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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of, LYNN TILTON PATRIARCH PARTNERS, LLC, PATRIARCH PARTNERS VIII, LLC, PATRIARCH PARTNERS XIV, LLC and PATRIARCH PARTNERS XV, LLC Respondents.	:	Administrative Proceeding File No. 3-16462 Judge Carol Fox Foelak

REPLY MEMORANDUM OF LAW IN FURTHER SUPPORT OF RESPONDENTS' MOTION *IN LIMINE* TO PRECLUDE EVIDENCE CONCERNING RECKLESSNESS AND NEGLIGENCE AND TO REQUIRE THE DIVISION TO PROVE INTENTIONAL MISCONDUCT

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

INTRODUCTION

The Commission's OIP repeatedly and explicitly charges Respondents with engaging in "fraud" that was "intentional" and motivated by a desire to obtain illicit profits. The OIP nowhere states that the fraud alleged was anything less than intentional. Nonetheless, in its Opposition brief ("Opp.")—nearly 18 months since the OIP was filed, and less than 2 months away from the administrative hearing—the Division states *for the very first time* that it intends to proceed on theories of recklessness and negligence at the hearing. The Division attempts to downplay the significance of this last-minute change, portraying as commonplace the unprecedented theory of notice-by-silence on which it is based. According to the Division's novel proposal, when the Commission alleges securities law violations based on a particular theory, it is the respondents' burden to identify all the possible, un-pleaded theories of liability lurking beneath the surface, and prepare to defend against all of them.

The Division has it exactly backwards. As a matter of due process, binding case law, and the Division's limited role in carrying out the Commission's instructions in the OIP, it is the Commission's responsibility to adequately inform Respondents, through the allegations of the OIP, of any potential theories of liability, and the Division is bound to proceed only within the scope of the theories actually articulated by the Commission. The OIP here did not put

Respondents on notice that the Division would seek to prove anything less than intentional misconduct. The Division should therefore be precluded from introducing evidence concerning negligence or recklessness, and should be required to prove the intentional misconduct actually alleged in the OIP in order to prevail on any of the claims. The cases on which the Division relies say nothing to the contrary.

ARGUMENT

I. The Division Fails to Show That the OIP Authorized, Alleged, or Provided Notice of Recklessness or Negligence Theories of Liability.

The Division effectively acknowledges that the OIP focuses on allegations of intentional misconduct—*e.g.*, that it twice alleges that Respondents' alleged violations were *"intentional"* (and never once states that they were anything *less* than intentional), that it focuses on Respondents' alleged *motive* for committing intentional fraud, and that it uses the term *"fraud"* to describe Respondents' alleged misconduct. The Division mostly waives these inconvenient facts off, though it does pause to half-heartedly contend that the OIP's use of the term "fraud" does not imply any intent to defraud, and is instead consistent with a tacit assertion of negligence. The Division's supposed support for this assertion is *Vernazza v. SEC*, 327 F.3d 851 (9th Cir. 2013), *amended by* 335 F.3d 1096 (9th Cir. 2003). But *Vernazza* says nothing whatsoever about whether allegations of "fraud" contain tacit allegations of negligence, since in *Vernazza*, no negligence was ever alleged. *Id.* at 857-58 (holding that substantial evidence supported the Commission's "finding that petitioners acted with scienter" and accordingly upholding the Commission's sanctions decision). The case simply does not speak to the Division's contention that an allegation of fraud is consistent with or otherwise puts a respondent on notice of a negligence theory of liability.

The Division cannot identify any allegation in the OIP that actually references negligence or recklessness, because there is none. Nevertheless, the Division cites three instances in which the OIP purportedly provides notice of a negligence charge. Opp. 3. But the supposed examples do no such thing. Rather, each example alleges an intentional omission of material information for the purpose of defrauding investors, consistent with the OIP's intent-based theory of liability.

The Division first quotes OIP ¶ 45, which states, "Moreover, investors were not informed about the decline in value of the Funds' assets . . . ." Opp. 3. Not only is that statement plainly *not* an allegation of negligence; read in context with the sentences immediately preceding it, it clearly represents an allegation of *intentional* material omission—*i.e.*, an example of the OIP's allegations of intentional fraud. *See* OIP ¶¶ 44-45 ("Had Respondents appropriately classified the Zohar Funds' assets, Zohar II and Zohar III would have failed the OC Ratio test by at least the summer of 2009. Tilton's approach *allowed Respondents to collect or accrue almost $200 million* in Subordinated Fees and preference share distributions to which she was not entitled. *Moreover, investors were not informed* about the decline in value of the Funds' assets . . . .") (emphasis added). The Division's second supposed example of a negligence allegation comes a few sentences later in the OIP, makes exactly the same point, and is similarly an example of the OIP's intentional fraud theory (in the form of intentional material omissions), not an allegation of negligence. *See* Opp. 3 (citing OIP ¶ 49 ("Investors have not been told that the OC Ratio test would have failed . . . .")). The Division fails to explain how these allegations that Respondents omitted purportedly material information in their communications with investors in order to continue collecting illicit profits would put Respondents on notice of a negligence theory.

The Division's third and final example of its supposed allegations of negligence is likewise inapposite. The Division quotes OIP ¶ 67, which states that "Patriarch has no

procedures in place to analyze future collections and no such analysis occurred." Opp. 3. Not only does this not allege negligence, but in context it represents an elaboration on the OIP's fraud theory—namely, its allegation of intentional misrepresentation. *See* OIP ¶ 66-67 ("Even though Patriarch does not conduct an impairment analysis that complies with GAAP, Respondents tell investors that it does. . . . Patriarch has no procedures in place to analyze future collections and no such analysis occurred."). Again, the Division does not explain how such allegations, read in context, put Respondents on notice of a negligence theory.[1]

In short, as discussed in Respondents' opening brief, the OIP repeatedly alleges intentional fraud motivated by a desire to obtain illicit profits. The Division's citations to allegations of intentional omissions and misrepresentations utterly fail to demonstrate that the OIP somehow put Respondents on notice that the Division would proceed with a negligence or recklessness theory of liability.

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[1] The Division, citing *SEC v. Mannion*, 789 F. Supp.2d 1321, 1340 (N.D. Ga. 2011), additionally asserts that "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." Opp. 4. But regardless whether that is true in the abstract (and it is far from clear that it is, given that intent and negligence involve different kinds of evidence, *see* Opening Br. 7-8), the question here is whether the OIP put Respondents on notice that the Division was authorized to pursue a negligence theory. That issue was not raised in *Mannion*. Rather, the defendants in *Mannion* asserted that there was an "'inherent contradiction' in alleging that Defendants' conduct was both intentional and unintentional"—an argument that the court easily discarded given that "[t]he Federal Rules of Civil Procedure . . . permit plaintiffs to plead inconsistent claims." *Mannion*, 789 F. Supp.2d at 1340. Here, Respondents do not contend that there is any inconsistency or contradiction. To the contrary, Respondents here assert that the Commission's OIP is premised *solely on a theory of intentional fraud.*

II. The Division's Radical Theory of Notice-By-Silence Is Irreconcilable with Due Process, Governing Case Law, and the Limitations Placed on the Division by the Commission in the OIP, and the Case Law the Division Cites Is Inapposite.

Lacking any allegations of recklessness or negligence in the OIP, the Division argues that simply "Because the Division Alleged Intentional Misconduct, it also Alleged Both Reckless and Negligent Misconduct" sufficient to put Respondents on notice of those theories of liability. Opp. 4-5. In other words, the Division takes the incredible position that whenever the Commission alleges *intentional* misconduct, it has provided adequate notice that it will attempt to prove negligence. This novel notice-by-silence doctrine is irreconcilable with basic due process requirements, Opening Br. 5, flies in the face of Commission and U.S. Supreme Court precedent, *id.* at 6-7,[2] and would permit the Division to single-handedly introduce new theories of liability into this and virtually any case, freeing it from its properly limited role of agent bound by the scope of the Commission's instructions in the OIP, *id.* at 5. The Division would, in other words, arrogate to itself powers and authority that properly belong to the Commission, and in the

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[2] The Division's attempt to distinguish the cases that preclude its novel theory only reinforces their applicability here. *See* Opp. 6-7 (discussing *In re Albert Glenn Yesner, CPA*, Administrative Proceedings Release No. 42030, 70 S.E.C. Docket 2076 (Oct. 19, 1999); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976)). In *Yesner*, as the Division points out, the Division informed the respondent *during the course of litigation* that it would proceed on a scienter-based theory of liability, not negligence. *See* Opp. 6 (citing *Yesner*, at *2). The Division's argument presumes that a representation made during the course of litigation is somehow more weighty or binding than the OIP itself, but this has it precisely backwards: it is the OIP that defines the scope of the charges, providing notice to the respondent, and constraints on the Division's enforcement authority. *See* Opening Br. 5. Where, as here, the Commission's charging document provides notice only of a theory of intent-based liability, that should be treated as even more binding than would its mid-litigation representations. Likewise, in *Ernst*, the Court held the plaintiffs to the theory of liability they had adopted in representations made to defendants during the course of litigation. *See* Opp. 7. Where, as here, those representations regarding the level of scienter were made by the Commission in the charging document itself, the Division certainly cannot introduce a new theory of liability on the eve of trial.

process negate the limitations imposed on its enforcement authority by the Commission's Rules of Practice and by fundamental notions of fair notice. *See id.* 5-8.

The three federal district court cases the Division cites in support of its novel theory do not in fact support it. Most importantly, none involved—let alone decided—whether a charging document's allegations of intent implicitly charge non-intentional conduct as well for fair notice purposes. Instead, two examined whether a complaint stated a claim at all, even under an intent theory, where the pleading was deficient in some way. For example, in *Morris v. Wachovia Sec., Inc.*, 277 F. Supp. 2d 622, 644–45 (E.D. Va. 2003) (discussed at Opp. 5), the Virginia district court refused to dismiss a claim under Section 206(2) of the Advisers Act where plaintiff alleged "actions [that] were reckless or knowing." Likewise, in *SEC v. Nacchio*, 438 F. Supp.2d 1266, 1283 (D. Colo. 2006) (discussed at Opp. 4), the Colorado district court refused to dismiss a claim under Sections 17(a)(2)-(3) of the Securities Act of 1933, 15 U.S.C. § 77q(a), where the Commission alleged scienter-based liability. Respondents here do not dispute that Section 206(2) *can* be violated with scienter, and that the OIP's allegations of knowing misconduct state a claim for intentional fraud (though Respondents of course dispute that the Division will be able to prove its allegations). Respondents, however, dispute that the Commission's OIP alleges anything *other than* scienter-based theories of liability, and assert that the Division cannot now introduce new, non-intent theories, an issue to which neither *Morris* nor *Naccio* speaks.

The one decision the Division cites that did not involve a motion to dismiss for failure to state a claim—*Life Wealth Mgmt., Inc.*, No. CV 10-4769 RSWL, 2013 WL 1660860, at *4 (C.D. Cal. Apr. 17, 2013)—involved a complaint that clearly alleged in the alternative both a scienter-based and a non-scienter-based theory of liability. That is obviously a very different situation from the one presented here, where the OIP expressly charges intentional misconduct, and only

intentional misconduct. *See* First Amended Complaint, *S.E.C. v. Life Wealth Mgmt., Inc.*, No. CV 10-4769 RSWL, 2013 WL 1660860 (C.D. Cal. Apr. 17, 2013), Dkt. No. 7, ¶ 38 (explicitly alleging that defendants *either* acted "a. *with scienter*, employ[ing] devices, schemes, or artifices to defraud clients or prospective clients; ***or*** b. engaged in transactions, practices, or courses of business which *operated as* a fraud or deceit . . . .") (emphasis added). Indeed, in *Life Wealth Management*, it was clear that the defendant was on notice of the Commission's negligence theory because the defendants propounded an interrogatory, to which the Commission responded, requesting that the Commission "*identify all facts supporting your contention, if any, that the defendants acted negligently* with respect to the notes." *See id.* Dkt. Nos. 77, at p. 10 (defendants' Motion, quoting Interrogatory No. 18) (emphasis added), 87, at pp. 5-6 (Commission's Opposition brief, quoting Interrogatory No. 18 and the Commission's response to it). Here, the OIP contains no conspicuous non-scienter-based alternate pleading allegation, and no such acknowledgment during the early stages of discovery that the charging document had provided notice of a negligence theory of liability.

In short, the Division's cases fail to support its novel theory of notice-by-silence, according to which whenever the Commission chooses to expressly allege only intentional fraud in the OIP, respondents are thereby put on notice that the Division may also proceed on a theory of negligence nowhere addressed therein. The Division's approach, were it adopted here for the first time, would create a dangerous and expansive exception to the due process and fair notice requirements that underlie the Commission's enforcement authority. *See W. Pacific Capital Mgmt. LLC*, Administrative Proceedings Release No. 691, 102 S.E.C. Docket 3633, at *1 (ALJ Feb. 7, 2012) ("It is well-established that respondents in administrative proceedings are entitled

to be sufficiently informed of the charges against them so that they may adequately prepare their defense.").

Finally, the Division brushes aside Respondents' contention that Respondents would suffer prejudice if the Division were allowed to proceed on a new negligence or recklessness theory at this late date. After all, the Division reasons, Respondents "received the charging document seventeen months ago," and Respondents "are fully capable of, and no doubt have already, reviewed" the expert reports, exhibit lists, and witness lists that were recently produced to them. Opp. 7. This reasoning not only ignores the fact that "the charging document" expressly told Respondents that the Commission intends to proceed exclusively on an intentional fraud theory of liability; it also ignores the fact that Respondents must be allowed to effectively *respond* to the case that the Division puts forth, and are only now—after witness and exhibit lists are in and on the eve of trial—being informed that this case will apparently focus on recklessness and negligence if the Division is allowed the opportunity. This is prejudicial and inappropriate for all of the reasons discussed herein and in Respondents' opening brief (at 5-8). The Division should be held to the theory of liability espoused in the Commission's OIP.

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

The Division contends that the issue of available sanctions is "premature," and explains that the Division will "request appropriate sanctions based on the evidence presented in the proceeding," Opp. 7-8. The Division implicitly acknowledges that the level of scienter it seeks to prove will impact the sanctions available. Nonetheless, it has kept Respondents in the dark until now concerning its decision to attempt to prove negligence. The Division should not be afforded that opportunity, and should instead be held to the higher standard of proving intentional fraud, as alleged in the OIP.

CONCLUSION

For the foregoing reasons, Respondents respectfully request that the Division be precluded from introducing evidence concerning recklessness or negligence, and that the Division be required to prove intentional misconduct to prevail on any of the claimed violations in this matter, consistent with the allegations in the OIP.

Dated: New York, New York
September 8, 2016

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CERTIFICATE OF SERVICE

I hereby certify that I served true and correct copies of Reply Memorandum of Law in Further Support of Respondents' Motion *In Limine* to Preclude Evidence Concerning Recklessness and Negligence and to Require the Division to Prove Intentional Misconduct on this 8th day of September, 2016, in the manner indicated below:

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