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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-16462

In the Matter of **LYNN TILTON;** **PATRIARCH PARTNERS, LLC;** **PATRIARCH PARTNERS VIII, LLC;** **PATRIARCH PARTNERS XIV, LLC;** **AND** **PATRIARCH PARTNERS XV, LLC,** **Respondents.**	**DIVISION OF ENFORCEMENT'S OPPOSITION TO RESPONDENTS' MOTION IN LIMINE TO PRECLUDE EVIDENCE CONCERNING RECKLESSNESS AND NEGLIGENCE AND TO REQUIRE THE DIVISION TO PROVE INTENTIONAL MISCONDUCT**

Introduction

Respondents seek to preclude the Division from introducing "evidence concerning recklessness or negligence and to require the Division . . . to prove intentional misconduct" in order to prevail on its claims. (Memorandum of Law ["MOL"] at 1). Premised on the dubious claim that Respondents did not know that the Division is proceeding on a theory of liability that includes negligent or reckless conduct, Respondents' motion *in limine* ("Motion") is constructed from just two instances of the use of the word "intent" or "intentional" in the seventy-six paragraph Order Instituting Proceedings ("OIP"). The Motion is meritless. The OIP unequivocally alleges violations of provisions of the Investment Advisers Act of 1940 ("Advisers Act") that require only a showing of negligence or recklessness. Respondents have been on notice of these charges for nearly 18 months. Additionally, the Division's allegations overtly support negligence and recklessness-based theories of liability. Moreover, courts that have considered the issue have consistently held that when intentional conduct has been alleged, lesser culpability standards have

also been sufficiently alleged. Because the Division has adequately notified Respondents of the basis of its claims, the motion *in limine* should be denied.

Argument

I. Respondents Have Been On Notice of the Commission's Allegations Since At Least March 2015.

The Division made explicit that it was bringing charges under Sections 206(1), 206(2), and 206(4) of the Advisers Act: "As a result of the conduct described above, Respondents willfully violated Sections 206(1), 206(2), and 206(4) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser." OIP, ¶ 74. The level of scienter required to prove violations of Sections 206(1), (2), and (4) of the Advisers Act is well-settled and not controverted. Negligent conduct is actionable under Sections 206(2) and Section 206(4). *See, e.g., SEC v. Treadway*, 430 F. Supp. 2d 293, 338 (S.D.N.Y. 2006); *SEC v. C.R. Richmond & Co.*, 565 F.2d 1101, 1105 (9th Cir. 1977). Recklessness satisfies the scienter standard under Section 206(1). *SEC v. Steadman*, 967. F.2d 636, 641 (D.C. Cir. 1992).

Additionally, the term "fraud," which is used in the OIP, by and of itself does not denote a particular scienter requirement. A provision of federal securities laws that can be violated through negligent conduct can still be an antifraud provision. *See, e.g., Vernazza v. SEC*, 327 F.3d 851, 859, *amended* 335 F.3d 1096 (9th Cir. 2003) ("The Commission found . . . fraud in violation of the Advisers Act § 206(1) and (2)"). In addition to the provisions of Section 206 of the Advisers Act, the federal securities laws contain other non-scienter based fraud charges, notably, Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 ("Securities Act"). *Aaron v. SEC*, 446 U.S. 680, 695-697 (1980).

II. The Division Has Alleged Facts That, on Their Face, Support a Negligence and Recklessness Claim.

Contrary to Respondents' assertions, the Division has more than adequately alleged facts supporting negligent conduct. Respondents repeatedly cite to two—the only two—uses of the terms "intent" or "intentional" to support their unfounded contention that Respondents are not on notice that the Division will attempt to prove negligence as a basis for liability in its case.[1] Although the Division does intend to prove scienter in connection with the allegations in the OIP, as in any case, the evidence is subject to interpretation by the finder of fact. Moreover, to assert that allegations in the OIP on their face could not support a finding of negligence—or put Respondents on notice that negligence is in play—strains credulity. *See, e.g.*, OIP ¶ 45 ("[I]nvestors were not informed about the decline in value of the Funds' assets . . . ."); *Id.* ¶ 67 ("Patriarch has no procedures in place to analyze future collections and no such analysis occurred."); *Id.* ¶ 49 ("Investors have not been told that the OC Ratio test would have failed . . .").[2] These types of allegations clearly support a finding of negligence. Even if the conduct at issue was not intentional (a point that the Division does not concede), Respondents failed to exercise reasonable care in their communications with investors regarding the categorization of collateral,

[1] Contrary to Respondents' assertions, *see* MOL at 3, the Division does not spend 22 paragraphs discussing Tilton's improper collection of management fees. Improper collection of fees is mentioned in paragraph 6, the heading just before paragraph 29, and one other time, in paragraph 44.

[2] The Division does not concede that these particular statements do not support a finding of intentional conduct or that these are the only allegations that support a negligence or recklessness-based claim, but rather offers them as illustrative of the types of allegations made in the OIP—allegations that also support a negligence-based theory.

the value of the Fund assets, and their preparation of their financial statements, in addition to the other matters alleged in the OIP.[3]

Finally, the same allegations that can be used to support a scienter-based fraud claim, can also be used to support a negligence-based fraud claim. *See SEC v. Mannion*, 789 F. Supp.2d 1321, 1340 (N.D. Ga. 2011) (Plaintiff's motion to dismiss claim under Section 206(2) denied after Division asserts that same allegations used to prove intentional misconduct also establish a negligence-based claim). The ultimate import of the Division's allegations will be measured by the factfinder against the applicable standard of care.

III. Because the Division Alleged Intentional Misconduct, it also Alleged Both Reckless and Negligent Misconduct.

Respondents concede that the Division has alleged intentional misconduct. (Motion at 1). The case law interpreting this issue is clear: because intentional misconduct has been adequately pled, the lesser scienter standards of recklessness and negligence are also adequately pled. *See, e.g., SEC v. Nacchio*, 438 F. Supp.2d 1266, 1283 (D. Colo. 2006). In *Nacchio*, several defendants moved to dismiss the Commission's claims under Section 17(a) of the Securities Act, specifically moving to dismiss negligence-based claims under 17(a)(2) and 17(a)(3), claiming that negligence was not separately pled. Like Section 206 of the Advisers Act, provisions of Section 17(a) can be proven with either scienter (Section 17(a)(1)) or negligence (Sections 17(a)(2) and 17(a)(3)). The *Nacchio* court rejected defendants' arguments that the SEC failed to "plead the lesser negligence requirement" of the 17(a)(2) and 17(a)(3) claims because the complaint adequately pled "scienter against each Defendant under the more rigorous scienter standards associated with" the Section 17(a)(1) claims. *Id.*

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[3]Negligence requires a showing that the defendant failed to exercise reasonable care. *Dennis J. Malouf*, SEC Release No. 4463, 2016 WL 4035575 at *11 fn. 74 (July 27, 2016).

Likewise, a district court, when ruling on a motion *in limine* similar to the one at issue here, stated that "[w]hen a complaint alleges a fraud claim that legally can be based on a finding of negligence, that is more than sufficient to put a defendant on notice that negligence is part of the lawsuit." *SEC v. Life Wealth Management*, 2013 WL 1660860 at *4 (C.D. Cal. 2013). The court noted, as is the case here, that because the Division had alleged "since the beginning of this litigation that Defendants violated Section 206(2) of the Investment Advisers Act," there was not support in the record for Defendants' argument that negligence had never been alleged. *Id.* *See also Mannion*, 789 F.Supp.2d at 1340 ("[T]he allegations that Defendants intentionally deceived the Fund . . . also reasonably support the inference that Defendants did not take reasonable care to fairly value [Fund] assets. . .."); *Morris v. Wachovia Securities*, 277 F.Supp. 2d 622, 644-45 (E.D. Va. 2006) (Refusing to dismiss a claim under Section 206(2) of the Advisers Act where plaintiff alleged "actions [that] were reckless or knowing, states of mind more culpable than the negligence required under § 206(2).").

As noted above, the Division has explicitly alleged violations of Sections 206(1), 206(2), and 206(4) of the Advisers Act from the institution of these proceedings. Respondents acknowledge that the Division has alleged intentional misconduct. By virtue of charging statutory provisions that allow for negligence or recklessness to serve as the basis of a violation, the Respondents are on notice that the Division may seek to prove its case based on negligence or recklessness.

IV. The Division Is Not Proceeding On A New Theory of Liability

The Respondents' motion argues that the Division is somehow changing its legal argument. This is patently untrue—the Division has not amended its OIP to change the facts or the legal

violations alleged. As noted above, from the outset, the Division has alleged violations that do not require a showing of intentional misconduct.

As such, the cases relied upon by Respondents do not apply. Respondents citation to *Albert Glenn Yesner, CPA*, Administrative Proceedings Release No. 42030, 70 S.E.C. Docket 2076 (Oct. 19, 1999) does not support their arguments. That is because Yesner moved for summary disposition on the Division's charges under a provision of Rule 102(e) of the Commission's Rules of Practice after a decision by the D.C. Circuit Court of Appeals in another matter that called into question the culpability standard required under this provision. *Id.* at *2. In response to this ruling, the Commission amended this provision of Rule 102(e) to clarify that negligence or intentional misconduct could be the basis for a claim. In *Yesner*, the Commission informed the Respondent that it would conduct any review using the "intentional, knowing, or reckless" standard because the Division had told the Respondent that it would proceed under that standard. *Id.* at *2. Here, unlike *Yesner*, there is no ambiguity about the standard required to establish a violation of Section 206 and, also unlike *Yesner*, the Division has made no representations of any type that only an intentional scienter standard would apply. To the contrary, as noted above, by alleging violations that can be proven through negligent or reckless conduct, the Division has clearly communicated its intent.

Respondents' reliance on *Pierce v. SEC*, 786 F.3d 1027 (D.C. Cir. 2015), for the proposition that the Division is seeking to act outside the scope of the OIP, is similarly misplaced. In that case, the Respondent argued that where the Commission had instituted a proceeding against him, a second Commission action against him violated the doctrine of *res judicata*. The Court ruled in favor of the Commission on the basis that the second action was necessary due to evidence that had not been discovered at the time of the OIP. Here, the Division has not alleged different or

additional facts or changed its legal theory since the OIP was instituted and thus, is not seeking to act beyond the original order.

Finally, Respondents cite to *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), to support the proposition that a plaintiff cannot shift from a theory of intentional misconduct to negligence during the course of litigation. However, the plaintiffs in *Ernst & Ernst* alleged violations of Section 10(b) of the Securities Exchange Act of 1934, a provision that the Supreme Court determined in that case required a showing of scienter. The Supreme Court refused to allow the plaintiff to relitigate the entire case when the plaintiff had relied on only evidence of negligence from the outset. This is not the case here. The Division has alleged facts and law that support intentional, reckless, and negligent violations. The Division is not seeking to change its theory or relitigate the case.

Respondents also make the dubious claim that they will be prejudiced if the Division introduces evidence regarding the standard of care to prove a negligence claim, and then go on to speculate as to what the Division's evidence may look like, what their response would be, and assert that they would have to "scramble" to defend against a negligence theory. This argument is entirely without merit. (MOL at 7). In addition to having received the charging document seventeen months ago, Respondents have also already received the Division's expert reports, exhibit list, and witness list. They are fully capable of, and no doubt have already, reviewed those sources to see what evidence the Division has identified to support its allegations.

V. Briefing on Sanctions is Premature.

Respondents also raise the issue of sanctions, and assert that the scienter is relevant to the sanctions to be imposed. Respondents do not seek any relief on this point. Although the Division does not adopt Respondents' characterizations of the case law cited, discussion of this point is

premature. The Division will request appropriate sanctions based on the evidence presented in the proceeding. Respondents will have the opportunity to argue their position as well. Your Honor will, no doubt, take all relevant law and evidence into account when determining the sanctions to apply.

Conclusion

The Respondents have been on notice of the charges against them since March 2015. The Division has alleged facts that support charges of negligence, recklessness, and intentional misconduct, and is not seeking to add additional matters of law or fact to the OIP. The Division therefore respectfully requests that the Court deny the Respondents' Motion *in Limine* to Preclude Evidence Concerning Recklessness and Negligence And to Require the Division to Prove Intentional Misconduct.

Dated: September 2, 2016

Respectfully Submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true copy of the **DIVISION OF ENFORCEMENT'S OPPOSITION TO RESPONDENTS' MOTION IN LIMINE TO PRECLUDE EVIDENCE CONCERNING RECKLESSNESS AND NEGLIGENCE AND TO REQUIRE THE DIVISION TO PROVE INTENTIONAL MISCONDUCT** was served on the following on this 2 day of September, 2016, in the manner indicated below:

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(By Facsimile and original and three copies by UPS)

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