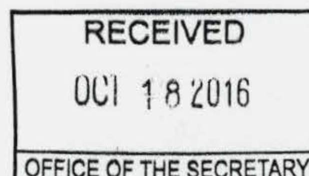
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION



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

RESPONDENTS' PRE-HEARING MEMORANDUM

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PRELIMINARY STATEMENT

This case should never have been brought. After a five-year investigation by the Division, and over the dissent of two commissioners, the Commission filed an Order Instituting Administrative Cease-and-Desist Proceedings ("OIP") grounded on two demonstrably false premises: *First*, that Respondents' method for categorizing assets—holding off on "assign[ing] a lower valuation category to an asset" until "[Lynn] Tilton subjectively decide[d] to stop 'supporting' the distressed company"—was "inconsistent with the categorization method set forth in documents governing the Funds," OIP ¶ 5; and *second*, that "Respondents have never disclosed Tilton's discretionary valuation approaches to the Funds or their investors," OIP ¶ 9. But as Respondents will prove at this hearing—and as the record already amply demonstrates—the Division's theory is wrongheaded and demonstrably false, rooted as it is in a fundamental misunderstanding of the design of the Zohars, the Division's willful blindness to the key terms in the Indentures, and its refusal to acknowledge exculpatory evidence, including Respondents' repeated disclosures to stakeholders.[1]

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[1] Zohar I, Zohar II, and Zohar III (the "Zohars") were each primarily governed by three agreements: an indenture, a collateral management agreement, and a collateral administration agreement. The Zohars' indentures (Div. Exs. 1-3) are collectively referred to herein as the "Indentures," and cited to as "Indenture § __." The Zohars' collateral management agreements (Div. Exs. 13-15) are collectively referred to herein as the "CMAs," and cited to as "CMA § __." The Zohars' collateral administration agreements (Respondents' ("Resp.") Exs. 7, 11, 17) are collectively referred to herein as the "CAAs," and cited to as "CAA § __." For ease of reference, when citing to or quoting the Indentures, CMAs, or CAAs, this brief quotes the Zohar II indenture (Div. Ex. 2), collateral management agreement (Div. Ex. 14), and collateral administration agreement (Resp. Ex. 11), unless otherwise noted. The Indentures, CMAs, and CAAs for Zohar I, II, and III are materially consistent, unless otherwise noted.

The simple truth is that Ms. Tilton had discretion under the governing agreements to categorize assets using subjective factors such as Respondents' continuing support for the companies that were included in the Zohars' portfolios (the "Portfolio Companies")—and to amend loan terms to avoid default—in order to effectuate turnarounds of the Portfolio Companies, ensure a return for noteholders, and maximize the portfolios' value. The Zohars were plainly and openly designed to confer such discretion on Ms. Tilton, who had to navigate these distressed companies through challenging industry cycles and market conditions. And disclosures were made monthly and quarterly to Zohar noteholders (or what the Division calls "Fund investors") that demonstrated that Patriarch was holding loans in "Category 4" (as non-defaulted loans), even when interest payments due were deferred.

The Division concedes that it can prevail only if its interpretation of the Indentures, and its non-disclosure allegations, are correct. *See, e.g.*, Div. Br. in Opp. to Respondents' ("Resp.") Mot. for Summ. Disposition, at 16-17 (June 26, 2015) ("Opp. to Summ. Disposition") (interpretation of the Indentures is "what this case is about"); Div. Br. in Opp. to Resp. Mot. for a More Definite Statement, at 4 (Apr. 29, 2015) ("Opp. Mot. More Definite Statement") (conceding that the Division "does not make any allegation that Respondents' subjective judgments relating to the portfolio companies were incorrect," only that *"investors were not aware* that Respondents were using subjective judgment, rather than disclosed, objective criteria, to categorize assets") (emphasis added). But instead of forthrightly acknowledging that its claims simply do not match the facts, the Division irresponsibly continues to accuse the Respondents here of securities fraud.

The Division's entire case rests upon its blind insistence that "[t]here is no reference in the indenture to any type of discretion for asset categorization," Opp. to Summ. Disposition, at 3,

which would make it improper for "Tilton [to] use[] her own subjective judgment" in that regard, *id.* at 1. But the problem with the Division's position is that it is flat-out wrong: in multiple respects, these Indentures (as well as the CMAs between Respondents and the Zohars) put front-and-center Ms. Tilton's discretion to be able to exercise her business judgment to determine categorization. For example, the parties expressly "acknowledge[d] and agree[d]" that Respondents had broad discretion—which they were expected to use "extensive[ly]"—to amend and otherwise restructure loans, and to do so "without the consent of the Holders of any Notes or the Credit Enhancer [(MBIA)]." Indenture § 7.7(a); *see also, e.g.*, CMA § 2.2(c), (p). Furthermore, Respondents were *required* to subjectively evaluate loans, and to make a "reasonable judgment" as to the loans' "risk" and "credit quality" in determining whether to maintain certain loans in Category 4 or, alternatively, to move them to Category 1. Indenture § 1.1 at 9 (Definition of "Category 4" at (v)); *see also id.* at 23 (Definition of "Defaulted Obligation" at (a)(ii)(A)). These discretion-granting provisions not only put the lie to the Division's fraud case, they destroy it. Indeed, these provisions were a critical and foundational element of the Zohars' design and business strategy to invest in "distressed loans," Indenture § 7.7(a), retain the discretion to provide loan payment flexibility, and ultimately turn around these distressed companies, as was well-known to all involved, including the sophisticated financial institutions that were the Zohar noteholders. Since the Indentures and CMAs contemplate, disclose, and permit the very practices the Division claims were inappropriate, the notion that these practices (or the alleged failure to disclose them) constitute misrepresentations, fraudulent omissions, or deceptive conduct is specious.

The Division's theory of wrongdoing similarly crumbles because Respondents openly revealed that loans were not considered defaulted—and remained in Category 4—even in the

absence of full payments of stated interest. The Trustee Reports alone—available monthly and quarterly to the Zohars and noteholders—disprove the alleged secrecy of Respondents' approach—even assuming Respondents had a duty to disclose information to the noteholders, which they did not. *See infra* Factual Background ("Facts" Part V; Argument ("Arg.") Part I.A.1. In fact, the reports disclosed (a) the stated interest for each loan; (b) the actual interest payments; and (c) the categorization of the loan. And on plain reading, one could see loans categorized as "4," or performing, paid less than full or no interest.

Not only was Respondents' categorization approach obvious from the Trustee Reports provided to noteholders during the relevant period, it was also made plain in direct communications with noteholders. For example, when a noteholder asked about the non-payment of interest on Category 4 loans, Respondents responded forthrightly to explain how their practices were in accordance with the governing documents. *See infra* pp. 26-27. Ms. Tilton was also candid about her approach in investor calls. *See infra* 24-25. And now, in recent weeks, the Division has disclosed to Respondents that its own noteholder witnesses have provided direct, exculpatory statements on this issue. For example, the Division's SEI witness told the Division that he knew "that certain loans were not paying current interest but were still carried as performing loans." *See infra* p. 43. Having predicated its theory of wrongdoing on the notion that Respondents "never disclosed Tilton's discretionary valuation approach," OIP ¶ 9, the Division's case collapses like a house of cards under the weight of these repeated disclosures.

Respondents' discretionary approach to categorizing loans and their authority to amend loan terms were inherent in the design of the Zohars' investment strategy: the Zohars were to invest in loans to distressed companies—in other words, companies that were, by definition, in default on their loan facilities—at exceptionally high interest rates. The Zohars would then

collect as much interest as could be squeezed out of each Portfolio Company—but likely not all of the full stated interest—and from enough of the Portfolio Companies in the aggregate to pay the noteholders the interest due on the notes. Only through loan payment flexibility could Respondents keep the companies afloat, obtain the anticipated return for noteholders, and make money for the Zohars.

This approach was made clear from the funds' inception. It was, in fact, exactly what noteholders were investing in. For example, the offering memorandum for Zohar III explained that Patriarch, as collateral manager on behalf of Zohar III, would "originate or purchase loans and debt obligations of [companies] that are experiencing significant financial or business difficulties, including companies involved in bankruptcy or other reorganization and liquidation proceedings," and that "[t]he Collateral is expected to include a material amount of stressed and distressed loans that may be the subject of extensive amendment, workout, restructuring and other negotiations." Div. Ex. 6 at 41, 44. The Indentures were structured in such a way as to preserve Respondents' discretion to effectuate this strategy, as memorialized in the provisions of the Indentures and the CMAs discussed above. These were not standard provisions in traditional CLOs, but, rather, *sui generis* terms purposefully included in order to provide Respondents the flexibility essential to effectuate the Zohars' stated strategy. It is impossible to reconcile these contract terms, and business strategy, with the Division's theory of wrongdoing.

Nor can the Division possibly prove that Respondents failed to disclose their categorization methods, or the resulting purported "conflict of interest," to the Zohars—which is the Division's sole theory of fiduciary breach. The Division cannot possibly prove that Respondents totally abandoned the Zohars, as it must to negate the agent-principal relationship under which Respondents' knowledge is imputed to them. In fact, Respondents actively

managed the Zohars and the Portfolio Companies for the Zohars' benefit. The evidence will also show that Ms. Tilton invested over $200 million in the Zohars, and that she reinvested substantial amounts of money into the Portfolio Companies, which inured to the Zohars' advantage. Moreover, Patriarch's strategy has proven successful: Many once-failing Portfolio Companies currently have tremendous value that is largely attributable to Ms. Tilton's extensive efforts to rehabilitate them, including by using her discretion to amend loans to postpone interest payments due.

In any case, the Zohars' Directors were well aware of Respondents' approach to categorization. The Zohars were parties to the Indentures and the CMAs, and received the Trustee Reports. And the Zohars expressly acknowledged and broadly waived conflicts of interest between themselves and Respondents—a fact that the OIP simply ignores. Tellingly, the Zohars' Directors continued to retain Respondents as their collateral manager for almost six years after the SEC began its investigation, and for a year after the filing of the OIP (until Ms. Tilton voluntarily stepped down). In other words, notwithstanding the Division's strained fiduciary breach theory, the Zohars' Directors, themselves, clearly "did not think that [Respondents] had acted in bad faith or under a conflict of interest in connection with their . . . investments." *Belmont v. MB Inv. Partners, Inc.*, 708 F.3d 470, 506 n.43 (3d Cir. 2013).

In sum, the Division has inexplicably continued to press theories that are manifestly wrong and demonstrably false. Worse still, Respondents have recently learned that, in their zeal to target Ms. Tilton, the Division staff have engaged in troubling conduct unbefitting a government enforcement agency. Most concerning, Division staff provided confidential Patriarch documents to MBIA, and permitted MBIA to use information gleaned from those materials in litigation against Respondents, while, at the same time, acceding to MBIA's request

that they keep Ms. Tilton in the dark. *See infra* Procedural Background ("Proc.") Part I. The only limitation that the Division placed on MBIA's use of Respondents' confidential information was that MBIA "not cite or attach any of the documents received from the SEC." *See infra* p. 32. In other words, MBIA was free to use the documents to its advantage as long as those documents could not be traced back to the Division. As a result of this dirty deal, MBIA torpedoed a potential restructuring of the Zohars that would have made all noteholders and MBIA whole, and would have undermined the Division's case against Ms. Tilton.

For its part, over the three-year period prior to the filing of the OIP (and continuing through the present), MBIA fed its self-serving version of events to the SEC, admitting to the Division staff that it wanted to "own Zohar I" and dupe Ms. Tilton into "go[ing] all in" before suing her company, using the confidences improperly divulged by the SEC. Resp. Ex. 501. Indeed, MBIA's tall tales fueled the Division's erroneous theory of Respondents' purported misconduct. At the same time, the Division did not seek testimony from the Zohars' Directors or most of the parties who were involved in the creation of the deal documents—presumably, because it knows they would not support the Division's strained effort to manufacture misconduct here.

In the face of these facts, and for multiple independent reasons, the Division cannot meet its burden of proving each of the required elements of the violations alleged in the OIP.

First, the Division cannot show any misrepresentations, actionable omissions, or deceptive conduct, which it must to prevail on any charges in the OIP. Respondents operated openly and transparently in accordance with the terms of the Indentures, and disclosed their categorization practices, again and again. *See infra* Arg. Part I.A.

Second, even if the Division was correct in its interpretation of the Indentures—and it is not—the Division cannot meet its burden of proving the materiality of any misrepresentations, omissions, or deceptive conduct because there is not a "substantial likelihood" that the "disclosure of the [purportedly] omitted fact"—namely, that Respondents considered subjective factors, and not just the non-payment of interest, in making categorization decisions—"would have been viewed by the reasonable investor as having significantly altered the total mix of information made available." *Russell W. Stein*, Initial Decision Release No. 150, 1999 WL 756083, *11 (ALJ Sept. 27, 1999) (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988)). *See infra* Arg. Part I.B. In fact, additional disclosures would not have altered the total mix of information in any substantive way, because all of the information needed to understand the "omitted fact" was available.

Third, the Division cannot prove that Respondents engaged in intentional misconduct. *See infra* Arg. Part I.C. In fact, every action taken by Respondents is wholly inconsistent with malevolence or scienter. It is indisputable that on numerous occasions—indeed, whenever asked—Respondents disclosed their categorization approach. No one intending to commit fraud would openly announce their wrongful conduct on a public investor call, or respond in writing to questions from alleged victims by telling the person exactly what they were doing, as Respondents did here. *See infra* pp. 24-25, 26-27. In fact, every fraudster in history has done just the opposite, concealing wrongful conduct when confronted. Here, the record is devoid of any evidence that Respondents hid their discretionary approach. And it would make no sense for Respondents to provide to noteholders and the Zohars in monthly reports the very information that they were purportedly withholding from those same parties, including that interest was not being collected while loans were still being maintained as Category 4. Nor can the Division

prevail on a theory of recklessness or negligence, because Respondents' conduct was based on a reasonable interpretation of the governing contracts, which—even if erroneous—defeats a recklessness or negligence claim. *See Gen. Ins. Co. of Am. v. K. Capolino Constr. Corp.*, 983 F. Supp. 403, 437 n.63 (S.D.N.Y. 1997).

Finally, as the Division concedes, its theory of misleading financial statements is based on the same erroneous view of categorizations. *See* OIP ¶ 8 (financial statements "mirror[ed] the discretionary approach Tilton uses to categorize assets"); *see supra* Arg. Part II.A. The Zohars' financial statements fairly presented the financial condition of the CLOs, and the Division presents no evidence to the contrary. Instead, the Division contends that the financial statements were misleading in two respects: by disclosing impairment and fair value processes that purportedly did not exist, and by suggesting that financial statements were prepared in accordance with GAAP. Both theories are unsupportable nitpicking immaterial to noteholders. Indeed, one of the Division's own noteholder witnesses has already admitted that the financial statements' compliance with GAAP was not important to the noteholder's investment decisions, *see* Resp. Ex. 541, which comes as no surprise, given the volume of detail in the far lengthier, regular Trustee Reports.

The simple truth is that this case should never have been brought in the first place. And it likely never would have been if the Division had fully and fairly presented the Commission with the facts as it knew them, instead of fabricating a false narrative based on cherry-picked Indenture terms and an unsupportable non-disclosure theory. Now that a fuller picture has been revealed—more so with each new document and Division disclosure—the just and proper outcome would have been for the Division to drop its case. Instead, the Division has opted to double-down, seeking an astonishing $200+ million in disgorgement and a permanent bar of Ms.

Tilton from the securities industry. But the Division cannot meet its burden of proof on any of these asserted violations. Respondents therefore respectfully request that Your Honor issue an Initial Decision dismissing the charges in their entirety, and granting such other and further relief as is just and proper.

FACTUAL BACKGROUND

The following is a summary of relevant facts Respondents anticipate establishing at the upcoming hearing.

I. Beginning In 2000, Lynn Tilton Created Innovative CLOs To Enable Investment In Distressed Debt While Revamping Iconic American Companies.

Ms. Tilton founded Patriarch in 2000, after 19 years of experience on Wall Street focusing on mergers and acquisitions, leveraged buyouts, and distressed debt research, sales, and trading. With that experience and knowledge, Ms. Tilton and Patriarch created two collateralized loan obligations ("CLOs"), Ark I and Ark II (collectively, "the Arks")—the first CLOs investing exclusively in distressed debt to receive investment grade ratings.[2] The Arks

[2] A CLO is a type of collateralized debt obligation ("CDO"), which is an investment vehicle created to purchase a pool of debt instruments (a "collateral pool"), such as mortgages, bonds, and loans. A CLO's collateral pool consists primarily of commercial loans. *See* Resp. Ex. 21 ("Froeba Rep.") ¶ 33. CLOs borrow money to purchase the collateral pool by issuing notes to investors ("noteholders"). *Id.* The collateral pool secures the notes and generates the income the CLO will use to make payments to investors over time. *Id.* Specifically, interest and principal payments made by borrowers are used to make scheduled interest and principal payments to the noteholders. A CLO typically has different classes of notes, also called "tranches." Higher classes are paid first, typically at a lower interest rate than lower classes. The notes issued by most CLOs have public ratings from two ratings agencies, usually Moody's and Standard & Poor's ("S&P"). *Id.* ¶ 37. The ratings help potential investors assess the potential risk of investing in the CLO. The notes are also typically "wrapped" with financial guaranty insurance in order to enhance marketability to investors. *Id.* ¶ 39. If the CLO cannot itself meet its payment obligations to noteholders, the financial guaranty insurance will make those payments. *Id.*

were created to allow two banks to unload portfolios of defaulted or distressed loans. Through the Arks, Patriarch purchased the portfolios, with a total face (or "par") value of over $2.3 billion, at a discount to their face value, thus enabling the banks, which also became junior noteholders in the deals, to remove the non-performing loans from their balance sheets while retaining some ability to benefit if the loans performed well, *i.e.*, if the borrowers ultimately repaid the principal and interest owed.

As "collateral manager" of the Arks, Ms. Tilton, on behalf of Patriarch, was responsible for managing the loan portfolios, including selecting and pricing loans for purchase, creating value through active participation in restructuring and loaning to own companies, monitoring the cash flows of interest and principal, and ultimately monetizing the loans and related collateral. Ms. Tilton's extensive experience with distressed assets and innovative strategies was critical to the success of the transactions, which paved the way for other distressed debt CLOs. All of the ratings on the notes were upgraded during the life of the transactions, and the Arks paid off all of their notes more quickly than noteholders anticipated. *See, e.g.*, Resp. Ex. 70 at 74 (Christine Richard, *In Hard Luck Industries, Patriarch Seeks Revival Funds*, Wall St. J. (July 30, 2003) ("Patriarch's overall strategy has been working. At a time when CDO downgrades have exceeded all expectations, Ark I and Ark II have had numerous tranches upgraded.")).

The success of the Arks led to the formation of Zohar I, which was created, in part, as a solution to financial problems faced by MBIA, a financial guaranty insurer. MBIA was familiar with Patriarch and Ms. Tilton because it had insured the Ark II transaction. When MBIA encountered loan losses and accounting issues related to a distinct set of CDOs it insured, it turned to Ms. Tilton for help. Specifically, seven CDOs insured by MBIA were expected to have a shortfall of up to $287 million, meaning MBIA would likely have to make significant payments

to noteholders when the CDOs failed to meet their obligations. MBIA looked to Ms. Tilton for a strategy to help mitigate that insurance exposure. To that end, in April 2003, MBIA and Patriarch agreed to a strategy in which: (1) MBIA would replace the managers of the troubled CDOs with Patriarch affiliates; (2) MBIA would insure the senior notes of a new Patriarch-sponsored CLO, Zohar I;[3] and (3) a portion of any value created in a set of unfunded junior notes in Zohar I would be used, under certain conditions, to remediate MBIA's troubled CDOs.[4]

Instead of investing in a static pool of loans identified at the closing of the transaction, as was the case in the Arks, Zohar I had a five-year reinvestment period during which Zohar I could reinvest interest and principal payments collected into new collateral by extending additional loans to Portfolio Companies or new loans to new companies. The reinvestment period was intended to allow Zohar I to maintain a stable asset base over time, which would generate consistent income over a longer period than in the Ark transactions, where the successful repayment of the loans occurred so rapidly that noteholders did not receive as much interest as they could have with reinvestment and an extended maturity.

Like the Arks, Patriarch originally planned for Zohar I to purchase distressed corporate loans on the secondary market at a steep discount to their face value. Using her extensive experience with distressed debt, Ms. Tilton would actively manage the portfolio to maximize

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[3] As used herein, "Zohar I" refers to the aggregate of Zohar CDO 2003-1, Ltd., Zohar CDO 2003-1, Corp., and Zohar CDO 2003-1, LLC. "Zohar II" refers to the aggregate of Zohar II 2005-1, Ltd., Zohar II 2005-1, Corp., and Zohar II 2005-1, LLC. "Zohar III" refers to the aggregate of Zohar III, Ltd., Zohar III, Corp., and Zohar III, LLC.

[4] For a more detailed discussion of MBIA's involvement in the Zohar I CLO, *see* Resp. Ex. 128 (*MBIA Ins. Corp. v. Patriarch Partners VII, LLC*, 950 F. Supp. 2d 568 (S.D.N.Y. 2013)). On the merits, Judge Sweet rendered a complete defense victory for Respondents. *See id.* at 621.

value to noteholders. In order to create the most value for noteholders over time, Ms. Tilton and Patriarch were given extensive discretion to manage and amend, as necessary, payment terms on the loans. If successful, Zohar I would generate enough value that, after payments were made to senior noteholders, MBIA would benefit from a class of junior notes that would be indirectly transferred to MBIA at no cost under certain conditions. The parties drafted the original indenture and associated transaction documents to reflect this strategy.

The Zohar I transaction (and subsequently, Zohar II and III) was not marketed to the general public. Instead, the Zohars were private deals executed with small groups of sophisticated investors, who participated in the negotiation of the Indentures and who understood the risks associated with investing in the Zohars. Each Zohar transaction involved exclusively sophisticated institutional investors, including MBIA, Natixis, Barclays, and Goldman Sachs. The investors were familiar with Ms. Tilton, and invested in the Zohars because of her expertise in distressed debt and her prior successes. For example, MBIA served as underwriter and insurer for the Ark II transaction; in the wake of Ark II's success, it sought to continue to do business with Ms. Tilton. Similarly, Natixis, which served as the investment bank for the Zohar I deal, expressed interest due to the successful Ark II results.[5]

After Zohar I closed, the market dynamics for distressed debt changed. By February 2004, other market participants were investing in the secondary market for distressed loans. As a result principally of increased demand, prices increased and fewer distressed loans were available on the market, making it more difficult for Zohar I to carry out the original strategy of

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[5] Some of the Zohar notes were later sold on the secondary market to other investors, including SEI Investments Company, Rabobank International, and Varde Partners, which were also all sophisticated institutional investors.

buying distressed loans at a discount to par value in the secondary market. In response, Patriarch proposed a revised investment strategy to noteholders. Instead of exclusively purchasing discounted loans, Zohar I would originate high-yield loans to distressed companies at or close to par (face value), and seek equity "kickers" in return, such as warrants, cash bonuses at maturity, prepayments, or certain types of stock. Zohar I would become the sole, and thus controlling, lender to each Portfolio Company. And Patriarch, as collateral manager, would work closely with the Portfolio Companies' management to rebuild and restructure the companies so they could pay off the loans extended by Zohar I. Additionally, if the Portfolio Companies improved their financial performance, the kickers would increase in value.[6]

While Patriarch was purchasing the collateral for Zohar I, it also began work on the Zohar II CLO, which would invest in or originate loans alongside Zohar I. Zohar II was necessary because Zohar I's purchasing power was constrained: its largest seven investments could each constitute no more than 5% to 9% of a predetermined Maximum Investment Amount ("MIA"), as set out in the indenture. After those "buckets" were filled, any investment could not exceed 3% of the MIA. Generally, that amount was insufficient to purchase controlling interests in companies, as was intended under the revised investment strategy. Zohar II was thus intended to benefit Zohar I by investing the remaining funds necessary to gain control of companies. Ms. Tilton later proposed, and effectuated, the creation of a third CLO, Zohar III, for the same purpose. All parties to the transactions consented to asset transfers from the Arks to the Zohars

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[6] Several amendments to Zohar I's indenture were adopted to account for the change in investment strategy. For example, the Second Supplemental Indenture added the concept of an "Originated Special Loan/Preferred Security," which allowed the Zohars to originate loans with equity kickers. *See* Resp. Ex. 3.

and from Zohar I to Zohars II and III to help those CLOs ramp-up and to allow Zohar I to purchase additional assets. Together, the Zohars invested in iconic American companies such as Rand McNally, Stila Cosmetics, Dura Automotive, and MD Helicopters.

II. The Zohars Were Unique Distressed-Debt CLOs, Actively Managed By Patriarch, And Were Structured To Incentivize The Turnaround Of Distressed Companies.

The primary investment plan under the revised Zohar I strategy was to originate loans to deeply distressed companies and implement a long-term turnaround strategy to create value for the Zohars and their noteholders. *See* Resp. Ex. 24 ("Hubbard Rep.") ¶ 8. The noteholders understood that the strategy would involve Patriarch providing capital to middle-market companies experiencing severe distress due to shifting industry dynamics, an unsustainable capital structure, or poor management. *See, e.g.*, Resp. Ex. 73 at 4; Hubbard Rep. ¶ 8. The Zohars would provide senior secured loans to these companies with higher-than-average interest rates, reflecting the risk that the distressed companies would be unable to pay. *See* Hubbard Rep. ¶ 18. Patriarch—and Ms. Tilton in particular—would control and be actively involved in the turnaround of the companies to ensure the ultimate recovery of interest and principal. *See id.* ¶ 10.

Central to the investment strategy was that the Zohars would have the authority and discretion to control the terms of repayment of the loans they originated. *See id.* ¶¶ 26-27. The Zohars were often the sole lender to the borrower companies. *See* Froeba Rep. ¶ 99. As such, Patriarch, as collateral manager, would be in a position to control the terms of the borrowers' loans without having to address the competing interests of other lenders. By design, Ms. Tilton also often owned and controlled the Portfolio Companies, sometimes acting as Chief Executive Officer and always as a board member or manager of the companies (in most cases, the sole board member or manager), which enabled her to direct the rehabilitation of the companies. This

level of control was integral to the Zohar strategy and was fundamentally different from most other CLOs. *See id.* ¶¶ 95-96. It allowed Patriarch to direct the loan repayment and restructuring of the companies without negotiating with several other parties—eliminating "constituency conflict," as Ms. Tilton called it—with the ultimate goal of maximizing the value of the noteholders' investments.

Because the Portfolio Companies were deeply distressed, and in order to maximize the value of the noteholders' investments, the Zohars collected the maximum amount in interest payments each month that did not threaten the Portfolio Companies' liquidity and the prospect for an effective turnaround. Ms. Tilton's ability to control the interest payments in the short term provided flexibility necessary to rehabilitate a distressed Portfolio Company so that it could eventually pay all of the interest and principal it owed on its loans. *See* Hubbard Rep. ¶ 10. Without this flexibility, any failure to make a full stated interest payment by a Portfolio Company (which was, by design, a company in distress) could lead to rapid liquidation of the collateral for less-than-full value, causing losses for noteholders.

The strategy was also based on the entirely logical assumption that not every Portfolio Company would be able to pay the full stated interest at all times. Indeed, interest rates for the loans ranged from eight to 25 percent, which was five to six times higher than the interest rates on the notes issued by the Zohars to investors. In order for the Zohars to successfully meet their payment obligations to noteholders, therefore, not every loan had to pay off all of the interest, or even all of the principal. Companies paying full stated interest would provide sufficient cash flow to the Zohars when other companies, at times, could not. In addition, the profit from any sale of a rehabilitated company would provide additional support for interest and principal owed

to noteholders through equity upside interests in the Portfolio Companies that were a part of the Zohar investment strategy.

Noteholders agreed to this investment strategy after Ms. Tilton explained to them that it was a necessary reaction to market conditions and that the building of collateral value would require long-term work to revitalize the distressed companies. Because of Ms. Tilton's widely hailed skill in turning around distressed companies, noteholders not only agreed to the investment strategy, they insisted that Ms. Tilton personally maintain an active role in overseeing the turnaround of the Portfolio Companies. *See* CMA § 1.1(vi). In fact, Ms. Tilton's active involvement and expertise in resuscitating the distressed companies was one of the core selling points for the transactions. An MBIA internal memorandum, for example, highlighted the following as one of the "key strengths" of the deal: "Strong key person provision on Lynn Tilton, allowing MBIA to gain control of the deal if she is not directly involved in managing the deal on a day to day basis for any reason." Resp. Ex. 73 at 7.

Patriarch made this strategy and business plan clear through marketing materials for Zohars I and II, and a formal offering memorandum for Zohar III. For instance, a 2004 Patriarch pitch book explained that "Patriarch is in the business of . . . originating and acquiring secured loans to companies undergoing periods of turmoil and acquiring those same companies." *See* Resp. Ex. 72 at 3. The presentation continues: "Patriarch's platform is founded upon its intent to offer time, stability, liquidity and an appropriate capital structure in order to enhance the long-term value of its portfolio companies." *Id.* Similarly, the offering memorandum for Zohar III explains that Patriarch, as collateral manager, would "originate or purchase loans and debt obligations of [companies] that are experiencing significant financial or business difficulties, including companies involved in bankruptcy or other reorganization and liquidation

proceedings," and that "[t]he Collateral is expected to include a material amount of stressed and distressed loans that may be the subject of extensive amendment, workout, restructuring and other negotiations." *See* Div. Ex. 6 at 41, 44.

The press also covered Ms. Tilton's investment strategy extensively. The Wall Street Journal, for example, reported on Patriarch's "hands-on management" in "provid[ing] long-term investment-grade funding that gives stressed companies the breathing room to find a way back to profitability." Resp. Ex. 70 at 74 (Christine Richard, *In Hard Luck Industries, Patriarch Seeks Revival Funds*, Wall St. J. (July 30, 2003)). The Financial Times also described Ms. Tilton as a "champion [of] broken companies," and explained that Patriarch "specializes in rescuing ailing businesses." Liz Moscrop, *Highflier Rebuilds Broken Companies*, Financial Times (Oct. 19, 2010); *see also* Robert Frank, *Tilton Flaunts Her Style at Patriarch*, Wall St. J. (Jan. 8, 2011) (Ms. Tilton's "strategy is to buy manufacturers headed for the scrap heap and bring them back to life with new management teams and products.").

III. The Governing Documents Give Ms. Tilton Substantial Discretion In Executing The Zohar Investment Strategy.

The indentures for each Zohar transaction were drafted with the express purpose of affording significant discretion to Ms. Tilton and Patriarch in managing the cash flows to and from the Portfolio Companies—including broad discretion to amend the amount of interest owed by the Portfolio Companies. Section 7.7(a) of the Indentures thus acknowledged that the nature of the investments—specifically, "stressed and distressed loans"—would require "extensive amendment," and explicitly granted Patriarch the ability to "enter into any amendment, forbearance or waiver of or supplement to any" loan or credit agreement "without the consent of the Holders of any Notes or [MBIA]." Indenture § 7.7(a). This provision was specifically

discussed, negotiated, and agreed to by the interested parties, including the original noteholders, and was critical to the success of the Zohars' articulated strategy.

While granting Patriarch broad discretion to manage the collateral, the Indentures also included numeric tests used in typical CLOs, which provided objective statistics about the Zohars: the Interest Coverage ratio test and the Overcollateralization ratio test ("IC ratio test" and "OC ratio test," respectively). *See* Froeba Rep. ¶ 43. The IC ratio test measured the interest payments received from the Portfolio Companies against the interest owed to the noteholders, *see* Indenture § 1.1 at 10-11, and thus provided critical insight into whether the portfolio generated sufficient interest income on an aggregate basis such that the Zohars could meet their payment obligations to the noteholders. Froeba Rep. ¶ 90. The minimum IC ratio—110%—reflected the Zohar investment strategy. *See* Indenture § 1.1 at 11. Even though the loans had interest rates much higher than the rates payable to noteholders, the minimum IC ratio set forth in the Indentures only required the Zohars to collect *slightly* more (10%) interest than they had to pay out to noteholders. Froeba Rep. ¶ 90. The IC ratio test was an important indicator of the Zohars' performance. If all loans were paying the full stated interest, the IC ratio would be far higher than the minimum. *Id.*

The OC ratio test measured the 'carrying value' of the loans against the remaining principal owed to the noteholders. *See* Indenture § 1.1 at 11-12. The OC ratio test was not calculated using the market value of the loans. Instead, Patriarch was required to assign each loan to a numeric category for purposes of the calculation. *See id.* § 1.1 at 43-44. The categorization was essentially binary: a loan was either a Category 1, "Defaulted Obligation," or

a Category 4, "Current" obligation.[7] Category 1 loans had a reduced value for purposes of calculating the OC ratio. *See id.* § 1.1 at 43. Category 4 loans were carried at the principal amount outstanding on the loan. *See id.* § 1.1 at 44.

If either the IC or OC ratio fell below certain thresholds, the Indentures imposed restrictions on Patriarch as collateral manager, including restrictions on Patriarch's ability to reinvest proceeds, to provide further funding to any Portfolio Company, and to receive management fees. *See id.* §§ 1.1 at 57, 59, 11.1(a)(H), 11.2(a)(iii)-(iv), 12.1(a)(19). Because any OC failure would restrict funding, it would likely force fire sales of the distressed and illiquid companies and lead to rapid losses for noteholders. If the OC ratio fell low enough, an "event of default" would be triggered, which would permit wholesale liquidation of the CLO. *See id.* § 5.2(a).

Critically, and contrary to the Division's fundamental misunderstanding of the way the Indentures operated, the Indentures expressly required Patriarch to make a number of subjective determinations regarding the anticipated future performance of the Portfolio Companies in determining whether a loan was Category 4 or 1. Thus, whether a Portfolio Company was meeting its payment obligations or not, Patriarch had the authority to put it into Category 1 if, "in the reasonable judgment of the Collateral Manager, [there was] a significant risk of declining in credit quality or, with the passage of time, becoming Category 1." *Id.* § 1.1 at 9 (Definition of

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[7] The four-category approach was specifically tailored to the parties' initial strategy of buying distressed loans on the secondary market and consolidating control over the companies in bankruptcy. Each category was intended to correspond to a certain phase of bankruptcy. After the strategy pivoted, *see supra* pp. 13-14, Categories 2 and 3 were rarely, if ever, used. By the time Zohar III was created, numerical categories were eliminated altogether, and loans were designated as either "Defaulted Investments" (roughly analogous to Category 1 loans) or "Collateral Investments" that are not Defaulted Investments (roughly analogous to Category 4). *See* Zohar III Indenture § 1.1 at 18-19, 40-41.

"Category 4" at (v)); *see also id.* at 23 (Definition of "Defaulted Obligation" at (a)(ii)) (Collateral Manager to move a loan out of Category 4 if in its "sole judgment" the loan "will likely result in a default as to the payment of principal and/or interest"). Conversely, if a Portfolio Company could not meet loan payment obligations but Patriarch still had confidence in the company, the Indentures were designed so that Patriarch could exercise its discretion under Section 7.7(a) to "enter into any amendment, forbearance or waiver of or supplement to any Underlying Instrument," thereby avoiding a default and permitting the loan to remain in Category 4. *See id.* § 7.7(a). The Indentures made clear that, "for the avoidance of doubt," the Zohars invested in distressed loans for which "extensive amendment, workout, restructuring and/or other negotiations" would be necessary, and that Patriarch could take such action "without the consent of the Holders of any Notes or the Credit Enhancer [(MBIA)]." *Id.*

The specific terms of the Zohars' governing documents were heavily negotiated. Several parties were involved, including: (i) the investment bank, Natixis, (ii) the collateral manager, Patriarch, (iii) the rating agencies, (iv) the Trustee and Collateral Administrator, LaSalle (later U.S. Bank), (v) the guarantor, MBIA, and (vi) key noteholders, such as Barclays. Each of these sophisticated entities, with reputable counsel, reviewed and commented on the terms of the Indentures. And they were fully aware of the discretion granted to Patriarch under Section 7.7, which was a central feature of the Indentures and the Zohars' investment strategy. These same parties also negotiated what information would be made available to noteholders in monthly and quarterly Trustee Reports (referred to as the "Monthly Report" and "Note Valuation Report," respectively, in the Indentures). *See* Indentures §§ 10.13(a), (b); *infra* Facts Part V; Arg. Part I.A.1 (discussing disclosures).

IV. Patriarch Operates The Zohars And The Portfolio Companies In Accordance With The Strategy Set Forth In The Governing Documents.

For over a decade, Ms. Tilton, acting on behalf of Patriarch, has employed the discretion and business judgment granted to her under the Indentures in managing the Zohars, and restructuring the Portfolio Companies. Under her direction, the Zohars have invested billions in over 125 distressed companies, and are responsible for the employment of hundreds of thousands of American workers. And Patriarch's management of the Zohars has proven successful as the Portfolio Companies have sufficient value to pay the noteholders in full.

To execute the Zohar investment strategy, Ms. Tilton was extensively involved with the Portfolio Companies, including on a day-to-day basis. Ms. Tilton received both weekly and monthly reports from (1) the senior management of each of the Portfolio Companies; and (2) Patriarch's credit officers and lawyers overseeing the Portfolio Companies. She participated in annual or biannual budgeting meetings with senior management, guided the hiring of new talent for each Portfolio Company, and met with large or strategically important customers. She appointed platform leaders—executives with extensive experience in particular industries—to Portfolio Companies as advisers to assist in effectuating the turnaround strategies. She was even more involved in the companies for which she served as CEO. For those companies, she made site visits for at least a few days each month, directly and regularly communicated with senior management, and set the budget, strategies, and initiatives. Ms. Tilton comprehensively understood the Portfolio Companies' operations and funding needs, which enabled her to support and rebuild the companies by, among other things, exercising her discretion under Section 7.7 of the Indentures to amend loans for the deeply distressed Portfolio Companies.

The discretion granted to Ms. Tilton and Patriarch was particularly important during the 2008 global financial crisis. To avoid liquidation in the middle of a severe economic downturn, Patriarch amended the amount of interest owed by several companies, which provided critical

liquidity for the companies through the financial crisis. By doing so, Patriarch not only prevented severe losses to noteholders, but it also prevented several Portfolio companies from going into liquidation. For instance, one portfolio company, Global Automotive Systems ("GAS"), experienced a drastic decrease in revenue in 2009 after two of its largest customers, General Motors and Chrysler, filed for bankruptcy. Patriarch amended GAS's loans, and provided additional liquidity from Zohar II and Zohar III. As a direct result, GAS survived the financial crisis, and achieved $276 million in revenue and $21.8 million in EBITDA by 2013. *See* Hubbard Rep. ¶ 27. Other Portfolio Companies similarly struggled during the financial crisis, but survived and later thrived as a direct result of Ms. Tilton's hands-on management, and the cash infusions and loan payment flexibility Patriarch was able to provide.

Amendments were made pursuant to an established process. Before interest payments were due, Patriarch's credit analysts obtained comprehensive information from each Portfolio Company about whether and what amount of interest the company's managers believed it was able to pay, including cash flow projections and updated budgets. After receiving that information, Ms. Tilton, with her particularized understanding of the financial needs of each company, would determine whether, in her business judgment, to accept less than the full stated interest for any company. Ms. Tilton was discerning in making these determinations and did not readily accept less than the full stated interest due. Ultimately, her decision turned on whether further effort and support would allow the company to recover and continue to generate value for the Zohars' noteholders. *See* Hubbard Rep. ¶ 27. If Ms. Tilton determined that further support would enable the company to recover, Patriarch generally amended the loan, and continued to categorize the loan as "current" under Category 4 for purposes of the OC ratio test. If, on the other hand, Ms. Tilton determined that amending the loan would not ultimately lead to a

successful restructure of the company, the loan was defaulted and placed in Category 1. In either event, the amount of interest actually paid was documented in Patriarch's loan administration system, provided to the Trustee, U.S. Bank, and reflected in its monthly and quarterly Trustee Reports to noteholders.[8]

Also, as part of her active management and efforts to build value for the Zohar noteholders, Ms. Tilton invested over $200 million in cash in the Zohars—approximately $108.4 million in Zohar I, $49.9 million in Zohar II, and $60 million in Zohar III—that still sits in the CLOs today as a cushion and source of recovery for noteholders (the preference shares and notes purchased by Ms. Tilton are the last to pay out). Ms. Tilton also reinvested significant amounts of money in the Portfolio Companies which inured to the Zohars' advantage by helping to keep the companies in which the Zohars had invested afloat. Moreover, Patriarch's strategy has proven successful: Many Portfolio Companies currently have tremendous value that is largely attributable to Ms. Tilton's extensive efforts to rehabilitate the once-failing companies.

V. Patriarch's Approach To Loan Amendment And Categorization Was Openly Disclosed To Noteholders.

Patriarch's use of its discretion to amend the terms of the loans was a necessary feature of its investment strategy, which was openly disclosed to the parties involved with the Zohars, including noteholders, both in marketing materials, *see supra* p. 17, and the specific language of the Indentures, *see supra* Facts Part III. Consistent with this well-understood strategy, Ms. Tilton openly and transparently utilized her discretion for over a decade. For example, Ms.

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[8] The Division does not take issue with Ms. Tilton's use of her discretion in this regard. *See* Opp. to Summ. Disposition at 4 ("*while Section 7.7(a) does allow for loan modifications*, it simply does not address or alter the categorization requirements contained in those portions of the indentures described above" (emphasis added)).

Tilton discussed with noteholders during the Zohars' December 2011 investor calls that the deals "look very different than other CDOs in terms of the ability to change maturities, adjust interest rates, . . . extend, restructure. . . . [W]e knew that these companies go through long roads of turmoil and have ups and downs, and we had to have the ability to see them through to create the most value." Resp. Ex. 49 at 2 (Zohar II Investor Call).[9]

Noteholders and other interested parties could also readily see that it was Patriarch's regular practice to collect less than full interest due, while continuing to categorize the loans as current, through the detailed Trustee Reports that they received and reviewed each month. *See* Resp. Ex. 23 ("Dolan Rep.") ¶¶ 62-63. The reports, together with additional data files, were made available to noteholders, the rating agencies, and MBIA, among others. *See, e.g.*, CAA § 2(b). Because the Trustee Reports contained detailed information on interest payments, categorization, and the OC and IC ratio tests, noteholders looked to these reports to evaluate the performance of their investments. *Cf.* Dolan Rep. ¶¶ 56-59, 85, 91, 108.

The Trustee Reports for each Zohar CLO reported the total outstanding balance of its loans, the total interest collected, and the weighted average spread ("WAS") over LIBOR—in effect, the average interest rate—on the loans. By doing basic math, a noteholder could determine precisely the extent to which loans in each category were and were not paying the full

[9] *See also, e.g.*, Resp. Ex. 48 at 4 (Zohar I Investor Call) ("[T]hese deals were constructed such that maturities could be extended, that interest rates could be changed, that things could be done to elongate the time needed to be able to create the most amount of value to pay off the loans."); Resp. Ex. 50 at 16 (Zohar III Investor Call) ("Had I not been here to hold [Global Automotive Systems] steady, change its interest rate, move the maturity out, [it] too would have gone [into bankruptcy].").

stated interest on an aggregate portfolio basis.[10] The Zohar I and II Trustee Reports also provided the same information to noteholders on a loan-by-loan basis.[11] Each Trustee Report was distributed with accompanying electronic data files containing even more detailed loan-level data, which were, in fact, downloaded and used by noteholders. *See* Dolan Report ¶¶ 16, 56, 61. These electronic data files were referenced on the front page of each Trustee Report, were accessible on the Trustee's website, and were regularly downloaded and used by noteholders. *Id.* ¶¶ 16, 56, 108. Information disclosed in the electronic data files allowed noteholders to systematically track interest payments on a loan-by-loan basis for any or all of the loans in the Zohars. *Id.* ¶¶ 61, 70.[12]

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[10] For example, the May 2011 Zohar I Trustee Report indicated that the balance of Category 4 funded loans was approximately $477 million, Resp. Ex. 18.29 (Quarterly) at 10-13, the WAS plus LIBOR was 9.00%, *id.* at 35, and the total quarterly interest collected was approximately $5.5 million, *id.* at 5. By multiplying the balance of Category 4 loans by the interest rate and dividing by four, a noteholder could easily determine the total quarterly interest due on the outstanding loans. From that, it was a simple matter for noteholders to determine that about 50% of the aggregate interest due on Category 4 loans was actually collected for the quarter. *See also* Dolan Rep. ¶¶ 64-65.

[11] A Zohar II noteholder could see from the July 2009 quarterly Trustee Report that the three loans with a prefix of 0855 (American LaFrance) had a total principal balance of approximately $50 million and an interest rate of 10 percent. *See* Resp. Ex. 19.094 at 36 (The "Funded Balance" for each is as follows: 855_11 ($44,949,848.59), 855_12 ($1,895,363.94), and 855_16 ($2,400,240.02)). From that, noteholders could calculate that American LaFrance's stated interest due was approximately $5 million per year, or about $1.25 million per quarter. Crucially, noteholders could also determine from the same Trustee Report that, the company's loans were all categorized as Category 4, *id.* at 31 and 36, and that the company paid only $200,000 in interest for the quarter, *id.* at 28-29.

[12] For example, the Trustee Reports and data files showed that the $25 million Category 4 term loan to Electro Source at an interest rate of Prime plus 2 percent (loan ID "BL0009078") was generally paying stated interest. *See* Dolan Rep. ¶ 70; *id.* Ex. 13. As another example, an investor monitoring the $29.4 million Category 4 term loan at a stated interest rate of one-month LIBOR + 8 percent to Global Automotive Systems (loan ID "BL0096513") could have observed from the disclosed information that the company fell behind its stated interest

[Footnote continued on next page]

No one objected to Patriarch's categorization practices, even after inquiring about interest payment discrepancies. In June 2011, for example, a Barclays employee emailed to ask why one of the quarterly reports showed Zohar I receiving substantially less interest than the full amount of stated interest that he had calculated using the Trustee Report. *See* Resp. Ex. 117. Patriarch explained forthrightly in response that the interest rate was "only the nominal spread" because Patriarch had the right under the Indentures to amend loans to defer or forgive interest. *Id.* Barclays raised no objection to this answer. Similarly, in September 2011, Patriarch explained to a Natixis employee that "a few loans have been amended to reduce the interest rates to align with the interest the companies can pay from current cash flow." Resp. Ex. 118. Patriarch continued:

> The lowered coupon rates reflect the amounts that these companies are able to pay and still maintain a healthy cash flow, which will in turn maximize the values for the Note holders. The reduction of interest rate is part of the process of allowing the company the time to build to pay the debt in full and, as most of the companies' equity is also owned by the Zohars, create equity value for the benefit of the Note holders.

Id. There were no further questions from Natixis.

In addition, the rating agencies, which were monitoring the credit estimates of the loan portfolio and the ratings on the notes, did not require Patriarch to treat amended loans as defaulted, as they could have done by assigning "default" credit estimates to loans that were not paying full stated interest in Zohars II and III. *See* Froeba Rep. ¶ 77. Indeed, an S&P press release describing its ratings on Zohar II acknowledged that "several of the assets to which we previously assigned a 'CC' credit estimate and treated as defaulted for our July 2013 rating

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[Footnote continued from previous page]

payments beginning in mid-2007, but resumed payment of the full amount of stated interest in 2013. *Id.* ¶ 70 & Ex. 14.

actions are still carried as performing assets by the trustee to calculate Zohar III's O/C ratios, based on provisions in the transaction documents." *Id.*

The Trustee, likewise, could have objected if it believed Patriarch's categorization approach violated the terms of the Indentures. The Indentures and CAAs established the Trustee's fiduciary duty to the Zohars and their noteholders, which would have obligated the Trustee to notify those entities about any improper practices. *See, e.g.*, Indenture § 6.17. But the Trustee did no such thing—despite the fact that in performing its operational functions for the Zohars, including the preparation and distribution of the Trustee Reports, the Trustee was well aware that Patriarch amended loans to postpone or forgive interest while continuing to categorize the loans as Category 4. *See, e.g.*, Div. Ex. 152; *see also* Froeba Rep. ¶ 77.

It was also the Trustee's duty to independently calculate the OC ratio. *See, e.g.*, CAA ¶ 2(c)(xxxvi); Indenture § 10.13(a). In connection with that duty, Patriarch provided its categorization for each loan to the Trustee. Indenture § 12.1(b). At the same time, the Trustee collected, calculated, and distributed all funds on behalf of the Zohars, including the exact amounts of all principal and interest payments made and the funds extended to the Portfolio Companies. CAA ¶ 2(d); Indenture, Art. 11. On an ongoing basis, the Trustee kept track of all principal and interest payments actually paid by the Portfolio Companies, as well as the interest rates and maturity dates on the loans. *See, e.g.*, CAA ¶ 2(b), (c)(v). The Trustee was obligated to identify any loan that was defaulted, non-current, or non-performing and the date on which the loan became defaulted. *Id.* ¶ 2(c)(vii), (2)(c)(xxix). Moreover, if the Trustee did not receive a principal and interest payment when due, it was required to send written notice to Zohar and Patriarch and request payment from the Portfolio Company within three days. *See* Indenture

§ 6.14. If payment was not made within three days thereafter, the Trustee was required to take further action. *Id.* The Trustee never did so.

With the foregoing information at its disposal, the Trustee would have been able to—and did—determine that Patriarch categorized loans as Category 4 that had not made all of the principal and interest payments due under the original terms of the loans. *See, e.g.*, Div. Ex. 152. Despite being aware that some loans, at times, had not paid the full stated interest due but were categorized as Category 4, the Trustee did not instruct Patriarch to re-categorize any of the loans, nor did the Trustee list the at-issue loans as defaulted on the Trustee Reports. Further, the Trustee was responsible for calculating and distributing fees to Patriarch. Indenture, Art. 11. The Trustee could have notified noteholders and refused to pay fees to Patriarch if Patriarch's practices with respect to loan amendment and categorization were problematic. But it did not.

VI. Patriarch Implemented Formal Processes For The Preparation Of The Zohars' Financial Statements, Including Review By An External Accountant.

In addition to the Trustee Reports, noteholders received the Zohars' quarterly financial statements. *See* Resp. Exs. 28 (Zohar I Financial Statements), 29 (Zohar II Financial Statements), 30 (Zohar III Financial Statements). The financial statements provided less detail than the Trustee Reports. They included a one-page balance sheet, a one-page income statement, a one-page certification, and notes about the Zohars' accounting processes. In preparing these statements, Patriarch relied on the advice of an outside accountant, Anchin, Block & Anchin ("Anchin"), which was well-versed in Patriarch's businesses. Anchin was involved in drafting the Zohar Indentures and subsequent amendments.

At Ms. Tilton's request, Anchin created the form and content of the Zohars' financial statements. Anchin was also involved in the creation of work papers for the statements, which were user-friendly forms that could be populated by Patriarch accounting personnel to generate

draft financial statements. Anchin also drafted a "Certificate as to Financial Statements," which accompanied every quarterly financial statement and included the representation that, although the financial statements did not constitute "complete presentation[s] of GAAP financial statements," the statements were "prepared in accordance with [GAAP]." Resp. Exs. 28-30.

Anchin and Patriarch established formal procedures for preparing the financial statements, as set forth in Patriarch's "Fund Accounting Manuals." *See* Resp. Exs. 123 (Zohar I Accounting Manual) & 124 (Zohars II and III Accounting Manual). First, Patriarch's Finance & Accounting Department completed the work papers and generated draft financial statements. Next, the work papers and financial statements were "sent to Peter Berlant at Anchin Block & Anchin (ABA)" for review and comment; over the course of nearly 15 years, Anchin consistently provided feedback, comments, and revisions, including with respect to GAAP issues. Pursuant to the procedures established in the accounting manuals, only after Patriarch's accounting department "incorporate[ed] comments from ABA," could the papers be "submitted to Ms. Tilton . . . for approval." Resp. Ex. 123 at PP122680; Resp. Ex. 124 at PP122706. Both by policy and in practice, Ms. Tilton, who has no formal accounting training, would not sign the financial statements unless and until Anchin reviewed and approved the documents. Although Ms. Tilton reviewed the statements before signing them, she relied on Anchin for its accounting advice and to ensure the statements were fairly presented.

PROCEDURAL BACKGROUND

I. Despite The Zohar Investment Strategy's Overall Success, The Division Engages In A More Than Five Year Investigation Of Purported Fraud Marred By The Division's Improper Information-Sharing With MBIA, Which Torpedoes The Zohars' Restructuring.

As noted above, Patriarch's management of the Zohars and the Portfolio Companies has proven successful, as the Portfolio Companies have sufficient value to pay all noteholders in full.

Nevertheless, MBIA—which suffered severe economic blows during the financial crisis—has embarked on a multi-year, multi-proceeding litigation campaign against Ms. Tilton and Patriarch, with the apparent goal of obtaining the value of Portfolio Company equity interests and fees to which Ms. Tilton and Patriarch would otherwise be entitled.

In 2009, MBIA brought a $120 million lawsuit against Patriarch for alleged breaches of contract; Judge Sweet of the Southern District of New York ultimately rendered a verdict in favor of Patriarch on all claims. At around the time MBIA filed its lawsuit, the Division opened an investigation of Respondents. The investigation ended up spanning more than five and a half years and employing the Division's sweeping subpoena power to collect millions of pages of documents dating back to 2000 from Respondents and third parties. The Division also issued dozens of subpoenas to third parties and interviewed dozens of witnesses.

Despite the breadth of the Division's investigation, the Division's record of that investigation is in many ways surprisingly incomplete. For example, several of the Division's witnesses are nowhere mentioned in the investigative record—in some instances apparently because the Division did not interview those witnesses until its post-OIP investigation—and some purport to testify on behalf of noteholders for which the Division apparently never subpoenaed a single document.[13] Other central players—such as the Zohars' Directors for whom

[13] For example, the investigative record neither mentions noteholder Varde Partners, Inc.'s witness, Matthew Mach, nor contains any documents the Division obtained from Varde Partners, Inc. during its entire investigation. But more than two months after the OIP was filed, the Division did request documents from noteholder Varde Partners, Inc. Those documents were later disclosed to Respondents, who were assured by the Division that they had been "voluntarily provided to" the Division, despite the fact that they were actually produced pursuant to the Division's apparent request. Such post-OIP investigation may help explain how the Division came to depend on so many witnesses who show up nowhere in the investigative record and whose documents the Division never subpoenaed.

the Division purports to speak in bringing breach of fiduciary duty claims—were not interviewed. And where the Division did create a record, it sometimes failed to create an accurate one, as in the case of numerous facially inaccurate transcripts of taped investigative interviews (and the subsequent destruction of audio tapes of the interviews).

In 2011, while MBIA's action against Ms. Tilton and Patriarch was still pending, MBIA began communicating with the SEC about Ms. Tilton, Patriarch, and the Zohars, feeding the Division information that formed the basis of the Division's theory of Respondents' purported misconduct. Moreover, while it was in communication with the SEC, MBIA drew Ms. Tilton into a series of discussions about a potential restructuring of Zohar I, and whether to extend the maturity date for Zohar I so that Ms. Tilton could continue to rehabilitate the companies (which had been hit hard by the financial crisis in 2009) and maximize the value of the notes. MBIA gave the SEC constant updates on the discussions with Ms. Tilton, and its desire to obtain possession of Zohar assets.

As MBIA representatives acknowledged, though, in many respects, a restructuring made sense, and thus could have served the noteholders' best interests. *See* Resp. Ex. 504 at SECNOTES000728. Indeed, by late August 2013, MBIA conveyed to the SEC that it had gone so far as to negotiate a tentative agreement with Ms. Tilton. The SEC understood that a restructuring of Zohar I would greatly diminish the chances of their being authorized to bring a case against Ms. Tilton and Patriarch, because any noteholder that agreed to a restructuring would have had to implicitly approve of Ms. Tilton's continued and past management of the Zohars, thereby undermining the SEC's potential case.

Shockingly, instead of letting the restructuring go forward, the SEC acceded to MBIA's requests and supplied MBIA with confidential, nonpublic financial statements, interest payment

and accrual listings, balance sheets, and income statements for eight of the Portfolio Companies, which Ms. Tilton had provided to the SEC during the SEC's investigation. *See* Resp. Exs. 515-16, 518 (Dec. 18, 2013 and Jan. 30, 2014 emails). The SEC expressly authorized MBIA to use the documents for the purpose of targeting Ms. Tilton and Respondents in civil litigation, so long as it did not "cite or attach any of the documents received from the SEC to any complaint while those documents remain confidential and non-public." Resp. Ex. 516 (Dec. 17, 2013 email). In other words, MBIA was free to use the documents to its advantage as long as those documents could not be traced back to the SEC.

Documents received from the SEC in hand, MBIA chose not to allow a restructuring that would have benefited noteholders. Instead, it set its sights on litigating against Ms. Tilton and trying to obtain equity and fees that belong to Ms. Tilton, fully understanding the litigation advantage it was gaining through the SEC's actions. MBIA fed its self-serving version of events to the SEC, admitting to the Division staff that it wanted to "own Zohar I" and dupe Ms. Tilton into "go[ing] all in" before suing her company, using the confidences improperly divulged by the SEC. Resp. Ex. 501. The SEC, for its part, used the dispute between Ms. Tilton and MBIA to manufacture grounds for an SEC enforcement proceeding.

In the fall of 2013, Ms. Tilton hired the investment bank Moelis & Company to help with an alternative restructuring plan: Ms. Tilton would spend $300 million of her own funds, along with additional money raised from a third party or parties, to repurchase all of the Zohar notes from noteholders. Moelis & Company helped raise $1.1 billion for this purpose. Under this alternative plan, once the Zohar noteholders were fully repaid, Patriarch would withdraw as an investment advisor, and operate instead as a family office focusing on the Portfolio Companies. However, notwithstanding that this plan was in the works, the SEC issued a Wells Notice in

October 2014, and the deal (which the SEC was aware of) fell through. Respondents provided the Division with a detailed Wells Submission contesting the alleged, potential violations of the Wells Notice.

II. The Division Files An OIP Alleging That Respondents Failed To Disclose That They Maintained Loan Categorizations While Postponing Interest Payments, And That Their Financial Statements Were Inaccurate As A Result.

In March 2015, by a 3-2 vote, the Commission authorized the Division to institute proceedings against Respondents based on narrow allegations set forth in the OIP. *See Lynn Tilton*, Investment Advisers Act Release No. 4053 (Mar. 30, 2015). Commissioners Daniel M. Gallagher and Michael S. Piwowar "[d]isapproved." SEC, Final Commissioner Votes, at 849 (Mar. 2015), *available at* https://www.sec.gov/foia/docs/votes/2015-03.pdf. The OIP contains a single core factual allegation: That Ms. Tilton and Patriarch had failed to disclose that they were categorizing loans using "subjective" methods, rather than in accordance with the purportedly objective standards set forth in the Indentures. *See* OIP ¶¶ 3-6, 29-51. This factual allegation animates the Division's legal theories: (i) as a purported material misrepresentation or actionable omission in communications with noteholders made via the Trustee Reports, *see id.*; (ii) as a purported breach of Ms. Tilton and Patriarch's fiduciary duties to the Zohars, either in failing to disclose the actual method of categorization, or in failing to disclose the conflict of interest that purportedly arose from use of that method, *see id.* ¶¶ 9, 52-56; and (iii) as financial statement-related misconduct, either insofar as the financial statements were inaccurate because they misrepresented that those statements were GAAP-compliant, *see id.* ¶¶ 7-8, 57-68, or because the notes to the Zohars' financial statements misrepresented that the fair value of the loans in the portfolio was approximately equal to their carrying value on the balance sheet, *id.* ¶¶ 7-8, 69-73. These legal theories, in turn, are charged against all Respondents as alleged violations of

Sections 206(1), 206(2), and 206(4) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq.* (2015) ("Advisers Act" or "IAA"), and Rule 206(4)-8 promulgated thereunder, *see* 17 C.F.R. § 275.206(4)-8 (2007); and the same theories are further charged against Patriarch (but not Ms. Tilton individually) as aiding and abetting the substantive charges. OIP ¶¶ 74-76.

Notably, "[t]he Division does not make any allegation that Respondents' subjective judgments relating to the portfolio companies were incorrect." Opp. Mot. More Definite Statement, at 4. Instead, the Division alleges that "Respondents' fraud stems from the use of Tilton's own subjective methodology to value and categorize the Funds' assets, rather than following the objective methodology disclosed in the governing documents . . . . [and the] failure to disclose [that] subjective methodology also breached fiduciary duties . . . owed to the Funds." Opp. to Summ. Disposition, at 19; *see also* Opp. Mot. More Definite Statement, at 3-7 (same).

III. The Division Builds A Case Resting Almost Solely On Its Experts, Whose Reports Are Unreliable, And On Noteholder Witnesses Who Were Fully Aware Of The Practices The Division Now Claims Were Not Disclosed.

Despite the Division's extended five-year investigation, its case rests almost entirely on the opinions of three experts, Ira Wagner, Dr. Steven L. Henning, and Michael G. Mayer, whose reports are replete with improper, unreliable testimony. In fact, the Division's experts are the only witnesses on its "will call" list other than Respondent Lynn Tilton herself.

Each of these expert reports is filled with improper legal conclusions (*e.g.*, contract interpretation), improper fact-finding (*e.g.*, Ms. Tilton's practices with respect to loan categorization), and wholly inappropriate factual narratives (*e.g.*, wholesale recitation of hearsay

investigative testimony).[14] *See* Resp. Br. in Supp. of Mots. *in Lim.* to Strike (Aug. 26, 2016); Resp. Br. in Supp. of Mot. *in Lim.* to Exclude Henning (Aug. 31, 2016). In fact, a respected federal judge recently excoriated the Division for proffering written expert testimony from Mr. Wagner—one of the Division's experts in this proceeding—that was "problematic and not admissible" because Mr. Wagner purported to "find[] facts that [we]re in contention," and he opined on "legal conclusion[s]" that were "not proper expert testimony." *See SEC v. Tourre*, 950 F. Supp. 2d 666, 681 (S.D.N.Y. 2013) (Forrest, J.). Additionally, the Division's experts are not qualified to render the opinions offered, and they employ unreliable methodologies to reach their conclusions. *See* Aug. 31, 2016 Mem. Law in Supp. of Resp. Mots. *in Lim.* to Exclude Expert Testimony of Mayer/Wagner; Aug. 31, 2016 Mem. Law in Supp. of Resp. Mot. *in Lim.* to Exclude Henning.

Moreover, each of the Division's experts failed to take into account crucial evidence in forming their opinions. For example, Mr. Wagner ignores the role of independent agents in the Zohars' operations, including the responsibilities of the Trustee with respect to compiling and verifying the information in the Trustee Reports, performing the quality and coverage tests, calculating the waterfall, and identifying defaulted obligations. Mr. Henning has not performed the type of analysis necessary to conclude that the Zohar financial statements did not "present fairly in conformity with GAAP" the balance sheets of the Zohars, and his conclusion that the financial statements are false and misleading because "Patriarch made the disclosure that it

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[14] *See, e.g.*, *United States v. Scop*, 846 F.2d 135, 140 (2d Cir. 1988) (government expert's opinions were "legal conclusions" that inappropriately "invade[d] the province of the court to determine applicable law"); *United States v. Cruz*, 981 F.2d 659, 663 (2d Cir. 1992) ("manifestly erroneous" to admit expert testimony that merely "bolster[s]" a party's factual narrative); *see also Del Mar Fin. Servs., Inc.*, Securities Act Release No. 8314, 2003 WL 22425516, at *8-9 (Oct. 24, 2003) (rejecting admission of investigative testimony).

conducted a specific impairment analysis, but it did not perform the analysis that it purports to have done," Div. Ex. 21 ("Henning Rebuttal") at 11, is not supported by accounting (or auditing) guidance. And when Mr. Mayer measured the OC ratio for a given period, he did so in isolation without considering the effect a paydown of principal would have on subsequent measurements. These are only some of the many evidentiary and methodological flaws that will be brought out at the hearing.

The Division's current "may call" list, meanwhile (as narrowed in conversations with counsel for the Division subsequent to the exchange of witness lists), includes primarily noteholders who, as made clear by the Division's recent disclosures of exculpatory noteholder witness statements, were aware of the practices the Division claims are unlawful. *See infra* pp. 43. Moreover, these witnesses are biased against Ms. Tilton and Patriarch. Three out of five of the Division's most important witnesses are tainted because their employers are all adverse to Respondents in either ongoing or threatened litigation, one of which has flatly refused Your Honor's order requiring that witness to produce documents. *See Lynn Tilton*, Administrative Proceedings Release No. 4153, at 2 (ALJ Sept. 14, 2016); Mem. of Law in Support of Resp. Mot. to Preclude Div.'s Witness, Matthew Mach, from Testifying (Oct. 11, 2016). What is more, a witness for SEI Investments Company has already disclosed that he "hopes that this proceeding against Respondents results in financial recovery for his fund and the fund's clients." And a separate witness for Norddeutsche Landesbank Girozentrale stated that "he hopes that testimony he gives in this proceeding is helpful to his legacy at Nord," which was purportedly affected by his recommendation to invest in the Zohars.

IV. Respondents Continue To Contest The Constitutional Validity And Fundamental Fairness Of This Proceeding, Including Through Motions In This Proceeding.

Respondents have, *inter alia*, contested in federal actions the validity of this proceeding under the Appointments Clause and as a violation of their due process and equal protection rights under the Fifth Amendment of the U.S. Constitution.[15] Respondents urge Your Honor to find this proceeding to be invalid for each of these reasons. In addition, since the Division issued the OIP, Respondents have filed a series of motions aimed at obtaining a full and fair hearing, including, among others, two motions to compel production of *Brady* materials pursuant to Rule 230, and a motion to stay the proceedings and compel further *Brady* disclosures in light of the Division's repeated misconduct discovered on the eve of trial. *See* Mem. of Law in Supp. Resp. Mot. to Compel Production of *Brady* Materials (Aug. 31, 2016); Mem. of Law in Supp. Resp. Mot. to Compel. Production of *Brady* Material and Jencks Act Witness Statements (Oct. 12, 2016); Mem. of Law in Supp. Resp. Mot. to Stay Proceedings and Compel Div. to Make Further Disclosures Regarding Two Witnesses (Oct. 16, 2016). The Division's misconduct at issue in these motions warrant remedies ranging from witness preclusion, issue preclusion, or even termination of this proceeding. In addition to moving to compel exculpatory and impeachment evidence, Respondents have challenged the fundamentally unfair timing of the hearing, filed motions to strike the Division's expert witnesses, moved to preclude the Division from introducing irrelevant, unreliable, immaterial, and unduly repetitious evidence, and filed a motion for summary disposition. Respondents incorporate by reference and reiterate all of the motions Respondents have made throughout this proceeding that have been denied in whole or in part. To the extent Respondents' motions have been denied, Respondents urge Your Honor to

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[15] *See, e.g.*, Compl., *Tilton v. SEC*, No. 15 Civ. 02472 (S.D.N.Y. Apr. 1, 2015); Pet. to Comm'n, Tilton, Admin. Proc. File No. 3-16462 (July 25, 2016); Applic. Stay Pending Filing & Disp. Pet. Writ Cert., *Tilton v. SEC*, No. 16A242 (U.S. Sept. 2, 2016).

reconsider those rulings to safeguard the fundamental fairness of this proceeding. To the extent Your Honor deemed certain motions to be premature, Respondents intend to renew those objections at the hearing.

LEGAL STANDARDS

The Division "bears the burden of proving, by a preponderance of the evidence, each of the elements of the alleged causes of action." *SEC v. Lowry*, 396 F. Supp. 2d 225, 240 (E.D.N.Y. 2003).[16] Here, each charged provision or rule includes the following elements: (a) that Respondents made false representations or actionable omissions to, or engaged in deceptive conduct towards, a client or investor, *see Lawrence M. Labine*, Initial Decision Release No. 973, 2016 WL 824588 (ALJ Mar. 2, 2016); Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Advisers Act Release No. 2628, at 11 (Aug. 3, 2007) (final rule); (b) that the misrepresentations, omissions, or deceptive conduct were material, *see Anthony Fields*, Initial Decision Release No. 474, 2012 WL 6042354 (ALJ Dec. 5, 2012); and (c) that Respondents acted with scienter—meaning actual intent to defraud or extreme recklessness—or negligence.[17]

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[16] The Division alleges that Respondents violated: (a) Sections 206(1) and 206(2) of the Advisers Act, which regulate an investment adviser's conduct towards its clients (here, the Zohars); and (b) Section 206(4) of the Advisers Act and Commission Rule 206(4)-8, which regulate an investment adviser's conduct towards investors (here, the noteholders). In Section 206(4), Congress directed the Commission to define the investor-directed conduct prohibited by the provision; Rule 206(4)-8 does so. Accordingly, while the OIP alleges separate violations of the provision and the rule, they are in fact coextensive. The Division alternatively alleges that Patriarch (but not Ms. Tilton personally) aided and abetted violations of these same provisions and rule.

[17] While the Supreme Court has held that the preponderance of the evidence standard applies to securities fraud claims, *Steadman v. SEC*, 450 U.S. 91, 102 (1981), it has also acknowledged that there may be cases in which the severity of the penalty raises constitutional concerns that require greater due process protections, *id.* at 95; *see also In re Ruffalo*, 390 U.S. 544, 550-52

[Footnote continued on next page]

Section 206(1) may be violated only with intent or extreme recklessness, *SEC v. Steadman*, 967 F.2d 636, 641 (D.C. Cir. 1992), while Sections 206(2) & (4) and Rule 206(4)-8 may also be violated by negligent misconduct, pursuant to Your Honor's ruling denying Respondents' motion to require the Division to prove intentional misconduct for all charges. Rule 206(4)-8 is invalid, and Respondents ask that the Rule 206(4)-8 charge be dismissed on that basis, but this submission otherwise assumes its validity.[18]

As discussed below, the Division cannot establish any of the elements of any of the substantive violations alleged here. And if there is no "primary . . . violation," there can be no aiding and abetting liability. *Stein*, 1999 WL 756083, at *9. Accordingly, the charges should be dismissed. *See, e.g., id.* at *12 (dismissing claims asserted under Sections 206(1) & (2) because undisclosed facts were "not material" and respondents acted in "good faith"); *Brandt, Kelly & Simmons, LLC*, Initial Decision Release No. 289, 2005 WL 1584978, at *7 (ALJ June 30, 2005) (Foelak, J.) (finding "no scheme to defraud, no material misrepresentations or omissions, and [therefore] no violation of Sections 206(1) or 206(2) of the Advisers Act"); *SEC v. Mannion*, 2013 WL 1291621, at *15 (N.D. Ga. Mar. 25, 2013) (granting partial summary judgment for respondents on SEC's 206(1) and 206(2) claims on lack of materiality grounds).

[Footnote continued from previous page]

(1968). Given the Division's request that Ms. Tilton be permanently barred from the securities industry and that Respondents pay over $200 million in disgorgement, this is such a case.

[18] Rule 206(4)-8 is invalid because it exceeds the authority granted to the SEC in the enabling statute, *see* IAA § 206(4), and is unconstitutionally vague. Contrary to the statutory mandate to "define . . . such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative," *id.*, the rule defines the prohibited conduct as, *inter alia*, "any act, practice, or course of business that is fraudulent, deceptive, or manipulative," Rule 206(4)-8(a)(2). The rule is accordingly inconsistent with Congress's command and provides no meaningful notice of what conduct is prohibited. *See Kolender v. Lawson*, 461 U.S. 352, 358 (1983).

ARGUMENT

The Division's allegations regarding Respondents' categorization methods are meritless. Respondents did not misrepresent or deceptively omit information relating to their approach to categorizing loans, as their categorization practices were fully disclosed in Trustee Reports, investor calls, and other communications, *infra* Arg. Part I.A.1, and were plainly contemplated and permitted by the relevant Indentures and CMAs, *infra* Arg. Part I.A.2. Moreover, even if Respondents' approach to categorizing loans had not been disclosed (and it was), that information was not material because it would not have affected the Zohars' or noteholders' investment decisions. Arg. Part I.B, *infra*. Nor can the Division prove intentional fraud (or even recklessness or negligence). Arg. Part I.C, *infra*.

The Division's case with respect to the financial statements is likewise meritless: It rests on the same fundamental misinterpretation of the Indentures and misunderstanding of Respondents' appropriate and transparent business practices. Arg. Part II.A, *infra*. These charges are a transparent attempt to manufacture wrongdoing, even though Respondents had appropriate processes in place for the preparation and review of the financial statements and reasonably relied on their external accountants to review and sign off on those statements, negating any scienter (or even negligence). Arg. Part II.B, *infra*. Furthermore, the Division cannot possibly prove the materiality of the purported financial statement errors. Arg. Part II.C, *infra*. Finally, the Division's trumped up charges fail to justify the sanctions it seeks. Arg. Part III, *infra*.

I. The Division's Case With Respect To Categorizations Has No Merit.

A. Respondents Did Not Make Any Actionable Misrepresentations Or Omissions Or Engage In Deceptive Conduct.

1. Respondents' Approach To Categorization Was Evident On The Face Of Trustee Reports Available To All Stakeholders, And Was Openly Discussed With Noteholders.

The Division's case rests on the assertion—repeated throughout the OIP—that Respondents "never disclosed Tilton's discretionary valuation approach to the Funds or their investors." OIP ¶ 9.[19] According to the Division, Respondents deliberately acted to ensure that they were the only parties aware that, at times, certain loans identified by Respondents as Category 4 had not paid the full stated interest due under the original terms of the loans. As an initial matter, however, Section 206 does not create a duty to disclose *anything* to noteholders, for whom Respondents were not fiduciaries. *Cf. SEC v. Mapp*, 2016 WL 5870576, at *6, 14 (E.D. Tex. Oct. 7, 2016) (dismissing securities fraud claims because defendant "did not have a legal obligation to disclose his financial arrangement" to potential investors, with whom the defendant "did not form a fiduciary relationship"). And with respect to the Zohars, Respondents were their agents, and worked for their benefit, so anything Respondents knew is imputed to the Zohars, defeating any nondisclosure theory. *See infra* Arg. Part I.A.III.2. Putting aside those legal defenses, the Division's theory crumbles factually because Respondents transparently disclosed that loans were not automatically downgraded to Category 1 when the full stated interest was not paid. *See Brandt, Kelly & Simmons LLC*, 2005 WL 1584978, at *8 ("Assuming, *arguendo*, that BKS was required to disclose the payment . . . , its failure to do so was mitigated

[19] *See also, e.g.*, OIP ¶¶ 49 ("Respondents have not at any time disclosed Tilton's discretionary approach to categorization to the Funds or their investors."), 54 ("undisclosed approach to categorization"), 56 (Respondents "have not disclosed Tilton's actual method of categorization").

by its subsequent amendment to disclose the payment when it learned that Commission staff considered that it should be disclosed."); *cf. Frigitemp Corp. v. Fin. Dynamics Fund, Inc.*, 524 F.2d 275, 283 (2d Cir. 1975).

The Trustee Reports alone disprove the alleged secrecy of Respondents' approach. Each monthly and quarterly Trustee Report revealed Patriarch's categorizations along with whether or not the loans had paid in full the interest due under the original terms of the loans. Consider the Zohar II July 2009 quarterly Trustee Report, from which noteholders learned that three Category 4 loans, to American LaFrance, had paid $200,000 in interest for the quarter, despite owing $1.25 million for that period under the original terms of the loan. *See supra* pp. 26 n.11.[20] Or consider the May 2011 Zohar I Trustee Report, from which noteholders learned that the aggregate of Category 4 funded loans had paid $5.5 million in interest, but had a quarterly stated interest of approximately $11 million. *See supra* p. 25-26 n.10.[21] In addition, with each Trustee Report, noteholders had access to raw, detailed, loan-level data, which they used to assess the performance of the loans. *See supra* pp. 25-26. From that data, noteholders could readily determine the amount of interest paid versus the amount owed under the original terms of the loans.

By comparing the interest paid to the stated interest on the Trustee Reports, a noteholder could, using basic arithmetic, discern that nonpayment of the full stated interest did not automatically remove the loans from Category 4. That understanding is neither theoretical nor

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[20] The stated interest for the quarter could be calculated by multiplying the interest rate, 10%, by the principal balance, approximately $50 million, and dividing by four.

[21] The stated interest for the quarter could be calculated by multiplying the interest rate, 9%, by the principal balance, approximately $477 million, and dividing by four.

the product of hindsight: Noteholders' contemporaneous communications reveal that they used these numbers and understood the results, occasionally engaging with Respondents to discuss the non-payment of interest on Category 4 loans. *See supra* pp. 26-27; *see also* Dolan Rep. ¶¶ 61-83, 85, 91, 108. Ms. Tilton was also upfront about her discretionary approach during investor calls. *See supra* pp. 24-25. And when ratings agencies and noteholders asked questions about loans remaining in Category 4 despite interest payments being deferred, Respondents disclosed their practices forthrightly. *See supra* pp. 26-28.

On top of the contemporaneous documents that make clear that noteholders were well aware—and did not object—that Respondents were maintaining loan categorizations despite sometimes not collecting full stated interest, the Division has disclosed to Respondents that *its own noteholder witnesses* provided direct, exculpatory statements on this issue. In particular, a representative from noteholder Nord "noted from time to time from the trustee reports that certain loans were not up to date on their interest payments" and knew that the "collateral manager does have some ability to defer an interest payment in the short term," Resp. Ex. 542, while a representative from noteholder SEI told the Division he "noted that in certain cases interest rates of loans reflected on monthly trustee reports were lowered and maturity was extended" and that he knew "that certain loans were not paying current interest but were still carried as performing loans," Resp. Ex. 541.

Moreover, on several occasions between 2011 and 2015—in other words, before and after the SEC's allegations of wrongdoing were made public—Ms. Tilton conveyed to MBIA an offer to resign as collateral manager, so long as the resignation was part of a responsible and orderly transition to another collateral manager, as was required by the CMAs. Not only did MBIA never accept her resignation, its representatives repeatedly told her that she was essential

to the success of the Portfolio Companies. It defies logic that MBIA would have permitted Ms. Tilton to remain as collateral manager—even after it indisputably knew of the SEC's allegations—if it truly believed it had been misled about her categorization practices, or that she had otherwise defrauded them or willfully breached the Indentures or CMAs.

The Division cannot overcome this basic defect in its theory of wrongdoing. Having predicated its entire case on the notion that Respondents "never disclosed Tilton's discretionary valuation approach," OIP ¶ 9, the allegations fail because the allegedly hidden conduct was revealed on the face of monthly and quarterly reports sent to noteholders, and in numerous other communications with interested parties, including the noteholders. There simply were no material misrepresentations or omissions, or deceptive conduct of any kind.

2. The Governing Documents Permitted The Practices Now Challenged By The Division.

According to the Division, "this case is about" their erroneous view that the relevant contracts required Respondents to automatically treat as defaulted, and to re-categorize as failing, any loan that did not pay interest as originally scheduled. Opp. to Summ. Disposition at 16-17. Specifically, the Division argues that "[t]here is no reference in the indenture to any type of discretion for asset categorization," *id.* at 3, and that it was thus improper for "Tilton [to] use[] her own subjective judgment" with respect to categorization, *id.* at 1. Contrary to the Division's theory, the Indentures expressly authorize Respondents' exercise of their discretion to unilaterally amend and restructure loans. *See infra* Arg. Part 1.A.2.i. Since the Indentures contemplate, disclose, and permit the very practices that the Division says were inappropriate, there is no basis to contend that these practices (or the alleged failure to disclose them) constitute misrepresentations, fraudulent omissions, or deceptive conduct.

Moreover, given that the Division's allegations are premised on its (erroneous) interpretation of the contract, the alleged fraud is nothing more than a re-packaged breach-of-contract theory. But a "breach of contract claim cannot be dressed up as a fraud claim." *Todi Exports v. Amrav Sportswear Inc.*, 1997 WL 61063, at *3 (S.D.N.Y. Feb. 13, 1997). There is no breach-of-contract liability under Advisers Act § 206 and Rule 206(4)-8. Accordingly, the OIP's fraud claims fail. *Cf. Bridgestone/Firestone, Inc. v. Recovery Credit Servs., Inc.*, 98 F.3d 13, 20 (2d Cir. 1996) (vacating common-law fraud liability "premised upon an alleged breach of contractual duties").

i. The Indentures' Plain Meaning Provides For "Extensive Amendment" To Loan Terms By Respondents, To Avoid Default And To Maintain The Loans' Categorization.

Each Indenture establishes a categorization scheme that fundamentally distinguishes between: (a) loans the Zohars continue to support, and (b) failing loans that are no longer performing. A loan from which the collateral manager continues to expect performance (*i.e.*, the ability to ultimately pay the principal and interest owed) is placed in Category 4, while a failing loan is placed in Category 1.[22] According to the Indentures, a loan belongs in Category 4 if it satisfies each of five elements: (i) it is "a Current Collateral Debt Obligation"; (ii) it is not involved in bankruptcy proceedings; (iii) there has been no "event of default or any default" under the credit agreements, "which has not been waived"; (iv) "there are no negotiations, at

[22] The Zohar III indenture uses different terminology for essentially the same loan categorization system. What was "Category 1" in the Zohar I and Zohar II indentures is called "Defaulted Investment" in the Zohar III indenture. Instead of "Category 4," as in the Zohar I and Zohar II indentures, the Zohar III indenture employs the category "Collateral Investment." *See* Zohar III Indenture § 1.1 at 18-19, 21. Although the definitions are not identical, the result is the same, and the Division appears to consider them equivalent. *See* OIP ¶ 38. Respondents therefore use the terms "Category 1" and "Category 4" to refer to the counterpart categories across the various Indentures, unless otherwise noted.

time of measurement, to restructure"; and (v) "in the reasonable judgment of the Collateral Manager" it is not at "significant risk of declining in credit quality or, with the passage of time, becoming Category 1, Category 2 or Category 3." Indenture § 1.1 at 9; *see also* Zohar I Indenture § 1.1 at 10; *cf.* Zohar III Indenture § 1.1 at 18-19.[23] The Division does not meaningfully dispute that elements 2 through 5 were satisfied as to the loans that the Division now contends should not have been in Category 4. *See* OIP ¶ 37. Instead, the Division hangs its case on the first element: whether a given loan is a "Current Collateral Debt Obligation."

A Current Collateral Debt Obligation is one that is not "Non-Current." Indenture § 1.1 at 22. A "Non-Current Obligation," in turn, is a "Defaulted Obligation." *Id.* at 44.[24] The Indentures define "Defaulted Obligation" as applying to several groups of loans. *Id.* at 23. The relevant group here is a loan "with respect to which a *default* as to the payment of principal and/or interest has occurred (without regard to any applicable grace period or any waiver of such default), but only so long as such default has not been cured." *Id.* (emphasis added).[25] This definition uses the term "Default," which is itself defined essentially as an "Event of Default."

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[23] Categories 2 and 3, which are not directly at issue in this litigation, refer to current loans at various stages of bankruptcy. *See* Indenture § 1.1 at 8-9. Because Category 1 is defined as the residual category for any loan (with exceptions not relevant here) "that does not satisfy the criteria of any of Category 2, Category 3 or Category 4," *id.* at 8, and because the Division agrees that Categories 2 and 3 are not at issue in this case, the categorizations at issue hinge on the five elements of Category 4.

[24] In full, this prong of the definition of "Non-Current Obligation" provides: "Any Defaulted Obligation the issue of, or Obligor on, which has previously deferred and/or capitalized as principal any interest due thereon (unless any interest so deferred and capitalized has subsequently been paid in full in Cash to the Issuer or the Zohar Subsidiary, as applicable)." Indenture § 1.1 at 44.

[25] In the Zohar III indenture, the terminology was adjusted slightly (to "Defaulted Investment") but the provisions are substantially the same. *See* Zohar III Indenture § 1.1 at 21.

Id. at 23.[26] As relevant here, an "event of default" means a "default in the payment of" interest on any Class A-1, Class A-2, or Class A-3 Note "when the same becomes due and payable." Indenture § 5.1(a); Zohar III Indenture § 5.1(a).

The Division's case is based entirely on the faulty premise that a "default" automatically occurs—and a loan must be automatically re-categorized as Category 1—when an interest payment is not paid in full by the due date provided in the original loan agreement. But the Division ignores the collateral manager's express authority to unilaterally amend a loan's payment terms, or to forebear on loan payments. *See* Froeba Rep. ¶¶ 53-62. The language in the Indentures does not support the Division's view that an interest payment postponed by the collateral manager (through amendment or forbearance) causes the loan to automatically default. *See id.* ¶¶ 63-75. To the contrary, the definition of "Event of Default" applies only if the interest is unpaid "when the same becomes due and payable." Indenture § 5.1(a). If the collateral manager amends the terms of the loan to reflect a different date on which the interest becomes due and payable, default is measured pursuant to the amended deadline rather than the superseded deadline. *See* Froeba Rep. ¶¶ 53-56.

The Indentures expressly authorize the collateral manager to make such discretionary amendments, and provide that the parties "acknowledge and agree" that it will do so "extensive[ly]":

> [T]he Collateral Manager . . . may, without the consent of the Holders of any Notes or the Credit Enhancer [*i.e.*, MBIA], enter into any amendment, forbearance or waiver of or supplement to any Underlying Instrument included in the Collateral, so long as such amendment, forbearance, waiver or supplement

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[26] The full definition of "Default" reads as follows: "Any Event of Default or any occurrence that is, or with notice or the lapse of time or both would become, an Event of Default." Indenture § 1.1 at 23.

> does not contravene the provisions of any Transaction Document or contravene any applicable law or regulation. For the avoidance of doubt and notwithstanding anything else contained herein, the parties hereto acknowledge and agree that the Collateral Debt Obligations will consist of stressed and distressed loans that may be the subject of extensive amendment, workout, restructuring and/or other negotiations . . . .

Indenture § 7.7(a).[27]

By providing that the collateral manager "may . . . enter into *any* amendment to *any* Underlying Instrument" (emphases added) "without the consent" of the noteholders or MBIA, Section 7.7(a) makes clear that loan amendments are the discretionary domain of the collateral manager. Froeba Rep. ¶¶ 58-62. The same section goes on to state the common understanding of the parties that each of the Zohars "will consist of stressed and distressed loans that may be the subject of *extensive* amendment" (emphasis added), thereby articulating the parties' understanding that the collateral manager's discretion to amend loans will be used frequently and is critical to the success of the investment.[28] This discretion to amend loans or forbear on interest payments would be fruitless if its exercise triggered an automatic re-categorization of those loans

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[27] The CMAs contain substantially the same language, providing that "the Collateral Manager may, . . . without the consent of the holders of any Notes or any other Person, enter into any amendment, modification or waiver of, or supplement to, any term or condition of any Collateral, Collateral Debt Obligation, Unrestricted Collateral Debt Obligation and/or Equity Security . . . ." CMA § 2.2(c). Those agreements also emphasized the risky nature of the investments and the necessity of the collateral manager's flexible administration of the collateral: "For the avoidance of doubt and notwithstanding anything else contained herein, the [parties] acknowledge and agree that the [collateral] will consist of stressed and distressed loans that may be the subject of extensive amendment, workout, restructuring and/or other negotiations . . . ." *Id.* § 2.2(p).

[28] These amendments can be accomplished either in writing or orally. *See United States v. Schwimmer*, 968 F.2d 1570, 1575 (2d Cir. 1992) (noting that "an oral modification to a contract may be valid, even if the contract was in writing"). Here, oral modification was not only permitted, *see id.*, but was necessary, given the impracticable and costly alternative of preparing a written amendment to the loan documents each time Patriarch permitted a Portfolio Company to pay less than the stated interest.

as defaulted; any other interpretation would "have the effect of rendering [the 'extensive amendment'] clause superfluous or meaningless" and should therefore "be avoided if possible." *Garza v. Marine Transport Lines, Inc.*, 861 F.2d 23, 27 (2d Cir. 1988); *accord A.X.M.S. Corp. v. Friedman*, 948 F. Supp. 2d 319, 332 (S.D.N.Y. 2013).

The propriety of this construction is confirmed by comparison with another aspect of the definition of a "Defaulted Obligation" in the Zohar I and II indentures. Specifically, a default occurs "without regard to any applicable grace period or waiver of such default." Indenture § 1.1 at 23. This clause omits any mention of amendment or forbearance. *Cf.* Froeba Rep. ¶¶ 63-75. Under the bedrock canon of contract interpretation, *expressio unius est exclusio alterius*, "the inescapable conclusion is that the parties intended the omission." *Quadrant Structured Prods. Co. v. Vertin*, 23 N.Y.3d 549, 560 (2014).[29] The omission of language from a given clause—here, amendment or forbearance from the definition of default—"is particularly significant [when] . . . sophisticated drafters elsewhere employed precisely such language." *Bank of N.Y. Mellon Tr. Co. v. Morgan Stanley Mortg. Capital, Inc.*, 821 F.3d 297, 306 (2d Cir. 2016) (per curiam) (applying New York law). Because Section 7.7(a) expressly grants the collateral manager the authority to undertake "any amendment, forbearance or waiver," the drafters and signatories knew that an otherwise defaulted loan might be amended or subject to forbearance to avoid default. Yet the definition of default carves out only a waiver, while omitting any mention of amendment or forbearance. If the definition of a Defaulted Obligation were intended to include payments postponed beyond the original due date by amendment or forbearance, the definition of default could easily have read: "without regard to any applicable grace period,

[29] New York law governs the interpretation of the Indentures and the CMAs. *See, e.g.*, CMA § 7.5 ("Governing Law"); Indenture § 18.9 ("Governing Law").

amendment, forbearance, or waiver of such default"—but it does not. *Cf.* Froeba Rep. ¶¶ 63-75. Thus, the Indentures make clear—as a matter of unambiguous contract interpretation—that there is no default where the due date for payment has been modified by amendment or forbearance.[30]

It is also important that the definition of Category 4 expressly requires the collateral manager to *subjectively* evaluate each loan, and to make a "reasonable judgment" as to the loan's "risk" and "credit quality" in determining the appropriate categorization, Indenture § 1.1 at 9 (Definition of "Category 4" at (v))—contrary to the Division's attempt to depict the requirements as entirely "objective" and to demonize Respondents for using their "subjective judgment." Opp. to Summ. Disposition at 16-17. In point of fact, Respondents were *required* to use their subjective business "judgment" to evaluate loans and to determine whether to maintain loans in Category 4 or, alternatively, to move loans from Category 4 to Category 1, as they sometimes did.[31] It is incredible that the Division (or any noteholder) would claim that the use of such subjective judgment in categorizing the loans (in addition to such factors as defaulted status) was not disclosed to, and agreed upon, by all participants.

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[30] The Zohar III indenture goes even farther than the Zohar I and Zohar II indentures by excluding from the definition of Defaulted Investment unpaid interest even where the Collateral Manager waives payment without amending the loan. *See* Zohar III indenture § 1.1 at 21 (removing from the definition of Defaulted Investment "without regard to any applicable grace period or any waiver of such default"); *see also id.* § 7.7(a) (permitting "amendment, forbearance or waiver"); Froeba Rep. ¶ 67.

[31] *See also* Indenture at 23 (Definition of "Defaulted Obligation" at (a)(ii)) (Collateral Manager to move a loan out of Category 4 if in its "sole judgment" the loan "will likely result in a default as to the payment of principal and/or interest," even if no such payment default has yet occurred). Although the categorization terminology changed for the Zohar III indenture, as noted above, such that it does not use the "reasonable judgment" language cited above, the definition of Defaulted Obligation (called "Defaulted Investment" in the Zohar III indenture) carries over the same "sole judgment" provision.

The meaning of these provisions is manifest. First, all parties "acknowledge[d] and agree[d]" to a system of "extensive amendment" of loan terms pursuant to the collateral manager's business judgment and sole discretion; and second, when the collateral manager exercises that discretion to amend a loan's terms by modifying the original date on which certain interest payments are due, non-payment of the full stated interest on the original due date does not trigger a default, and the loan is not automatically re-categorized as Category 1. And because the plain language is unambiguous in this regard, any attempt by the Division to manufacture ambiguity by relying on extrinsic evidence must be rejected. *See, e.g.*, *Omni Quartz, Ltd. v. CVS Corp.*, 287 F.3d 61, 64 (2d Cir. 2002).

ii. Respondents' Interpretation Of The Indentures Is The Only One That Is Commercially Reasonable And Consistent With The Structure And Purpose Of The Governing Documents.

It would be commercially unreasonable for the governing documents to be interpreted in a way that limits Respondents' discretion to amend loans, or that treats any payment not in accordance with the original loan terms as a default. A contractual interpretation is defective if it would "produce a result that is absurd, commercially unreasonable [and] contrary to the reasonable expectations of the parties." *SportsChannel Assocs. v. Sterling Mets, L.P.*, 807 N.Y.S.2d 61, 61 (1st Dep't 2006) (quotation marks and citation omitted). The Zohars' very existence, and the noteholders' investment expectations, depended on Ms. Tilton's ability to implement a distressed loan investment strategy in which the collateral manager could restructure payment terms in order to maximize the value of distressed loans over a long time horizon. Section 7.7(a) embodied this fundamental element of the Zohars' design.

Similarly, Respondents' interpretation is the only one that is consistent with the structure and commercial purposes of the agreements as a whole. *See Rex Med. L.P. v. Angiotech Pharm. (US), Inc.*, 754 F. Supp. 2d 616, 624 (S.D.N.Y. 2010) ("Under New York (and every other

state's) law, parties are not free to interpret a contract in a way that frustrates the purpose of that contract . . . ."); *see also* 11 Williston on Contracts § 32:9 (4th ed. 2015) (correct interpretation of a contract is the one that "effectuate[s] the principle or main apparent purpose of the parties"). Here, the governing documents were tailored to the Zohars' strategy: originate loans to distressed companies at interest rates well above the interest due to noteholders and provide broad discretion to an expert in distressed debt, Ms. Tilton, in order to facilitate the successful turnaround of the companies and maximize the value to noteholders. *See* Froeba Rep. ¶ 92. The Indentures and the CMAs highlight this strategy, in memorializing the parties' acknowledgement and agreement that the assets "will consist of stressed and distressed loans" and that the loans will be subject to "extensive amendment, workout, restructuring and/or other negotiations." Indenture § 7.7(a); CMA § 2.2(p). To effectuate this pivotal clause, and the strategy that the governing documents memorialize, Respondents needed the discretion to freely amend loans to avoid default and thereby maintain the loans' status in Category 4.

The Division's contrary interpretation would invite a perverse and irrational scenario, in which Patriarch and its affiliates invest new management teams and products in a distressed company, the company cannot make a full interest payment, and Respondents are required to immediately withdraw their support for the company, declare it in default, and reassign it to Category 1. Under the Division's misguided interpretation, this result was required even if Respondents have assessed in their business judgment that the Zohars would receive greater long-term value by allowing delayed payment of loan interest than by demanding immediate payment of full interest. This outcome would be undesirable for everyone—the Zohars themselves, the noteholders, and Patriarch—and cannot be what the parties intended. *See* Hubbard Rep. ¶ 23. Not only that, pursuant to Section 5.2 of the Indentures, such a scenario

would permit the Trustee or the Controlling Party to immediately accelerate the maturity of *all* of the Zohar notes, and as a result "declare the Outstanding principal of all the Notes" (as well as "all accrued or unpaid" interest) to be "immediately due and payable." It is inconceivable that the parties agreed to give the collateral manager extensive, unilateral authority to amend loan terms in order to "restructur[e]" and "workout" distressed loans, while at the same time permitting "all the Notes" to be called any time the collateral manager actually exercised that authority. The Division's interpretation, and its theory of liability, must be rejected.

3. Respondents Did Not Breach Any Fiduciary Duties To The Zohars.

i. Respondents Disclosed What The Division Mistakenly Calls A Conflict Of Interest.

The OIP's sole theory of fiduciary breach is that "Respondents have never disclosed Tilton's discretionary valuation approaches to the Funds or their noteholders, much less the conflict of interest these approaches created. As a result, Respondents also purportedly breached their fiduciary duties . . . ." OIP ¶ 9; *see also id.* ¶ 56. In other words, the Division's fiduciary breach claim depends on precisely the same allegations of nondisclosure addressed and rebutted above, and it fails for the same reason. *See supra* Facts Part V.A.1.

Respondents fully disclosed the practices at issue in the Indentures and CMAs. *See supra* Facts Part I.V. The Zohars expressly "acknowledge[d] and agree[d]" to these practices, CMA § 2.2(c), (p), and enjoyed the benefit of their bargain for 13 years, fully aware of its terms, including its grant of discretion to Ms. Tilton. Any breach of fiduciary duty allegation rooted in purported nondisclosure has no merit. *See, e.g.*, *Rodman v. Grant Found.*, 608 F.2d 64 (2d Cir. 1979) (upholding dismissal of fiduciary breach claim predicated on failure to disclose, since "full and fair disclosure was made"); *In re Seidman*, 37 F.3d 911, 933-36 (3d Cir. 1994) (no breach of fiduciary duty where interest giving rise to the purported conflict was disclosed).

The purportedly undisclosed "conflict of interest" allegation is equally meritless. *First*, the Zohars *explicitly acknowledged and waived* any conflict of interest between themselves and Respondents. In a section of each CMA titled "Conflicts of Interest; Acknowledgment of the Company," the Zohars: (1) acknowledged that "[v]arious potential and actual conflicts of interest may arise from the overall advisory, investment and other activities of [Respondents] . . . and their respective clients, including but not limited to the matters described in" a specific section of the CMA, Section 6.2(a); and (2) stated that "The Company and the Zohar Subsidiary hereby . . . consent to and waive the various potential and actual conflicts of interest that may exist from time to time with respect to [Respondents] as generally described in Section 6.2(a) above," Section 6.2(b). The Division's fiduciary duty charge cannot survive this broad, express waiver. *Cf. Bank of Am. v. Bear Stearns Asset Mgmt.*, 969 F. Supp. 2d 339, 356 (S.D.N.Y. 2013) (dismissing "as a matter of law" breach of fiduciary duty claim based on Collateral Management Agreement provision "waiv[ing] any conflict of interest that might otherwise exist for purposes of th[e] transaction").[32] *Second*, the alignment of interests between the Zohars and Ms. Tilton that the Division tries to twist into something untoward was a fundamental, necessary, and universally recognized feature of the Zohar deals. *See supra* Part Facts Part II-III.

Tellingly, Respondents continued to act as collateral manager for the Zohars until they voluntarily resigned in February 2016—almost six years after the Division began its investigation and almost one year after the Division filed the OIP. "The fact that [the investment manager] continued to manage investments for [its client] . . . suggests that they, at least, did not

[32] This is especially clear given the Zohars' and noteholders' extraordinary level of sophistication—a factor courts routinely take into account in upholding waivers as valid in the face of fiduciary breach claims under the IAA and elsewhere. *See, e.g.*, *Heitman Capital Mgmt. LLC*, SEC No-Action Letter, 2007 WL 789073 (Feb. 12, 2007).

think that [the investment manager] had acted in bad faith or under a conflict of interest in connection with their . . . investments." *Belmont*, 708 F.3d at 506 n.43.[33] The Zohars' independent Directors held multiple meetings after the OIP was filed—and even "retained Blank Rome LLP as US counsel to advise" with respect to, *inter alia*, the interpretation of the "terms of the Indenture"—but never suggested that Respondents had failed to disclose their categorization methodology or any purported conflict of interest. Div. Ex. 44 at PP131290 (minutes of Feb. 3, 2014 Zohar I Board meeting); *see also* Div. Ex. 45 at PP131309 & Div. Ex. 46 at PP 131362 (Zohar II & III post-OIP Board minutes). And just as tellingly, the Division has not interviewed, or made any effort to introduce in the hearing as a witness, any member of the Zohars' independent Directors—despite purporting to act on their behalf in asserting a breach of fiduciary duty, *see* Opp. to Summ. Disposition at 19—likely because it knows that they were fully informed of, and fully supported, the conduct at issue.

ii. Respondents Acted In The Best Interests Of The Zohars.

The Division does not dispute that Respondents are the agent of their client, the Zohars. *See* Opp. to Summ. Disposition at 18. Nor does the Division appear to dispute that, under principal-agent law, Respondents' knowledge is imputed to the Zohars (thus defeating any fraud claim under Section 206(1) and (2)), unless a narrow "adverse interest" exception applies. *Id.*; *see also, e.g., Apollo Fuel Oil v. United States*, 195 F.3d 74, 76 (2d Cir. 1999). The "adverse interest" exception on which the Division relies "cannot be invoked merely because [the agent] has a conflict of interest or because he is not acting primarily for his principal." *Center v.*

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[33] *See also Stein,* 1999 WL 756083, at *11 (noting that an IAA duty to disclose exists "so that the client [can] make an informed decision as to whether to enter into or continue an advisory relationship with the adviser or whether to take some action to protect himself against the specific conflict of interest involved" (internal quotation marks omitted)).

Hampton Affiliates, Inc., 488 N.E.2d 828, 830 (N.Y. 1985). Instead, as Your Honor has noted, the agent must "exhibit[] a 'total abandonment' of [the principal]'s interests." *Lynn Tilton*, Admin. Proc. Rulings Release No. 4157, at 2 (ALJ Sept. 16, 2016) (quoting *Bank of China, N.Y. Branch v. NBM LLC*, 359 F.3d 171, 179 (2d Cir. 2004)).

Here, Respondents did not "exhibit a total abandonment" of the Zohars' interests. Utterly to the contrary, they acted in the Zohars' best interests at all times, including by actively managing the Portfolio Companies on the Zohars' behalf and by working tirelessly to restructure the Zohars in a way that would benefit all stakeholders. Ms. Tilton invested over $200 million in the Zohars, and she reinvested substantial amounts of money into the Portfolio Companies, which inured to the Zohars' advantage. Moreover, Patriarch's strategy has proven successful: Many once-failing Portfolio Companies currently have tremendous value that is largely attributable to Ms. Tilton's extensive efforts to rehabilitate them, including by using her discretion to amend loans to postpone interest payments due. These facts preclude liability for purported breaches of fiduciary duty, and alleged fraud on the Zohars, under Sections 206(1) and (2). *See Apollo Fuel Oil*, 195 F.3d at 76; *Brandt, Kelly & Simmons LLC*, 2005 WL 1584978, at *8 (finding no violations of § 206(1) and § 206(2) where respondent "worked diligently" in pursuit of client interests).

B. Any Misrepresentations, Omissions, Or Deceptive Conduct Would Not Have Been Material, In Light Of Respondents' Extensive Disclosures.

Even if Respondents had not accurately described or disclosed their practices, the Division's theory would still fail because any misrepresentation or omission was immaterial to noteholders and the Zohars. Materiality is an element of each charge and is satisfied only if the Division can prove to "a substantial likelihood that a reasonable investor would consider [the fact] important," meaning that "'disclosure of the omitted fact would have been viewed by the

reasonable investor as having significantly altered the total mix of information made available.'" *Stein*, 1999 WL 756083, at *11 (quoting *Basic*, 485 U.S. at 231-32). Even if Respondents had not fully and accurately disclosed the at-issue practices, further disclosure would not have changed the overall mix of information for the Zohars or noteholders for numerous reasons.

First, Respondents provided abundant disclosures that revealed the information that the Division alleges was withheld—namely, that Respondents held loans in Category 4 even if interest payments were not made on the stated due date. While a misleading statement "will not always lose its deceptive edge simply by joinder with others that are true," here the accurate information cured any potential misinformation "so obviously that the risk of real deception drop[ped] to nil." *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1096-98 (1991); *cf. Brandt, Kelly & Simmons LLC*, 2005 WL 1584978, at *8 (finding no violation of § 206(1) or § 206(2) where respondents made adequate disclosures). Thus, in *Flannery v. SEC*, 810 F.3d 1 (1st Cir. 2015), the Commission's finding of liability was reversed because, among other defects, the availability of additional information "weigh[ed] against any conclusion that the [offending statistics] had 'significantly altered the total mix of information made available,'" and rendered any misrepresentation immaterial. *Id.* at 11-12 (quoting *Basic*, 485 U.S. at 232).[34] Moreover, where an investor "could easily have obtained" the accurate information, "failure to pursue this line of investigation suggests [among other possibilities] that, despite appearances, the

[34] In a recent administrative proceeding, the Commission declined to apply *Flannery* based on particular factual distinctions in that case, namely that "unlike in *Flannery*, Respondents in this case made material misrepresentations in advertisement disseminated to the general public . . . ." *ZPR Inv. Mgmt., Inc.*, Advisers Act Release No. 4417, 2016 WL 3194778, at *4 (June 9, 2016). Here, however, the Division does not allege that Respondents directed any misrepresentations to the general public, but only to noteholders and the Zohars, who were also given additional information that was complete and accurate.

knowledge he would have discovered was immaterial." *Hirsch v. DuPont*, 553 F.2d 750, 762 (2d Cir. 1977). In this case, the unassailably true information in the Trustee Reports would have corrected any misconception as to Respondents' practice of amending without automatically re-categorizing loans.

Second, materiality must be assessed in light of the extraordinary sophistication of the noteholders. The "sophistication of the investor" affects materiality because it informs the "adequacy of the defendants' disclosure" in light of the total mix of information available. *United States v. Litvak*, 808 F.3d 160, 185 (2d Cir. 2015) (internal quotation marks omitted); *see also, e.g.*, *Hirsch*, 553 F.2d at 763. Here, the so-called victims are the most experienced, capable investors in the world. They expertly processed the information available to them, including the Trustee Reports and the accompanying raw data, as confirmed by the fact that they actually used the data to analyze their investments. *See, e.g.*, Dolan Rep. ¶¶ 85, 91, 108.

Third, when an investment adviser is accused of exposing investors to unwanted risks, the materiality analysis incorporates the investors' "level of risk tolerance." *Maria T. Giesige*, Initial Decision Release No. 359, 2008 WL 4527777, at *1 (ALJ Oct. 7, 2008). Here, the Zohar noteholders invested in distressed debt CLOs *because* they are aggressive in their risk tolerance. The asset class into which these noteholders bought was distressed by definition. *See* Resp. Ex. 70 at 81-82. The aggressive, extensively hedged, institutional investors who sought out this notoriously high-risk investment would not have changed their investment behavior with additional disclosures regarding Respondents' approach to loan categorization.

Fourth, the Division must surmount the limited utility of the OC Test to noteholders compared to other information available about the Zohars' financial health. As S&P explained, "[i]n a distressed CDO, the potential use of . . . overcollateralization tests is more limited"

because "the debt is distressed and its principal balance does not adequately reflect its ultimate value in the transaction." *Id.* at 87. In light of other available data, such as the interest ratio coverage test and reports of actual payments received from portfolio companies, the "more limited" OC ratio Test did not affect the total mix of information. *See supra* pp. 18-19, 25-26.

What is true of the noteholders is equally true of the Zohars themselves. Putting aside that Respondents' knowledge is imputed to the Zohars (*see supra* pp. 56-57), the Zohars' sophisticated Directors had access to all relevant information, and had a high risk tolerance, such that the Division simply cannot prove that the challenged representations or omissions with respect to categorization were critical to the total mix of information available to the Zohars.

C. Respondents Did Not Intend To Deceive The Zohars Or The Noteholders, And Did Not Act With Recklessness Or Negligence.

The OIP alleges that Respondents "defrauded" the Zohars and noteholders, and that they did so "intentionally" in order to obtain illicit profits. OIP ¶¶ 1, 4, 29-51. Several of the alleged Advisers Act violations require proof of intentional misconduct or extreme recklessness. *See* IAA § 206(1); *Stein*, 1999 WL 756083, at *12 (dismissing § 206(1) and § 206(2) claims where respondent "acted in good faith"). Your Honor has ruled that the Division may prove other allegations by recklessness or negligence. *See Lynn Tilton*, Admin. Proc. Rulings Release No. 4245 (Oct. 12, 2016). Respondents urge Your Honor to reconsider this ruling and hold the Division to the OIP, which alleges only intent-based theories of fraud and which does not refer to negligence or recklessness; but even measured against the low bar of negligence, the Division's evidence will be insufficient. The Division will not be able to prove that Respondents' actions were anything but the product of their objectively reasonable, good faith interpretation of the Indentures, and their good faith understanding of their disclosure obligations and fiduciary duties.

In particular, Respondents' testimony will show that they believed in good faith that they fully disclosed the at-issue practices and faithfully carried out their duties, in accordance with the Indentures. Respondents' frequent and fulsome disclosures demonstrate that they did not believe they had anything to hide, and did not attempt to hide anything. *See supra* Arg. Part I.A.1. Therefore, even assuming that Ms. Tilton incorrectly interpreted the Indentures, Ms. Tilton did not intentionally deceive the Zohars or noteholders.

Ms. Tilton's sincere belief that she was acting in accordance with the terms of the Indentures was objectively reasonable, and therefore not reckless or negligent. As explained above, Respondents' interpretation is the most natural reading of the Indentures, the only interpretation that accords with the document as a whole, and the only interpretation that is commercially reasonable. *See supra* Arg. Part I.A.2. But even if Your Honor were to credit the Division's reading of the Indentures, there is no question that, at the very least, "reasonable minds could differ about how the contract should be interpreted." *Bagley v. Blagojevich*, 685 F. Supp. 2d 904, 912-13 (C.D. Ill. 2010). In other words, Ms. Tilton's interpretation was objectively reasonable, even if it were deemed incorrect. *See id.* A "reasonable but incorrect interpretation" of a contract does not "give rise to bad faith," *Amitie One Condo. Ass'n v. Nationwide Prop. & Cas. Ins. Co.*, 2008 WL 2973097, at *4 (M.D. Pa. Aug. 4, 2008), and is not negligent or reckless, *cf. Gen. Ins. Co. of Am.*, 983 F. Supp. at 437 n.63 ("incorrect" statements "were not negligent" as "[t]hey were based upon a reasonable interpretation of a complicated dispute involving the relative legality of . . . behavior under the contracts").

Ms. Tilton's good faith, reasonable interpretation of the Indentures, and her good faith, reasonable belief that Respondents fully disclosed their practices and acted appropriately, cannot support a finding of negligence or recklessness, let alone intentional fraud.

II. The Division's Case With Respect To The Financial Statements Has No Merit.

Courts have consistently held that "allegations of GAAP violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim." *Dempsey v. Vieau*, 130 F. Supp. 3d 809, 818 (S.D.N.Y. 2015) (quoting *Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000)).[35] Instead, to establish a securities fraud claim based on alleged GAAP violations or accounting irregularities, the Division must prove: (1) that the financial statements contained false or misleading representations, *see Russell Ponce*, Initial Decision Release No. 102, 1996 WL 700565, at *14 (ALJ Dec. 4, 1996); (2) the materiality to investors of the purportedly false statements, *see id.*; *David J. Montanino*, Initial Decision Release No. 773, 2015 WL 1732106, at *33 (ALJ Apr. 16, 2015), meaning that the information would have altered an investor's investment decisions, *see supra* p. 57; and (3) "that [the respondent] acted with scienter with regard to both the truth and the materiality of the allegedly misleading statements," *SEC v. Snyder*, 292 F. App'x 391, 399-400 (5th Cir. 2008). Moreover, reliance on the review and approval of the challenged financial statements by professional accountants is a well-established defense to an accounting irregularity charge. *See infra* Arg. Part II.B. Here, the Division cannot prove any of the elements of the charge, and Respondents easily meet the advice-of-experts defense. The evidence will show that the Division's allegations are wholly unsupported—

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[35] *See also, e.g.*, *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 270 (2d Cir. 1996) ("Allegations of a violation of GAAP provisions . . . are not sufficient to state a securities fraud claim."); *Owens v. Jastrow*, 789 F.3d 529, 543-44 (5th Cir. 2015) (dismissing complaint where plaintiff alleged that defendants relied on a faulty pricing model and, as a result, reported non-GAAP-compliant figures, and that defendants delayed reporting an "other than temporary impairment" in violation of GAAP, because the fact that "the reported figures are alleged to have violated GAAP is not, by itself, actionable").

because Respondents did, in fact, have a process for evaluating impairment and fair value of the Zohars' loans—and Respondents' practices were compliant with GAAP.

A. The Financial Statements Did Not Contain False Or Misleading Statements.

The Division tries to dress up the same baseless allegations regarding categorization of loans as financial statement disclosure violations. But its allegations are identical, as the OIP implicitly concedes: "[R]ather than applying a GAAP-compliant impairment methodology, Respondents impair assets only when Tilton decides to withdraw support for a distressed company. This approach mirrors the discretionary approach Tilton uses to categorize assets . . . ." OIP ¶ 8. Based solely on the Division's erroneous theory of improper categorization, the OIP alleges that the financial statements are "not GAAP-compliant, nor do they present a fair picture of the Zohars' financial conditions," contrary to certifications signed by Ms. Tilton. *Id.* ¶¶ 59-60. The OIP also alleges that this approach is "inconsistent with other disclosures in the financial statements that falsely indicate that Respondents assess and consider impairment issues and the fair value of the Funds' loan assets." *Id.* ¶ 8.

Each of the Division's theories of financial statement improprieties or misrepresentations are meritless. The Division alleges that Respondents did not properly record impairments for the loans held by the Zohars, Respondents did not properly estimate the loans' fair value, and the financial statements did not comply with GAAP, contrary to the certification that accompanied those statements. In fact, the challenged certifications were accurate, and the Division cannot establish a violation of the Investment Advisers Act based on them.

Respondents employed a process for evaluating the Portfolio Company loans and estimating the portfolio's overall value, as hearing testimony will establish. Based on this process, Respondents determined when to record an impairment and whether the carrying value

of the loan approximated the estimated fair value. As a result, the financial statements "present[ed] a fair picture of the Zohar Funds' financial condition." *Cf.* OIP ¶ 60. Notably, the Division never claims that the substance of the financial statements—the actual dollar values reported—were incorrect; the Division and its expert contend only that Respondents did not follow the Division's preferred *process*. But the Division and its expert ignore the express language of the notes to the Financial Statements, *see, e.g.*, Resp. Ex. 28 at Note 2.4. Notes in the financial statements disclose that Respondents had a process to estimate the value of the Portfolio Companies and their ability to repay the loans. The fact that the documents reflecting that process were not titled "Impairment Analysis" or "FAS 157 Analysis" do not make the notes false. The Division's expert does not acknowledge the existence of Respondents' process or evaluate it and the corresponding disclosures; he simply prefers a different process (based on the same flawed misperception of the Zohars' business model that underlies the allegations regarding loan categorization). But the failure to comply with Dr. Henning's preferences does not constitute a GAAP violation, and it certainly does not render the certification to the financial statements false or misleading. Consequently, the Division cannot carry its burden to prove a failure to disclose the processes for impairment and fair value.

Furthermore, it was appropriate for Respondents to certify that the financial statements were "GAAP-compliant." In arguing to the contrary, the Division and its expert suggest that Respondents' processes were deficient because they were not always reflected in writing—but GAAP nowhere requires that procedures be written down, and Respondents never represented that they were.

Finally, it is well-established that both the measurement of fair value and the recognition of impairments are subjective assessments for which GAAP permits a range of acceptable

outcomes, depending on "the particular methodology and assumptions used." *Fait v. Regions Fin. Corp.*, 655 F.3d 105, 111-12 (2d Cir. 2011); *see also Owens*, 789 F.3d at 544. Indeed, the Zohar financial statements—in a note titled "Collateral Debt Obligations"—explicitly disclose that "[f]air value estimates are generally subjective in nature," and that the Zohars' valuation techniques are "significantly affected by the assumptions used and judgments made" regarding various factors. *See* Resp. Ex. 28 at Note 3. As a result, the Division cannot demonstrate the falsity of the GAAP certification—which is a statement of opinion—unless it can prove that Respondents subjectively did not believe the challenged statements. *See Fait*, 655 F.3d at 1112 (holding that complaint was deficient where it "[did] not . . . plausibly allege that the defendants did not believe the statements . . . at the time they made them"); *see also In re American Int'l Grp. Inc.*, 2013 WL 1787567, at *3 (S.D.N.Y. Apr. 26, 2013) (dismissing claim based on GAAP noncompliance where plaintiff failed to "plead subjective falsity"). The Division cannot possibly make that showing, because Respondents relied in good faith on their accountants, as discussed below. *See infra* Pt.II.B. In any event, the Zohar financials statements were in fact GAAP-compliant from a technical perspective, as hearing testimony will establish.

B. Respondents Relied On The Advice Of Accountants In Preparing The Financial Statements, Which Were The Product Of A Reasonable, Good Faith Accounting Process.

Even if the certifications were not accurate—and they were—the Division cannot establish Respondents' scienter or negligence in signing them. Respondents, who are not certified public accountants, established a reasonable, good faith accounting process—with the input and advice of both internal and external accountants—which they carried out month after month and year after year, with great transparency and without any challenge or criticism from their accountants or from noteholders. And those same accountants drafted the challenged

certifications and notes, and reviewed and signed off on each financial statement, which easily demonstrates an advice-of-experts defense.

To show good faith reliance on the advice of a professional, a defendant "should show that he [1] made a complete disclosure, [2] sought the advice as to the appropriateness of the challenged conduct, [3] received advice that the conduct was appropriate, and [4] relied on that advice in good faith." *SEC v. Goldsworthy*, 2008 WL 8901272, at *4 (D. Mass. June 11, 2008). This defense defeats both intent and negligence-based charges. *See, e.g.*, *Addington v. C.I.R.*, 205 F.3d 54, 58 (2d Cir. 2000) ("Good faith reliance on professional advice is a defense to negligence penalties.").[36]

Reliance on a professional's advice is reasonable when the advice falls within the professional's area of expertise. *See United States v. Boyle*, 469 U.S. 241, 251 (1985). Here, Respondents relied on the advice of accounting professionals, including external accountants at Anchin, in preparing the financial statements. Indeed, Anchin established a formal process for the preparation of the financial statements and drafted the notes and certifications to the financial statements that the Division now challenges; it was involved in the drafting of every Zohar indenture and amendment; and it also was well-versed in the comprehensive work papers that were updated every quarter by Patriarch's accounting department and used to populate the financial statements.

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[36] Respondents asserted reliance on advice of experts as an affirmative defense. *See* Answer at 11 (Apr. 22, 2014). The Commission, in its revisions to the Rules of Practice, acknowledged that this is an available and appropriate affirmative defense. *See* Amendments to the Commission's Rules of Practice, Release No. 78319, 2016 WL 3853756, at *15 (July 13, 2016) (specifically referencing "the advice of . . . accountants"); *see also id.* at *42 (amending the language of Rule 220(c) to read: "[A] respondent must state in the answer whether the respondent relied on the advice of counsel, accountants, auditors, or other professionals in connection with any claim, violation alleged or remedy sought.").

Patriarch's detailed accounting processes are set forth in Accounting Manuals (one for Zohar I and one for Zohars II and III). *See* Resp. Exs. 123 & 124. In accordance with those manuals, the Zohars' Finance & Accounting ("F&A") Department was responsible for preparing the certificate to be "signed by Ms. Lynn Tilton," as well as the "consolidated balance sheet" and "consolidated income statement" for each period, which were to be "prepared in each case in accordance with U.S. generally accepted accounting principles and certified by the Issuer as presenting fairly, in all material respects, the financial position of the Issuer and its consolidated subsidiaries." Resp. Ex. 123 at PP122679; Resp Ex. 124 at PP122706. Moreover, under the accounting manuals, workpapers are to be "used to prepare the Financials." The manuals in turn set out the detailed information ("16 Tabs" and "12 Tabs," respectively) that must be contained in the workpapers and updated for each reporting period, as well as the process for doing so, including with respect to interest payments. *See* Resp. Ex. 123 at PP122679-80, 682-93; Resp. Ex. 124 at PP122706-07, 711-23.

Moreover, pursuant to the accounting manuals, "Workpapers and Financial Statements are first sent to Peter Berlant at Anchin Block & Anchin (ABA) for comments." Resp. Ex. 123 at PP122680; Resp. Ex. 124 at PP122706. Berlant then communicated any substantive comments on the financial statements to Patriarch's F&A Department. Only after Mr. Mercado incorporated Mr. Berlant's comments were the papers submitted to Ms. Tilton for approval. Resp. Ex. 123 at PP122680; Resp. Ex. 124 at PP122706.

In accordance with the manuals and the process established with Anchin, every month Patriarch's internal accounting team prepared a workbook with internal work papers that contained data used to populate the financial statements; the workpapers and financial statements were then sent to Patriarch's external accountant, Mr. Berlant, for his review. Mr. Berlant would

review the draft financial statements and provide comments—including from time to time on issues relating to GAAP, such as FAS 157. Only after Mr. Berlant had signed off on the financial statements were they sent to Ms. Tilton. Resp. Ex. 123 at PP122680; Resp. Ex. 124 at PP122706. Indeed, Ms. Tilton insisted that Mr. Berlant sign off on all financial statements before she put her signature on them.

Ms. Tilton had every reason to rely on Anchin and Mr. Berlant in good faith. And, in fact, the CMAs contemplated Respondents' reliance on the advice of "counsel and accountants" and permitted Respondents to act "in accordance with th[at] advice." CMA § 4.5(b). Moreover, Anchin was a highly respected accounting firm, and Mr. Berlant was a highly respected senior partner. Mr. Berlant's approval of each month's financial statements—and the comments he frequently provided—gave Respondents a good faith, reasonable basis to presume that Anchin was performing the services that Respondents expected of it, namely to provide accounting advice. Anchin served as Ms. Tilton's certified public accountant for everything—Zohar deals, taxes for the funds, and Ms. Tilton personally. Ms. Tilton therefore did what a reasonable person would do: she depended and relied on Mr. Berlant every time she put her signature on the financial statements. Ms. Tilton understood that her external accountants were reviewing for interpretation and presentation of GAAP and other accounting issues—as Anchin's advice and comments on such issues reflected. *See* Resp. Ex. 51 (Letter from P. Berlant to L. Tilton (July 1, 2007)) at 2 (providing that Anchin "shall provide such Business and Finance Advice as [Patriarch] may specifically request," and that such advice "may include . . . advice relating to the interpretation of accounting issues").

SEC v. Jensen, 2013 WL 6499699, at *28 (C.D. Cal. Dec. 10, 2013), *vacated on other grounds*, 2016 WL 4537377 (9th Cir. Aug. 31, 2016), is directly on point. In that case, the SEC

brought several federal securities claims, including under Sections 17(a)(2) and (3), which include negligence standards. The SEC argued that "scienter [was] present because Defendants recognized revenue in ways that were either in contravention of GAAP and/or misleading . . . ." *Id.* The court found that:

> Defendants did not act negligently. They had in place several levels of internal and external review, and thoroughly vetted all the transactions at issue in this case before deciding to record revenue on those transactions. The evidence shows that [the CFO] personally worked diligently on ensuring that he got the accounting right. *This included his reasonable reliance on the advice of the numerous professionals working both inside and outside* [the company].

Id. at *29 (emphasis added). Numerous other cases have reached the same result on similar facts, which will be established here as well.[37]

Respondents' reasonable reliance on the advice of its accountants defeats the financial statement-based allegations, both because scienter (or at least negligence) is an element of the claims for which the Division bears the burden of proof, and because the evidence supports an advice-of-experts affirmative defense.

C. The Challenged Certifications Were Immaterial To The Zohars And Noteholders.

Finally, and independently, the financial statements charge fails because the Division cannot possible establish the materiality of the challenged certifications and notes. "In assessing the magnitude of alleged GAAP violations, one needs to look to see if the violations were 'minor

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[37] *See, e.g.*, *In re Digi Int'l, Inc., Sec. Litig.*, 14 F. App'x 714, 717 (8th Cir. 2001) ("no reasonable jury could find the necessary element of scienter even if the accounting treatment was improper," in light of advice given by defendants' independent accountant and lawyers); *see also Robare Grp., Ltd.*, Initial Decision Release No. 806, 2015 WL 3507108, at *36 (ALJ June 4, 2015) ("Respondents' reliance on the advice of compliance counsel demonstrates good faith and represents possible evidence of an absence of any intent to defraud.").

or technical in nature' or 'material in light of the company's overall financial condition.'" *In re Atlas Mining Co. Sec. Litig.*, 670 F. Supp. 2d 1128, 1141 (D. Idaho 2009) (magistrate judge's order adopted by the district court) (quoting *In re Dauo Sys.*, 411 F.3d 1006, 1017-18 (9th Cir. 2005)). Here, the purported GAAP violations—notwithstanding the Division's attempt to dress them up—were technical in nature, and did not change the total mix of information available to noteholders or impact noteholder behavior in any way.

First, the financial statements *as a whole* were not material to the Zohars or to noteholders. Under the Indentures, and in accordance with industry practices, material information with respect to the CLOs was instead provided to noteholders in the Trustee Reports, which contained significantly more detailed information on interest payments, loan categorization, and the OC and IC ratio tests. It was the Trustee reports that noteholders looked to in evaluating the performance of the Zohars and the collateral manager. Indeed, the Indentures set forth dozens of detailed categories of information that must be included in the Trustee Reports (referred to as the "Monthly Report" and the "Note Valuation Report," detailing 36 and 54 specific required categories respectively), Indenture § 10.13(a) & (b). Yet the Indentures provided no specific requirements whatsoever on the contents of the financial statements or even that the financial statements be audited by an independent CPA firm. Trustee Reports, as a result, were approximately 50 pages long, with voluminous data on every page—and they were released both monthly and quarterly. In contrast, the financial statements contained two pages of information (a one-page balance sheet and a one-page income statement), plus a certification and notes. Moreover, Patriarch was required under the Indentures to send the financial statements out quarterly (rather than monthly)—but only seven days after the end of each quarter. As a result, the financial statements could not contain the comprehensive data

contained in the Trustee Reports, and there is no evidence that any noteholder believed otherwise.

Second, the specific certifications and notes that the Division seizes on were *certainly* not material to noteholders. The Division does not allege that any noteholder actually read or relied on those certifications or the footnotes. Nor could it possibly carry its burden of proving that explicit disclosure of Respondents' categorization approach (which all of the purportedly misleading or inaccurate statements turn on) would have altered the "total mix of information available to investors," *Stein*, 1999 WL 756083, at *11 (quoting *Basic*, 485 U.S. at 231-32), or made any difference in the behavior of any noteholder, given the information actually presented in the financial statements, Trustee Reports, Indentures, website, and noteholder communications, including as to interest payments and categorization, which provided the very information the Division now says Respondents should have explicitly noted in their financial statements.[38]

III. The Division Cannot Justify The Sanctions It Seeks.

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[38] *See Vosgerichian v. Commodore Int'l*, 862 F. Supp. 1371, 1374, 1377 (E.D. Pa. 1994) (dismissing fraud claims because reporting errors did not materially "alter the total mix of information available" to investors where information regarding the relevant transactions was generally disclosed in defendant company's financial statements (internal quotation marks omitted)); *In re Atlas Mining Co. Sec. Litig.*, 670 F. Supp. 2d at 1131, 1133 (dismissing fraud claims brought against auditor, where even though the financial statements at issue did not comply with GAAP, they fairly represented the financial condition, because "the violations [we]re not material"); *Ponce*, 1996 WL 700565, at *14 ("The Division is unable to sustain its burden of proof as to materiality" where "no reasonable [investors] could have been misled by the figures, the filings, or the audit reports in the instant case."). The Division also cannot meet its burden of proving materiality because it has "fail[ed] to quantify the financial impact of . . . the alleged GAAP violations." *In re Hansen Nat. Corp. Sec. Litig.*, 527 F. Supp. 2d 1142, 1161 (C.D. Cal. 2007) (dismissing Exchange Act allegations arising from purported GAAP violations).

The Division seeks an unprecedented sum of over $200 million in "disgorgement" and to permanently bar Ms. Tilton from the securities industry. OIP ¶¶ 6, 44. As Respondents will establish at the hearing and address fully in post-hearing submissions, neither sanction is justified, for at least the following reasons:

- It would be against the public interest to impose significant monetary penalties or a permanent bar on the facts presented here. *See* IAA § 203(i)(3) (directing the Commission to consider whether the penalty sought is "in the public interest"); *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979) (same). This is particularly so in the event that the Division is permitted to proceed on a theory of—and proves only—negligence.[39]

- The Division does not allege—nor could it show—that any of the instances of purported financial statement noncompliance increased Respondents' fees. Accordingly, it cannot "demonstrate the receipt of profits or other benefits [that is] causally connected to" the alleged financial statement violations. *SEC v. Adelphia*, 2006 WL 8406833, at *17 (S.D.N.Y. Nov. 16, 2006); *see also Mannion*, 2013 WL 1291621, at *11.

- Disgorgement of over $200 million 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) (SEC's theory of disgorgement "not appropriate" where it would "work a punishment, contrary to well-settled law"); *Lynn Tilton*, Admin. Proc. Rulings Release No. 4124 (ALJ Sept. 2, 2016). Such a result would be unjust, arbitrary, confiscatory, grossly disproportionate to the alleged offenses, and would constitute an excessive fine. *See, e.g.*, *FXC Inv'rs Corp.*, Initial Decision Release No. 218, 2002 WL 31741561, at *20-21 (ALJ Dec. 9, 2002); *SEC v. Wyly*, 56 F. Supp. 3d 260, 271 (S.D.N.Y. 2014). A lifetime ban would likewise be an unjust, arbitrary, and oppressive punishment.

- In requesting over $200 million in "disgorgement," the Division consistently overstates Respondents' gains, ignoring that Ms. Tilton invested funds in the

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[39] *See, e.g.*, *Steadman v. SEC*, 603 F.2d at 1141 (permanent bar based on isolated negligent violations is a "gross abuse of discretion"); *Valicenti Advisory Servs., Inc.*, Initial Decision Release No. 111, 1997 WL 36200064, at *19 (ALJ July 2, 1997) (Foelak, J.) ("revocation and suspension" sanctions are "excessively harsh" where respondents act without scienter), *rev'd on other grounds by* Advisers Act Release No. 1774, 1998 WL 798699 (Nov. 18, 1998); *Terry T. Steen*, Initial Decision Release No. 107, 1997 WL 104603, at *11-12 (ALJ Mar. 7, 1997) (Foelak, J.) (declining to impose "'significant' money penalty" where respondent "lack[ed] scienter").

Zohars and Portfolio Companies that dwarf the amount the Division is seeking in disgorgement and belie any notion that Ms. Tilton was conducting a scheme to accumulate fees and aggrandize herself. Ms. Tilton invested over $200 million in the Zohars, reinvested substantial sums in the Portfolio Companies, and incurred significant business expenses to keep the Zohars and the Portfolio Companies afloat. *See supra* Pt. I.A.3.ii. Any disgorgement award must be reduced by these amounts,[40] and must take account of all equitable factors.[41]

- Because the requested sanctions would represent a "civil fine, penalty, or forfeiture," they cannot be premised on conduct prior to the five-year statute of limitations under 28 U.S.C. § 2462 (*i.e.*, prior to March 30, 2010); *see also SEC v. Lorin*, 869 F. Supp. 1117, 1121-22 (S.D.N.Y. 1994) ("the label placed on a monetary liability—whether, for example, 'fine,' 'penalty,' 'sanction,' or 'disgorgement'—is not dispositive; instead, the determining consideration concerns whether the amount so labeled serves a remedial or punitive function").

CONCLUSION

For the foregoing reasons, the Division will not be able to meet its burden of proving the charges set forth in the OIP, and the OIP should be dismissed in its entirety.

[40] *See, e.g.*, *David F. Bandimere*, Initial Decision Release No. 507, 2013 WL 5553898, at *82 (ALJ Oct. 8, 2013) ("[I]t is appropriate to reduce the disgorgement amount by the amount [] returned to investors."); *SEC v. AmeriFirst Funding, Inc.*, 2008 WL 1959843, at *3–4 (N.D. Tex. May 5, 2008) ("[I]nvestor money within reach of the investors (*i.e.*, money the investors will eventually obtain) should reduce a defendant's disgorgement liability"); *SEC v. Capital Sols. Monthly Income Fund, LP*, 28 F. Supp. 3d 887, 897 (D. Minn. 2014); *see also* Restatement (Third) of Restitution and Unjust Enrichment § 51(4)(e), comment (2011) (sum subject to disgorgement is "the net increase in the assets of the wrongdoer").

[41] *See, e.g.*, *SEC v. Thomas James Assocs., Inc.*, 738 F. Supp. 88, 92-93 (W.D.N.Y. 1990) (considering, for purposes of reducing disgorgement, factors including underwriting expenses, harm to defendant's reputation, and whether the defendant's company and its investments resulted in employment for a large number of people). Respondents will detail such equitable considerations in post-hearing submissions.

Dated: New York, New York
October 17, 2016

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CERTIFICATE OF SERVICE

I hereby certify that I served a true and correct copy of Respondents' Pre-Hearing Memorandum on this 17th day of October, 2016, in the manner indicated below:

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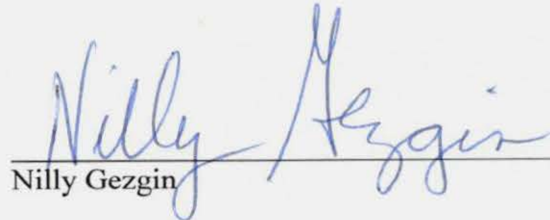

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