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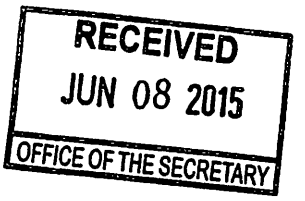
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION



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 Hon. Judge Carol Fox Foelak

MEMORANDUM AND POINTS OF AUTHORITIES IN SUPPORT OF RESPONDENTS' MOTION TO HALT THE DIVISION'S SEARCH FOR A SUBSTITUTE CASE FOR TRIAL

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PRELIMINARY STATEMENT

After more than five years of investigation, the Division of Enforcement recommended an administrative forum and obtained an Order Instituting Proceedings ("OIP") against Respondents on March 30, 2015. Yet as the October 13 trial date rapidly approaches, the Division trial attorneys recently assigned to actually try this case – who did not participate in compiling the investigative record underlying the OIP – have recognized that they have a problem. They have realized that the testimony and documents subpoenaed from a handful of investors cannot prove the Division's fraud-based claims in the OIP.

Thus, although the investigative file is supposed to have been closed following years of extensive investigation, the Division is now embarking on a remarkable effort to gather new investor evidence in order to develop a new case for trial. Last week alone, the Division contacted *fifteen* different Zohar investors never previously subpoenaed by the Division. The Division is not simply refining the pool of witnesses already identified and examined during the investigative phase. Rather, the Division is trying to build a different case for trial – separate and apart from the insufficient factual record developed before the OIP – from a wide group of investors ignored for five years. This is entirely improper and unfair.

As we noted to the Court in our letter of May 7, 2015, the Division should never have brought a case of this nature and complexity in an administrative forum requiring an expedited decision from Your Honor within 300 days. But now, having made that choice, the Division wants to change its case for trial. The Division's approach is fundamentally at odds with the traditional structure and rules of administrative proceedings, under which the investigative record must be closed at the point when the OIP is issued, in order to provide Respondents a meaningful opportunity to prepare for trial.

If there is to be any hope of a fair trial in this case, the Court must halt the Division's eleventh-hour attempt to find a substitute case for trial. It would be fundamentally unfair for Respondents to have to prepare for an October trial not only against the pre-OIP record but also against a totally new and fluid investigative record being developed as we speak.

FACTUAL BACKGROUND

The Investigation and OIP

The Division initiated its investigation in December 2009. (Gunther Decl. ¶ 2.) Over the course of more than five years, the Division's investigation included the collection of nearly 2.4 million pages of documents, sworn testimony from nineteen witnesses and dozens of informal witness interviews. (Gunther Decl. ¶ 3.) During its extraordinarily lengthy investigation, the Division explored and discarded a host of theories. Ultimately, the Division settled on an omissions-based fraud theory, as described in the OIP, that Respondents misled investors in the Zohar Funds by deliberately withholding information from its investors about the performance of the loans in its portfolio and its discretionary approach to classifying those loans. (OIP ¶¶ 1-6.) The case therefore necessarily turns on the information in the possession of, or available to, investors. However, in invoking its subpoena power to collect documents and take testimony, the Division chose to collect the documents of only five investors of the Zohar Funds, and collected a significant number of documents from only one investor, Natixis. (Gunther Decl. ¶ 4.) Over this same time period, the Division chose to take testimony from representatives of only three investors: MBIA, Barclays, and Rabobank, and to conduct only informal interviews of representatives of Natixis and Tokio Marine. (Gunther Decl. ¶ 5.) On March 30, 2015, the Commission, by a split 3-2 vote, and based on the investigative file as it existed at that time, authorized the OIP.

The Current Investigative Record

During a Pre-Hearing Conference on May 7, 2015, the Division noted that "[t]he allegations of the OIP indicate that *all investors* were defrauded in the same way." (Ex. 1 ("Pre-Hr'g Conference Tr.") 11:11-12 (emphasis added).)[1] Yet the record developed by the Division prior to the issuance of the OIP demonstrates that investors were aware of the performance of the Respondents' portfolio companies and the way in which Respondents classified those assets. For example, one of the three major investors interviewed by the Division responded to questions relating to the categorization of the funds' assets as follows:

> *Q. Do you have an understanding of when an asset is considered a category 4?*
>
> *A. My understanding is from what the indenture says what [sic] a category 4 should be. My understanding is that Lynn [Tilton] can decide what is a category 4 and she has some discretion to what to call [category] 4 whatever she wants.*

(Ex. 2 ("Aldama Tr.") 49:4-9 (emphasis added).)

Similar comments, showing that investors were aware of the categorization practices at the heart of the allegations in the OIP, are repeated throughout the testimony from the three investors questioned under oath by the Division, as well as in the documents collected by the Division and the Division's notes of informal interviews conducted prior to the OIP.[2] Based on that record, the Division would be unable to demonstrate any fraud by Respondents (because there was none), and would have no pool of investor witnesses to testify that they had been misled about or were unaware of the critical issues in this case.

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1 The Division said the same thing at page 5 of its opposition to Respondents' Motion for a More Definite Statement dated April 22, 2015. ("Respondents made the same core misrepresentations/omissions to every investor in the Zohar Funds.")

2 Deficiencies in the record developed prior to the OIP are described in detail in Respondent's Motion for Summary Disposition, filed separately today.

The Division Seeks to Develop Substitute Evidence

The Division recently assigned to this case two trial attorneys – Messrs. Dugan Bliss and Nicolas Heinke – who had not participated in the investor testimony gathered before the OIP. Given the unfavorable investigative record described above, trial counsel now wishes to embark on a new, wide-ranging series of contacts with Zohar investors.

The Division signaled this new investigation during the Pre-Hearing Conference with the Court on May 7, 2015, during discussion of Respondents' application for a more definite statement of the investors on whom the Division would rely at trial. (Ex. 1, 10-31.) Responding to Your Honor's questions as to when the Division could identify the investor witnesses, Mr. Bliss revealed for the first time that the Division was reopening its investigation by speaking to a "substantial number" of "additional investors" to determine which among this new crop of investors could be called to testify at trial. (*Id.* 22:5-24:13.) The Division reported that it planned to contact so many additional investors that its efforts could require three full months of work. (*Id.* 24:10-17.) The Court observed that "the Division is looking for, I guess, better witnesses" just ahead of trial. (*Id.* 30:22-23.) The Court cautioned the Division to proceed "certainly without investigative subpoenas, which would be not allowed by the Commission's rules at this point." (*Id.* 31:2-4.)

In an order following the telephone conference, the Court directed the Division to "notify Respondents on a rolling basis up to July 10, 2015, of additional investors that it contacts." (May 7, 2015 Prehearing Order.) The Division provided its first such rolling notification by letter to Respondents' counsel dated May 29, 2015. (Ex. 3.) The letter identified nineteen investors contacted by the Division in the prior week. (*Id.*) Of these, fifteen investors had never been subpoenaed previously during more than five years of investigation. (Gunther Decl. ¶ 9.) Thus, the Division now is seeking information from three times the number of investors that it

had subpoenaed during the entire five-year investigation, which was supposed to have been closed upon the issuance of the OIP on March 30, 2015. This, potentially only the first roll of the Division's rolling notifications, goes far beyond what the Respondents or Your Honor could have contemplated at the conference. The Division is clearly not simply refining the pool of witnesses identified and examined during the investigative phase of this matter. Rather, the Division is trying to develop new evidence to support a different case at trial, in order to avoid having to rely on the flawed factual record upon which its original recommendation for an OIP was based.

ARGUMENT

Rule 111(d) grants power to the hearing officer to "[r]egulat[e] the course of a proceeding and the conduct of the parties and their counsel." 17 C.F.R. § 201.111(d). As demonstrated below, the Division's significant efforts to gather new investor evidence, following the OIP, is at odds with the fundamental structure of administrative proceedings, as reflected in the Rules of Practice, as well as traditional notions of fairness and transparency. This Court should invoke its powers under Rule 111(d) to halt the Division's post-OIP search for a substitute case for trial.

I. THE DIVISION'S NEW INVESTIGATION CONTRAVENES THE SEC'S RULES OF PRACTICE.

Rule 230(g) directs hearing officers to prevent the Division from issuing investigatory subpoenas for the purpose of obtaining additional evidence following the institution of proceedings against a party. *See* 17 C.F.R. § 201.230(g). The purpose of this rule is "to assure that investigative subpoenas are not used for the purpose of gathering information for use in the proceeding." Rules of Practice, Exchange Act Release No. 35,833, 59 S.E.C. Docket 1170, 1995 WL 368865, at *55 (June 9, 1995). Your Honor recognized this principle during the Pre-Hearing

Conference on May 7, 2015, noting that "investigative subpoenas . . . would be not allowed by the Commission's rules at this point." (Ex. 1, 31:3-4.)

Judges of this Court have ruled that Rule 230(g) stands for a broader principle that evidence gathering by the Division must come before the OIP, not after. When the Division sought to use trial subpoenas to develop new evidence for trial, Chief Judge Murray barred the Division from doing so, explaining that "the import of the Commission's rules is that the Division's evidence gathering as to the issues in this proceeding should be concluded when the OIP issues. . . . [A]fter issuance of the OIP, all indications are that the investigative phase of the proceeding has ended." Order Following Prehearing Conference at 3, *In re OptionsXpress, Inc.*, No. 3-14848 (S.E.C. May 25, 2012). "The language of Rule 230(g) of the Commission's Rules of Practice make clear that the Division should not gather additional evidence after the Commission has instituted the proceeding at its recommendation." *Id.* at 3 n.4.

Similarly, another Judge of this Court ruled that the Division was barred from gathering additional evidence for use in a proceeding wherein the OIP had already been issued. *See* Order Addressing Issues Under Rule of Practice 230(g) at 4, *In re Morgan Asset Mgmt., Inc.*, No 3-13847 (S.E.C. July 12, 2010). The Court applied this rule even where the Division attempted to gather evidence seemingly in compliance with Rule 230(g) through the use of investigative subpoenas in a separate, related investigation. *Id.* The Court stressed the consequences of the issuance of an OIP before the Division fully develops the evidence that it intended to use at trial:

> [T]he Division elected to follow a high-risk strategy: it asked the Commission to issue the OIP before it had completed the relevant parts of its investigation. The Division is free to take this sort of risk, of course, but it cannot now ask for a ruling that, in effect, guarantees that it will suffer no adverse consequences.

Id.

The Court has broad authority to manage proceedings under Rule 111(d) and should use this power to forbid the Division from continuing its broad new investigation.

II. THE DIVISION'S IMPROPER SEARCH FOR A SUBSTITUTE CASE FOR TRIAL UPENDS THE ADMINISTRATIVE PROCEEDING PROCESS.

This backwards approach to the investigative process – filing an OIP first, then, subsequently, seeking investors to support a theory for trial – is inconsistent with standard practices involved in administrative proceedings. The breadth of the Division's investigative efforts following the OIP does not comport with the general approach that administrative proceedings should be fairly and promptly tried based on the record developed during the Division investigation prior to the OIP.

The Rules of Practice require the Division to provide to respondents "documents obtained by the Division prior to the institution of proceedings, in connection with the investigation leading to the Division's recommendation to institute proceedings." 17 C.F.R. § 201.230(a)(1). This illustrates that the Rules of Practice contemplate the cessation of the Division's investigative activity upon the institution of proceedings. Otherwise, any evidence gathered by the Division following the OIP need not be provided to respondents. This approach would incentivize the Division to present a case to the Commission based on as little information as possible, and then commence its true investigation after the OIP is filed and the allegations are made public. The Division may then go door-to-door with its OIP in hand asking investors whether, based on the Division's own theories, they feel aggrieved by Respondents.

The Division investigated for more than five years and cannot provide an explanation as to why it failed to interview these many investors until now. These investors were certainly within the ambit of the original investigative order. Moreover, the Division cannot provide an explanation as to why it chose to recommend proceedings before it had properly established the

evidence on which its allegations are based. Here the Division, as it has before, adopted "a high-risk strategy" and must live with the consequences. *In re Morgan Asset Mgmt., Inc.*, No. 3-13847, at 4. The Division can hardly show any prejudice in being limited to the existing investigative record and the investors already contacted, given the fact that it used that record to recommend that the Commission bring charges in the first place, as well as its repeated contention that "all investors were defrauded in the same way." (Ex. 1, 11:11-12.)

Further, the Division itself chose to bring this action as an administrative proceeding knowing full-well the accompanying expedited schedule. Prior to the OIP, Respondents in a Supplemental Wells Submission explained to the Division and to the Commission that any action should be brought in U.S. District Court precisely due to this very concern. (Gunther Decl. ¶ 10.) Having secured its chosen forum over Respondents' explicit objection, the Division must live with the procedural consequences.

III. THE DIVISION'S CONTINUED INVESTIGATIVE ACTIVITY JEOPARDIZES THE FAIRNESS OF THE ADMINISTRATIVE PROCESS.

Given the complexity of the facts at issue and the sheer number of individuals and entities involved in this matter, this case is, by its nature, inappropriate for the expedited schedule of administrative hearings. Putting aside the fundamental unfairness of the Division's five-year investigative power as compared to the limited subpoena power afforded to Respondents over a period of several months, the Division's continuing investigation alone poses a significant risk to the fairness and, in turn, the credibility, of these proceedings.

The reality of this case is that, absent intervention by this Court, the Division has a one-sided ability to explore new theories of investor harm, while Respondents have no parallel ability to meet any new investor case the Division chooses to construct for trial. The Zohar investors are all sophisticated financial institutions, often regulated by the Commission, with every

incentive to curry favor with the Commission by acceding to voluntary requests for information. By contrast, those same institutions have little or no incentive to provide information voluntarily to Respondents for a contested proceeding brought in the name of the Commission. Unlike a proceeding in U.S. District Court, Respondents have no ability to compel pretrial testimony from newly contacted investors without leave of this Court. While this Court can authorize Respondents to issue document subpoenas to third-party investors, there is no realistic hope for Respondents to complete such third-party document discovery from fifteen institutions (assuming that the Division does not continue to reach out to additional investors over the following weeks or months) on a schedule allowing for timely production of documents for an October trial, let alone conduct a meaningful review of such materials.

The questioning of nineteen investors more than a month after the OIP allows the Division to develop a new theory for trial. The Division's case-in-chief will continue to evolve as its informal investigation progresses. Yet Rule 103(a) holds that the Rules of Practice "shall be construed and administered to secure the *just*, speedy, and inexpensive determination of every proceeding." 17 C.F.R. § 201.103(a) (emphasis added). It is fundamentally unjust to require Respondents to shoot at a moving target, particularly where the investigative file is already voluminous and the Commission has imposed strict time limits for this Court to issue an Initial Decision. Given our trial date of October 13, 2015, and the current scope of third party discovery that needs to be completed to meaningfully address the Division's allegations, the addition of fifteen additional witness-entities – and perhaps more, depending on whether the Division is able to goad any favorable testimony from the current crop – is beyond unreasonable. Respondents must be protected from having to defend against a case which will otherwise continue to evolve until the very eve of trial in four months' time.

IV. REQUESTED RELIEF.

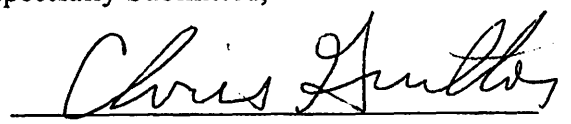
This Court should issue an order prohibiting the Division from gathering evidence from investors that were not subpoenaed for testimony or documents prior to the OIP. If the Division wishes to embark on a new investigation, it should withdraw the current OIP and resume its inquiry. It is imperative that this Court facilitate a fair adjudication of the allegations against Respondents and prevent the Division from investigating and litigating a substitute case created to address the shortcomings in its own investigative record.

CONCLUSION

For the foregoing reasons, Respondents respectfully request that the Court grant the relief requested herein.

Dated: June 5, 2015
New York, New York

Respectfully Submitted,

By: 

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