page]

a number of cases in recent months where we have threatened administrative proceedings[;] it was something we told the other side we were going to do, and they settled'").

is not equitable; instead, it constitutes a "punishment." *See, e.g.*, *SEC v. Wyly*, 56 F. Supp. 3d 260, 271 (S.D.N.Y. 2014).

Similarly, as a former Assistant Director of the Division of Enforcement has argued, the Division exceeds the scope of its statutory power by purporting to request disgorgement when, in substance, it seeks restitution at law. *See* Ryan, *supra*, at 5-12. To determine whether the Division seeks "truly equitable relief," the "starting point" should be the Supreme Court's decision in *Great-West Life & Annuity Ins. Co. v. Knudson*. *Id.* at 6 (citing *Great-West*, 534 U.S. 204 (2002)). There, the Court made clear that restitution *at law* encompasses cases in which the plaintiff seeks "a judgment imposing merely personal liability upon the defendant to pay a sum of money." *Great-West*, 534 U.S. at 213 (quotation marks omitted). Congress has *not* authorized the Division to seek restitution at law. *See* Ryan, *supra*, at 6-12 & n.67 (citing *Am. Bus. Ass'n v. Slater*, 231 F.3d 1, 8 (D.C. Cir. 2000) (Sentelle, J., concurring) ("[A] statutory silence on the granting of a power is a *denial* of that power to the agency.")); *accord La. Pub. Serv. Comm'n v. F.C.C.*, 476 U.S. 355, 374 (1986).[10] Yet that is what the Division seeks here.

C. The Division Has Failed to Establish an Evidentiary or Causal Basis For The Disgorgement Of The Subordinated Collateral Management Fees Or Preference Share Distributions.

Even if the Division were seeking an equitable monetary remedy here—and it is not—the Division's theory of disgorgement nevertheless would fail, as it is based upon the unreliable methodologies of unqualified experts, as discussed above. *See supra* Pt. III. The Division has

---

[10] In contrast, equitable restitution involves cases "where money or property identified as belonging in good conscience to the plaintiff [can] clearly be traced to particular funds or property in the defendant's possession," and the action generally does not seek "to impose personal liability on the defendant," but instead "to restore to the plaintiff particular funds or property." *Great-West*, 534 U.S. at 213-14.

offered no other grounds for obtaining such relief; it has placed all of its eggs in the Mayer-Wagner basket, and that basket is full of holes. The Division has, therefore, utterly failed to offer any "reasonable approximation" of profits caused by Respondents' purported misconduct. *See, e.g., SEC v. Adelphia Comm'n. Corp.*, 2006 WL 8406833, at *17 (S.D.N.Y. Nov. 16, 2006).

Mr. Mayer's "disgorgement" theory is entirely unreliable. Even Mr. Mayer opines only that "funds should not have been paid to Respondents" "*when the OC Ratio test was violated.*" Mayer Rebuttal 3 (emphasis added). No one disputes that Respondents received fees and preference share distributions; the dispositive question is whether they received them *improperly*. Mr. Mayer's reports offer no insight on that critical question—nor could he—outside of his flawed analysis of the OC Ratio. Mr. Mayer claims in his rebuttal that under his analysis, the "OC Ratio tests failed during *each*"—that is, *independent*—"reporting period beginning in July and June 2009." *Id.* at 4 (emphasis added). But even on its own terms, Mr. Mayer's analysis fails, because Mr. Mayer would have to calculate the OC Ratio over multiple periods (to determine when fees were "improperly" paid) and the outstanding amount of Class A Notes (the key component of the OC Ratio's denominator) in any given period is *necessarily* dependent on repayments of Class A Notes in periods immediately preceding.

Mr. Mayer admits that he did not perform a multi-period analysis of the OC Ratio. Instead, he claims in his rebuttal report that a multi-period analysis is unnecessary because he is merely conducting a "disgorgement" analysis. *See* Mayer Rebuttal 3. According to Mr. Mayer, because the Division seeks "disgorgement" of "actual payments made due to Respondents' actions and omissions," *id.* at 3, he need not analyze the dependence between OC Ratios of different periods. But merely labeling his analysis as one of "disgorgement" does not

cure the defects detailed above, and because Mr. Wagner's report hinges upon Mr. Mayer's flawed analysis, Mr. Wagner's analysis fails, too.

The Division has, therefore, utterly failed to offer any "reasonable approximation" of profits caused by Respondents' purported misconduct. *See, e.g.*, *Adelphia Comm'n. Corp.*, 2006 WL 8406833, at *17 (holding that the SEC had "failed to demonstrate the receipt of profits or other benefits [was] causally connected to the violation"); *SEC v. Kelly*, 765 F. Supp. 2d 301, 325 (S.D.N.Y. 2011) (denying the SEC's request for disgorgement where it had "proffered no evidence [that the] Court could use to reasonably approximate the percentage of [defendants'] compensation that was casually connected to the alleged violations").

Under these circumstances, disgorgement of $208 million in subordinated collateral management fees and preference share distributions would amount to an improper penalty, beyond the scope of the Division's power. *See SEC v. McCaskey*, 2002 WL 850001, at *8-10 (S.D.N.Y. Mar. 26, 2002) (holding that the SEC's theory of disgorgement was "not appropriate" where it would "work a punishment, contrary to well-settled law"); *see also Wyly*, 56 F. Supp. 3d at 271 ("Here, the SEC's proposed disgorgement does not appear to arise from the violations and therefore smacks of punishment, not equity or deterrence."). Such a result cannot stand—especially where, as here, the deck is already stacked in the Division's favor.[11]

---

[11] Because disgorgement is an equitable remedy, any disgorgement must take full account of all equitable considerations. If the disgorgement claim is not stricken altogether—which, as described above, it must be—Respondents will detail such equitable considerations in a future submission.

CONCLUSION

For the foregoing reasons, Respondents respectfully request that the expert reports of Michael G. Mayer and Ira Wagner be stricken in their entirety, that they be precluded from testifying at the upcoming hearing, and that the Division be precluded from seeking disgorgement.

* * *

Rule 154(c) Certification: Undersigned counsel certifies that this omnibus brief in support of three motions contains 7297 words and therefore complies with the length limitations set forth in Rule 154(c).

Dated: New York, New York
August 31, 2016

GIBSON, DUNN & CRUTCHER LLP

By: Randy M. Mastro /mc
Randy M. Mastro
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