HARD COPY

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

RECEIVED
JUN 08 2015
OFFICE OF THE SECRETARY

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

MEMORANDUM AND POINTS OF AUTHORITIES IN SUPPORT OF
RESPONDENTS' MOTION FOR SUMMARY DISPOSITION

SKADDEN, ARPS, SLATE,
MEAGHER & FLOM LLP
Four Times Square
New York, NY 10036

BRUNE & RICHARD LLP
One Battery Park Plaza
New York, NY 10004

Counsel for Respondents

June 5, 2015

TABLE OF CONTENTS

PRELIMINARY STATEMENT 1

FACTUAL BACKGROUND 3

The Zohar CLOs 3

Patriarch's Discretion in Managing the Zohar CLOs 4

The OC Ratio and Loan Categorization 4

Patriarch's Categorization Practice 6

Indenture Reporting 7

Procedural History 8

ARGUMENT 9

I. The Categorization Theory at the Heart of the OIP Is Contradicted by the Investigative Record 9

II. Patriarch Had No Affirmative Duty to Disclose to Noteholders Its Interpretation of the Zohar Indentures. 13

III. The Division Has Failed to Allege Any Fraud on Patriarch's "Clients," Which Is Required for Charges Under Advisers Act §§ 206(1) and (2) 15

A. The Zohar CLOs Are the "Clients." 16

B. Patriarch's Knowledge Is the CLOs' Knowledge. 17

CONCLUSION 18

TABLE OF AUTHORITIES

CASES

Apollo Fuel Oil v. United States,
195 F.3d 74 (2d Cir. 1999) 17

Ash v. LFE Corp.,
525 F.2d 215 (3d Cir. 1975) 12

Basic Inc. v. Levinson,
485 U.S. 224 (1988) 14

Bullmore v. Ernst & Young Cayman Is.,
861 N.Y.S2d 578, 582-85 (Sup. Ct. 2008) 17

Center v. Hampton Affiliates, Inc.,
488 N.E.2d 828, 830 (N.Y. 1985) 17

Golden Pac. Bancorp v. FDIC,
273 F.3d 509 (2d Cir. 2001) 13

Goldstein v. SEC,
451 F.3d 873 (D.C. Cir. 2006) 16

In re AlphaStar Ins. Grp. Ltd.,
383 B.R. 231 (Bankr. S.D.N.Y. 2008) 17

In re Doctors Hosp. of Hyde Park, Inc.,
474 F.3d 421 (7th Cir. 2007) 16

In re Netflix, Inc. Securities Litigation,
2005 WL 3096209 (N.D. Cal. Nov. 18, 2005) 12

Kramer v. Time Warner Inc.,
937 F.2d 767 (2d Cir. 1991) 13

Oddo Asset Mgmt. v. Barclays Bank PLC,
973 N.E.2d 735 (N.Y. 2012) 15

Park Place Cafe, Inc. v. Metro. Life Ins. Co.,
563 S.E.2d 463 (Ga. Ct. App. 2002) 14

Pride Int'l, Inc. v. Bragg,
259 S.W.3d 839 (Tex. App. 2008) 14

SEC v. Northshore Asset Mgmt.,
2008 WL 1968299 (S.D.N.Y. May 5, 2008) 16

SEC v. Wills,
472 F. Supp. 1250 (D.D.C. 1978) 15

Spaulding v. Abbott Labs.,
2010 WL 4822894 (N.D. Ill. Nov. 22, 2010) 14

Starr v. Georgeson Shareholder, Inc.,
412 F.3d 103 (2d Cir. 2005) 12

Vacold LLC v. Cerami,
545 F.3d 114 (2d Cir. 2008) 14

Werner v. Werner,
267 F.3d 288 (3d Cir. 2001) 13

STATUTES

15 U.S.C. § 80b-6(1) 15

15 U.S.C. § 80b-6(2) 15

17 C.F.R. § 250(a) 9

17 C.F.R. § 250(b) 9

OTHER AUTHORITIES

In the Matter of Jay T. Comeaux,
2014 WL 4160054, at *2 (S.E.C., Aug. 21, 2014) 9

Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles,
Investment Advisers Act Release No. 2628, 72 Fed. Reg. 44,756 (Aug. 9, 2007) 15

Respondents Lynn Tilton and Patriarch Partners, LLC; Patriarch Partners VIII, LLC; Patriarch Partners XIV, LLC; and Patriarch Partners XV, LLC (collectively, "Patriarch") respectfully move for summary disposition, pursuant to Rule 250 of the Rules of Practice.

PRELIMINARY STATEMENT

Patriarch's investment approach is to turn around companies that others have abandoned. This mission is carried out through collateralized loan obligation funds (or CLOs) that Patriarch manages and that make loans and other investments in the Patriarch portfolio companies.

By a 3-2 vote, the Commission approved legally and factually flawed charges against Patriarch concerning three CLOs referred to as Zohar I, Zohar II, and Zohar III. The charges are based on two overarching theories. One relates to how Patriarch categorized loans under the governing Zohar indentures (the "categorization theory"), and the other relates to certain financial statement entries. While both theories are deeply flawed and incorrect, the categorization theory now is ripe for dismissal on this motion.

The Division of Enforcement's ("Division") categorization theory is that Patriarch should have separately disclosed to investors its method for categorizing loans. Patriarch's view is that, under the indentures, merely accepting reduced interest does not make a loan "defaulted"; the Division disagrees.

The Division's reading of the indentures is, quite simply, wrong. The indentures expressly allow Patriarch to defer interest or to modify loan terms. Indeed, this approach is core to Patriarch's well-disclosed business strategy of turning around distressed companies. The companies often need relief on their interest payments during the long and challenging turnaround process. If Patriarch had categorized the loans as defaulted every time full interest was not paid, Patriarch would be severely constrained, under the indentures, from lending those companies more money when they need it most — leading to failed businesses, lost jobs, and

losses for the CLO investors. That is not what anyone wanted or bargained for and is not what the indentures require. Instead, as the indentures allowed, Patriarch, from time to time, amended loan terms to allow for reduced interest payments. In those instances, there was no default in the first place, and no requirement to categorize those loans as "defaulted."

The Division's contrary reading ignores the express contract language and the business reality. But regardless of which side has read the indentures correctly, there are two fundamental flaws with the Division's categorization theory that call for its dismissal now.

First, the information supposedly concealed by the alleged miscategorization – that the companies did not pay the full interest owed – was, in fact, disclosed. Monthly reports and supporting materials, provided to investors, listed, down to the dollar, the amount of interest actually collected on each loan and the category assigned to that loan. Simply by comparing the cash collected to the (typically high) stated interest rates, any investor could easily see that the borrowers were paying less than the stated interest amounts. And any investor could easily see from the same reports that the loans were not being defaulted.

Second, the Division's fraud theory is, in reality, a contract dispute. According to the Division, Patriarch should have announced to investors that it read the indentures to allow it to accept reduced interest from borrowers without also marking their loans as defaulted. But there is no legal duty for a contracting party to disclose its every judgment about how a contract should be read. If Patriarch's reading of the indentures is wrong, then perhaps investors can bring a breach of contract lawsuit. Over the 12-year lifespan of the Zohar CLOs, no investor has seen fit to do so. But irrespective of whether there would be a valid breach of contract action, there is no proper fraud case and certainly no proper SEC enforcement action.

Separately, all claims against Patriarch under Advisers Act §§ 206(1) and (2) (whether pertaining to categorization or to the financial statement entries), must be dismissed because Patriarch's alleged conduct could not have defrauded any Patriarch "client," as required by the statutory language. The "clients" in this case are the CLOs themselves and not the outside investors. The CLOs are ultimately owned by Patriarch's principal, Lynn Tilton, and are managed by Patriarch, whose knowledge is imputed to the CLOs.

In effect, the SEC is alleging that the CLOs defrauded themselves, which is, of course, impossible.

FACTUAL BACKGROUND

Ms. Tilton is the founder and CEO of Patriarch Partners, LLC. (Tilton Aff. ¶ 1.) Through her ownership of Patriarch and its affiliates, Ms. Tilton runs one of the largest woman-owned businesses in the United States. (*Id.* ¶.) Patriarch, through CLOs it manages, invests in businesses that others have abandoned, and turns them around. (*Id.* ¶ 2.) Ms. Tilton has restructured and rebuilt many companies, including well-known American brands such as Rand McNally, Stila Cosmetics, Dura Automotive and MD Helicopters. (*Id.*)

The Zohar CLOs

The three CLOs at the center of the Division's allegations were originated in 2003 (Zohar I), 2005 (Zohar II), and 2007 (Zohar III). (OIP ¶ 16.) Each CLO sold notes to sophisticated investors and has been using those proceeds to make loans to, and acquire equity in, distressed portfolio companies. (*Id.* ¶ 2; Tilton Aff. ¶ 4.) The cash flows from these investments have been used, in turn, to repay Zohar CLOs' noteholders over time. (OIP ¶ 15.)

The CLOs' principal investment strategy is to improve the operations of the portfolio companies so that the companies can pay off their debt, increase in value, and eventually be sold

for additional profit. (*Id.* ¶ 22.) Ms. Tilton actively manages the business of the portfolio companies by (among other things) advising on their major operating decisions. (*Id.* ¶ 28.)

<u>Patriarch's Discretion in Managing the Zohar CLOs</u>

A core component of the Zohar CLOs is the flexibility to reduce the portfolio companies' interest payments to allow the companies more time to complete the often long and challenging turnaround process. (Tilton Aff. ¶ 5; Ex. 3 ("Tilton Day 1 Tr.") 193-94; Ex. 4 ("Tilton Day 2 Tr.") 61-62, 68, 97-98.) To that end, each of the Zohar indentures allows Patriarch freely to "enter into any amendment, forbearance or waiver of or supplement to any" loan. Indeed, each indenture expressly states that "[f]or the avoidance of doubt and notwithstanding anything else contained herein," the parties agree the portfolio "will consist of stressed and distressed loans that may be the subject of extensive amendment, workout, restructuring and/or other negotiations." (Ex. 5 § 7.7(a) (PP050056); Ex. 6 § 7.7(a) (PP050399); Ex. 7 § 7.7(a) (PP001881).)

This broad language made it abundantly clear to investors from the start that Patriarch was authorized to exercise and would be exercising discretion. And Patriarch did, in fact, utilize its discretion by reducing interest that would otherwise have been due. (Tilton Aff. ¶ 5.)

<u>The OC Ratio and Loan Categorization</u>

The indenture for each Zohar CLO contains certain numeric tests that must be met each month. (OIP ¶ 29.) One is the Overcollateralization Ratio ("OC Ratio"), which, in summary, is the ratio of the carrying amount of loans against the outstanding amount owed to investors on the notes. (*See id.* ¶¶ 30-31.)

To determine how loans are carried in the OC Ratio, each loan is held in one of various categories. (*Id.* ¶ 34.) Asset categories for Zohar I and Zohar II are numbered 1 through 4. (*Id.* ¶ 35.) Category 4 assets are typically carried at the principal amount outstanding on the loan to

the portfolio company. (*Id.*) Category 1 assets are often carried at a lower amount. (*Id.*) For Zohar III, these numeric category designations were eliminated and replaced with two categories: "Defaulted Investment" and "Collateral Investment," which are equivalent to Categories 1 and 4, respectively. (*Id.* ¶ 36.) Generally, loans originated or acquired by the Zohar Funds were initially designated "Category 4" or "Collateral Investment." (*Id.* ¶ 41.) Categories 2 and 3 were used for loans to companies in formal bankruptcy. (Ex. 5 § 1.1 (PP044946); Ex. 6 § 1.1 (PP050273-74).)

The loan categories could affect the Zohar CLOs in various ways, including the following:

First, the indentures had limits on how much of the portfolios could consist of defaulted (Category 1) loans, and so the practical effect of defaulting loans that paid reduced interest would be to shut off the companies' access to cash when they needed it the most. (Ex. 8 § 2(uu) (amending Ex. 5 § 12.1(a)(28) (PP050126)) (5% limit for Defaulted Obligations); Ex. 6 § 12.1(a)(28) (PP50468) (same); Ex. 7 § 12.1(a)(27) (PP001942) (same).)

Second, if the OC Ratio (which is based in part on the loan categories) falls below certain levels, Patriarch's ability to reinvest loan proceeds could be shut off. (Ex. 5 § 12.1(a)(19) (PP050125); Ex. 6 § 12.1(a)(19) (PP050467); Ex. 7 § 12.1(a)(19) (PP001942); Ex. 5 § 1.1 (PP049988) (defining "Reinvestment Period" by reference to "Collateral Value Ratio," which is similar to OC Ratio); Ex. 6 § 1.1 (PP050324) ("Reinvestment Period").)

Third, if the OC Ratio falls to even lower levels, the CLOs might have to be liquidated altogether, effectively ensuring not only failed portfolio companies but massive investor losses. (Ex. 5 § 5.1(k) (PP050028) (defining default to include drop in "Collateral Value Ratio"); Ex. 6 § 5.1(k) (PP050371); Ex. 7 § 5.1(j) (PP001854).)

Fourth, if the OC Ratio falls below certain levels, portions of the management fees otherwise owed to Patriarch will not be paid. (Ex. 5 § 11.2(a)(iv) (PP050119); Ex. 6 § 11.2(a)(iv) (PP050461); Ex. 7 § 11.1(a)(i)(K)(2)(II) (PP001934).)

Patriarch's Categorization Practice

As Ms. Tilton testified, Patriarch does not default loans when Patriarch agrees to accept reduced interest because, in those instances, there is no default in the first place. (Tilton Day 1 Tr. 168-69, 187-89; Tilton Aff. ¶ 7.) These modifications are essential to implementing Patriarch's well-disclosed business strategy. (*Id.*)

Patriarch holds loans at Category 4 if the turnaround process is continuing and Patriarch believes there are reasonable prospects for success. (*Id.* ¶ 8) Where the turnaround process is abandoned or lacks a reasonable prospect for success, loans are generally defaulted or placed in Category 1. (*Id.*) For historical reasons, Categories 2 and 3 have essentially become obsolete in practice. (*Id.*)

Contrary to the contention of the Division, it is perfectly appropriate for Patriarch to bring to bear its good-faith subjective judgment to these decisions. The definition of a Category 4 loan is one that (among other criteria) does not have "in the reasonable judgment of [Patriarch], a significant risk of declining in credit quality or, with the passage of time," falling into a lower category. (Ex. 5 § 1.1 (PP049946); Ex. 6 § 1.1 (PP050274).) Patriarch properly exercised that judgment in deciding how to categorize the loans. Notably, the Division concedes that it "does not make any allegation that [Patriarch's] subjective judgments relating to the portfolio companies were incorrect." (Ex. 9, at 4.)

Parties to the transactions were aware that Ms. Tilton was applying her discretion. A representative from MBIA Insurance Corporation, the company with the largest exposure to the Zohar CLOs, testified that "[a]lmost every time" they met, Ms. Tilton would explain Patriarch's

approach to these issues. (Ex. 10 at 62-64.) Handwritten notes from the Division's interview of another large Zohar investor, Natixis, make clear that Patriarch's discretion was no secret: "Categorization: knows its @ her discretion to categorize assets. . . . If she continues 2 fund co. it will get a high rating. They have a 100% manager risk which was disclosed." (Ex. 11, at SECNOTES000526-27.)

During the negotiation of amendments to the indenture for Zohar I, Standard & Poor's asked that the parties "amend the definition of Defaulted Obligation to include any new loan or restructure made with respect to an existing obligor in the portfolio without which such obligor would have defaulted under its existing obligations." (Ex. 12 at 1, 3.) But the proposal, which mirrors what the Division appears to believe is the governing rule today, was never adopted. And for good reason. Having done so would have doomed the business strategy from the start. The drafting history confirms what was central and well understood: that Patriarch could avert defaults by modifying loans.

Indenture Reporting

The Zohar indentures require monthly and quarterly reports to the noteholders that include, among other things, detailed information about the underlying loans on an aggregate and loan-by-loan basis (including the principal balance, the stated interest rate, and maturity, and how much interest and principal was collected), as well as the amount of fees paid to the collateral manager. (Ex. 5 § 10.13 (PP05099-109); Ex. 6 § 10.13 (PP050441-52); Ex. 7 § 10.10 (PP001919-29).) In Zohar I and II, the reports include the category of each loan and the balance of the loans falling within each category. (Ex. 5 § 10.13(a)(20)-(23), (c)(21)-(24) (PP050107); Ex. 6 § 10.13(a)(20)-(23) (PP050443); § 10.13(b)(35)-(38) (PP050449).) The Zohar III indenture similarly includes a report of Defaulted Investments. (Ex. 7 § 10.10(a)(6)

(PP001919).) These reports make it abundantly clear that the borrowers were often paying reduced interest amounts on loans being held in Category 4.

This information was readily obtained from a review of the reports. For instance, a Barclays analyst noted from the reports that a CLO received less interest than the full, face amounts, and emailed Patriarch to ask why. (Ex. 13.) Patriarch explained that the indentures allow it to "restructure company's debt, delay or forgive a portion of the past due interest" and invited the analyst to ask any follow up questions. (*Id.*) Barclays did not challenge the explanation or otherwise object.

Likewise, the trustee (the party who issues the reports and actually holds the funds for the CLOs) explained, in response to a question from one of the ratings agencies, that the reason certain loans were not defaulted was that Patriarch was "hanging their hat on the 'forbearance/waiver of default' clause," *i.e.*, the provisions cited above allowing Patriarch to modify loans. (Ex. 14.) Here again, there was no objection or challenge to the explanation.

A public ratings announcement from Standard & Poor's similarly confirms that Patriarch's approach was not hidden: "[W]e note that several of the assets to which we previously assigned a 'CC' credit estimate and treated as defaulted for our July 2013 rating 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.*" (Ex. 15 (emphasis added).)

Procedural History

On March 30, 2015, the Commission, by a 3-2 split vote, authorized the Division of Enforcement to file this action against Patriarch. (Ex. 16.) The principal allegation is that

Patriarch had a duty to disclose its approach to categorization because that approach supposedly disadvantaged investors and presented a "conflict of interest." (OIP ¶¶ 54-56.)[1]

ARGUMENT

Under Rule of Practice 250(b), a "hearing officer may grant the motion for summary disposition if there is no genuine issue with regard to any material fact and the party making the motion is entitled to a summary disposition as a matter of law." 17 C.F.R. § 201.250(b). Although, generally, the "facts of the pleadings of the party against whom the motion is made shall be taken as true," the allegations of the OIP may be overcome by "admissions made by that party, by uncontested affidavits, or by [judicially noticeable] facts." 17 C.F.R. § 201.250(a).

"Once the moving party has carried its burden of establishing that it is entitled to summary disposition on the factual record, the opposing party may not rely on bare allegations or denials but instead must present specific facts showing a genuine issue of material fact for resolution at a hearing." *In the Matter of Jay T. Comeaux*, 2014 WL 4160054, at *2 (S.E.C., Aug. 21, 2014).

I. THE CATEGORIZATION THEORY AT THE HEART OF THE OIP IS CONTRADICTED BY THE INVESTIGATIVE RECORD.

The Division contends that investors did not know that Patriarch exercised discretion in categorizing as performing loans that do not pay the full stated interest, rather than automatically defaulting them. (OIP ¶¶ 49-51.)

---

1 The Division's second theory is that the Zohars' financial statements were not, as required, prepared in accordance with GAAP, because Patriarch did not "impair" poorly performing loans. (OIP ¶¶ 57-73.) But, as will be developed at trial, Ms. Tilton, who is not a CPA or a GAAP expert, believed that the Zohars' financial statements complied with GAAP, and followed longstanding procedures that were established in good faith. (Tilton Day 1 Tr. 66; Tilton Day 2 Tr. 138, 141.) Moreover, the financial statements were read in the context of the investment strategy and overall disclosures.

Nothing could be further from reality. The periodic reports for each Zohar CLO reported the total outstanding balance of its loans, the total interest collected, and the weighted average spread over LIBOR — in effect, the average interest rate — on the loans. By doing only very basic math, an investor could determine the extent to which loans were and were not paying full interest, in the aggregate and on a loan-by-loan basis.

For example, the May 2011 Zohar I Trustee Report indicated that the balance of Category 4 funded loans was approximately $477 million ($504,981,963.63 - $27,438,878.71 (unfunded portion)), the weighted average spread plus LIBOR was 9.00%, and the total quarterly interest collected was approximately $5.5 million. 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. (Ex. 17, at PP007673, 674, 701.) From there, it was a simple matter for noteholders to determine that about 50% of the aggregate interest due on Category 4 loans was collected for the quarter.

The same calculation can also be performed loan by loan, enabling investors to readily see the loans held as Category 4 that were not paying full interest. Thus, for example, a Zohar II noteholder could see from the July 2009 quarterly report that loans with a prefix of 0855 (American LaFrance) had a principal balance of approximately $50 million and an interest rate of 10%. (Ex. 18, at PP00863.) 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:

LaSalle Global Trust Services

ZOHAR II 2005-1, LIMITED

Current Asset Characteristics II

Category 4

Security I.D.	Funded Balance	Unfunded Exposure Balance	PIK Balance	Coupon Type	Applicable Index	Index Rate	Spread	All-in-Rate	Cash Coupon	Non-Cash Pay Interest Rate	Payment Frequency
855_16	2,400,240.02	1,600,160.02	-	Floating	LIBOR (1 month	2.00000%	8.00000%	10.00000%	10.00000%	-	Monthly
855_12	1,895,363.94	3,228.12	-	Floating	LIBOR (1 month	2.00000%	8.00000%	10.00000%	10.00000%	-	Monthly
855_11	44,949,848.59	-	-	Floating	LIBOR (1 month	2.00000%	8.00000%	10.00000%	10.00000%	-	Monthly

But noteholders also could see from the same report that the company paid only $200,000 in interest for the quarter, notwithstanding that the loans were held as Category 4 (*id.* at PP008855-56):

LaSalle Global Trust Services

ZOHAR II 2005-1,

Intra Period Collection Account Detail

Security I.D.	Payment Status	Payment Date	Interest: Prior Balance	Interest: Current Amounts Received	Interest: Ending Balance	Principal: Prior Balance	Principal: Current Amounts Received	Principal: Ending Balance	Total Collected
855_11	S	07-Jul-10	-	200,000.00	200,000.00	-	-	-	200,000.00
855_12			-	-	-	-	-	-	-
855_16			-	-	-	-	-	-	-

Courts expect that even ordinary investors can perform simple arithmetic of the sort set forth above. *Ash v. LFE Corp.*, 525 F.2d 215, 219 (3d Cir. 1975) (refusing to "assume that stockholders cannot perform simple subtraction"). And here, the Zohars CLOs' highly sophisticated institutional investors actually did the math.

For example, in June 2011, an analyst for Barclays emailed Patriarch to ask why one of the quarterly reports showed Zohar II receiving less interest than the full amount. (Ex. 13.) The analyst pointed out that, based on funded performing assets of about $475 million and a weighted average spread of 9%, he "was expecting to see interest income of close to $12mm per quarter. But the interest proceeds only show ~5.5mm for May 2011." (*Id.*) (Patriarch explained in response that the interest rate was "only the nominal spread" because Patriarch had the right under the indentures to defer or forgive interest. (*Id.*))

Even if not all noteholders actually did the math (which given their sophistication is highly unlikely), the Court should dismiss the claims here because there is no fraud when underlying facts or figures are disclosed but investors fail, in effect, to "put two and two together." *See Starr v. Georgeson Shareholder, Inc.*, 412 F.3d 103, 111 (2d Cir. 2005) (holding that failure to disclose an agent's total fee was not fraud where the agent properly disclosed the fees per share). For example, in *In re Netflix, Inc. Securities Litigation*, the court held that Netflix had not made a false or misleading statement or omission regarding its "churn" rate of customer losses when Netflix had disclosed how it calculated churn in its company filings and provided the necessary "raw data" that investors could have used to calculate churn themselves. *See* 2005 WL 3096209, at *8–10 (N.D. Cal. Nov. 18, 2005). Likewise here, the periodic reports

disclosed what the Division claims was hidden: that loans categorized as performing were actually paying less than full stated interest.[2]

The disclosures were effective, because investors were in fact aware that Patriarch was accepting reduced interest on Category 4 loans. (*See, e.g.* Ex. 10 at 62-64 (MBIA); Ex. 11, at SECNOTES000526-27 (Natixis).) The ratings agencies and indenture trustees knew it, too (Ex. 14 (email from trustee regarding rating agency)), and in one instance even highlighted that fact in a public release. (Ex. 15 (stating that various loans treated as defaulted for ratings purposes are "still carried as performing assets by the trustee to calculate Zohar III's O/C ratios, *based on provisions in the transaction documents*") (emphasis added).)

The parties could not have been mistaken about Patriarch's understanding of the indentures because, when a ratings agency proposed new language to require a default in instances where a loan is modified — essentially the Division's reading of the indentures today — it was never adopted. That alone wholly undermines the Division's position. *Golden Pac. Bancorp v. FDIC*, 273 F.3d 509, 517 (2d Cir. 2001) (rejected contract language is evidence of what parties did *not* intend).

The Division's central allegation of concealment is demonstrably false, and, accordingly, the Court should dismiss the categorization theory altogether.

II. PATRIARCH HAD NO AFFIRMATIVE DUTY TO DISCLOSE TO NOTEHOLDERS ITS INTERPRETATION OF THE ZOHAR INDENTURES.

Even if there were no disclosure, the Division's theory would still fail.

---

2 *See also Kramer v. Time Warner Inc.*, 937 F.2d 767, 777-78 (2d Cir. 1991) (rejecting fraud claim based on alleged concealment of "the magnitude of the profits" that executives stood to gain from a transaction when the data that "enabled any interested shareholder to calculate" that profit was disclosed); *Werner v. Werner*, 267 F.3d 288, 297-300 (3d Cir. 2001) (rejecting fraud claim where plaintiffs could have calculated gain flowing to interested directors from transaction by performing calculations based on numbers reported in company's annual reports).

The failure to disclose something generally cannot give rise to fraud liability unless the defendant is under a "duty to disclose the omitted facts." *Vacold LLC v. Cerami*, 545 F.3d 114, 121 (2d Cir. 2008) (interpreting Rule 10b-5 language substantially identical to Advisers Act) (citation omitted); *see also Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988) ("Silence, absent a duty to disclose, is not misleading . . . ."). But, we have not located a single SEC case (or any other type of case) in which a contracting party was found liable for fraud for failing to disclose how it reads a contract. The few cases we have found in which plaintiffs have asserted this imaginative type of theory have routinely been dismissed. *See, e.g.*, *Spaulding v. Abbott Labs.*, 2010 WL 4822894, at *8-9 (N.D. Ill. Nov. 22, 2010) ("If parties had a duty to disclose their respective interpretations of a contract during negotiation or prior to execution, every breach of contract lawsuit . . . would be a fraud lawsuit as well . . . . [T]he appropriate vehicle to resolve disputes over a contract's meaning is a contract claim, not a fraud claim."); *Pride Int'l, Inc. v. Bragg*, 259 S.W.3d 839, 850 (Tex. App. 2008) (in the context of litigation relating to the interpretation of an employment agreement, an employee "had no duty to disclose his private views as to the interpretation of the agreement in the context of negotiating and renewing his own employment"); *Park Place Cafe, Inc. v. Metro. Life Ins. Co.*, 563 S.E.2d 463, 465-66 (Ga. Ct. App. 2002) (rejecting claim against landlords for failing "to disclose their intent to seize upon the deliberate ambiguity" in lease agreements to overcharge tenants for electricity because the "lease provision concerning utility billing was 'a matter equally open to the observation of all parties' at the time the leases were negotiated"). If a contracting party has acted on a misreading or misinterpretation of a contractual provision resulting in a breach, then the appropriate remedy would be for the other contracting party to bring an action for breach of contract.

Here, Patriarch negotiated the indentures with the other parties at arm's length. CLO managers' fiduciary duties flow to the CLOs themselves (which, as discussed in Section III, could not have been misled about their own loans), not to outside noteholders. *See Oddo Asset Mgmt. v. Barclays Bank PLC*, 973 N.E.2d 735, 741-42 (N.Y. 2012); *see also* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Investment Advisers Act Release No. 2628, 72 Fed. Reg. 44,756, 44,760 (Aug. 9, 2007) (Advisers Act does not create "a fiduciary duty to investors or prospective investors in a pooled investment vehicle").

In its role of collateral manager, Patriarch necessarily has had to make all manner of judgments as to how to interpret the multiplicity of provisions in the indentures. Patriarch's legal duties could not possibly have involved disclosing its interpretive judgments (or even just the ones that may be viewed as "material"), given that *the indentures themselves are equally available to all parties*. In other words, even if the indentures were ambiguous or "inartfully drawn," that "is not a proper subject for SEC concern, for the terms of the indentures were never concealed" from anyone. *SEC v. Wills*, 472 F. Supp. 1250, 1264 (D.D.C. 1978).

The Court should reject the Division's attempt to dress up contract claims as fraud and should dismiss these claims.

III. THE DIVISION HAS FAILED TO ALLEGE ANY FRAUD ON PATRIARCH'S "CLIENTS," WHICH IS REQUIRED FOR CHARGES UNDER ADVISERS ACT §§ 206(1) AND (2).

The claims against Patriarch under Advisers Act §§ 206(1) and (2) must be dismissed for the separate reason that Patriarch's alleged conduct could not have "defraud[ed] any client or prospective client," 15 U.S.C. § 80b-6(1), or "operate[d] as a fraud or deceit upon any client or prospective client," 15 U.S.C. § 80b-6(2), as required by the statute. Patriarch's "clients" in this case are the Zohar CLOs themselves, not the outside noteholders whom the SEC has alleged were defrauded. The Zohar CLOs could not have been defrauded because Ms. Tilton is the

ultimate owner of the CLOs, and she could not have defrauded herself or breached any duties owed to herself.

In addition, under basic agency principles, the Zohar CLOs are deemed to have the same knowledge as Patriarch, and thus could not have been defrauded.

A. The Zohar CLOs Are the "Clients."

In *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), the court held that under the Advisers Act, the "clients" of an adviser managing investments funds are the funds themselves, not the funds' individual investors. *Id.* at 879-81. The distinction is important because the funds and individual investors will often have conflicting interests. *Id.* at 881. Advisers must owe their duties to the funds alone because they cannot be "servants of two masters." *Id.*

Following *Goldstein*, the court in *SEC v. Northshore Asset Mgmt.*, 2008 WL 1968299 (S.D.N.Y. May 5, 2008), ruled that, because the defendants' "clients were the [funds], a failure to disclose information or misrepresentations to the [funds'] investors cannot form the basis for a claim" under Advisers Act § 206(1) or (2). *Id.* at *6. Here, while the SEC alleges in a conclusory fashion that the "Funds" were misled (*see* OIP ¶¶ 49, 56), there are no factual allegations of how this could be so. And, as discussed below, to allege that the CLOs were misled would be to allege the impossible.

Lynn Tilton is the ultimate owner of both Patriarch and each of the Zohar CLOs. (Tilton Aff. ¶ 9.) The Division's allegation that Patriarch defrauded the Zohar funds is an untenable claim that Ms. Tilton defrauded herself. *In re Doctors Hosp. of Hyde Park, Inc.*, 474 F.3d 421, 428 (7th Cir. 2007) (holding that "the sole shareholder" of a corporate entity "can hardly have defrauded [herself] or breached a fiduciary duty to [herself]").

B. Patriarch's Knowledge Is the CLOs' Knowledge.

The same outcome follows under basic agency law because "when an agent is employed to perform certain duties for his principal and acquires knowledge material to those duties, the agent's knowledge is imputed to the principal." *Apollo Fuel Oil v. United States*, 195 F.3d 74, 76 (2d Cir. 1999). Here, there can be no dispute that any decisions made by Patriarch regarding how to categorize the assets, or what to report on the financial statements, were prepared as an agent for the CLOs.

While there is a narrow "adverse interest" exception to the rule — an agent's knowledge is not imputed to the principal in cases where the agent has "totally abandoned his principal's interests" — that exception "cannot be invoked merely because [the agent] has a conflict of interest or because he is not acting primarily for his principal." *Center v. Hampton Affiliates, Inc.*, 488 N.E.2d 828, 830 (N.Y. 1985). As discussed above, the Division concedes that it is not challenging Patriarch's subjective judgment that the companies could be turned around with more time, (Ex. 9, at 4), and thus could hardly be contending that Patriarch was "totally abandoning" the CLOs.

The "adverse interest" exception is also inapplicable where, as here, the agent is the sole shareholder or there are otherwise no "'innocent' decision-maker(s) among management" who could have stopped the agent's supposed wrongdoing. *In re AlphaStar Ins. Grp. Ltd.*, 383 B.R. 231, 273 (Bankr. S.D.N.Y. 2008). Ms. Tilton is, as discussed, the ultimate owner of the CLOs, and the Division has charged all of the management entities with wrongdoing, so the "adverse interest" exception is inapplicable for this additional reason. *See Bullmore v. Ernst & Young Cayman Is.*, 861 N.Y.S2d 578, 582-85 (Sup. Ct. 2008) (imputing managers' wrongdoing to fund and rejecting adverse interest exception).

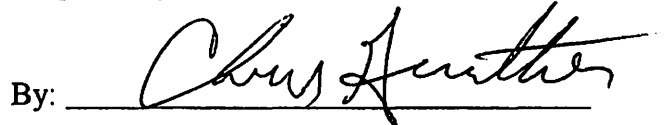
The charges under Advisers Act § 206(1) and (2) should be dismissed.

CONCLUSION

For the foregoing reasons, Patriarch respectfully request that the Court grant this motion for summary disposition, and enter and Order dismissing all claims relating to its categorization theory (OIP ¶¶ 29-56) and dismissing all claims under Advisers Act § 206(1) and (2).

Dated: June 5, 2015
New York, New York

Respectfully Submitted,

By: 

David M. Zornow
Christopher J. Gunther
SKADDEN, ARPS, SLATE,
MEAGHER & FLOM LLP
Four Times Square
New York, NY 10036

Susan E. Brune
MaryAnn Sung
BRUNE & RICHARD LLP
One Battery Park Plaza
New York, NY 10004