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' POST-HEARING BRIEF

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PRELIMINARY STATEMENT

After a six-year investigation and a 3-2 Commission vote to bring any charges, the Division proceeded to trial against Respondents. The trial proved only this: that the Commission grossly overreached in charging Respondents, because the Division's case was nothing more than a contract dispute outside the Commission's regulatory authority. The trial record overwhelmingly confirms what the transaction documents, disclosures, and exculpatory materials belatedly wrung from the Division had already established—that Respondents' practices were fully authorized by the deal Indentures, disclosed to investors, and in the best interests of the Zohar Funds ("Zohars") and their noteholders ("Noteholders"). Faced with this evidence, the Division tried to switch course during the trial itself. But its late-breaking, newfound theories of liability nowhere to be found in its charging document—including that the financial statements did not appropriately disclose accrued interest, or that Respondents did not take the steps necessary to amend loan terms—are, as discussed below, as meritless as the original theories and barred as outside the scope of the Order Instituting Proceedings ("OIP").

Indeed, this case has been flawed from day one. In March 2015, the Commission by split vote authorized the Division to institute proceedings against Respondents based on narrow allegations set forth in the OIP. The OIP makes three claims, each of them meritless. *First*, it alleges that Respondents categorized loans made to Portfolio Companies in a manner "inconsistent with the categorization method set forth in [the governing] documents," OIP ¶ 5, and "never disclosed Tilton's discretionary valuation approaches to the Funds or their investors," *id.* ¶ 9. *Second*, it alleges that Respondents breached their statutory fiduciary duties to the Zohars by failing to disclose the purported conflict of interest that arose from their categorization method. *See id.* ¶¶ 9, 52-56. *Third*, it alleges that the financial statements Respondents prepared for the Zohars misrepresented GAAP compliance with respect to impairment, and misstated fair value methodology. *Id.* ¶¶ 7-8, 57-73. The Division failed to prove a single one of these claims at trial, and notably has conceded that it is not alleging "Respondents' subjective judgments relating to the portfolio companies were incorrect." Div. Opp. to Mot. for a More Definite Statement 4 (Apr. 29, 2015).

As to the charges about categorization, Respondents proved, and Division fact and expert witnesses conceded, that the Indentures themselves permitted Ms. Tilton to amend loan terms and defer interest payments in her business judgment, and that when she amended the terms to defer payment that did not trigger an interest payment default necessitating re-categorization. *See infra* pp. 51-57. The Division's first three investor witnesses so roundly undermined the Division's claim on this point that it dropped its remaining investor witnesses.

By summation, the Division had retreated to claiming that Ms. Tilton had not actually amended the loans made by the Portfolio Companies. *See, e.g.*, Tr. 3673:2-3. This argument appears nowhere in the OIP, and thus has no place in this case. *Int'l S'holders Servs. Corp.*, Exchange Act Release No. 12389A, 1976 WL 182458, at *4 n.19 (June 8, 1976). It is also incorrect. As the Division's own expert, Ira Wagner, admitted, and as New York law makes clear, amendments to a contract need not be in writing. Tr. 2963:2-8 (Wagner). And as Ms. Tilton testified and both Portfolio Company witnesses confirmed, Respondents engaged in a rigorous process whenever a Portfolio Company sought to pay less than full stated interest, and did so by agreeing to amend the loan terms and defer interest until the company could pay it. *See infra* pp. 57-61.[1]

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[1] The Division's extensive misrepresentations of the record in summation are presented and rebutted in Appendix A.

Likewise, while the OIP alleged that Ms. Tilton did not disclose that she exercised discretion in loan categorization, at trial, Respondents proved—and all three of the Division's investor witnesses admitted—that, in fact, the transaction documents, including the Indentures and Collateral Management Agreements ("CMAs"),[2] disclosed and permitted Respondents' use of discretion and "business judgment" in amending and categorizing loans. FOF ¶¶ 93-96. The Trustee Reports disclosed, month after month, the interest rate, interest payments, and categorization of the loans, as well as the interest coverage ratio, all of which made plain that many loans were not paying full interest, and yet remained in Category 4—as the Noteholder witnesses admitted. FOF ¶¶ 53-55, 125-50, 157-59; Tr. 321:4-41 (Aniloff), 612:9-613:21 (Mach), 1674:13-18 (Aldama). The same transaction documents also made plain Respondents' strategy of investing in deeply distressed companies that no one expected would necessarily pay full interest from day one, as numerous witnesses explained. Ms. Tilton and others at Patriarch forthrightly, uniformly, and unambiguously explained their amendment, deferral, and

[2] Each Zohar transaction was governed by an Indenture, a Collateral Management Agreement ("CMA"), and a Collateral Administration Agreement ("CAA") (together the "governing documents"). Respondents' Proposed Findings of Fact ("FOF") ¶ 16. The Indenture is a comprehensive agreement that specifies, among other things, the types of collateral the relevant Zohar Fund may purchase, the priority of payments to the Zohar Noteholders, and the various coverage and quality tests (the Zohar I, II, and III Indentures collectively referred to herein as the "Indenture" or "Indentures," and cited to as "Indenture § __," unless a specific Indenture is cited, *e.g.* "Zohar III Indenture § __"). FOF ¶ 17; RX 21 (Froeba Rep.) at ¶ 40. The CMA is an agreement between the relevant Zohar Fund and Patriarch as collateral manager that sets forth Patriarch's duties and standard of care (the Zohar I, II, and III CMAs collectively referred to herein as the "CMA," and cited to as "CMA § __," unless a specific CMA is cited, *e.g.*, "Zohar III CMA § __"). FOF ¶ 18. The CAA is an agreement between the relevant Zohar, Patriarch as collateral manager, and the Collateral Administrator/Trustee for that Zohar, which, in connection with the Indentures, establishes the Trustee's duties and responsibilities, including to prepare monthly and quarterly Trustee Reports, to monitor payments to and from the Portfolio Companies and Noteholders, and to effectuate such payments (the Zohar I, II, and III CAAs collectively referred to herein as the "CAA," and cited to as "CAA ¶ __," unless a specific CAA is cited, *e.g.*, "Zohar III CAA § __"). FOF ¶ 19.

categorization practices. FOF ¶¶ 151-56. Even the Division's own witness, David Aniloff of SEI Investments Company, testified that Respondents' "categorization approach [was] disclosed to [him] as an investor in the Zohar bonds" "in the offering memorandum and indenture." Tr. 146:16-19.

Having entirely failed to prove their allegations about categorization, the Division tried to shift gears, arguing in summation that "even if you credit Ms. Tilton's claim that there were amendments by course of performance" under Section 7.7(a), that "doesn't save her" because the "amendments were not expressly disclosed" to investors and others. Tr. 3674:22-3675:11. But the evidence showed that they were: Not only did the Indentures and CMAs expressly disclose that Respondents anticipated entering into "extensive amendments" to effectuate the "turnaround" of "distressed" companies, *see* Indenture § 7.7(a), but Jaime Aldama of Barclays also admitted that he "met with Ms. Tilton, and she told [him] that she was, in fact amending the loan agreements," Tr. 1676:21-1678:6, when in her judgment it was in the best interests of the Noteholders to do so. And Respondents sent monthly and quarterly reports providing all of the relevant information regarding interest payments and categorization; through this data—the language of Wall Street—these reports conveyed as directly as any words could that Respondents were regularly amending loan terms to accept less than full stated interest while maintaining loan categorization.

Indeed, Respondents' authority to amend loan terms was the critical means of implementing Respondents' disclosed strategy of investing in distressed companies that had been "left for dead," Tr. 1838:5-7 (Tilton), and turning them around by providing them with liquidity through new loans and loan repayment flexibility. As Ms. Tilton testified, only by deferring interest and amending loans could she hope to steer the Zohars through the financial crisis and obtain "a couple of billion dollars of value that would not be here" otherwise, enough to cover in full the amounts owed to investors. Tr. 2727:5-7. And the testimony of the Division's own witnesses confirms this point. *See* Tr. 742:10-743:3, 746:17-23 (Mach); Tr. 1728:23-1729:9 (Aldama).

The Division also alleged that Respondents' categorization practices were designed to maintain a high Overcollateralization Ratio ("OC Ratio") to allow Ms. Tilton to collect fees and preference share distributions "to which she was not entitled." *See* OIP ¶¶ 44-45. But the trial revealed that the OC Ratio was in fact appropriately calculated under the Indentures and was in any case of limited utility as it did not factor in the value of equity interests gifted by Ms. Tilton to the Zohars. *See* FOF ¶¶ 41, 57; Tr. 3588:7-11 (Hubbard); RX 24 (Hubbard Rep.) at ¶ 25 n.47. The evidence also showed that another metric—the Interest Coverage Ratio ("IC Ratio")—was of far greater significance because it disclosed the ratio of interest payments received from Portfolio Companies to the total interest owed to the Noteholders. *See* FOF ¶ 53.

In sum, the Division's purported fraud case failed miserably. There is hardly even a live dispute as to the interpretation of the Indentures. The only remaining question is whether the amendments Ms. Tilton believed she was executing under Section 7.7(a) orally or by course of performance had legal effect under New York state contract law. There is no sensible reason for the Division to have devoted its enforcement resources to this question. The Division should not be in the business of policing the performance of contracts, especially ones among sophisticated parties. Notwithstanding this fact, the answer to the question is clear—the amendments did have legal effect under New York law.

The Division's theory of fiduciary breach similarly collapsed at trial. The only fiduciary breach alleged in the OIP, the Division's pretrial brief, and its opening, was a purported undisclosed conflict of interest based on Respondents' categorization approach. Not only did the documentary and testimonial evidence show that this approach was both authorized and disclosed, the Division's theory also ignored the express conflicts of interest disclosure and waiver in the CMAs. The Division has now changed course, asserting that Ms. Tilton was not acting in the best interests of the Zohars and of the Noteholders more generally. Tr. 3645:17-23, 3649:19-24 (Div. summation). That is an inappropriate expansion of the charges, and is in any case meritless. The evidence confirmed that Ms. Tilton put the Zohars' and Noteholders' interests ahead of her own (even though she had no fiduciary duty to the Noteholders, *see infra* pp. 71-74). She reinvested hundreds of millions of dollars of her own money into the Zohars and the Portfolio Companies, Tr. 2548:5-18 (Tilton)—a sum more than double the $200 million in collateral management fees and distributions the Division now seeks from Ms. Tilton as disgorgement. And the Division now concedes that Ms. Tilton "chose to gift" the equity upside to the Zohars. Tr. 3681:16-3682:2 (Div. summation). Ms. Tilton also elected to defer tens of millions of dollars in subordinated management fees and preference share dividends during the financial crisis, Tr. 2487:24-2488:22 (Tilton), and subordinated her interests behind others, for the benefit of the Noteholders and the Zohars, Tr. 2070:24-2071:2, 2260:8-21, 2422:14-25, 2687:7-11 (Tilton). She even offered to resign as collateral manager if that would help facilitate a restructuring and save the Zohars. FOF ¶ 190. In short, Ms. Tilton behaved admirably, conducting herself at all times as someone committed to putting the interests of the Zohars and the Noteholders before her own, belying any allegation of fiduciary breach.

The Division likewise failed to adduce credible proof of its claim that the financial statements were misleading. The Division called Peter Berlant, who was Ms. Tilton's outside accountant. Berlant advised the Zohars since their inception, and was Ms. Tilton's outside accountant for predecessor funds Ark I and Ark II. Berlant's testimony—particularly his insistence under oath that all he ever did for 15 years was to look for "clerical errors" in Patriarch's financial statements—was patently false, as contemporaneous documents conclusively established. *See* Tr. 775:23-776:1, 838:3-17, 936:5-25, 937:1-6. His attempt to minimize his relationship to Ms. Tilton was similarly false, as his own emails proved. *See* Tr. 1040:9-1041:11 (Berlant); RX 1195.

The Division's other witnesses offered no support for the financial statement allegation. The Division called Patriarch's controller, Carlos Mercado, who testified that Berlant had reviewed and approved the financial statements, and explained in detail Respondents' impairment and fair value processes. *See* Tr. 1181:5-20, 1280:13-21, 1300:14-1301:10, 1318:15-1319:7. And the Division's purported accounting expert witness, Steven Henning, admitted that many of his opinions were not based on accounting principles at all, FOF ¶¶ 311, 313; Tr. 1424:7-14, that he had failed to review documents detailing Patriarch's processes, FOF ¶ 310, and that the Division had not communicated to him fundamental facts about the case that undermined his conclusions, Tr. 1425:6-1427:11.

As with its other claims, the Division sought to retool its financial statements case, trotting out the new, uncharged theory that the financial statements did not adequately disclose accrued interest. Mercado and Respondents' expert Charles Lundelius definitively refuted that assertion, and also explained that the accounting approach recommended by Division lawyers—that Patriarch reported on its financial statements as accrued interest amounts that it did not expect to collect—would have been "misleading" and inconsistent with GAAP. *See* Tr. 1221:2-18, 1222:16-25, 1235:3-7. Tellingly, the Division did not ask its own accounting expert, Henning—who testified after Mercado—a single question on the topic and, indeed, presented no expert testimony at all to buttress its new theory.

The witnesses the Division did not call are equally revealing. It failed to present a single witness—other than Ms. Tilton—who was present at the inception of the Zohars, any witness from the Zohar Trustee, any witness from the Rating Agencies, or any of the Zohars' independent directors. Moreover, even though the Division interviewed many dozens of investor witnesses and as late as opening statements had indicated that it would call five investor witnesses, it called only three—pulling the remaining investor witnesses as its case collapsed.

Even if the Indentures had not authorized Respondents' practices—which they did—the Division failed to prove the materiality of any alleged misrepresentations, omissions, or deceptive conduct. The Division made no showing—let alone a "substantial likelihood"—that the "disclosure of the [purportedly] omitted fact" (namely, that Respondents used their discretion to amend loans in a way that affected categorization) "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, at *11 (ALJ Sept. 27, 1999) (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988)). *See infra* pp. 77-78. Additional disclosures could not have altered the total mix of information with respect to Respondents' categorization methodology, because all of the information needed to grasp the so-called "omitted fact" was available to these sophisticated investors. *See infra* pp. 79-80. Multiple investor witnesses testified to the immateriality of the financial statements allegations, and one admitted that he had not even bothered to avail himself of the information that was available to him. *See infra* pp. 62-64.

Nor can the Division prove that Respondents engaged in intentional misconduct or acted negligently. *See infra* pp. 80-83. Quite the opposite: Respondents' actions were wholly inconsistent with bad faith. In the monthly Trustee Reports, Respondents provided Noteholders and the Zohars with the very information that they were purportedly withholding, including that full interest was not being collected on loans classified as Category 4. Nor has the Division shown recklessness or negligence in Respondents' categorization of loans, because their conduct was based on a reasonable interpretation of the governing contracts. *See Gen. Ins. Co. of Am. v. K. Capolino Constr. Corp.*, 983 F. Supp. 403, 437 n.63 (S.D.N.Y. 1997). Indeed, the Division has conceded that it does not allege that "Respondents' subjective judgments relating to the portfolio companies were incorrect[.]" Div. Opp. to Mot. for a More Definite Statement 4 (Apr. 29, 2015).

The same is true for the Division's charges relating to the financial statements. Both Mercado and Ms. Tilton consistently testified that they relied reasonably and in good faith on Berlant to provide GAAP advice and to review and approve the financial statements, and the evidentiary record includes two dozen examples of Berlant being asked to "review and approve" or of Patriarch employees referring internally to the fact that Berlant would need to "review and approve" financial statements. The documentary evidence showed that Berlant in fact did so. Respondents had formal systems and processes in place for the preparation and review of the financial statements for accuracy and GAAP compliance. And both Mercado and Ms. Tilton consistently testified that they understood that the financial statements were GAAP-compliant and appropriate in all respects. These facts establish the defense of good faith reliance on the advice of accountants—a complete defense to the financial statements charge—and, in any case, make it impossible for the Division to meet its burden of proving scienter or negligence.

More fundamentally, this case should be terminated for reasons of basic fairness. Ms. Tilton and Patriarch have been denied most of the procedural rights they would have been afforded in a federal district court—starting with a jury and extending even to the right to serve subpoenas—and have been treated dramatically differently than others similarly situated. And in their zeal to target Ms. Tilton, Division lawyers have engaged in troubling conduct unbefitting a government enforcement agency, and the manner in which the Division's lawyers have prosecuted this case simply does not comport with due process and fundamental fairness. Both before and at trial, Division lawyers repeatedly failed to honor their most basic disclosure obligations and misled Respondents and Your Honor as to the nature of their relationship with multiple witnesses. Under similar circumstances, federal courts have dismissed the charges for prosecutorial misconduct, *see, e.g.*, *United States v. Chapman*, 524 F.3d 1073, 1078-80 (9th Cir. 2008), and the same remedy is warranted here. *See infra* pp. 110-12.

In no event should this Court take seriously the Division's request for an astonishing $208 million in disgorgement and a permanent bar of Ms. Tilton from the securities industry. These sanctions would be completely inappropriate on the evidence adduced here. *See infra* pp. 112-20. Now that a fuller picture has been revealed through the crucible of trial, the only just and proper outcome is to dismiss these charges in their entirety.

THE EVIDENCE

Respondents' Proposed Findings of Fact contain a full statement of relevant facts and supporting evidence. An overview of the key points established at trial is below.

I. Ms. Tilton Designed The Zohars To Originate Loans To Deeply Distressed Companies And Implement A Long-Term Turnaround Strategy To Create Value.

A. Ms. Tilton Created The Innovative Zohars To Provide A Solution To Financial Institutions Seeking To Invest In Distressed Assets.

Ms. Tilton founded Patriarch in 2000, after nineteen years of experience on Wall Street, to develop and market innovative solutions for financial institutions carrying portfolios of distressed and defaulted loans. FOF ¶ 1; *see also* RX 72. To that end, Ms. Tilton created two collateralized loan obligations ("CLOs") in 2000 and 2001, respectively called Ark I and Ark II (collectively, the "Arks"). FOF ¶ 2. Through the Arks, Patriarch purchased and took over the management of portfolios of distressed and defaulted loans from two major banks, thereby allowing the banks to remove those failing assets from their balance sheets. FOF ¶ 2. The Arks were the first CLOs invested exclusively in distressed debt to receive an investment-grade rating, FOF ¶ 3, and were widely heralded as successful transactions, FOF ¶ 4. The ratings on the Notes in these CLOs were upgraded during the life of the transactions, and Noteholders were repaid earlier than expected. FOF ¶¶ 5-6. Respondents were praised for their "hands-on management style," RX 70 (Introduction to Patriarch Partners Pitchbook, dated Sept. 15, 2003) at 77 (quoting from a July 30, 2003 Wall Street Journal Article, *In Hard Luck Industries, Patriarch Seeks Revival Funds*), and developed a reputation as "superior manager[s] of distressed loans," RX 551 (Internal MBIA email attaching Feb. 22, 2006 write-up on Patriarch from MBIA's Credit Analytics Group) at 4; *see also* FOF ¶ 4.

Ms. Tilton's success with the Arks prompted insurer MBIA, which faced insurance liability for a potential shortfall of $200-300 million on a set of unrelated CDOs, to seek Ms.

Tilton's help in creating a transaction designed to reduce that liability. FOF ¶¶ 7-8. In response, she created Zohar I. FOF ¶ 7. MBIA insured the Zohar I senior Notes, Ms. Tilton took over as collateral manager of MBIA's seven failing CDOs, and MBIA was granted a potential interest in a set of junior Zohar I Notes. FOF ¶¶ 9-10. Like the Arks, Zohar I was originally set up to invest in distressed corporate loans by purchasing them on the secondary market at a steep discount to their face value ("par value") and improve the prospects for success. FOF ¶ 11. After Zohar I closed, however, the market for distressed debt changed and prices for distressed loans increased, making this strategy less feasible. FOF ¶ 12.

To avoid unwinding the Zohar I deal, Ms. Tilton proposed a revised strategy: Zohar I would continue to purchase distressed loans on the secondary market at a discount when possible, but the primary strategy (the "Zohar Strategy") would be to originate loans to distressed companies (the "Portfolio Companies") at or near par value, gain control over them, and implement a long-term turnaround strategy to create value. FOF ¶¶ 13, 15. Shortly after the parties decided on the new strategy, Zohar II and Zohar III were created to invest side-by-side with Zohar I, thereby providing sufficient investment power to gain controlling interests in the distressed companies. FOF ¶ 14.

B. The Zohars Were Private Transactions Among Sophisticated Parties Who Understood The Investment Strategy And Its Risks.

The Zohars were private transactions involving only sophisticated parties. The parties to the governing documents included the Zohars, the "Credit Enhancer," the "Note Agent," the Trustee/Collateral Administrator, the collateral manager, the Rating Agencies, and a small group of sophisticated institutional investors. FOF ¶ 21. The "Credit Enhancer," MBIA, provided a financial guaranty insurance policy on the Zohar Notes that would pay the Noteholders if the

Zohars were unable to meet their principle repayment obligations. FOF ¶ 22.[3] The "Note Agent" (otherwise known as the investment bank), Natixis Financial Products Inc. ("Natixis"), participated in structuring the transactions, worked with the Rating Agencies to obtain ratings on the Notes, and marketed and placed the Notes and preference shares with investors. FOF ¶ 23. LaSalle Bank (later U.S. Bank and others) served as Trustee and Collateral Administrator for the Zohars, and had many responsibilities in those capacities, including maintaining a database documenting each of the Zohar loans, compiling and distributing monthly and quarterly Trustee Reports, and collecting and disbursing funds. FOF ¶ 24.

As collateral manager to the Zohars, Patriarch made all decisions regarding the management of the Zohars and their collateral, including regarding the purchase of loans from the secondary market, the origination of loans to the Portfolio Companies, and the restructuring of the loans and rehabilitation of the Portfolio Companies. FOF ¶ 25. Patriarch is owned and controlled by Ms. Tilton, who acted on behalf of Patriarch as collateral manager. FOF ¶ 26. Ms. Tilton typically owned equity in the Portfolio Companies, often served as CEO and as a board member of the Portfolio Companies, and actively fought for their rehabilitation. FOF ¶ 97.

The Rating Agencies (Standard and Poor's and Moody's) reviewed and analyzed the terms of the transactions in order to issue ratings on the Notes issued by the Zohars, reflecting their view of the risk associated with investment. FOF ¶ 28. The Rating Agencies also conducted ongoing monitoring of the transactions in order to adjust their ratings if the risk changed. FOF ¶¶ 182-84. The Zohar Noteholders—all sophisticated institutional investors, including MBIA, Goldman Sachs, Barclays, and Natixis—invested capital into the Zohars by

[3] There was no Credit Enhancer for the Zohar III transaction. *See* RX 12 (Zohar III Indenture).

purchasing Notes, and were, in exchange, entitled to interest payments over time in addition to return of their principal at the maturity date. FOF ¶ 29.[4]

Together, these parties heavily negotiated the governing documents, including the supplemental indentures that were negotiated to address the change in investment strategy. FOF ¶ 30. They also specifically negotiated what disclosures would be provided by the Zohars, including the content of the Trustee Reports and financial statements. FOF ¶¶ 20, 31.

C. The Unique Zohar Investment Strategy Involved Originating High-Interest Loans To Distressed Portfolio Companies, Gaining Control, And Rehabilitating The Companies To Maximize The Zohars' Return On Investment.

Although the Zohars shared some characteristics with typical CLOs, they were unique in several respects. Like typical CLOs, the Zohars raised capital by issuing Notes to Noteholders who were, in exchange, entitled to interest payments over time, plus return of their principal at the maturity date, and the Zohars also paid collateral management fees to Patriarch for managing the portfolio. FOF ¶¶ 27, 34.[5] But the fundamental investment strategy and value proposition of

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[4] Some Zohar Notes were sold on the secondary market exclusively to other sophisticated institutional investors, including SEI Investments and Värde Partners. FOF ¶ 32. Those investors were given the Indentures and other governing documents, as well as marketing materials that detailed the Zohar Strategy, prior to investing in the Zohars. FOF ¶ 33; *see also* RX 72 (Introduction to Patriarch Partners Pitchbook, dated Nov. 11, 2004) at 3-4 (executive summary of Respondents, the Zohars, and the Zohar Strategy); RX 15 (Zohar III Offering Memorandum) at 56-57 (discussing the "[i]nherent [i]lliquidity and [v]olatility" of the Zohar loans).

[5] Payments of fees and interest were made according to a payment "waterfall" established in the Indenture, which directed payment based on the seniority of the Notes. *See* Indenture § 11.1(a); *see also* FOF 59. The Zohar waterfall provided that interest payments from the Portfolio Companies would first go toward the Zohars' operational and administrative costs, then to Patriarch's senior collateral management fee, then to pay interest to the Class A Noteholders. Indenture § 11.1(a). If funds remained, cash flowed to an account for preference shares, then to Patriarch's subordinated collateral management fee, then to pay principal to all Noteholders in order of priority, and finally to the equity and preference shareholders. Indenture § 11.1(a).

the Zohars differed markedly from traditional CLOs, FOF ¶ 35, and as detailed below, *see infra* Pt. II,[6] the governing documents were drafted to reflect that unique strategy.

The Zohar Strategy was built upon the premise that Ms. Tilton would be the catalyst for the success of the Portfolio Companies. An investment in Zohar Notes was really an investment in Ms. Tilton's judgment. The structure of the transaction reflects this fact at every step. Thus, the Zohar Strategy gave Respondents broad authority and discretion to control the repayment terms of the loans the Zohars originated to the Portfolio Companies. FOF ¶¶ 36-40, 48-51. Because the Portfolio Companies were deeply distressed, typically had no positive cash-flow prior to the Zohars' investment, were sometimes purchased out of bankruptcy, and often were not operating, they were generally unable to obtain funding from any source other than Respondents and the Zohars. FOF ¶ 37. As the representative of the sole lenders to highly distressed Portfolio Companies, Patriarch, as collateral manager, could control the terms of the loans without having to address the competing interests of other lenders. FOF ¶ 36. Ms. Tilton and her affiliates often owned all or almost all of the equity in the companies, which she typically purchased with personal funds. FOF ¶ 40. In connection with that equity ownership, Ms. Tilton was actively involved in the management of the Portfolio Companies, often acting as CEO and as a board member or manager of the companies (in most cases, the sole board member or manager). FOF ¶¶ 97-98. Ms. Tilton's active involvement enabled her to direct the rehabilitation of the companies, which, given her prior successes, was a key selling point for Noteholders. FOF ¶¶ 38-39.

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[6] Cross-references in this brief to "*infra* Pt. __," or "*supra* Pt. __," refer to the numbered Part falling within the same major heading as the reference (*i.e.*, "The Evidence," "Procedural History and Trial," "Legal Standards," or "Argument").

Ms. Tilton generally directed "equity upside" of the Portfolio Companies to inure to the benefit of the Zohars and Noteholders before herself. FOF ¶ 41. If that "equity upside" was realized upon a sale, those funds would be used to make principal and interest payments on the loans before any profits flowed to Ms. Tilton. FOF ¶ 41; *see also* FOF ¶¶ 35, 94.[7] The Indentures also allowed the Zohars to benefit from "Equity Kickers" and "Equity Workout Securities," including warrants, preferred second lien loans, prepayment penalties, and cash bonuses at maturity, which were arrangements pursuant to which a Portfolio Company would pay the Zohars more than 100% of the principal they owed on a loan. FOF ¶ 42.

The large spread between the high interest rate that the Zohars, as lenders of last and only resort, charged the highly distressed Portfolio Companies (typically LIBOR plus 8 percent), and the interest rate paid to Zohar Noteholders (LIBOR plus 0.38 percent to LIBOR plus 1.4 percent) reflected the parties' expectation that—consistent with the Zohars' disclosed business strategy of investing in highly distressed companies—not all Portfolio Companies would always make timely, full interest and principal payments on their loans. FOF ¶¶ 43, 46-47. But if some of the Portfolio Companies succeeded and could pay the high interest on their loans, plus yield additional returns through potential equity upside and equity kickers, the Zohars would meet their financial obligations to Noteholders and create additional value besides. FOF ¶ 44.

[7] For example, the Zohars benefitted from the equity upside from the sale of a company called Xpient in 2014, when it was sold for a $17 million profit. Tr. 2312:6-14 (Tilton). The principal on the loan to Xpient, originated by the Zohars, was paid off first, followed by the payment of an equity kicker in the form of a preferred second lien loan, and then the Zohars were paid a portion of the remaining equity upside. *Id.*

II. The Obligations Set Forth In The Governing Documents Reflected The Unique Zohar Investment Strategy.

A. The Governing Documents Expressly Granted Respondents Unilateral Discretion to Amend Loan Terms.

Because the value of the Zohars depended on the successful turnaround of the Portfolio Companies, the Indentures were drafted to give Respondents significant discretion in managing cash flows from the Portfolio Companies—including broad, unilateral discretion to amend the terms of the loans originated and purchased by the Zohars. *See* FOF ¶¶ 37-38, 48-49, 51, 87-92; Indenture § 7.7(a).[8]

B. The IC And OC Ratios Reflected Respondents' Exercise Of Discretion Pursuant To The Zohar Strategy.

The Indentures required the calculation of both an IC Ratio and an OC Ratio. FOF ¶ 52. The IC Ratio measured the interest payments received from Portfolio Companies as against the interest owed to the Noteholders, and indicated whether the portfolio was generating sufficient interest income, on an aggregate cash basis, to satisfy interest payment obligations to Noteholders. FOF ¶ 53. The Indentures established a minimum IC Ratio of 110 percent (the "IC Ratio Test"), meaning the Zohars needed to collect only 10 percent more in interest from the Portfolio Companies than they owed to Noteholders in order to "pass." FOF ¶ 54. Because the interest rates on loans to the Portfolio Companies were significantly higher than the interest rates on the Notes, if every Portfolio Company paid the full stated interest, the IC Ratio would far surpass (by *multiples* of) the threshold. FOF ¶ 55. Thus, in the context of the very high interest rates charged to the failing or failed companies, setting the IC Ratio at 110 percent reflected the

[8] The Collateral Management Agreements contained substantially the same language. FOF ¶ 50; RX 6 § 2.2(c) at 7-8; RX 10 § 2.2(c) at 7-8; RX 16 § 2.2(c) at 8.

unambiguous understanding and expectation that not all loans would pay the full stated interest at all times. FOF ¶ 55.

The OC Ratio, by comparison, reflected the "carrying value" of the loans, plus cash, divided by the remaining principal owed to the Noteholders. FOF ¶ 56. Because the OC Ratio did not take into account the value of the equity upside that would benefit the Zohars and Noteholders when a Portfolio Company was successfully rehabilitated, it did not give a full picture of the value available to make payments to Noteholders and was of limited utility. FOF ¶ 57.[9]

If either the IC or OC Ratio Tests fell below the thresholds set forth in the Indentures, the payment waterfall re-directed cash flows to reduce the principal balance owed to the Noteholders, at the expense of paying Patriarch's subordinated management fees. FOF ¶ 60; RX 24 (Hubbard Rep.) at ¶ 37. If the OC Ratio decreased further, to an even lower threshold, it would trigger an "Event of Default." FOF ¶ 61. An "Event of Default" would empower the "Controlling Party"[10] to liquidate the CLO. FOF ¶ 62. As collateral manager, Ms. Tilton properly could "manage to the tests" by deferring management fees, forgoing preference share distributions, or buying new loans at a discount on the secondary market, to ensure that the OC and IC Ratios did not fail and that the Zohars would generate sufficient value to pay Noteholders. FOF ¶ 63.

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[9] The minimum OC Ratio was 105 percent, 112 percent, and 112.7 percent for Zohar I, II, and III, respectively (the "OC Ratio Test"). *See* FOF ¶ 58.

[10] The "Controlling Party" (known as "Controlling Class" in Zohar III) was a Noteholder or group of Noteholders as determined according to a complex rubric in the Indentures. FOF ¶ 62; Indenture § 1.1 (definition of "Controlling Party" or "Controlling Class"). MBIA was the Controlling Party of Zohar I. FOF ¶ 62; Tr. 2181:3-10 (Tilton).

C. The Indentures Permitted Respondents To Use Their Business Judgment To Amend Loans And Categorize Them According To Their Amended Terms.

To calculate the OC Ratio, Respondents were required to assign each loan to one of four numeric categories: Categories 1, 2, 3 or 4.[11] FOF ¶ 64. In practice, the categorization was essentially binary: a loan was either a Category 1, "Defaulted Obligation," or a Category 4, a current obligation. FOF ¶¶ 66-67. The "carrying value" of the loans, which served as the numerator of the OC Ratio, was determined according to these categories. FOF ¶¶ 69-73.[12] Assignment of a loan to either Category 1 or Category 4 turned, in part, on whether a payment "default" had occurred under the current loan terms. FOF ¶¶ 74-84.

The Indentures expressly required Respondents to make a number of subjective determinations regarding the anticipated future performance of the Portfolio Companies in determining whether to maintain loans in Category 4 or move them to Category 1. Regardless of whether a Portfolio Company was meeting its payment obligations, Respondents had the authority to put a loan into Category 1 if, "in the reasonable judgment of the Collateral Manager,

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[11] The four-category approach was tailored to the initial strategy of buying distressed loans on the secondary market and consolidating control over the companies in bankruptcy. FOF ¶ 65. By the time Zohar III was created, the four categories had been eliminated, and loans were designated as either "Defaulted Investments" (roughly analogous to Category 1 loans) or "Collateral Investments" that were not Defaulted Investments (roughly analogous to Category 4). FOF ¶¶ 66-68. The Division made no claim that investments categorized should have been categorized as a "2" or "3" instead.

[12] Category 4 loans were carried at the principal amount outstanding on the loan for purposes of calculating the OC Ratio. FOF ¶ 70. For Zohar I, the carrying value of a Category 1 loan was measured by the lower of the purchase price or the market price (if there was one). FOF ¶ 72. The loans originated by Zohar I would typically be held at par value even in Category 1 since there was typically no market value and the loans were originated (*i.e.*, purchased) at 100 cents on the dollar. FOF ¶ 72. In Zohars II and III, the carrying value for Category 1 loans was typically measured by the Moody's recovery rate, "which would have been anywhere between 50 and 60 percent of par." Tr. 2418:17-2419:2 (Tilton); *see also* FOF ¶ 73.

[there was] a significant risk of declining in credit quality or, with the passage of time, becoming Category 1." Indenture § 1.1 (definition of "Defaulted Obligation" at (a)(ii) stating the collateral manager can 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); *see also* FOF ¶ 79.[13]

Conversely, if Respondents had confidence that a Portfolio Company would likely provide long-term value to the Zohars and their Noteholders, Respondents could exercise their discretion under Section 7.7(a) of the Indentures 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. Indenture § 7.7(a); FOF ¶ 80. Ms. Tilton exercised her discretion "not to default something but to amend and defer if [she had the] reasonable belief or reasonable judgment or good-faith business judgment that by doing so [she would] maximize the cash flows of principal, interest and equity over a longer period of time." Tr. 1831:7-12; *see also* FOF ¶¶ 80, 107.

Under the Indentures, "a payment default [was] measured by the loan's current terms after giving effect to all of the amendments." RX 21 (Froeba Rep.) at ¶ 63. Thus, if Respondents amended the terms of a loan to extend the due date for interest payment, default was measured pursuant to the amended deadline, not the superseded deadline, and did not need

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[13] While the categorization terminology changed in the Zohar III Indenture, as noted above, the definition of "Defaulted Investment" in the Zohar III Indenture carried over the same "sole judgment" provision. *See* Zohar III Indenture § 1.1 (definition of "Defaulted Investment").

to be put into Category 1 because there was no default of principal or interest. FOF ¶¶ 80-83.[14] On the other hand, if payment was not timely made according to the amended terms of the loan, Respondents would have to—and did—place the loan in Category 1. FOF ¶ 84.

The Indentures also included "Eligibility Criteria" for loans held by the Zohars, including that no more than 5 percent of the Zohars' loans could be "Defaulted Obligations" (Zohar I and II) or "Defaulted Investments" (Zohar III). FOF ¶ 89.[15] If the 5 percent limit was exceeded, the Zohars could not acquire or originate any loans that would increase the percentage. FOF ¶ 90. Because the Eligibility Criteria discouraged the Zohars' exposure to "Defaulted Obligations" or "Defaulted Investments" by setting a limit, while the disclosed Zohar Strategy was to invest in loans that would be subject to "extensive amendment," a reading of the Indentures that required amended loans to be reclassified as "Defaulted Obligations" or "Defaulted Investments" would be inconsistent with the "Eligibility Criteria." Moreover, if the 5 percent threshold were exceeded, the Zohars would be prohibited from making further loans to those Portfolio Companies when they were at their most vulnerable. FOF ¶¶ 89-90. If Portfolio Companies could not obtain funding in times of distress, it would almost certainly force fire sales of the

[14] Unlike other CLO indentures, which provided that a loan would still be considered to be defaulted if it "would be so delinquent but for any amendment or modification to such loan," the Indentures had no such language barring categorization by reference to the amended terms of a loan. FOF ¶ 83. To the contrary, while the Zohar I and II Indentures specified that a loan would be considered in default "without regard to . . . any waiver of such default," they did not contain parallel language regarding amendments, despite expressly authorizing amendments in Section 7.7(a) of the Indentures. *See* Indenture § 1.1 (definition of "Defaulted Obligation").

[15] Under the Indentures, if one loan to a Portfolio Company was a Category 1, all other loans to that company were also reclassified to Category 1, meaning that if Respondents did not have the ability to amend and defer interest, the 5 percent threshold would have been quickly exceeded. FOF ¶ 78.

distressed and illiquid Portfolio Companies and lead to rapid and precipitous losses for noteholders.

III. Respondents' Approach To Loan Amendment And Categorization Was Fully Disclosed.

A. Monthly And Quarterly Trustee Reports Disclosed Respondents' Categorization Approach.

The Indentures required that the Zohars' Trustee distribute a "Monthly Report" and a quarterly "Note Valuation Report" (together, the "Trustee Reports") to Noteholders and other interested parties, including the Rating Agencies. FOF ¶ 125. As required by the Indentures, the Trustee Reports contained detailed information on their face about the Zohar loans, including the principal balance, the interest rate, amount of interest collected during that period, and the numeric category to which Respondents had assigned each loan for purposes of calculating the OC Ratio, as well as the IC and OC Ratios for each Zohar for the given period. FOF ¶¶ 127-30.[16] The Trustee also posted on its website data files containing detailed loan-level information, which Noteholders and other interested parties regularly downloaded and analyzed alongside the Trustee Reports. FOF ¶ 126. The Trustee Reports and associated data files regularly disclosed on their face that some of the loans held by the Zohars did not pay the full amounts of stated interest and were categorized as Category 4 loans. FOF ¶¶ 128, 139-50.

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[16] For example, the July 2009 quarterly Trustee Report disclosed that loan 0855_11 (corresponding to American LaFrance) did not pay the full stated interest for the relevant period, and was a Category 4 loan. The Report stated that loan had a total principal balance of approximately $45 million, and an interest rate of 10 percent. Simply by multiplying $45 million by 10 percent, it was evident that the stated interest on the loan was around $4.5 million per year, or just over $1 million per quarter, but the July 2009 Report showed that American LaFrance paid only $200,000 in interest for the quarter, and that the loan was classified as Category 4. FOF ¶¶ 131-34; *see also* FOF ¶¶ 135-38 (September 2007 monthly Trustee Report disclosures for loan 865_02).

B. Investor Calls And Emails Provided Even More Detail On Respondents' Categorization Approach.

Not only did the governing documents, marketing materials, and Trustee Reports make clear Respondents' investment strategy and concomitant approach to loan amendment and categorization, but also Ms. Tilton was transparent in explaining and clarifying Respondents' approach on investor calls and in emails. On a December 2011 conference call for Zohar I Noteholders, Ms. Tilton told Noteholders, "[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," RX 48A at 4:2-6; *see also* FOF ¶ 154, namely by "deferring and amending and using the cash flow that the company can use to create value rather than paying interest and going into liquidation." Tr. 2711:22-2712:5 (Tilton).

Similarly, on a Zohar II investor call, Ms. Tilton told Noteholders that the Zohar strategy involved gaining control over companies in their "deepest and darkest moments, at low prices," and "tak[ing] the long journey of rebuilding these companies and ultimately selling them for value. And the deals were actually structured with the knowledge that that would be what we were doing, which is why they look very different than other CDOs in terms of the ability to change maturities, adjust interest rates, extend, restructure." RX 49A at 2:12-23; *see also* FOF ¶ 155. On a Zohar III investor call, Ms. Tilton told Noteholders, "[T]iming is everything. Selling things at their worst moment is the worst that you could do. . . . The automotive company that we owned prior to 2009, Global Automotive Systems, in 2009 it lost fifty percent of its revenues when Chrysler and GM went into bankruptcy. . . . Had I not been here to hold it steady, change its interest rate, move the maturity out, we too would have gone that way. Yet this year it'll probably do $27 million of EBITDA." RX 50A at 15:25-16:17; FOF ¶ 156. Ms. Tilton did not receive a single follow-up inquiry after any of these investor calls. Tr. 2557:7-11.

Respondents were equally open in email communications with Noteholders. FOF ¶¶ 151-52. For instance, in responding to an inquiry from a Barclays analyst about the difference between the interest stated and the interest actually paid on a certain loan, Respondents explained that "[t]he Indenture allows Patriarch Partners, as Collateral Manager, to restructure [a] company's debt . . . [w]e have recently amended many of the credit agreements to lower interest rates to allow them to pay full interest or defer current due interest." RX 117 (June 23, 2011 email from Frank Li to Anand Sankaranarayanan, Barclays) at 1-2. Barclays did not ask any follow-up questions. *See also, e.g.*, RX 118 (Patriarch employee email to Noteholder Natixis explaining that some "loans have been amended"). Similarly, when analysts at the Rating Agencies noted that certain loans that were not paying the full stated interest were carried as Category 4 loans—precisely the information the Division wrongly alleges was not disclosed—Respondents openly explained their amendment and deferral practices. FOF ¶¶ 185-86.

C. The Trustee Received And Reviewed Detailed Information Regarding Each Loan, And Never Objected To Respondents' Management Of The Zohars.

As agent and fiduciary to the Zohars, the Trustee was responsible for monitoring all aspects of the Zohars' transactions and preparing the monthly and quarterly Trustee Reports, which entailed a thorough review of the principal amounts on the loans, the interest rates on the loans, and the interest payments made by the Portfolio Companies. FOF ¶¶ 173-175. The Trustee also independently calculated the OC Ratio based on Respondents' loan categorizations, and included it in the Trustee Report. FOF ¶ 176. Additionally, the Trustee was tasked with calculating, collecting, and distributing all funds on behalf of the Zohars, including the amounts loaned to the Portfolio Companies, as well as the principal and interest payments made by the

Portfolio Companies and fees paid to Patriarch, and tracking the interest rates and maturity dates on the loans. FOF ¶¶ 177, 180. The Trustee was also obligated to identify any defaulted, non-current, or non-performing loan, and the date on which it became defaulted. FOF ¶ 178. If the Trustee did not receive a principal and interest payment when due, it was required to send written notice to the Zohars and Patriarch and request payment from the Portfolio Company within three days. FOF ¶ 179. The Trustee never did so, and never objected to Respondents' management of the Zohars. FOF ¶¶ 179, 181.

IV. Patriarch Prepared GAAP-Compliant Financial Statements For The Zohars With The Advice And Approval Of Internal And External Accountants.

In addition to the Trustee Reports, Noteholders received the Zohars' quarterly financial statements, as required by Section 7.9(a) of the Indenture. FOF ¶ 219. Section 7.9(a) prescribed the content of the financial statements, and they provided significantly less detail than the Trustee Reports: a one-page balance sheet, a one-page income statement, notes about the Zohars' accounting processes, and a one-page certification that the balance sheet and income statements were "prepared . . . in accordance with [GAAP] and certified by the Issuer as presenting fairly, in all material respects, the financial position of the Issuer and its consolidated subsidiaries." FOF ¶ 220; Indenture § 7.9(a).

In preparing the Zohars' financial statements, Respondents relied on the advice and approval of its long-time outside accountant, Peter Berlant of Anchin, Block & Anchin ("Anchin"). FOF ¶¶ 247-270. By the time the Zohars were formed, Berlant was deeply familiar with Patriarch and its business operations, because he had served as Patriarch's accountant since "the inception of [the] business" in 2001, created the Arks' financial statements, and participated in negotiating the Zohar I governing documents (including the Zohar I Indenture, the Collateral Management Agreement, and the Collateral Administration Agreement). Tr. 1956:5-25 (Tilton);

FOF ¶¶ 247, 249-52, 254-56. Berlant helped to develop the form and content of the Zohars' financial statements; indeed, he revised the fair value and impairment notes of the very first statement to include language that was incorporated in all of the subsequent statements. FOF ¶¶ 249-50.[17]

Over the next 15 years, Berlant routinely reviewed and approved the Zohars' financial statements and provided accounting advice to Respondents, including with respect to GAAP. FOF ¶¶ 255, 257-60, 269-70. He advised Respondents on fair value disclosures, impairment policy, and how certain disclosures should be revised in light of new GAAP guidelines that arose from time to time. FOF ¶¶ 250-52, 257-60. In accordance with the processes Berlant helped create, Respondents regularly conducted impairment and fair value analyses.[18] FOF ¶¶ 223-28, 232-40. Patriarch analyzed the performance and future prospects of the Portfolio Companies through "credit templates" that applied a discounted cash flow analysis to estimate the value of future collections, and conducted an "event-driven" impairment analysis, writing down loans when underperforming assets needed to be restructured and writing off loans upon liquidation,

[17] Further, Anchin worked with Patriarch to develop a manual of accounting policies, which included advice from Berlant on how to conduct GAAP-compliant impairment analyses. FOF ¶¶ 251-53.

[18] Respondents created detailed models that "la[id] out [Portfolio Company] cash flows credit-by-credit and as a whole," and "discount[ed] those cash flows back to create a fair value number." Tr. 2297:8-2298:5 (Tilton); *see also* FOF ¶¶ 223-24. Patriarch then compared the discounted cash flow numbers from the valuation models to the "carrying cost on the financial statements as well as to the holding value in the trustee reports," and reported "the lowest number" as the fair value in the financial statements. Tr. 2281:15-25 (Tilton); *see also* FOF ¶ 224.

all in accordance with Berlant's advice. FOF ¶¶ 232-33, 250-52, 255, 257. These analyses were plainly disclosed in the financial statements.[19]

Anchin and Respondents also established formal procedures for preparing the financial statements, as set forth in Patriarch's "Fund Accounting Manuals," and adhered to those procedures every month for 15 years (with respect not only to the Zohars, but also the Ark I and Ark II funds, which preceded Zohar I). FOF ¶¶ 247, 250-52; DX 127 (Fund Accounting Manual for Zohar I). Patriarch's Finance & Accounting ("F&A") Department completed workpapers and generated draft financial statements using information provided by the Trustee. FOF ¶¶ 256, 264. Specifically, Patriarch's F&A Department, "ensure[d that] the financial statements were prepared in accordance with US GAAP." Tr. 1144:10-13 (Mercado); FOF ¶¶ 264-65. The workpapers and financial statements were sent for review and comment to Berlant, who would inform Patriarch's internal accountants of any proposed changes or state that he "approv[ed]" the financial statements. *See, e.g.*, RX 1761; FOF ¶¶ 264-65, 269. Only after Patriarch's accounting department satisfied themselves that the statements were GAAP compliant and "incorporate[d] comments from" Berlant could the papers be "submitted to Ms. Tilton . . . for approval." DX 127 (Fund Accounting Manual for Zohar I) at 4; FOF ¶ 268. Both by policy and in practice, Ms. Tilton, who has no formal accounting training, would not sign the financial

[19] As to fair value, the Zohar financial statements disclosed that the estimated "fair value of the Collateral Debt Obligations/Collateral Investments, taken as a whole, is approximately equal to the [] carrying value presented on the Balance Sheet" and "[t]he Collateral Debt Obligations/Collateral Investments are recorded at cost upon acquisition or origination." FOF ¶ 221. The Zohar financial statements further disclosed that "fair value estimates are generally subjective in nature," and may be based upon "valuation techniques" that "involve uncertainties." FOF ¶ 222. As to impairment, the Zohar financial statements also disclosed that an impairment loss would be recorded "[i]n the event . . . that the anticipated future collections are determined to be less than the carrying value of the loan," FOF ¶ 229, and that Patriarch "employs the cost-recovery basis of accounting for the recognition of capital gain or loss" due to the "uncertainty with regard to future collection[s]," FOF ¶ 230-31.

statements unless and until she was assured by her internal accountants that Berlant had reviewed and approved the documents. FOF ¶¶ 263, 265, 268; DX 127 at 4.

PROCEDURAL HISTORY AND TRIAL

I. After A Nearly Six-Year Investigation By The Division, The Commission—On A Split Vote—Authorized Narrow Charges Against Respondents.

In 2009, the Division commenced an investigation of Respondents that spanned nearly six years. During that time, the Division interviewed dozens of witnesses and gathered millions of pages of documents dating back to 2000. The Division's record is nonetheless startlingly incomplete, precisely as the Division wished it to be. Several of the Division's trial witnesses are not mentioned at all in the investigative record, the vast majority of its witness interviews were conducted off the record, and the Division resisted production of any notes from post-OIP interviews. FOF ¶ 348.

In March 2015, by a 3-2 vote, the Commission authorized the Division to institute proceedings against Respondents based on the 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 disapproved of any charges being filed. SEC, Final Commissioner Votes, at 849 (Mar. 2015), https://www.sec.gov/foia/docs/votes/2015-03.pdf. The charges rest on a single core allegation: that Respondents had failed to disclose their use of "subjective" methods for categorizing loans, rather than the purportedly objective standards set forth in the Indentures. *See* OIP ¶¶ 3-6, 29-51. This allegation animates the Division's various legal theories: the OIP characterizes it as a purported material misrepresentation or actionable omission in communications with Noteholders made via the Trustee Reports; as a purported breach of Respondents' fiduciary duties to the Zohars, by failing to disclose the actual method of categorization or an alleged conflict of interest linked to that method; and as an inaccuracy in the

FOF ¶ 153. Aldama also testified that he regularly reviewed the Trustee Reports, Tr. 1648:11-1; FOF ¶ 127, and conceded that he could determine from the Trustee Reports that some Category 4 loans were not paying the full stated interest, FOF ¶ 159; Tr. 1649:13-1650:1. Aldama further admitted that he was able to tell that "not all of the loans were paying the full amount of interest" from the face of the Trustee Reports because "[t]he weighted average spread and the interest collected was not the same." Tr. 1651:6-13; FOF ¶ 159.[22]

The Division's own experts also undermined the categorization claims. Ira Wagner, the Division's purported "expert in the structure and function of CLO[s]," Tr. 2834:6-12 (Div.), admitted that: (1) Ms. Tilton had "the authority to amend and make changes to the loan[s]," Tr. 2948:8-12; FOF ¶ 51; (2) if a loan were amended, it would need to be reclassified as Category 1 only "if it didn't make the payment according to its current"—that is, post-amendment—"contractual terms," Tr. 2932:23-2933:3; *see also* FOF ¶ 82; and (3) loan amendments did not need to be in writing, Tr. 2963:2-8; FOF ¶ 82. Far from helping the Division's case, Wagner's testimony supported Respondents' loan amendment and categorization practices.

The Division also called Michael Mayer, a purported "disgorgement expert." He claimed to have analyzed when it was that the OC Ratio Test should have failed had the Division's categorization theory been correct. Mayer's analysis was flawed as a matter of logic, economics, and arithmetic. FOF ¶¶ 328-31. Indeed, Mayer did not consider the consequences of an OC Ratio Test failure—the very hypothetical he had assumed. FOF ¶ 329. Mayer, moreover, first

[22] To the extent the Noteholder witnesses testified that they were not aware of Ms. Tilton's approach to categorization, that testimony is not credible, FOF ¶¶ 160-72, particularly in light of the fact that, as several witnesses confirmed, the face of the Trustee Reports revealed that loans that did not pay full interest were nonetheless categorized as a "4," FOF ¶¶ 128, 139-50, 157-59.

asserted that certain data was unavailable to investors, but then conceded that he had no way of knowing whether the data was contemporaneously available or not. FOF ¶ 324.

These experts not only failed to further the Division's case but also proffered improper legal opinions, engaged in improper fact-finding, and gave otherwise unreliable testimony. FOF ¶¶ 302-43. Your Honor should therefore not accord their testimony any weight.

The Division called Ms. Tilton, who testified about the creation of the Zohars, the governing documents, the Zohar Strategy, the financial statements, and the extensive disclosures made by Respondents to Noteholders and other parties to the transactions. Ms. Tilton explained that the structure of the Zohars, including the high interest rates on the loans to the Portfolio Companies, reflected the parties' expectation that Respondents would collect as much interest as possible from each Portfolio Company without unnecessarily exacerbating a liquidity crisis (and all of them had liquidity crises at the time of purchase), which would lead to a fire sale. Tr. 2006:10-16; *e.g.* FOF ¶¶ 38, 44, 55, 87-92. Accordingly, Ms. Tilton explained that her ability under Indenture Section 7.7(a) to "defer[] interest as an amendment" was the strategy for which the "noteholders negotiated and bargained." Tr. 1871:25-1872:15; FOF ¶ 87. She testified that, in line with this strategy, she had chosen "not to default something but to amend and defer" only if she had the "good-faith business judgment that by doing so [she would] maximize the cash flows of principal, interest and equity over a longer period of time." FOF ¶¶ 86, 92, 98, 107; *see also* Tr. 2743:1-12.[23] She "never categorize[d] something as a 1 or 4 if

[23] For example, Ms. Tilton testified at length about using her discretion to amend to defer interest payments for two Portfolio Companies, MD Helicopters and Global Automotive Services ("GAS"), both of which later successfully turned around and provided value to the Zohars. FOF ¶¶ 114-24.

[she] believed it should be a 1 just to keep the OC ratio higher." Tr. 1930:7-9; *see also* Tr. 1930:17-21; FOF ¶ 84. There was no evidence to the contrary.

Ms. Tilton also testified that she had elected to defer preference share dividends (over a two-year period) and over $32 million in subordinated management fees (for more than three years) during the financial crisis. Tr. 2487:24-2488:22; FOF ¶ 196. She reinvested into the Zohars and Portfolio Companies hundreds of millions of dollars of her own money, Tr. 2548:5-18; FOF ¶¶ 212-18—a sum far greater than the collateral management fees the Division now seeks from Ms. Tilton as disgorgement—reinforcing not only how closely her own interests were aligned with those of the Noteholders, but also her adherence to the highest standards of care. FOF ¶¶ 63, 193-98.

2. The Division's Witnesses Undermined Its Financial Statements Claim.

Berlant, the Division's key witness regarding the Zohars' financial statements, was Ms. Tilton's outside accountant for the Zohars since their inception, as well as for predecessor funds (Ark I and Ark II). FOF ¶ 247-49. On direct examination, the Division elicited the extremely implausible testimony from Berlant, a Certified Public Accountant and partner at the accounting firm Anchin, Block & Anchin, that even after 15 years of receiving financial statements starting with Ark I, he did not know why the Zohars generated financial statements at all, or even whether the statements went to Noteholders, *see* Tr. 775:23-776:1, 838:3-17, 936:5-25, 937:1-6, and for the entire 15 years of receiving the Zohar financial statements to review and approve, his review was limited to checking for "clerical accuracies," *see* Tr. 928:13-20; FOF ¶¶ 261-62. Impeached with contemporaneous documents on cross-examination, Berlant conceded that he had helped create the Zohar financial statements, had reviewed them for substantive accuracy for over 15 years, and had provided accounting advice, including on GAAP issues, completely undermining the Division's attempt to show that Respondents were not relying on Berlant in preparing their financial statements.

The Division's only other fact witness who testified about the financial statements was Mercado, a Certified Public Accountant who has worked in Patriarch's accounting department since 2008 and currently serves as controller. Tr. 1099:14-18, 1102:2-6, 1103:11-13 (Mercado). Mercado detailed Patriarch's process for preparing the Zohars' financial statements, and explained why those statements were GAAP-compliant. *E.g.* FOF ¶¶ 226, 232, 236, 241, 244. He also testified to Berlant's role in advising on GAAP and other accounting issues, Tr. 1131:23-1132:1, 1135:21-1136:2; *see also* FOF ¶ 269; Berlant's review and approval of every financial statement, Tr. 1126:17-20, 1292:10-15; FOF ¶¶ 256, 264; and Ms. Tilton's insistence that both Mercado and Berlant sign off before she would sign a financial statement certification, Tr. 1292:5-7; FOF ¶¶ 264-65, 268.

The Division's accounting expert, Henning, did not advance the Division's claims. Henning admitted that many of his opinions were not based on accounting principles at all, FOF ¶ 304, and his opinion that Patriarch did no impairment or fair value analyses simply ignored Respondents' processes and corresponding disclosures, as he conceded on cross-examination, *see* FOF ¶ 310; Tr. 1429:14-1430:8 (Henning). Henning also admitted that the Division had failed to tell him fundamental facts about the case that undermined his opinions, FOF ¶ 305; Tr. 1426:2-1427:14, and he took the incredible position that his confidence in his opinions would be unchanged even if Berlant—on whom he relied heavily—had lied on the stand, FOF ¶ 314.[24]

[24] Because the testimony from the Division's witnesses failed to make out even a *prima facie* case for the allegations in the OIP, Respondents moved for summary disposition at the close of the Division's case. Noting that the Commission disfavors rulings on such motions before the presentation of the Respondents' case, Your Honor deferred a decision. Respondents hereby renew that motion and request dismissal of the Division's claims in their entirety.

B. The Testimony From Respondents' Witnesses Confirmed That The Division's Allegations Are Baseless.

Respondents' case at trial included three fact witnesses from the Portfolio Companies and six expert witnesses, each of whom further rebutted the Division's theories.

Respondents first called Thomas Lys, a professor emeritus at Northwestern University. Tr. 2997:1-18. Lys' summary testimony illustrated that Respondents' loan amendment and categorization approach was disclosed in the Trustee Reports. Lys prepared summaries of the data in 111 quarterly Trustee Reports, FOF ¶ 139, which confirmed that in most quarters beginning in the very first years and continuing throughout the relevant period, the aggregate interest collected on the Zohar loans was less than the aggregate interest due, FOF ¶¶ 140-41, 146 (the very same rough calculation actually done by the Barclays analyst in RX 117 (June 22-23, 2011 email chain)), 151, and that Noteholders could readily identify whether the full stated interest on a loan to a Portfolio Company had been paid during that quarter, Tr. 2998:7-3002:10, 3013:24-3030:7, 3015:5-11 (Lys); RX 573 (Trustee Report summary exhibit); *see also* FOF ¶¶ 143-45, 147-50.[25] Lys testified that such a comparison could be conducted in "only a few minutes." Tr. 3015:12-23; FOF ¶ 142.

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[25] For example, Lys demonstrated that loan number beginning with 851 could be readily matched to the name of the Portfolio Company—MD Helicopters. Tr. 3019:12-17 (Lys). As shown in Lys's summary, the December 8, 2010 Zohar III Quarterly Trustee Report disclosed on its face that the MD Helicopter loan, 851_03, was held at a Category 4 even though it had not paid almost $173,000 of stated interest due. RX 20.073 (Zohar III Trustee Report) at 22, 34; *see also* RX 573 (Trustee Report Summary Exhibit) at 8. According to the Trustee Report, again on its face, the funded balance was almost $8,000,000 and the interest rate was 10 percent due quarterly, which equaled a quarterly interest payment of about $197,000. RX 20.073 (Zohar III Trustee Report) at 34; *see also* RX 573 (Trustee Report Summary Exhibit) at 8. However, the face of the Trustee Report disclosed that MD Helicopter only paid $25,000. RX 20.073 (Zohar III Trustee Report) at 22; *see also* RX 573 (Trustee Report Summary Exhibit) at 8.

As to Ms. Tilton's personal investments, Lys calculated that Respondents have invested over $500 million into the Zohars and Portfolio Companies, FOF ¶ 217, including $441 million that Ms. Tilton personally invested, FOF ¶¶ 212-13, and approximately $70 million in deferred fees, FOF ¶¶ 214-16.[26] That amount far exceeds what the Division now seeks in disgorgement.

Two Portfolio Company CEOs—Jean-Luc Pelissier, the CEO of Portfolio Company Universal Instruments, Tr. 3061:22-3062:13, and John Harrington, the CEO of Portfolio Company Hussey Copper, Tr. 3517:14-3519:24—also testified. Pelissier and Harrington are both "Platform Leaders" for Patriarch, and as such, are responsible for helping other Portfolio Companies, in consultation with Ms. Tilton, create and implement operating plans to effectuate their turnaround. FOF ¶ 99; Tr. 3072:11-3073:15 (Pelissier); Tr. 3518:18-3519:7 (Harrington). Through their involvement with the Portfolio Companies, Pelissier and Harrington each witnessed firsthand the close watch that Ms. Tilton kept on the Portfolio Companies' financial statuses and her decisions to amend loans in order to defer interest payments for Portfolio Companies experiencing periods of distress. Both corroborated Ms. Tilton's testimony that she amended loans to Portfolio Companies when doing so would provide greater value to the Zohars over the long term.

Both Pelissier and Harrington testified that Ms. Tilton took the timely payment of interest seriously, and understood that, to Ms. Tilton, making the full stated interest payments was

[26] Ms. Tilton has invested over $223 million of her own personal funds into the Portfolio Companies through entities that she owned, including ARK II, AIP, and ARK Angels, to benefit the Zohars and the Noteholders. FOF ¶ 212. She also invested over $218 million into Zohar I, II, and III through preference share and Series A (Zohar I) Notes investments. FOF ¶ 213. Ms. Tilton and the Patriarch entities have also deferred, and are therefore owed, approximately $35 million in management and secondment services, approximately $7.5 million in agency and amendment fees, and approximately $26.4 million in collateral management fees. FOF ¶¶ 214-16.

"critical and absolutely need[ed] to be addressed timely." Tr. 3082:11-21 (Pelissier). Harrington explained that the Portfolio Companies understood that they had "an obligation . . . to pay interest" and doing so "was a very high priority" because the Zohars "had investors" and Ms. Tilton "had to report to them." Tr. 3537:24-3538:14; *see also* Tr. 3542:5-8 ("I regarded [paying interest] as very important, because Lynn has instilled that into me.").

Pelissier and Harrington also testified to the processes and procedures Ms. Tilton followed in monitoring the financial state of the Portfolio Companies. FOF ¶¶ 97-104. They explained that Patriarch had a "very sophisticated reporting [system]" that kept Ms. Tilton informed of each Portfolio Company's performance: each of the CEOs reported to Ms. Tilton on a weekly basis directly, Tr. 3081:17-3082:5, 3119:10-3121:10, 3131:14-3134:15 (Pelissier); RX 409 (weekly report for NetVersant, dated Dec. 7, 2013), a Patriarch credit officer and a Platform Leader responsible for overseeing each Portfolio Company reported to Ms. Tilton on a weekly basis, Tr. 3081:17-3082:5, 3119:10-3125:1 (Pelissier); Tr. 3540:20-3543:23 (Harrington); RX 453 (weekly platform update on Scan Optics, dated Nov. 20, 2011), Patriarch's credit officers were constantly monitoring each Portfolio Company's 13-week cash flow projections, which were also provided to Ms. Tilton, Tr. 3120:7-12, 3125:2-3129:7 (Pelissier); Tr. 3544:22-3545:20 (Harrington); RX 453 (board packet from Scan Optics, dated Aug. 7, 2012), and Ms. Tilton held annual budget meetings for each Portfolio Company, Tr. 3545:21-3546:14 (Harrington).

Pelissier and Harrington likewise testified about the process Ms. Tilton followed when determining whether to amend a loan to accept less than full stated interest or to provide additional funding to a Portfolio Company. FOF ¶¶ 105-12. Harrington testified that a Portfolio Company facing an inability to make payroll or an interest payment would, only after "explor[ing] every other option of keeping the cash flow of that business going," have a lengthy in-person meeting with Ms. Tilton to seek approval of a business plan. Tr. 3533:1-3535:14. Pelissier testified that as part of this process, Ms. Tilton would "dig into the data in order to provide guidance," and would typically "demand a meeting in which the company is going to explain the root cause of the problem." Tr. 3083:3-3084:15; *see also* Tr. 3083:3-9 (Pelissier); Tr. 3135:3-16 (Harrington). Pelissier made clear that when Ms. Tilton ultimately agreed to defer interest, she did so before the interest was due. Tr. 3117:25-3118:4, 3134:7-10. If Ms. Tilton did provide additional funding, it was typically "doled out day by day," and the Portfolio Company had to "itemize where that money was going." Tr. 3536:6-3537:9 (Harrington). When the Portfolio Companies faced a cash flow emergency or as otherwise needed, Ms. Tilton would sometimes loan her personal funds to the Portfolio Companies and defer and forgive fees owed her. Tr. 3128:18-3129:7, 3138:11-20 (Pelissier); Tr. 3528:23-3529:1, 3529:4-3530:23, 3531:20-3532:10, 3546:15-3547:17 (Harrington); RX 437 (board packet from Scan Optics, dated Aug. 7, 2012).

Respondents' expert witnesses explained why the Division's theory that Ms. Tilton hid her amendment and categorization approach from investors was totally without merit. Mark Froeba was accepted without objection by the Division as an expert on the interpretation of indentures and on the Zohar deals. He had rated and monitored hundreds of CLOs (including the Zohars) for Moody's. Froeba—the only witness in the case accepted as an expert on the Zohars—testified that the Indentures were specifically designed to allow Respondents to amend the terms of the loans and categorize them according to the amended terms. Tr. 3327:13-23, 3332:8-3333:23; RX 21 (Froeba Rep.) at ¶¶ 21-23 & n.5; *see also* FOF ¶¶ 81, 285-89. He testified that the Indentures were unique in providing the collateral manager "broad discretion to amend, to forbear, to defer, to supplement" the underlying loans, and explained that the

Indentures did not require a writing for any of these. Tr. 3334:11-23, 3418:1-3419:14; *see also* FOF ¶¶ 35, 48. The Division's theory that Respondents' amendment and categorization practices eliminated protections for Noteholders was incorrect, he testified, because Section 7.7(a) protected Noteholders by "making sure that [Ms. Tilton] could . . . execute her . . . unique and successful investment strategy in these series of deals." Tr. 3416:13-25. Without this discretion, Noteholders would be harmed, because the "stressed and distressed loans" in which the Zohars were investing would quickly default, causing Noteholders to lose money. Tr. 3350:11-3351:4, 3351:22-3352:9 (Froeba).

Froeba also described how the flexibility vested in the collateral manager is evidenced by both the OC Ratio Test—which is "very different from a standard CLO" because "it was designed to be a test that would not impair the manager's management strategy and, therefore, be difficult to fail," Tr. 3430:22-24, 3428:22-24; FOF ¶ 71—and the IC Ratio Test—which featured an unusually large cushion "to permit for the management of a unique, a new, a different asset type," Tr. 3415:7-19; FOF ¶ 55. Froeba further testified to the Trustee's significant role in a structure like the Zohars, including the responsibility "to not just receive and pass along the data, but to process it, evaluate it and give it their own stamp of approval." Tr. 3389:7-3390:2, 3387:25-3389:6; FOF ¶ 173.

Peter Vinella, an expert with over 30 years' experience in financial services, including as CEO and President of a trustee/collateral administration firm, Tr. 3439:22-3440:1, testified about the critical role of the collateral administrator and trustee. FOF ¶¶ 292-93. Vinella's testimony was entirely unrebutted: the Division did not respond to Vinella's statement, RX 25 (Vinella Statement), nor did the Division cross-examine Vinella at trial. Vinella explained, based on industry custom and practice, that when the Trustee was managing the cash accounts, approving and effectuating payments, and perfecting security interests in the collateral, Tr. 3446:14-3448:20, not to mention calculating the OC Ratio and preparing the periodic reports, the Trustee would have to do so with an "understand[ing]" of the "economic objective of the deal," Tr. 3446:20-25; *see also* Tr. 3444:6-3445:4; FOF ¶ 174. In other words, the Trustee would have understood Respondents' loan categorization practices, and yet there was no evidence presented that the Trustee ever objected. FOF ¶ 181.

John H. Dolan, an expert in CLOs and structured financial products, Tr. 3484:7-11; RX 23 (Dolan Rep.) at ¶ 3, directly refuted the notion that Patriarch's loan categorization process was concealed from Noteholders. FOF ¶¶ 290-91. He testified that Noteholders had extensive information available to them regarding the performance of their investments in the Zohars. Most notably, he testified that Noteholders could plainly see from the face of the Trustee Reports that certain Category 4 loans were not paying full stated interest, Tr. 3471:7-11, 3473:24-3476:21, 3480:23-25, 3483:18-3484:5; *see also, e.g.*, FOF ¶¶ 128-30—the very information that the Division asserted was not disclosed. Dolan also testified to the voluminous additional information about the underlying loans available to Noteholders, Tr. 3472:7-3473:18, and identified the myriad ways in addition to the Trustee Reports that Noteholders could obtain information about the performance of their investments. RX 23 (Dolan Rep.) at ¶¶ 20-55. Dolan also refuted Mayer's assertions that data were missing from the Trustee's data files, explaining that the Trustee Reports referenced supplementary data, which Mayer apparently did not even attempt to access. Tr. 3483:1-17.

Professor Steven L. Schwarcz, an expert in workout of distressed companies and structured finance, Tr. 3505:10-21, 3507:18-3508:6; FOF ¶¶ 294-96, testified that the execution of the Zohars' disclosed business strategy required flexibility in managing Portfolio Company investments, including amending the loans to allow for less than full interest payments to assist in the Portfolio Companies' turnaround. He explained that because the Notes in the Zohars were long-term, the Noteholders "would lose the benefit of their bargain" if the Notes were liquidated. Tr. 3511:20-3512:2; FOF ¶ 91. For the Zohars to realize their contemplated returns from their investment in stressed and distressed companies, it was essential for the collateral manager to "work closely with the loans to modify them as needed." Tr. 3512:3-7 (Schwarcz); *see also* Tr. 3510:22-3511:11 (Schwarcz) ("[C]ompanies that are financially stressed, in trouble or in bankruptcy, they need to continue operating as companies . . . if they are going to turnaround, so to speak. And that means that they must be able to pay their operating expenses."); FOF ¶ 88. Schwarcz's testimony about the need for flexibility in turning around troubled companies supported Pelissier's and Harrington's testimony. And, just as with Vinella, the Division neither challenged Schwarcz's written statement nor cross-examined him at trial.

Glenn Hubbard, dean of the Graduate School of Business of Columbia University, Tr. 3560:13-3561:24; *see also* FOF ¶¶ 297-301, testified that the business strategy of the Zohars was fully disclosed to investors, Tr. 3566:2-19; *see also* FOF ¶ 45, and that the Division's theory of loan classification was wholly inconsistent, from an economic perspective, with that disclosed business strategy. He described the unique nature of the Zohars, and explained what distinguishes them "from traditional CLOs," Tr. 3564:20-23: the unusual business strategy, Tr. 3564:21-23; the "very active management involvement of Ms. Tilton," Tr. 3567:8-16; the "importance of . . . equity upside for the Funds," *id.*; the "nature of the Funds' collateral," RX 24 (Hubbard Rep.) at ¶ 24; and "the Funds' expected sources and timing of cash flows from their collateral," *id.*; *see also* FOF ¶ 35. He elaborated on the critical role of the "equity upside," which would flow initially through the waterfall to benefit Noteholders; although this upside was not reflected in the OC Ratio, it was critical "for the structure to be profitable." Tr. 3567:13-16, 3587:6-11, 3588:7-11; RX 24 (Hubbard Rep.) at ¶ 25 (explaining that the equity upside, in the form of "cash when portfolio companies . . . . are sold" is part of the "significant value to the Funds"); *see also* FOF ¶¶ 41, 57.

Like Schwarcz, Hubbard testified that the Zohar Strategy depended on flexibility, such that some companies would not pay the full stated interest, Tr. 3569:7-3570:1—a strategy made "abundantly clear" in marketing materials and investor conference calls, Tr. 3566:15-19; *see also* Tr. 3587:12-3588:6; FOF ¶¶ 43, 45. He also explained how that strategy was implemented: "Patriarch would modify the terms of its debt collateral and the corresponding stated Collateral Interest payments when it felt that doing so would enhance the long-term value of the portfolio companies and, thus, enhance the long-term value of the Zohar Funds." RX 24 (Hubbard Rep.) at ¶ 27; *see also* FOF ¶¶ 87, 107. A contrary policy of forced re-categorization of loans to Category 1 or Defaulted upon remitting less than full stated interest, he testified, would be totally inconsistent with the Zohars' 5 percent maximum for Category 1 or Defaulted Investments set forth in the Indentures' Eligibility Criteria, and would "make little sense as a matter of economics, because it would almost doom the strategy." Tr. 3571:1-3572:13; RX 24 (Hubbard) at ¶ 23; *see also* FOF ¶ 90.[27]

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[27] Separately, Hubbard explained why Mayer's analysis of the OC Ratio Test was flawed: If the OC Ratio Test ever failed, "incoming money would be diverted to principal repayments," Tr. 3576:1-5, and those repayments would decrease the denominator of the OC Ratio in the next period, rendering the OC Ratio Test less likely to fail going forward, Tr. 3577:8-21; RX 24 (Hubbard Rep.) at ¶ 35; *see also* ¶¶ 328-30. Hubbard recalculated Mayer's analysis with only one change—namely, accounting for the principal repayments—and found a minimum of $61 million less in preference share distributions and collateral management fees. Tr. 3579:14-3581:21; RX 24 (Hubbard Rep.) at ¶ 43; FOF ¶ 330. Hubbard also pointed out that a hypothetical failure of the OC Ratio Test might have had other effects (for example, Ms. Tilton

With respect to Patriarch's GAAP compliance, Lundelius, a Certified Public Accountant with 30 years of accounting experience, RX27A (Lundelius curriculum vitae) at 1-2; Tr. 3276:15-17; *see also* FOF ¶¶ 280-84, confirmed that Patriarch's financial statements were GAAP compliant and that it conducted appropriate loan impairment and fair value analyses, consistent with the Zohars' financial statement disclosures. Tr. 3181:14-21, 3199:24-3200:5, 3161:25-3162:8, 3304:25-3305:3, 3311:9-12; *see also* FOF ¶¶ 226, 236-40, 315. Lundelius also debunked the Division's uncharged theory that the Zohars' financial statements did not properly account for interest accruals. Tr. 3162:10-3164:1.

III. The Investigation And Trial Were Marked By Serious Constitutional And Procedural Deficiencies.

Throughout this investigation and trial, the Division's actions have fallen far short of what is required by the Constitution and by fundamental fairness. Respondents have contested in federal actions the validity of this proceeding under the Appointments Clause, as well as the Due Process and Equal Protection Clauses of the U.S. Constitution.[28] Those claims have not yet been adjudicated on the merits, but remain a substantial hurdle to any final decision that might be issued in the Division's favor.

In addition, Respondents moved to strike the Division's expert witnesses, who were unqualified, employed unreliable methodologies, and whose expert reports (and subsequent

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might have responded in a way that would have affected subsequent periods), and that Mayer's failure to consider the possibility of this and other effects was an "economic logic error," Tr. 3574:22-3575:8, which rendered his analysis "incomplete and therefore unreliable," RX 24 (Hubbard Rep.) at ¶ 34; *see also* FOF ¶ 328.

[28] *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). Respondents incorporate by reference and reiterate the claims raised in these filings, as well as all of Respondents' objections that were improperly rejected in this proceeding. *See* App'x B.

testimony at trial) were replete with improper, unreliable statements and conclusions. *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); Resp. Br. in Supp. of Resp. Mots. in Lim. to Exclude Expert Test. of Mayer/Wagner (Aug. 31, 2016); *see also SEC v. Tourre*, 950 F. Supp. 2d 666, 681 (S.D.N.Y. 2013) (admonishing Division for proffering written expert testimony from one of the experts in this proceeding, Wagner, and finding his testimony "problematic and not admissible" because he purported to "find[] facts that [we]re in contention," and opined on "legal conclusion[s]" that were "not proper expert testimony").

Respondents also moved for application of the Amended SEC Rules of Practice, which were adopted to "modernize [the SEC's] administrative proceedings." *Mary Jo White Explains the New SEC Rules*, Wall St. J., Nov. 24, 2015, *available at* http://www.wsj.com/articles/mary-jo-white-explains-the-new-sec-rules-1448302777. Respondents further moved under Amended SEC Rule of Practice 320 to preclude the Division from introducing irrelevant, unreliable, immaterial, and unduly repetitious evidence, and repeatedly renewed their objections to the admission of that evidence at trial. Your Honor denied the motions but indicated that Respondents could "argue against [the] weight" of inappropriately admitted evidence in their post-hearing briefs, and Respondents urge Your Honor now not to give weight to such evidence, as detailed below. *E.g.*, *Lynn Tilton*, Admin. Proc. Rulings Release No. 4245, at 4 (ALJ Oct. 12, 2016). Respondents also challenged the unfair timing of the trial, moved to permit the filing of three new reports for expert witnesses who testified in place of previously designated experts, and filed a motion for summary disposition. These motions were likewise denied. Respondents incorporate by reference and reiterate all of the motions Respondents made throughout this proceeding that have been denied in whole or in part.

Finally, the Division failed to meet its obligations to produce exculpatory and impeachment materials, as Respondents' motions outlined.[29] Despite the Division's repeated representations that it was complying with its *Brady* obligations, Respondents subsequently uncovered, and the Division belatedly disclosed, additional exculpatory evidence that had been wrongfully withheld. *See* FOF ¶¶ 344-45.

LEGAL STANDARDS

"The Division has the burden of showing that the allegations in the OIP are true by a preponderance of the evidence." *Miguel A. Ferrer*, Admin. Proc. Rulings Release No. 730, 2012 WL 8751437, at *4 (ALJ Nov. 2, 2012) (citing *Steadman v. SEC*, 450 U.S. 91, 101-02 (1981)). The Division must establish "each of the elements" of an allegation in order to prove it true. *SEC v. Lowry*, 396 F. Supp. 2d 225, 240 (E.D.N.Y. 2003). *See generally* Respondents' Proposed Conclusions of Law ("COL") ¶¶ 2-7.

To prove any of its allegations under Section 206(1), 206(2), or 206(4) of the Advisers Act, or under Advisers Act Rule 206(4)-8, 17 C.F.R. § 275.206(4)-8 ("Rule 206(4)-8"), the Division must establish: (a) that Respondents made false representations or actionable omissions, or engaged in deceptive conduct; (b) that the misrepresentations, omissions, or deceptive conduct were material, *see, e.g.*, *Lawrence M. Labine*, Initial Decision Release No. 973, 2016 WL 824588, at *28, *30-31 (ALJ Mar. 2, 2016) (applying to Section 206(1) and (2)); Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Advisers Act Release No. 2628, 2007 WL 2239114, at *9 (Aug. 3, 2007) (final rule) (materiality required for Section 206(4) and Rule

[29] *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).

206(4)-8); and (c) under Section 206(1), that Respondents acted with scienter—that is, actual intent to defraud or extreme recklessness, *see Labine*, 2016 WL 824588, at *28, *31, or under the other provisions, that Respondents acted with scienter or negligence (pursuant to Your Honor's ruling denying Respondents' motion to require the Division to prove intentional misconduct for all charges, which Respondents reassert here, but recognize as the law of the case for purposes of their post-hearing submissions), *see, e.g.*, *Steadman*, 967 F.2d at 643 n.5, 647 (scienter or negligence required for Section 206(2) and (4)); *see also* Advisers Act Release No. 2628, 2007 WL 2239114, at *5 (scienter or negligence required for Rule 206(4)-8). Rule 206(4)-8 is invalid, and Respondents accordingly ask that the Rule 206(4)-8 charge be dismissed on that basis, *see* COL ¶ 8, but Respondents' post-hearing submissions otherwise assume the Rule's validity.

In addition, to prove a violation of Section 206(1) or 206(2), the Division must prove that misrepresentations, omissions, or deceptive conduct were directed to the adviser's client (here, the Zohars); for Section 206(4) or Rule 206(4)-8, the Division must prove that misrepresentations, omissions, or deceptive conduct were directed to investors (here, the Noteholders). *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Advisers Act Release No. 2628, 2007 WL 2239114, at *1 (Aug. 3, 2007) (final rule).[30]

[30] In addition to the primary violations, the Division has also alleged that the Patriarch entities (but not Ms. Tilton) aided and abetted those violations. To prevail on the claim of aiding and abetting, the Division must prove: "(1) the principal, or primary wrongdoer, has violated the securities laws; (2) the aider and abettor provided substantial assistance to the primary violator; and (3) such assistance was rendered with knowledge of, or extreme recklessness regarding, the securities law violation." *Optionsxpress, Inc.*, Securities Act Release No. 10125, 2016 WL 4413227, at *47 n.185 (Comm'n Aug. 18, 2016) (citing *Howard*, 376 F.3d at 1143). As explained herein, the Division has not met its burden of proof with respect to any primary violation, and it therefore has plainly failed to prove that any Respondent aided and abetted a

ARGUMENT

I. The Division Failed To Prove That Respondents' Loan Categorization Methodology Was Improper Or Undisclosed.

A. The Evidence At Trial Established Respondents' Approach To Loan Categorization Was Proper And Fully Disclosed.

The gravamen of the OIP is that Respondents categorized loans in a "discretionary" manner inconsistent with the methodology set out in the Zohars' Indentures and failed to disclose that they were doing so. *See, e.g.*, OIP ¶¶ 9, 49. Under the Division's interpretation of the Indentures, distressed companies that remitted less than the full interest payments stated on the face of the loan agreements should have been immediately categorized as "Category 1" or "Defaulted Investment," even when the loans had been amended to defer interest payments. But the trial proved just the opposite: Respondents' conduct was entirely consistent with the Indentures, *see infra* Pt. I.A.1; and Respondents fully disclosed the categorizations and interest payments to the Zohars and Noteholders, *see infra* Pt. I.A.2.

The theory articulated in the OIP is no more. Indeed, even the testimony of the Division's own witnesses established that the Indentures gave Respondents broad discretion to amend loans to defer interest and maintain categorization—and that Respondents fully disclosed that reality. By the time of summations, the Division retreated, instead claiming that Respondents had not in fact amended the loans. *See* Tr. 3671:23 (Div. summation). While the amendments Ms. Tilton was executing under Section 7.7(a), either orally or by course of performance, clearly had legal effect under New York contract law, *see infra* pp. 60-61, the

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violation. *See id.* at *47 ("Because the record in this case does not support a finding that [the alleged principal] committed fraud, there is no primary violation and thus no basis for aiding and abetting."); *see also* COL ¶¶ 91-93.

Division never should have tarred Respondents with fraud charges that reduce to a disagreement over the performance of contracts among sophisticated parties, *see infra* Pt. I.A.3.

1. Respondents' Loan Amendments And Categorization Approach Were Permitted By The Zohars' Governing Documents And Necessitated By Their Design.

Because the Division failed to prove that Respondents engaged in any misrepresentation, omission, or deception related to the categorization of loans, Respondents' categorization methodology cannot violate the Advisers Act. The evidence at trial confirmed that Respondents' conduct was consistent with the express provisions of the Zohars' governing documents. The Indentures granted Respondents discretion to amend loans, and Respondents exercised that discretion in amending loans to permit payment of less than full stated interest, and concurrently, to defer the remaining stated interest to a later due date. FOF ¶¶ 48-51, 97-113. Respondents categorized all loans in strict compliance with the Indentures: a current loan—one that satisfied the operative terms of the credit agreement, including any amendments, at the time of the categorization—would retain its Category 4 designation, and a defaulted loan would be placed into Category 1. FOF ¶¶ 74-86. The Indentures' authorization of this approach fully answers the Division's allegations on this point. *See Ellington v. EMI Mills Music, Inc.*, 21 N.E.3d 1000, 1003 (N.Y. 2014) ("Where the terms of a contract are clear and unambiguous, the intent of the parties must be found within the four corners of the contract, giving a practical interpretation to the language employed and reading the contract as a whole."); *see also Krys v. Butt*, 486 F. App'x 153, 155 (2d Cir. 2012) ("Generally, where parties have entered into a contract, courts look to that agreement to discover the nexus of the parties' relationship." (quoting *EBC I, Inc. v.*

Goldman Sachs & Co., 832 N.E.2d 26, 31 (N.Y. 2005)); COL ¶¶ 9-23.[31] Any contrary reading is foreclosed because it would have destroyed Respondents' ability to protect the value of the Zohars' investments and thereby "produce a result that is absurd, commercially unreasonable [and] contrary to the reasonable expectations of the parties." *SportsChannel Assocs. v. Sterling Mets, L.P.*, 25 A.D.3d 314, 314 (N.Y. 1st Dep't 2006) (internal quotation marks omitted).

a) The Evidence At Trial Confirmed Respondents' Broad Discretion To Amend Loans To Defer Interest And Avoid Default.

As proven at trial, the Zohar governing documents give Respondents discretion to amend loans and defer interest payments; in fact, that authority is the cornerstone of the Zohar strategy. FOF ¶¶ 48-51, 87-91. Each Indenture provides in Section 7.7(a) that "the Collateral Manager . . . may, without the consent of the Holders of any Notes or the Credit Enhancer, enter into any amendment, forbearance or waiver of or supplement to any Underlying Instrument included in the Collateral." The same provision underscores that this discretion will be used broadly: "For the avoidance of doubt and notwithstanding anything else contained" in the Indenture, "the parties hereto acknowledge and agree that the [CDOs] will consist of stressed and distressed loans that may be the subject of extensive amendment . . . ." Indenture § 7.7(a).[32] The Division

[31] New York law governs interpretation of these contracts. *See, e.g.*, Indenture § 18.9; Zohar III Indenture § 17.9; CMA § 7.5; Zohar III CMA § 7.4 at 30.

[32] The CMAs contain the parallel provision that "the Collateral Manager may, . . . without the consent of the holders of any Notes or any 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). Like the Indentures, the CMAs emphasize the risky nature of the investments and the necessity of the collateral manager's "extensive amendment" and flexible administration of the collateral. Zohar I CMA § 2.2(p); Zohar II CMA § 2.2(c); Zohar III CMA § 2.2(m) ("For the avoidance of doubt and notwithstanding anything else contained herein, the [parties] acknowledge and agree that the [collateral] will consist of stressed an distressed loans that may be the subject of extensive amendment, workout, restructuring and/or other negotiations . . . .").

has conceded that "Section 7.7(a) does provide discretion to amend," Tr. 28:1-2 (Div. opening), and this discretion was confirmed by numerous witnesses at trial—including the Division's purported expert on the interpretation of indentures, Wagner, *see* Tr. 2948:8-12 (Wagner); *see also* FOF ¶¶ 48, 51, 93-96.

The discretion vested in Respondents plainly includes authority to amend a loan's interest payment requirements, as even Wagner conceded. *See* Tr. 2949:17-21 ("a given interest payment that was due could be deferred"). When Respondents exercise this discretion to defer all or part of a given interest payment, the interest is paid pursuant to the amended schedule, the payment complies with the amended loan terms, and there is no default. FOF ¶¶ 80-86.

The absence of a default, in turn, is what allows the loan to remain in Category 4. A default is the operative distinction between Category 1 and Category 4 loans, as well as between "Defaulted Investments" and "Collateral Investments,"[33] as Wagner (the Division's putative expert) and Aldama (the Division's Noteholder witness) confirmed. *See* DX 16 (Wagner Rep.) at ¶ 96 (quoting Aldama Testimony) (the key feature that moves a loan from Category 4 into Category 1 is "[i]f the company doesn't pay interest that is due and payable under the terms of the facility."); *see also* FOF ¶ 74-76. The provisions of the Indenture spell this out: a Category 4

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[33] In the Zohar III Indenture, the categories "Defaulted Investment" and "Collateral Investment" are used in a manner analogous to the Zohar I and Zohar II Indentures' usage of Category 1 and Category 4, respectively. Accordingly, the parties in this proceeding have treated the categories as equivalent, *see, e.g.*, OIP ¶ 36 ("'Defaulted Investment' and 'Collateral Investment . . . are equivalent to Categories 1 and 4, respectively."), and this brief uses "Category 1" and "Category 4" to refer to the analogs across the Zohars unless otherwise indicated.

loan is defined in part as "Current Collateral Debt Obligation," Indenture § 1.1;[34] "Current Collateral Debt Obligation" is defined as "[a]ny [CDO] that is neither a Non-Current Obligation nor a Workout Obligation," Indenture § 1.1; a "Non-Current Obligation" is defined as "Any Defaulted Obligation . . . ," Indenture § 1.1; and a "Defaulted Obligation" (or, in the case of Zohar III, "Defaulted Obligation") is defined as "[a]ny [CDO] . . . 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 waiver of such default), but only so long as such default has not been cured," Indenture § 1.1. Category 1 is defined simply as a CDO that does not fall into any of the other defined categories, and the other categories (2 and 3) are irrelevant here because they apply only to Portfolio Companies in bankruptcy. Indenture § 1.1.

Critically, a default occurs—and re-categorization may be required—only when an interest payment is due under the loan's terms as amended. FOF ¶¶ 80-86. Indeed, it would make no sense to measure a default when no payment is actually due, because the terms were

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[34] The Indentures set forth five characteristics of a Category 4 loan. The Division has put only one element ("Current Collateral Debt Obligation") at issue in this proceeding; it does not contend that any of the other elements were not satisfied for loans designated by Respondents as Category 4. A Category 4 loan is defined as:

> A [CDO] . . . that (i) is a Current Collateral Debt Obligation, (ii) is not an Insolvency Collateral Debt Obligation, (iii) with respect to any Underlying Instruments related to such Collateral Debt Obligation, there shall not have occurred any "event of default" or any "default" by the Obligor thereon with respect to any covenant, representation or warranty contained therein, . . . which has not been waived, (iv) with respect to the Obligor thereon, there are no negotiations, at the time of measurement, to restructure . . . the financial obligations . . . and (v) is not a [CDO] that has, in the reasonable judgment of the Collateral Manager, a significant risk of declining in credit quality or, with the passage of time, becoming Category 1, Category 2 or Category 3.

Indenture § 1.1.

amended. As the Division's own expert stressed, it is the "current" terms of a loan that are relevant to analyzing categorization and default. FOF ¶ 82. Indeed, Wagner himself testified that after a loan was amended, "the loan would have the contractual features reflecting the amendment, and if it met those contractual features . . . it would not have to be placed in Category 1." Tr. 2949:22-2950:6 (Wagner).[35] Given this admission by the Division's purported expert on indenture interpretation, there can be no live dispute as to Respondents' authority under the Indenture to amend a loan, defer interest, avoid a default, and maintain the categorization of that loan in Category 4.

Several structural features of the Zohars make plain the importance of this authority to amend a loan and defer interest without re-categorizing it. First, interest payments to Noteholders were small relative to the stated interest due from Portfolio Companies, and thus, the Zohars could make full payments to Noteholders even if they collected only a fraction of stated Collateral Interest. FOF ¶¶ 43-44. Because all parties expected that many Portfolio Companies would not, in fact, pay full stated interest, but would nonetheless remain part of the Zohar portfolio and continue to be supported by Ms. Tilton, a "very large cushion" was built into the IC Ratio Test. Tr. 3570:12-22 (Hubbard). An interpretation of the Indentures that required Respondents to default a loan and move it to Category 1 when a loan was amended to defer payment of full stated interest would be irreconcilable with an IC Ratio Test that was designed on the assumption that the loans in the portfolio would pay a relatively small portion of stated interest in any given period. The IC Ratio Test is thus "evidence that the transaction was

[35] To the extent Wagner attempted to limit his testimony to written amendments, that caveat is legally meaningless: under New York law, a written amendment has no greater legal force than an amendment made orally or by course of performance. *See infra* pp. 60-61 & n.40.

deliberately designed to facilitate [the] investment strategy." Tr. 3381:14-3382:1 (Froeba); *see also* FOF ¶¶ 53-55; Tr. 3570:2-22 (Hubbard).

Additionally, the Zohars' "Eligibility Criteria" for collateral specified that if more than 5 percent of loans consisted of "Defaulted Obligations" (Zohar I and II) or "Defaulted Investments" (Zohar III), the Zohars would be restricted from making new investments if such investments would increase the percentage of loans that were "Defaulted Obligations." Indenture §§ 12.1(a)(28), 12.1(b); *see also* FOF ¶¶ 89-90. A loan would be considered a "Defaulted Obligation" (or, in the case of Zohar III, "Defaulted Investment") if it missed interest payments, *or* if another loan to that same Portfolio Company was a "Defaulted Obligation." Indenture § 1.1. FOF ¶ 78.

If merely missing one or two interest payments meant that the loan was a "Defaulted Obligation," the Zohars would quickly exceed the 5 percent threshold, particularly because at the inception of the relationship with the Portfolio Companies, those companies typically had negative cash flow, or no cash flow, were not even operational, or were in bankruptcy. When Respondents' summary witness, Lys, analyzed the Trustee Reports' disclosures of instances in which Category 4 loans paid less than full stated interest, he found that the very first reports for Zohar I, Zohar II, and Zohar III revealed such instances,[36] *see* FOF ¶¶ 141, 148 —meaning that under the Division's theory of an "automatic" default, loans would have begun defaulting almost immediately upon inception of each Zohar. *See also* Tr. 3571:23-3572:13 (Hubbard); RX 24 (Hubbard Rep.) at ¶¶ 7.B, 21-23. In addition, the Division's interpretation effectively would prevent the Zohars from lending to distressed companies in their time of greatest need. If a

[36] As to each of Zohar I, Zohar II, and Zohar III, Lys never found a single quarter in which the Trustee Report did not show loans categorized as either Category 4 or Collateral Investments that had not paid full stated interest. Tr. 3030:1-7; *see also* FOF ¶ 150.

Portfolio Company had a loan that was a "Defaulted Obligation"—and many would under the Division's incorrect interpretation—the Zohars could not extend any further loans to that company once the 5 percent limit had been breached (which would happen very quickly, as noted). That is because any further loan would by definition be a "Defaulted Obligation" and, contrary to the Indentures, increase the total percentage of "Defaulted Obligations."[37]

The Indentures' plain language, which allows for and anticipates that Respondents will exercise discretion extensively to amend loan agreements, defer interest, and thereby avoid default, is the only interpretation of the Indentures that would be consistent with the design and objective of the agreements. By design, the success of the Zohars depends on Respondents' ability to exercise discretion to continue supporting Portfolio Companies, even when those companies could not pay full stated interest in any given month. Ms. Tilton explained this design point: "[T]he design of the deal is a reflection of the expectation that we would do our best to put high interest rates on distressed companies, to collect as much interest as due without impairing the liquidity and forcing a crisis, in order to maximize the cash flows over the time until that company was rebuilt and of value," Tr. 2006:10-16, and as a result "[t]he deals were

[37] Wagner asserts that the 5 percent limit was not meaningful because it was not an outright prohibition on further investment: under Wagner's theory, even after the Zohars would have quickly exceeded the 5 percent limit, they could still make other investments that did not cause the percentage of "Defaulted Obligations" to increase. RX 19A (Wagner Rebuttal) at ¶ 90. But Wagner's position disregards the Zohars' business strategy, which focused on supporting Portfolio Companies while they were in distress in order to create opportunities to turn them around.

Wagner's flawed analysis in this regard is but one example of his generally unreliable testimony, to which Your Honor should assign no weight. Your Honor declined to exclude Wagner's testimony upon Respondents' motions *in limine* and objections, but the same reasons laid out in those motions and objections are now reasons not to credit Wagner's testimony. *See Lynn Tilton*, Admin. Proc. Rulings Release No. 4245, at 3 (ALJ Oct. 12, 2016) (noting that Respondents may "argue against [the] weight" of admitted evidence).

designed with the ability and with the expectation that partial interest would get paid," Tr. 2016:13-2017:02*; see also* FOF ¶¶ 34-44, 87. This design was what made the Zohar deals possible. After all, the "business niche that [Ms. Tilton] plays in is she buys very distressed companies and endeavors to turn them around," Tr. 3518:4-7 (Harrington); see also FOF ¶¶ 45-47—a strategy fundamentally irreconcilable with an indenture that would require Respondents to default a loan and stop supporting it if it could not pay full stated interest in a given month.

The Division nonetheless contends that distressed companies that remitted less than full stated interest payments were required to be categorized as "Category 1" or "Defaulted Investments," which would have caused the OC Ratio Test to fail very quickly. In fact, the OC Ratio may have fallen to such a low level that it would have triggered an "Event of Default," which in turn would have allowed a Noteholder or a group of Noteholders to liquidate the entire Zohar Fund. *See* FOF ¶¶ 60-62. Under the Division's interpretation, the "Defaulted Obligations" or "Defaulted Investments" would also have quickly exceeded 5 percent of each portfolio, thus forcing a fire sale under the Indenture, Indenture § 12.1(b); FOF ¶ 90, and in turn stripping the Zohar of any potential return on investment. That reading of the Indentures would "make little sense as a matter of economics, because it would almost doom the strategy" from inception. Tr. 3571:18-3572:23 (Hubbard); *see also* FOF ¶ 106. That interpretation is surely "commercially unreasonable," and must be rejected under bedrock principles of New York law. *SportsChannel Assocs*, 807 N.Y.S.2d at 61.

b) Respondents Did Exactly What The Indentures Provided, Amending Loans In Their Discretion To Defer Interest And Avoid Default.

As it became clear throughout the course of trial that Respondents' interpretation of the Indentures was virtually undisputed, the Division took a different tack in summation: Instead of disputing Respondents' ability to amend loan terms and defer interest, it disputed whether the loan terms had actually been amended. Tr. 3671:23 (Div. summation) ("These were not amendments."); Tr. 3672:10-3673:21 (Div. summation). Not only did the Division fail to meet any burden of proof on this point—which is in any case outside the scope of the OIP—but the evidence showed that Respondents in fact amended loans orally and by course of performance.

Ms. Tilton gave the question of whether to amend and defer intense scrutiny. FOF ¶ 106. Ms. Tilton decided methodically, and based on meticulous collection of data and inputs, whether to accept less than full stated interest from a Portfolio Company, based on whether amendment and deferral "w[ould] maximize the cash flows of principal, interest and equity over a longer period of time." Tr. 1830:20-1831:12 (Tilton); *see also* Tr. 3083:12-3084:1 (Pelissier) (weekly cash flow forecasts); Tr. 3539:19-1340:1 (Harrington) (same); Tr. 3080:6-10 (Pelissier) (quarterly meetings, observed "religiously," to review performance); Tr. 1250:13-23 (Mercado) (credit analysts' statistical reports); Tr. 1246:2-9, 1251:2-8 (Mercado) (these many inputs shared with Ms. Tilton personally, who considered them in her decisions); *see also* FOF ¶¶ 97-113. She amended only as a last resort.[38]

Although the Division has attempted to relabel these transactions as something other than amendments—and has contended that they are a post hoc rationalization for Respondents' categorization practices—this ignores that the Indentures themselves disclose and authorize "extensive amendments." Indenture § 7.7(a). It is also inconsistent with the testimony from the Division's own witness, Aldama, that he "met with Ms. Tilton, and she told [him] that she was,

[38] Both CEOs testified at length to this point. *See, e.g.*, Tr. 3082:11-21 (Pelissier) (describing Ms. Tilton's message that "[i]nterest must be paid" as arising "in every meeting" and "prevalent in every communication"); Tr. 3533:4-7 (Harrington); Tr. 3083:3-9 (Pelissier) ("Always a difficult process to justify and be in front of Lynn Tilton and explain."); Tr. 3084:2-15 (Pelissier); Tr. 3533:23-3535:7 (Harrington) ("Those meetings were brutal. Brutal. . . . They were long meetings. Could go days. I've been thrown out within minutes.").

in fact amending the loan agreements," Tr. 1676:21-1678:6 (Aldama), as well as contemporaneous emails from Patriarch employees discussing such amendments, *see* RX 118 (email chain Sept. 1-2, 2011); FOF ¶¶ 151-53. And even if Respondents had not used the word amendment at that time, this would signify nothing more than that they were "saying the same thing in different words," Tr. 1943:1-2, as Your Honor has correctly recognized.

If Ms. Tilton agreed to amend a loan, she first required that (prior to any deferral) the Portfolio Company pay the maximum amount of interest that would not threaten the Portfolio Company's prospects for an effective turnaround. FOF ¶ 110. After the amendment, the Portfolio Company "continued to have the obligation to pay the outstanding interest," albeit on a deferred timetable. Tr. 3128:14-17 (Pelissier); *see, e.g.*, Tr. 1832:15-22 (Tilton); Tr. 3118:5-15 (Pelissier); Tr. 3539:15-18 (Harrington) (testifying that Respondents never waived any interest payment for Harrington's Portfolio Companies, but changed only the timing of the required payment); Tr. 2727:8-10 (Tilton) ("[M]uch of that deferment actually got paid back as these companies came back."); *see also* FOF ¶ 111. And if she declined to amend and full stated interest payments were not timely made, Respondents would re-categorize the loan as "a Category 1 and . . . default and liquidate the company." Tr. 2466:2-9 (Tilton); *see also* FOF ¶ 84.

The Division accused Ms. Tilton of having provided inconsistent testimony on this point, Tr. 1942:15-20, but as Your Honor rightly noted, the two snippets of testimony the Division referenced "seem[] to be saying the same thing in different words," Tr. 1943:1-2—that Ms. Tilton has consistently viewed her oral agreements and course of performance as amending the loan terms to defer interest payments. The Division also argued that if Respondents did not submit a loan amendment to the Rating Agencies, the amendment must have been fabricated post

Issuer"); *see also* FOF ¶ 173, and the Division has not accused the Trustee of any wrongdoing or conflict of interest. The Trustee's knowledge is therefore imputed to the Zohars. *See, e.g.*, *Apollo*, 195 F.3d at 76. While this would be true whether or not the Zohars actually received information from the Trustee, this is no mere legal fiction here: the Trustee actually agreed to maintain a "Collateral database" of detailed payment information, and make that database available to the Zohars. CAA § 2(b); *see also* FOF ¶ 177. The Trustee was also required to identify defaulted, non-current, or non-performing loans, Zohar II CAA § 2(c)(vii); *see also* Zohar III CAA § 2(c)(vi) at 3; FOF ¶ 178, and if the Trustee did not receive a principal and interest payment when due, it was required to give the Zohars written notice. Indenture § 6.14. *See* FOF ¶ 179. It never did so. The Division cannot now claim that the Zohars were shielded from the information to which they had access as a matter of fact and as a matter of law.

The bottom line is this: through the myriad deal documents and communications from Respondents and the Trustee Reports; from the array of Respondents' and the Trustee's knowledge that must be imputed to the Zohars; Respondents' discretion to amend loans, defer interest payments, and maintain such loans in Category 4 was fully disclosed. The Division has failed to prove any misrepresentation or omission and its claims based on categorization must be dismissed.

3. The Categorization Claims Are Based On A Breach Of Contract Theory, Which Cannot Give Rise To Advisers Act Liability.

At trial, the Division's case collapsed into a claim that Respondents breached their contracts with the Noteholders. During summation, Division counsel admitted as much: "Ms. Tilton and Respondents didn't give investors what they were promised." Tr. 3654:3-4 (Div. summation); *see also, e.g.*, Tr. 3678:2-4 (Div. summation) ("[T]he investors didn't get what they were promised."); Tr. 3754:3-5 (Div. summation) ("It is about promises made and promises broken to investors. That is what's at the heart of this case."). Thus, as the Division acknowledged, "[t]his is a case about . . . failures to keep . . . promises," not fraud. Tr. 3690:5-10 (Div. summation); *cf.* Black's Law Dictionary (10th ed. 2014) (defining "breach of contract" as "[v]iolation of a contractual obligation by failing to perform one's own promise"). Respondents' conduct was in fact entirely consistent with the Indentures, *see supra* Pt. I.A.1, but even if it had not been, the Advisers Act does not empower the Division to police compliance with the Indentures. *See* COL ¶¶ 49-52.

The claims against Respondents thus fail for the simple reason that there is no liability for breach of contract under Advisers Act § 206 and Rule 206(4)-8. *See Carroll v. Bear, Stearns & Co.*, 416 F. Supp. 998, 1002 (S.D.N.Y. 1976) (holding that allegations of breach of contractual obligations "fail to state a claim for fraud or deceit" under Advisers Act § 206). 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), because fraud is something more than the mere failure to abide by a contractual promise. In the "absence of additional allegations of wrongdoing," the Division's fraud claim cannot stand. *See, e.g.*, *Rogen v. Scheer*, 1991 WL 33294, at *8 (S.D.N.Y. Feb. 22, 1991); *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"). Accordingly, all of the claims against Respondents related to amendment, deferral, and categorization of loans must be dismissed.

B. Respondents Performed Their Fiduciary Duties Appropriately.

As investment advisers to the Zohars, Respondents owed the Zohars "a fiduciary duty of loyalty." *Goldstein v. SEC*, 451 F.3d 873, 881-82 (D.C. Cir. 2006). The OIP's sole theory of fiduciary breach is that Respondents labored under "An Undisclosed Conflict of Interest." OIP ¶ 9. The Division's prehearing brief likewise alleged only one theory of fiduciary breach:

"Failure to Disclose Facts Creating Conflict of Interest." Div. Prehearing Br. 28 (Oct. 17, 2016). And in its opening statement, the Division again explained that the alleged fiduciary breach concerns an undisclosed conflict of interest—namely, that Respondents' discretion to amend loans would have supposedly allowed Ms. Tilton to profit at Noteholders' expense. *See* Tr. 29:24-30:1 (Div. opening). The Division's allegation of fiduciary breach fails because, as just laid out, that alleged conflict of interest was the subject of express disclosure and waiver. *Infra* Pt. I.B.1.

Perhaps recognizing that the evidence at trial overwhelmingly established disclosure, the Division attempted to switch theories mid-trial, contending for the first time that the manner in which Respondents exercised their discretion concerning categorizations was not in the Noteholders' interests. This theory of fiduciary breach is not only outside the scope of the OIP (and therefore cannot serve as the basis for any liability), but it is also meritless. First, as with the OIP's theory of fiduciary breach, it is based on flawed legal premises (*e.g.*, that a fiduciary duty was owed to the Noteholders), and thus fails as a matter of law. *Infra* Pt. I.B.2. And second, it is based on a factual premise that bears no resemblance to what was conclusively demonstrated at trial—namely, the premise that Respondents did not act in the Zohars' interests. *Infra* Pt. I.B.3. To the contrary, Respondents' performance of their fiduciary duties is undeniable in light of the evidence adduced at trial. Ms. Tilton described her unyielding efforts to build value on behalf of the Zohars, and the Portfolio Company witnesses testified that Ms. Tilton has "dedicated her life, almost every waking hour, that I know of, in the last 10 years to improving these businesses and getting them . . . cash flow." Tr. 3548:18-3549:6 (Harrington); *see also* Tr. 3137:14-22 (Pelissier) ("[S]he work[s] tirelessly. And she's 100 percent focused on the future of her companies."); FOF ¶ 98. Meanwhile, the Division has conceded that it has never challenged

"Respondents' subjective judgments relating to the portfolio companies." Div. Opp. to Mot. for a More Definite Statement 4.

1. Any Conflicts Of Interest Were Disclosed And Expressly Waived.

Even if there had been no evidence of disclosure, the OIP's allegations of an undisclosed conflict of interest would be baseless because conflicts of this type were expressly waived in the CMAs. Where a collateral management agreement "waiv[es] any conflict of interest that might otherwise exist," a conflicts-based fiduciary duty claim is invalid "as a matter of law." *Bank of Am. v. Bear Stearns Asset Mgmt.*, 969 F. Supp. 2d 339, 356-57 (S.D.N.Y. 2013); *see* COL ¶¶ 34-40. This principle applies with particular force in this case, given the Zohars' (and other actors') extraordinary level of sophistication—a factor courts routinely take into account in upholding waivers as valid in the face of fiduciary breach claims. *See, e.g.*, *Heitman Capital Mgmt. LLC*, SEC No-Action Letter, 2007 WL 789073 (Feb. 12, 2007).

The Zohars explicitly acknowledged and waived conflicts of interest between themselves and Respondents. Each CMA contains a section titled "Conflicts of Interest; Acknowledgement of the Company," which provides as follows: "Various potential and actual conflicts of interest may arise from the overall advisory, investment and other activities of [Respondents] . . . and their respective clients . . . ." CMA § 6.2(a); *see also* FOF ¶¶ 18, 194. The same section continues: "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." CMA § 6.2(b). The OIP's sole theory of fiduciary breach is foreclosed by these clear, explicit disclosures and waivers.[45]

The Division's fiduciary breach claim also fails for the same reasons that defeat the fraud claims: Respondents' approach to categorization was fully disclosed. *See supra* Pt. I.A. The OIP is explicit about the complete overlap of conduct alleged in the fraud and fiduciary breach claims. After alleging that Respondents' categorization of loans was misleading, the OIP again recites the allegations of nondisclosure as the basis for a fiduciary duty claim. *See* OIP ¶ 9. In the more detailed discussion of the fiduciary duty allegations (which occupies just five short paragraphs of the 76-paragraph-long OIP), the only facts alleged to give rise to a conflict of interest are the "approach to categorization" and the "deci[sion] when to accept less than the full interest due from the Portfolio Companies." OIP ¶¶ 54-55.

The evidence showed just the opposite. It was well-disclosed that Ms. Tilton used good-faith business judgment to categorize loans while earning collateral management fees and owning and operating Portfolio Companies. *See generally* FOF ¶¶ 125-59. This strategy was necessitated by the design of the Zohars (as any reasonable investor would, and did know), and it was evident on the face of the Zohars' governing documents and Trustee Reports, in addition to being disclosed via investor calls and other communications. *See supra* Pt. I.A.

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[45] In addition, for the same reasons explained in Part I.B.2 *infra*, all the knowledge of Respondents and the Trustee is also imputed to the Zohars. *See Rodman v. Grant Found.*, 608 F.2d 64, 72-73 (2d Cir. 1979) (upholding dismissal of fiduciary breach claim predicated on failure to disclose, because "full and fair disclosure was made"); *In re Seidman*, 37 F.3d 911, 933-36 (3d Cir. 1994) (no breach of fiduciary duty where the fiduciary's interest—purportedly in conflict with the principal's interest—was disclosed). Given the Zohars' knowledge of everything Respondents knew (and the Zohars' knowledge of all the information in the Trustee Reports and all underlying financial data by way of the Trustee), Respondents lacked the legal capacity to keep any conflict undisclosed from the Zohars.

2. The Fiduciary Duty Claim Should Be Dismissed Because It Is Merely A Dressed-Up Breach Of Contract Claim, Based On Conduct Towards Noteholders To Whom No Fiduciary Duty Was Owed.

Even aside from the trial evidence of Respondents' allegiance to the Zohars and the Noteholders, the Division's fiduciary breach claim suffers from two flaws that independently preclude any finding of liability against Respondents. First, these claims are nothing more than dressed-up (and meritless) breach of contract claims. As with the fraud claims, the fiduciary duty claims are based on allegations that Respondents did not keep their contractual promises. That is exactly how the Division alleged its fiduciary duty claims, albeit with stray references to fiduciary duties scattered throughout its opening and closing arguments. Tr. 3679:22-24 (Div. summation) ("[T]hat's the protection investors bargained for. And a fiduciary investment adviser has to honor the promises made."); Tr. 36:14-20 (Div. opening) ("This case is . . . about Ms. Tilton's breaches of her core promises made and duties owed to her investors and about Ms. Tilton's disregard of those promises and duties for her own personal benefit."). Substituting "contractual duties" for "fiduciary duties" gets the Division no closer to making out an Advisers Act violation.

Moreover, the Division's arguments about what "investors bargained for" and Ms. Tilton's "duties owed to her investors," Tr. 3679:22-24 (Div. summation); Tr. 36:14-20 (Div. opening), would transmute the fiduciary duty imposed by the Advisers Act from an obligation owed to a client (the Zohars) into one owed to a client's investors (the Noteholders). The duty flows exclusively from the adviser to the client. *See Goldstein v. SEC*, 451 F.3d 873, 881-82 (D.C. Cir. 2006) (discussing the "fiduciary duty of loyalty between an adviser and his client"); *see also SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 201 (1963) (noting the Advisers Act's "recognition of the adviser's fiduciary relationship to his clients"). For advisers to pooled investment vehicles, "[t]his type of direct relationship exists between the adviser and the fund, but not between the adviser and the investors in the fund." *Goldstein*, 451 F.3d at 880.[46] In fact, the fiduciary duty must be owed exclusively to the fund, because "[i]f the investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest." *Id.* at 881; *see also* COL ¶¶ 41-45.

The OIP appears to recognize that Respondents owed fiduciary duties exclusively to the Zohars. *See* OIP ¶ 52 (characterizing the Zohars as Respondents' clients and stating that Respondents "owed fiduciary duties to these funds," but making no similar allegations as to Noteholders). And the Division made effectively the same concession in its Opposition to Summary Disposition. Div. Opp. to Summ. Disposition 18 ("The Division does not dispute that under Sections 206(1) and (2) of the Advisers Act, Respondents' 'clients' are the Funds themselves, rather than the Funds' investors.") (citing *Goldstein*, 451 F.3d at 881-82).[47]

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[46] *See also, e.g.*, *Capital Gains Research Bureau*, 375 U.S. at 194 (describing fiduciary duty as "an affirmative obligation to . . . [the advisor's] clients"); *Moran*, 922 F. Supp. at 895-96 ("Section 206 of the Advisers Act establishes a statutory fiduciary duty for investment advisers to act for the benefit of their clients, requiring advisers to exercise the utmost good faith in dealing with clients, to disclose all material facts, and to employ reasonable care to avoid misleading clients."); Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Advisers Act Release No. 2628, 2007 WL 2239114, at *1 (Aug. 3, 2007) (Final Rule 206(4)-8) (describing courts' "view that, for purposes of sections 206(1) and (2) of the Advisers Act, the 'client' of an investment adviser managing a pool is the pool itself, not an investor in the pool" and therefore expressing skepticism about "whether the Commission could continue to rely on sections 206(1) and (2) of the Advisers Act to bring enforcement actions in certain cases where investors in a pool are defrauded by an investment adviser to that pool"); Definition of "Client" of Investment Adviser for Certain Purposes Relating to Limited Partnerships, 50 Fed. Reg. 8740, 8741 (proposed Mar. 5, 1985) ("[I]t appears appropriate to view the pool—rather than each participant—as a client of the adviser.").

[47] During trial, the Division appeared to suggest that the Patriarch's compliance manuals were evidence of a fiduciary duty to Noteholders. But the compliance manuals made clear that the fiduciary duty was owed to the funds, and not the Noteholders. The manuals explained:

> The clients of the Investment Advisers are the collateralized loan obligation funds whose investment portfolios we manage (each a "Client" and collectively, the

Whatever position the Division now takes, the law provides no support for such liability, and the OIP's breach of fiduciary duty allegations should be dismissed as a matter of law.

3. Respondents At All Times Prioritized The Interests Of the Zohars And The Noteholders, Working Tirelessly On Their Behalf And Investing Hundreds Of Millions Of Dollars For Their Benefit.

The Division's contention that Respondents disserved the Zohars and Noteholders by amending loans and deferring interest in order to keep the Portfolio Companies afloat and collect fees is nonsensical. The evidence showed that, in a fully disclosed strategy, Respondents amended loans and deferred interest to create and maintain value for the Portfolio Companies. But according to the Division, the only proper course of conduct would have been for Respondents to cease supporting Portfolio Companies—all of which were highly distressed and the ability of which to repay stated interest was non-existent—a course that would have destroyed the value of the collateral and pushed the Zohars to failure. This position is preposterous and ignores the basic investment strategy: to draw upon Respondents' expertise and business judgment as collateral manager, and thereby gain value through loans issued to stressed and distressed companies that could be turned around. *See, e.g.*, Tr. 1838:15-22, 1839:3-22 (Tilton); Tr. 3511:13-3512:07 (Schwarcz); Tr. 3566:4-11 (Hubbard); FOF ¶¶ 13, 98. This bid to equate Respondents' exercise of business judgment on behalf of the Zohars with a breach of fiduciary duty is even more bizarre in light of the Division's explicit choice to "not make any

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> "Clients"). . . . As registered investment advisers, the Investment Advisers are in a position of trust and confidence with respect to their Clients and have a fiduciary duty to place their Clients' interests before the Firm's and its Employees' interests.

DX 39 (Patriarch Partners Compliance Manual) at PP130557. In light of this definition, the compliance manuals' references to Patriarch's clients are plainly references to the Zohars, and the compliance manuals' references to Patriarch's fiduciary duties are plainly references to duties owed to the Zohars.

allegation that Respondents' subjective judgments relating to the portfolio companies were incorrect." Div. Opp. to Mot. for a More Definite Statement 4.

In fact, the evidence showed that Respondents went far beyond their fiduciary duty in serving the interests of the Zohars. *Cf. Brandt, Kelly & Simmons, LLC*, 2005 WL 1584978, at *8 (no liability for breach of fiduciary duty under Advisers Act where respondents "worked diligently" for clients); COL ¶¶ 46-48. Respondents were not required to, but chose to, dedicate staggering amounts of their own capital to the Zohars and directly to Portfolio Companies, and structured their investments so that they would not get paid until after Noteholders were paid, with the specific purpose of advancing the interests of the Zohars and the Noteholders, and avoiding any conflict of interest. Respondents have (through Ms. Tilton's investment vehicles) invested over $218 million of their own money in Zohar I, Zohar II, and Zohar III directly, Tr. 3038:18-3040:23, 3060:1-5 (Lys); RX 132 (Summary of Preference Share and Class A 3A/3B Investments in the Zohar Funds), and they have invested over $223 million of their own money in the Portfolio Companies, Tr. 3031:8-3038:15 (Lys); RX 129 (Summary of Investments in Portfolio Companies made by ARK II, AIP, and ARK Angels through Aug. 31, 2016) at 1; FOF ¶¶ 212-18. Because the investments were structured such that upon sale of a Portfolio Company, the equity upside would "flow through the waterfall and pay the noteholders" and only pay Respondents last, they aligned Respondents' interests squarely with the Zohars' and Noteholders' interests. Tr. 2755:23-2756:5 (Tilton); *see also* Tr. 1800:9-11, 2113:23-2114:21 (Tilton) (describing "last-out equity," which "gets paid after the notes"); Tr. 3567:22-3568:8 (Hubbard) (only after investors are paid, "[t]o the extent those returns are very handsome, Ms. Tilton and Patriarch would also be rewarded"); FOF ¶ 41.

Respondents have proved their loyalty in other ways as well, as evidenced by the over $68.4 million in fees that have been accrued and have not been paid to Respondents. RX 134 (Summary of Fee Accruals and Payments) at 1 ($34,026,603 in unpaid management fees, and $1,014,299 in unpaid secondment fees); *id.* at 2 ($7,456,287 in unpaid agency fees); *id.* at 3 ($26,461,341 in unpaid collateral management fees); FOF ¶¶ 214-16. Ms. Tilton took no pay for 41 months during the financial crisis, Tr. 1841:6-11; deferred fees to provide extra liquidity to the Zohars, Tr. 1906:12-15; took no fees while Portfolio Companies were in bankruptcy, Tr. 1906:24-1907:6; and generally volunteered to "for[go] subordinated collateral management fees and preference share dividends to make sure that the noteholders had a deal that was performing well," Tr. 1908:17-24; *see also* FOF ¶ 196. She also attempted on multiple occasions to implement restructuring plans that would have made Noteholders whole, and offered to resign as collateral manager if it would help persuade MBIA to accept such a deal. Tr. 2577:2-2579:5 (Tilton); RX 498 (Mar. 15, 2013 email from Ms. Tilton to McKiernan) (attaching term sheet for the proposed Zohar I restructure); RX 48A, 48B (Dec. 12, 2011 Zohar I Investor Call) at 13:5-10; RX 497 (Mar. 14, 2013 email from Ms. Tilton to McKiernan); FOF ¶¶ 190, 199-211.[48]

Notably, Respondents continued to act as collateral manager for the Zohars until they voluntarily resigned in March 2016, almost six years after the Division began its investigation

[48] In view of Respondents' loyal work in service of the Zohars, there could be no breach of the standard of care memorialized in the CMAs. Respondents and the Zohars were parties to the CMAs (further evidence that the fiduciary duty flows exclusively to the Zohars), which imposed a specific standard of care on Respondents: "reasonable care," which the contract defined in part as "the same degree of skill and attention . . . that the Collateral Manager [*i.e.*, Respondents] . . . exercises with respect to comparable assets that it manages for itself and its Affiliates." RX 10 (Zohar II CMA) § 2.4 at 11; *see also* RX 6 (Zohar I CMA) § 2.4 at 11; RX 16 (Zohar III CMA) § 2.4 at 11; FOF ¶ 198. Respondents invested heavily in the Zohars' Portfolio Companies, so by definition, they managed the Portfolio Companies the way they would (and did) manage companies in which they invested. *See* FOF ¶ 213.

and almost one year after the Division filed the OIP. *See* FOF ¶¶ 190-91. Each of the Zohars' independent directors held several meetings during this interval. *See* FOF ¶¶ 188-89. This continued relationship "suggests that [the independent directors], at least, 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); *see also Stein*, 1999 WL 756083, at *11 (noting that the Advisers Act duty to disclose conflicts exists "so that the client [can] make an informed decision" as to whether to "continue an advisory relationship" or "take some action to protect himself against the specific conflict of interests involved" (internal quotation marks and citation omitted)). And the Division failed to call even one independent director to testify. It is absurd that the Division purports to assert claims on behalf of the Zohars when the directors of the Zohars themselves have never said a word indicating they believed the Zohars were in fact wronged.

C. Any Inaccuracies, Nondisclosures, Or Fiduciary Breach Relating To Categorization Were Not Material.

There can be no liability under the antifraud provisions of the Advisers Act unless the Division proves materiality. *Stein*, 1999 WL 756083, at *11; *see also Clarke T. Blizzard*, Advisers Act Release No. 2409, 2005 WL 1802401, at *4 (Comm'n July 29, 2005) (requiring materiality for breach of fiduciary duty under Advisers Act § 206); COL ¶¶ 53-57. To prevail here, the Division must prove that the alleged omission—namely, a more explicit description of Respondents' categorization approach—would have "substantially altered the total mix of information," given the information that Respondents did in fact disclose. *Stein*, 1999 WL

756083, at *11 (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988)).[49] The Division's proof fell far short of that burden, particularly in light of the evidence that Respondents accurately disclosed their categorization approach. *See supra* Pt. I.A.2.

The Division responded to this gap in its proof by claiming that these disclosures required too much effort from the reader of the Trustee Reports. Almost laughably, the Division asserts that the disclosures in the Trustee Reports communicate no useful information because they require the reader to "look at page 1 . . . and then . . . flip and look at another page." Tr. 3684:10-23 (Div. summation). But as Respondents' expert Dolan showed, a reader could easily determine "from the face of the Trustee Report . . . both that a loan isn't paying stated interest and that the loan is listed as Category 4." Tr. 3471:7-11; *see also, e.g.*, Tr. 3476:17-21 (Dolan) (a reader need only look at three pages of the Trustee Report to determine that a given loan is in Category 4 and did not pay full stated interest); Tr. 3015:15-19 (Lys) (after becoming familiar with the organization of the Trustee Reports, Lys spent "a few minutes" to analyze each report for Category 4 loans paying less than full stated interest); RX 24 (Hubbard Rep.) at ¶ 45; FOF ¶ 142.

[49] The Division cannot meet its burden if "the risk of real deception drops to nil" in light of the truthful facts included in the total mix of information. *See, e.g., Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1097 (1991) ("publishing accurate facts in a proxy statement can render a misleading proposition too unimportant to ground liability" due to the materiality requirement); *cf. Brandt, Kelly & Simmons, LLC*, 2005 WL 1584978, at *8 (finding "no material misrepresentations or omissions, and no violation of Sections 206(1) or 206(2) of the Advisers Act," in part because respondents "disclosed to each client individually the benefits and costs" related to the alleged violation); *see also Ieradi v. Mylan Labs., Inc.*, 230 F.3d 594, 599 (3d Cir. 2000) (affirming the "conclusion that [defendant's] failure to disclose . . . was immaterial" because "public disclosure was more than sufficient to put potential investors . . . on notice" of the allegedly omitted fact); *In re Hyperion Sec. Litig.*, 1995 WL 422480, at *7 (S.D.N.Y. July 14, 1995), *aff'd*, 98 F.3d 2 (2d Cir. 1996) ("Because [alleged misrepresentations] in the prospectus . . . appeared amidst abundant factual disclosures . . . the alleged misrepresentations do not rise to the requisite level of materiality").

Even if the Division were correct that the Trustee Reports required inference or interpretation by the reader—and, of course, that is entirely untrue—this would not render the disclosure inadequate. The disclosures were directed to sophisticated investors who had ample capacity to process complex information, *see* FOF ¶¶ 29, 32-33; Tr. 480:10-17 (Mayer) (admitting that "people who buy these kinds of securities" generally "have those kinds of capabilities" necessary to analyze this information), and in fact analyzed the information in the Trustee Reports and associated data files, FOF ¶¶ 125-27. To the extent any of them purportedly "fail[ed] to pursue this line of investigation," that reveals that, "despite appearances, the knowledge [they] would have discovered was immaterial." *Hirsch v. DuPont*, 553 F.2d 750, 763 (2d Cir. 1977); *see id.* at 762-63 (in analyzing adequacy of disclosures, the key question is whether a "reasonable investor of [the purported victims'] level of sophistication would have made a further inquiry").[50] The law on this point is clear, and directly contradicts the Division's argument that a disclosure defeats materiality only if it requires no diligence at all on the part of the recipient.[51] To the contrary: "The securities laws were not enacted to protect sophisticated

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[50] *See also United States v. Litvak*, 808 F.3d 160, 185 (2d Cir. 2015) ("[T]he sophistication of the investor is relevant . . . to the adequacy of the defendant's disclosure." (internal alterations omitted)); *In re Merrill Lynch Auction Rate Sec. Litig.*, 2011 WL 536437 (S.D.N.Y. Feb. 9, 2011) (finding no misrepresentation because the investor, "armed with the information [in the disclosure], was on notice of that information and all information that a diligent inquiry would have disclosed"); *Steed Finance LDC v. Nomura Sec. Int'l, Inc.*, 2004 WL 2072536, at *6 (S.D.N.Y. Sept. 14, 2004) ("[T]he more sophisticated the investor and the more resources available to the investor, the greater the burden on the investor to act to protect itself." (internal quotations and citations omitted)); *cf. In re Hyperion Sec. Litig.*, 1995 WL 422480, at *6 ("[T]he securities laws were not meant to shelter those who deliberately disregard disclosed risks.").

[51] The Division cited only one legal authority in its entire summation: an opinion by a Magistrate Judge in the Northern District of Illinois, partially granting and partially denying a motion for summary judgment, which the Division quoted for the uncontroversial proposition that "willingness to disclose is a poor substitute for actual disclosure." *SEC v. Nutmeg Grp.*

businessmen from their own errors in judgment. Such investors must, if they wish to recover under federal law, investigate the information available to them with the care and prudence expected from people blessed with full access to information." *Id.* at 763.

D. Any Inaccuracies, Nondisclosures, Or Fiduciary Breach Relating To Categorization Could Not Have Been Intentional Or Negligent, Given Respondents' Good-Faith, Reasonable Interpretation Of The Indentures.

For Respondents to be found liable, the Division bears the burden of proving their scienter, or, for charges other than § 206(1), their negligence. *See supra* p. 48; *Labine*, 2016 WL 824588, at *28, *31; *Steadman*, 967 F.2d at 643 n.5, 647; *cf. Lincolnshire Mgmt., Inc.*, Advisers Act Release No. 3927, 2014 WL 4678600, at *5 (Comm'n Sept. 22, 2014) (applying the same state-of-mind requirement for claim of breach of fiduciary duty). The Division cannot meet that burden. The Division fell far short of proving intentional fraud; all the usual trappings of such a prosecution are conspicuously absent from the record. And the evidence at a minimum demonstrates that Respondents acted out of a "good faith" belief that their conduct was appropriate, and with "due care," *Howard v. SEC*, 376 F.3d 1136, 1147 (D.C. Cir. 2004), in the face of which the charges should be dismissed, *see* COL ¶¶ 58-70.

When conduct is based on a reasonable—even if ultimately erroneous—interpretation of a contract, the conduct is not negligent, because it was based on an objectively reasonable attempt to comply with the contract. *See Gen. Ins. Co. of Am. v. K. Capolino Constr. Corp.*, 983 F. Supp. 403, 437 n.63 (S.D.N.Y. 1997); *see also Amitie One Condo. Ass'n v. Nationwide Prop. & Cas. Ins. Co.*, 2008 WL 2973097, at *4 (M.D. Pa. Aug. 4, 2008) ("reasonable but incorrect interpretation" of a contract does not "give rise to bad faith"). Even if Your Honor were to

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LLC, 162 F. Supp. 3d 754, 779-80 (N.D. Ill. 2016). The entire case is, however, inapposite given the contrast between the *Nutmeg* defendants, who contended only that they "were willing to answer questions," *see id.* at 779, with the robust actual disclosures made by Respondents here.

disagree with Respondents' reading of the Zohars' governing documents, Ms. Tilton's testimony established that Respondents' conduct was nonetheless motivated by a firm belief in that interpretation. *See, e.g.*, Tr. 1798:24-1799:7 (Tilton) (testifying that Respondents believed they "worked in accordance with those indentures" and that they "implemented practices and procedures to make sure that Patriarch complied with those indentures for the Zohar deals"). Indeed, that is the only possible explanation here—nobody who is proceeding in bad faith or with negligence spends a decade or longer refining, memorializing, and publishing the details of the challenged behavior, including through open discussions of what the contract means.[52] FOF ¶¶ 45-47, 125-59.

Likewise, Respondents' disclosures confirm their good-faith state of mind. No fraudster would openly announce deceptive conduct on a public investor call, or respond in writing to questions from an alleged victim by telling that person exactly what they were doing, as Respondents did here. FOF ¶¶ 151-56. Fraudsters do the opposite: they conceal wrongful conduct when confronted. *See In re Loral Space & Commc'ns Ltd. Sec. Litig.*, 2004 WL 376442, at *14 (S.D.N.Y. Feb. 27, 2004) ("[I]n the context of the consistent disclosures by the defendants, there is no basis to infer from this alleged omission that the defendants acted with scienter."); *In re Merrill Lynch Auction Rate Sec. Litig.*, 2011 WL 536437, at *9 (disclosures are probative of defendant's compliance with "standards of ordinary care" (citation omitted)). And

[52] *See, e.g.*, RX 118 (Sept. 2, 2011 email from Karen Wu at Patriarch to Daniel Strong at Natixis) ("[W]e have amended agreements to align with payments rather than issuing waivers or forgiving interest. You are well aware that the ability to waive, amend, or change interest rates to meet the current conditions of a company is a[n] integral part of the business model."); RX 117 (June 23, 2011 email from Frank Li at Patriarch to Anand Sankaranarayanan at Barclays, responding to a question about interest payments below stated interest) ("Interest may have been deferred for some of the borrowers. Different from other CLO managers, Patriarch Partners' business model is a unique vertically integrated model.").

tellingly, the Division presented no evidence, nor any reason to believe, that Respondents ever attempted to interfere with the Trustee Reports, attempted to alter or hinder the presentation of information in the Trustee Reports, or failed to cooperate with the Trustee in any way.

Ms. Tilton's rigorous process for deciding when to amend loans is also inconsistent with intentional or reckless deception, and it unequivocally establishes that Ms. Tilton was not negligent. *See, e.g.*, *Hoemke v. N.Y. Blood Ctr.*, 912 F.2d 550, 552 (2d Cir. 1990) (negligence defeated by "procedures that reasonable prudence would dictate be instituted"). On an ongoing basis, Ms. Tilton was intensively involved in supervising the financial performance of the Portfolio Companies; she required (among other things) weekly financial reports, quarterly meetings, regular calls with Patriarch's workout officers to discuss "hot issues," and ongoing analysis by Patriarch's credit analysts. FOF ¶¶ 97-104. When considering whether to amend a loan to defer interest, Ms. Tilton heightened her scrutiny: she met with credit analysts, considered interest projections, and compared the expected value of letting the loan default with the long-term value of continuing efforts to turn around the Portfolio Company. FOF ¶¶ 105-08. She exerted substantial pressure on the Portfolio Companies to pay full stated interest if they could possibly do so. FOF ¶¶ 106, 111; *see supra* pp. 38-40. The Platform Leaders who testified at trial described the final stage before a loan amendment as a "brutal" series of meetings (which could last days), in which the Platform Leader would advocate for a deferral of interest. Tr. 3533:1-3535:6 (Harrington); *see also* Tr. 3083:3-13 (Pelissier); FOF ¶ 106. If the Portfolio Company could not pay full stated interest, Ms. Tilton sought to maximize the value of the collateral by either amending to defer an interest payment "in order to hold securities that would be worth much more later on," or refusing to amend and moving the loan to Category 1. Tr. 2090:23-2091:7 (Tilton); *see also* FOF ¶¶ 107-11. This approach to interest deferral was an exercise in diligence—not negligence—with the intent of increasing value to the Zohars and the Noteholders.

Finally, the Division has argued that Respondents' categorization methodology was designed to allow Ms. Tilton to collect greater fees and distribution. *See, e.g.*, Tr. 18:11-15, 20:18-24 (Div. opening); Tr. 3657:15-19 (Div. summation). Not only does the evidence of Ms. Tilton's unflagging loyalty to the Zohars—and the lack of any evidence that Respondents misrepresented their amendment, deferral, and categorization strategy—disprove this theory, but it makes no economic sense. The relevant fees and distributions pale in comparison to Ms. Tilton's stake in the success of the Zohars and the Portfolio Companies, and her hundreds of millions of dollars in investments. FOF ¶¶ 202-18. Her financial interests were tightly aligned with those of the Zohars and the Noteholders, and she had every reason to want them to succeed.

The trial record makes clear the fierce loyalty and dedication that Respondents showed to the Zohars and Noteholders. Their willingness to sacrifice for the Zohars is especially clear from Ms. Tilton's repeatedly volunteering to resign as collateral manager, her decision not to take fees for 41 months during the financial crisis, and her massive investments of her own capital in the Zohars and the Portfolio Companies. *See infra* part I.B.3; FOF ¶¶ 202-18. Accordingly, none of the categorization-based claims (including the fiduciary duty claims) can give rise to a finding of scienter or negligence.

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

Each Zohar Indenture requires Respondents to deliver "an Officer's certificate attaching (i) a consolidated balance sheet . . . and (ii) a consolidated income statement . . . 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." Indenture § 7.9(a); *see also* FOF ¶¶ 219-220. The OIP alleged that

"Respondents do not prepare the financial statements in conformity with GAAP," contrary to the certifications signed by Ms. Tilton, and that the "disclosures in the financial statements . . . falsely indicate that Respondents assess and consider impairment issues and the fair value of the Funds' loan assets." OIP ¶ 8.[53]

Courts have consistently held that "[a]llegations 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)).[54] Instead, to establish a claim of misrepresentation based on alleged GAAP violations or accounting irregularities, the Division must prove: (1) that the financial statements contained false or misleading representations, *see Brandt, Kelly & Simmons, LLC*, Initial Decision Release No. 289, 2005 WL 1584978, at *8 (June 30, 2005); (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); and (3) "that [the respondent] acted with scienter with regard to both the truth and the materiality of the allegedly misleading

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[53] As a preliminary matter, the Indentures did not require the Zohars to produce GAAP-compliant "financial statements"—only GAAP-compliant balance sheets and income statements. *See* Indenture § 7.9(a). The financial statements themselves made clear on their face that they were "special purpose" financial statements prepared in accordance with the "specific reporting requirements set forth under Section 7.9(a) of the Indenture," and "should not be regarded as a complete presentation of GAAP financial statements," RX 30.009 (Dec. 8, 2009 Zohar III Financial Statements) § 2.1 at 4, and the officer's certificate certified GAAP-compliance only as to the "Balance Sheet[s]" and "Income Statement[s]," *id.* at 1. Accordingly, as used in this brief, references to GAAP-compliant financial statements serve as a shorthand for the GAAP-compliance of the balance sheets and income statements contained in the financial statements.

[54] *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 because the fact that "the reported figures are alleged to have violated GAAP is not, by itself, actionable").

statements," *SEC v. Snyder*, 292 F. App'x 391, 399-400 (5th Cir. 2008) (citing *Fine v. Am. Solar King Corp.*, 919 F.2d 290, 297 (5th Cir. 1990)).[55] Finally, reliance on the review and approval of the challenged financial statements by professional accountants is a complete defense to both intent and negligence-based accounting charges. *See infra* Pt. II.B; COL ¶¶ 71-73.

Here, the Division failed to prove any of the elements of the charge, and Respondents easily proved the advice-of-experts defense. Respondents introduced uncontroverted evidence, corroborated by expert testimony, of their robust process for evaluating impairment and fair value of the Zohars' loans, as well as evidence that their practices were GAAP-compliant. *See infra* Pt. II.A. The evidence also established that Respondents relied in good faith on their external accountant, Berlant of Anchin, to create their accounting policies and financial statement disclosures, and then to review and approve their financial statement disclosures on a monthly basis for over 15 years. *See infra* Pt. II.B. Respondents' accounting policies were, moreover, never challenged or questioned by the Noteholders, and the Division's Noteholder witnesses admitted that the financial statement disclosures were not material to their investment decisions. *See infra* Pt. II.D. And far from acting with scienter, Respondents and their internal accountant testified to their reasonable, good faith continuing belief that the financial statements and the process for evaluating impairment and fair value complied with GAAP. *See infra* Pt. II.C.

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[55] Because the GAAP certification is a statement of opinion, the Division must prove that Respondents subjectively did not believe the challenged statements. *See Fait v. Regions Fin. Corp.*, 655 F.3d 105, 112 (2d Cir. 2011) (holding that complaint was deficient where it "[did] not . . . plausibly allege that defendants did not believe the statements . . . at the time they made them"); *see also In re Am. Int'l Grp. Inc.*, 2013 WL 1787567, at *3-4 (S.D.N.Y. Apr. 26, 2013) (dismissing claim based on GAAP noncompliance where plaintiff failed to "plead subjective falsity").

A. Respondents' Financial Statements Were Accurate And GAAP Compliant.

The OIP alleges GAAP non-compliance only as to fair value and recognition of impairments. 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. Here, the evidence at trial established that Respondents' treatment of fair value and recognition of impairments in financial statements fell within the range of acceptable outcomes that GAAP permits, and that Respondents assessed and considered both impairment issues and the fair value of the Zohars' loan assets. COL ¶¶ 74-80.

1. Respondents Analyzed And Reported Fair Value In Accordance With GAAP.

The Zohar financial statements disclosed that the "fair value of the Collateral Debt Obligations . . . is approximately equal to the . . . carrying value presented on the Balance Sheet" and that "fair value estimates are generally subjective in nature," and may be based upon "valuation techniques" that "involve uncertainties." *See, e.g.*, RX 28.022 (Nov. 17, 2008 Zohar I Financial Statements) at 6; *see also* FOF ¶¶ 221-22. The OIP contended that these disclosures were misleading because "no analysis at all was conducted to determine fair value," OIP ¶ 72, but this allegation is false. As Respondents established at trial, detailed and accurate valuation analyses of the Collateral Debt Obligations were regularly performed by Ms. Tilton and Patriarch's credit and structured finance groups. FOF ¶¶ 223-24; *see also* Tr. 1977:19-22 (Tilton) ("Q. Who conducted this fair value analysis . . . ? A. I did, along with the structured finance team and the credit officers."). Respondents conducted their fair value analyses with detailed models that "la[id] out [Portfolio Company] cash flows credit-by-credit and as a whole," and then Ms. Tilton and Patriarch's credit and structured finance groups "discount[ed] those cash flows back to create a fair value number." Tr. 2297:8-2298:5 (Tilton); *see also* FOF ¶ 224. Respondents introduced several examples of these valuation models at trial, which the Division at best failed to understand, or worse, simply disregarded in their rush to charge Respondents with accounting fraud. *See, e.g.*, FOF ¶ 223; RX 487.001 (Spreadsheet of Portfolio Company performance history and projected performance); RX 1832 (Compilation of Equity Analysis Spreadsheets); RX 557 (Patriarch's model into which the credit templates fed to create cash flow analyses). Indeed, the Division's own accounting expert did not consider a single one of the detailed spreadsheets that lay out this analysis. *See* FOF ¶ 228.

These analyses were part of the process by which Patriarch confirmed that the estimated fair value of the Collateral Debt Obligations reported in the Zohar financial statements was accurate. FOF ¶ 224. Ms. Tilton, "along with the structured finance team and the credit officers," compared the discounted cash flow numbers from the valuation models to the "carrying cost on the financial statements as well as to the holding value in the trustee reports. And then [they] chose the most conservative or the lowest number that was usually, if not always, carrying at . . . cost." Tr. 1977:19-22, 2281:15-25 (Tilton). Far from misleading Noteholders with inflated valuations, Ms. Tilton reported only "the most conservative [valuation], which was the cost of the collateral, plus borrowings, less paydowns, minus impairment." Tr. 2297:8-2298:5 (Tilton). Respondents' fair value analyses always ensured that the financial statements "present[ed] a fair picture of the Zohar Funds' financial conditions," OIP ¶ 60, by confirming that the fair value of the Collateral Debt Obligations was at least equal to the carrying value presented on the balance sheet of the financial statements. FOF ¶ 225. Indeed, even the Division's accounting expert, Henning, did not conclude that any fair value figure reported in a Zohars' financial statements was inaccurate, materially or otherwise. FOF ¶ 227.

Respondents' estimation of Collateral Debt Obligations' fair value as approximately equal to their carrying value complied with GAAP. FOF ¶ 226. Respondents' expert witness, Lundelius, found that Patriarch regularly prepared valuation analyses, which is "what the guidelines require. The guidelines then suggest that you use methods such as some multiple of earnings. That's exactly what Patriarch did . . . [a]nd Patriarch was following the guidelines almost to the letter." Tr. 3161:25-3162:8 (Lundelius). Contrary to the OIP's insinuation that Patriarch blindly followed "[Ms.] Tilton's direction" to "carr[y] these assets at cost unless and until Tilton decided to stop supporting the relevant Portfolio Company," OIP ¶ 72, Mercado, Patriarch's Controller, testified that "the accounting and finance group consulted with Ms. Tilton. And based upon [their] understanding of GAAP rules and based upon the asset class[] being . . . all distressed assets and . . . subject to highly subjective assumptions, . . . [they] determine[d] that cost was the most effective way of determining the aggregate value of the assets on the balance sheet," Tr. 1181:5-16 (Mercado). As such, Respondents' CPA witnesses, Lundelius and Mercado, both testified that "that Patriarch was presenting fair value in accordance with GAAP." Tr. 3311:9-12 (Lundelius); *see* Tr. 1181:17-20 (Mercado) ("Q. So you're telling this court that a current valuation technique of cost is compliant with GAAP in your opinion? A. Yes."). Moreover, each statement that forms the basis of the Division's charges is "a statement of opinion," which, because it was sincerely held, "is not an untrue statement of material fact" regardless whether it is correct or incorrect, *Omnicare, Inc. v.*

Laborers Dist. Council Constr. Indus., 135 S. Ct. 1318, 1327 (2015), and therefore cannot give rise to liability.[56]

2. Respondents' Loan Impairment Policies And Practices Complied With GAAP.

The Zohar financial statements disclosed that an impairment loss would be recorded "[i]n the event . . . that the anticipated future collections are determined to be less than the carrying value of the loan." *See, e.g.*, RX 28.022 (Zohar I Financial Statements) at 5; *see also* FOF ¶ 229. The OIP alleges this disclosure was misleading because Patriarch did "not conduct an impairment analysis that complies with GAAP" and had "no procedures in place to analyze future collections." OIP ¶¶ 66-67. This allegation, too, is false. As Respondents established at trial, Patriarch regularly analyzed the performance and future prospects of the Portfolio Companies through "credit templates" that applied a discounted cash flow analysis to estimate the value of future collections. FOF ¶ 232. Ms. Tilton and her team used the credit templates to make decisions regarding Portfolio Companies, including decisions to restructure or liquidate an asset. FOF ¶ 233; *see also* Tr. 2279:4-6 (Tilton). Patriarch would then conduct an "event-driven" impairment analysis to determine whether to write off a loan upon the occurrence of events, such as bankruptcies, restructurings, and liquidations. *See* Tr. 1959:21-1960:2 (Tilton). As with the valuation models, Respondents introduced an example of these credit templates at

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[56] Because "[a]pplying GAAP often involves subjective determinations," *Owens*, 789 F.3d at 543, courts have held statements regarding GAAP compliance non-actionable under the securities laws absent proof that the person issuing the statement "did not actually believe" the statement when made, *City of Westland Police & Fire Ret. Sys. v. Metlife, Inc.*, 129 F. Supp. 3d 48, 73 (S.D.N.Y. 2015). Respondents' GAAP certifications provided opinions as to inherently subjective matters, and the Division has not undermined the sincerity of Respondents' belief in that accuracy. Similarly, the evidence shows that Respondents' purported misrepresentations regarding categorization involved their sincere belief in the appropriateness of their discretionary exercise of good faith business judgment to amend the terms of the loans under the Indentures.

trial, *see* RX 561 (ALF Credit Template), which put the lie to the Division's claim that Patriarch had "no procedures in place to analyze future collections," OIP ¶ 67. Again, in its rush to judgment, the Division failed to confirm the veracity of the allegations that formed the basis of its charges.

The Division's expert, Henning, conceded that he ignored the credit templates used by Patriarch's credit team when he concluded Patriarch did not conduct an impairment analysis. *See* Tr. 1429:14-1430:8 (Henning); FOF ¶ 240. Lundelius, who had no difficulty understanding the importance of the credit templates in Patriarch's impairment analyses, testified that "it seemed like the only evidence [Henning] would consider is something that says 'impairment calculation' or 'impairment process' at the top of the page," and Lundelius could not "understand why [Henning] was coming to [the] conclusion" that there was no evidence of an impairment analysis. Tr. 3247:8-17 (Lundelius). In fact, as detailed in Dietrich's report, and explained by Lundelius, Patriarch analyzed loan impairment. *See* FOF ¶ 236; RX 22 (Dietrich Rep.) at ¶¶ 39-42; Tr. 3256:22-3258:19 (Lundelius). Lundelius "found . . . contemporaneous evidence that . . . showed the enterprise value was being assessed at least annually if not more frequently. And that given enterprise values, significantly above the loan levels, that an impairment analysis was, in fact, being done." Tr. 3199:24-3200:5 (Lundelius).

The Division also falsely alleged that "Patriarch does not write down loans for impairment purposes but, instead, writes them off if and when Tilton determines that she will no longer support a Portfolio Company." OIP ¶ 64. The slender reed on which the Division bases the entirety of this allegation is a single email, in which Ms. Tilton stated, "we do not write up or write down—we write off," DX 162 (Aug. 13, 2010 email from Ms. Tilton to Mercado) at PP2_00580148, and claimed that this showed "[Ms.] Tilton explicitly directed that loan values were not to be written down," Div. Prehearing Br. 21. The Division, however, "read[s] [too] much into an email string . . . . [when] there was actual evidence of both actual write-downs and write-offs." Tr. 3248:25-3249:5 (Lundelius); *see also* Tr. 1263:16-23 (Mercado) ("Q. Did you take Ms. Tilton's email [DX 162], the one about write off and write down, to mean that we wait, we don't record the . . . loss until we write off the whole amount of the . . . loan? A. No. Q. And, in fact, you recognize the loss upon the event of restructuring; is that right? A. That's correct.").

The evidence adduced at trial established that under its impairment policy, Patriarch both wrote down loans when underperforming assets needed to be restructured and wrote off loans upon liquidation. FOF ¶ 235. Respondents introduced a sample workpaper (a spreadsheet employed to populate the financial statements) from the Division's exhibit list to showcase how easy it was to see what Patriarch's write-down practices were. *See* Tr. 1258:3-4 (Mercado) (addressing DX 57 (Sept. 7, 2011 Zohar III Workpapers)). Each workpaper contains a "payoffs" tab, which "reflects quarter by quarter any gains and losses . . . on the income statement since the inception of the fund." Tr. 1258:20-1259:1 (Mercado). During his testimony, Mercado highlighted examples on the payoffs tab where Patriarch restructured a loan and wrote down "the amount that is not included in the restructure." Tr. 1259:5-1262:3 (Mercado). Berlant testified during cross-examination that he reviewed the workpapers each month and that he was aware the payoffs tab showed "that losses were reported when restructurings occurred." Tr. 1027:15-17 (Berlant). The Division tellingly failed to ask a single witness about the contents of the payoffs tab, including their own witness Berlant. Much like the valuation models and credit templates, the Division either failed to understand the information on the payoffs tab, or simply elected to ignore any evidence that directly undermined its allegation.

In any event, Respondents' process of regularly reviewing the loan portfolio and impairing assets upon the occurrence of certain events complied with GAAP. FOF ¶¶ 236-39. Analyzing future collections is "what GAAP requires you to do. And that's what [Patriarch's] policy requires you to do, future anticipated collections." Tr. 3181:15-17 (Lundelius); *see also* FOF ¶ 236. Lundelius found Patriarch "look[ed] to the future and look[ed] at what [a portfolio] company will be worth, and then assess[ed] whether or not at that point in time it will have enough value to pay all of its debts." Tr. 3181:18-21 (Lundelius). This approach to impairment complied with GAAP, because "what you're looking for is just enough [enterprise value] to cover the debt. That's all that GAAP would require, and that's all that the investors in the Zohar funds would need." Tr. 3183:22-25 (Lundelius). Lundelius testified that as such, he "did not find that there was . . . anything incorrect in terms of the application to GAAP for the financial statements for loan impairment." Tr. 3304:25-3305:3 (Lundelius). In addition, during cross-examination, Mercado remained firm in his conviction that Patriarch's impairment process complied with GAAP. Tr. 1118:6-8 (Mercado) ("Q. As a CPA here in the state of New York, can you tell the judge, is that [impairment policy] GAAP compliant? A. I believe it is, yes.").

The Division's expert, Henning, was neither reliable nor persuasive in his opinions about GAAP compliance.[57] He simply ignored Respondents' processes and corresponding disclosures, and then asserted that no analysis was done. Nor did Henning show that the financial statements were false or misleading; he simply testified that he preferred a different process (based on the

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[57] Although Your Honor declined to exclude Henning's testimony on the basis of Respondents' motions *in limine* and objections, all of the reasons why Henning should have been excluded are also reasons why Your Honor should assign no weight to his testimony. *See Lynn Tilton*, Admin. Proc. Rulings Release No. 4245, at 4 (ALJ Oct. 12, 2016) (noting that "Respondents may argue against [the] weight" of admitted evidence); Tr. 396:22-397:1 (Div.) (arguing against an evidentiary objection on that ground that it "goes to the weight").

same flawed misperception of the Zohars' business model that underlies the allegations regarding loan categorization). Consequently, the Division did not carry its burden to prove the "disclosures in the financial statements . . . falsely indicate that Respondents assess and consider impairment issues and the fair value of the Funds' loan assets." OIP ¶ 8.

3. Patriarch Recorded Accrued Interest In Accordance With GAAP.

With its case unravelling, the Division sought to change its case by advancing a previously undisclosed theory that appears nowhere in the OIP—that Patriarch had incorrectly recorded "accrued interest" in its financial statements. The Division's new, uncharged allegation is not only without merit, but also it violates the bedrock principle that the Division cannot pursue at trial any alleged wrongdoing that was not charged in the OIP.

An ALJ "may only admit 'new matters of fact or law that are within the scope of the original order instituting proceedings.'" *Pierce v. SEC*, 786 F.3d 1027, 1036 (D.C. Cir. 2015), *cert. denied*, 136 S.Ct. 1713 (2016) (citation omitted). Facts that are "wholly outside the framework of the order for proceedings," such as those pertaining to accrued interest, have no place in the record. *Int'l S'holders Servs. Corp.*, Exchange Act Release No. 12389A, 1976 WL 182458, at *4 n.19 (June 8, 1976); *see also Brandt, Kelly & Simmons, LLC*, 2005 WL 1584978, at *7 (rejecting Division's evidence that respondent distributed funds according to inappropriate criteria because the allegations in the OIP concerned misappropriation of separate funds). The Division was well aware of Respondents' interest accrual procedures prior to filing the OIP and chose not to include allegations related to that issue. As the Commission has recognized: "If the staff thought that it had a case in these areas, it should have touched on them in its pleading. Or, having failed to do so the first time around, it should have amended that pleading to raise [the issues that were not alleged]." *Int'l S'holders Servs. Corp.*, 1976 WL 182458, at *4 n.19.

In any event, Respondents' treatment of accrued interest complied with GAAP, as the unrebutted testimony confirmed. According to the Division's newly-invented theory, the Zohars should have recorded all unpaid interest as an asset—even if it was not likely to be collected in that reporting period—and then taken an allowance against that asset in the same amount. But Respondents recorded as accrued interest on the Zohar financial statements only the unpaid interest that the Zohars reasonably expected to collect from the Portfolio Companies. FOF ¶ 241. "Rather than inflat[ing] . . . revenue," Respondents' internal accountants believed that "it was a more accurate description and more meaningful number to show the investors what [they could] expect to collect as opposed to grossing up the revenue number by this huge amount of interest that [they] did not expect to collect." Tr. 1189:2-8 (Mercado). Respondents also recorded a percentage allowance, or "haircut," to account for the fact that there was some uncertainty surrounding the possibility of collecting all of the interest that it otherwise reasonably expected to collect from the Portfolio Companies. FOF ¶¶ 241-42.

Respondents' policy of recording only the accrued interest that the Zohars reasonably expected to collect from the Portfolio Companies, and taking a haircut from that number, was consistent with GAAP. FOF ¶ 243. Lundelius confirmed this point, explaining that "if there is a point where you cannot make a reasonable estimate of what is uncollectible, then you can't go over and accrue the income related to it as well." Tr. 3163:6-7, 3296:4-8. In fact, it would have been inconsistent with GAAP, and "misleading" to record interest that the Zohars were owed by the Portfolio Companies, but that Respondents did not reasonably expect to collect. FOF ¶ 244; *see also* Tr. 1222:21-25 (Mercado) ("Q. And would it be wrong under GAAP to accrue for interest that Patriarch does not expect to receive in that quarter? A. It would be misleading to reflect an amount that you don't expect to collect.").[58] The Division never even asked its own expert to opine that the accounting was incorrect. In the face of the unrebutted evidence, the Division's arguments regarding Respondents' reporting of accrued interest are not only outside the scope of the OIP, they are in no way relevant or supportive of the allegation that Respondents were attempting to hide non-payment of interest.

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

The evidence adduced at trial showed that Respondents established a reasonable, good faith accounting process, with the input and advice of both internal and external accountants. It further showed that Respondents carried out that process month after month and year after year, and relied in good faith on internal and external accountants to review the financial statements and ensure they complied with GAAP.

To show good faith reliance on the advice of a professional, a defendant "should show that [she] [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); *see also United States v. Boyle*, 469 U.S. 241, 251 (1985) (reliance on a professional's advice is reasonable when the advice falls within the professional's area of expertise). This is a complete defense that defeats both intent and negligence-based charges. *See, e.g., Addington v. Comm'r of*

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[58] Contrary to the Division's insinuations, Respondents did not change their interest accrual policy in March 2010. Rather, they modified the interest accrual methodology so that the financial statements would continue to reflect only the interest that the Zohars reasonably expected to collect, based upon the status of restructurings and amendments in process with the Portfolio Companies. FOF ¶ 245.

Internal Revenue, 205 F.3d 54, 58 (2d Cir. 2000) ("Good faith reliance on professional advice is a defense to negligence penalties.").[59] That standard was more than satisfied here. *See* COL ¶¶ 89-91.

1. Respondents Hired Berlant At The Inception Of The Business, Relying On Him To Provide Accounting Guidance, Create Respondents' Financial Statements, And Develop A Manual of GAAP-Compliant Accounting Policies.

Respondents hired Anchin, a prominent national accounting firm, "right after [Patriarch closed its] first deal," "to help [Patriarch] formulate what the financial statements . . . would look like; the basis for the accounting; the notes to the financial statements; and to make certain that [Respondents] were following the terms of the [I]ndenture and issuing financial statements that were in accordance with GAAP." Tr. 1954:25, 2135:8-14 (Tilton); *see also* FOF ¶¶ 247-49. Respondents "trusted in Anchin" and worked with Anchin for the next 15 years, paying the firm more than $17 million for its professional services. Tr. 1954:24-1955:1, 1958:4-5 (Tilton). Patriarch's relationship partner at Anchin from the inception of the relationship, Berlant, was a highly qualified accountant. Berlant is "one of the senior leaders" of Anchin's fund accounting practice, "supervis[ing] 40 professionals" and serving on the governing council of the American Institute of Certified Public Accountants. Tr. 909:18-916:8 (Berlant); *see also* FOF ¶ 248. And Anchin itself is designated in the Indentures as a "firm of Independent or certified public accountants of recognized national reputation." *See, e.g.*, Indenture § 1.1.

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[59] Respondents asserted reliance on advice of experts as an affirmative defense. *See* Answer 11 (Apr. 22, 2015). The Commission, in its revisions to the Rules of Practice, acknowledged that this is an available and appropriate affirmative defense. *See* Final Rule, Amendments to the Commission's Rules of Practice, 81 Fed. Reg. 50,212, 50,220 (July 29, 2016) (to be codified at 17 C.F.R. Pt. 201) (specifically referencing "the advice of . . . accountants"); *see also id.* at 50,234.

Berlant "was involved from the inception of [Patriarch's] business. . . . [H]e and his tax partners put together the manual and the process that [Patriarch] would follow" for the next 15 years. Tr. 1956:5-8 (Tilton); *see also* FOF ¶ 249. Berlant helped develop the form and content of Patriarch's fund financial statements and "taught [Patriarch] how to do the accounting" for its distressed "asset class in accordance with GAAP." Tr. 2137:16-2138:3 (Tilton). Berlant revised the fair value and impairment notes in the first financial statements issued by Patriarch and drafted the impairment policy disclosure at issue in this litigation. FOF ¶ 250. The impairment language included in the first Patriarch financial statements by Berlant remained in place "for the next 14 years." Tr. 957:2-7 (Berlant); *compare* RX 1740.001 (Aug. 30, 2001 Ark I Financial Statements) at 5 *with* RX 28.022 (Nov. 6, 2008 Zohar I Financial Statements) at 5.

Anchin also worked with Patriarch to develop a manual of accounting policies, which included advice from Berlant on how to conduct GAAP-compliant impairment analyses. FOF ¶ 251. Patriarch employed no internal CPAs and "had no [external] accountants" other than Anchin at the time the template and policies were created. Tr. 956:10-12 (Berlant); *see also* FOF ¶ 253. As Ms. Tilton testified, Patriarch followed the accounting advice provided in the policy manual, including as to impairment. Tr. 2147:12-18 (Tilton); *see also* FOF ¶ 252.[60]

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[60] *Compare* RX 1766.001 (Oct. 10, 2001 Ark CLO 2000-1 Ltd. Accounting/Tax Manual) at 63 ("If the modification [to the terms of a loan] results in a material diminution of anticipated collections versus Loan Carrying Value, this situation may call for an Impairment Charge. However, since most of the modifications will be engineered to enhance the borrower's ability to service its debt, we expect that a modification will rarely, if ever, necessitate an Impairment Charge.") *with* Tr. 2146:2-12 (Tilton) ("That is . . . the advice that was given to us on when you impair; when there is an event and an estimated principal loss that you can see based on the restructure or the bankruptcy. And that estimated principal amount would then be written off or written down . . . at that time of that event. That's where we get, 'Don't write up, don't write down, write off.'").

2. Ms. Tilton Relied On Berlant To Provide Guidance On GAAP And Other Substantive Accounting Issues, And To Review And Approve The Zohars' Financial Statements.

Berlant was deeply involved in Respondents' business throughout the years. Respondents regularly sought and received GAAP guidance and accounting advice from him. Berlant served on Patriarch's "deal team in connection with the creation of Zohar I," where Respondents relied on him to review and comment on drafts of the Zohar I Indenture, CMA, and CAA. FOF ¶ 254; Tr. 2136:12-14 (Tilton) (Berlant "and the Anchin firm had guided [Patriarch] on [its] financial and tax accounting, and what [Patriarch] had to put together for [its] first reporting period."). After the Zohar I deal closed, Respondents relied on Berlant to review the first Zohar financial statements and workpapers, which were based on the Ark financial statements formulated by Berlant in 2001. FOF ¶ 255.

Every month for many years, the financial statements for all three Zohar Funds were prepared by Respondents' internal accountants, utilizing information provided by the Trustee, and were reviewed and approved by Berlant. FOF ¶¶ 255-56, 264-67. The trial evidence established the pattern. In accordance with Patriarch's accounting manuals, the 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." DX 127 (Zohar I Patriarch Fund Accounting Manual) at PP122679; *see also* FOF ¶ 264. The accounting manuals specifically instructed that "Workpapers and Financial Statements are first sent to Peter Berlant at Anchin Block & Anchin (ABA) for comments." DX 127 at 122680; *see also* Tr. 1292:10-15 (Mercado) ("When we submit the financial statements to [Anchin] on a monthly basis, they provide a review of the financial statements. And our expectation is that they would provide any guidance with respect to accounting issues that they feel need to be addressed in the financial statements."). Respondents also provided Berlant with all of the relevant data relating to the financial statements. FOF ¶ 256. Berlant was "very familiar with the work papers and how they flowed," as he "ha[d] been reviewing them since the inception of every fund." Tr. 1126:17-20 (Mercado); *see also* Tr. 1027:4-5 (Berlant) ("I regularly received the work papers and I read the financial statements."). Only after Patriarch's F&A Department incorporated Berlant's comments were the papers submitted to Ms. Tilton for approval. DX 127 at PP122680.

Ms. Tilton, who is not a CPA, FOF ¶ 263, reasonably relied on her internal and external accountants to review the financial statements and ensure they complied with GAAP. FOF ¶¶ 264-69; *see also* Tr. 1144:10-13 (Mercado) ("Q. Did you take any steps, Mr. Mercado, to ensure the financial statements were prepared in accordance with US GAAP? A. Yes, that's part of my responsibility."); Tr. 1955:5-17 (Tilton) ("I would believe that if [Anchin] didn't think that these financial statements were in accordance with GAAP, then they would have advised me"). Indeed, Respondents introduced at least 25 emails, many of which were addressed to or copied Berlant himself, into evidence showing that, over a period of years, Ms. Tilton was repeatedly informed that Berlant "reviewed and approved," "signed off" on, or "blessed" the Zohar financial statements. RX 1768 (compilation of 19 emails between Patriarch's F&A Department and Ms. Tilton); *see also* FOF ¶¶ 266-67.

Berlant affirmatively told Patriarch that he "approv[ed]" the financial statements, and never "corrected" Patriarch's stated understanding that he was reviewing and approving the financial statements. FOF ¶ 267; *see, e.g.*, RX 1761 (Oct. 13, 2008 emails between Richard Buckley and Berlant) at 1-2 (Buckley asking Berlant, "does that constitute an approval from you on the overall financial statements?" Berlant replies to Buckley, "As long as the few changes were made . . . the answer is yes."); Tr. 979:19-22 (Berlant) ("Q. And that line, where she asks you to review it, you don't write back and say, Kim, I'm not doing the kind of review you're talking about. A. That's correct.").

The evidence also showed that Ms. Tilton would not sign the financial statements unless and until Berlant had reviewed and approved them. FOF ¶ 268; *see also* Tr. 1074:12-16 (Berlant) ("Q. And what needs to happen before the financials go to the trustee, to the best of your knowledge? A. I read them, I comment on them. Then whomever at Patriarch goes through their process, ultimately to Lynn, who then goes through her process before signing."); Tr. 1292:5-7 (Mercado) ("Q. And has Ms. Tilton ever signed that officer certificate without Mr. Berlant's review? A. Not to my knowledge."). Ms. Tilton testified, "I don't believe I ever agreed to sign without his approval," because "I'm not a CPA. I wasn't building the financial statements myself. I expected Peter [Berlant] and his expertise, along with my people, to make certain that when I sign this, that it was in accordance with my responsibilities and my standard of care." Tr. 2269:18-2270:2. To Ms. Tilton, Berlant's review "was that extra layer that I expected after my people had done their work to make certain that everything was as it should be before I affixed my signature." Tr. 2270:3-6.[61]

Berlant routinely provided GAAP advice to Respondents on other issues, such as the interpretation of accounting standards promulgated by the Financial Accounting Standards Board

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[61] In addition, Ms. Tilton's longstanding personal relationship with Berlant gave her every indication that he was worthy of trust and confidence. FOF ¶ 272. For example, Berlant was an advisor to Ms. Tilton on the establishment of a trust for her daughter, meeting one-on-one with Ms. Tilton's daughter and telling Ms. Tilton that he "truly care[d]" for Ms. Tilton's family. 1036:18-1038:22. Berlant was also Ms. Tilton's expert witness in a malpractice suit against her prior accountant. Tr. 1033:14-1034:7 (Berlant).

("FASB"). FOF ¶ 257; *see also, e.g.*, RX 60 (Feb. 16, 2009 email from Berlant to Chris Denune) (addressing FAS 157 and FIN 48); RX 64 (Nov. 17, 2009 email chain between Berlant and Chris Denune) (addressing FAS 165); RX 1256 (Feb. 28. 2006 email from Kimberly Sturkey to Ms. Tilton) (addressing FAS 150). When Berlant proposed "[a]dditional language [be] added to the [financial statement] fair value disclosures . . . pursuant to FAS 157," RX 61 (Feb. 16, 2009 email from Chris Denune to Ms. Tilton), Respondents relied on his advice in good faith and added the language, *see* Tr. 1296:11-12 (Mercado) ("Q. And did Patriarch rely on his advice? A. Yes, we did."); Tr. 2491:2-4 (Tilton) ("Q. Did you follow the advice that Mr. Berlant gave on this point? A. Yes."). Respondents also sought and received accounting advice from Berlant on GAAP issues relevant to the Zohar financial statements, including interest accruals, carrying value, tax, and accounting for preferred stock conversion. FOF ¶¶ 258-60; *see also, e.g.*, RX 1260 (Dec. 15, 2008 email from Chris Denune to Berlant); RX 1263 (Dec. 14, 2009 email from Mercado to Berlant) (addressing carrying value); RX 1271 (May 13, 2002 email from Berlant to Ms. Tilton); RX 1741 (Jan. 23, 2004 email from Kimberly Sturkey to Berlant, copying Ms. Tilton) (addressing tax); RX 1776 (Mar. 15, 2010 email chain between Berlant and Mercado) (addressing interest accruals); RX 1777 (Mar. 31, 2010 email chain between Chris Denune and Berlant, copying Mercado) (addressing preferred stock conversion).

The Division attempted to question Respondents' reliance on Berlant, pointing to a single paragraph of standard disclaimer language in a 2007 engagement letter between Berlant and Ms. Tilton. That document was signed six years into the relationship—six years after the inception of the relationship and for which time the Division produced no engagement letter—where course of performance was already well-established; it stated that Anchin would "take no responsibility regarding the accuracy or completeness of such statements, computation or data or whether such statement or data comply with generally accepted accounting principles." Div. Prehearing Br. 20 n.16 (quoting DX 34 (July 1, 2007 Engagement Letter) at ABA-000009). It is ludicrous to claim that standard disclaimer language in an engagement letter signed years after the inception of the parties' relationship means that Respondents could not reasonably rely on the GAAP advice embodied in the very financial statements that Berlant has created and reviewed for years. The Division's attack also conveniently ignored the very next paragraph of the letter, which states that Anchin "shall provide such Business and Finance Advice as [Patriarch] may specifically request," and that "[s]uch advice may include . . . advice relating to the interpretation of accounting issues." DX 34 at ABA-000010. The course of conduct that existed before, during, and after the time this engagement letter was signed, whereby Berlant repeatedly reviewed and approved the Zohar financial statements and provided GAAP guidance and substantive accounting advice to Respondents, is consistent with the latter paragraph and was likewise ignored by the Division. *See* FOF ¶ 270.

All these facts provide the clearest possible evidence that Ms. Tilton and the other Respondents did rely on Berlant, and over the course of a 15-year close relationship, had every reason to do so. *SEC v. Jensen* confirms that this evidence of Ms. Tilton's reliance on professional advice precludes a finding of negligence. 2013 WL 6499699 (C.D. Cal. Dec. 10, 2013), *vacated on other grounds*, 2016 WL 4537377 (9th Cir. Aug. 31, 2016). In that case, the Division brought several federal securities claims, including under Sections 17(a)(2) and (3), which include negligence standards. *Id.* at *27-29. The Division argued that "scienter [was] present because Defendants recognized revenue in ways that were either in contravention of GAAP and/or misleading . . . ." *Id.* at *28. 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.[62] The same is true here.

3. The Division Failed To Rebut Respondents' Advice-Of-Experts Defense.

The Division failed to introduce any credible evidence to rebut Respondents' advice-of-experts defense. Berlant falsely testified that for 15 years he had only a "very administerial" role, reviewed the financial statements only for "silly mistakes" and "clerical errors," and charged Patriarch $600 per hour to serve merely as an "expensive clerk." Tr. 775:23, 759:20-21, 849:18, 935:6-14 (Berlant); *see also* FOF ¶ 261. He also claimed that he did not know Patriarch's accounting policies (which he had helped draft), never considered the purpose of the financial statements or whether they complied with GAAP, did not know the financial statements were sent to Noteholders, did not even know why the financial statements were generated at all, and proposed language for inclusion in financial statements without "satisfy[ing] [himself] that [the] statement was true." Tr. 893:24-894:3, 936:5-10, 937:22-24, 1005:13-19, 1081:12-22. The contemporaneous documentary evidence proved the falsity of that testimony. *See, e.g.*, FOF ¶¶ 257-60; 266-67. Berlant in fact regularly provided substantive GAAP and accounting advice, and he had extensive and longstanding involvement in Patriarch's accounting practices.[63] If the

[62] Other cases have reached the same result on facts similar to those established here at trial. *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).

[63] Berlant also falsely testified that it "did not cross [his] mind" that he could be a target of the SEC, even though he brought three attorneys when he testified before the SEC in 2014, and conceded that Anchin had notified its malpractice carrier about the SEC investigation. FOF ¶ 271.

stakes were not so high for Respondents, Berlant's transparently false testimony would be laughable.

C. The Division Did Not Satisfy Its Burden Of Proving Scienter Or Negligence With Respect To The Zohar Financial Statements.

Even if Respondents had not established reasonable reliance on the advice of professionals, the Division did not satisfy its own burden of proving scienter (or even negligence). *See* COL ¶¶ 81-83. The Division's claim that Ms. Tilton "certified the financial statements, knowing that she applied her own standards for impairment without regard to standards prescribed by U.S. GAAP," Div. Prehearing Br. 32, was roundly refuted at trial. Ms. Tilton consistently and credibly testified that Respondents "believed that these [financial statements] were [prepared] in accordance with GAAP" and "still believe they're in accordance with GAAP." Tr. 2737:24-2738:1 (Tilton); *see* FOF ¶¶ 273-76. Mercado also testified that the financial statements prepared by his F&A Department complied with GAAP. FOF ¶ 274; *see* Tr. 1356:17-18 (Mercado) ("Q. In your opinion, they do comply with GAAP? A. That's correct."). And the Division failed to introduce any evidence that *any* Patriarch employee or advisor did not believe that the financial statements complied with GAAP, or was in any way negligent as to the preparation of the financial statements.

This should come as no surprise, because Respondents reasonably relied on their external accountants at Anchin to provide GAAP guidance and to review and approve the financial statements on a monthly basis for over 15 years. *See supra* Pt. II.B. Respondents' trust and confidence in their external accountants is rooted in their deep and longstanding relationship with Anchin and Berlant. It was eminently reasonable for Ms. Tilton to "certainly expect[] that [Anchin] would guide [her] properly, as they did at the beginning along the way, if anything changed." Tr. 1956:23-25 (Tilton).

In an improper "gotcha" gambit, the Division alleged that Patriarch's removal of certain GAAP-related language from the Zohar financial statements in early 2015 was an admission that the statements had not been prepared in accordance with GAAP. Div. Prehearing Br. 22. The Division, however, omitted the crucial context in which these changes to the financial statements were made: As Ms. Tilton testified, Patriarch removed the financial statements' references to GAAP in 2015 "out of respect" for the SEC, in response to the SEC's suggestion that it would like her to do so. FOF ¶ 276. Respondents, however, "didn't change how [they prepared] the financial statements. [Respondents] believed that [they] had done them correctly, and that they actually gave the most accurate performance of the fund. [They] still believed they were in accordance with GAAP." Tr. 2597:22-2598:2 (Tilton).

The Division promised that its expert, Henning, would "explain at the hearing, the fact that the financial disclosures eliminated these references to U.S. GAAP compliance . . . is an acknowledgement by the Respondents that the prior reporting departed from U.S. GAAP." Div. Prehearing Br. 22. During cross-examination, though, Henning conceded that his conclusion that the financial statement modifications were an admission of error was not an accounting-based opinion but, rather, based on his own purported "belief as to what the change represents." Tr. 1393:9-10 (Henning); *see also* FOF ¶¶ 304-05. Moreover, as he acknowledged, Henning's "belief" was dependent on the Division's failure to apprise him of the relevant facts: He testified that he was never made "aware of the fact that in December 2014 . . . the Enforcement staff said that, in their view, the current form of the financial statements constituted ongoing violations, and . . . needed to be addressed if the matter could ever be resolved." Tr. 1426:20-1427:8 (Henning). With Henning's "expert" opinion on the modifications to the financial statements completely discredited, the Division was unable to proffer any evidence of scienter. A company's good faith efforts to appease a regulator are generally called cooperation; here, the Division seeks to miscast such good faith efforts as scienter. This is simply wrong, and should not be countenanced.

D. The Challenged Certifications Were Immaterial To Noteholders.

Even if the financial statements did not comply with GAAP (they do), and even if there were no advice-of-experts defense (there is), the financial statements charge should be dismissed for the independent reason that the Division failed to carry its burden of demonstrating the materiality of the challenged certifications. *See* COL ¶¶ 84-88. "In assessing the magnitude of alleged GAAP violations, one needs to look to see if the violations were 'minor 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)); *see also Brandt, Kelly & Simmons, LLC*, 2005 WL 1584978, at *8 (Division bears burden of proving materiality). Here, the purported GAAP violations were technical in nature and did not change the total mix of information available to Noteholders, as the Division's Noteholder witnesses themselves testified.

The financial statements were immaterial as a whole. The evidence established that Noteholders looked at the Trustee Reports, not the financial statements, to evaluate the performance of the Zohars. Noteholder witness Aldama agreed that he "had never once looked at the financial statements" and "had never discussed [them] with anyone" in the years prior to his investigative testimony. Tr. 1547:15-25 (Aldama); *see also* FOF ¶ 278. And Ms. Tilton testified without contradiction that she "never got one question by anyone over 15 years on these financial statements . . . not the trustee, not the Rating Agency, not the noteholders." Tr. 1981:2-8 (Tilton); *see also* FOF ¶ 279. The financial statements were simply not important sources of information in light of the Trustee Reports, which contained significantly more detailed information.[64]

Nor did the Division introduce any evidence that the specific GAAP certifications and notes at issue were material. To the contrary, Noteholder witness Aniloff, for example, agreed that "the representations that financial statements were GAAP compliant were not important" to him. Tr. 375:9-12; *see also* FOF ¶ 278. It is thus unsurprising that neither Aniloff, nor any other Noteholders (nor the Rating Agencies, nor the Trustee) asked any questions or raised any objections when, in a show of respect for the SEC, Respondents removed the GAAP certifications from their financial statements. Tr. 2598:6-18 (Tilton); FOF ¶ 279. None of the Noteholders altered their behavior in response to the presence or absence of a GAAP certification in the financial statements, nor did any Noteholder testify that it would have made different investment decisions had there been no GAAP certifications all along.

Although two of the Division's three Noteholder witnesses acknowledged that the financial disclosures, and the GAAP certifications within them, were not important in light of the more detailed Trustee Reports, the Division did manage to find one Noteholder, Mach, who claimed to have held a different view. Tr. 618:3-621:9. But Mach's testimony was absurd and hardly a reliable indicator of whether the "reasonable investor" would have found the alleged GAAP improprieties altered the "'total mix' of information available to investors." *Stein*, 1999

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[64] The Indentures set forth dozens of detailed categories of information that were required to be, and were, included in the Trustee Reports. *See, e.g.*, Indenture § 10.13(a) & (b) (detailing 90 specific required categories); FOF ¶ 277. Yet the Indentures included *no* specific requirements on the contents of the financial statements or even a requirement that the financial statements be audited. 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. *See* FOF ¶ 277.

WL 756083, at *11 (quoting *Basic Inc.*, 485 U.S. at 231-32). Mach admitted to having never even bothered to look at the interest payment cash flows in the Trustee Reports—the disclosures that were key to following the progress of the investments—and instead supposedly preferred to rely on the far less detailed information in the financial statements and his own understanding of GAAP. *See, e.g.*, Tr. 618:3-621:9, 692:02-693:01 (Mach). Mach's self-interested testimony was entirely unreasonable and does not support any inference about relevant issues. In short, the Division failed to carry its burden of proving that the absence of GAAP-compliance certification, or revisions to the impairment and fair value notes, would have made any difference in the behavior of any Noteholder, given the information actually presented in the financial statements, Trustee Reports, Indentures, and Noteholder communications.[65]

Finally, the Division failed to demonstrate that Ms. Tilton possessed the requisite scienter as to materiality—in other words, that Ms. Tilton believed that Noteholders considered the GAAP certifications important, or was at least grossly reckless as to whether Noteholders considered them important. *See ECA & Local 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co.*, 553 F. 3d 187, 202-203 (2d Cir. 2009); *Snyder*, 292 F. App'x at 399-400 (5th Cir. 2008) (citing *Fine*, 919 F.2d at 297). Ms. Tilton, along with Mercado and Respondents' expert Lundelius, not only believed and continue to believe in good faith that the financial statements

[65] *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, "the violations [we]re not material"). 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).

comply with GAAP, but also that the Noteholders, who never once asked a question about the financial statements over the course of 15 years, did not deem the financial statements important in light of the total mix of information available to them. *See* Tr. 1981:2-8 (Tilton); Tr. 1356:14-18 (Mercado); FOF ¶¶ 226, 236, 273-76.

III. The Unconstitutionality Of These Proceedings And The Division's Litigation Misconduct Each Present Independent Reasons To Dismiss The Charges.

A. The Denial Of Respondents' Constitutional Rights Presents An Independent Basis To Dismiss.

Respondents have previously argued, and continue to assert, that this proceeding violates their constitutional rights in several critical respects. *See* COL ¶¶ 110-127; FOF ¶¶ 344-55.

- The SEC's internal administrative tribunals, including this one, are facially unconstitutional under the Appointments Clause of Article II of the U.S. Constitution.[66]

- This forum violates Respondents' due process rights by, *inter alia*, requiring enforcement cases to be tried to an initial decision in an unduly limited timeframe regardless of their complexity; insisting that the SEC need not specify salient factual allegations in the OIP; denying Respondents a meaningful opportunity to gather information from key witnesses; interpreting in overly narrow terms the Division's obligation to turn over exculpatory materials; approving the Division's improper use of experts to introduce legal conclusions; and admitting hearsay and other forms of unreliable evidence.[67] *See* FOF ¶¶ 302-03, 306, 327, 335, 344-55, App'x B.

- To the extent recent amendments to the Commission's Rules of Practice were not deemed applicable to Respondents in this proceeding, the Commission's failure to apply all of the amended Rules to Respondents and those similarly situated violates Respondents' equal protection rights.[68]

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[66] *See, e.g.*, Complaint for Declaratory and Injunctive Relief and Demand for Jury Trial, *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); Complaint for Declaratory and Injunctive Relief and Demand for Jury Trial, *Tilton v. SEC*, No. 16 Civ. 07048 (S.D.N.Y. Sept. 9, 2016).

[67] *See* sources cited *supra* n.66.

[68] *See* sources cited *supra* n.66.

Numerous erroneous rulings in this particular proceeding manifest the lack of due process characteristic of this forum. *See* COL ¶¶ 92-95, 113-24. Respondents incorporate by reference and reiterate all of the written and oral motions they have made throughout this proceeding that have been denied in whole or in part. These erroneous rulings, which are listed more fully in Appendix B, include:

- Admission of testimony elicited by the Division concerning the legal conclusions of its unqualified "experts." App'x B at 4-6; FOF ¶¶ 302-03, 306, 327, 335.
- Admission of irrelevant testimony concerning "accrued interest" allegations not contained in the OIP. App'x B at 8; *see also, e.g.*, FOF ¶ 354.
- Failure to timely conduct *in camera* review of documents improperly withheld by the SEC's Office of Litigation and Administrative Practice. App'x B at 2.
- Failure to compel production of improperly withheld documents, on the ground that witnesses to whom the documents relate had already testified. *Id.* at 3.
- Denial of the request to dismiss the charges based on the Division's litigation misconduct, on the ground that an ALJ does not have such authority. *Id.* at 3.

The lack of due process manifested in these and other erroneous rulings addressed in Appendix B presents an independent basis for dismissal.

B. Division's Litigation Misconduct Presents An Independent Basis To Dismiss.

The Division has engaged in significant misconduct throughout its investigation of Respondents and this proceeding. Such misconduct should provide grounds to dismiss the charges against Respondents pursuant to Rule 111, just as a "district court may dismiss an indictment on the ground of outrageous government conduct" under its "supervisory powers" even "[i]f the conduct does not rise to the level of a due process violation." *United States v. Chapman*, 524 F.3d 1073, 1084 (9th Cir. 2008) (affirming dismissal for misconduct) (citation omitted); *see* COL ¶¶ 99-109. Respondents accordingly incorporate by reference and reiterate their written and oral motions to dismiss for prosecutorial misconduct, for all of the reasons explained therein, including:

- *Untimely and deceptive partial disclosure of engagement of Anchin in another SEC enforcement action.* Four days after Respondents' external accountant, Berlant, testified, the Division disclosed that Berlant's accounting firm, Anchin, has been working for the Division in another matter since May 2016, for a fee of $366,000. In making this belated disclosure, Division counsel failed to disclose that the other matter is *their* prosecution, which made their initial failure to disclose difficult to justify as an oversight. The Respondent in the other case was advised of Anchin's involvement—weeks earlier. FOF ¶ 350; Letter from Respondents to ALJ Foelak (Oct. 31, 2016); Tr. 1443:24-1491:8.

- *Failure to disclose Anchin emails.* The Division produced to Respondents only two Anchin emails, in response to a subpoena seeking seven years of Zohar-related emails, despite Berlant's testimony on cross-examination that he had reviewed responsive documents in his files, he had withheld nothing for privilege, and that "likely, yes," he had provided more than that to the Division. FOF ¶ 353; Tr. 924:25-925:15, 927:25-928:3 (Berlant); RX 1275 (Apr. 22, 2014 Division subpoena to Anchin).

- *Improper collusion with MBIA.* The Division provided MBIA confidential, non-public information produced by Respondents during the Division's investigation, in exchange for MBIA's cooperation with this investigation, on the condition that MBIA not reveal that it received the information from the Division. *See* FOF ¶ 352; RX 515 (Dec. 18, 2013 email from Amy Sumner to Susan DiCicco).

- *The Division's unwillingness to create and provide investigative record.* Several of the Division's trial witnesses are not mentioned anywhere in the investigative record, and the Division conducted the vast majority of its witness interviews off-the-record. Even where interview notes were taken, the Division's lawyers refused to produce them. *See, e.g.*, FOF ¶ 348; Tr. 901:12-22 (Berlant).

- *Undisclosed role of allegedly independent expert witnesses in developing the Division's theory.* The Division presented Mayer as an independent expert witness, but on cross-examination, Respondents elicited that Mayer had assisted the Division during the investigation in developing its theory of the case. *See* Tr. 438:25-439:6. Division experts Wagner and Henning were likewise retained pre-OIP yet presented as independent experts. *See* Tr. 2822:16-2823:7 (Wagner); Tr. 1393:11-20 (Henning); FOF ¶¶ 307-08, 323, 346, 351.

The Division's misconduct in this proceeding has been the result, "at best, [of their] sloppy investigative work or, at worst, [of] their knowing failure to meet constitutional duties," *United States v. Lyons*, 352 F. Supp. 2d 1231, 1252 (M.D. Fla. 2004) (dismissing charges), and easily warrants dismissal of the charges against Respondents.

IV. If Respondents Were To Be Found Liable, Any Significant Sanctions Would Not Be Appropriate.

The Division has failed to satisfy its burden of proof on any of its charges. Although Respondents fervently believe there is no valid basis to rule otherwise, if Your Honor does, the Division has vastly overreached in asking for some of the most severe sanctions in SEC history: a permanent bar on Ms. Tilton and Patriarch from the securities industry and over $200 million in disgorgement. These sanctions, or sanctions of any severity, are simply inappropriate on the evidence adduced here. *See* COL ¶¶ 128-54.

The determination of appropriate sanctions turns in part on "[t]he public interest analysis," *F.X.C. Inv'rs Corp.*, Admin. Proc. Rulings Release No. 218, 2002 WL 31741561, at *14 (ALJ Dec. 9, 2002), based on the factors set forth in *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd*, 450 U.S. 91 (1981). Those factors include:

> (1) the egregiousness of the respondents' actions; (2) the isolated or recurrent nature of the infractions; (3) the degree of scienter involved; (4) the sincerity of the respondents' assurances against future violations; (5) the respondents' recognition of the wrongful nature of their conduct; and (6) the likelihood that the respondents' occupation will present opportunities for future violations.

F.X.C. Inv'rs Corp., 2002 WL 31741561, at *14 (quoting *Steadman*, 603 F.2d at 1140). The Division "has a greater burden to show with particularity the facts and policies that support th[e] sanctions [it seeks] and why less severe action would not serve to protect investors." *Steadman*, 603 F.2d at 1137. The severe sanctions the Division seeks here are wholly unjustified in light of these factors, and each would disserve the public interest.

A. A Permanent Bar On Ms. Tilton's Involvement In The Securities Industry Would Be Inequitable And Ill Serve The Public Interest.

In seeking to bar Respondents from the securities industry, the Division has asked Your Honor to impose one of "the most drastic remedies at [the Commission's] disposal." *Steadman*, 603 F.2d at 1137. An industry bar is simply not appropriate where, as here, there is no scienter. *See, e.g.*, *Valicenti Advisory Servs., Inc.*, Initial Decision Release No. 111, 1997 WL 362000, at *19 (ALJ July 2, 1997) (Foelak, J.) ("revocation and suspension" sanctions are "excessively harsh" where respondents acted without scienter), *rev'd on other grounds by* Advisers Act Release No. 1774, 1998 WL 798699 (Comm'n Nov. 18, 1998), *aff'd*, 198 F.3d 62, 63 (2d Cir. 1999); *see also Steadman*, 603 F.2d at 1141 ("It would be a gross abuse of discretion to bar an investment adviser from the industry on the basis of isolated negligent violations."). Respondents believed that their categorization strategy was permitted (indeed mandated) by the Indentures, and it was disclosed and known to all. *See supra* Pts. I.A-B, I.D. They believed that their financial statements were accurate, and issued them in reliance on a well-respected outside accountant. *See supra* Pts. II.A-C. Even if Your Honor finds a violation of the Advisers Act, the complete absence of any evidence of ill motive is dispositive of the request for any bar, let alone a permanent bar.

The other *Steadman* factors also weigh heavily against an industry bar. Respondents' unflagging efforts to increase value to the Zohars and the Noteholders—even putting hundreds of millions of dollars of their own money into the Zohars and the Portfolio Companies—demonstrates that their conduct was anything but egregious. *See* FOF ¶¶ 193-96, 206, 208, 211-18. And given that Respondents are charged with a single categorization error (albeit one that played out over the course of several years), there are no recurrent infractions. Moreover, Respondents are sincere in their assurances against future violations. *See* Tr. 3139:5-13

B. Any Monetary Sanction—And Certainly A Significant One—Would Disserve The Public Interest.

The Division's requested disgorgement figure of more than $200 million plus civil penalties is outlandishly large and incommensurate with the charges against Respondents. Disgorgement is "an equitable remedy," *SEC v. Spongetech Delivery Sys. Inc.*, 2015 WL 5793303, at *5 (E.D.N.Y. Sept. 30, 2015), and it would be manifestly inequitable to award a significant monetary penalty on the facts adduced here.

As with the permanent bar, a "lack of scienter" is a mitigating factor that can render inappropriate a "significant money penalty." *Terry T. Steen*, Initial Decision Release No. 107, 1997 WL 104603, at *11-12 (ALJ Mar. 7, 1997) (Foelak, J.); *see also SEC v. Mannion*, 28 F. Supp. 3d 1304, 1311 n.8 (N.D. Ga. 2014) (good faith "is an independent factor the Court must consider in determining remedies" in a Section 206 case). Similarly, the *Steadman* public interest factors apply to all monetary penalties sought by the Division. *See, e.g.*, *Timbervest, LLC*, Initial Decision Release No. 658, 2014 WL 4090371, at *64 (ALJ Aug. 20, 2014) (considering whether "the *Steadman* factors weigh in favor of ordering disgorgement"); *Michael A. Horowitz*, Initial Decision Release No. 733, 2015 WL 77529, at *31 (ALJ Jan. 7, 2015) (same); *Terry T. Steen*, 1997 WL 104603, at *11-12 (applying *Steadman* factors to civil penalties analysis). For the same reasons that an industry bar is unwarranted here, *see supra* Pt. IV.A, the monetary remedies sought by the Division are completely inappropriate.

C. The Division's Disgorgement Figure Is Based On Inaccurate Calculations And Is Offset Entirely By Respondents' Substantial Transfers To The Zohars.

The standards governing a disgorgement amount are well-established. "Because disgorgement does not serve a punitive function, the disgorgement amount may not exceed the amount obtained through the wrongdoing." *SEC v. Contorinis*, 743 F.3d 296, 301 (2d Cir.

CONCLUSION

For the foregoing reasons, the Division has failed to meet its burden of proving the charges set forth in the OIP, and Your Honor should issue an initial decision finding Respondents not liable.

Dated: New York, New York
December 16, 2016

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APPENDIX A

In the Matter of Lynn Tilton et al.

Administrative Proceeding File No. 3-16462

December 16, 2016

The Division's False Statements in Summation

I. Categorization

II. Financial Statements

I. Categorization

II. Financial Statements

THE DIVISION'S FALSE STATEMENT:

Noteholders "didn't know what Ms. Tilton was doing."

Tr. 3646:24-25 (Div. Summation)

THE TRUTH: Noteholders Admitted Lynn Tilton "Disclosed" Her Approach to Loan Categorization

David Aniloff
SEI

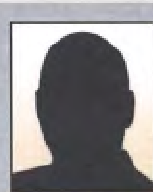
Q. Was that categorization approach disclosed to you as an investor in the Zohar bonds?

A. If you mean by "disclosed," was it in the offering memorandum and indenture, yes.

Q. And how so?

A. . . . . [Section 7.7(a)] does state that the collateral manager has discretion on amendments and this section. It goes through all the detail around that. But, yes, it's in there.

Tr. 146:16-147:2 (Aniloff)



David Crowle
MBIA

"I'm sure there was some objectivity to how a loan is classified as one of those buckets. But I would also strongly believe that there is a lot of subjectivity to them as well. . . . That's just how I remember the categories for the deal; that they were subject to how you would define the transition, if there is a transition, from a 1 loan to it becoming a 4."

Tr. 2776:23-2777:6 (Tilton) (quoting DX 197)

Anthony McKiernan
MBIA

"Category 4s is anything that was, my words, still breathing. But there was an opportunity for the manager to inject some kind of life in it operationally or otherwise. . . . [I]n a general fashion I would say that's the explanation you get [from Ms. Tilton]."

Tr. 2907:25-2908:14 (Wagner) (quoting DX 198)

THE DIVISION'S FALSE STATEMENT:

If an interest payment does not meet the amount on the face of a loan agreement, the loan "should not be categorized as performing and shouldn't be carried at its full par value."

Tr. 3653:9-11 (Div. Summation)

THE TRUTH: Even Noteholder Witnesses and the Division's Own Experts Admitted That Lynn Tilton Had Discretion Under the Indenture "to Amend Loan Agreements," Thereby Keeping Portfolio Companies "in Compliance with [Their] Loan Obligations" and in Category 4 as Performing Loans

Jaime Aldama
BARCLAYS

Q. You understood that under Section 7.7(a), Ms. Tilton had the authority to amend?

A. . . . . She had some discretion to amend, yes.

Q. And if the loan agreements were amended, then the borrowers were in compliance with terms as amended, correct?

A. If she was able to amend, she could have gotten the compliance, yes.

Tr. 1634:1-13 (Aldama)

Ira Wagner
Division Expert

Q. Would you agree with me that Section 7.7(a) is a critical provision designed to give effect to the business strategy disclosed to investors?

A. I don't disagree. It gives her authority to amend and make changes to the loan.

* * *

Q. [If there were] a written amendment to the credit agreement, provide that a given interest payment that was due was deferred, then the loan would not have to be placed in Category 1?

A. If there was an amendment, . . . I agree, it would not have to be placed in Category 1.

Tr. 2948:8-12, 2949:22-2950:6 (Wagner); *see also* Tr. 3419:15-25 (Froeba) (confirming § 7.7(a) gave Lynn Tilton "very broad discretion to manage the portfolio)

THE DIVISION'S FALSE STATEMENT:

Lynn Tilton's Investigative Testimony Shows that She Based Categorization on Subjective Beliefs Alone, Rather Than on the Authority Granted to Her Under the Indentures.

Tr. 3654:9-3655:15 (Div. Summation)

THE TRUTH: The Division Reads a Snippet of Lynn Tilton's Investigative Testimony Out of Context; Lynn Tilton's Investigative Testimony Was Consistent with Her Trial Testimony and with Patriarch's Actual Strategy of Amending and Deferring Based on Her Reasonable Judgment

PATRIARCH PARTNERS

"That's part of my testimony. I know you're reading from my testimony in front of the SEC, because I've re-read it, and I know what I said. Just like today, I was asked that question multiple times. And what I have said consistently is, [categorizing a loan as a Category 1] is in part [based on my reasonable judgment]. Because if I believe in the reasonableness of a turnaround, if I believe that it will ultimately be better for the funds and the noteholders to support a company through its restructuring until it would be able to create value, then I amend. Then I do restructurings. Then I defer. So, yes, that plays into the actions I take and the discretion afforded to me consistent with the indentures, because that's what I am supposed to do as the collateral manager; use my reasonable business judgment to decide whether my strategy is to amend, to defer, to restructure, to forgive, to take equity, to take second liens. Because, in the end, I am maximizing the cash flows for the funds."

Tr. 1938:10-1939:4 (Tilton)

JUDGE FOELAK: It did seem to me, maybe a little different to you, that the quoted portion [of Ms. Tilton's investigative testimony] was more or less consistent with the way Respondents have described Ms. Tilton's discretion, you know, citing to Section 7.7, which is discretion.

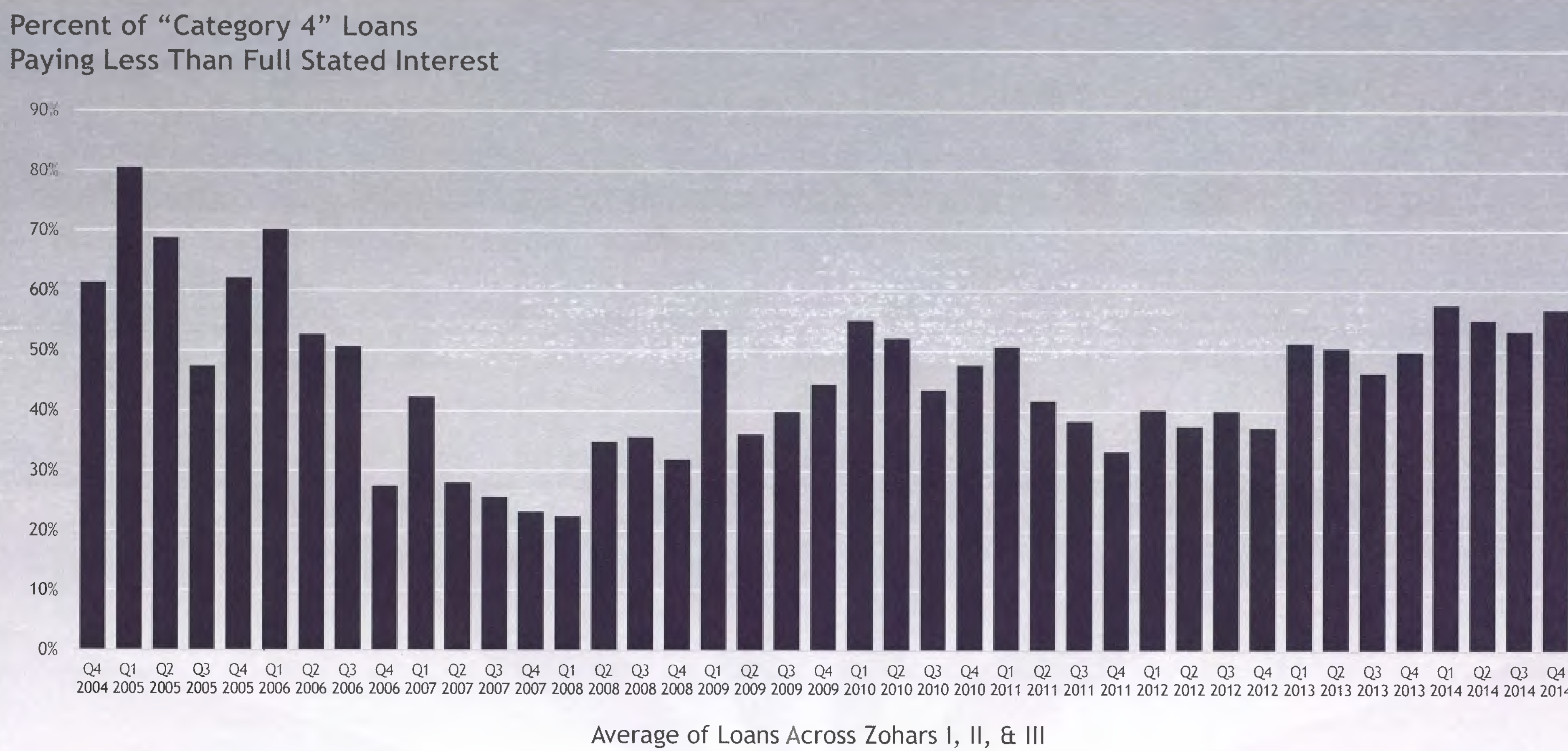
Tr. 142:12-16 (Aniloff)

THE DIVISION'S FALSE STATEMENT:

"[B]efore the financial crisis, many companies were, in fact, making their interest payments. . . . But then the financial crisis hit. Portfolio companies lost a significant amount of their revenues. Those companies started paying even less interest."

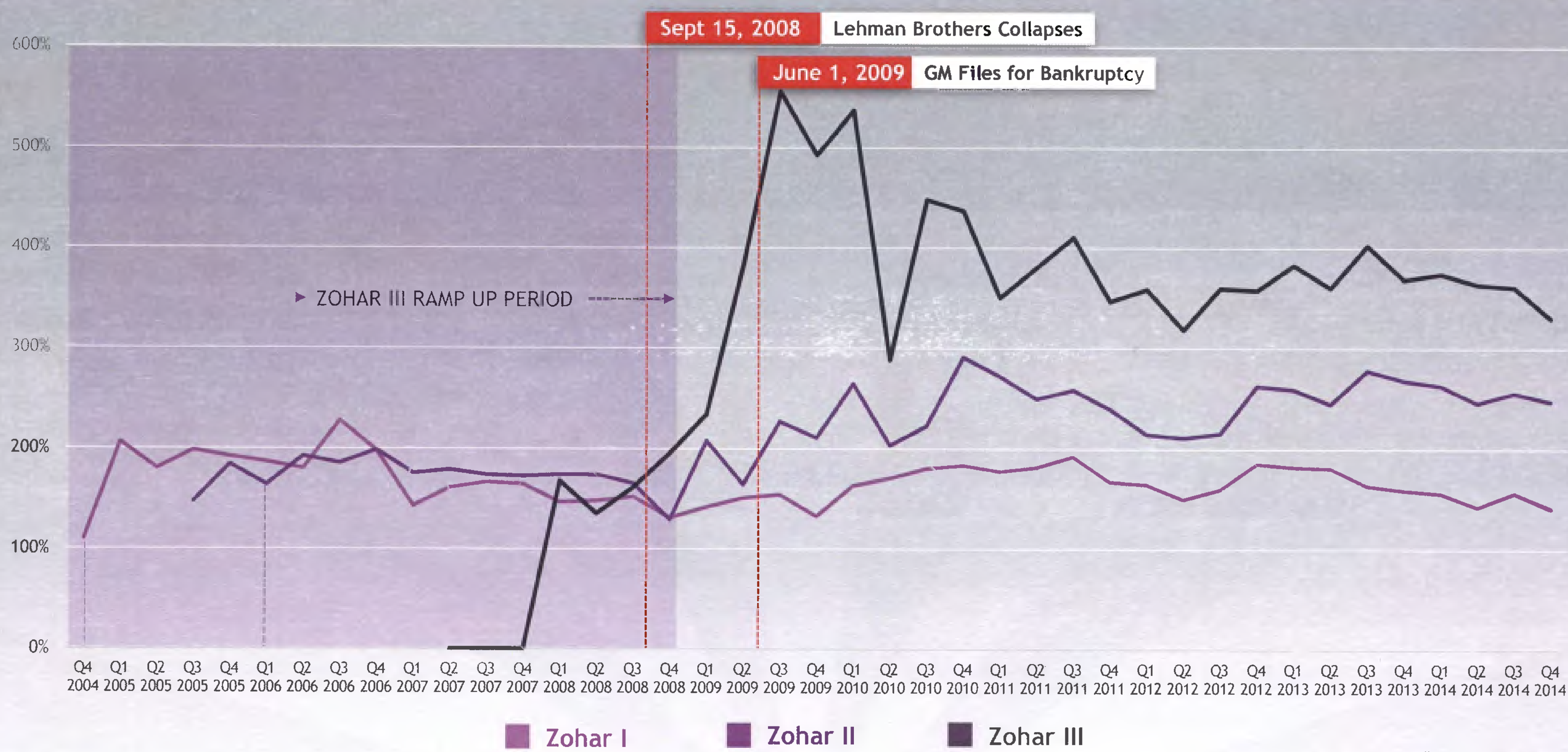
Tr. 3656:2-15 (Div. Summation)

THE TRUTH (Part 1): Lynn Tilton Consistently Amended and Deferred Interest Payments from 2004-2015



RX 573 at 20-22

THE TRUTH (Part 2): The Interest Coverage Ratio Remained Strong and Even Increased After the Financial Crisis



RX 573 at 20-22

THE DIVISION'S FALSE STATEMENT:

"Patriarch Itself Called [Accrued Interest] Past Due . . . ."

Tr. 3657:6-14 (Div. Summation); *see also* DX 156, 186, 187

THE TRUTH: Lynn Tilton Explained Several Times and Your Honor Correctly Noted that the "Past Due Interest from Prior Periods" Column to Which the Division Refers Displays <u>Accrued</u> Deferred Interest

PATRIARCH PARTNERS

"What [this column shows] is an accrual of deferred interest that I have not forgiven that is on its balance sheet and is deferred and accrued."

* * *

"I know you are reading from the column, but that would be a misstatement, because it's deferred and accrued. And it's not due and owing at the time; but it's the amount that was deferred and accrued that I have not forgiven."

Tr. 2055:19-21: 2056:16-20 (Tilton)

JUDGE FOELAK: Okay. We can take every time it says past due, it's being deferred and accrued.

Tr. 2056:25-2057:2 (Tilton)

THE DIVISION'S FALSE STATEMENT:

"The OC ratio is an - in Patriarch's words - an objective test score, because cash doesn't lie."

Tr. 3652:20-23 (Div. Summation)

THE TRUTH: **Lynn Tilton Explained that the Division Is "Mischaracterizing" the Evidence: The IC Test Is "the Only Cash Test," While the OC Test Uses "Discretionary Information" and Has "Subjective Element[s]"**

PATRIARCH PARTNERS

Q. [E]ven though you were using what you call your good-faith, reasonable business judgment to manage to the [OC ratio] test, you were representing to MBIA that this was an objective test, and that cash does not lie? That's right, isn't it?

A. You are mischaracterizing that. They are objective tests. But every one of them, except the interest coverage test, has discretionary information . . . . The other tests are objective tests. They're arithmetic formulas where every bit of its criteria has a subjective element in this deal where you can amend interest rate, maturity.

So, yes, there are objective tests with discretionary information, but not the interest coverage test as reported. That's where the cash -- that's the only cash test. Cash doesn't lie.

Tr. 1911:17-1912:23 (Tilton)

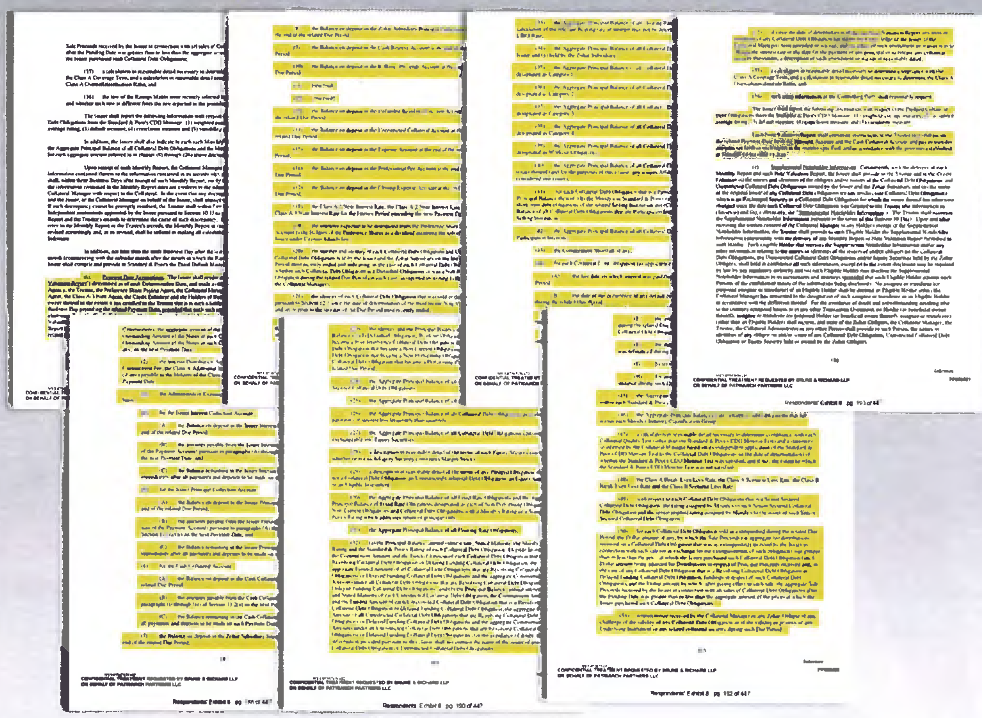
THE DIVISION'S FALSE STATEMENT:

"The trustee didn't have significant information in this deal. It wasn't their responsibility."

Tr. 3687:12-14 (Div. Summation)

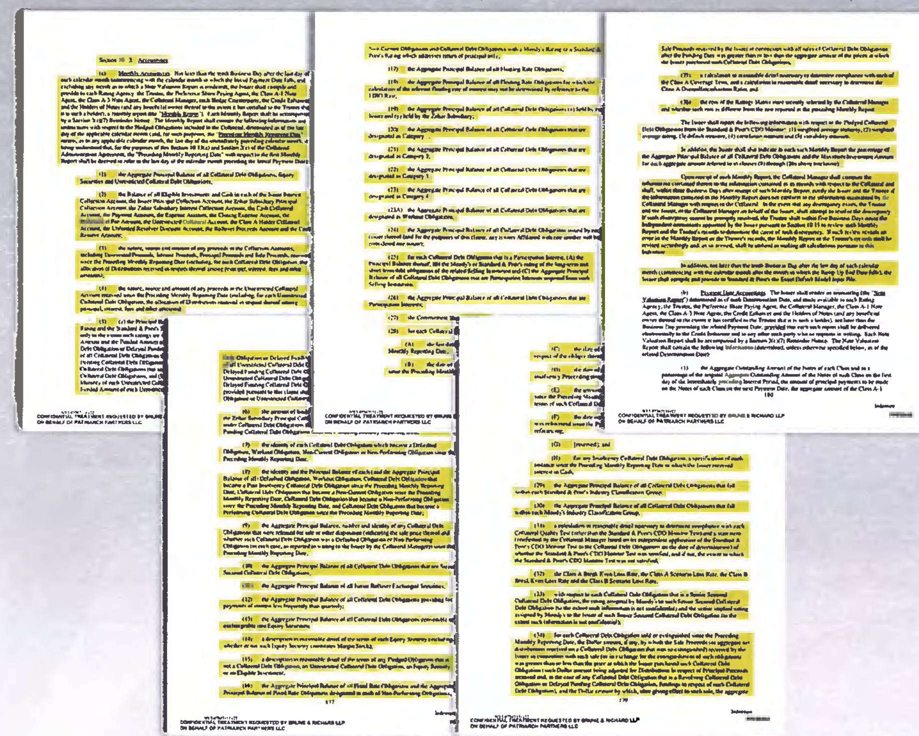
THE TRUTH (Part I): The Trustee Received Voluminous Information about the Performance of the Loans in the Deal—Including Interest Payments and Categorization—Which It Published In Trustee Reports, Pursuant to Its Fiduciary Duty

Requirements of Quarterly Reports Prepared and Issued by the Trustee (54 Discrete Calculations and Pieces of Information Regarding the Loans and Fund)



RX 8 at 187-93, Zohar II Indenture § 10.13(b)

Requirements of Monthly Reports Prepared and Issued by the Trustee (36 Discrete Calculations and Pieces of Information Regarding the Loans and Fund)



RX 8 at 183-87, Zohar II Indenture § 10.13(a)

THE TRUTH (Part 2): The Trustee Had Significant Duties and Responsibilities Under the Indentures and Collateral Administration Agreement, and Performed Substantive Review and Analysis

- The Trustee was responsible for independently calculating the OC Ratio. *E.g.*, RX 8 at 183-87; RX 11 at 7.
- The Trustee was responsible for collecting, calculating, and distributing all funds on behalf of the Zohars. *E.g.*, RX 8 at 196-207; RX 11 at 8-14.
- The Trustee was responsible for keeping track of all principal and interest payments actually paid by the Portfolio Companies, as well as the interest rates and maturity dates of the loans. *E.g.*, RX 11 at 2-3.
- 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. *E.g.*, RX 11 at 4, 6.
- The Trustee was responsible for calculating and distributing fees to Patriarch. *E.g.*, RX 8 at 196-207.
- The Trustee was required to send written notice to the Zohars and Patriarch and request payment from the Portfolio Company within three days if the Trustee did not receive a principal and interest payment when due. *E.g.*, RX 8 at 134.

THE TRUTH (Part 3): The Trustee was Fully Aware That Not All Loans Categorized as Performing (or Category 4) Were Paying Stated Interest

The Trustee was copied on noteholder and rating agency inquiries on this topic as well as Patriarch's explanations in response thereto

From: Frank Li <Frank.Li@PatriarchPartners.com>
Sent: Thursday, June 23, 2011 5:58 PM
To: <anand.sankaranarayanan@barclayscapital.com>; <thrisha.rose@usbank.com>
Cc: <becky.ng@usbank.com>; Karen Wu <Karen.Wu@PatriarchPartners.Com>; Frank Li <Frank.Li@PatriarchPartners.com>; <brand.hosford@usbank.com>

Interest may have been deferred for some of the borrowers.

The Indenture allows Patriarch Partners, as Collateral Manager, to restructure company's debt, delay or forgive a portion of the past due interest.

We have recently amended many of the credit agreements to lower interest rates to allow them to pay full interest or defer current due interest.

CONFIDENTIAL - FOIA TREATMENT REQUESTED

RX 117

From: Davis, Chris [mailto:christopher_davis@standardandpoors.com]
Sent: Tuesday, March 02, 2010 12:15 PM
To: Kruse III, Robert W

The obligors below are being treated as performing according to the latest trustee report. Would you please provide an explanation as to why they are not considered defaulted?

RX 492

I. Categorization

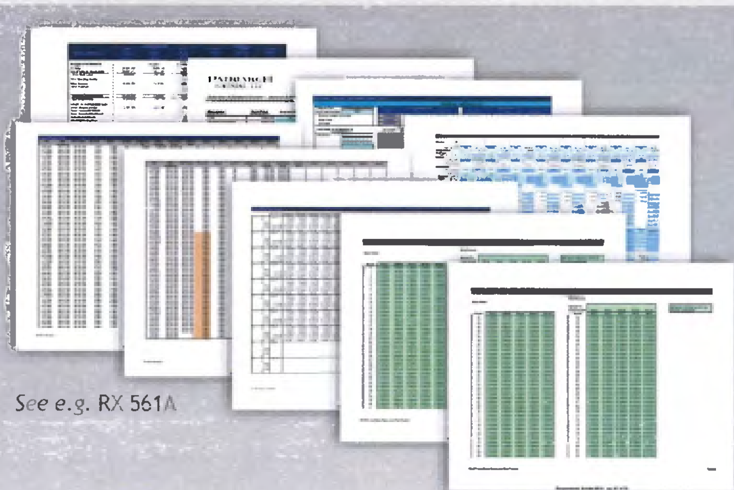
II. Financial Statements

THE DIVISION'S FALSE STATEMENT:

"There wasn't a fair value analysis done."

Tr. 3660:16-17 (Div. Summation)

THE TRUTH: Patriarch Regularly Conducted Fair Value Analysis



See e.g. RX 561A

See, e.g., RX 487, 557

Charles Lundelius
Berkeley Research Group

"I found this contemporaneous evidence that . . . showed the enterprise value was being assessed at least annually if not more frequently. And that given enterprise values, significantly above the loan levels, that an impairment analysis was, in fact, being done."

* * *

The documentation in Patriarch's files demonstrates that "there was a fair value analysis performed."

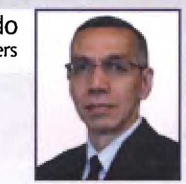
Tr. 3199:24-3200:5; 3305:13-14 (Lundelius)

PATRIARCH PARTNERS

Q. Who conducted this fair value analysis presented in Note 3?

A. I did, along with the structured finance team and the credit officers.

Tr. 1977:19-22 (Tilton) (discussing DX 11-B)



Carlos Mercado
Patriarch Partners

Q. [D]oes Patriarch, in fact, have a process in place for developing a fair value estimate?

A. Yes, we do.

Tr. 1274:9-11 (Mercado)

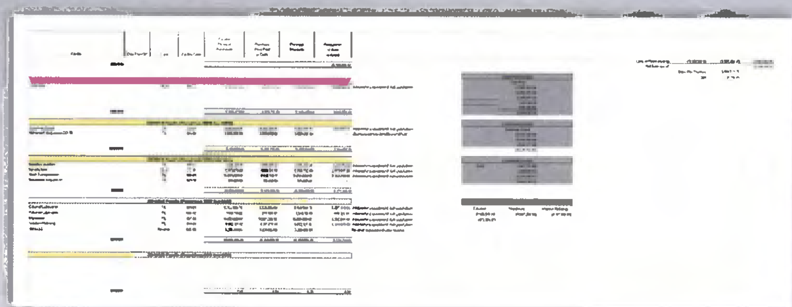
THE DIVISION'S FALSE STATEMENT:

"[T]here was no loan impairment analysis done."

Tr. 3661:25 (Div. Summation)

THE TRUTH: Patriarch Consistently Conducted GAAP-Compliant Impairment Analyses

Zohar III Financial Statement Work Paper, "Payoffs" Tab



See, e.g., DX 57

Charles Lundelius
Berkeley Research Group

"I also found evidence that they did perform various procedures at Patriarch that . . . supports, in fact, very much works together to show that there was an impairment analysis performed . . . ."

Tr. 3305:6-14 (Lundelius)

Carlos Mercado
Patriarch Partners

Q. So if we can scroll through [the payoffs tab of DX 57] . . . I see a $3.7 million figure in Column 8, "Recognition of Gain or Loss." What is that?

A. This is the portfolio company Ark II Manufacturing that was restructured. And in the restructure, it was determined that the overall loan was impaired and, as a result, we took a $3.7 million write-off on that borrower.

Tr. 1259:5-13 (Mercado)

PATRIARCH PARTNERS

"[W]e wrote down or impaired when we did something or there was an event, like a bankruptcy where we forgave debt, or restructuring where we forgave principal, and we impaired on that basis."

Tr. 1948:10-13 (Tilton)

T ISION'S FALSE STATEMENT:

"[Patriarch's] policy . . . that the loans aren't considered impaired until an event or sale occurs from which a loss can be conclusively determined. . . . doesn't comply with GAAP."

Tr. 3662:16-3663:1 (Div. Summation)

THE TRUTH: Accounting Expert Charles Lundelius Confirmed that "Conclusively Determined," as Used by Respondents' Internal and External Accountants in Fact "Fit" the GAAP Standard

Charles Lundelius
Berkeley Research Group

Q. [I]f it's probable, not conclusive, probable, and reasonably estimable, you don't write-off, you write-down, right?

A. No. You're talking about the same thing. If you . . . hit the probable standard, and you can conclusively determine some portion or all of a loan is impaired, you write-down that portion or all depending upon your findings.

JUDGE FOELAK: Yeah, the reasonably estimable could be 100 percent . . . or 5 percent.

* * *

Q. So then, in your opinion, in order for something to be probable, it need be conclusively determined? Is that your opinion?

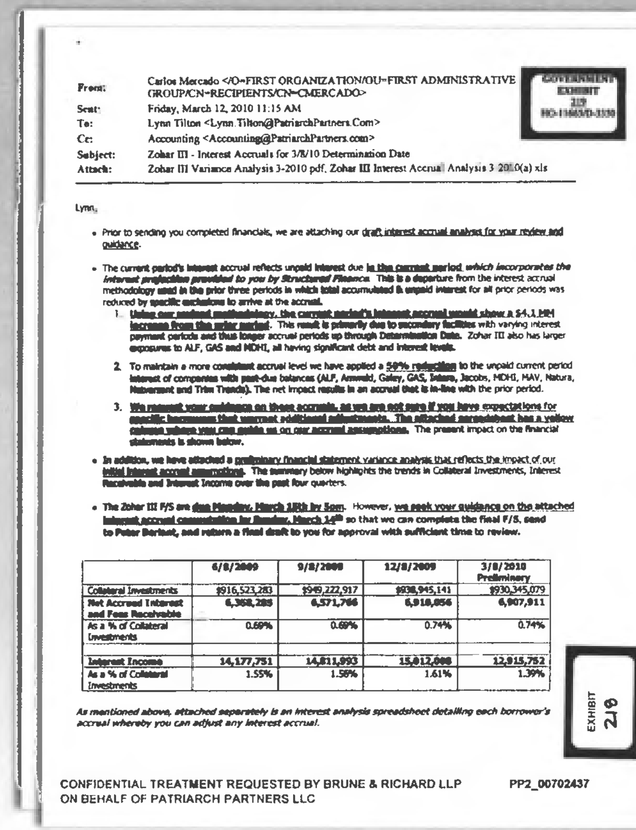
A. I find that the wording "conclusively determined" used here fit that standard. . . . I'm telling you that this does not seem to contravene GAAP.

Tr. 3215:12-3216:9 (Lundelius)

THE DIVISION'S FALSE STATEMENT:

An E-Mail From Carlos Mercado To Lynn Tilton Showed That Respondents Changed Their Methodology For Reporting The Amount of Unpaid Interest To "Keep It Concealed That There Was an Increasing Amount of Interest from Portfolio Companies That Wasn't Being Collected."

Tr. 3664:18-3665:24; *see also* DX 218



GOVERNMENT EXHIBIT

From:	Carlos Mercado </O=FIRST ORGANIZATION/OU=FIRST ADMINISTRATIVE GROUP/CN=RECIPIENTS/CN=CMERCADO>
Sent:	Friday, March 12, 2010 11:15 AM
To:	Lynn Tilton <Lynn.Tilton@PatriarchPartners.Com>
Cc:	Accounting <Accounting@PatriarchPartners.com>
Subject:	Zohar III - Interest Accruals for 3/8/10 Determination Date
Attach:	Zohar III Variance Analysis 3-2010 pdf, Zohar III Interest Accrual Analysis 3 2010(a) xls

Lynn,

- Prior to sending you completed financials, we are attaching our draft interest accrual analysis for your review and guidance.
- The current period's interest accrual reflects unpaid interest due in the current period *which incorporates the interest projection provided to you by Structured Finance.* This is a departure from the interest accrual methodology used in the prior three periods in which total accumulated & unpaid interest for all prior periods was reduced by specific exclusions to arrive at the accrual.
  1. Using our revised methodology, the current period's interest accrual would show a $4.1 MM increase from the prior period. This result is primarily due to secondary facilities with varying interest payment periods and thus longer accrual periods up through Determination Date. Zohar III also has larger exposures to ALF, GAS and MDHI, all having significant debt and interest levels.
  2. To maintain a more consistent accrual level we have applied a 50% reduction to the unpaid current period interest of companies with past-due balances (ALF, Amweld, Galey, GAS, Intera, Jacobs, MDHI, MAV, Natura, Natureant and Trim Trends). The net impact results in an accrual that is in-line with the prior period.
  3. We request your guidance on these accruals, as we are not sure if you have expectations for specific increases that warrant additional adjustments. The attached spreadsheet has a yellow column where you can guide us on our accrual assumptions. The present impact on the financial statements is shown below.
- In addition, we have attached a preliminary financial statement variance analysis that reflects the impact of our initial interest accrual assumptions. The summary below highlights the trends in Collateral Investments, Interest Receivable and Interest Income over the past four quarters.
- The Zohar III F/S are due Monday, March 15th by 5pm. However, we seek your guidance on the attached interest accrual computation by Sunday, March 14th so that we can complete the final F/S, send to Peter Bertant, and return a final draft to you for approval with sufficient time to review.

	6/8/2009	9/8/2009	12/8/2009	3/8/2010 Preliminary
Collateral Investments	$916,523,283	$949,222,917	$938,945,141	$930,345,079
Net Accrued Interest and Fees Receivable	6,368,288	6,571,766	6,910,056	6,907,911
As a % of Collateral Investments	0.69%	0.69%	0.74%	0.74%
Interest Income	14,177,751	14,811,993	15,012,008	12,915,752
As a % of Collateral Investments	1.55%	1.58%	1.61%	1.39%

As mentioned above, attached separately is an interest analysis spreadsheet detailing each borrower's accrual whereby you can adjust any interest accrual.

EXHIBIT 218

CONFIDENTIAL TREATMENT REQUESTED BY BRUNE & RICHARD LLP ON BEHALF OF PATRIARCH PARTNERS LLC PP2_00702437

DX 218

THE TRUTH: The Division Purposely Read This Email Out Of Context, Blatantly Ignoring Lynn Tilton's Testimony That The Proposed Change In Methodology Was Necessitated By The Effects Of The Financial Crisis

PATRIARCH PARTNERS

The full context of this email conversation displays that the proposed change in methodology was due to "the financial crisis, [such that] looking at how much of the accrued might get paid from [prior periods] doesn't really make sense. . . . [T]here's an answer to this email where I say, We need to go through these one-by-one. This is not a formula. We need to be very meticulous here looking at each and every credit, and going through one-by-one, not just haircutting."

Tr. 2019:21-2020:15 (Tilton)

From: Carlos Mercado </O=FIRST ORGANIZATION/OU=FIRST ADMINISTRATIVE GROUP/CN=RECIPIENTS/CN=CMERCADO>
Sent: Sunday, March 14, 2010 4:58 PM
To: Lynn Tilton </O=FIRST ORGANIZATION/OU=FIRST ADMINISTRATIVE GROUP/CN=RECIPIENTS/CN=LTILTON>
Cc: Accounting </O=FIRST ORGANIZATION/OU=FIRST ADMINISTRATIVE GROUP/CN=RECIPIENTS/CN=ACCOUNTING>
Subject: RE: Zohar III - Interest Accruals for 3/8/10 Determination Date

From: Lynn Tilton
Sent: Sun 3/14/2010 4:14 PM
To: Carlos Mercado
Cc: Accounting
Subject: RE: Zohar III - Interest Accruals for 3/8/10 Determination Date

I would prefer to take you through this in person so let us do this first thing tomorrow morning before I begin reviews again.

We need to do this borrower by borrower based upon the restructures and amendments that are in process with SF and legal.

It is more than a formula

RX 1775

THE DIVISION'S FALSE STATEMENT:

"There can be no dispute that whatever Mr. Berlant was doing, he wasn't auditing, he wasn't reviewing, he wasn't compiling, he wasn't testing. . . . [H]e wasn't impeached with any evidence that he was actually aware of much less performing Patriarch's procedures for loan impairment, fair value analyses or any other internal Patriarch accounting procedure."

* * *

"Given [Mr. Berlant's] limited role, given what he was and wasn't doing, he didn't have any reason to be concerned [about the SEC coming after him]. He didn't give false testimony."

Tr. 3666:8-11, 3667:19-23, 3756:9-12 (Div. Summation)

THE TRUTH (Part 1): Faced with His Own Paper Trail of Reviewing and "Approv[ing]" Zohar Financial Statements, Peter Berlant Admitted His Substantive Role

From: Richard Buckley <Richard.Buckley@PatriarchPartners.com>
To: Peter Berlant
Cc: Chris Denune <Chris.Denune@PatriarchPartners.com>
Sent: Mon Oct 13 11:05:53 2008
Subject: RE: Zohar II 10-7-08

Per Chris' comments below, the corrections have been made.

With Chris' comments below and your comment of No problem below, does that constitute an approval from you on the overall financial statements?

Subject: Re: Zohar II 10-7-08

As long as the few changes were made (i can't read the financial on the Blackberry), the answer is yes.

****

This email is intended only for the use of the individual or entity to which it is addressed and may contain information that is privileged, confidential and exempt from disclosure

From: Peter Berlant [mailto:peter.berlant@anchin.com]
Sent: Monday, October 13, 2008 12:18 PM
To: Richard Buckley
Subject: Re: Zohar II 10-7-08

As long as the few changes were made (i can't read the financial on the Blackberry), the answer is yes

With Chris' comments below and your comment of No problem below, does

AP No 11462

Respondents' Exhibit 1761 pg 1 of 5

Berlant's Admissions

- Admitted it wasn't "clerical or ministerial" work to interpret the indenture to provide accounting advice regarding the financial statements
  Tr. 967:16-22, 974:4-8 (Berlant); RX 1271
- Admitted he provided substantive accounting "advice" on a range of issues, including interest accruals, carrying value, and tax.
  Tr. 1018:14-19, 1021:6-8, 1024:15-17 (Berlant); RX 1263, 1741

RX 1761; *see also* RX 1768 (compiling emails confirming Berlant "reviewed and approved" Zohar financial statements)

THE TRUTH (Part 2): Mr. Berlant Was Aware of And Provided "Substantive GAAP Advice" Regarding Patriarch's Loan Impairment, Fair Value, and Other Accounting Processes

From:	Peter Berlant <peter.berlant@anchin.com>
Sent:	Monday, February 16, 2009 11:17 AM
To:	Chris Denune <Chris.Denune@PatriarchPartners.com>
Subject:	Zohar CDO 2003-1
Attach:	FIN 48 Note.doc; FAS 157 Note doc

Anchin, Block & Anchin LLP
1375 Broadway

<<FIN 48 Note.doc>> <<FAS 157 Note.doc>>

Please call me re: attached and a few other comments I have on the financials

entity to which it is addressed and may contain information that is privileged, confidential and exempt from disclosure under applicable law. If the reader of this e-mail message is not the intended recipient, or the employee or agent responsible for delivery of the message to the intended recipient, you are hereby notified that any dissemination, distribution or copying of this communication is prohibited. If you have received this e-mail in error, please notify us immediately by telephone at (212) 840-3456

At February 9, 2009 all of the Company's Collateral Debt Obligations were valued using Level 3 inputs.

The adoption of SFAS No. 157 did not have an impact on the Partnership's financial position or results of operations.

RESPONDENTS' EXHIBIT 60

01078986

Respondents' Exhibit 60 pg 1 of 1

RX 60; RX 60.002

- Mr. Berlant was "involved from the inception of [Patriarch's] business. Where he and his tax partners put together the manual and the process that [Patriarch] would follow."
  Tr. 1956:5-25 (Tilton); *see also* RX 1766.001 at 63 (Ark I Accounting/Tax Manual dated 10/10/01, reflecting advice from Anchin regarding when "an Impairment Charge" is required "[u]nder GAAP" in connection with a modification of a loan)
- As a result of Berlant's review of "all of the work papers since the inception of the fund," he "knew what [Patriarch's] [internal] processes were."
  Tr. 1330:5-7 (Mercado)
- Mr. Berlant admitted he "had on occasion given Ms. Tilton substantive GAAP advice on issues with respect to financial statements," including the interpretation of FAS 157, which relates to fair value measurements, along with FIN 48, FAS 165 and FAS 150.
  Tr. 1002:1-4, 1003:10-12, 1008:19-24, 1015:4-1016:15 (Berlant); RX 60, 61, 64, 1256

THE TRUTH (Part 3): Accounting Expert Charles Lundelius Confirmed Berlant's Direct Involvement in the "Agreed-Upon Procedures" Performed by Anchin—a Key Step in the Preparation of Financial Statements and Part of the Basis for Certification

Charles Lundelius
Berkeley Research Group

Q. Did the work performed by Anchin inform your opinion?

A. It certainly did. . . . I had essentially work papers filled out by Mr. Berlant mostly. I can see his initials on the . . . work papers. And it showed how he traced balances back from the working trial balance into the trustee report. And he traced interest, accrual calculations back into the trustee report. . . . as well as quite a few other items that he performed under that A[U]P.

* * *

"The working trial balance is a key document that generates the financial statements. . . . [T]here is a provision in the indenture that calls for an accounting firm to come in and perform agreed-upon procedures that trace the working trial balance numbers back into the trustee report. And that was a function performed by Anchin, and specifically I think by Mr. Berlant."

Tr. 3281:19-3282:11; 3156:16-3157:5 (Lundelius)

THE TRUTH (Part 4): And Peter Berlant Lied Under Oath When He Testified It "Did Not Cross [His] Mind" That He Could Be a Target of the SEC

Tr. 1050:11-14 (Berlant)

Peter Berlant
Partner
Anchin, Block & Anchin

ANCHIN
Accountants and Advisors

- Berlant had <u>three attorneys accompany him</u> when he provided testimony to the SEC during the investigation.
  Tr. 1050:2-4 (Berlant)

- Berlant conceded that Anchin notified its malpractice carrier about the SEC investigation.
  Tr. 1055:17-19 (Berlant)

APPENDIX B

KEY ERRONEOUS RULINGS

Respondents' Motion	Date Made	Respondents' Primary Arguments	Ruling	Date of Ruling
		***Brady*, Jencks Act, Document Disclosure, and Division Misconduct**		
Motion to Compel the Production of Witness Statements Under the Jencks Act	Aug. 22, 2016	Notes memorializing witness proffers made directly or through counsel are not excluded from Jencks Act requirements. The informational asymmetry caused by the Division's contact with 19 witnesses in May 2015 without disclosing notes requires *in camera* review of those notes. The Division already conceded that audio recordings of interviews are Jencks Act material and must be produced.	Denied by Order.	Sept. 8, 2016
Motion to Compel the Production of *Brady* Materials	Aug. 31, 2016	Respondents requested 27 categories of particularized *Brady* materials (18 categories of impeachment, 9 categories of exculpatory material), and the Division responded that it is aware of its ongoing *Brady* obligations but stopped short of stating whether it disputes that one or more of the categories actually constitutes *Brady* material and whether it has reviewed the evidence with the categories in mind. Respondents moved under Rule 230 to force the Division to respond with particularity to each of the 27 categories identified by Respondents.	Denied by Order.	Sept. 16, 2016
Motion to Compel MBIA to Produce Documents Responsive to Respondents' Subpoenas	Oct. 5, 2016	MBIA refuses to produce documents responsive to Respondents' subpoena that are directly relevant to the Division's theory of the case.	Denied. *See* Tr. 2619:18-21, 2620:25-2621:2.	Nov. 3, 2016
Motion to Preclude the Division's Witness, Matthew Mach, from Testifying and for Expedited Briefing	Oct. 11, 2016	The documents Värde refuses to produce pursuant to the 2015 and 2016 subpoenas are directly relevant and necessary for the cross-examination of Mach. Värde's excuse for non-production was already rejected by Judge Foelak and was in any event unfounded. Respondents attempted to enter into a protective order with Värde. Värde's privacy concerns were patently invalid and in any event outweighed by Respondents' need. The Division is largely responsible for Respondents' lack of information concerning these subjects and would not suffer prejudice if Mach's testimony were excluded.	Denied. *See* Pre-Hearing Conference Transcript 25:7-22.	Oct. 19, 2016
Motion to Compel the Production of *Brady* Material and Jencks Act Witness Statements	Oct. 12, 2016	Information that undermines the government's prosecution theory and "harmonizes" with the Respondents' theory is material and favorable to the defense and must be produced under *Brady*. Notes or audio recordings of Division's interviews with Aniloff and Bolli are Jencks Act and *Brady* material.	Denied. *See* Pre-Hearing Conference Transcript 32:16-33:15.	Oct. 19, 2016
Motion to Stay the Proceedings and Compel the	Oct. 16, 2016	The Division refuses to provide basic information about recently-disclosed *Brady* and *Giglio* material concerning two investor witnesses, including when and how	Denied. *See* Pre-Hearing	Oct. 19, 2016

Respondents' Motion	Date Made	Respondents' Primary Arguments	Ruling	Date of Ruling
Division to Make Further Disclosures Regarding Two Division Witnesses, and For Expedited Briefing and an Evidentiary Hearing		the Division learned about the relevant facts. The trial must be postponed so Respondents can explore the circumstances of the exculpatory information.	Conference Transcript 36:04-40:03.	
Motion to Compel OLAP to Produce Documents Responsive to Respondents' Subpoenas	Oct. 17, 2016	After numerous meet-and-confers with Respondents, OLAP continues to withhold documents that Judge Foelak on September 1, 2016, directed OLAP to produce to Respondents by September 14, 2016. OLAP erroneously invokes the deliberative process privilege and the law enforcement privilege to improperly withhold inter-agency communications from Respondents.	After *in camera* review of withheld documents, no ruling made. *See* Tr. 3626:3-17.	N/A
Request to Issue Subpoenas to Allison Herren Lee, Nicole Creola Kelly, and Brent Mitchell	Oct. 21, 2016	Hearing subpoenas should be issued so that Respondents can question Lee, Kelly, and Mitchell about the Division's improper information-sharing arrangement with MBIA, an issue integral to Respondents' defense. A series of handwritten notes taken by Lee, Kelly, and Mitchell evidence this agreement. The fact that Lee, Kelly, and Mitchell were counsel for the Division during the investigation in this matter is of no import.	Denied. *See* Tr. 7:16-21.	Oct. 24, 2016
Motion to Compel Production of Division Notes Taken During Witness Interviews	Oct. 25, 2016	The notes requested are different from the attorney notes previously requested by Respondents. The notes requested here reflect witness statements and thus are not subject to the work product doctrine. *See* Tr. 383:1-385:21, 901:23-902:6.	Denied. *See* Tr. 534:1-8, 301:19. Although initially agreeing to undertake *in camera* review, Tr. 385:22-24, no *in camera* review was undertaken, Tr. 534:24-25, 905:24-906:3.	Oct. 25, 2016; Oct. 26, 2016.
Request for *Brady* and *Giglio* Material Related to Mayer's Involvement in the Division's Investigation of Respondents	Oct. 25, 2016	Though the Division repeatedly assured Respondents that it was complying with its *Brady* obligations, Mayer testified that he was involved in the Commission's investigation of the case prior to the issuance of the OIP, a fact that the Division did not disclose to Respondents. The Division should be ordered to produce all	Denied. *See* Tr. 455:17-18.	Oct. 25, 2016

Respondents' Motion	Date Made	Respondents' Primary Arguments	Ruling	Date of Ruling
		documents disclosing this and other *Brady* material such that Respondents can effectively cross-examine Mayer and other Division witnesses. *See* Tr. 443:5-449:2, 449:22-451:20.		
Request for Additional Cross-Examination of Mayer	Oct. 25, 2016	Respondents must be permitted to extensively cross-examine Mayer about potential bias given his admission that he was involved in the Commission's investigation of the case. *See* Tr. 462:2-464:13.	Denied. *See* Tr. 466:5-6.	Oct. 25, 2016
Request to Exclude Mach Testimony and to Compel Värde to Produce Documents Related to Mach Testimony	Oct. 26, 2016	Värde or the Division must provide Respondents with documents related to Mach's testimony so that Respondents can effectively cross-examine Mach. To date, Respondents have not received certain categories of documents responsive to their subpoenas despite the relevance and importance of those documents. *See* Tr. 571:7-573:14.	Motion to Exclude Testimony denied. *See* Tr. 584:23-24. Respondents were permitted to submit a written motion to compel, which was later denied partially on grounds of mootness because Mach had already testified. *See* Tr. 2619:18-21.	Oct. 26, 2016
Request to Strike Expert Testimony, to Require Further *Brady* Disclosure Concerning Division Expert Witnesses, and to Issue Subpoenas to Expert Witnesses and the Firms for Which They Work.	Oct. 28, 2016	Division experts were involved in pre-OIP consultation with the Division concerning the theories of liability about which they would later opine as allegedly neutral experts. Testimony by such non-neutral experts should be stricken, further disclosures concerning the scope of their pre-OIP engagement are appropriate, and subpoenas should be issued to discern the scope of the pre-OIP engagement. Tr. 1366:9-1370:6.	Denied, partially on ground that another "authority" would need to address misconduct. Tr. 1369:25-1370:6.	Oct. 28, 2016
Motion to Dismiss Case Based on *Brady* Violation for Anchin Disclosure; Request to Stay Hearing and Conduct	Oct. 31, 2016	The Division, in failing to disclose its attorneys' concurrent engagement with Anchin in a matter in Connecticut, committed prosecutorial misconduct in violation of *Brady*. The Division disclosed its relation with Anchin to the federal judge in the Connecticut matter but failed to disclose it here. Anchin was paid	Denied, partially on the ground that "the actions of the Division	Oct. 31, 2016

Respondents' Motion	Date Made	Respondents' Primary Arguments	Ruling	Date of Ruling
Evidentiary Hearing on *Brady* Violation; Motion to Strike Berlant's Testimony Based on *Brady* Violation; Request to Subpoena Anchin Regarding SEC Engagements		$366,000 in the Connecticut matter. The late disclosure was deceptively limited, as it failed to state that two of the Division's attorneys in this matter are also the attorneys on record in the Connecticut matter. Despite the Division's attorneys making repeated representations that they were in compliance with *Brady*, they failed to disclose this conflict. This lack of disclosure is further evidence of the infection of each of the witnesses and of the Division's case, given that *Brady*, *Giglio* and Jencks Act issues have come up with every witness. The Division's proposed remedy of re-calling the witness is insufficient and would improperly give the Division an opportunity to rehabilitate their witness. At minimum, Berlant's testimony should be stricken. *See* Tr. 1443:22-1455:16; 1461:16-1465:19; Tr. 1469:12-1472:16; 1475:5-25; 1478:10-1481:19.	are not before" this tribunal. Tr. 1471:16-17. Subpoena request granted, Tr. 1481:20-1482:6, but limited to requests unrelated to nonpublic SEC matters, Tr. 2617:13-20.	
Request for *Brady* Disclosure Regarding Aldama's View that the Financial Statements Were Not Material	Nov. 1, 2016	Respondents were denied *Brady* material concerning Aldama's belief that the financial statements were not material. *See* Tr. 1985:11- 1987:7. Respondents request disclosure of the questions Aldama was asked about the financial statements, and Aldama's answers, post-May 2014. *See* Tr. 1989:2-1990:9; 1992:11-16.	Denied. *See* Tr. 1992:17-18.	Nov. 2, 2016
		Expert Witnesses		
Motion *in Limine* to Strike Inadmissible Portions of the Reports of Division of Enforcement Expert Steven L. Henning and to Preclude Testimony on the Stricken Matters and Related Topics	Aug. 26, 2016	Henning improperly offered legal conclusions, e.g., by interpreting the Investment Advisers Act and opining as to whether particular disclosures would have been material to investors. Henning also engaged in improper fact-finding, improperly offered investigative testimony, and offered irrelevant and immaterial opinions concerning, for example, the conduct of unrelated persons.	Denied by Order.	Sept. 1, 2016
Motion *in Limine* to Strike in Their Entirety the Reports of Division of Enforcement Expert Michael G. Mayer and to Preclude His Testimony	Aug. 26, 2016	Mayer improperly offered legal conclusions as to the loans' current or non-current status and misapprehended his role as akin to that of a judge. Mayer also engaged in unsupported fact-finding, improperly introduced investigative testimony (and in so doing reintroduced hearsay statements), and offered several irrelevant and immaterial conclusions, such as opining generally as to other CLOs and the private equity market without reference to the case at issue.	Denied by Order.	Sept. 1, 2016
Motion *in Limine* to Strike in Its Entirety the Rebuttal	Aug. 26, 2016	Wagner improperly offered legal conclusions by interpreting the Indentures and opining on whether Respondents breached their fiduciary duties. Wagner also	Denied by Order.	Sept. 1, 2016

Respondents' Motion	Date Made	Respondents' Primary Arguments	Ruling	Date of Ruling
Report of Division of Enforcement Expert Ira Wagner, to Strike Portions of Wagner's Opening Report, and to Preclude Testimony on the Stricken Matters and Related Topics		improperly engaged in unsupported fact finding, improperly introduced investigative testimony, and offered several irrelevant and immaterial conclusions such as whether the categorization of assets affected investors. Wagner's rebuttal report should be excluded in its entirety, given that it opines on issues not discussed in the opening or opposition reports.		
Motion *in Limine* to Exclude the Expert Testimony of Michael G. Mayer	Aug. 31, 2016	The experts should be excluded because (a) their reports include legal conclusions, improper fact-finding, and speculation; (b) they are not qualified to render the opinions offered; and (c) their methodologies are inherently flawed because, for example, they based their reports on one another's work and analyzed only one loan out of 350.	Denied by Order.	Sept. 2, 2016
Motion *in Limine* to Exclude the Expert Testimony of Ira Wagner	Aug. 31, 2016	The experts should be excluded because (a) their reports include legal conclusions, improper fact-finding, and speculation; (b) they are not qualified to render the opinions offered; and (c) their methodologies are inherently flawed, because, for example, they based their reports on one another's work and analyzed only one loan out of 350.	Denied by Order.	Sept. 2, 2016
Motion *in Limine* to Exclude the Expert Testimony of Steven L. Henning	Aug. 31, 2016	Henning should be excluded because his report amounts to nothing more than improper legal conclusions, which have been excluded from similar federal cases on several occasions, improper fact-finding, and speculation. Additionally, Henning's opinion suffers from a significant lack of citation to authority, and is merely "spin . . . on contested facts." And "false and misleading" is not a GAAP determination, despite Henning's repeated references to it and conclusions drawn from it.	Denied by Order.	Sept. 2, 2016
Renewed Objection to Mayer's Testimony	Oct. 25, 2016	Mayer has never previously performed the type of analyses he has undertaken in this case, and he is therefore unqualified. Mayer's testimony is fatally flawed and unreliable and must therefore be excluded under SEC Rule of Practice 320 and under the *Daubert* doctrine as incorporated in administrative proceedings through Rule 320. *See* Tr. 419:8-423:7.	Denied. *See* Tr. 424:8-9.	Oct. 25, 2016
Request to Strike the Testimony of Mayer; Request to Issue Subpoenas to Henning and His Business Regarding Work for the SEC in This Matter; Request to	Oct. 28, 2016	The Division's expert witnesses consulted with the Commission about this matter before the OIP was issued. Failure to disclose the fact of these consultations violates *Brady*. Further, the experts' cooperation with the Division prior to the issuance of the OIP renders their testimony unreliable. Respondents request to subpoena the experts and their affiliated firms to uncover their relationship with the SEC prior to the filing of the OIP to determine the credibility of the experts	Denied. *See* Tr. 1369:16-17; 1371:18-20.	Oct. 28, 2016

Respondents' Motion	Date Made	Respondents' Primary Arguments	Ruling	Date of Ruling
Issue Subpoena to Wagner and his Affiliated Entity Regarding Work for the SEC in this Matter; Renewed Application for *Brady* Disclosure; Request for Separate Hearing On Misconduct		and their potential role in helping the SEC develop its theory of the case. *See* Tr. 1365:25-1373:1.		
Motion to Preclude Henning from Testifying	Oct, 31, 2016	Henning should be precluded from testifying because his opinions are fraught with legal conclusions, as are the opinions of the Division's other expert witnesses. *See* Tr. 1400:2-1404:7.	Denied. *See* Tr. 1403:23-1404:7.	Oct. 31, 2016
Division's Objection to Respondents' Line of Questioning in *voir dire* Regarding Wagner's Collaborating with the SEC Before the OIP	Nov. 7, 2016	*Voir dire* is Respondents' only opportunity to ask questions about the scope of Wagner's engagement and his communications with the SEC. *See* Tr. 2818:18-20.	Division's objection sustained. *See* Tr. 2820:5-13.	Nov. 7. 2016
Motion to Preclude Wagner from Testifying	Nov. 7, 2016	Wagner lacks the relevant experience, does not cite relevant authority, and gives views on legal interpretations for which he is not qualified. Tr. 2835:15-2837:18.	Denied. *See* Tr. 2837:19-2838:7.	Nov. 7, 2016
Renewed Motion *in Limine* to Exclude Wagner Rebuttal Report, or for More Time for Direct Expert Testimony	Nov. 7, 2016	Wagner's rebuttal report raised a new issue not in the original report and in the rebuttal report. Wagner also improperly engaged in fact-finding. Tr. 2851:18-2862:8.	Denied. *See* Tr. 2863:7-8.	Nov. 7, 2016
Transcripts, Declarations, Hearsay				
Motion *in Limine* to Preclude the Admission of Any Portions of Investigative Testimony Transcripts Without the Introduction of Corresponding Portions of Audio Recordings of the Testimony, and to Exclude Transcripts for Which Audio	Sept. 12, 2016	It is impossible to tell whether the unsigned transcripts are accurate. The transcripts are unreliable, and do not constitute best evidence where the original recordings are available. Transcripts without audio recordings should not be admitted where Division has failed to maintain original recordings.	Denied by Order.	Oct. 12, 2016

Respondents' Motion	Date Made	Respondents' Primary Arguments	Ruling	Date of Ruling
Recordings Were Not Preserved and Produced				
Motion *in Limine* to Preclude the Division from Introducing into Evidence Exhibits or Portions of Exhibits Containing Unreliable Hearsay	Sept. 12, 2016	Several exhibits on the Division's list contain unreliable hearsay, including emails authored by individuals not on the Division's Witness List, which should be excluded pursuant to Rule 320. The Division has not shown that these witnesses are unavailable or that the hearsay is corroborated by other evidence on the record.	Denied by Order.	Oct. 12, 2016
Objection to Use of Ms. Tilton's Prior Testimony in Opening Statements	Oct. 24, 2016	Prior testimony should only be used for impeachment when Ms. Tilton is on the stand. *See* Tr. 9:7-21.	Denied. *See* Tr. 9:22-23.	Oct. 24, 2016
Objection to Fact Witness Opinion on Ms. Tilton's Prior, Investigative Testimony	Oct. 24, 2016	A fact witness cannot opine as to another witness' prior testimony, especially where the Division has made no showing that the prior testimony is admissible in this hearing. Further, the Division impermissibly offers the answers Ms. Tilton provided in investigative testimony without also offering the questions posed, which were often times unclear. *See* Tr. 132:4-133:11, 133:18-134:9, 135:7-136:8, 140:4-142:9.	Denied. *See* Tr. 135:2-3, 143:15-21, 144:11-13.	Oct. 24, 2016
Objection to Use of Bates 414 of DX 51 for Lack of Foundation	Nov. 4, 2016	The exhibit lacks foundation. Moreover, to the extent any stipulation to admissibility exists, the stipulation is no longer valid because the Division is no longer calling McKiernan. Tr. 2675:6-2676:5; 2676:8-13.	Denied. *See* Tr. 2676:6-7, 2676:16-17.	Nov. 4, 2016
Scope of Division's Case				
Motion for a More Definite Statement	Apr. 22, 2015	The OIP does not provide notice to Respondents regarding: (1) which assets the Division alleges should have been categorized as Category 1/impaired but were not, and when; (2) which of the investors were misled by the categorizations.	Denied by Order.	May 7, 2015
Motion for Summary Disposition	June 5, 2015	The categorization strategy was disclosed. Patriarch has not committed fraud against the Zohars, which are the "clients" under the Investment Advisers Act.	Denied by Order.	Sept. 16, 2016
Motion *in Limine* to Preclude Testimony and Evidence Regarding the Subjective States of Mind of Zohar Fund Investors	Aug. 22, 2016	Investors' subjective state-of-mind testimony is irrelevant and immaterial to the violations alleged in the OIP. The only state of mind at issue is Respondents'. Division's Summary Disposition Brief shows their intent to introduce this evidence. Limiting this evidence is consistent with Rule 300's fairness requirement and Rule 320's relevance requirement.	Denied by Order.	Oct. 12, 2016

Respondents' Motion	Date Made	Respondents' Primary Arguments	Ruling	Date of Ruling
Motion *in Limine* to Preclude Evidence Concerning Recklessness and Negligence and to Require the Division to Prove Intentional Misconduct	Aug. 26, 2016	Because the OIP charges Respondents with intentional conduct, the ALJ should not permit the Division to introduce evidence as to negligent or reckless conduct. Respondents contend that they did not have notice of these lesser charges and that the Division should not be permitted to proceed on a new theory of liability on the eve of trial. To the extent the motion is denied and the Division proves only negligence, sanctions should be limited.	Denied by Order.	Oct. 12, 2016
Motion *in Limine* to Preclude the Division of Enforcement from Seeking Disgorgement	Aug. 31, 2016	The Division's theory of disgorgement is predicated *entirely* on improper expert testimony, and the Division's theory is actually legal in nature but put forth under the guise of equitable remedy of disgorgement.	Denied by Order.	Sept. 2, 2016
Objection to Division's Line of Questioning Related to Accrued Interest	Oct. 27, 2016	The Division's line of questioning relating to accrued interest does not relate to any of the charges within the OIP and should therefore be excluded. *See* Tr. 1191:25-1192:7, 1201:3-9.	Denied. *See* Tr. 1201:12.	Oct. 27, 2016
Objection to Division's Line of Questioning Related to Accrued Interest	Oct. 28, 2016	The Division's line of questioning, which seeks to elicit evidence suggesting that accrued interest and the fee receivable line are misleading, is outside scope of the OIP and therefore should be excluded. *See* Tr. 1338:21-1340:20.	Denied. *See* Tr. 1339:12-15; 1340:21-22.	Oct. 28, 2016
Motion to Strike or Not Consider as Evidence Division's Line of Questioning Related to Accrued Interest	Oct. 28, 2016	The evidence the Division elicited regarding financial statements and the consolidated balance sheet, showing the accrued interest and fees receivable, should be stricken as they are outside the scope of the OIP. Moreover, Mercado's testimony showed that that Ms. Tilton's way of showing accrued interest was appropriate. *See* Tr. 1360:15-1365:5.	Denied Motion to Strike. *See* Tr. 1364:19-22.	Oct. 28, 2016
Motion to Strike Ms. Tilton's Testimony Regarding Accrued Interest	Nov 2, 2016	Any theory of liability premised on accrued interest is not charged in the OIP, and such testimony is therefore irrelevant. *See* Tr. 2068:5-24.	Denied. *See* Tr. 2069:5-7.	Nov. 2, 2016

CERTIFICATE OF SERVICE

I hereby certify that I served true and correct copies of 1) Respondents' Post-Hearing Brief, 2) Appendix A, 3) Appendix B, 4) Respondents' Proposed Findings of Fact, and 5) Respondents' Proposed Conclusions of Law on this 16th day of December, 2016, in the manner indicated below:

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