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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-16462

In the Matter of **LYNN TILTON;** **PATRIARCH PARTNERS, LLC;** **PATRIARCH PARTNERS VIII, LLC;** **PATRIARCH PARTNERS XIV, LLC;** **AND** **PATRIARCH PARTNERS XV, LLC,** **Respondents.**	**DIVISION OF ENFORCEMENT'S PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW**

I. FINDINGS OF FACT

<u>David Aniloff</u>

1. Mr. Aniloff is a portfolio manager at SEI Investments ("SEI"). Mr. Aniloff works in SEI's asset management division, which provides investment vehicles for institutional investors and high net worth individuals. Mr. Aniloff is the portfolio manager over below-investment-grade bond strategies for SEI, which includes oversight of SEI's high-yield-bond portfolios, emerging market debt, bank loans and structured products. (Tr. 88:12-13, 90:12-91:5.)

2. Mr. Aniloff manages several portfolios at SEI that invest primarily in collateralized debt obligations ("CDOs"). The total assets of these portfolios are approximately $2.5 billion. The vast majority of the CDOs in these portfolios are collateralized loan obligations ("CLOs"). (Tr. 91:11-92:1.)

3. In his career at SEI, Mr. Aniloff has had experience with between 500 and 1,000 CLOs. (Tr. 94:18-20.)

4. SEI was a secondary market investor in Zohar III. (Tr. 99:2-9.)

5. Between 2010 and early 2013, SEI purchased a total of $100 million in Zohar III A-2 notes. In 2014, SEI sold $10 million of those notes; its current holding is $90 million in Zohar III A-2 notes. In 2012, SEI also purchased $50 million in Zohar III A-3 notes. SEI paid less than full notional value for these notes. (Tr. 95:19-98:14.)

6. SEI's expected return on the Zohar III bonds was to receive the principal amount of the notes at some date in the future, as well as interest that is currently at a rate of approximately 1.5% per year. (Tr. 100:5-20.)

7. SEI was not investing in the equity of the underlying distressed companies to which Zohar was making loans. (Tr. 100:21-101:9.)

8. Mr. Aniloff was personally involved in SEI's investment in Zohar III; it was his analysis and recommendation to purchase. (Tr. 88:16-19, 94:21-95:1.)

9. When purchasing CLO notes on the secondary market, the collateral manager's influence is less important than when purchasing CLO notes in the primary market, since in the primary market the portfolio of loans is not year purchased, meaning the collateral manager's influence on that purchase of the portfolio is very important. (Tr. 190:21-191:14.)

10. Prior to first being offered the Zohar bonds on the secondary market, Mr. Aniloff had not heard of the Zohar funds, Patriarch Partners, or Lynn Tilton. (Tr. 95:10-18.)

11. Tilton was not an important factor in Mr. Aniloff's decision to invest in Zohar III. (Tr. 302:25-303:21.)

12. Mr. Aniloff did not invest in the Zohar bonds because of Tilton's purported experience in turning around distressed companies. (Tr. 170:24-171:3.)

13. Even though underlying loans that a CLO owns will vary, the structure of the CLO vehicle is generally standardized. There are standard definitions and terms around the overcollateralization tests, interest coverage tests, and calculations of credit quality. (Tr. 197:13-198:3.)

14. As an investor, it is important to Mr. Aniloff to have objective tests and definitions about what is permitted and what is not permitted in a deal. (Tr. 158:12-25.)

15. It is important to Mr. Aniloff that collateral managers follow the terms of the indenture. If a collateral manager uses flexibility not to follow the rules of the indenture, then the noteholder protections in the deal are not secured or reliable. (Tr. 102:2-16, 377:10-22.)

16. The overcollateralization ratio ("OC Ratio") is a measure of the value of the loans held in a CLO relative to the amount investors have invested in a CLO. It is a margin of safety to protect the money an investor has invested. (Tr. 102:20-103:18.)

17. The OC Ratio is "the most important ratio in a CLO, by far." (Tr. 103:19-23.)

18. It was important to Mr. Aniloff that the collateral manager accurately report the OC Ratio, because Mr. Aniloff places the "utmost importance" on the OC Ratio in conducing his analysis of a CLO. (Tr. 378:18-379:25.)

19. Changes in the OC Ratio reflect how well the collateral in the underlying deal is performing. (Tr. 104:23-105:7.)

20. Proper categorization of loans, both generally and in the context of the Zohar III deal, was important to Mr. Aniloff. (Tr. 107:21-108:9.)

21. Mr. Aniloff expected some defaults in any CLO he invested in, since the underlying loans were to below-investment-grade companies. (Tr. 105:8-15.)

22. Even during the financial crisis, approximately 90% of CLO portfolio companies continued to pay their principal and interest; approximately 10% defaulted. (Tr. 184:18-185:6.)

23. In general, if a loan is not paying its interest, it should be categorized as a defaulted asset and not given full par credit for purposes of the OC Ratio. (Tr. 105:19-106:10.)

24. For example, if a portfolio company had a loan with a 6% coupon rate stated in a trustee report, and the company could not pay that 6% interest, but rather only paid 1% interest, that loan should be categorized as defaulted. (Tr. 185:7-11, 299:9-14; *see also* Tr. 380:2-15 (if contractual interest rate was 10%, Mr. Aniloff expected the interest collection to be 10%).)

25. The definition of a "defaulted investment" in the Zohar III governing documents – that a defaulted investment includes a loan "with respect to which a default as to the payment of principal and/or interest has occurred" – is consistent with Mr. Aniloff's understanding of how loans should be categorized in a CLO (Tr. 111:14-112:7, 113:21-114:2.)

26. Loans that are categorized as defaults should negatively impact the OC Ratio. (Tr. 106:14-16.)

27. The fact that loans categorized as defaults drive the OC Ratio down is an added protection for SEI as an investor. If the OC Ratio falls below a certain level, monies that are scheduled to be paid to people subordinate to SEI's investment do not receive their interest payments, and instead their interest gets paid to SEI as a senior noteholder. (Tr. 106:17-107:4.)

28. This protection is "extremely important" to Mr. Aniloff as an investor in Zohar III, as it is an extremely powerful remediation tool if the underlying loans perform worse that Mr. Aniloff expected. (Tr. 107:5-20.)

29. At the time Mr. Aniloff invested in Zohar III, he did not expect that Tilton would categorize loans based on her subjective belief in the underlying companies. Rather, in his experience in investing in CLOs, whether a loan is paying interest on time is objective, not subjective. (Tr. 169:5-22.)

30. In 2010, when Mr. Aniloff reviewed a Zohar III trustee report showing 140 Senior Secured Collateral Investments and five Defaulted Noncurrent and Nonperfoming Collateral Investments, Mr. Aniloff believed this meant that all but the five loans were making their full interest payments on time. (Tr. 314:11-315:22.)

31. Had Mr. Aniloff known that Ms. Tilton was categorizing assets based on her subjective belief in the underlying portfolio companies, that would have affected his investment

decision. Mr. Aniloff is highly confident that he would not have invested had he known this. (Tr. 169:23-170:6.)

32. Given the importance of the OC Ratio to Mr. Aniloff as an investor, and the importance of the protection of redirecting interest if the OC Test is not passing, it would be extremely relevant to him if the OC Ratio and OC Test were subject to Tilton's interpretation of the performance of the loans. (Tr. 171:21-172:18.)

33. After hearing significant argument by respondents' counsel about what Ms. Tilton meant when she testified that "the categorizations are based on the belief in the future recovery and the reorganization, not based on how much interest is collected. The categorizations are based on the belief in the ultimate reasonableness of the recovery and the future," including argument that Section 7.7(a) provided content for this testimony, Mr. Aniloff stated that this categorization approach was in the offering memorandum and indenture because Section 7.7(a) does state that the collateral manager has discretion to make amendments. However, after reviewing Section 7.7(a), Mr. Aniloff further stated that Section 7.7(a) does not reference the categorization of loans, and that amendment and categorization were "two separate definitions." (Tr. 140:4-151:5.)

34. Any amendments to loans must be consistent with the creditworthiness of the underlying borrower and within the context of prudent lending practices. (Tr. 298:6-299:8.)

35. Had Mr. Aniloff known that the OC Ratio was not actually above the 112.7% trigger level at the time he purchased the Zohar III notes, it would have been extremely important to his investment decision. (Tr. 130:14-131:22.)

36. Mr. Aniloff monitored the Zohar III OC Ratio each month by looking at the number reported on the trustee report. (Tr. 104:19-22, 118:17-21.)

37. Mr. Aniloff focused his review of the trustee reports on the summary statistics on the CLO. The first number he looked at was the OC Ratio. (Tr. 120:17-121:20.)

38. The trustee reports did not disclose that Ms. Tilton was using her subjective belief in the underlying companies to categorize assets. (Tr. 380:16-21.)

39. While Mr. Aniloff also looked at the Interest Coverage Ratio ("IC Ratio"), in his experience managing CLOs, the OC Ratio was "by far the most important test." (Tr. 122:7-21.)

40. From 2010 until today, Mr. Aniloff's portfolio at SEI has held approximately 150 CLOs. In general, he received and reviewed a monthly trustee report for each of these holdings. (Tr. 122:22-125:10.)

41. On average, approximately half of Mr. Aniloff's time is spent monitoring this existing portfolio of approximately 150 CLOs. Mr. Aniloff's review of each trustee report would generally range from 5 minutes to a few hours. (Tr. 123:12-124:16.)

42. Mr. Aniloff generally spent less time than average reviewing the Zohar monthly trustee reports, because those reports did not always come out monthly and because there was not as much detail provided in the Zohar trustee reports as in a typical CLO. (Tr. 125:11-126:15.)

43. Mr. Aniloff did not recalculate whether the OC Ratio was being properly calculated because he trusted the information provided by the collateral manager and trustee. He did not expect to have to duplicate that work on 150 CLOs that each own myriad loans to ensure the accuracy of the numbers. (Tr. 126:16-22, 320:2-12.)

44. In order to tick and tie interest payments back to particular loans for all of the CLOs Mr. Aniloff held would be a "full-time job for multiple people." (Tr. 129:15-17.)

45. Mr. Aniloff does not believe that any CLO investor would look to the underlying interest collection files and tie those files out to the interest rates on the loans. (Tr. 320:13-20.)

46. It is not the responsibility of a CLO investor to review the details of every interest payment made and every par value calculation before making an investment. If investors had to undertake this level of diligence, they would not be able to make investment decisions on a timely basis. (Tr. 378:25-379:5.)

47. Beginning in approximately late 2013, Mr. Aniloff received information from third parties about the Zohar III CLO, including that interest payments actually collected on the Zohar loans did not tie to the weighted average spread reported on the trustee reports and that certain loans were not paying full interest. This concerned him. Mr. Aniloff did not generate this information himself. (Tr. 128:13-130:4, 319:19-320:1.)

48. Mr. Aniloff reviewed the Zohar III financial statements, in particular the section of the financial statements that discussed fair value. (Tr. 151:15-152:12.)

49. Mr. Aniloff relief on the collateral manager's assessment of fair value, particularly because he did not have access to information on the underlying companies to which Zohar has made loans. (Tr. 154:17-25.)

50. It would have been important to Mr. Aniloff to know if Patriarch had not actually conducted a fair value analysis. (Tr. 155:12-21.)

51. The original cost of the loans in the Zohar III deal was not what Mr. Aniloff was concerned about when he was reviewing the fair value information in the Zohar III financial statements. What he was interested in was whether there was enough value to cover the investments in the A-2 and A-3 note tranches. (Tr. 345:25-346:12.)

52. Mr. Aniloff reviewed the Zohar III Collateral Management Agreement once he began to have concerns about the Zohar deal in late 2013. (Tr. 160:5-19.)

53. It was important to Mr. Aniloff that the collateral manager comply with Section 2.4(b) of the Collateral Management Agreement, which provided that "[t]he collateral manager shall, in rendering its services as collateral manager, use reasonable care and the same degree of

skill and attention exercised by institutional investment managers of national standing generally in respect of assets of the nature and character of the collateral and for clients having similar investment objectives and restrictions, in each case except as otherwise expressly provided in the indenture." This was important particularly given the lack of transparency into the underlying collateral pool and the fact that the collateral manager did have leeway in amending the underlying loans. (Tr. 161:5-162:6.)

54. Mr. Aniloff relied on this standard of care to mitigate any potential conflicts of interest that Tilton had given her various roles in the Zohar deal. (Tr. 306:8-307:17.)

55. Mr. Aniloff inquired of Patriarch whether there was any communication between the collateral manager and investors about how the deal was performing. He was told that there were periodic investor calls. However, he never received notification of any such call. (Tr. 164:9-20.)

56. Mr. Aniloff was told that more detail could be provided on the underlying collateral in the Zohar deal if SEI would sign a nondisclosure agreement. He did not know exactly what information he would get access to. He provided that agreement to SEI's legal department. SEI did not sign the nondisclosure agreement. (Tr. 164:21-165:9, 340:23-341:5.)

57. Mr. Aniloff has signed other NDAs to get financial information from private companies. (Tr. 341:9-19.)

58. Mr. Aniloff reached out to Patriarch on multiple occasions for additional information on deal performance. He did not receive any additional information. (Tr. 165:19-166:17.)

59. Mr. Aniloff's experience with Patriarch was not typical of a collateral manager. Typically, collateral managers are accommodative to investor requests. Patriarch was not accommodative of his requests. (Tr. 167:18-168:7.)

60. On Zohar III alone, the collateral manager would make approximately $25 million per year in collateral management fees and the deal was likely to have a 10 year life. So Patriarch stood to make a significant amount of money managing the deal even if Tilton's investment in the equity tranche was completely wiped out. (Tr. 261:1-15.)

61. Mr. Aniloff's understanding was that, although Patriarch deferred collateral management fees during the financial crisis, it was still entitled to those fees and got those fees later. Mr. Anlioff also believed that, since Tilton was using subjective elements to categorize loans for the OC Ratio and OC Test, the collateral manager knew with a high degree of confidence that it could keep the OC Test passing and thus could claim those management fees later. (Tr. 265:8)

Michael Mayer

62. Michael Mayer is an expert witness who has worked in securities-related disputes for about 30 years. He holds an MBA degree and CFA and CFE certifications. He has extensive expertise in the matters at issue in his opinions. (Tr. at 389:16-390:31; DX 17 at 1.)

63. Mr. Mayer conducted an analysis to determine whether loans made by the Zohar Funds to 14 select borrowers were current or delinquent with respect to interest rate payments and if delinquent (and reflected as current in the monthly investor reports), reduce the amount of loan principal included in the OC Ratio (as mandated by the respective indenture) and compare this adjusted OC Ratio to the minimum required OC Ratio in the indenture (the OC Test). (DX 17 at 20.)

64. Based on his analysis, Mr. Mayer opined that Zohar II and Zohar III failed their respectively OC Tests starting in July 2009 and 2009, respectively, as follows:

Zohar II OC Ratio Test Results by Quarter

Zohar II CLO					
Year	Quarter Ending	Original	CRA Adjusted	Minimum	Pass/Fail
2005	Jul-05	118.33%	[illegible]	112.00%	Pass
	Oct-05	113.95%	113.85%	112.00%	Pass
2006	Jan-06	118.49%	118.36%	112.00%	Pass
	Apr-06	122.53%	122.41%	112.00%	Pass
	Jul-06	122.39%	122.27%	112.00%	Pass
	Oct-06	123.85%	123.74%	112.00%	Pass
2007	Jan-07	123.12%	122.78%	112.00%	Pass
	Apr-07	123.38%	123.02%	112.00%	Pass
	Jul-07	120.90%	119.40%	112.00%	Pass
	Oct-07	122.97%	122.59%	112.00%	Pass
2008	Jan-08	122.06%	121.47%	112.00%	Pass
	Apr-08	121.43%	121.00%	112.00%	Pass
	Jul-08	123.57%	120.85%	112.00%	Pass
	Oct-08	121.97%	119.15%	112.00%	Pass
2009	Jan-09	125.93%	121.93%	112.00%	Pass
	Apr-09	124.39%	120.35%	112.00%	Pass
	Jul-09	121.19%	111.65%	112.00%	Fail
	Oct-09	121.83%	107.82%	112.00%	Fail

Zohar II CLO					
Year	Quarter Ending	Original	CRA Adjusted	Minimum	Pass/Fail
2010	Jan-10	121.88%	[illegible]	112.00%	Fail
	Apr-10	120.45%	103.69%	112.00%	Fail
	Jul-10	120.07%	101.80%	112.00%	Fail
	Oct-10	120.35%	101.77%	112.00%	Fail
2011	Jan-11	119.44%	100.73%	112.00%	Fail
	Apr-11	120.29%	101.11%	112.00%	Fail
	Jul-11	120.26%	100.47%	112.00%	Fail
	Oct-11	120.41%	100.94%	112.00%	Fail
2012	Jan-12	119.72%	99.91%	112.00%	Fail
	Apr-12	120.23%	100.02%	112.00%	Fail
	Jul-12	120.56%	100.07%	112.00%	Fail
	Oct-12	118.23%	98.52%	112.00%	Fail
2013	Jan-13	118.03%	98.26%	112.00%	Fail
	Apr-13	115.26%	98.40%	112.00%	Fail
	Jul-13	115.35%	98.35%	112.00%	Fail
	Oct-13	115.45%	98.30%	112.00%	Fail
2014	Jan-14	115.54%	98.51%	112.00%	Fail
	Apr-14	115.29%	97.78%	112.00%	Fail
	Jul-14	115.80%	97.64%	112.00%	Fail
	Oct-14	114.79%	97.76%	212.00%	Fail

Zohar III OC Ratio Test Results by Quarter

Zohar III CLO					
Year	Quarter Ending	Original	CRA Adjusted	Minimum	Pass/Fail
2007	Dec-07	110.33%	103.48%	112.70%	N/A
2008	Mar-08	107.55%	106.74%	112.70%	N/A
	Jun-08	127.35%	126.77%	112.70%	Pass
	Sep-08	122.78%	113.06%	112.70%	Pass
	Dec-08	127.31%	122.53%	112.70%	Pass
2009	Mar-09	127.04%	115.00%	112.70%	Pass
	Jun-09	122.75%	110.31%	112.70%	Fail
	Sep-09	123.99%	103.17%	112.70%	Fail
	Dec-09	125.19%	110.19%	112.70%	Fail
2010	Mar-10	125.08%	103.77%	112.70%	Fail
	Jun-10	125.28%	109.21%	112.70%	Fail
	Sep-10	125.27%	103.04%	112.70%	Fail
	Dec-10	125.28%	103.08%	112.70%	Fail

Zohar III CLO					
Year	Quarter Ending	Original	CRA Adjusted	Minimum	Pass/Fail
2011	Mar-11	126.12%	109.81%	112.70%	Fail
	Jun-11	123.18%	107.98%	112.70%	Fail
	Sep-11	124.44%	108.43%	112.70%	Fail
	Dec-11	124.41%	109.13%	112.70%	Fail
2012	Mar-12	124.32%	108.99%	112.70%	Fail
	Jun-12	120.97%	107.33%	112.70%	Fail
	Sep-12	121.50%	107.44%	112.70%	Fail
	Dec-12	121.48%	107.47%	112.70%	Fail
2013	Mar-13	119.62%	106.42%	112.70%	Fail
	Jun-13	120.05%	106.37%	112.70%	Fail
	Sep-13	120.39%	106.31%	112.70%	Fail
	Dec-13	120.63%	106.21%	112.70%	Fail
2014	Mar-14	116.75%	106.67%	112.70%	Fail
	Jun-14	118.74%	107.28%	112.70%	Fail
	Sep-14	117.83%	106.71%	112.70%	Fail
	Dec-14	118.13%	106.82%	112.70%	Fail

(Tr. 391:2-392:1; DX 17 at 56-57.)

65. Mr. Mayer also opined that a large amount of data needs to be accessed, including data beyond the trustee reports, and be maintained, updated and analyzed in order for an investor to calculate whether the Zohar Funds passed or failed their OC Tests. (Tr. 392:2-14; DX 17 at 57.)

66. Mr. Mayer also opined that Zohar II and Zohar III paid $208 million in subordinated collateral management fees and preference share distributions to Respondents during periods in which those funds failed their OC Tests as follows:

Preference Share Distributions and Subordinated Collateral Management Fees Paid During the Period in which Zohar II and Zohar III Failed their OC Ratio Tests

CLO	OC Ratio Test Fail Period	Preference Share Distributions	Subordinated Collateral Manager Fees	Total
Zohar II	Jul 2009 - Dec 2014	$0	$76,012,349	$76,012,349
Zohar III	Jun 2009 - Dec 2014	$41,000,000	$91,403,522	$132,403,522
Total	[illegible]	[illegible]	[illegible]	[illegible]

(Tr. 392:15-393:6; DX 17 at 63.)

67. Mr. Mayer rebutted the criticisms against him by opining that his approach is based on what actually happened. Specifically, that each time a preference share distribution or subordinated collateral management fee payment was made from the Zohar Funds to Respondents when the OC Test was violated, those funds should not have been paid to Respondents. Respondents' experts, Mr. Froeba and Dr. Hubbard, opined that instead of relying on what actually happened (as Mr. Mayer did), Mr. Mayer should have created a but-for world involving numerous assumptions, including that cash flow would be directed to pay down principal on investor notes when the OC Ratio test failed, and that Tilton would take unspecified actions to rectify a portfolio loan that was not current on its interest and thereby rectify a failed OC Ratio test at or near the time such failure occurred. Additionally, the OC Ratio estimations provided by Respondents' experts are not reliable. Ultimately, calculation by an investor of the OC ratio would be impossible or extremely and unreasonably difficult to accomplish at best, and would be unreliable. (DX 20 at 3.)

<u>**Matthew Mach**</u>

68. Mr. Mach is a Managing Director at Varde Partners ("Varde"), where he is the trader and senior member of the investment team. Mr. Mach has worked at Varde since 2008. Varde is an alternative investment manager with a focus on opportunistic credit and special situations investing, with a focus on distressed debt. (Tr. 587:8-16; 588:11-589:7.)

69. Mr. Mach has extensive experience in distressed debt investing as well as with collateralized debt obligations ("CDOs"). (Tr. 589:8-590:15.)

70. Mr. Mach was personally involved in Varde's investment in Zohar III; it was his analysis and recommendation to purchase. Varde ultimately purchased $110 million in face value of the Zohar III A1 notes and $38 million in face value of the Zohar III A2 notes. (Tr. 590:16-591:18; 593:3-7.)

71. When making its Zohar III investment decision, Varde found cash flows to be important. (Tr. 593:12-594:4.)

72. Given his experience in distressed debt investing, Mr. Mach did not expect the Zohar portfolio companies to routinely miss interest payments. Mr. Mach expect companies that were current on payments would continue to be current. (Tr. 594:5-18; 747:25-748:12; 750:4-14.)

73. Prior to investing in Zohar III, Mr. Mach and Varde reviewed the indenture, collateral management agreement, the trustee reports, and the financial statements, which were very important and the only information available to Varde. (Tr. 594:19-595:17.)

74. The OC ratio was very important to Mr. Mach and Varde, as it provided a quick snapshot of the overall health of the Zohar III vehicle. (Tr. 595:18-596:11.)

75. Mr. Mach and Varde understood, based on the indenture, that categorization of assets for the OC test would be objective, and that non-payment of interest would result in a defaulted categorization. This was important to Mr. Mach and Varde, as only the collateral manager had the information and ability to properly categorize. This categorization was straightforward, so Mr. Mach and Varde did not believe it to be necessary to double check Patriarch and Ms. Tilton's categorizations. (Tr. 596:12-598:14; 748:13-749:2.)

76. It was never disclosed to Mr. Mach that Ms. Tilton was categorizing loans based on her belief in the future recovery and the reorganization of the portfolio companies. This would have been tremendously important information because this subjective belief method would make Zohar III borderline un-investable due to lack of information and clarity. (Tr. 601:17-603:1; 751:4-21.)

77. When Mr. Mach reviewed the Zohar III trustee reports, he noted that the OC ratio test was passing, which was important. If it had been failing, it would have impacted his and Varde's investment decision. (Tr. 604:3-604:2; 610:1-612:3.)

78. It was important to Mr. Mach and Varde that the collateral manager follow the deal documents and provide accurate information. (Tr. 604:3-605:10.)

79. It was important to Mr. Mach and Varde that the collateral manager was an investment adviser owing fiduciary duties and a standard of care. (Tr. 607:14-609:25.)

80. After learning of this lawsuit, Mr. Mach and his team took two days to analyze prior Zohar III trustee reports and determined that the OC ratio could not have been passing, but must have been breached. This lead Mr. Mach to want to replace Patriarch and Ms. Tilton as collateral manager. Also as a result, Varde sold the remainder of it Zohar III A1 notes. (Tr. 612:4-614:11; 617:8-618:2.)

81. The work required to analyze the trustee reports to independently verify Patriarch and Ms. Tilton's OC ratio disclosure was cumbersome, and could not realistically be done on a monthly basis. Mr. Mach and Varde believed it was unnecessary to do this double checking before learning of this lawsuit, as it never crossed Mr. Mach's mind that Patriarch and Ms.

Tilton, as investment advisers, would not accurately categorize loans. (Tr. 614:12-.615:15; 747:6-13; 749:15-750:3)

82. Mr. Mach and Varde did not participate in investor calls, as doing so required the signing of a non-disclosure agreement. (Tr. 615:23-616:9.)

83. The Zohar III financial statements were important to Mr. Mach and Varde, in particular the fair value and GAAP certification representations, and the fact that Ms. Tilton was certifying the financial statements herself. It would have been important to Mr. Mach and Varde if the fair value and GAAP certification representations were untrue. (Tr. 618:3-621:9.)

84. As a secondary market investor, Varde did not need to speak to anyone who negotiated the Zohar III deal, but rather rely on disclosures. (Tr. 751:15-751:3.)

Peter Berlant

85. Mr. Berlant is a CPA and Partner at Anchin, Block & Anchin ("Anchin"). (Tr. 753:16-18; 754:17-755:4.)

86. Approximately 15 years ago, Mr. Berlant began performing services for Ms. Tilton and Patriarch. Those services included "agreed-upon procedures" for the ARK funds. Agreed-upon procedures involved comparing numbers and reporting any differences, but not investigating those differences. (Tr. 755:19-756:22; 757:7-758:20.)

87. In or around 2003, Mr. Berlant was asked to perform services with respect to Zohar I, and later Zohar II and Zohar III. Mr. Berlant performed agreed-upon procedures, which involved comparing internal records. Agreed-upon procedures did not have anything to do with reviewing or auditing the Zohar funds' financial statements. (Tr. 758:21-759-9; 760:13-20; 761:2-9.)

88. Anchin also performed tax services for the Zohar funds (Tr. 759:22-760:12; 761:6-9;

89. From approximately 2003 to January 2016, Mr. Berlant also received the Zohar funds' financial statements prior to their issuance. Mr. Berlant read the financial statements to determine if everything added up, which is referred to as "footing." (Tr. 759:14-21; 761:13-762:11; Tr. 765:10-16.)

90. Mr. Berlant was never asked to draft the Zohar funds' financial statements and did not draft the Zohar funds' financial statements. (Tr. 762:14-18.)

91. An "audit" is a deep dive into the information supporting the financial statements, as well as understanding the basis for the financial statements, the disclosures, and making sure the disclosure are complete and reasonably accurate. Mr. Berlant was never engaged to perform an audit of the Zohar funds financial statements, was never asked to perform an audit of the Zohar funds financial statements, and did not ever perform an audit of the Zohar funds' financial statements. (Tr. 763:1-21.)

92. A "review" is looking at financial statements to make sure that they are in compliance with whatever standard they're reporting to be reporting on. Mr. Berlant was never engaged to perform a review of the Zohar funds financial statements, was never asked to perform a review of the Zohar funds financial statements, and did not ever perform a review of the Zohar funds' financial statements. (Tr. 763:22-764:20.)

93. A "compilation" is preparing the form of financial statements with information that is provided by the entity. Mr. Berlant was never engaged to compile the Zohar funds financial statements, was never asked to compile of the Zohar funds financial statements, and did not ever compile the Zohar funds' financial statements. (Tr. 764:21-765:9.)

94. Div. Ex. 34 is the engagement letter between Anchin and Patriarch with respect to the financial statements for the various Patriarch entities. It was signed by Mr. Berlant and Ms. Tilton. The engagement letter defined what level of service Anchin would and would not provide. The engagement letter defined what Anchin would and would not do, and where Anchin's responsibilities lie and where Patriarch's responsibilities lie. (Tr. 765:18-767:11.)

95. The engagement letter includes a section called Financial Statement Services. It states "Financial statements services shall consist of reading and commenting on financial statements, computations or other financial data compiled by Patriarch employees." The services Mr. Berlant performed were consistent with the engagement letter and did not go beyond the services outlined in the engagement letter. (Tr. 767:20-768:20; 769:15-771:11; 1000:24-1001:16)

96. To perform those services, Mr. Berlant received draft financial statements and an electronic set of work papers, which were prepared by Patriarch. Mr. Berlant would spend approximately one or two hours making sure dates were changed correctly, numbers added up correctly, and that the financial statements had been updated and were internally consistent. He would then typically make a phone call to the controller or CFO at Patriarch and provide comments. (Tr. 778:13-781:14; 881:14-882:1; 1077:13-1079:11.)

97. Mr. Berlant typically had 24 to 48 hours after receiving the Zohar funds' financial statements to provide comments. It would not have been possible for Mr. Berlant to perform a review in this time frame, nor would it be possible to do anything aside from the tasks outlined in the paragraph above and in the engagement letter. (Tr. 781:24-782:24; 1073:19-1075:11; 1096:21-1097:20.)

98. The Zohar funds' financials represented that they were prepared in accordance with U.S. generally accepted accounting principles. (Tr. 782:25-783:16.)

99. Mr. Berlant has no knowledge of whether the Zohar funds' financial statements were prepared in accordance with GAAP. Mr. Berlant was never asked to interpret, or given an opportunity to research and consider, whether the Zohar funds' financials were GAAP compliant. (Tr. 786:6-9; Tr. 893:24-894:9.)

100. Under GAAP, in most cases, the inability to collect on a loan in full or in part would require the carrying value of the loan asset to be reduced. The notes to the Zohar funds' financials also state the principal of the loans assets were being impaired when anticipated future

collections were determined to be less than the carrying value of the loan. (Tr. 787:16-789:17.)

101. Mr. Berlant did not know what Patriarch did to consider whether Zohar funds' loan assets were impaired, or whether Patriarch did anything to consider loan impairment, because that was outside the scope of his engagement and he was never asked to perform a loan impairment analysis. (Tr. 789:7-792:17.)

102. Mr. Berlant did not tell Ms. Tilton or anybody else at Patriarch that he was evaluating Zohar fund loan assets for impairment. (Tr. 793:3-6.)

103. Mr. Berlant did not advise Ms. Tilton or anyone else at Patriarch that Patriarch was not obligated under U.S. GAAP to write down loans until those loans were written off the books. (Tr. 795:8-13.)

104. The notes to the Zohar funds' financials stated that Patriarch was engaging in a valuation approach to determine the fair value of the loan assets. (Tr. 796:10-797:14.)

105. Mr. Berlant did not know what Patriarch did to evaluate the fair value of Zohar funds' loan assets, or whether Patriarch did anything to evaluate their fair value, because that was outside the scope of his engagement and he was never asked to evaluate the fair value of loan assets. (Tr. 797:15-798:9.)

106. Mr. Berlant did not advise Ms. Tilton or anybody else at Patriarch that he was evaluating the fair value of the Zohar funds' loan assets. (Tr. 797:24-798:2.)

107. FAS 157 was a new standard that came out approximately five or six years ago that changed the disclosure requirements with regard to the fair value of assets and liabilities. (Tr. 798:17-799:3.)

108. Although Mr. Berlant told somebody at Patriarch that FAS 157 may apply to Patriarch and it should consider it for the Zohar funds' financial statements, Mr. Berlant was never asked to opine on whether FAS 157 had an impact on the Zohar funds' financial position. (Tr. 800:22-25; 1009:18-1013:10)

109. Mr. Berlant was never asked, engaged or directed to opine on the Zohar funds' compliance with FAS 157, nor was he asked, engaged or directed to opine on the methodology or applicability of FAS 157 to the Zohar funds. (Tr. 799:15-18; 801:9-12.)

110. FIN 48 was a new standard about accounting reporting for uncertainty and income taxes. (Tr. 1003:10-17.)

111. Mr. Berlant sent a FIN 48 draft footnote (prepared by Anchin's technical department) to Patriarch to be considered for inclusion. Mr. Berlant did not advise Patriarch whether the footnote was applicable, but rather advised Patriarch a new standard (FIN 48) came out and that Patriarch should consider it for inclusion. Patriarch determined it was applicable without advice from Mr. Berlant other than it should consider the new standard. (Tr. 1003:18-1008:18.)

112. There came a time that references to GAAP were removed from the Zohar funds' financial statements. Mr. Berlant learned of this when he received a draft financial statement via email and the references to GAAP had been removed. (Tr. 801:13-803:1; 803:24-6; 817:8-25.)

113. Mr. Berlant was not asked to opine on the new language in the Zohar funds' financials that replaced the GAAP language, was not consulted on the change, and was not asked on opine on the change. (Tr. 819:1-3; 822:9-15.)

114. The language that replaced the GAAP disclosures was unique. Mr. Berlant had never before seen a similar disclosure, and Mr. Berlant does not know how drafted the new language. (Tr. 818:15-821:16; 822:9-10; 883:3-7.)

115. The notes to the Zohar funds' financials were also changed to include disclosures that the loan assets would not be impaired until in the judgment of the collateral manage, principle losses could be conclusively determined. Mr. Berlant was not asked to opine on the new language. (Tr. 822:16-826:11.)

116. The notes to the Zohar funds' financials were also changed by removing language that Patriarch was performing a fair value analysis on the Zohar funds' loan assets. Mr. Berlant was not asked to asked to pone on whether this language should be removed. (Tr. 826:12-827:12.)

117. After the above changes were made to the Zohar funds' financial statements, nobody at Patriarch ever stated to Mr. Berlant that he was doing a poor job, that he missed things in past financial statements, that changes were made because of his work, or that anybody at Patriarch was unsatisfied with his work. Rather, Patriarch continued to send the Zohar funds' financial statements to Mr. Berlant and pay him for his services. (Tr. 827:13-828:16.)

118. After the above changes were made, nobody at Patriarch ever told Mr. Berlant that Patriarch believed he was performing services in addition to those outlined in his engagement letter. (Tr. 830:13-831:20.)

119. Mr. Berlant understood that Ms. Tilton had been a financial analyst for years looking at financial statements, understanding them, deciphering them, breaking them apart, and interpreting them. Mr. Berlant believed Ms. Tilton understood whatever accounting topics came up in conversation between them. (Tr. 835:1-836:13.)

120. Mr. Berlant did not recall any conversation where Mr. Tilton was confused on the scope of Mr. Berlant's services with respect to the Zohar funds, nor did Ms. Tilton ever state, imply or infer that she believed he was auditing, reviewing, or compiling the Zohar funds' financial statements. (Tr. 888:23-890:2.)

121. Mr. Berlant was never asked, engaged, directed, or requested to approve any of the Zohar funds' financial statements. (Tr. 890:14-17.)

122. Although there were emails that referred to Mr. Berlant and Mr. Tilton "reviewing" the Zohar funds financial statements, the term "review" in these emails was used in the vernacular that each would perform their typical functions. Ms. Tilton was not permitted to perform an accounting review of the Zohar funds financial statements, and Mr. Berlant was not hired to perform an accounting review of the Zohar funds financial statements. (Tr. 1067:21-1069:12; 763:22-764:20.)

123. During the 10 years that Mr. Berlant received the Zohar funds' financial statements, Mr. Berlant had no concerns that he and Ms. Tilton were clear on what the scope of Mr. Berlant's engagement was, and that it did not include performing an accounting review. (Tr. 1071:6-1073:12.)

124. Because Mr. Berlant did not know what analysis Patriarch was performing to impair loans or determine their fair value with respect to the Zohar funds, Mr. Berlant could not have cautioned Ms. Tilton about these analyses.

125. Because Mr. Berlant was not engaged to evaluate whether Patriarch's accounting policies or procedures complied with the footnote disclosures in the Zohar funds' financial statements, Mr. Berlant never did any such evaluation or performed any such analysis. (Tr. 1083:7-1085:22.)

126. Mr. Berlant did not provide any analysis on whether Zohar polices and procedures complied with GAAP. (Tr. 1095:25-1096:20.)

<u>**Carlos Mercado**</u>

127. Mr. Mercado is a CPA who joined Patriarch in October 2008 as an Assistant Controller after answering an employment advertisement on Craigslist. (Tr. 1099:14-18; 1103:11-1104:9; 1324:13-15.)

128. Mr. Mercado was twice promoted and now holds the position of Controller. (Tr. 1105:1-8.)

129. Ms.Tilton has the authority to promote or demote Mr. Mercado, to raise or lower his salary, or to immediately fire him. (Tr. 1114:22-1115:12.)

130. Mr. Mercado testified that the Zohar funds are "three funds that are private equity funds that invest in collateral asset obligations." (Tr. 1106:9-18.)

131. From the beginning of his employment, Mr. Mercado worked on the quarterly financial statements of the three Zohar funds. Ms. Tilton has always signed the officer certificate of the Zohar funds' financial statements, and there was never anyone with authority to change the financial statements above Ms. Tilton. (Tr. 1106:19-1107:20; 1110:10-12; 1111:10-13.)

132. Although the notes in the Zohar funds' financial statements referenced loan impairment and fair value analysis with regards to loan assets, Patriarch did not have a manual

containing policies and procedures for either loan impairment or fair value analyses. (Tr. 1112:11-1114:21.)

133. With regards to loan impairment, Patriarch's policy has been, since the inception of each one of the Zohar funds, that the collateral debt obligations (i.e. loan assets) are not considered to be impaired unless an event or sale occurs from which a principal loss can be conclusively determined. (Tr. 1117:25-1118:5.)

134. The Zohar funds' financial statements are required under each of their respective indentures, and are required to be prepared in accordance with U.S. GAAP. The purpose of the financial statements is to provide financial status of the funds. (Tr. 1119:14-1120:1.)

135. To create the Zohar funds' financial statements, the Patriarch accounting department would obtain the daily abstract showing the loans that are outstanding along with a cash balance sheet, would reconcile the balances, and then place a draft income statement and balance sheet into a word document with updated notes to the financial statements. The draft financial statement would then be sent to Mr. Berlant. (Tr. 1120:5-22; 1290:4-1291:10.)

136. Mr. Berlant typically had about two days to look at and comment on the draft financials. It was not possible for Mr. Berlant to have more than five days because the Patriarch accounting department only had five days to create the draft financials and get them finalized. (Tr. 1120:23-1121:19; 1126:5-15; 1334:6-13.)

137. Mr. Berlant did not ever perform an accounting audit, review or complication of the Zohar funds' financial statements, nor did Mr. Berlant have the time to perform an audit, review or complication of the Zohar funds' financial statements. (Tr. 1121:20-1125:15; 1127:12-1128:3.)

138. Rather, according to Mr. Mercado, Mr. Berlant checked the "accuracy" of the work papers and the financial statements and provided any commentary with respect to accounting issue that he felt were relevant to the Zohar funds' financial statements. "Accuracy" means that "what was in the work papers was being reflected on the financial statement document." (Tr. 1125:16-1126:4.)

139. Mr. Berlant was not reviewing or opining on whether the Zohar funds' financial statements complied with GAAP. Mr. Berlant was not testing whether the Zohar funds' financial statements complied with GAAP. Rather, according to Mr. Mercado, Mr. Berlant was providing instruction as to whether or not there was an issue that Patriarch needed to incorporate into the financial statements, or "consider to be included into the financial statements." (Tr. 1128:18-1129:9.)

140. After receiving the Zohar funds' draft financial statement, Mr. Berlant typically had a very short phone call with Mr. Mercado where he would say "looks good to me" or to "just double check the wording here," but there had not "been anything of real substance that [Mr. Berlant] addressed...other than the FAS 157 item." (Tr. 1141:7-1142:5.)

141. The Zohar funds' financial statements represented that Patriarch was impairing loans. Loan impairment is when one expects that they will not collect full principal and interest on

the loan, they reduce the carrying amount of the loan based upon the amount that has been estimated to be the loss, which is also known as a "write-down." (Tr. 1148:18-1149:6.)

142. Patriarch policy for determining loan impairment was "if an event occurred or sale occurred from which [Patriarch] [could] conclusively gather that a principal loss ha[d] occurred, then [Patriarch] would impair the loan and record a write-off of that loan." (Tr. 1149:7-14.)

143. An "event" determined whether Patriarch impaired a loan. The only three events that Mr. Mercado recalled that led to impairment were bankruptcies, liquidations, and restructurings. Ms. Tilton would make the determination whether an impairment would occur upon any of these events. (Tr.1149:15-1154:19; 1163:25-1164:6.)

144. Patriarch never wrote down its loan assets. Patriarch's policy was "to write off assets." (Tr. 1160:24-1161:18; 1265:6-12.)

145. Ms. Tilton specifically emailed Mr. Mercado stating "[w]e do not write up or write down. We write off." *See* Div. Ex. 162. In the same email chain, Ms. Tilton had stated "I do not think we write these down until we write them off," but that it was "not an email discussion." *Id.* This occurred before the financial statement in question was sent to Mr. Berlant. (Tr. 1158:19-25; 1161:6-7; 1162:18-20.)

146. Patriarch's policy of only writing off at the point of "conclusive determination of what the loss is going to be" was not disclosed in in the Zohar funds' financial statements. (Tr. 1174:24-1175:7.)

147. The Zohar funds' financial statements represented that the Zohar funds' loan assets (i.e. CDOs) were represented at their "fair value," which were "based on estimates using present value of anticipated future collections or other valuation techniques." (Tr. 1176:2-1177:3.)

148. Patriarch's fair valuation technique to determine the fair value of its loan assets (i.e. CDOs) was the "cost of the actual CDO balances." "Cost is the actual cash that was paid for th[e] loans." (Tr. 1177:4-14.)

149. If in 2010 Patriarch sought to determine the fair value of loans purchased in 2003 (or funds loaned out in 2003), it would look at the cost of those loans (or the amount of money loaned out) in 2003. (Tr. 1178:7-14.)

150. The terms "fair value" and "cost" are not the same thing. (Tr. 1180:3-1181:4.)

151. According to Mr. Mercado, Patriarch's use of cost as a fair valuation technique each quarter, year after year, was disclosed by the representation that "[t]he collateral debt obligations are recorded at cost upon acquisition, which is equal to the amount of cash paid to acquire the collateral debt obligation." Mr. Mercado was unable to explain how one could know the loans were carried at cost in the quarters and years following acquisition in light of the "upon acquisition" language (Tr. 1178:20-1180:2; 1182:11-1183:2.)

152. Mr. Mercado – who has been employed at Patriarch for eight years and is the head of the accounting department – was never involved in a process for determining fair value of the Zohar funds' loan assets. Mr. Berlant was also not involved in any such process. (Tr. 1325:23-1327:20.)

153. Accrued interest is interest that is earned, but has not been received at a specific point in time (*i.e.* interest that is owed but has not been collected). (Tr. 1183:5-1184:12.)

154. The Zohar funds' balance sheet contained a line item for accrued interest, along with a "net of an allowance for uncollectible items." (Tr. 1185:4-17.)

155. At one time the Zohar funds' financial statements disclosed the entirety of accrued interest (i.e. the total amount of interest owed to the respective Zohar fund but not collected). (Tr. 1204:19-1205-2.)

156. By 2010, the Zohar funds' financials no longer disclosed the total amount of accrued interest; the allowance for uncollectible item did not contain the total amount of interest that had been accrued but was not expected to be collected. (Tr. 1187:1-7; 1188:18-21; Tr. 1190:7-15.)

157. According to Mr. Mercado, the total accrued interest was omitted because it would have inflated the revenue number on the income statement. (Tr. 1190:16-1191:8.)

158. The total accrued interest could have been disclosed by placing the amount that was not expected to be collected within the "allowance for uncollectible items," but was not because Mr. Mercado believed "it was more appropriate to just show what we actually expected to collect." (Tr. 1199:25-1200:6.)

159. According to Mr. Mercado, the amount of accrued interest that Patriarch did not expect to collect could have been reflected on the Zohar funds' balance sheet, but was not because it was felt that "it wasn't a number that was meaningful to the investors." The decision to not show this figure was made by Ms. Tilton. (Tr. 1207:6-16; ;1221:10-18.)

160. On the Zohar III March of 2010 financial statement, the "allowance for uncollectible items" was $900,000. However, there was approximately $40 million more in accrued interest that was not expected to be collected. (Tr. 1341:16-1343:16.)

161. Had this $40 million figure been included on the balance sheet as an uncollectible in addition to the $900,000, it would have had no effect on the balance sheet because the figure was not an asset, but rather an uncollectible item. (Tr. 1343:20-1343:19.)

162. Had this $40 million figure been treated in the same manner as the $900,000 figure that did appear on the balance sheet, it would have had no effect on the income statement because the line item "interest and fee income" netted the amount of interest owed and the amount expected to be collected. However, Mr. Mercado testified that in his judgement, had the $40 million been included, it would have been broken out. Regardless, it would have no effect on Net Income. (Tr. 1344:11-1346:2.)

163. The Zohar III March of 2010 financial statement showed approximately $6.9 million in accrued interest expected to be collected and approximately $900,000 that was not expected to be collected, which calculates to 88% collection. If the $40 million was included as uncollectible accrued interest, it would calculate to a 14.6% collection rate. (Tr. 1346:14-1347:19.)

164. According to Mr. Mercado, omitting the $40 million figure was done for the benefit of investors because the amount that was not expected to be collected "didn't seem to [Patriarch] that it was a meaningful number." (Tr. 1347:20-1348:1.)

165. In 2010 there was an "uptick" in portfolio companies that could not pay their owed interest and there was a reduction in what Patriarch expected to collect. The amount of unpaid interest began to grow. (Tr. 1201:17-21; 1203:11-17; 1351:2-7.)

166. In March 2010 Mr. Mercado sought the guidance of Ms. Tilton on changing its methodology as to how Patriarch calculated accrued interest. (Tr.1200:11-16; 1201:22-1202:7; 1351:16-1352:9.)

167. Under the prior methodology, the Accrued Interest figure would have increased by $4.1 million from the previous quarter. Mr. Mercado sent an email outlining how the methodology could be changed "to maintain a more consistent accrual level" that "results in accrual that is in line with the prior period," and showing how the new figure would be similar to the prior quarters. *See.* Div. Ex. 218. (Tr. 1352:10-21.)

168. Mr. Mercado conceded that the goal of a financial statement is to an accurate reflection of the entity at that point in time, not to have the statement be consistent with past statement. (Tr. 1353:5-10.)

169. Following this email, Patriarch's accrued interest methodology was changed after Ms. Tilton made the final decision to make the change. According to Mr. Mercado, this change was made for the benefit of investors. (Tr. 1354:20-1356:25.)

170. Noteholders (i.e. Zohar fund investors) had to be placed first in terms of all the decisions that were made by Patriarch. The Zohar funds' financial statements were intended to provide Noteholders with an accurate picture of their investment in the Zohar funds. (Tr. 1335:2-18.)

171. The collectability of a loan's principle and interest payment were treated two different ways. (Tr. 1208:3-16.)

172. Loan interest deferral was not an event that triggered an impairment analysis. Thus, even when Patriarch did not expect to collect interest that was owed on a loan, it did not impair the principal of that loan. (Tr. 1334:14-1335:1.)

173. Mr. Mercado does not want Ms. Tilton to get in trouble in this proceeding, and does not want to get in trouble himself, as he could have lability with the AICPA or New York CPA authority because he was involved in creating the financial statements at issue in this case. (Tr. 1323:13-1324:12.)

Steven Henning

174. Dr. Henning is a partner at Marks Paneth, a public accounting and business consulting firm. Since 2004, Henning has practiced as an accounting expert in litigation matters that address allegations of improper financial reporting. He also has experience consulting on matters involving loans held for investment. (Tr. 1405:6-1406:7, Div. Ex. 18 at 2.)

175. Dr. Henning has been licensed as a CPA in Wisconsin since 1986 and in New York since 2005. Dr. Henning holds a PhD in business with an emphasis in accounting and economics. (Tr. 1404:22-24, 1406:9-14.)

176. Prior to working at Marks Paneth, Dr. Henning was a professor in financial accounting at Southern Methodist University and the University of Colorado at Boulder. He also worked as an academic fellow in the Office of the Chief Accountant at the SEC. (Tr. 1406:15-25.)

177. Dr. Henning was accepted as an expert in GAAP and financial reporting. (Tr. 1384:2-3, 1411:24-1413:3.)

178. GAAP requires a creditor to record a loss when it is probable that a loan is impaired as of the date of the financial statements. Under GAAP, a loan is impaired and must be measured for the amount of impairment loss when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contract with the debtor. Probable means that an event is likely to occur. (Div. Ex. 18 at 10-11.)

179. To conduct an impairment analysis, GAAP required Patriarch to identify loans that exhibited indicators of impairment. This includes loans that are delinquent in their interest and/or principal payments. (Div. Ex. 18 at 12.)

180. Patriarch discloses that it bases its measure of loan impairment on a present value calculation. As a result, its estimates of future cash flows should be Patriarch's best estimate based on reasonable and supportable assumptions and projections. (Div. Ex. 18 at 12.)

181. Patriarch discloses that it will evaluate whether it will receive the interest and principal payments it is to receive on each loan. If it determines it will collect less than the carrying value of the loan, Patriarch discloses that it will write down the loan to the reduced amount it expects to receive. Patriarch did not follow this methodology. (Div. Ex. 18 at 14.)

182. Patriarch evaluated loans for impairment under only very limited circumstances. (Div. Ex. 18 at 14.)

183. Patriarch did not perform an impairment analysis in each reporting period whereby it compared cash flows it anticipated to be received for each loan to its carrying value. Instead, Patriarch wrote off loans only when there was debt forgiveness or extinguishment.

The impairment practice that Patriarch used does not comply with either Patriarch's disclosed impairment methodology or GAAP. (Div. Ex. 18 at 16.)

184. Patriarch's impairment practice was plainly deficient in light of the indicators of impairment that should have been evaluated, such as contractually obligated interest payments that were not paid to the Zohar funds, a requested extension on the maturity of the Zohar I notes, and regular modification of loans based on what the portfolio companies could pay. (Div. Ex. 18 at 17-18.)

185. Patriarch's policy to wait for an event to occur, such as a bankruptcy or liquidating even when it is known for certain that a loan has been impaired permanently before recording an impairment loss is a violation of GAAP. (Div. Ex. 18 at 19.)

186. Patriarch's failure to follow the impairment methodology it disclosed and its failure to conduct a GAAP-compliant impairment analysis rendered the Zohar Funds' financial statements false and misleading. (Div. Ex. 18 at 19.)

187. Patriarch disclosed that the fair values of the loans to the portfolio companies, taken as a whole, were approximately equal to the carrying value presented on the balance sheet. In other words, Patriarch reported that the cost of loans on the balance sheets was the same as the discounted present value of the cash it expected to collect on those loans. (Div. Ex. 18 at 20.)

188. Patriarch did not calculate the fair value of the loans, either individually or in the aggregate. The Funds' financial statements departed from GAAP because Patriarch had no basis to make the fair value disclosures that they did. (Div. Ex. 18 at 20, 22.)

189. Patriarch disclosed that its fair values are based on estimates using present value of anticipated future cash collections or other valuation techniques. However, loans were not valued on the basis of future cash flows, but rather, values were based on historical cost. (Div. Ex. 18 at 23-24.)

190. There is no basis for the assertion in the Funds' financial statements that cost and fair value are the same. Patriarch does not conduct a fair value analysis because it does not estimate the cash flows expected to be collected on the loans. These disclosures make it appear that the Funds are conducting fair value analyses when they are not, rendering the Funds' financial statements false and misleading. (Div. Ex. 18 at 24.)

191. The Funds' financial statement disclosures and the Certificate as to Financial Statements signed by Tilton were changed significantly in 2015. (Div. Ex. 18 at 24.)

192. In the certification and in the notes to the financial statements, the stated basis of accounting was changed from U.S. GAAP to a different basis of accounting. The new basis of accounting was described as "the Company's investment in Collateral Debt Obligations ('CDOs') are recorded at cost and the company's equity interests in portfolio companies are not recorded on the consolidated balance sheet." (Div. Ex. 18 at 24-25.)

193. In the certification and in the notes to the 2015 financial statements, the references to GAAP were eliminated. In addition, all references for measuring fair value were eliminated. There were no disclosures explaining the reason for the changes. (Div. Ex. 18 at 24-25.)

194. Changes in the disclosures that eliminate references to GAAP-compliant financial statements, without changes in the underlying methodologies, are an acknowledgement by Respondents that the prior reporting was not in accordance with GAAP and the changes were made in order to correct these disclosures. (Div. Ex. 18 at 25.)

195. There is no indication that Patriarch changed the methods it used to prepare its financial statements in 2015. (Div. Ex. 18 at 25.)

196. GAAP is a commonly accepted and widely understood framework by which financial reports are prepared. An entity would not remove a reference to financial statements being GAAP-compliant without changing the underlying methodologies used unless, in fact, those financial statements were not prepared in accordance with GAAP. (Div. Ex. 18 at 25-26, Tr. 1439:2-22.)

197. Dr. Henning did not consider the equity value of loans to the portfolio companies in reaching his conclusion that a GAAP-compliant impairment analysis was not performed by Patriarch. He did not consider the equity value because any equity component associated with the loan assets of the Funds, was not recorded on the Funds' financial statements. (Div. Ex. 21 at 4-5, Tr. 1438:4-6.)

198. It would have been improper under GAAP to consider the equity value associated with loans to portfolio companies. While any equity held by the Zohar Funds may have economic value in the future, impairment analysis is performed as of the balance sheet date, based on the recoverability of assets recorded on the balance sheet. (Div. Ex. 21 at 5.)

199. Even if GAAP allowed Patriarch to consider the value of equity in assessing the impairment of loans to portfolio companies, that equity has no value until the loans are repaid. (Div. Ex. 21 at 6, Tr. 1438:11-13.)

200. Dr. Henning did not opine as to which unit of accounting Patriarch was required to use in conducting an impairment analysis, but instead opined that Patriarch failed to conduct a GAAP-complaint impairment analysis no matter which unit it selected. Moreover, spreadsheets allegedly reviewed by Patriarch to conduct an impairment analysis do not demonstrate a GAAP-compliant analysis took place, because there is no information in those documents regarding the collectability of the loans. (Div. Ex. 21 at 11.)

201. Financial statements that contain misleading disclosures can still be false and misleading even if it has not been demonstrated that the reported numbers are materially misstated. Irrespective of the amount by which any numbers may differ, Dr. Henning opined that

Patriarch made disclosures that were simply untrue. (Div. Ex. 21 at 11-13, Tr. 1435:20-1436:8.)

202. Financial statements are the responsibility of management. (Tr. 1422: 21-22, 1433: 5-9.)

203. Impairment looks at and contemplates a loss when it becomes probable and you can estimate the amount; not when it becomes certain. Dr. Henning did not observe any work performed by Patriarch regarding future cashflows or prospects for collection of those cash flows. (TR. 1434:25-1435:14.)

204. There is a difference between writing assets off and writing them down. When an asset is written down, management is required to apply judgment regarding the value of an asset. When an asset is written off, no more judgment is required. Writing assets down is a process of showing a decline in value of the assets. (Tr. 1437:1-19.)

Jaime Aldama

205. Mr. Aldama is a managing director at Barclays Bank. (Tr. 1496:8-11.)

206. Mr. Aldama has significant experience with CDOs and CLOs. He worked at JP Morgan Chase as a trustee for CDOs and CLOs from 2002-2004. He then worked at structuring CDOs and CLOs with CitiGroup from 2004 to 2007. He then worked at Lehman Brothers on structured products, including CDOs, from 2007 to 2008. He then joined Barclays Bank in 2008 to continue his work on structured products. (Tr. 1493:4-1496:7.)

207. Throughout his career, Mr. Aldama has been exposed to between 150 and 200 CDOs and CLOs. (Tr. 1496:12-14.)

208. Barclays was an investor in Zohar I. (Tr. 1492:4-6.)

209. Barclays originally purchased $350 million in Zohar I notes. (Tr. 1498:8-13.)

210. There were some paydown of Barclays' Zohar I notes; the position during Mr. Aldama's exposure to the Zohar I notes was approximately $300 million. (Tr. 1498:14-23.)

211. Barclays sold its Zohar I notes in 2015 for approximately $100 million. (Tr. 1498:24-1499:3, 1522:14-20.)

212. Barclays took a $200 million loss on its investment in the Zohar I notes. (Tr. 1522:19-20.)

213. Barclays was receiving a relatively low interest rate on its investment in Zohar I. (Tr. 1499:4-11, 1594:25-1595:3.)

214. Barclays did not own equity in the underlying Portfolio Companies. (Tr. 1499:12-15.)

215. Mr. Aldama did not understand that Zohar I owned equity in the underlying Portfolio Companies. (Tr. 1499:16-19.)

216. Mr. Aldama is familiar with Barclays' investment in Zohar I. It was one of the CLOs he worked on in his work with structured products at Barclays. He became aware of Barclays' investment in Zohar I in approximately 2010. Barclays already owned its Zohar I notes when Mr. Aldama began working on the CLO. (Tr. 1496:15-1497:17.)

217. Prior to Mr. Aldama's exposure to Barclays' position in Zohar I in 2010, he did not know anything about Ms. Tilton or the Zohar funds. (Tr. 1497:22-1498:7.)

218. When Mr. Aldama was first exposed to Barclays' investment in Zohar I, he reviewed the governing documents, including the indenture and collateral management agreement, along with the trustee reports. He reviewed the governing documents, and specifically the indenture and collateral management agreement, because they provide the rules of the deal. (Tr. 1499:20-1501:4.)

219. Mr. Aldama initially attempted to get information from the Zohar trustee. The trustee could only provide limited information, and directed Mr. Aldama to contact Patriarch or the deal underwriter for additional information. Specifically, Mr. Aldama had asked the trustee for additional information on the Portfolio Companies and the credit agreements between the Portfolio Companies and Zohar, and the trustee referred Mr. Aldama to Patriarch for that information. (Tr. 1501:13-1502:17, 1503:12-1504:4.)

220. Mr. Aldama initially met with Mr. Tilton in 2011. (Tr. 1502:18-24.)

221. During this initial meeting, Mr. Aldama discussed with Ms. Tilton that he needed additional information on the Portfolio Companies and the credit agreements between the Portfolio Companies and Zohar. He had a productive conversation with Ms. Tilton; Ms. Tilton explained that there needed to be a nondisclosure agreement ("NDA") in place to share that information. (Tr. 1502:25-1504:22.)

222. Barclays was seeking information on the Portfolio Companies because, without the information, Barclays could not appropriately capitalize its investment. What this meant is that, without the information, Barclays was required to reserve capital equal to the full value of it Zohar I investment (i.e., approximately \$300 million). This cost Barclays approximately \$40 million. Mr. Aldama explained to Ms. Tilton this cost of capital issue every time he met with her. Barclays never received the information it needed. (Tr. 1513:1-1514:24.)

223. Following the initial meeting with Ms. Tilton, Patriarch provided Barclays with an NDA that included a clause waiving Barclays' right to institute litigation against Patriarch based on any confidential information Patriarch provided. (Tr. 1505:1-22.)

224. Mr. Aldama has entered into many NDAs in his career. He has never seen an NDA with a litigation waiver. (Tr. 1505:23-1506:3.)

225. Mr. Aldama participated in a Patriarch investor call at the end of 2011. He did not learn much helpful information on that call. (Tr. 1506:4-22.)

226. Mr. Aldama and his boss met with Ms. Tilton again sometime in early 2012. The purpose of this meeting was again to attempt to get more information on the Portfolio Companies to help Barclays understand and manage its investment. The meeting did not result in Barclays receiving any additional information. (Tr. 1509:2-23.)

227. Mr. Aldama participated in an investor meeting in 2012. Investors were explicitly prohibited from recording this meeting. Ms. Tilton provided "random pieces of information" about the Portfolio Companies, but did not provide audited financial information for the Portfolio Companies. Mr. Aldama did not find this information helpful. (Tr. 1510:23-1512:25.)

228. Tilton proposed restructuring the Zohar I deal to extend the maturity of the deal. As part of the restructuring proposal, Tilton proposed removing all coverage tests from the deal, including the OC Test. (Tr. 1515:8-1516:22.)

229. Removal of these tests was not beneficial to Barclays as an investor because the tests exist to protect the interests of investors if the portfolio of loans starts deteriorating. (Tr. 1518:14-1519:11.)

230. Barclays was not necessarily opposed to a restructuring, but needed additional financial information on the Portfolio Companies to evaluate and agree to a restructure. That information was never provided. (Tr. 1517:1-1518:13, 1519:18-1520:9.)

231. The OC Ratio is very important to an investor in the Zohar I CLO. (Tr. 1524:12-16.)

232. The OC Ratio provides structural support to an investor – if the portfolio of loans in a CLO starts to deteriorate, cash flows are supposed to be redirected to the senior noteholders to pay down their principal rather than allowed to continue flowing down the "waterfall" to more junior positions. (Tr. 1524:17-1525:16.)

233. The assets in the Zohar I deal were categorized from a Category 4 asset to a Category 1 asset. In essence, a 4 was supposed to be a performing asset; a 1 was supposed to be a nonperforming asset. (Tr. 1527:8-16.)

234. Mr. Aldama understood that, based on the language of the Zohar I indenture, a loan that was not paying its interest would be categorized as a Defaulted Obligation. (Tr. 1527:17-1528:15, 1749:10-17, 1755:24-1756:14.)

235. A loan that was a Defaulted Obligation could not be categorized as a Category 4 asset. (*See* Div. Ex. 1 at 10 (definition of "Category 4" includes a loan that is a "Current Collateral Debt Obligation"), 23 ("Current Collateral Debt Obligation" cannot be a "Non-Current Obligation"), 38 ("Non-Current Obligation" is a "Defaulted Obligation").)

236. Even though Mr. Aldama knew that Tilton was making loans to distressed companies, he still understood and expected that loans categorized as a Category 4 would be current on their obligations and paying their interest. (Tr. 1651:18-1652:6, 1660:6-10, 1748:24-1749:3.)

237. A good company could not be paying interest, in which case it should be categorized as a Category 1. (Tr. 1652:15-18, 1749:4-9.)

238. It was not disclosed to Mr. Aldama that Ms. Tilton was categorizing loans based on her subjective belief in the future of the underlying Portfolio Companies. (Tr. 1530:10-1531:24.)

239. Information that Ms. Tilton was categorizing loans based on her subjective belief in the future of the underlying Portfolio Companies would have been important to Mr. Aldama as an investor in Zohar I. (Tr. 1531:25-1532:12.)

240. The Zohar I indenture does not permit the collateral manager discretion in categorizing loans. (Tr. 1531:25-1532:12, 1744:6-24.)

241. Mr. Aldama has seen CLOs where the indenture gives the collateral manager discretion in categorizing loans; the Zohar I CLO is not one of those CLOs. (Tr. 1532:13-16.)

242. It is important that the collateral manager follow the indenture. The indenture exists not just to protect the collateral manager, but also to protect the investors. (Tr. 1532:17-1533:5.)

243. Mr. Aldama did not need to go back and speak with individuals who negotiated the Zohar I deal because the indenture existed to capture the terms of the deal. (Tr. 1631:15-19, 1653:19-25; 1704:25-1705:19, 1735:19-18.)

244. As a CLO investor, Mr. Aldama expects a collateral manager to act in the best interest of investors. (Tr. 1535:11-1539:14.)

245. Mr. Aldama expects a collateral manager to exercise any judgment within the bounds of the indenture. (Tr. 1743:14-1744:5.)

246. Mr. Aldama's experience with Tilton and Patriarch was not typical of his relationship with other collateral managers. Typically, collateral managers provided him, as an investor, more free flowing access to information about the investment. (Tr. 1539:17-1541:10.)

247. The Zohar I trustee reports did not show cash flow information, including interest payments made, on a loan-by-loan basis. (Tr. 1596:12-23, 1647:18-25, 1738:7-1739:8.)

248. The Zohar I trustee reports reported stated interest rates on the underlying loans. Mr. Aldama was advised by the trustee that the trustee did not have access to the underlying credit agreements, so these interest rates that were reported on the trustee reports were simply based on information provided by Patriarch. (Tr. 1623:9-1626:3.)

249. Tilton had authority to amend loan agreements under Section 7.7(a), but that authority was subject to other provisions in the indenture. (Tr. 1633:20-24.)

250. Based on Mr. Aldama's experience, if a loan was amended, there would be significant documentation between the lender and the borrower. (Tr. 1749:23-1750:11, 1771:14-19.)

251. If the interest rate on a loan was amended, and the loan paid the amended interest rate, the loan would be in compliance with its current obligations. (Tr. 1660:11-21.)

252. You could not necessarily tell from the fact that a loan had not paid its full interest payment that the loan had been amended. (Tr. 1702:15-1703:5.)

253. Mr. Aldama expected the collateral manager to accurately report information to the trustee. (Tr. 1739:14-22.)

Lynn Tilton

254. Patriarch Partners, LLC ("Patriarch Partners") is a Delaware limited liability company with a principal place of business in New York, New York. (Tr. 1784:1-5.)

255. Ms. Tilton and Patriarch Partners' employees ran the business of Patriarch VIII, Patriarch XIV, and Patriarch XV, when those entities (the "Patriarch Collateral Managers") were collateral managers of the Zohar funds. The Patriarch Collateral Managers have no employees of their own, but are operated by Ms. Tilton with the assistance of Patriarch Partners employees. (Tr. 1784:6-1785:1; 1802:3-19.)

256. Ms. Tilton owns, controls, and acts on behalf of Patriarch Partners. Ms. Tilton founded Patriarch in 2000, originally with a partner, but has run the company herself since 2002. Ms. Tilton refers to Patriarch Partners as a distressed private equity firm. (Tr. 1785:2-12; 1801:12-1802:2.)

257. Patriarch Partners VIII, LLC was a Delaware limited liability company with its principal place of business in New York, New York. It was the collateral manager for Zohar I and is indirectly owned 100% by Ms. Tilton in a trust for the benefit of her daughter. (Tr. 1786:1-15.)

258. Zohar I was issued in 2003, raised $532 million from investors, and Ms. Tilton acted as its collateral manager. (Tr. 1786:16-1787:2.)

259. Patriarch Partners XIV, LLC was a Delaware limited liability company with its principal place of business in New York, New York. It was the collateral manager for Zohar II and is indirectly owned 100% by Ms. Tilton in a trust for the benefit of her daughter. (Tr. 1787:3-17.)

260. Zohar II was issued in 2005, raised $1 billion from investors, and Ms. Tilton acted as its collateral manager. (Tr. 1787:18-1788:6.)

261. Patriarch Partners XV, LLC was a Delaware limited liability company with its principal place of business in New York, New York. It was the collateral manager for Zohar III and is indirectly owned 100% by Ms. Tilton in a trust for the benefit of her daughter. (Tr. 1788:13-1789:4.)

262. Zohar III was issued in 2007, raised $1 billion from investors, and Ms. Tilton acted as its collateral manager. (Tr. 1789:5-1789:14.)

263. The Zohar funds are structured as collateralized loan obligations, which used investor funds to make loans to distressed companies. (Tr. 1789:15-1790:25.)

264. Investors (or noteholders) in the Zohar funds invested for cash flow in the form of quarterly interest payments and principal repayment at maturity. (Tr. 1795:16-21; 1799:16-1800:5; 1844:16-18; 2729:4-10.)

265. Zohar I matured and defaulted in November 2015. Zohar II will mature and is expected to default in January 2017. (Tr. 1796:3-1798:5; 2072:5-2074:15.)

266. The Zohar deals are governed by deal documents, including the indentures and the collateral management agreements (the latter of which Ms. Tilton signed). Ms. Tilton was the lead person negotiating the Zohar deals for Patriarch. (Tr. 1798:6-20.)

267. The indenture is the main deal document, and Ms. Tilton implemented practices and procedures to make sure that Patriarch complied with the indentures. (Tr. 1798:21-1799:7.)

268. The collateral management agreement describes the collateral manager's obligations. (Tr. 1799:8-15.)

269. Ms. Tilton obtained equity in the Zohar funds and the underlying portfolio companies. (Tr. 1800:6-1801:10.)

270. Ms. Tilton acted as collateral manager for the Zohar funds; she made decisions regarding management of the collateral, signed documents as collateral managers, and received collateral management fees and subordinated collateral management fees of 1% each per annum. (Tr. 1802:9-1804:9; DX 13-15 (Collateral Management Agreements).)

271. Ms. Tilton's receipt of subordinated collateral management fees and preference share distributions for the Zohar funs was contingent on each fund passing its overcollateralization test ("OC Test"). Additionally, failing the OC test by a certain amount would give the Zohar I and II noteholders the right to remove Ms. Tilton as collateral manager (Tr. 1804:10-1806:7; 1894:3-21.) In total, Ms. Tilton collected about $600 million in collateral management fees and preference share distributions from the Zohar funds. (RX 134 at 3).

272. Ms. Tilton actively manages the business of the Zohar funds' underlying portfolio companies. She acts as CEO or manager, is involved with hiring and firing of employees, makes major operating decisions, requires that the companies regularly report their financial condition and business prospects, and was aware of the interest payments being made to the Zohar funds by the portfolio companies. (Tr. 1806:8-1808:22.)

273. Ms. Tilton tried to collect as much interest from portfolio companies as possible, was informed if a portfolio company was not willing to pay interest, and ultimately decided whether to accept less than the contractual rate of interest from portfolio companies. (Tr. 1808:23-1809:11.)

274. Ms. Tilton and the Patriarch Collateral Managers recognized that as fiduciaries, there were obligated to make investments consistent with the client's investment objectives, and to ensure the accuracy of its regulatory filings and communications to investors and potential investors. (Tr. 1821:18-1823:24.)

275. Ms. Tilton and the Patriarch Collateral Managers further recognized that as fiduciaries, their fiduciary duties included operating and executing on the disclosed investment strategy, acting in accordance with the indentures and collateral management agreements, and acting in the best interests of the Zohar funds and their investors. (Tr. 1824:1-1825:14.)

276. Ms. Tilton and the Patriarch Collateral Managers recognized that they were required to abide by a standard of care, to use reasonable care and the same degree of skill and attention; (a) that the collateral manager (i) exercises with respect to comparable assets that it manages for itself and its affiliates; and (ii) exercises with respect to comparable assets that it manages for others; and (b) exercised by institutional investment managers of national standing generally in respect of assets of the nature and character of the collateral and for clients having similar investment objectives and restrictions. (Tr. 1826:20-1827:23; DX 14 § 2.4 at 8.)

277. When Ms. Tilton deferred interest payments, payments were deferred until she would ask for them to be paid, which could be any point in the future or never. (Tr. 1836:16-1837:13.)

278. Contrary to her repeated claims that "everyone knew" the portfolio companies would not make their interest payments, in fact the portfolio companies largely did make their interest payments from 2005-2008. (Tr. 1837:10-1840:17.)

279. Ms. Tilton rarely waived or forgave interest payments. (Tr. 1849:1-7.)

280. Ms. Tilton previously testified that in terms of waivers, forbearance, and deferrals, when there was no formal agreement to accept less interest than due, in her mind an action she took could be characterized as any of those. (Tr. 1849:12-1853:1.)

281. Ms. Tilton was the ultimate decision maker on when to categorize a portfolio company as defaulted. (Tr. 1853:3-1854:6.)

282. Ms. Tilton claims that deferrals of interest were "amendments by course of performance" that were disclosed to investors, but interest deferrals "would begin to [be] see[n] . . . in the trustee report" only by calculating cash flows using different portions of the trustee reports; no terms of any purported amendments were disclosed. (Tr. 1843:21-1844-18; 1859:6-1860:22; 2013:17-2015:15.)

283. In order to attempt to understand whether interest had been deferred or amended, in Ms. Tilton's words, "the cash flows tell the story" in the trustee reports, even though the cash flows did not reflect the terms of any amendment. (Tr. 1872:16-1873:13.)

284. The definition of "Category 4" in the indenture provided that the collateral manager could categorize a loan that would otherwise be a 4 (or current) as a 1 (or defaulted), based on her judgment, but it provided no discretion to categorize a loan that would otherwise be a 1 (or defaulted) as a 4 (or current). Thus, Ms. Tilton had no discretion to categorize loans as 4s (or current) when they had not made their total interest payment. (DX 2 at 16 (Category 4); 30 (Defaulted Obligation).)

285. Section 7.7(a) of the indentures does not mention categorization of loans. (Tr. 1878:12-15; DX 2 at 174.)

286. Loans that had been properly categorized as 1s (or defaulted) could nevertheless be revitalized and moved back to a category 4 (or current). (Tr. 1869:13-25.)

287. The Patriarch Collateral Managers' obligations included monitoring the collateral in the Zohar funds, categorizing the loans held by the Zohar funds, and acting in the interest of the noteholders. (Tr. 1879:9-1881:22 DX 14 at 8.)

288. Under the terms of the indenture, the trustee was not under any obligation to monitor, evaluate or verify compliance by the collateral manager with the terms of the indenture or the collateral management agreement, or to verify or independently determine the accuracy of information received by it from the collateral manager. (DX 2 at 120 6.3(k).)

289. The OC ratio is essentially the carrying value or the holding value of the loan assets, plus cash, divided by the outstanding balance of the class A notes. (Tr. 1890:12-16.)

290. Ms. Tilton cannot tell whether the OC ratio was important to investors. (Tr. 1892:17-24.)

291. Categorizing a loan as a 1 (or defaulted) rather than a 4 (or current) would have a negative impact on the OC ratio, particularly in Zohar II and III. (Tr. 1896:1-1899:2.)

292. Ms. Tilton proactively managed the OC ratio for the Zohar funds. While acting as collateral manager, she wrote in contemporary e-mails "I'll take OC where I can get it" and "You need to get to me in advance if OC will retreat so radically. I need to know this before the end of the month so I can see if there is anything I want to do to change things. We need to be proactive before the month closes." (Tr. 1906:2-11; DX 138; DX 147.)

293. The OC test is an objective test, and Ms. Tilton and Patriarch touted the objective nature of the OC test to an investor and a ratings agency, stating "Zohar Objective Test Scores (LTM) Cash Does Not Lie." (Tr. 1911:6-1912:23; DX 27, 35.)

294. Ms. Tilton admitted that as collateral manager of the Zohar funds, she would not be permitted to categorize a loan as a 4 (or current) that was actually a 1 (or defaulted) just to keep to OC Test from failing. (Tr. 1930:10-1931:2.)

295. Ms. Tilton admitted that as collateral manager of the Zohar funds, improperly categorizing loans as 4s (or current) to keep money coming to her would violate her standard or care, breach her fiduciary duty, and eviscerate the investor protection of the OC Test. (Tr. 1932:21-1934:1.)

296. Ms. Tilton's categorization of loans was based on whether she believed in the recovery of the portfolio company to which a loan was made. (Tr. 1935:4-1938:12.)

297. In all of her testimony that Ms. Tilton gave in 2013, her first testimony in this case, she did not say that she was amending by course of performance. (DX 219.)

298. Ms. Tilton personally signed the officer's certificate on the financial statements for the Zohar Funds. Patriarch took responsibility for the financial statements. (Tr. 1947:14-20; 1957:15-25.)

299. Mr. Berlant of Anchin looked at the Zohar Funds' financial statements, but did not perform an audit or review. Mr. Berlant typically only had about two days to look at the financial statements, providing inadequate time for a review or audit. (Tr. 1949:1-17.)

300. The balance sheet and the income statement in Patriarch's financial statements are required to be prepared in accordance with U.S. GAAP. (Tr. 1965:17-22.)

301. Respondents' engagement letter with Anchin and Mr. Berlant regarding the financial statement made clear that Anchin and Mr. Berlant would "take no responsibility regarding the accuracy or completeness of such statements, computations or data, or whether such statements or data comply with generally accepted accounting principles or any other specified basis of accounting." Ms. Tilton took full responsibility for the accuracy of the financial statements. (DX 34; Tr. 2733:10-2734:3; 2735:6-19; 2736:23-2737:9.)

302. One of Patriarch's accounting practices was that Patriarch did not write up, it did not write down, it wrote off. (Tr. 1959:12-16; 1962:9-15; DX 162.)

303. Under U.S. GAAP, loans should be impaired when it is probable that an estimable amount of interest and/or principal payments contractually due will not be collected. (ASC 310-10-35-10.)

304. The Zohar Funds represented in their financial statements that "In the event the company's expected realization of principal under a collateral debt obligation is impaired, such that the anticipated future collections are determined to be less than the carrying value of the loan, the company will record an impairment loss equal to the amounts of the anticipated shortfall and will thereafter carry the loan at the reduced amounts." And further that "With respect to assets for which the collection of interest and fees is doubtful, the company recognizes such income when received." (DX 11B at 5.)

305. Contrary to its disclosed impairment analysis, Patriarch's actual impairment analysis simply mirrored its analysis for the trustee reports: category 1 (or defaulted) loans were impaired, while category 4 (or current) loans were held at cost, because Patriarch "believed in the future recovery." (Tr. 1973:19-1976:2.)

306. The Zohar Funds' financial statements claimed that "For substantially all of the collateral debt obligations, however, fair values are based on estimates using present value of anticipated future collections or other valuation techniques." (DX 11B at 6.)

307. Ms. Tilton cannot tell whether the financial statements were important to investors. (Tr. 1980:22-1981:12.)

308. When Ms. Tilton deferred interest payments, the balance was still due and owing. (Tr. 1993:17-1995:17; DX 167.)

309. Despite claiming that only amendments to a credit agreement with portfolio companies were amendments to that document, Respondents now claim that "amendments by course of performance" were also somehow amendments to "the agreed interest." This post-hoc lawyer-created argument is nonsensical given that the interest rate is a term of a credit agreement. Thus, these purported "amendments by course of performance" were not amendments at all; Ms. Tilton was simply subjectively deciding whether to allow certain companies to pay less than the amount of interest that was due. (Tr. 2002:6-2008:12.)

310. Even if an investor did the math calculations necessary to see that some interest payments by portfolio companies were being missed, they would not be able to tell when such missed interest payments were due to be paid in the future. If the missed payments were ultimately made, that would only be reflected in future trustee reports. Thus, the very terms of these purported "amendments by course of performance," and their subjective bases, were not disclosed. (Tr. 2015:16-2016:6.)

311. Respondents changed their accounting interest accrual disclosure to "maintain a more consistent accrual level," in other words, to make the disclosed interest accrual number look the same even as interest accrual had grown substantially. Over $47 million of interest had been deferred, yet less than $7 million was disclosed in the financial statements. (Tr. 2018:18-2021:1; 2025:25-2026:5; 2030:2-2031:19; DX 218.)

312. Respondents' misconduct as it relates to both the falsity of their disclosures and their bad intent is shown by the fact that in the financial statements, Respondents did not disclose $40 million in unpaid interested because "collection of interest and fees is doubtful," yet these portfolio companies that owed tens of millions of dollars of "doubtful" interest payments were still categorized as 4s or current (Tr. 2031:11-2032:20.)

313. For Zohar I, II, and III, Ms. Tilton categorized as 4s or current loans that had millions or tens of millions of dollars in unpaid interest that was past due, even though the financial statements indicated that collection of that interest was doubtful. In 2010 numerous loans had unpaid interest in the millions of dollars. By 2012, those numbers increased, with some loans having tens of millions of dollars of unpaid interest, totaling about $200 million in unpaid interest throughout the Zohar Funds. (Tr. 2032:21-2063:25; 2065:25-2066:7; DX 153, 156, 157, 186, 187, 188.)

314. Categorizing a loan as a defaulted investment or a defaulted obligation for OC Test purposes in and of itself did not require a sale or liquidation of the loan or the underlying company. (Tr. 2670:11-16.)

315. Ms. Tilton concedes that her discretion to amend was limited by the provisions of the transaction documents and applicable laws and regulations. (Tr. 2685:11-18.)

316. During the financial crisis, the Zohar Funds' portfolio companies lost 30 to 35 percent of their revenues and did not pay their interest due, yet Ms. Tilton still kept the loans to these portfolio companies categorized as 4 or current. (Tr. 2763:7-2764:3.)

317. The Zohar Funds' notes were highly rated before being severely downgraded. For instance, the Zohar III Class A1 and A2 tranches were rated AAA by S&P, while the A3 tranche was rated AA; the Zohar II notes had an average rating of B+/Ba1. (Tr. 2551:1-2552:5; 2679:1-1680:22; RX 72 at 16, 18.)

318. Contemporaneous documents represented that category 4 "Companies will pay current interest. . . ." (RX 67.002; DX 51 at 20-21.)

319. In order to fail the OC Test, Zohar II required a 26.96% default rate, while Zohar III required a 20.94% default rate. (RX 556.)

320. Equity upside is not disclosed in the trustee reports and is not collateral of the Zohar Funds. (Tr. 2757:17-20.)

321. Ms. Tilton's defense boils down to her false claim that "Category 4 just meant that it wasn't defaulted. And if I agreed to accept less interest than the stated amount on the credit agreement, I had amended and it wasn't defaulted." This was not disclosed in the indentures, nor was her subjective method to categorize loans based on her personal belief in the portfolio companies. Instead of disclosing her practice, Ms. Tilton merely disclosed – in different portions of the trustee report and ratings agency reports – certain information about cash flows, which she calls "transparency." Ms. Tilton's "transparency" included stating in an investor call 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." And she now claims that that was a disclosure of her purported practice of amending by course of performance, which she claims "everyone knew, everyone saw it, everyone understood." In fact, no evidence was presented that Ms. Tilton disclosed her subjective categorization method to any investor; rather investors testified that they did not know about Ms. Tilton's subjective method; and Ms. Tilton did not call a single investor to back up her false claim that she disclosed her deceptive practice. (Tr. 2332:17-20; 2523:20-2525:13; 2526:11-2528:5; 2532:2-14; 2711:3-2712:22).

Ira Wagner

322. Mr. Wagner worked in the structured finance industry for 27 years, including ultimately as the head of Bear Stearns' collateralized debt obligation ("CDO") group from 2004-2008. In his career, Mr. Wagner worked directly with approximately 30 CLOs and also worked indirectly, through his supervision of the Bear Stearns' CDO group, with a total of 70 CLOs. Mr. Wagner has also served as a consultant and expert witness on issues related to structured finance and securitized transactions like CDOs and CLOs. (Tr. 2828:24-2840:14, 2841:10-19; Report ¶¶ 2-6.)

323. Mr. Wagner worked extensively with CDO and CLO collateral managers, including doing due diligence on collateral managers and participating in road shows where collateral managers interacted with CDO and CLO investors. (Tr. 2840:15-2841:9; Report ¶ 3.)

324. In a cash flow CLO, the interest and principal payments on the pool of financial assets, net of any assumed future losses, are projected to be sufficient to pay in full the obligations of the CDO. (Report ¶ 12.)

325. The Zohar CLOs are cash flow CLOs. (Report ¶ 14.)

326. The general structure and terms of the Zohar CLOs operate similarly to other cash flow CLOs. That structure and those terms would be familiar to the participants in the CLO market. (Report p.3 at I; *see also* ¶¶ 42-43.)

327. In general, in a CDO, as part of its ongoing duties, the Collateral Manager will take action on behalf of the CDO Issuer with respect to any decision-making required with respect to the assets and provide ongoing information on the assets to the CDO Trustee and the rating agencies. (Report ¶ 17.)

328. The principal governing document of each CDO is the Indenture. (Report ¶ 18.)

329. CDO transactions generally have a long maturity – often 10 years or longer; therefore, the CDO may be in existence well after the parties that negotiated the transaction remain involved with the security. Accordingly, the Indenture is the best indicator of the intention and agreement of all of the parties involved in the transaction at the time the CDO was created and how it was intended to operate over its life. (Report ¶ 20.)

330. The principal party responsible for carrying out, following and implementing the provisions of the Indenture is the Collateral Manager. (Report ¶ 21.)

331. Investors in CDOs expect that the Collateral Manager will follow the Indenture to the letter. (Report ¶ 21.)

332. Investors rely on the protections offered by the many requirements and covenants contained in the agreement and make their decision to invest based on the stated terms of the transaction as codified in the Indenture. The Indenture also carefully spells out the rights of various parties to take actions and in what circumstances. (Report ¶ 21.)

333. Investors closely monitor their CDO investments in an efficient manner consistent with the size of their portfolio, rating on the transaction, management cost, and return. (Report ¶ 33.)

334. Generally, monitoring of a CDO investment begins with a review of the periodic reports issued by the CDO Trustee (the "Trustee Report"). This provides a current snapshot of the portfolio as well as measures of various tests and the conformity of the portfolio to various guidelines, tests and constraints, including OC Ratios and OC Tests. The Trustee Report also provides information on the current categorization of the assets. Investors depend on the accuracy of these reports to follow and track trends in the performance of the collateral

and test levels. Increasing levels of non-performing assets and declines in the OC Ratios and cushions against the OC Tests would generally be red flags that investors would want to follow and understand. (Report ¶ 33.)

335. Investors in the Notes of CDO transactions are institutional investors with generally very large investment portfolios comprised of a large number of assets. In order to efficiently manage their portfolios, they generally review the aggregate data in Trustee Reports and rely on its accuracy. With a large portfolio to manage, they look first to aggregate indicators of performance to decide which transactions they need to monitor or understand more closely. Such monitoring would include looking at declines in the OC Ratio or an increase in the amount of assets that are categorized as defaulted or downgraded. They may then choose to investigate individual asset performance once they are identified as problem assets in some way – for example a change in their performance status. (Report ¶ 34.)

336. Investors in the debt of CDOs and other structured finance securities do not expect to be in an active role where they will have to take action to enforce the terms of transactions they invest in. With a large number of investments they generally expect to rely on the accuracy of the reports they receive, and reviews of aggregate performance, as well as following trends in the market to understand the risk profiles of their investments. Once there is an indication that an asset is not performing as expected, investors may spend additional time analyzing the risk and the reasons for underperformance. It would not be reasonable to expect such investors to have to ascertain the accuracy of reporting on the payment or default status of the individual assets underlying their investments. If investors had to do such analysis on this type of investment, as they do with more risky below investment grade or high yield securities, they would have to demand more spread or yield as compensation for the effort involved in monitoring and managing their portfolios. (Report ¶ 35; *see also* ¶ 105.)

337. Among the features of the Zohar CLOs that are common to cash flow CLOs are the use of OC ratios as a way to measure the performance of the transactions, the valuation of assets for purposes of calculating the OC ratios, tests of the level of the OC Ratio (the Overcollateralization Tests), and the remedies resulting from a decline in such ratios. (Report ¶ 14.)

338. In a Cash Flow CDO, the Overcollateralization Ratio is equal to the CDO's assets divided by the CDO's liabilities. In a CLO, these assets are the loans owned by the Issuer, and the liabilities are the Notes issued to investors. (Report ¶ 23.)

339. The OC Ratio and related tests are important. Investors commonly monitor the OC Ratio to assess the performance of the CLO. In addition, if various OC tests are failed, important investor protections are triggered, including the redirection of cash flow from payments of subordinated management fees and equity distributions to making principal payments to investors, limiting the ability to make new investments in collateral, and an event of default under the Indenture giving investors the right to take certain actions. (Report pp. 3-4 at II; *see also* ¶¶ 27-29.)

340. Applying a "haircut" for purposes of the OC Ratio for assets that are not performing – which has the effect of reducing the OC Ratio – is a common feature to CLOs and structured finance transactions generally. (Report p.4 at III; *see also* ¶¶ 23-24.)

341. Assets required to be haircut are specified in each CDO's Indenture. These will generally include assets that have actually defaulted under the related loan or transaction documents as well as assets that are not making their payments of interest and/or principal. (Report ¶ 24.)

342. Assets may be haircut even if they have not actually defaulted as defined under the related loan or transaction agreement or the event of default on the asset has been waived. (Report ¶ 24.)

343. In the Zohar CLOs, the categorization of loans for purposes of the OC Ratio is based on objective and clear criteria set out in the Indenture. Consistent with cash flow CLOs generally, according to the Zohar CLO Indentures, the categorization of loans is based primarily on their payment status; a loan that has not made its contractual loan payment on a timely basis is to be haircut for purposes of calculating the OC Ratio. (Report p.4 at III; *see also* ¶¶ 48-53.)

344. The categorization of assets in the Zohar CLOs is objective with discretion in only these limited circumstances:

a. The Collateral Manager can designate an asset a Defaulted Obligation in Zohar I and Zohar II (under subsection (a)(ii) of the definition of Defaulted Obligation) or a Defaulted Investment in Zohar III (under subsection (a)(ii) of the definition of Defaulted Investment) based on the Collateral Manager's judgment that a nonpayment related default has occurred which will likely result in a default as to the payment of principal and/or interest on such asset.

b. The Collateral Manager may take an asset that otherwise meets the definition of Category 4 and place it in a lower category if the Collateral Manager believes there is a significant risk of declining in credit quality or becoming Category 1, 2 or 3.

This discretion only applies to move an asset down from Category 4 to a lower category in Zohar I and II, or to categorize an asset as a Defaulted Investment in Zohar III. (Report ¶ 54; *see also* ¶ 65.)

345. In Zohar I and II, a loan that has not made its current required interest payment must be in Category 1. Similarly, in Zohar III, a loan that has not made its current required interest payment must be categorized as a Defaulted Investment. (Report ¶ 54; *see also* ¶ 64.)

346. Categorizing loans based on whether they have made their current required interest payment is consistent with the understanding of participants in the CDO market and other CLO transactions. As cash flow transactions, current payments on the underlying assets are critically important. When a borrower is not paying as it is contractually obligated to do, that asset should not be categorized as a performing asset according to the relevant

definitions and should no longer be valued at par in a transaction's OC Ratio. (Report ¶ 55.)

347. This feature of applying a "haircut" to assets that are not performing is incorporated into the Zohar CLOs. (Report p.4 at III; *see also* ¶ 60.)

348. In each Zohar CLO, if the OC Test is breached, certain interest and principal proceeds from the underlying assets in the Priority of Payments will be re-directed to make additional principal payments on the Notes. The re-direction of these payments will continue until the OC Test is again passed, and will generally block payments of the Subordinated Collateral Management Fee to Patriarch (generally 1% of the amount of assets), preference share distributions and other payments junior in the Waterfall. (Report ¶ 61.)

349. In Zohar I and Zohar II, the Indentures also contain an "Event of Default" which it triggered by the decline in the OC Ratio to specified levels, and which also constitutes "cause" to terminate the Collateral Manager under the Collateral Management Agreement. (Report ¶ 62.)

350. Tilton's approach to categorizing loans, including categorizing loans based on her support for and subjective belief in the future of the Portfolio Companies rather than based on whether the loans had made their full contractual interest payment, is contrary to the Zohar indentures. (Report pp. 4-5 at IV; *see also* ¶¶ 64-81.)

351. If the parties to the Zohar CLOs had understood that Tilton would be categorizing loans based on her support for and subjective belief in the future of the Portfolio Companies, the language of the indentures would have explicitly incorporated this concept. (Report ¶¶ 86-87.)

352. Categorizing assets based on support for and subjective belief in the future of the Portfolio Companies does not make sense in the realm of cash flow CDOs or structured finance transactions generally. A cash flow CDO, like most structured finance securities, depends on the cash flows from the assets. If that cash flow is impaired or has a higher likelihood of becoming impaired, the assets would be haircut in performance tests. (Report ¶ 88.)

353. Other provisions in the Zohar indentures also support the importance of receiving current cash flow in the form of interest payments from borrowers. For example:

a. Loans must make at least semi-annual interest payments to be acquired by the Zohar CLOs;

b. The indentures limit the percentage of loans that can pay interest less frequently than quarterly to 15%;

c. Zohar I and II prohibit the acquisition of PIK loans – which are loans that are contractually allowed to defer a portion of their interest payments – and Zohar III limits the acquisition of PIK Loans to 5% of the assets;

(Report ¶¶ 56-57, 89-90.)

354. Not properly reporting the OC Ratios and categorizing the loans harmed Zohar investors because they were denied information that they regularly utilize to analyze the performance of their CLO investments. Investors carefully monitor changes in the OC Ratio and in the categorization of the loans; a decline in the OC Ratio or an increase in the amount of delinquent loans is a signal that the investment may not be performing. (Report p. 6 at VI; *see also* ¶ 101.)

355. Without correct information about the OC Ratio, investors could not accurately assess the risk of their Zohar investments. (Report ¶ 104.)

356. Not properly reporting the OC Ratios and categorizing the loans also harmed Zohar investors because the OC Ratios were overstated. (Report ¶ 101.)

357. For Zohar II and Zohar III, the OC Ratios should have failed the related Indenture tests for the distribution of the subordinated collateral management fee and preference share distributions. As a consequence of such failure, funds that should have been paid to investors as additional principal payments were instead allocated to lower priorities in the waterfall, including payments of the subordinated management fees and distributions on the CDOs equity, both of which would go instead to Tilton-controlled entities. (Report ¶ 101.)

358. For Zohar II, the OC Ratio should have fallen below 102%, which would have triggered an Event of Default. (Report ¶ 102.)

359. The failure to properly categorize the assets is more important in the Zohar transactions than in CLOs that acquire interests in large loan syndications because the loan facilities in the Zohar CLOs themselves are not widely traded (for many of them, the Zohar CLOs and related parties are the only holders) and information on the underlying borrowers is virtually impossible to obtain elsewhere. Therefore the categorization of assets is essentially the only information available to investors on the status of the underlying borrowers in the Zohar CLOs. (Report ¶ 103.)

360. The Zohar CLO governing documents balance allowing the collateral manager to use its expertise in selecting and managing assets, while at the same time protecting investors by providing constraints on the collateral manager. Among the provisions in the Collateral Management Agreement reflecting this balance are:

a. Section 2.2 "Management Services," which specifies the services the Collateral Manager will perform in each case subject to and in accordance with the terms of the Indenture;

b. Section 2.4 "Standard of Care," which requires that the Collateral Manager will render its services with the same degree of skill and attention exercised by institutional investment managers of national standing generally in respect of assets of the nature and character of the Collateral and for clients having similar investment objectives and restrictions (the "Standard of Care"); and

c. Section 2.6 "Obligations of the Collateral Manager," which requires the Collateral Manager not to take any action which it knows or should be reasonably expected to know in accordance with prevailing market practices would cause the CLO Issuers to violate the terms of the Indenture or adversely affect the interests of the CLO investors.

These provisions are common to CDO transactions. (Report ¶¶ 111-112.)

361. Re-directing cash flows *away from* subordinated management fees and preference share payments to the Respondents, and instead *toward* the Zohar investors, would have benefited the Zohar CLO Funds by reducing the Funds' outstanding liabilities. (Report p. 5 at V; *see also* ¶ 115-116.)

362. By allowing the Acquired Companies to continually make less than the required amount of interest payments due, it is clearly to the benefit of Patriarch as owner of the companies because it minimizes the on-going cash requirements for the Acquired Companies and therefore, the support that Tilton would otherwise be required to provide to avoid default on the loans and retain control of the companies. As both in effect lender and borrower, Patriarch has a clear advantage in continuing to just defer interest and hope the company's prospects improve. In effect, Patriarch is able to substitute the funds owed to the Zohar CLOs for additional equity investments that would otherwise be required in the Acquired Companies in order to continue operating and make their debt service payments. (Report ¶ 117.)

363. Section 7.7(a) of the Zohar indentures is unique. However, what is unique about Section 7.7(a) in the Zohar CLOs is not the fact that the collateral manager has the ability to enter into amendments and waivers – that power is generally available to CLO collateral managers. What is unique about Section 7.7(a) is that it permits the Zohar CLOs to hold securities received in bankruptcies or restructures. In a typical CLO, the collateral manager is required to sell such securities. (Tr. 2972:9-2975:8; Report p. 3 at I and ¶¶ 44-45; Rebuttal Report ¶¶ 36-44.)

364. Section 7.7(a) does not override the provisions of the indenture related to loan categorization. (Report ¶ 82.)

365. None of the experts retained by Respondents opine that it is permissible to categorize assets based on support for and subjective belief in the future of the Portfolio Companies, regardless of whether or not the borrower was making contractual payments of interest when due. (Rebuttal Report p. 2 at A and ¶¶ 1-3.)

366. Tilton was not amending loans when she accepted less than the contractual amount of interest due from Portfolio Companies. (Rebuttal Report p. 3 at B. and ¶ 9.) For example:

a. While there were documented amendments to loans, these documented amendments did not address myriad instances where loans paid less than the contractual amount of interest due (*id.* ¶¶ 13-15);

b. The interest rates reported on the trustee reports did not change when Tilton accepted less than the contractual amount of interest due (*id.* ¶¶ 16-24);

c. The "non-cash pay coupon interest" column on the trustee reports (which is where interest that was not being currently paid, but rather was being deferred/accrued, should be reported) did not indicate that there was any non-cash component (*id.* ¶ 18 & n.19);

d. There was no resubmission to the rating agency when the loan paid less than full interest, even though the Zohar II and III indentures require that changes in the terms of the loans which resulted in a reduction in, or a change in or waiver of, the interest rate, of more than 3% had to be reported to the Rating Agencies, and even though the Zohar III indenture requires a loan which has been materially restructured to apply for a new credit estimate (*id.* ¶¶ 25);

e. The periodic submission made to the rating agency[1] stated that the "date of last amendment" was the date of the last written amendment, not the date of the last time a loan had paid less than the contractual amount of interest due, and stated the current contractual interest rate (*id.* ¶¶ 26-30).

(*See also* Tr. 2842:9-2848:9, 2960:24-2961:17.)

367. Rather than amending loans, Tilton was simply choosing not to exercise her rights as a lender when the Portfolio Company paid less than full interest due. While Tilton has the right not to put the borrower in default, that does not change the required categorization of the loan under the indenture. Since the loans failed to pay the contractual rate of interest, they should be categorized as Category 1/Defaulted Investments. (Rebuttal Report ¶¶ 31-35.)

368. Mr. Wagner has significant experience with credit and similar agreements in the structured finance market. In his experience, amendments to such agreements would be made in writing. (Tr. 2959:23-2960:23; *see also* Rebuttal Report ¶¶ 8-9.)

369. It makes no sense to say a loan was amended if the credit agreement itself was not amended, since the loan's terms are evidenced by the credit agreement. (Tr. 2978:6-2979:7.)

370. Just because the Zohar transactions are designed to invest in speculative-grade debt collateral, and even if the parties should expect that some distressed companies would remit less than full stated interest payments, it does not follow that it would be inconsistent with the Zohar strategy to actually categorize such missed payments as Category 1/Defaulted. While investors expect that there will be some amount of loans that do not pay their full contractual payments of interest or otherwise default, they also have built in tests that measure the level of defaults and provide for the potential correction of a declining OC Ratio before an Indenture Event of Default is reached, by redirecting subordinate cash flow to the payment of principal on the Zohar notes. (Rebuttal Report ¶ 81.)

[1] This was not the required resubmission discussed in item d., above.

371. Proper categorization of a loan did not require Tilton to declare the loan to be in default or take any actions under her/Patriarch's rights as a lender. For example, Tilton could utilize her own judgment not to call an event of default following the non-payment of interest, even though the loan must be placed into Category 1 (Zohar I and Zohar II) or categorized as a Defaulted Investment (Zohar III). (Report ¶ 58; *see also* Tr. 2848:13-2849:8, Rebuttal Report ¶ 94.)

372. Categorizing a loan as a Category 1 or Defaulted Investment did not prohibit the Zohar Funds from originate new loans to that same Portfolio Company. (Tr. 2968:19-2970:12.)

373. Redirecting cash flows if the OC test was triggered would not take away the flexibility Respondents claim is necessary to manage the Zohar deals. (Rebuttal Report p. 4-5 at D and ¶ 85.)

374. In the Zohar deals, there was a large cushion between the starting level of the OC Ratio and the level at which an Event of Default would take place, meaning a significant amount of re-categorizations would have to take place before an Event of Default was reached. (Rebuttal Report p. 4 at D. and ¶ 84; *see also* Tr. 2849:9-21.)

375. Even once the level of Defaulted Assets reached 5%, the Zohar Funds could still make new loans so long as the new loan did not make the level of Defaulted Assets worse than it was before such acquisition. (Rebuttal Report ¶ 90; *see also* Tr. 2971:1-24.)

376. Even the occurrence of an Event of Default does not result in an automatic outcome with respect to the Zohar CLO's notes or collateral. Instead, the Event of Default gives investors (or the bond insurer) rights to take certain actions, which may include acceleration of debt and, subject to certain restrictions, the sale of all or part of collateral. An Event of Default does not mean an automatic liquidation of the CLO's collateral. (Report ¶¶ 63, 83; *see also* Tr. 2849:9-2850:3.)

377. Other provisions and features of the Zohar CLOs provide Tilton with flexibility to manage the OC Ratios. (Rebuttal Report p.5 at D. and ¶¶ 87, 89.)

378. The trustee in the Zohar CLOs was entitled to rely on information they received from the collateral manager. (Rebuttal Report ¶ 57; *see also* Tr. 2882:8-15, 2882:21-2883:4, 2886:4-10.)

379. The trustee in the Zohar CLOs was entitled to rely on the collateral manager's categorization of the loan assets. (*See, e.g.*, Tr. 2888:16-2889:25, 2890:22-2892:4, 2893:12-17, 2894:11-2895:4.)

380. The fact that there is a large cushion between the Interest Coverage Ratio ("IC Ratio") and the IC Test level is not relevant to the proper categorization of loans that have not made their contractual payment of interest under the Indenture, since the IC Ratio and the OC Ratio capture different things. (Rebuttal Report p. 5 at E and ¶¶ 76-79.)

381. The IC Ratio will vary with the level of LIBOR. When LIBOR is lower, the IC Ratio will be higher. Thus, the fact that there is a large cushion in the IC Ratio for the period during

and after the financial crisis, when LIBOR was very low, is not indicative of investors' expectations of what interest would and would not be paid. (Tr. 2937:12-2938:20; Rebuttal Report ¶ 78.)

382. The objectives of both the Collateral Manager (for flexibility to implement its investment strategy) and the senior debt investors (for a low risk investment) have to be considered to successfully undertake a CLO transaction. These two interests are brought together in the terms of the transaction, which are documented in the Indenture. Specifically, the Indenture documents investment guidelines, permitted and prohibited Collateral Manager actions, and protections offered to investors. (Rebuttal Report p.5-6 at F and ¶ 95.)

383. It is unreasonable to assume that a Collateral Manager pursuing a strategy involving risky speculative grade investments can do so without limitation if funds are raised from investors in the CLO market. Rather, the Collateral Manager's discretion is balanced by protections to investors. (Rebuttal Report p.5-6 at F and ¶¶ 97-98.)

384. In the Zohar CLOs, this balance is reflected in the Collateral Manager's flexibility to manage the assets, on the one hand, and features such as the loan categorization methodology and OC Tests (to measure the performance of the assets), on the other hand. (Rebuttal Report p.5-6 at F.)

385. While Respondents' strategy may be more commonly found in private equity funds, the Zohar CLOs are not private equity funds. They are highly structured transactions designed to fund Tilton's strategy with debt that was designed to be of low risk and high investment quality and had covenants and terms, including the categorization of loans and the OC Tests designed for the protection of investors. As a result of raising money in the CLO market, Tilton took on obligations to the Zohar investors. (Rebuttal Report p.6 at F. and ¶¶ 100-102.)

386. Respondents' categorization arguments are not consistent with expectations in the industry, since the amount of assets that were not making their contractual payments would not impact the very test designed to measure that occurrence; there would be virtually no limit to the amount of non- or underperforming assets until an Indenture Event of Default occurred. By design, the OC Test is a protective and self-correcting mechanism designed to take effect before such an event occurs. (Rebuttal Report p.6 at F and ¶ 96.)

387. During the Financial Crisis, many of the Portfolio Companies failed to make their contractual payments of interest on multiple payment dates yet did not get categorized as Category 1/Defaulted. The protections of the OC Test built into the Indentures are designed to take effect in just such an event; yet throughout the crisis, by failing to properly categorize the loans, the OC Ratios did not hit their test levels and Tilton continued to receive the subordinated management fees and preferred share distributions. (Rebuttal Report pp. 7-8 at H. and ¶¶ 116-118.)

Thomas Lys

388. Professor Lys summarized information in the Zohar CLO quarterly trustee reports pertaining to the interest collected on Portfolio Company loans. (Tr. 2998:7-15; *see also* Resp. Ex. 573.)

389. To summarize the information in the trustee reports, Professor Lys had an analyst assist him. That analyst had several helpers who assisted him. (Tr. 3000:2-10, 3044:20-3045:11.)

390. The analyst and his helpers spent approximately 450 hours summarizing the Zohar CLO monthly trustee reports. Professor Lys spent an additional 45 hours. (Tr. 3000:22-3001:19.)

391. Professor Lys and his team only summarized quarterly trustee reports (i.e., four reports per year); trustee reports came out monthly (i.e., 12 reports per year). (Tr. 3046:9-23.)

392. Tilton, through various entities, had approximately $500 million invested in the Portfolio Companies and the Zohar Funds or owed to them by the Portfolio Companies. (Resp. Exs. 129, 132, 134; Tr. 3059:16-3061:1.)

Jean Luc Pelissier

393. Mr. Pelissier is the CEO of Universal Instruments, a portfolio company of Patriarch Partners. He reports directly to Ms. Tilton, who serves as Chairman of the Board for Universal Instruments. (Tr. 3061:22-3062:3; 3074:5-9.)

394. Mr. Pelissier had no role with respect to the collateral manager of the Zohar funds, did not read the indentures of the Zohar funds, did not read the offering memoranda of the Zohar funds, and did not read the collateral management agreement of the Zohar funds.

395. According to Mr. Pelissier, the priorities for portfolio companies with respect to cash are: (1) payroll; (2) interest payments; and (3) other critical payments necessary to make the company implement their turnaround. (Tr. 3078:11-3079:10.)

396. According to Mr. Pelissier, interest "must be paid," is a "critical item that each of the company must comply to," and that paying less than full interest is "[a]lways a difficult process to justify and be in front of Lynn Tilton and explain why a company has failed or why a company is not always in position of not being able to do those interest payment." (Tr. 3082:11-3083:9.)

John Harrington

397. Mr. Harrington works for Ms. Tilton as the CEO of Hussy Copper (Tr. 3519:15-24;)

398. The priority on a portfolio's company cash was payroll, payroll taxes, and to pay interest. Portfolio companies did 13 week cash flows; if the cash flow indicated those three things could not be paid, the company's management would need put together a 12 month business plan, go to New York to meet with Ms. Tilton, and present the plan. These meetings were brutal and long, sometimes lasting days. (Tr. 3533:1-3535:6; 3535:23-3536:7; 3557:17-3559:9)

399. Mr. Harrington's marching orders were to pay interest even if it shuts down the company. (Tr. 3537:10-23.)

400. When funds were loaned to portfolio companies, the goal was to have the companies pay the interest on those loans as well as future principal. (Tr. 3552:5-12.)

401. Even portfolio companies that had no revenues were expected to pay interest on their loans, even though it meant using funds it had borrowed to make such interest payments. (Tr. 3553:12-3555:1; 3555:17-3556:1.)

<u>Charles Lundelius</u>

402. The Collateral Debt Obligations on the Zohar funds' financial statements are "senior secured loans." (Tr. 3171:21-3172:24.)

403. Although the Zohar funds held some equity interest in certain portfolio companies, the equity is dependent on future events that do not reflect the condition that exists as of the balance sheet date. (Tr. 3180:21-3181:10; 3182:10-12; 3184:1-8.)

404. The Zohar funds' equity interests in portfolio companies did not appear on the Zohar funds' financial statements. (Tr. 3188:1-9; 3196:6-12.)

405. GAAP requires loan impairment when, based on current information and events, it is probable that a creditor will be unable to collect the amounts due according to the contractual terms of the loan agreement. (Tr. 3152:5-9; 3217:16-3218:9)

406. In Mr. Lundelius's professional opinion, in order for something be probable, it need be conclusively determined. (Tr. 3211:19-3212:15; 3216:1-3217:3.)

407. Under GAAP, if it is probable that certain amounts of interest are not going to be paid there needs to be impairment. (Tr. 3218:21-25.)

408. In Mr. Lundelius's opinion, the deferral of interest is a restructuring of the loan. (Tr. 3223:3-3224:4.)

409. A fair value analysis is an analysis to determine fair value. (Tr. 3232:1-5.)

410. Cost and fair value are different concepts. (Tr. 3232:21-3233:11.)

411. The Zohar funds' financial statements show the cost of the CDOs. (Tr. 3239:5-18.)

412. In order for cost and fair value to be the same each year for the Zohar funds, it must mean that the fair value analysis of the CDOs that was allegedly done year after year, for more than a decade, always came out to the same figure as the cost of the CDOs. (Tr. 3243:2-7.)

413. If someone represents that they are doing a fair value analysis, they should be doing a fair value analysis and not simply carrying an item at cost. (Tr. 3243:8-19.)

414. In Patriarch's alleged loan review process for impairment, "aspects about equity upsides and things like that, then that's an undocumented –perhaps less documented part of the process, but it's still part of the process." (Tr. 3245:22-3246:13.)

415. Patriarch wrote off entire loans and wrote off portions of loans, but did not write down loans. (Tr. 3247:18-3248:17; 3249:7-11)

416. Accrued interest is an amount of interest that one is owed but have not collected. As time goes on and the interest is not collected, it becomes increasing uncertain that the interest will ever be collected – "because there's so much uncertainty as to collection, you really don't have a collectible." (Tr. 3263:5-3264:16; 3296:14-16.)

417. According to Mr. Lundelius, accrued interest not appearing on the financial statements was so uncertain to be collected that it did not belong on the balance sheet. (Tr. 3264:2-10.)

418. If there was significant uncertainty as to whether the Zohar funds' would collect accrued interest from American LaFrance (ALF), then that accrued interest should not have appeared on the Zohar funds' financial statements. (Tr. 3268:4-3270:18.)

419. Portions of ALF's accured interest were included on Zohar funds' balance sheets. (Tr. 3270:19-3271:9.)

420. According to Mr. Lundelius, even after reading that the Zohar funds' financial statements "have been prepared under a basis of accounting in which the company's investment and collateral debt obligations (CDOs) are recorded at cost," Mr. Lundelius was unable to answer if the CDOs were valued at cost or fair value. (Tr. 3234:5-3235:2.)

421. Later Mr. Lundelius testified that when reads the Zohar funds' financial disclosures stating the CDOs are "are recorded at cost," he comes to the conclusion that, in his expert opinion, the Zohar funds' CDOs are carried at fair value. (Tr. 3236:14-25.)

Mark Froeba

422. Mr. Froeba worked at Moody's from 1997-2007. In that role, he was involved in rating CLOs. (Tr. 3327:2-12.)

423. Moody's is not a collateral manager or a trustee. (Tr. 3398:19-22.)

424. Mr. Froeba has never personally structured or actively managed a cash flow CLO or a CLO whose assets were highly distressed loans. He has not worked on distressed loan workouts. He has not managed a portfolio of distressed companies. He has not been involved in the daily operations of CLOs. He has not served as a trustee of a CLO. He has not served as a collateral manager of a CLO. (Tr. 3398:23-3399:23.)

425. The indenture is important, and is the governing document for the Zohar CLOs. (Tr. 3353:2-10.)

426. Investors expect indentures will be followed. (Tr. 3353:14-16.)

427. The OC Ratio and OC Test are important. (Tr. 3354:5-12.)

428. CLOs generally categorize loans based on objective criteria. (Tr. 3354:13-15.)

429. CLOs typically have a definition of defaulted security (or a similar term) that operates to segregate performing securities from defaulted securities for the OC test purposes. (Tr. 3354:20-24)

430. This defaulted security definition provides the expressed and sole bases for treating a security as defaulted in a CLO. (Tr. 3354:25-3355:3.)

431. Payment default is the first and most important element in this defaulted security definition. (Tr. 3355:4-6.)

432. In general, a payment default occurs whenever a security fails to make payment in full of all interest and or principal when due, according to its current terms, without regard to any waiver thereof or grace period applicable thereto. (Tr. 3355:7-11.)

433. The express definitions of a defaulted security in the Zohar indentures provide a complete list of the bases for categorizing the underlying loans as defaulted; there are no implied bases for default in the Zohar CLO indentures. (Tr. 3359:8-24.)

434. In the Zohar CLOs, if a loan has not been amended, and that loan defaults on the payment of interest, that loan should be categorized as a defaulted obligation. (Tr. 3360:22-3361:25.)

435. Although Mr. Froeba opined that Section 7.7(a) "expressly grants the collateral manager broad power to amend the terms of the underlying loans, even for amendments intended to avoid a payment default," Mr. Froeba conceded that the phrase "even for amendments intended to avoid a payment default" does not actually appear in Section 7.7(a). That phrase was Mr. Froeba's editorial comment. (Tr. 3362:1-3363:10.)

436. The phrase in Section 7.7(a) that the collateral manager may enter into amendments, forbearances, or waivers "so long as such amendment, forbearance, waiver or supplement does not contravene the provisions of any transaction document or contravene any applicable law or regulations" is not limited to amendments, forbearances, or waivers that contravene Section 7.8(a) of the indentures. (Tr. 3363:11-3364:8.)

437. The IC Ratio is impacted by the level of LIBOR. All else being equal, the IC Ratio will be higher when LIBOR is lower. (Tr. 3378:23-3379:22.)

438. Prior to the financial crisis, the IC Ratios were relatively similar to the OC Ratios. For example, in October 2006, the IC Ratio for Zohar II was 173.89% and the OC Ratio for Zohar II was 123.86. (Div. Ex. 8-B; *see also* Tr. 3383:1-3384:21.)

439. Mr. Froeba expected that the information collateral managers provided to the rating agencies would be truthful and accurate. If the information was not accurate, there could be consequences. (Tr. 3401:10-3404:15.)

440. If a loan were submitted for re-rating to the rating agencies and rated a "C" by Moody's, that loan would have to be categorized as a defaulted obligation. A "C" rating means that Moody's believed the loan would default over the subsequent 10 years. A default did not mean the CLO would get nothing back on the loan, but rather simply that there would be some default on the loan obligation, even if ultimately there was 100% recovery on the loan. (Resp. Ex. 21 ¶ 65; Tr. 3405:4-19.)

441. Mr. Froeba was aware that investors provided testimony during the Division's investigation, but did not review investor testimony in preparing his report. Mr. Froeba did review Ms. Tilton's investigative testimony. (Tr. 3410:2-3412:13.)

442. Mr. Froeba believed that Patriarch's submissions to the rating agencies, where they reported the date of the last amendment and did not include the date of the last instance where Patriarch allowed the portfolio companies to pay less than required interest, were accurate because the submissions were only reporting the date of the last <u>written</u> amendment. However, Mr. Froeba conceded that the submission does not say "date of last <u>written</u> amendment," it simply says "date of last amendment." (Tr. 3432:23-3434:13.)

443. Mr. Froeba believed that, even though Patriarch's submissions to the rating agencies said, for an exemplar loan, that the current rate of interest was LIBOR + 8% and that the interest payment status was "current," that the submission does not mean the loan was currently paying LIBOR + 8% interest. (Tr. 3434:14-3437:7.)

<u>John Dolan</u>

444. Mr. Dolan does not offer any opinions on the interpretation of the Zohar indentures. (Tr. 3485:5-14.)

445. The OC ratio is an important piece of information that investors monitor. (Tr. 3489:4-8.)

446. Mr. Dolan does not offer any opinions on whether the OC ratio was properly calculated. (Tr. 3489:24-3490:7.)

447. Mr. Dolan does not offer any opinions about the collateral managers' obligations, duties, or standard of care. (Tr. 3491:20-25.)

<u>Robert Glenn Hubbard</u>

448. The OC ratio is important information to CLO investors. (Tr. 3584:14-19.)

449. The OC ratio for the Zohar Funds did not factor in any equity upside. (Tr. 3588:7-11.)

450. Professor Hubbard does not dispute that Ms. Tilton and Patriarch received about $208 million in preference share distributions and subordinated collateral management fees from Zohar II and III from mid-2009 to the end of 2014. (Tr. 3594:19-24.)

451. Professor Hubbard does not offer a competing disgorgement calculation to that of Mr. Mayer. (Tr. 3603:6-3605:2.)

CONCLUSIONS OF LAW

See Division of Enforcement's Post-Hearing Brief Argument Section.

Dated: December 16, 2016

Respectfully Submitted,

Amy Sm

Dugan Bliss, Esq.
Nicholas Heinke, Esq.
Amy Sumner, Esq.
Mark L. Williams, Esq.
Division of Enforcement
Securities and Exchange Commission
Denver Regional Office
1961 Stout Street, Ste. 1700
Denver, CO 80294

CERTIFICATE OF SERVICE

I hereby certify that a true copy of the **DIVISION OF ENFORCEMENT'S PROPOSED FINDINGS OF FACTS AND CONCLUSIONS OF LAW** was served on the following on this 16th day of December, 2016, in the manner indicated below:

Securities and Exchange Commission
Brent Fields, Secretary
100 F Street, N.E.
Mail Stop 1090
Washington, D.C. 20549
(By Facsimile and original and three copies by UPS)

Hon. Judge Carol Fox Foelak
100 F Street, N.E.
Mail Stop 2557
Washington, D.C. 20549
(By Email)

Randy M. Mastro, Esq.
Lawrence J. Zweifach, Esq.
Barry Goldsmith, Esq.
Caitlin J. Halligan, Esq.
Reed Brodsky, Esq.
Monica K. Loseman, Esq.
Gibson, Dunn & Crutcher LLP
200 Park Avenue
New York, New York 10166
(By email pursuant to the parties' agreement)

Susan E. Brune, Esq.
Brune Law PC
450 Park Avenue
New York, NY 10022
(By email pursuant to the parties' agreement)

Martin J. Auerbach
Law Firm of Martin J. Auerbach, Esq.
1330 Avenue of the Americas
Ste. 1100
New York, NY 10019
(By email pursuant to the parties' agreement)

Nicole L. Nesvig