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

REPLY MEMORANDUM OF LAW IN FURTHER SUPPORT OF RESPONDENTS' MOTION *IN LIMINE* TO PRECLUDE TESTIMONY AND EVIDENCE REGARDING THE SUBJECTIVE STATES OF MIND OF ZOHAR FUND INVESTORS

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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 reply brief in further support of their motion *in limine* to preclude the Division of Enforcement (the "Division") from introducing evidence of, asking questions about, or soliciting testimony regarding the subjective states of mind of investors in the Zohar funds.

INTRODUCTION

The Division's Opposition brief, for all its bluster, effectively concedes that investor testimony concerning Respondents' state of mind has no place in this case: the Division represents for the first time that that it "does not anticipate asking investors about Respondents' intent or state of mind," Division Opposition Brief ("Opp.") 1, and the Division does not dispute Respondents' contention that such testimony would be neither probative nor relevant. The Division should be held to its word.

Having made that concession, the Division nonetheless contends that it needs to elicit testimony concerning "what an investors [sic] viewed as important in making their [sic] decision to invest," among other "particularities of an investor-witness's investment in the Zohar funds." Opp. 1. The Division claims that such evidence will demonstrate the alleged materiality of information that was supposedly wrongfully withheld from investors. But, as the Division itself has previously argued, an investor's "subjective belief" about materiality is "irrelevant to the objective 'reasonable investor' standard." *SEC v. Radius Capital Corp.*, No. 2:11-cv-116-FTM-29DNF, 2013 WL 298209, at *5 (M.D. Fla. Jan. 25, 2013). The Division attempts to sidestep this inconvenient double-standard, citing cases permitting investors to testify about the materiality of objective, historical facts in existence at the time of their initial investment. But such cases are inapposite here, where the Division proposes to ask speculative and prejudicial

"if-you-had-known" questions that would function as a back-door route to the very testimony concerning Respondents' state of mind that the Division purports to disclaim. The Division should instead rely on the probative, reliable evidence bearing on the materiality or immateriality of any alleged fraudulently withheld information that the Division and Respondents have at their disposal, such as evidence that the investors did not pull out of their investments upon learning the allegedly withheld information the Division claims was material.

Finally, the Division contends that investor state of mind testimony should not be precluded because it may prove useful for rebutting one of Respondents' potential affirmative defenses. This argument is unavailing. As with the Division's argument concerning materiality, it is a back-door attempt to elicit improper and irrelevant evidence. The mere *potential* assertion of an affirmative defense that might put some part of investors' subjective understanding at issue—namely, whether they were aware of Respondents' exercise of authorized discretion—does not preemptively open the door to any and all evidence concerning investors' state of mind in the Division's case-in-chief. Moreover, even in the event Respondents do end up offering evidence of what investors knew as a matter of fact to show that the investors were not misled, that would not in any way open the door to all evidence of investors' subjective views of the investments or of Respondents. Accordingly, Your Honor should preclude the Division from introducing investor state of mind evidence in its direct case. To the extent Respondents introduce evidence regarding what the investors actually knew (vis-à-vis evidence regarding what information was provided or otherwise available to the investors), Your Honor can permit the Division to offer such rebuttal evidence as Your Honor deems appropriate.

ARGUMENT

I. The Division Concedes That Investors Cannot Properly Testify Concerning Their Own Subjective Belief As To *Respondents'* Intent or State of Mind.

At the outset of its Opposition, the Division represents, for the first time, that it "does not anticipate asking investors about Respondents' intent or state of mind." Opp. 1. Moreover, the Division's Opposition nowhere contends that such testimony would be relevant or probative. In short, the Division tacitly concedes that, as argued in Respondents' opening brief, investor testimony concerning investors' subjective opinions or beliefs about Respondents' intent or state of mind would be irrelevant and non-probative as to the allegations at issue and the sanctions sought in this action. Accordingly, for the reasons articulated in Respondents' opening brief, Your Honor should hold the Division to the position it articulates in its Opposition and preclude the Division from introducing evidence of, asking questions about, or soliciting testimony regarding Zohar fund investors' subjective opinions or beliefs about Respondents' mental state.[1]

II. Investors' Testimony Concerning Their Own Subjective States of Mind Would Not Be Relevant or Probative of Materiality under the Objective "Reasonable Investor" Standard.

The Division further represents in its Opposition that it "intend[s] to elicit testimony on the particularities of an investor-witness's investment in the Zohar Funds," since such testimony would supposedly be relevant and probative of materiality. Opp. 1. The Division does not

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[1] Confusingly, the Division spills much ink purporting to distinguish the cases Respondents cite on this point, all the while conceding the proposition for which they were cited—*i.e.*, that investors' opinions or beliefs about Respondents' intent or state of mind are irrelevant. *Compare* Respondents' Opening Br. 3 (citing four cases suggesting that "*investors'* states of mind are wholly irrelevant" to "*Respondents'*" state of mind), *with* Opp. 8-11 (contending that these cases have "nothing to do with the case at bar" because, even though they address the irrelevance and lack of probity of testimony speculating as to the defendant or respondent's state of mind, they allegedly fail to demonstrate the much broader point that "investors cannot opine on their investment").

dispute that it has argued in other cases that testimony concerning an investor's "subjective belief" about materiality is "irrelevant to the objective 'reasonable investor' standard." *Radius*, 2013 WL 298209, at *5 (citing SEC's filing, Dkt. 147, at 14-15 (stating that investor witness's "declaration, which purports to express his subjective belief, is irrelevant to the question of materiality, which is an objective inquiry as to whether a 'reasonable investor' would consider the information important")).[2] Nor can the Division now dispute that, ultimately, "materiality is determined based upon the 'reasonable shareholder,' not on the subjective views of individual investors." *In re Piedmont Office Trust, Inc. Sec. Litig.*, 264 F.R.D. 693, 701 (N.D. Ga. 2010) (explaining why "the amount of knowledge held by different class members is irrelevant to the determination of whether individual or class issues predominate with regard to the materiality of the alleged omissions" in securities class action).

Of course, even under the objective "reasonable investor" standard, evidence regarding relevant, objective historical facts such as what documents investors received from Respondents and what information Respondents conveyed to investors during meetings (and that otherwise meets the requirements for admission under the Rules of Practice) is admissible, as Respondents noted in their opening brief. Opening Br. 7. Likewise, objective historical facts such as communications between Patriarch and its investors, including, *e.g.*, any requests for information made by investors and received by Patriarch, may be relevant to the Division's allegations

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[2] In their Opposition, the Division points out that in *Radius*, the Court determined (over the Division's strenuous protest) that the defendant, through an investor declaration, created a genuine issue of material fact as to materiality. Opp. 6. But the *Radius* court did not explain whether the investor declaration created an issue of material fact (a) by describing objective events (such as whether investors ever asked for the information allegedly wrongfully omitted in that case) or, instead, as the Division would have it here, (b) by describing the investor's subjective opinions about whether the information seemed material to him.

concerning the supposed materiality of the information allegedly sought. The same goes for actions taken (or not taken) by investors upon learning information they allege should have been disclosed to them earlier—*e.g.*, adjustments to investors' internal risk assessment modeling or valuations, or the withdrawal (or non-withdrawal) of moneys invested in the funds. Indeed, most of the investor testimony at issue in the cases the Division cites concerns such objective historical events and other objective, probative indicia of materiality. *See, e.g., In re Loewen Grp Inc. Sec. Litig.*, 395 F. Supp. 2d 211, 217 (E.D. Pa. 2005) (discussed at Opp. 4) ("On both of the disclosure dates cited by the plaintiffs, the price of TLGI stock dropped significantly and trading volumes rose appreciably. Because actual investors reacted to these disclosures, I find that a reasonable investor would be interested in knowing whether TLGI was earning money or losing it. Therefore, the failure to report imputed interest is not immaterial as a matter of law."); *United States v. Reyes*, 660 F.3d 454, 469 (9th Cir. 2011) (addressed at Opp. 5) (explaining that investors' decision to sell their shares after learning allegedly omitted information, as recounted in their testimony, evidenced materiality).[3]

Despite these alternative sources that are probative of materiality, as well as the possibility of expert testimony on the reasonable investor standard, the Division represents that it

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[3] Many of the remaining cases the Division cites address investor testimony only in dicta, if at all. *See, e.g.*, Opp. 5 (citing *United States v. Schlisser*, 168 Fed. Appx. 483, 485 (2d Cir. 2006) (explaining, in non-precedential summary order, that introduction of non-investor testimony did not violate defendant's Confrontation Clause rights, but that, assuming it did, its introduction would be harmless error since it concerned materiality and so did expert witness testimony and the testimony of an investor); *Eisenberg v. Gagnon*, 766 F.2d 770, 780-781 (3d Cir. 1985) (noting that non-investor lawyer and former employee of defendant firm testified against his own interest that offering memoranda he had been charged with ensuring complied with disclosure obligations, in his opinion, had in fact not been in compliance with disclosure obligations)).

needs to elicit testimony concerning "what an investors [sic] viewed as important in making their [sic] decision to invest." Opp. 1. Crucially, the Division fails to articulate what such testimony would supposedly add (other than prejudice to Respondents and waste of judicial resources) beyond the more reliable objective indicia of materiality or immateriality described above and prevalent in the case law. *See* Rule 320 of the U.S. Securities and Exchange Commission Rules of Practice, 17 C.F.R. § 201.100 *et seq.* (the "Rules") (hearing officer "*shall exclude* all evidence that is irrelevant, immaterial, unduly repetitious, or unreliable") (emphasis added); Rule 300 ("All hearings shall be conducted in a fair, impartial, expeditious and orderly manner.").

In this context, it is both notable and troubling that the Division relies primarily on case law concerning "if-you-had-known" questions addressing investors' initial decisions to invest. Opp. 4, 6-7 (citing *Riad*, Release No. 4420A (July 7, 2016); *FundamentalPortfolio Advisors, Inc.*, Release No. 2146, 80 SEC Docket 1851, at *12 (July 15, 2003); *United States v. Laurienti*, 611 F.3d 530, 549 (9th Cir. 2010)). Those cases do not apply here, where the OIP does not allege that Respondents fraudulently induced reliance at the time of initial contracting. *Cf. United States ex rel. O'Donnell v. Countrywide Home Loans, Inc.*, 822 F.3d 650, 662 (2d Cir. 2016) ("a contractual promise can only support a claim for fraud upon proof of fraudulent intent not to perform the promise at the time of contract execution"). Moreover, such lines of inquiry would be extraordinarily speculative and prejudicial, and would be impossible to disprove by cross-examination or other methods because they ask a witness to testify as to his or her own subjective state of mind years in the past. They would also call for speculation by investors about the Respondents' state of mind, which the Division rightly intends to avoid (*see supra* Pt. I), along the lines of: "Would you have invested in the Zohar Funds if you had known that Respondents planned to induce your reliance and later (allegedly) not provide you with X & Y

information?" These are a far cry from the sorts of questions about objective historical facts existing at the time of investment, including actual investment decisions—rather than subjective state of mind—permitted in the cases on which the Division relies. *Cf.* Rules 300, 320; Federal Rule of Evidence 403.

The Division should be precluded from introducing evidence of, asking questions about, or soliciting testimony regarding the subjective states of mind of investors in the Zohar funds because such testimony is unreliable and non-probative as to materiality under the objective reasonable investor test.

III. The Mere Potential Assertion Of An Affirmative Defense Implicating Evidence Of Information Investors Received, As A Matter of Objective Historical Fact, Does Not Preemptively Open The Door To Any And All Investor State Of Mind Evidence.

The Division asserts that, since "Respondents claim that investors knew about the categorization method employed by Patriarch," the Division must be allowed to put on investor state of mind testimony "to refute this defense." Opp. 5. Respondents do not dispute that the Division should be permitted to cross-examine investor witnesses and otherwise attempt to rebut any affirmative defenses put forth by Respondents. But this does not mean the Division is free to proactively put forth—in its case-in-chief—any and all evidence concerning "investors' subjective understandings of the operation of the Zohar Funds, and whether Respondents' conduct was consistent with that understanding," Opp. 5, without regard to whether it rebuts any evidence actually put forth by Respondents in support of their affirmative defense. *See, e.g.*, *Snake River Valley Elec. Ass'n v. PacifiCorp*, 357 F.3d 1042, 1046 (9th Cir. 2004) (approving district court's grant of motion *in limine* to exclude evidence "relevant only to rebut a defense," where motion was granted "without prejudice to [non-movant's] right to proffer the evidence during trial if the door is opened") (internal quotation marks omitted). Respondents may introduce evidence of their communications with investors, including disclosures provided to

investors—*i.e.*, evidence of objective, historical events that show investors "were aware that Ms. Tilton was applying her discretion," and that "Patriarch was authorized to exercise and would be exercising discretion." Opp. 5 (quoting Respondents' Motion for Summary Disposition). Such evidence, to the extent it is introduced, would not open the door to investor testimony concerning investors' own subjective states of mind (as opposed to evidence concerning the information that was, as a matter of objective historical fact, provided to them). In short, the mere potential assertion of an affirmative defense that might put disclosures to investors or, put another way, some part of investors' knowledge at issue does not preemptively open the door to any, let alone all, evidence concerning investors' state of mind in the Division's direct case.

IV. If This Motion Is Denied, Respondents Will Need Additional Discovery.

In the event Respondents' motion is denied, it is imperative that Respondents be allowed additional discovery concerning, at the very least, the institutional knowledge and position of each of the 10 investor witnesses the Division lists on its Witness List, and the relevant decision-making and information-disseminating processes at the institutions they purport to represent, from the lead-up to initial investment in the Zohar funds to the present. As is evident from the testimony the Division has previously elicited from these potential witnesses, these individuals purport to speak on behalf of large, sophisticated financial institutions (Barclays, Rabobank, etc.) that have multi-tiered risk analysis divisions and multiple independent methods of researching, valuing, and monitoring potential and existing investments—divisions and methods to which only certain people within the company are privy.[4] It would be both inefficient and prejudicial

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[4] Varde's response to Respondents' subpoena likewise illustrates the complex and multi-faceted nature of the relevant institutions' investment evaluations and related analyses. Varde claims, for example, that it would be "overly burdensome" to provide information

[Footnote continued on next page]

for Respondents, each time an investor witness purports to speak to the subjective state of mind of the institution—encompassing numerous other individuals and divisions within the investor witness's institution that are disseminating information and making decisions in accordance with the institution's complex systems and decision-making processes—to have to evaluate and attempt to establish via cross-examination alone whether the witness is sufficiently familiar with, and accurately represents, the state of mind of the institution, including those other individuals' and divisions' thoughts and opinions.

[Footnote continued from previous page]
concerning "the values [Varde] assigns to actual and potential investments, and its methods for pricing, valuing, analyzing, and monitoring those investments," and that doing so would necessitate disclosure of "proprietary model information." Non-Party Varde Partners, Inc.'s Reply to Respondents' Opposition to Motion to Quash Subpoena, dated Aug. 19, 2016, at 2, 6.

CONCLUSION

For the foregoing reasons, Respondents respectfully request that the Division be precluded from introducing evidence of, asking questions about, or soliciting testimony regarding the subjective states of mind of investors in the Zohar funds in its case-in-chief.

Dated: New York, New York
September 1, 2016

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CERTIFICATE OF SERVICE

I hereby certify that I served a true and correct copy of Reply Memorandum of Law in Further Support of Respondents' Motion *In Limine* to Preclude Testimony and Evidence Regarding the Subjective States of Mind of Zohar Fund Investors, on this 1st day of September, 2016, in the manner indicated below:

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