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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of

LYNN TILTON,
PATRIARCH PARTNERS, LLC,
PATRIARCH PARTNERS VIII, LLC,
PATRIARCH PARTNERS XIV, LLC and
PATRIARCH PARTNERS XV, LLC

Respondents.

Administrative Proceeding
File No. 3-16462

Judge Carol Fox Foelak

RESPONDENTS' POST-HEARING OPPOSITION BRIEF

GIBSON, DUNN & CRUTCHER LLP
200 Park Avenue
New York, NY 10166-0193
Telephone: 212.351.4000
Fax: 212.351.4035

BRUNE LAW P.C.
450 Park Avenue
New York, NY 10022
Telephone: 212.668.1900
Fax: 212.668.0315

Counsel for Respondents

January 13, 2017

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PRELIMINARY STATEMENT

The Division's post-hearing brief reads as if the trial in this case never happened. Instead of fairly grappling with the testimony and documents presented at trial—which roundly debunked the allegations in the Order Instituting Proceedings ("OIP")—the Division almost entirely ignores the trial evidence. The Division even tries to shirk its well-established burden of proof—a tactic which confirms its utter failure to establish Respondents' liability for any of the claims in the OIP.

The Division's entire categorization case is built upon a fundamental mischaracterization of both the Indentures and Respondents' practices. The Division claims that Ms. Tilton breached the Indentures by categorizing loans based solely on her "subjective, personal belief," without regard to "objective" criteria set forth in the Indentures. *See, e.g.*, Div. Br. 2. But the Indentures and the CMAs,[1] along with the evidence at trial, show exactly the opposite—that there was no breach of the Indentures at all, and that Ms. Tilton was permitted and, indeed, expected to use her subjective business judgment in categorizing loans. *See* Indenture § 1.1 at 16 (definition of "Category 4" requiring the Collateral Manager to use its "reasonable judgment" in categorizing loans to determine whether loans have "a significant risk of declining in credit quality"); *id.* § 1.1 at 30 (providing that a "Defaulted Obligation" includes a loan that, in the Collateral Manager's "sole judgment . . . will likely result in a default as to the payment of principal and/or interest," even if no such payment default has yet occurred). And Section 7.7(a) gives Respondents wide discretion to amend and modify the Zohar loans—a key provision that the Division does not even mention in its brief.

[1] Capitalized terms not defined herein have the meaning ascribed to them in Respondents' opening post-hearing brief.

Section 7.7(a) was crucial to Respondents' disclosed investment strategy, Resp. FOF ¶¶ 36-51, 87-92, and even the Division's expert, Ira Wagner, admitted that it is a "critical provision designed to give effect [to] the business strategy disclosed to investors," Tr. 2947:8-12. Not surprisingly, all of the Division's noteholder witnesses testified to their understanding that Section 7.7(a) allowed Respondents to amend the terms of the loans without noteholder consent. *See* Resp. FOF ¶¶ 93-96. Yet the Division simply ignores that testimony, along with the interplay between the discretion conferred by Section 7.7(a) and the provisions of the Indentures regarding categorization.

Ms. Tilton testified that she exercised her discretion under Section 7.7(a) to amend loans, accept less than the full stated interest in a given period, and defer the remainder to be paid at a later date, if she believed that doing so would likely lead to greater value for the Zohars and noteholders. *See* Resp. FOF ¶¶ 104-13; Tr. 1831:7-12 (Tilton). When such amendments were made, the loans remained "current," and no default occurred, as Wagner admitted. *See* Resp. FOF ¶¶ 80-84; *see also* Tr. 2953:6-21. Ms. Tilton's decision to classify loans that had been subject to such amendments as "Category 4" thus fully complied with the Indentures, and that should be the end of the Division's claims. Respondents called multiple expert witnesses who confirmed these points as a matter of contract interpretation, deal structure, industry custom and practice, and economics, *see* Resp. FOF ¶¶ 80-91 (citing Mark Froeba, Steven Schwarcz, and Glenn Hubbard), but the Division's brief fails to acknowledge a single one of these experts or their testimony.

Faced with this failure of proof, the Division points to a snippet of Ms. Tilton's investigative testimony in which she explains that a loan's categorization partially reflects her view about its future prospects. *See* Div. Br. 16-17. The Division's "cut-and-paste" job ignores

key aspects of her investigative and trial testimony that explain the significance of loan amendments and deferrals in the categorization process. As the trial testimony confirmed, Ms. Tilton adhered to the Indentures in categorizing loans. She assessed each Portfolio Company's potential for successful turn-around in deciding whether to amend loan terms and defer interest payments. If a loan was amended and interest deferred, and the borrower paid interest consistent with the amended terms, it remained "current" and could be classified as "Category 4." *See* Indenture § 1.1 at 30 (definition of "Defaulted Obligation"); *see also* Resp. FOF ¶¶ 80-82. The Division's entire argument about loan categorization hinges on this point; the Division reads the Indentures to preclude such amendment (or claims that Ms. Tilton did not actually amend the loans). That position is foreclosed by Section 7.7(a)'s grant of discretion, and would render the entire business strategy for the Zohars—which were not conventional CLOs—incoherent and dead on arrival, as these were distressed companies unable to meet their obligations at the time of purchase. And at all events, it does not warrant the full force of the SEC's enforcement apparatus, let alone the draconian sanctions now sought.

The Division also claims that Respondents did not disclose their categorization method, but the evidence they muster—noteholders' answers to misleading questions from the Division, *see infra* pp. 13-14—is insufficient and ignores all of the noteholders' admissions that they "read [Section 7.7(a)] as giving the collateral manager the ability to amend the terms of a loan," Tr. 150:22-25 (Aniloff), took note that such amendments could be made "without the consent of the noteholders," Tr. 681:23-683:1 (Mach), and understood that Ms. Tilton "had the right[]" to use her business judgment to amend the loans, Tr. 1758:21-1759:3 (Aldama). The Division also turns a blind eye to the testimony of Thomas Lys and John Dolan that Respondents' loan amendment and categorization approach was in fact disclosed in the Trustee Reports, *see* Resp.

FOF ¶¶ 125-30, 139-50; Tr. 3471:7-11 (Dolan); RX 23 (Dolan Rep.) ¶¶ 60-67, 71—witnesses and testimony that the Division does not acknowledge anywhere in its brief. Nor does the Division account for the fact that the Trustee never objected to Respondents' loan amendment and categorization practices, *see* Resp. FOF ¶ 181—despite the fact that the Trustee was responsible for monitoring all aspects of the transaction, received and reviewed detailed payment information regarding each loan, prepared the Trustee reports, calculated the OC Ratio, and distributed all funds on behalf of the Zohars, Resp. FOF ¶¶ 173-80.

The Division has little to say about the detailed information provided to the Zohars' sophisticated institutional investors in monthly and quarterly reports issued and verified by the Trustee—information that made clear that Ms. Tilton included loans in "Category 4" when full stated interest had not been paid for a given period. *See* Resp. FOF ¶¶ 125-50. The evidence showed that each month, noteholders were given Trustee Reports that disclosed the amount of stated interest that would have been due, the amount actually paid, and the category of each loan. *See infra* pp. 13-16. The Division's primary argument—that such information was too "cumbersome" to read—simply ignores testimony that the requisite analysis was both straightforward and a regular feature of institutional investor practices. *See* FOF ¶¶ 125-50, 157-59. Moreover, any purported non-disclosures about loan categorization were not material in light of the "total mix of information" directly provided to the Zohars and noteholders, including in the Trustee Reports, on investor calls, and in other direct communications with noteholders. *See infra* pp. 28-32.

The Division also fails to respond to the substantial evidence that Ms. Tilton categorized loans in good faith and managed the Zohars for the benefit of the funds and noteholders. *See infra* pp. 32-33. Ms. Tilton structured her equity interests in the Portfolio Companies to be

aligned with those of the noteholders and invested hundreds of millions of dollars of her own funds into the Zohars and the Portfolio Companies—putting her own interests last after noteholders were made whole. *See infra* pp. 32-33. The Division's silence on this point confirms its failure to prove any *mens rea* necessary for imposing liability here.

Nor does the Division's new "accrued interest" theory—which was not alleged in the charging instrument and must therefore be totally disregarded as a matter of law—show that Respondents engaged in some sort of "calculated effort" to conceal partial interest payments. Div. Br. 26-30. The Division mischaracterizes what "Accrued Interest" represented on the Zohars' financial statements: the amount of deferred interest that Respondents expected to collect in the next period, *see infra* pp. 16-17, not (as the Division inexplicably claims) the total amount of "interest that was owed to the Zohar funds, but not collected," Div. Br. 27. As for the email regarding Respondents' method for calculating accrued interest, DX 218, it actually confirms that the "Accrued Interest" line item on the financial statements was intended to accurately reflect the amount of accrued interest that Respondents expected to collect in the next reporting period, as Patriarch Controller Carlos Mercado explained, Tr. 1200:7-1203:21. Moreover, as accounting expert Charles Lundelius confirmed, that was proper GAAP treatment. Tr. 3162:10-3164:5. Any assertion that Respondents changed their method for calculating accrued interest to hide non-payment, *see* Div. Br. 28-29, is completely misplaced. And, of course, such a suggestion would be nonsensical, given the detailed disclosures in the Trustee Reports.

The Division's categorization case ultimately boils down to a dispute about the proper interpretation of the Indentures—in other words, a simple breach of contract case that has no place in the SEC's fraud enforcement realm. Indeed, the Division's primary theory of fraud in

its summation and initial post-hearing brief was Respondents' purported failure to honor the "promises" made in the Indentures. *See* Tr. 3678:2-4, 3690:5-10, 3754:3-5 (Div. summation); Div. Br. 3, 35. Such allegations, even if they were true, amount to a breach of contract, not a fraud or fiduciary breach. *See* Resp. Br. 67-68. While the evidence was clear that Respondents' conduct was consistent with the language of the Indentures, a disagreement about the terms of a contract provides no basis for a securities fraud or fiduciary breach case.

The Division likewise failed to prove its claims relating to the Zohars' financial statements. It ignored unrebutted evidence that Respondents had robust processes for determining fair value and impairment. *See infra* pp. 35-38. In asserting otherwise, the Division relies instead on a single sentence in a single email ("we do not write up or write down – we write off"), but leaves unaddressed documentary evidence and testimony showing that Respondents in fact both wrote down loans when underperforming assets needed to be restructured, and wrote off loans upon liquidation. *See* Resp. FOF ¶ 235. Nor has the Division rebutted Respondents' advice of accountants defense or proven scienter or negligence with respect to the financial statements. Both Ms. Tilton and Mercado testified that they believed that the financial statements were prepared in accordance with GAAP, and that Peter Berlant—the outside accounting firm partner retained by Patriarch to provide professional advice on its financial statements—was reviewing and signing off on GAAP compliance. *See infra* pp. 38-43. While the Division continues to stand by Berlant's ludicrous testimony that he did not substantively review or approve the financial statements, it can do so only by ignoring overwhelming contemporaneous emails and other documentary evidence admitting that he "reviewed" them, all of which conclusively demonstrated that Berlant repeatedly lied on the

stand in order to minimize his own role in reviewing and approving the Zohars' financial statements and advising Respondents about GAAP issues. *See* Resp. FOF ¶¶ 256-70.

It is also absurd—and unfair—for the Division to assert that changes Respondents made to their financial statements in response to the Division's Wells notice, and in the midst of explicit discussions with the Division about resolving this matter, were somehow an acknowledgment that they knew all along that the statements did not comply with GAAP. *See infra* pp. 42-43. In persisting with this argument, the Division pretends that its duplicity—in baiting Respondents into changing their financial statements, only to reverse course and later argue that Respondents' acquiescence is evidence of scienter, and in then intentionally shielding its "expert" from that obviously relevant fact, among others—was never exposed at this trial. *See infra* pp. 42-43. But it was, for all to see. The Division also failed to prove that the GAAP certifications were material; in fact, two of the Division's noteholder witnesses made clear that they had either "never once looked at the financial statements," Tr. 1547:15-21 (Aldama), or that "the representations that financial statements were GAAP compliant were not important," Tr. 375:9-12 (Aniloff).

The Division's opening post-hearing brief also ignores the constitutional deficiencies in this proceeding, *see* Resp. Br. 109-10 & App'x B—a failure made all the more glaring by the recent federal circuit court decision holding that the appointments of SEC administrative law judges are unconstitutional, *see Bandimere v. SEC*, 2016 WL 7439007 (10th Cir. Dec. 27, 2016). Nor does the Division address the numerous instances of serious litigation misconduct by the Division raised throughout these proceedings. *See* Resp. Br. 110-12.

Even if there were any merit to the Division's claims, the sanctions it seeks would be wildly inappropriate in light of the evidence presented at trial and the applicable law. The

Division completely failed to establish that a permanent bar on Ms. Tilton's involvement in the securities industry—one of "the most drastic remedies" available, *Steadman v. SEC*, 603 F.2d 1126, 1137 (5th Cir. 1979), *aff'd*, 450 U.S. 91 (1981)—would be in the public interest. *See infra* pp. 45-48. Where, as here, the evidence is clear that Respondents acted without scienter, the law does not permit such punishment. *See Steadman*, 603 F.2d at 1140. Moreover, the Division's request completely ignores Respondents' concerted efforts to provide value to noteholders, revitalize American companies, and save American jobs. *See infra* p. 47. For the same reasons, a cease-and-desist order and statutory monetary penalties are unwarranted. *See infra* p. 49. Nor is the Division's request for one of the largest disgorgement awards in history even remotely appropriate. The sole basis for the Division's request for more than $200 million in disgorgement is the unreliable, erroneous calculation by its proffered expert, Michael Mayer (who assisted the Division in developing its theory of the case, *see* Resp. Br. 111). That request also ignores the more than $500 million in value that Respondents returned to the Zohars and the Portfolio Companies—including by contributing hundreds of millions of dollars in investments into the Portfolio Companies and forgoing fees due (not to mention their gifting of equity upside interests to the Zohars valued in the billions of dollars)—which reduce Respondents' net profits (the appropriate measure of disgorgement) to below zero. *See infra* p. 54.

In sum, the trial revealed just how meritless this prosecution is. It is now obvious that there was no wrongdoing, no fraud or fiduciary breach, no misstatements or omissions, no materiality, no bad intent or negligence; in short, no basis for liability on any count. Respondents acted honestly and transparently, in accordance with the Indentures, in reliance on the advice of professionals, and in good faith. Your Honor should accordingly put an end to the

Division's relentless, misguided prosecution of this case and issue a finding of non-liability as to each and every claim.

FACTUAL OPPOSITION

I. The Indentures Gave Respondents Broad Discretion To Amend Loans And To Exercise Their Business Judgment In Categorizing Assets.

The Division's primary theory of wrongdoing is that Ms. Tilton did not categorize loans in accordance with the Indentures, and instead used an undisclosed "subjective, personal belief assessment approach" to categorization. *See, e.g.*, Div. Br. 17. The evidence at trial squarely defeated this contention.

As an initial matter, the Division's representation that the categories are purely "objective," Div. FOF ¶ 343; Div. Br. 12-15, is inaccurate. Pursuant to the Indentures, Respondents may only categorize a loan as a Category 4/Collateral Investment if, in their "reasonable judgment," the loan does not have a "significant risk of declining in credit quality or, with the passage of time, becoming Category 1, Category 2 or Category 3," Indenture § 1.1 at 16 (definition of "Category 4"); Resp. FOF ¶ 79, and if, "in the sole judgment of [Respondents]," a default has not occurred that "will likely result in a default as to the payment of principal and/or interest" in the future, Zohar I and Zohar II Indenture § 1.1 at 30 (definition of "Defaulted Obligation"); Zohar III Indenture § 1.1 at 27 (definition of "Defaulted Investment"); Resp. FOF ¶ 79.[2] Ms. Tilton was therefore required to make a subjective assessment about the future prospects of a Portfolio Company in order to appropriately categorize the asset.

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[2] While the Division insists that the Indentures lay out "objective and clear criteria," Div. FOF ¶ 343, it does not point to any Indenture language requiring objectivity. Instead it relies entirely on the impeached testimony of its conflicted experts and lay witnesses for this assertion. *See, e.g.*, Div. FOF ¶¶ 343-46, 352; *see also* Div. FOF ¶¶ 29, 75. The Division's findings of fact are further undermined by the fallacy that features of typical "cash flow CDOs or structured finance

The Division simply fails to grapple with the discretion that Section 7.7(a) of the Indentures gave Respondents to amend loans and defer interest payments, and then to categorize based on the amended terms. *See* Resp. Br. 19-21, 49-61; Resp. FOF ¶¶ 48-51, 80-83. The evidence adduced at trial showed that Section 7.7(a), which granted Respondents the unilateral right to "enter into any amendment, forbearance or waiver of or supplement to any" of the loans, was the key to Respondents' investment strategy. *See* Resp. FOF ¶¶ 38, 48-51, 87-92, 105-12. When it was unlikely that a Portfolio Company could make a full interest payment for a given period, Ms. Tilton would agree to amend the loan and accept less than full stated interest if, in her business judgment, further effort and support would enable the Portfolio Company to recover and generate greater value for the Zohars and noteholders. Resp. FOF ¶¶ 105-09. As the Division admits in its brief, Ms. Tilton was discerning in agreeing to such amendments, and did so "only after the respective portfolio company's management traveled to New York to meet with Tilton, explained why the company could not make its interest payments, and presented a 12-month business plan." Div. Br. 16; *see also* Resp. FOF ¶¶ 97-106; Resp. Br. 38-40.

When Ms. Tilton exercised her business judgment to amend to defer interest, as permitted under Section 7.7(a), a default did not occur and the loan did not automatically become a Category 1/Defaulted Investment under the Indentures. *See* Resp. FOF ¶¶ 80-86. As Ms. Tilton repeatedly testified at trial, when Respondents "deferred and amended during that period," the Portfolio Company "didn't miss, because [Respondents] actually agreed to accept less." Tr. 2763:12-24. Expert testimony confirmed that when loans were amended to defer interest, such loans "would not have to be placed in Category 1." Tr. 2949:22-2950:6 (Wagner); *see also*

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transactions generally" apply to the Zohars. Div. FOF ¶ 352. The overwhelming evidence established just the opposite: the Zohars are unique and cannot be analyzed as run-of-the-mill CDOs. *See* Resp. Br. 14-16; Resp. FOF ¶¶ 35-44.

Tr. 3332:8-3333:2 (Froeba) (explaining that when Ms. Tilton exercised her discretion to amend under Section 7.7(a), the amendment "change[d] categorization," meaning the loan was categorized according to whether a full payment was made under the amended term); Resp. FOF ¶¶ 81-82. The Division fails to acknowledge the overwhelming evidence of this key aspect of Respondents' business strategy.[3]

In its post-hearing brief, the Division relies almost entirely on a snippet of Ms. Tilton's investigative testimony, taken out of context, in which she explained that loan amendments and categorizations were based, in part, on whether Respondents reasonably believed that the performance of a Portfolio Company would improve over time. *See* Div. Br. 16-17; *see also* Div. FOF ¶ 296 (citing Tr. 1935:4-1938:12). This statement is entirely consistent with the Indentures: If Ms. Tilton believed a Portfolio Company had reasonable prospects for success even though it could not make full payment on an installment of interest, she exercised her authority under Section 7.7(a) to amend the loan terms and defer payment. That loan remained "current" so long as interest was paid pursuant to the amended terms, and it could properly be classified in Category 4 pursuant to the definition in Section 1.1 of the Indentures.

Further, though the Division erroneously asserts that Ms. Tilton's trial testimony suggests that she categorized loans as Category 4/Collateral Investments based solely on whether she reasonably believed in future recovery, Ms. Tilton actually testified that she considered the reasonable prospects of future recovery in determining whether to amend to defer interest, and

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[3] While the Division claims that moving amended loans to Category 1 would have been consistent with the Zohar investment strategy, Div. FOF ¶¶ 370-71, such a requirement would have caused the Zohars to quickly exceed the Indenture-mandated 5 percent limit on "Defaulted Obligations," resulting in restricted funding to those Portfolio Companies and fire sales, *see* Resp. FOF ¶¶ 89-90. Your Honor should not impose an interpretation of the Indentures that would fundamentally be at odds with the investment strategy.

then categorized according to the amended terms of the loan. *See* Tr. 1937:25-1939:8 ("[I]f I believe in the reasonableness of a turnaround, if I believe that it will ultimately be better for the funds and the noteholders to support a company through its restructuring until it would be able to create value, then I amend."). That process fully comports with the Indentures, and the Division can point to no provision saying otherwise.

Lacking any trial testimony in support of its claim that Ms. Tilton did not categorize loans in accordance with the Indentures, the Division relies heavily on Ms. Tilton's investigative testimony as purported evidence that her strategy of amending loans to defer interest payments is a post-hoc characterization. *See* Div. Br. 16-17. As Your Honor recognized at trial, however, Ms. Tilton's investigative testimony regarding categorization is consistent with the approach explained by Ms. Tilton at trial. *See* Tr. 1858:15-17 (Foelak, J.) ("It does seem that almost everything that you bring up from the prior testimony is not inconsistent with what she's saying today."). Ms. Tilton testified during the investigation that the discretion to amend loans under Section 7.7(a) was "at the core of our strategy of trying to maximize the cash flows of not only each individual company and interest and principal and equity value over time, but maximize the cash flows of the portfolio as a whole in looking at the future." Resp. Counter-Desig. Ex. B6 at 61:24-62:7; *see also id.* at 12:3-10, 89:22-90:12. She further testified that it was "very frequent that the companies [could not] pay the full contractual rate of interest," *id.* at 55:12-13, and when that occurred, she considered various options including "amendments by course of conduct and performance that less interest is accepted, than the contractual rate," *id.* at 60:12-14; *see also id.* at 56:9-11.[4]

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[4] The Division misleadingly asserts in its proposed findings of fact that "[i]n all of her

Far from a "post hoc" explanation, the amendment of loans and their continued classification as a Category 4 asset was the linchpin of the Zohar Strategy from the outset. As Ms. Tilton explained in her investigative testimony:

> [A Category 4 loan is a] current collateral debt obligation, which means we are currently, you know, working on an active restructuring. It's not an insolvency, it's not in any kind of formal bankruptcy or restructuring, there's no event of default *or default that otherwise hasn't been amended by 7.7-A*, there's – you know, there's no formal restructure bankruptcy, or that we do not believe in our reasonable business – you know, judgment and in our business judgment that it will become a declining credit quality over the passage of time.

Id. at 92:10-23 (emphasis added); *see also id.* at 94:18-95:20, 100:13-101:9, 107:12-108:11, 122:17-123:2, 184:3-185:4, 187:4-19, 201:11-17. None of the evidence—not Ms. Tilton's testimony, or any of the other evidence adduced at trial—comes close to establishing the Division's burden to prove any misrepresentation in the classification of loans, the calculation of the OC Ratio, or any other information provided to noteholders. Just the opposite: Ms. Tilton's amendment, deferral, and categorization practices, along with their ensuing impact on the OC Ratio, were fully consistent with the Indentures and central to the funds' investment strategy.

II. Noteholders Were Well Aware Of Respondents' Approach To Loan Amendment And Categorization.

The evidence at trial soundly defeats the Division's assertion that noteholders "were not aware" of how Respondents categorized loans. Div. Br. 21. The Division points only to a

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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." Div. FOF ¶ 297. But Ms. Tilton explained in her 2013 investigative testimony that when "[l]ess than full interest" was being collected, it was "because [the loan was] being modified, waived, or forgiven [pursuant to] 7.7A, which is sort of the driving force of what we do, having the flexibility to keep companies alive over the long term to maximize value for this restructur[ing] process." Resp. Counter-Desig. Ex. B5 at 194:10-16. And when she was called to testify next in 2014, Ms. Tilton testified repeatedly that she amended the loans "by course of conduct and performance" to accept less than full stated interest in a given period. Resp. Counter-Desig. Ex. B6 at 60:12-14; *see also id.* at 61:6-12.

leading question advancing its flawed categorization theory (whether the witness knew Ms. Tilton categorized loans based on a "subjective belief" in the future recovery of the Portfolio Companies) and three corresponding, short answers from noteholder witnesses: "I did not expect that to occur" (Aniloff); "No it was not" (Mach); and "No" (Aldama). Div. FOF ¶¶ 29, 76, 238; Tr. 169:5-14 (Aniloff); Tr. 601:17-21 (Mach); Tr. 1530:10-1531:24 (Aldama).

Not only is this testimony irrelevant, as it is based on a mischaracterization of Respondents' approach to loan amendment and categorization, but it should be disregarded because each noteholder witness conceded on cross-examination that he in fact understood Respondents' actual categorization approach. *See* Resp. FOF ¶¶ 33, 93-95, 157-59. Aniloff testified that he "read [Section 7.7(a)] as giving the collateral manager the ability to amend the terms of a loan." Tr. 150:22-25; *see also* Tr. 293:4-6. Mach admitted that he specifically noted Section 7.7(a), including the language establishing that the collateral manager could "without the consent of the noteholders, enter into any amendment, forbearance or waiver," and that the Zohars' collateral "consist[ed] of stressed and distressed loans that may be the subject of an extensive amendment, workout, restructuring and other negotiations." Tr. 681:23-683:1. And Aldama conceded that he understood that Ms. Tilton "had the right[]" to use her business judgment to amend the loans. Tr. 1758:21-1759:3; *see also* Tr. 1634:25-1635:6, 1640:12-20, 1674:8-12. The Division tellingly fails to address any of these admissions, instead opting to completely disregard Section 7.7(a)'s role in loan categorization.

The Trustee Report, which was distributed to noteholders monthly and contained detailed information about the loans, including the principal balance, the interest rates, the amount of interest collected that period, and the numerical category to which Respondents had assigned each loan for purposes of calculating the OC Ratio, also disclosed on its face that certain

Category 4 loans were not paying the full stated interest. Resp. FOF ¶¶ 125-50. The Division argues only that the Trustee Reports did not "explicitly disclose that companies categorized as a 4 or current were not making interest payments at the stated rates." Div. Br. 46. But that is just wrong. As Respondents' expert, John Dolan, who has over 30 years of experience in the financial industry, explained, any individual in the investment business would have readily understood from the Trustee Reports that many loans on which Portfolio Companies did not pay the full stated interest were categorized as Category 4. Tr. 3480:11-3481:21 (testifying that analyzing financial data like that provided in the Trustee Reports was "the normal course of business for people in the investment business . . . [i]t's done all the time"); *see also* Resp. FOF ¶ 128.

In fact, all three noteholder witnesses admitted that they could have done so. Aniloff conceded that he "could have matched the numbers" to determine whether a loan was paying full stated interest, Tr. 321:17-24, and admitted that when his analysts reviewed the Trustee Reports in 2013 they noted for him that "the amount that was actually collected did not tie out to the spread that was listed in the trustee report," Tr. 129:21-130:4; *see also* Resp. FOF ¶ 157. Similarly, Mach conceded that it took only "basic math to look at the actual interest rate that had been paid" on any given loan. Tr. 612:19-613:21; *see also* Resp. FOF ¶ 158. And Aldama conceded that he was able to tell that "not all of the loans were paying the full amount of interest" because "[t]he weighted average spread and the interest collected was not the same." Tr. 1649:13-1650:1, 1651:6-13; *see also* Resp. FOF ¶ 159. Thus, contrary to the Division's continued arguments that Ms. Tilton "conceal[ed] the actual performance of the Zohar funds' assets," Div. Br. 21, their performance was accurately reported in black and white, in the very format that the parties had agreed upon from the outset, *see* Resp. FOF ¶¶ 31, 125-50; *see also,*

e.g., Tr. 2013:17-2014:16 (Tilton); Tr. 3015:12-23 (Lys); DX 9A at 19, 31. Nothing was hidden here.

III. The Division's New Accrued Interest Theory Is A Red Herring.

Having neglected to bring any charges in the OIP related to accrued interest, the Division now contends that Respondents' treatment of accrued interest on the Zohar financial statements evidenced "a calculated effort to conceal from investors that portfolio companies were not making interest payments." Div. Br. 29-30. This theory should be disregarded wholesale; not only is it outside the scope of the OIP, it is unsupported by any expert opinion, and is nonsensical, as the Division's suggested treatment of accrued interest would have been entirely contrary to GAAP. *See* Resp. Br. 93-95.

As a threshold matter, the Division's assertions rest on a patently inaccurate representation as to what the at-issue line item, "Accrued Interest and Fees Receivable," represents. The Division erroneously asserts that this figure represents the "interest that was owed to the Zohar funds, but not collected (*i.e.*, interest the portfolio companies owed but could not pay)." Div. Br. 27. But in fact, the figure on the Zohars' financial statements represented the amount of interest that was accrued but not collected during that quarter, and that Respondents estimated they would collect in the next quarter. Resp. FOF ¶ 241. As Respondents' expert, Charles Lundelius—the only expert to opine on accrued interest—explained, "Accrued interest is an amount of interest that you can expect to receive . . . within a defined period. You're not talking about something that goes out long periods of time. Usually it's within the next reporting cycle. So if you are on a quarterly basis, you expect to receive an interest [payment] in the next

quarter." Tr. 3263:5-13.[5] Put simply, the accrued interest amount represented income from interest payments anticipated in the short-term, in light of the loan amendments which deferred certain interest amounts to be paid at a later date.[6] The line item did not, and was not intended to, represent the "total amount of interest owed to the respective Zohar fund but not collected," as the Division suggests. Div. Br. 27.

The Division tries to make much of a March 2010 email from Mercado to Ms. Tilton, which it claims evidences Respondents' attempt to "actively conceal the 'uptick' in portfolio companies missing interest payments in 2010." Div. Br. 28-29 (citing DX 218). To the contrary, Mercado's email evidences Respondents' efforts to ensure that the Zohar financial statements accurately estimated the amount of accrued interest Respondents expected to collect in the next quarter, given Respondents' agreement to defer interest payments for certain Portfolio Companies. As Mercado explained at trial, and as the email itself shows, when the financial crisis hit, "the amount that [Respondents] expected to collect may not have changed dramatically, but the amount that was unpaid began to grow." Tr. 1203:11-17. In other words, beginning in 2010, certain Portfolio Companies were acutely impacted by the financial crisis, and Respondents believed it would be in the companies' and, in turn, the Zohars' long-term best

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[5] The Division mischaracterizes Lundelius's testimony on this point. It asserts that, "[a]ccording 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." Div. FOF ¶¶ 416-17. Mr. Lundelius's testimony makes clear that accrued interest which was expected to be collected "further out" than the next quarter had a level of uncertainty under GAAP principles such that it should not have been reported on the balance sheet, Tr. 3263:14-21, and that Respondents' "eventual recognition of [that] interest when it was paid" was proper, Tr. 3297:13-20. He did not testify that any accrued interest excluded from the balance sheet was not expected to be collected at some future date.

[6] "Accrued Interest and Fees Receivable" is accordingly listed under "Assets" on the Zohar financial statements. *See, e.g.*, RX 30.009.

interests to defer a larger percentage of the companies' interest payments for a period of time. This deferment led to an increase in the total unpaid stated interest, but the total amount that Respondents expected to collect in the short term remained relatively stagnant. *See* Resp. FOF ¶ 245.

Given this shift, the method that Respondents had been using for estimating the accrued interest they expected to collect in the subsequent quarter would have led to an artificially high estimate. The accrued interest amount would have increased more than $4 million from the previous quarter, DX 218 at 1, even though Respondents had agreed to defer a larger portion of the stated interest, and therefore did not expect that amount to be collected in the next period. Respondents modified their method of calculating the accrued interest to avoid suggesting that they expected to receive more interest than actually anticipated in the short term. That change in no way supports the Division's argument that Respondents "fear[ed] disclosing missed interest payments alongside a Portfolio Company's categorization as current." Div. Br. 29. To the contrary, the evidence showed that the change in methodology was intended to ensure that the accrued interest line item accurately reflected the amount Respondents reasonably expected to collect in the short term, given Respondents' agreements to accept partial interest and defer the remainder.[7] At the same time, Respondents continued to report the precise amount of interest

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[7] The Division claims Mercado testified that, "[a]t 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)." Div. FOF ¶ 155. That is incorrect. Mercado testified that he believed that before he joined Patriarch in 2008, there was a time during which Respondents expected to collect the full amount of interest due each quarter, and that those quarterly financial statements would have therefore reflected the full amount due as income. Tr. 1204:19-1205:2. Mercado did not testify that it was Respondents' practice to include accrued interest that was not expected to be collected in the next quarter.

payments received in the Trustee Reports—an approach that would have made no sense if Respondents had been looking to hide that fact from investors in the financial statements.[8]

Contrary to the Division's contention, Div. Br. 28, Respondents' treatment of accrued interest is fully consistent with amending loans, classifying them in Category 4, and retaining them in "current" status for purposes of the OC Ratio. The evidence is clear that Ms. Tilton regularly used her discretion under Section 7.7(a) to amend the terms of the loans to accept less than the full stated interest in a given period, and to allow that interest to be paid at a later date. *See, e.g.*, Resp. FOF ¶¶ 80, 105-11. When such amendments were made, the Portfolio Company's payment of no or partial interest for that period did not result in a default because default was measured pursuant to the terms of the loan agreement, including the amended deadline rather than the superseded deadline. Resp. FOF ¶¶ 81-83. And because Ms. Tilton typically amended the loans to accept the maximum amount in interest in that period that would not threaten the Portfolio Company's liquidity, Resp. FOF ¶ 110, and to defer the remaining interest to be paid at a later date, Resp. FOF ¶ 111, it was appropriate for Respondents to list on the financial statements the amount of the accrued interest from that period that they expected to collect in the next period. Conversely, it would have been inaccurate, and not compliant with GAAP, to report the full amount of accrued interest to date, as Respondents did not expect to

[8] The Division also asserts that Respondents should have replaced the $0.9 million in "uncollectibles" with the full amount of unpaid interest to-date that they did not expect to collect in the next quarter. *See* Div. FOF ¶¶ 160-64. But the Division misconstrues the purpose of that figure. As Mercado explained, the $0.9 million uncollectible was a reduction ("haircut") from the amount of interest that Respondents *expected* to collect the following quarter. Tr. 1187:2-4. In other words, it was "a general provision" for reducing for unforeseen collection difficulties the amount of interest that Respondents *expected* to collect the following quarter. Tr. 1185:18-24 (Mercado). It did not represent the amount of interest Respondents did not expect to collect the following quarter. And, in fact, including the amount of unpaid interest Respondents did not expect to collect the next quarter would have been inappropriate under GAAP. Resp. FOF ¶ 244.

collect that entire amount in the next period. *See* Resp. FOF ¶ 244. The accrued interest recorded on the Zohars' financial statements was therefore consistent with Respondents' amendment and deferral process.

Finally, the Division now asserts that the methodology for recording accrued interest on the Zohars' financial statements is inconsistent with Respondents' alleged belief that "not engaging in impairment or a fair value analyses [sic] was proper." Div. Br. 29. But it was demonstrated at trial that Respondents did, in fact, conduct impairment and fair value analyses according to GAAP, and Respondents have never asserted that they did not engage in such analyses or that not doing so would have been proper.[9] Indeed, the treatment of accrued interest was entirely consistent with the impairment methodology and GAAP. As the Division's brief concedes, impairment relates to whether Respondents anticipated that the full amount of principal and interest would be collected according to the terms of the loan agreements. *See* Div. Br. 24, 29; *see also* Resp. FOF ¶¶ 229-30. Because Respondents had agreed to accept less than the full stated interest in a given period and to defer the remaining amount, the payments made by the Portfolio Companies were in accordance with the terms of the loan agreement. *See* Resp. FOF ¶¶ 80-83, 105-12. That Respondents recorded on the financial statements the amount of the deferred interest that was expected to be collected in the next period is consistent with what the line item was intended to represent, with GAAP principles, and with Respondents' impairment analysis.

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[9] Ms. Tilton's statement in an email to Mr. Mercado that a further discussion of Respondents' impairment analysis was "not an email discussion," DX 162, simply reflected that Ms. Tilton was "traveling at the time" and it would be easier, and in the normal course, to discuss that process in-person when she returned and could "discuss[] it in a comprehensive way." *See* Tr. 1265:21-1267:13 (Mercado). Mercado explained that, when Ms. Tilton was traveling, "she might have a hundred different things that she might be doing at the time," whereas during a meeting, "she can just focus on this issue." Tr. 1266:15-21.

ARGUMENT

I. The Division's Loan Categorization-Based Claims Should Be Dismissed.

The Division's brief does nothing to salvage its claim that Ms. Tilton's categorization of loans violated Section 206 or Rule 206(4)-8. Rather than rebut Respondents' explanation that Section 7.7(a) of the Indentures empowered Ms. Tilton to amend loans in order to defer interest due and avoid default, the Division never even addresses Section 7.7(a). Rather than respond to the evidence of accurate and complete disclosure about loan cash flows and categorization through the Trustee Reports, along with the evidence that noteholders could readily understand from these disclosures that some Category 4 loans were paying less than full stated interest, the Division's brief simply reiterates its false claim that the disclosures were too complicated to be understood. Rather than try to substantiate allegations of intentional fraud or negligent deception in the face of Ms. Tilton's massive infusions of value into the Zohars and Portfolio Companies, the Division's brief does not address those transfers at all.

Most fundamentally, the Division's brief confirms that the claims based on categorization are at best breach of contract claims. The Division admitted as much when it declared that "[t]his is a case about . . . failures to keep . . . promises." Tr. 3690:6-8 (Div. summation).[10] But there is no such thing as Advisers Act liability for breach of contractual promises, and thus the claims based on alleged miscategorization should be dismissed.

[10] *See, e.g.*, Div. Br. 35 ("First, Respondents' statements in the indentures and other governing documents . . . were false and misleading since Respondents were not engaging in the objective categorization methodology discussed in those documents."); *id.* (arguing that "[i]nvestors were promised an objective categorization method" and "they were also promised" certain categorization procedures, but that Ms. Tilton behaved inconsistently with the governing documents "[i]nstead of following the indenture"); *id.* at 3 (summarizing the evidence as showing that Ms. Tilton did not "categoriz[e] the funds' loan assets as promised" and accusing her of ignoring "protections that had been promised").

A. Respondents' Approach To Loan Categorization Was Appropriate Under The Indentures And Known To Noteholders.

The centerpiece of the Division's case is its claim that Respondents misrepresented the performance of Zohar assets by categorizing loans in a different way than that provided in the Indentures. The Division contends that the Indentures set forth an "objective" categorization methodology (though the Division's brief makes no effort to parse the text of the Indentures) and Ms. Tilton used a different, "discretionary" approach. OIP ¶¶ 9, 49; *see also, e.g.*, Div. Br. 22. But as Respondents have consistently noted, Ms. Tilton had discretion under the Indentures to enter into "extensive amendment[s]" of the loan agreements. Indenture § 7.7(a). The Division does not even address Section 7.7(a) in its brief, leaving Respondents' defense unrebutted. Indeed, the Division does not contest the essential facts: (i) Section 7.7(a) granted discretion to amend loans to preserve long-term asset value, *see* Resp. FOF ¶ 51; Tr. 2948:8-12 (Division expert Wagner admitting that Ms. Tilton had "authority to amend and make changes to the loan[s]"); (ii) Ms. Tilton in fact deferred interest "only after the respective portfolio company's management travelled to New York to meet with Tilton, explained why the company could not make its interest payments, and presented a 12-month business plan," Div. Br. 16; and (iii) if Ms. Tilton amended a loan to defer interest due, then the payment of interest along the deferred schedule would not require recategorization of the loan to Category 1, *see, e.g.*, Resp. FOF ¶¶ 74-84; Tr. 2932:23-2933:3 (Wagner admitting that if a loan had been amended, it would need to be reclassified as Category 1 only "if it didn't make the payment according to its *current* [*i.e.*, post-amendment] contractual terms").

The Division instead simply acts as if there were no amendments: time and again throughout the brief (as during trial), the Division starts from the false premise that any time a Portfolio Company paid less than full stated interest, the interest had been due and thus the

nonpayment constituted a default. *See, e.g.*, Div. Br. 3 ("Although . . . assets were . . . not making substantial interest payments that remained due and owing . . . , Tilton concealed these facts . . . ."); *id.* at 16 (assuming that when Ms. Tilton amended loans, she "deci[ded] to accept less interest than the amount that was *due*" (emphasis added)); *id.* at 37 (assuming that the contract had not been amended such that "contractual interest payments had not been made"). But Respondents have argued consistently and correctly that Ms. Tilton deferred interest payments, and thereby amended the due date. By asserting, without proof, that the due date remained fixed, the Division simply declines to grapple with Respondents' defense. That falls far short of the burden the Division must meet to prevail here.

The Division argues that Ms. Tilton ignored whether there had been a defaulted interest payment and made purely subjective determinations about the categorization of loans. Confronted with substantial evidence to the contrary, the Division can only quote one line of Ms. Tilton's investigative testimony—"in those instances where they are paying interest, and we are continuing our support with a reasonable belief of recovery, we keep it a Category 4." Div. Br. 17 (quoting DX 219, Ex. 5 at 182:17-183:1). But Ms. Tilton's meaning could not be clearer: Category 4 requires both payment of interest when due and continued support with a reasonable belief of recovery. And in fact, that is exactly what the Indenture requires: for a loan to qualify as Category 4, the loan must be current (subsection "i" of the definition) and the loan must "not . . . [have], in the reasonable judgment of the Collateral Manager, a significant risk of declining in credit quality" (subsection "v" of the definition). Indenture § 1.1 at 9.[11]

[11] The Division also claims that two emails referring to Ms. Tilton's ability to improve the OC Ratio suggest that she improperly categorized loans in order to artificially inflate that metric. *See* Div. Br. 18. In one email, Ms. Tilton notes her interest in "any OC where I can get it," DX 138,

The Division also insists that Respondents did not actually amend the terms of the Zohar loans. Div. Br. 48. The Division cannot dispute that amendments by course of performance—including a course of performance established by the acceptance of less than full payments—are commonplace and legally valid. *See* Resp. Br. 60-61 & n.40. Instead, the Division claims that the amendments are "a post-hoc legal fiction" because—according to the Division—Ms. Tilton's investigative testimony did not sufficiently explain this concept. Div. Br. 49; *see id.* 16-17. But Ms. Tilton's investigative testimony was consistent with her explanation at trial, as Your Honor correctly recognized. *See* Tr. 1943:1-2. And the evidence at trial confirms the validity of the loan amendments. *See* Indenture § 7.7(a) (disclosure of authority for "extensive amendment"); Tr. 1676:21-1678:6 (Aldama's testimony that he "met with Ms. Tilton, and she told [him] that she was, in fact, amending the loan agreements"); RX 118 (Patriarch employee email chain of Sept. 1-2, 2011, disclosing "amended agreements" as to the timing of interest payments "to meet the current conditions of a company"); Resp. FOF ¶¶ 151-53.

The Division also claims for the first time that a change in Respondents' accounting of accrued interest suggests that it did not view the amendments as amendments. *See* Div. Br. 28. This argument rests on the Division's misapprehension of what accrued interest represents: income from interest payments anticipated in the short-term, not total amount of uncollected interest, as the Division incorrectly claims. *See supra* pp. 16-17. Thus, the amount of accrued

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and in the other she asks an employee for notice "if OC will retreat so radically . . . so I can see if there is anything I want to do to change things," DX 147. The Division improperly and without substantiation assumes that these emails refer to categorization, ignoring the wide array of non-categorization actions Ms. Tilton could properly take to improve the OC Ratio, such as deferring management fees, forgoing preference share distributions, and buying new loans at a discount on the secondary market. *See* Resp. FOF ¶ 63; Tr. 1906:7-1908:24 (Tilton). Indeed, Ms. Tilton selflessly deferred tens of millions of dollars of fees for the benefit of the Zohars and noteholders, which bolstered the OC Ratio.

interest reported has nothing to do with the status of deferrals of interest by amendment. This argument also rests on a second incorrect premise: that any change in reporting of accrued interest must have been a shift from accurate reporting to inaccurate reporting. In fact, Respondents' earlier method had been accurate; the only change was to account for Respondents' decision to defer a greater amount of interest for particular Portfolio Companies in light of changing market conditions, in order to avoid unduly inflated figures as to what would be collected in the immediate period. *See supra* pp. 17-19.

The Division further claims that if Ms. Tilton did not report an amendment to the Rating Agencies, it was not valid. This argument misreads the reporting requirement, which applied only to amendments that "change[d] the interest rate or the date for the payment of any principal," Indenture § 10.13(b)(52), not to a deferral of interest payments. *See* Resp. Br. 59-60 & n.39. And even if the reporting requirement had applied to amendments that changed the dates of interest payments (without changing interest rates or the date for the payment of any principal), non-reporting of an amendment would not render it something other than an amendment. *See id.*; Resp. FOF ¶ 341. Not only does the Division's brief make no attempt to contend with these points, but also the Division chose not to call either of the Rating Agency witnesses who had been on its witness list.

Finally, in view of the overwhelming evidence that Ms. Tilton never misrepresented her categorization approach, the Division contends that Respondents' conduct was at least misleading. Div. Br. 49-50. But the Division offers no genuine arguments or facts in support of this claim, and that claim fares no better than the Division's other categorization allegations.

B. **The Division Does Not Contend That Ms. Tilton Breached A Fiduciary Duty To The Zohars (The Only Fiduciary Duty She Owed), And There Was No Undisclosed Conflict Of Interest With Any Noteholder Or Zohar.**

The Division's brief exposes that its claim for breach of fiduciary duty is nothing more than an attempt to bootstrap alleged misrepresentations about categorization into a separate cause of action for breach of fiduciary duty. The only alleged conflict of interest that the Division identifies is based on the same set of transactions and decisions that form the basis for its claimed misrepresentation or omission. The same disclosures about Respondents' categorization methodology that disprove the misrepresentation claim also defeat the breach of fiduciary duty allegations.[12]

There are multiple independent reasons that the Division's fiduciary duty allegations fail. The only type of conflict of interest that can give rise to Advisers Act liability is a breach of fiduciary duty to the client (in this case, the Zohars), yet the Division's fiduciary duty claim still rests on an allegation of a fiduciary duty as to the noteholders. The Division appears to acknowledge that a conflict of interest with respect to the "interest of the funds" is necessary for this type of liability. Div. Br. 36; *see also id.* at 11 ("As investment advisers, Respondents owed fiduciary duties to their clients."). However, the Division addresses only evidence regarding the Zohars' noteholders, not the Zohars themselves. *See id.* at 37-38.[13] Accordingly, the Division's claim of breach of fiduciary duty is foreclosed by the well-settled principle that the Advisers Act

[12] Moreover, Ms. Tilton's decision to structure her interests to align with those of the Zohars and noteholders, *see* Resp. FOF ¶¶ 41, 193, 196, 212-18, is fundamentally irreconcilable with any conflict of interest.

[13] This tactic also explains why the Division argues that the alleged conflict of interest "would necessarily be material to investors," Div. Br. 40, but does not argue that the alleged conflict would be material to the Zohars.

creates a fiduciary duty only to the funds themselves, and not to investors in the funds. *See* Resp. Br. 72-73 & n.46.

Perhaps the Division attempts this sleight of hand because it knows that any potential conflicts of interest between Respondents and the Zohars were expressly disclosed and waived. *See* Resp. Br. 70-71; CMA § 6.2(a); Resp. FOF ¶¶ 18, 194. The Division cites a single case, which is inapposite: there, the defense of disclosure was meritless because the respondents had only "disclose[d] a separate conflict of interest" from the one giving rise to the claims of breach of fiduciary duty. *Edgar R. Page*, Investment Company Act Release No. 32131, 2016 WL 3030845, at *7 (ALJ May 27, 2016), *cited in* Div. Br. 37 n.15. Respondents' disclosure here, by contrast, covered the type of conflict of interest alleged by the Division, and therefore defeats any claim sounding in undisclosed conflict of interest. *See* Resp. Br. 70-71. Moreover, there are other independent reasons the Division could not have argued that Respondents breached a fiduciary duty to the Zohars. It would be logically incoherent and legally untenable to argue that Ms. Tilton failed to disclose a conflict to the Zohars because she cannot hide information from herself, the manager and owner of the Zohars; as the owner of the Zohars' preference shares it would make no sense for Ms. Tilton to act contrary to the Zohars' interests, which were her own interests; the Zohars had imputed knowledge from both Ms. Tilton and the Trustee; and the Zohars themselves have never accused Ms. Tilton of breaching a fiduciary duty. *See id.* at 68-77.

Even if disclosures to noteholders were relevant to the fiduciary duty analysis, the Division has done nothing to challenge the conclusion that noteholders knew of Respondents' categorization methodology. The Division cites only cases featuring the most egregious

conflicts of interest, such as theft from clients and affirmative concealment when clients actively pursue information,[14] which are completely inapposite here.

C. Even If There Had Been Any Inaccuracies, Nondisclosures, Or Fiduciary Breaches Relating To Categorization, They Would Not Be Material.

In order to prevail, the Division must prove the materiality of the alleged violations. Respondents cannot be liable if they accurately disclosed the information that they are accused of misrepresenting, because materiality turns on the "'total mix' of information available" to the purported victim. *See Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988); Resp. Br. 77-78 & n.49. The Division seems to acknowledge this black-letter principle by citing *Basic* in its recitation of the relevant legal standards, *see* Div. Br. 32, but then fails to apply it, instead bizarrely dismissing as irrelevant the undisputed fact that noteholders received detailed, monthly interest payment and categorization information and other disclosures.

This array of available information alone compels dismissal of the categorization claims against Respondents. Even when a misrepresentation occurs, a disclosure elsewhere renders the original misrepresentation immaterial and therefore forecloses liability. *See, e.g.*, *Hirsch v. DuPont*, 553 F.2d 750, 762-63 (2d Cir. 1977). This principle applies whenever information is available that would dispel the misrepresentation, even if the alleged victim must conduct due diligence to discover the available information. *Id.*; *Flannery v. SEC*, 810 F.3d 1, 11 (1st Cir.

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[14] The Division cites one case where the respondents' conduct "grossly breached their fiduciary duties to clients through what . . . amounted to theft," *J.S. Oliver Capital Mgmt., LP*, Securities Act Release No. 4431, 2016 WL 3361166, at *16 (June 17, 2016), and another case where the respondents received concrete payments for investment decisions not aligned with the victim's interests and the victim went to vast lengths to learn of the respondents' incentives and demanded a disclosure to no avail, *Robare Grp., Ltd.*, Advisers Act Release No. 4566, 2016 WL 6596009 (Nov. 7, 2016). Even the Division's harshest allegations do not approach these facts, as Respondents are accused neither of theft nor of concealing information in the face of direct and pointed inquiries. To the contrary, all the evidence about client inquiries shows that Respondents provided complete and accurate answers. *See, e.g.*, RX 117 ; Resp. FOF ¶¶ 151-53.

2015). *Flannery* is directly on point. There, a respondent appealed the Commission's finding of liability based on a misleading slide that had been shared with investors. *See Flannery*, 810 F.3d at 4. The court assumed the slide was misleading for purposes of materiality, and examined various ways that investors might have learned accurate information. *Id.* at 9-12. Because the available information "weigh[ed] against any conclusion that the [misleading slide] had 'significantly altered the total mix of information made available,'" the court held that the Division had not proved materiality. *Id.* at 11 (quoting *Basic*, 485 U.S. at 232).[15] Ms. Tilton's disclosures have the same inoculating effects on any alleged misrepresentations as did the disclosures in *Flannery*: the noteholders and the Zohars in this case were given abundant access to complete and accurate information, thus rendering the alleged nondisclosures or misrepresentations immaterial.

The Division contends that Respondents' disclosures were not "explicit"—and therefore, by the Division's reasoning, not adequate—because they took the form of numbers in the Trustee Reports. *See* Div. Br. 43, 46. According to the Division, the noteholders—all of whom were large, sophisticated, institutional investors—were lulled into "false comfort" by these supposedly opaque Trustee Reports, which imposed too onerous a burden on readers to "look at page 1 . . . and then . . . flip and look at another page." Tr. 3684:10-23 (Div. summation); Div. Br. 50. But

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[15] Given the similarities between the instant case and *Flannery*, the opinion's materiality analysis should guide the outcome in this proceeding. By contrast, in a recent opinion, the Commission held that *Flannery*'s holding does not apply where the facts of the proceeding were "unlike . . . *Flannery*." *ZPR Inv. Mgmt., Inc.*, Advisers Act Release No. 4417, 2016 WL 3194778, at *4 (June 9, 2016). The Commission distinguished *Flannery* on the grounds that the alleged misrepresentation there was published to investors, while the misrepresentations in *ZPR* were "in advertisements disseminated to the general public." *Id.* The Commission's ground for declining to apply *Flannery* in *ZPR* therefore has no application in Ms. Tilton's case, where the Division does not allege that Respondents directed any misrepresentations to the general public, but only to noteholders and the Zohars.

the touchstone for materiality is the availability of the relevant information, not whether it was spoon-fed to an investor. Moreover, the evidence proved that the Trustee Reports were highly accessible and transparent, providing explicit notice to institutional investors and financial professionals that when a loan paid less than full stated interest, it was not automatically recategorized as Category 1. *See supra* 14-15; Resp. Br. 62-65, 78-79. For this reason, even the Division conceded that "investors in Zohar II and Zohar III may have been able to determine from the trustee reports that loans were not paying their contractual rate of interest at times." Div. Br. 46. More fundamentally, there is simply no dispute that the information in the Trustee Reports was part of the total mix of available information for noteholders, which rendered any purported nondisclosure immaterial.[16]

The Division instead tries to flip the burden of proof, arguing that Respondents should have called noteholders who would testify to disclosure. Div. Br. 43. That is contrary to the law, and in any event, the Division's own noteholder witnesses provided all the testimony necessary to prove that Respondents appropriately disclosed their practices. Aniloff admitted that he reviewed the Trustee Reports regularly, Resp. FOF ¶ 127, that the reports allowed him to determine that some Category 4 loans were not paying full stated interest, and that in analyzing

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[16] The Division misses the mark in relying on *ZPR Investment Management, Inc.* to argue against the sufficiency of these disclosures. In that case, the respondents made affirmative misrepresentations (for example, exaggerating historical returns) in magazine advertisements and their defense was that their website contained accurate disclosures that contradicted the misrepresentations. 2016 WL 3194778, at *7-8. In light of the combination of affirmative lies, misrepresentations made to the public, and disclosures in a different medium, the respondents had put too much "onus" on the audience "to seek out disclosures." *Id.* at *8. The contrast with the facts of the present case shows exactly why Ms. Tilton's disclosures were adequate: the Division alleges primarily that "Respondents . . . did not disclose th[eir] practice," Div. Br. 37, rather than that they affirmatively lied; the alleged deception was directed to a limited and sophisticated audience (noteholders and Zohars); and the complete, accurate information was sent directly to those same investors and funds in the very documents (the Trustee Reports) that purportedly contained Respondents' misrepresentations and omissions.

the Trustee Reports he indeed noted that "the amount that was actually collected did not tie out to the spread that was listed," Resp. FOF ¶ 157. Aldama testified that he regularly reviewed the Trustee Reports, from which he could determine that some Category 4 loans were not paying full stated interest. Resp. FOF ¶¶ 127, 159. Mach testified that he "look[ed] at the trustee reports as they would come out," Tr. 610:1-7, and that it took no more than "basic math" to understand the "actual interest payments that [Portfolio Companies] were making in many cases were . . . very often well below the stated interest rate." Tr. 612:9-15, 613:14-21. If Ms. Tilton had called a new round of noteholder witnesses as the Division now suggests she was required to do, the best possible testimony would only have been cumulative of the testimony given by the Division's witnesses, who unanimously agreed that the Trustee Reports made available to them complete and accurate information.

This robust evidence of disclosure is one of many reasons why the Division's continued reliance on *SEC v. Nutmeg Group*, 162 F. Supp. 3d 754 (N.D. Ill. 2016), is preposterous. The Division claims that "Respondents make the same claims about disclosure as the Defendants did in [*Nutmeg*]," and characterizes the *Nutmeg* defendants as having "failed to offer any evidence [of disclosure] other than their own testimony." Div. Br. 47 (citing *Nutmeg*, 162 F. Supp. 3d at 780). The Division's own characterization of *Nutmeg* defeats any reliance on it, because the record here includes reams of documentary evidence, profound admissions by the Division's witnesses, and expert reports as overwhelming evidence of disclosure. Even if this distinction did not exist, Respondents' disclosure argument is nothing like the *Nutmeg* defendants' argument, which relied on the notion that they would hypothetically have answered questions from investors. 162 F. Supp. 3d at 779-80. In contrast, Respondents did indeed answer questions from noteholders and explained the amendment strategy and categorization approach,

see, e.g., Resp. FOF ¶¶ 151-53, but this is beside the point because Respondents disclosed every detail of the cash flow and categorization in written reports sent to all the relevant players. In any event, even if *Nutmeg* were somehow analogous, the Division's reliance on a not-yet-appealable opinion of an Illinois-based magistrate judge in a case that is still awaiting a trial date, *see SEC v. Nutmeg Grp.*, No. 09-cv-1775 (N.D. Ill. Sept. 27, 2016), ECF No. 873, exposes the thinness of precedent for the Division's theory.

D. Any Inaccuracies, Nondisclosures, Or Fiduciary Breach Relating To Categorization Were Neither Intentional Nor Negligent.

The Division bears the burden of proving the requisite mental state as to each claim. Yet the Division's brief confirms what became clear at trial: there is simply no evidence of scienter or negligence on Respondents' part. To the contrary, the trial conclusively demonstrated that Ms. Tilton believed in good faith that she was acting in accordance with the Indentures and her fiduciary obligations, including with respect to categorization of loans, and that Respondents' categorization practices were known to all. *See* Resp. Br. 80-83; Resp. FOF ¶¶ 105-11, 125-59. The trial also proved that Ms. Tilton believed she was acting for the benefit of the noteholders and Zohars, especially in structuring her equity interests to be aligned with those of the noteholders, Resp. FOF ¶¶ 41, 193; transferring huge amounts of her own assets to the Zohars and Portfolio Companies, Resp. FOF ¶¶ 196, 212-18; and amending loans to Portfolio Companies to defer interest so as to give them the liquidity necessary to turn them around and increase their value to the Zohars, Resp. FOF ¶¶ 63, 193-98. The Division ignores these facts. Instead, the Division offers three grounds for a finding of scienter or negligence, none of which has any merit.

First, the Division claims that Ms. Tilton "had significant motivation" to deceive the Zohars and noteholders because inaccurate OC Ratios would benefit her, in part by increasing

the value (in some way not illuminated by the Division) of her "enormous potential equity upside." Div. Br. 42. The Division's paragraph-long argument cites just one proposed finding of fact, which reads in its entirety: "Ms. Tilton obtained equity in the Zohar funds and the underlying portfolio companies." Div. FOF ¶ 269 (citing Tr. 1800:6-1801:10). Respondents do not dispute this fact; indeed, the transcript passage that the Division uses to support it demonstrates Ms. Tilton's good faith. It explains, in Ms. Tilton's own words, that she would receive profits from her interests in the Zohars and Portfolio Companies only after noteholders had been repaid, and therefore that she "paid for that equity to . . . have my interest aligned with the noteholders as the last-out equity." Tr. 1800:6-1801:10.

Second, the Division considers the "the strongest evidence of scienter" to be the alleged misrepresentations themselves. Div. Br. 44. The Division's theory seems to be that if Your Honor finds a misrepresentation, then this finding "evidences [Ms. Tilton's] true intent." *Id.* This argument is a thinly veiled attempt to circumvent the Division's burden to prove mental state. Misrepresentation and mental state are two separate elements of each claim under the Advisers Act, *see* Resp. Br. 47-48, and if evidence of a finding of one element gave rise to a finding of another element, then they would not be distinct elements at all. The Division's allegations of scienter are no different than those raised in *Geinko v. Padda*, 2001 WL 1163728 (N.D. Ill. Sept. 28, 2001). The plaintiffs there accused defendants of securities fraud, "argu[ing] that the misstatements themselves are evidence of scienter," and the court rejected that theory as unsupported by the securities laws. *Id.* at *4 ("The Court is unaware of any case—and plaintiffs have not cited any—that suggest that the allegedly false statements can also be evidence of scienter. This approach is not persuasive."); *see also, e.g., In re Dothill Sys. Corp. Sec. Litig.*, 2009 WL 734296, at *10 (S.D. Cal. Mar. 18, 2009). Here, it makes even less sense to argue that

an alleged misrepresentation alone proves Ms. Tilton's mental state. The parties' disagreement about the misrepresentation element turns principally on a narrow issue of contract interpretation: whether interest remains "due and payable" even after an amendment that defers the stated interest payment, such that payment of interest consistent with the amended terms (but less than originally stated interest) constitutes a default. *See* Resp. Br. 52-53; Div. Br. 14. Even if Your Honor determines that Respondents' interpretation was incorrect (though it was not), and that they therefore misrepresented loan categories (though they did not), conduct based on a reasonable misinterpretation of a contract cannot support a finding of intentional misconduct or negligence. *See* Resp. Br. 80-81.

Finally, according to the Division, the "most damning[]" evidence of scienter or negligence is that Respondents "did not call a single investor." Div. Br. 43. As discussed above, this is a truly incredible and insulting assertion, given that it is the Division's burden to prove every element of its claims. Respondents had every right to rest without calling any witnesses, as defendants often do, and there would have been no basis for an adverse inference against Respondents if neither side had called any noteholder witnesses. The argument is all the more remarkable because the noteholder witnesses that the Division called in its own case not only failed to provide testimony sufficient to meet its burden of proof, but in fact definitively destroyed the Division's case. *See* Resp. Br. 31-33. In sum, that the "most damning[]" evidence of scienter is Respondents' choice not to call noteholder witnesses is in essence a concession that there was no affirmative evidence of scienter at all.

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

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

The Division alleges that Respondents' representations concerning fair value and recognition of impairments were misleading.[17] The evidence at trial showed no such thing.

1. Respondents Conducted GAAP-Compliant Fair Value Analysis.

The Division does not allege that any fair value figures reported in Respondents' financial statements were inaccurate. Instead, the Division alleges that Respondents "had no basis" for its figures because "no analysis at all was conducted to determine fair value." OIP ¶ 72; Div. Br. 22. The evidence at trial showed otherwise. Detailed valuation analyses were regularly performed by Ms. Tilton and Patriarch's credit and structured finance groups. Resp. FOF ¶¶ 223-24; Tr. 1977:19-22 (Tilton). Respondents introduced at trial several examples of their valuation models. *See, e.g.*, RX 487.001 (Spreadsheet of Portfolio Company Performance History and Projected Performance); RX 1832 (Compilation of Equity Analysis Spreadsheets); RX 557 (Patriarch's model into which the credit templates fed to create cash flow analysis). As Ms. Tilton explained, these models "la[id] out [Portfolio Company] cash flows credit-by-credit and as a whole." Tr. 2297:12-15. Ms. Tilton and Patriarch's credit and structured finance groups then "discount[ed] those cash flows back to create a fair value number." Tr. 2297:8-2298:5 (Tilton); Resp. FOF ¶¶ 223-24.

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[17] The Division has apparently recognized that it cannot introduce a new, uncharged (and non-meritorious) theory of financial statement misconduct at trial, and has accordingly dropped the argument that Respondents' reporting of accrued interest supports the financial statement claim. While the Division now tries to use accrued interest to support its categorization claim, that contention is also outside the OIP—as it rests on the utterly unproved assumption that the accrued interest was not reported in compliance with GAAP—and is otherwise meritless for the reasons explained *supra* pp. 16-20.

The Division simply ignores these examples of valuation models, along with testimony from Respondents and their experts about how the valuation models were used to arrive at accurate fair value determinations. Instead, the Division relies exclusively on the report of its expert, Henning, but he failed to consider any of the valuation model spreadsheets that detail Respondents' fair value analysis. Resp. FOF ¶ 228. Nor did Henning or any other witness rebut the testimony of Respondents' witnesses Lundelius and Mercado, two CPAs who both described the fair value analyses performed by Respondents, *see* Tr. 3304:25-3305:5 (Lundelius); Tr. 1181:5-20 (Mercado), and who both concluded "that Patriarch was presenting fair value in accordance with GAAP," Tr. 3311:9-12 (Lundelius); *see also* Tr. 1181:17-20 (Mercado).

2. Respondents Conducted GAAP-Compliant Impairment Analysis.

The Division alleges that Respondents did "not conduct an impairment analysis that complies with GAAP" and had "no procedures in place to analyze future collections" in order to inform their impairment analysis. OIP ¶¶ 66-67; *see* Div. Br. 38. The evidence at trial disproved this allegation. Patriarch regularly analyzed the performance and future prospects of the Portfolio Companies through "credit templates" that applied a discounted cash flow analysis to estimate the value of future collections, and used the templates to make decisions regarding the Portfolio Companies, including whether to restructure or liquidate an asset. Resp. FOF ¶¶ 232-33; *see also* Tr. 2278:25, 2279:4-6 (Tilton). Patriarch then conducted "event-driven" impairment analyses. Ms. Tilton explained these analyses at trial, and Respondents introduced an example of the credit templates on which they were based. *See* Tr. 1959:21-1960:2 (Tilton); RX 561 (ALF Credit Template).

The Division relies exclusively on Henning's report, but Henning conceded that he ignored the credit templates in concluding that Patriarch did not conduct an impairment analysis.

See Tr. 1429:14-1430:8 (Henning); Resp. FOF ¶ 240. Neither Henning nor any other witness rebutted Lundelius' conclusion, based on those credit templates and other "contemporaneous evidence," that "the enterprise value was being assessed at least annually if not more frequently. And that given enterprise values, significantly above the loan levels, that an impairment analysis was, in fact, being done." Tr. 3199:24-3200:5 (Lundelius); *see also* Resp. FOF ¶ 236; RX 22 (Dietrich Rep.) at ¶¶ 39-42; Tr. 3256:22-3258:19 (Lundelius). Nor did Henning rebut Lundelius' conclusion, confirmed by Mercado, that this process was GAAP compliant. *See* Resp. FOF ¶¶ 236-39; Tr. 3181:15-21, 3183:22-25, 3304:25-3305:3 (Lundelius); Tr. 1118:6-8 (Mercado).

Finally, the Division insists that Respondents did not "write down loans for impairment purposes but, instead, wr[o]te[] them off if and when Tilton determine[d] that she w[ould] no longer support a Portfolio Company." OIP ¶ 64; *see* Div. Br. 24. The Division's allegation is premised entirely on a single un-contextualized phrase from a single email chain, *see* DX 162 ("[W]e do not write up or write down – we write off"), but it ignores the evidence adduced at trial that under its impairment policy, Patriarch both wrote down loans when underperforming assets needed to be restructured, and wrote off loans upon liquidation. *See* Resp. FOF ¶ 235; Tr. 3248:24-3249:6 (Lundelius) (discussing "actual evidence of both actual write-downs and write-offs"); *see also* Tr. 1263:16-23 (Mercado). Respondents introduced at trial a sample workpaper (a spreadsheet employed to populate the financial statements) to demonstrate how, in the "payoffs" tab, Patriarch's practice of writing down loans was readily apparent. *See* Tr. 1258:3-4 (Mercado) (addressing DX 57). The payoffs tab showed "that losses were reported when restructurings occurred" (*i.e.*, that Respondents "wrote down" loans as part of calculated restructurings). Tr. 1027:15-17 (Berlant). Tellingly, the Division failed to ask a single witness

about the payoffs tab. In sum, only by ignoring the actual books and records introduced at trial is the Division able to persist in its financial statement allegations.

B. Respondents Reasonably Relied On The Advice Of External And Internal Accountants In Preparing The Financial Statements.

Even if the financial statements had contained misrepresentations—which they did not—Respondents cannot be held liable for fair value and impairment certifications that were signed only after being reviewed and approved by its external and internal accountants. The Division admits that courts recognize a defense based on reasonable, good faith reliance on accountants where: a defendant "[1] made a complete disclosure, [2] sought the advice as to the appropriateness of the challenged conduct, [3] received advice that the conduct was appropriate, and [4] relied on that advice in good faith." *SEC v. Goldsworthy*, 2008 WL 8901272, at *4 (D. Mass. June 11, 2008); Div. Br. 50-51 (citing *SEC v. Caserta*, 75 F. Supp. 2d 79, 94 (E.D.N.Y. 1999)). Reasonable reliance defeats both scienter-based and negligence-based charges. *See* Resp. Br. 95-103.[18]

The Division does not dispute that Ms. Tilton reasonably relied on the advice of Patriarch's internal accountants, including Mercado. As established at trial, before draft financial statements were sent to external accountants for their additional review, Patriarch's internal Finance and Accounting Department prepared them using data provided by the Trustee, and, with Mercado's assistance, ensured that they were prepared in accordance with GAAP. *See* Resp. FOF ¶¶ 264-65; Tr. 1144:10-13 (Mercado) ("Q. Did you take any steps, Mr. Mercado, to

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[18] Where courts find these four factors present, they routinely dismiss the relevant charges. *See, e.g.*, *Goldsworthy*, 2008 WL 8901272, at *4-5. While the Division cites dicta in *Markowski v. SEC*, 34 F.3d 99, 105 (2d Cir. 1994), for the proposition that "good faith reliance" is "not a complete defense, but only one factor for consideration," it fails to explain what additional "factors" it thinks might override Respondents' meritorious advice-of-accountants defense here. *See* Div. Br. 50-51.

ensure the financial statements were prepared in accordance with US GAAP? A. Yes, that's part of my responsibility."); Tr. 2270:3-6 (Tilton) (referring to external account as "that extra layer . . . after my people had done their work to make certain that everything was as it should be"). That alone defeats the financial statement-related allegations against Ms. Tilton.

Instead, the Division argues only that Ms. Tilton did not reasonably rely on her external accountant, Peter Berlant. The Division's brief focuses at length on the claim that Berlant was not "reviewing or opining on whether the Zohar funds' financial statements complied with U.S. GAAP," regardless of what Respondents paid him to do, what he indicated to Respondents he did, and what Respondents reasonably believed he did.[19] Div. Br. 51. But the notion that Berlant was only reviewing the financial statements for clerical errors rests solely on Berlant's testimony, which, as detailed in Respondents' opening post-hearing brief, was so transparently self-serving and inconsistent with the contemporaneous documents as to be completely unreliable.[20] *See* Resp. Br. 97-104. This argument is also irrelevant: what matters is what Ms. Tilton reasonably believed Berlant was doing, not whether he was in fact doing it. *See, e.g., SEC v. Prince*, 942 F. Supp. 2d 108, 140-44 (D.D.C. 2013).

As for the Division's claim that "Tilton has enough experience with financials to know that Berlant could not have been testing or opining . . . because Berlant spent merely a few hours per month looking over draft financials," this too is a red herring. Div. Br. 53. Ms. Tilton did

[19] *See also, e.g.*, Div. Br. 53 ("Berlant spent merely a few hours per month looking over draft financials. Simply put, there can be no credible dispute that Berlant did not perform the services necessary to support a reliance defense."); *id.* ("[Ms. Tilton's] recent attempt to blame [Berlant] . . . is meritless" because Berlant merely "spent a few hours each month looking at draft financial statements.").

[20] Moreover, Berlant's firm received $366,000 from the SEC for work in another enforcement action, beginning in May 2016—which payments were not disclosed to Respondents until days after Berlant stepped off the witness stand. *See* Resp. Br. 111. This conflict of interest brings into further disrepute Berlant's already unreliable testimony.

not think Berlant was engaging in a rigorous "audit" or "test" of the financial statements on a monthly basis (as those terms are used in financial accounting); indeed, no such attestation was required under the Indentures. *See* Tr. 1949:1-17 (Tilton). Rather, she believed he was reviewing the statements for GAAP compliance, among other things—a process that would not necessarily take any great length of time from one month to the next. *See* Tr. 1949:19-1950:11 (Tilton). The Division ignores that the notes to the Zohars' financial statements did not change on a regular basis. *See* DX 10, DX 11, DX 12. A few hours of review would therefore suffice, particularly because Berlant was involved in the drafting of the fair value and impairment notes in the first place, helped prepare Patriarch's manual of accounting policies, and designed Patriarch's financial data workpapers. *See* Resp. Br. 96-98; Resp. FOF ¶¶ 247-55.

The Division also ignores Ms. Tilton's 15-year relationship with Berlant and the services that he repeatedly confirmed he was providing, including giving substantive advice and guidance when relevant GAAP rules changed. *See* Resp. Br. 98-103; Resp. FOF ¶¶ 257-60. The Division looks only to boilerplate language in Anchin's engagement letter, which required Berlant to "read[] and comment[] on financial statements, computations or other financial data" while purportedly absolving Anchin of "responsibility" regarding GAAP compliance. Div. Br. 51 (citing DX 34). In its myopic focus on this excerpt, the Division ignores the rest of the engagement letter—including that Berlant's firm would provide accounting advice when Respondents "specifically request . . . [such] advice," and that the provision the Division relies on is a waiver of liability, not a limitation on the services Berlant could perform. *See* DX 34. It also disregards the mountain of evidence concerning Ms. Tilton's and Berlant's 15-year relationship and course of conduct before, during, and after the time this engagement letter was signed.

As detailed at trial and in Respondents' opening post-hearing brief, Respondents hired Berlant at the inception of the business, relying on him to provide accounting guidance, create Respondents' financial statements, and develop a manual of GAAP-compliant accounting policies. Resp. Br. 96-97. Ms. Tilton relied on Berlant to provide guidance on GAAP and other substantive accounting issues, and to review and approve the financial statements that he helped create, every month for many years. Resp. Br. 98-103. In light of Ms. Tilton's lengthy relationship with Berlant, including his frequent provision of advice concerning GAAP compliance, it was reasonable for Ms. Tilton to rely on Berlant, in addition to Patriarch's internal accountants, in believing that the financial statements were GAAP compliant. *See In re Austin*, 2009 WL 3193167, at *8-13 (Bankr. W.D. La. 2009) (recognizing that the "parties' relationship was much broader—and, in some ways inconsistent—with the terms of the Engagement Letter," and treating the parties' "broader relationship" as dispositive of whether professional's actions were taken pursuant to his role as client's counsel).[21]

In short, the Division does not dispute that Ms. Tilton reasonably relied on internal accountants and it provides no credible reason to doubt the extensive evidence adduced at trial that Respondents fully disclosed to their external accountant, Berlant, their approach to impairment and fair value—indeed, he designed their accounting processes and helped draft the challenged notes, *see* Resp. FOF ¶¶ 249-55—along with the monthly data underlying the

[21] The Division also implies that Respondents did not actually rely on Berlant, noting that Respondents removed GAAP certification language from the financial statements in the wake of the SEC's Wells notice. Respondents did not tell 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." Div. Br. 52. That, of course, was because Ms. Tilton had no reason to think Berlant had done anything incorrectly; the change was made simply to satisfy the Division. Respondents continued to believe (and still believe) that their financial statements were GAAP compliant.

reported figures, Resp. FOF ¶ 256; sought advice concerning whether or not the financial statements were GAAP compliant; were informed that the financial statements were in fact GAAP compliant (or were informed that the financial statements would be GAAP compliant so long as certain modifications were made, and then made those modifications); and reasonably relied on that advice in good faith. In light of Respondents' reliance on the advice of its accountants, the Division cannot establish liability with respect to the financial statements. *See Goldsworthy*, 2008 WL 8901272, at *4; *In re Digi Int'l, Inc., Sec. Litig.*, 14 F. App'x 714, 717 (8th Cir. 2001); *SEC v. Jensen*, 2013 WL 6499699, at *29 (C.D. Cal. Dec. 10, 2013), *vacated on other grounds*, 2016 WL 4537377 (9th Cir. Aug. 31, 2016).

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

To prevail on its financial statement-related charges, the Division has the affirmative burden of proving scienter or at least negligence. *See* Resp. Br. 104. The Division claims that Ms. Tilton "certified the financial statements, knowing that she applied her own subjective standards for impairment without regard to standards prescribed by U.S. GAAP." Div. Br. 42-43. But this allegation is roundly refuted by the trial evidence. Ms. Tilton consistently and credibly testified that she "believed that these [financial statements] were [prepared] in accordance with GAAP" and "still believe[s] they're in accordance with GAAP," Tr. 2737:24-2738:1 (Tilton); *see* Resp. FOF ¶¶ 273-76, having relied for 15 years on her internal and external accountants to help ensure that this was so, *see, e.g.*, Resp. FOF ¶ 265; *see also* Tr. 1356:17-18 (Mercado). The Division, meanwhile, failed to introduce any evidence that any Patriarch employee or adviser did not believe that the financial statements complied with GAAP, or was in any way negligent as to the preparation of the financial statements.

In its brief, the Division repeatedly falls back on its disingenuous contention that changes to Respondents' financial statement notes in 2015 constitute "an acknowledgment by the Respondents that the prior reporting departed from U.S. GAAP." Div. Br. 24-25; *see also id.* at 26. As the Division is well aware, Respondents removed references to GAAP in their financial statements during post-Wells notice discussions with the Division, and only after the Division suggested removing the language would further those discussions. Resp. FOF ¶ 276; Tr. 2597:19-2598:5 (Tilton). At trial, the Division's "expert" on this matter testified that the Division kept him in the dark concerning this crucial context, thereby eliciting his uninformed so-called "expert" opinion that the 2015 changes to the financial statements somehow represented an "admission." Tr. 1426:20-1427:8 (Henning) (admitting that he was never made "aware of the fact that in December 2014 . . . the Enforcement staff said that, in their view, the current form of the financial statements constituted ongoing violations and . . . needed to be addressed if the matter could ever be resolved"). Henning's report—produced prior to his learning, during cross-examination, of this crucial context—is the Division's only source of authority on these issues.

In persisting with its "gotcha" argument, the Division pretends that its duplicitous conduct—toward Respondents (in baiting Respondents into changing their financial statements, only to turn around and argue that Respondents' acquiescence is evidence of scienter), and toward Your Honor (in intentionally shielding its "expert" from obviously relevant facts)—was never exposed. The Division also ignores Henning's concession at trial that his "belief as to what the change [in the financial statements] represents," Tr. 1393:9-10 (Henning), was not based on any accounting expertise, *see* Resp. FOF ¶¶ 304-05. The Division's scienter allegations are wholly unsupported and were disproved by the evidence at trial. Nor was Ms. Tilton

negligent in believing, as she still does (consistent with CPA witnesses Lundelius and Mercado) that the financial statements are GAAP compliant and not misleading.

D. The Challenged Certifications Were Immaterial To Noteholders.

The Division must also prove the element of materiality as to the challenged statements in the financial statements. *See* Resp. Br. 106. The only support the Division provides for its conclusion that the alleged misrepresentations in the financial statements were "obviously material" is that "several investors . . . testified that" the disclosures at issue (concerning fair value and GAAP compliance) were "important to them." Div. Br. 39. But that is simply not true. Of the three noteholder witnesses the Division called (down from a pool of dozens), one stated unequivocally that he "had never once looked at the financial statements" and "had never discussed [them] with anyone" in the years prior to his investigative testimony. Tr. 1547:15-25 (Aldama); *see also* Resp. FOF ¶ 278. Another agreed that "the representations that financial statements were GAAP compliant were not important" to him. Tr. 375:9-12 (Aniloff); *see also* Resp. FOF ¶ 278. It is thus false to assert, as the Division does, that "several" noteholders testified that the relevant disclosures were important. In fact, the Division could find only one noteholder willing to claim that the financial disclosures and the fair value and GAAP certifications within them were important to him. But that noteholder, Mach, was hardly representative of a "reasonable investor" view of what was important in light of the "'total mix' of information available," *Russell W. Stein*, Initial Decision Release No. 150, 1999 WL 756083, at *11 (ALJ Sept. 27, 1999) (quoting *Basic*, 485 U.S. at 231-32), since he effectively conceded that, unlike an objectively reasonable investor, he had never bothered to consult key "information available" such as the interest payment cash flows in the Trustee Reports, *see, e.g.*, Tr. 692:02-693:01 (Mach). Nor did Mach—or any other noteholder—ever raise a question about the financial statements. *See* Resp. Br. 106-07, 109. In short, Mach's self-serving testimony

about the importance of this information to him is not credible. The Division thus failed to present any credible evidence of materiality. And at all events, the importance of the information provided in the financial statements must be evaluated in the context of the total mix of information available to noteholders, including the much more detailed and voluminous information provided in the Trustee Reports. *See id.* at 106-08.

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

As outlined in Respondents' opening post-hearing brief, Respondents have challenged the constitutionality of this proceeding on numerous grounds, including under the Appointments Clause and as violative of their due process and equal protection rights. *See* Resp. Br. 109-10. After Respondents submitted their brief, the Tenth Circuit held that SEC ALJs' appointments are unconstitutional under the Appointments Clause, further buttressing Respondents' position on this issue. *See Bandimere v. SEC*, 2016 WL 7439007, at *1 (10th Cir. Dec. 27, 2016). The Division has not addressed Respondents' arguments concerning the unconstitutionality of this proceeding, including specific examples of due process deprivations. *See* Resp. Br. 110 & App'x B. Nor does the Division address in its opening post-hearing brief the numerous instances of serious litigation misconduct by the Division raised by Respondents throughout the trial, which warrant dismissal of the charges. *See* Resp. Br. 110-12. The Division should not be rewarded for hiding its head in the sand in the hope that its misconduct will be ignored.

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

The Division's opening post-hearing brief makes clear what Respondents have known to be true since the OIP was filed: not only was the Division mistaken in charging and prosecuting Respondents, it has also grossly overreached in its requests for sanctions. The Division seeks a litany of severe punishments: a permanent industry bar, over $200 million in disgorgement,

unspecified amounts of monetary penalties, and a cease-and-desist order. But the Division has fallen woefully short of its burden of establishing that those grave sanctions are appropriate.

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

Despite requesting one of "the most drastic remedies" available, the Division fails to address a single one of the six *Steadman* factors, which courts and tribunals must weigh when determining whether a permanent bar would serve the public interest. *See* Resp. Br. 112 (outlining factors set forth in *Steadman v. SEC*, 603 F.2d 1126, 1137 (5th Cir. 1979), *aff'd*, 450 U.S. 91 (1981)). The Division also fails to make any showing as to "why less severe action would not serve to protect investors." *Steadman*, 603 F.2d at 1140. Those omissions underscore the impropriety of a permanent bar under the circumstances here.

The *Steadman* factors weigh decisively against the imposition of a permanent bar, which would undermine—not serve—the public interest. First and foremost, the evidence adduced at trial conclusively establishes that Respondents acted without scienter. *See, e.g.*, *Valicenti Advisory Servs., Inc.*, Initial Decision Release No. 111, 1997 WL 362000, at *19 (ALJ July 2, 1997) (Foelak, J.) (where respondents act without scienter, "revocation and suspension" sanctions are "excessively harsh"); *see also* Resp. Br. 113. Respondents genuinely and reasonably believed that their categorization method was permitted by the Indentures, and that their financial statements were accurate. *See* Resp. Br. 49-67, 71, 80-83, 104-06; *supra* Pts. I.D, II.C. And Respondents' actions were consistently motivated by a desire to increase value to the Zohars and noteholders. *See* Resp. Br. 69-70, 74-77; *supra* p. 32; FOF ¶¶ 195-96, 212-18. Those facts belie any contention that Respondents' conduct was deceitful—let alone egregious—

and render the cases on which the Division relies wholly inapposite. *See id.*[22] Other *Steadman* factors similarly weigh against the imposition of a bar: The charges against Respondents are founded upon a single course of purported misconduct (Respondents' approach to categorization), rather than recurrent infractions, *see* Resp. Br. 113; Respondents are committed to complying with the securities laws, *see id.*;[23] and the Division has failed to explain how a permanent bar would meaningfully reduce the already negligible risk of future violations, particularly in light of the fact that Respondents have resigned as collateral managers to the Zohars and that the Patriarch Respondents[24] are no longer registered as investment advisers, *see id.* 113-14; Div. Br. 56.

Not only does the Division ignore the specific *Steadman* factors, it also fails to explain why the stated goal of protecting investors could not be achieved through a less drastic remedy. *See Steadman*, 603 F.2d at 1137. That omission is even more troubling in light of substantial evidence establishing that the public interest would be best served by Respondents' continued

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[22] For example, in *J.S. Oliver Capital Management*, the respondents engaged in unabashed self-dealing by allocating profitable trades to their own accounts, at the direct expense of their clients. *See* Securities Act Release No. 10100, 2016 WL 3361166, at *3 (Mar. 7, 2016). Unlike Respondents here, the *J.S. Oliver* respondents' actions were not rooted in a reasonable interpretation of operative contracts, nor part of a larger strategy to realize value for their clients. Rather, the *J.S. Oliver* respondents' conduct was "egregious" and executed with "a high degree of scienter," *id.* at *11, precisely because it "amounted to theft," *id.* at *16. *See also ZPR Inv. Mgmt., Inc.*, Advisers Act Release No. 4249, 2015 WL 6575683, at *27 (Oct. 20, 2015) (imposing industry bar where, *inter alia*, individual's conduct was "egregious" and executed "with a high degree of scienter").

[23] Although Respondents vehemently dispute the purported "wrongful nature" of the alleged misconduct, that fact alone is not dispositive, *see, e.g.*, *Timbervest, LLC*, Initial Decision Release No. 658, 2014 WL 4090371, at *63 (ALJ Aug. 20, 2014) ("The Commission's inquiry into the appropriate sanction to protect the public interest is a flexible one, and no one factor is dispositive."), and Respondents will certainly accept responsibility, should they be found liable after exhausting all appeals.

[24] Ms. Tilton was never registered as an investment adviser.

participation in the securities industry: Respondents have provided significant financial benefits to many investors, rebuilt iconic American companies, and saved hundreds of thousands of jobs. *See* Resp. Br. 114; Resp. FOF ¶¶ 92, 97-106, 113-24, 191; Tr. 2352:18-24 (Tilton).

The Division's sole justification for the severe sanction it seeks is that "[a]n industry bar is particularly important in this case given the importance to the investment adviser industry of maintaining honest fiduciary relationships." Div. Br. 59. That argument is unpersuasive for several reasons. First, the existence of a fiduciary relationship does not automatically trigger a permanent bar. Indeed, in one of the very cases on which the Division relies, the court of appeals set aside the Commission's disbarment order despite the Commission's finding that the respondent had violated his fiduciary duties through "egregiously faithless" conduct, and remanded for further consideration of additional factors. *See Steadman*, 603 F.2d at 1140-41.[25] Second, the Division ignores overwhelming evidence that Respondents acted in the best interests of the Zohars and noteholders, often putting those interests ahead of their own. *See* Resp. Br. 6, 69-70, 74-77. Third, under the Division's theory, Respondents' purported misconduct was directed primarily at noteholders, with whom Respondents had no fiduciary relationship. *See id.*

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[25] The other cases on which the Division relies are similarly inapposite. For example, in *James C. Dawson*, an industry bar was upheld where the ALJ found the respondent's conduct—allocating profitable trades to his own account at the direct expense of his clients—to be "egregious, recurrent, and characterized by the highest degree of scienter." Advisers Act Release No. 3057, 2010 WL 2886183, at *2, 3 (ALJ July 23, 2010); *see also Don Warner Reinhard*, Advisers Act Release No. 3139, 2011 WL 121451, at *6 (Jan. 14, 2011) (imposing bar based on, *inter alia*, fact that respondent had acted with a "high degree of scienter"); *Mark S. Parnass*, Exchange Act Release No. 65261, 2011 WL 4101087, at *2 (Sept. 2, 2011) (modifying bar against respondent "insofar as it prohibit[ed] him from associating with an investment adviser or . . . company" but declining to vacate permanent bar as to association with any broker or dealer because it was entered with respondent's express consent); *Gary M. Kornman*, Advisers Act Release No. 59840, 2009 WL 367635, at *7 (Feb. 13, 2009) (imposing bar where respondent admitted to lying to a federal official "intentionally and for the purpose of misleading" an investigation).

at 72-74; *supra* pp. 26-27. Under the totality of these circumstances, a permanent bar would be completely inappropriate.

B. A Cease-And-Desist Order Is Not Warranted.

For the same reasons outlined above, the *Steadman* factors also weigh against a cease-and-desist order. *See supra* Pt. IV.A; *see also* Div. Br. 55 (acknowledging that *Steadman* factors guide determination of whether cease-and-desist order is appropriate). The absence of harm to the Zohars or noteholders confirms that a cease-and-desist order would be improper. *See infra* p. 54; Resp. Br. 119; FOF ¶¶ 92, 193, 195-96, 212-18. In *WHX Corporation v. SEC*, for example, the court declined to impose a cease-and-desist order where, *inter alia*, the Commission "fail[ed] to establish any serious harm . . . caused by [respondent's conduct]" and failed to "consider the possibility that [respondent's actions] might actually have benefited [the] shareholders." 362 F.3d 854, 861 (D.C. Cir. 2004). The same result should follow here.

The Division has also failed to show that there is a sufficient risk of future violations, which it concedes is necessary in order to obtain a cease-and-desist order. *See* Div. Br. 55. Although the Division, quoting *KPMG Peat Marwick LLP*, Exchange Act Release No. 1347, 2001 WL 223378, at *6 (Mar. 8, 2001), suggests that "'a finding of past violation raises a sufficient risk of future violation,'" Div. Br. 55, the D.C. Circuit has, subsequent to *KPMG*, sharply criticized the notion that a "risk of future violation" is established any time a party commits a violation and does not exit the market or in some other way disable itself from recommission of the offense. *See WHX Corp.*, 362 F.3d at 859. As the D.C. Circuit has explained, "[g]iven that the first condition is satisfied in every case where the Commission seeks a cease-and-desist order on the basis of past conduct, and the second condition is satisfied in almost every such case, this can hardly be a significant factor in determining when a cease-and-desist order is warranted." *Id.* In any event, Respondents here *have* reduced the already

negligible risk of future violations by resigning as the Zohars' collateral manager. *See supra* p. 47. Accordingly, a cease-and-desist order is unnecessary and inappropriate.

C. The Requested Statutory Penalties Are Insufficiently Quantified And Unmerited.

Your Honor should reject the Division's perfunctory request for statutory monetary penalties. The Division does not even bother to suggest general ranges of the penalties it believes to be appropriate, let alone tie those amounts to evidence adduced at trial. *See* Div. Br. 57-59. The Division's vague reference to Respondents' potentially "enormous" exposure, without any attempt to quantify that exposure, should not be permitted to serve as a basis for imposing any monetary penalties, and especially not sweeping, third-tier penalties.

Even if Your Honor were to entertain the Division's impossibly vague request, monetary penalties should be denied because they are unwarranted under the plain language of the statute. In order to obtain a third-tier penalty, the Division must show that Respondents' conduct: (i) "involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement"; and (ii) directly or indirectly resulted in (or created a significant risk of) substantial losses to other persons or resulted in substantial pecuniary gain to Respondents. 15 U.S.C. § 80b-3(i)(2)(C). Neither requirement is satisfied in this case. First, Respondents lacked scienter—they believed their conduct to be permitted under the Indentures and in the best interests of the Zohars and the noteholders, and believed their financial statements to be accurate. *See supra* Pts. I.D, II.C; Resp. Br. 80-83, 104-06. That fact alone forecloses the availability of third-tier penalties.[26] Second, Respondents' conduct did not cause or risk harm to others, nor

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[26] Second-tier penalties are similarly foreclosed. *See* 15 U.S.C. § 80b-3(i)(2)(B) (conditioning second-tier penalties on a showing that the respondent's conduct "involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement").

result in "substantial pecuniary gains" to Respondents. *See* Resp. Br. 114, 119-20. On the contrary, Respondents invested and re-invested into the funds and the Portfolio Companies far more money than they received in purportedly improper fees, *see infra* Pt. IV.D; *see also* Resp. Br. 119-20, and they created substantial value for the Zohars and noteholders, with billions of dollars of value currently locked in the Portfolio Companies, *see* Resp. Br. 114; Resp. FOF ¶ 92; Tr. 2727:4-7 (Tilton). Further, any penalty—even a first-tier penalty—must be "in the public interest," which is determined by considering the factors outlined in Section 203(i)(3) of the Advisers Act.[27] Here, the public interest would be ill-served by monetary penalties for the reasons outlined above, *compare* 15 U.S.C. § 80b-3(i)(2)(C), *with id.* § 80b-3(i)(3)(A)-(C), and also because Respondents have never been held liable for a violation of the securities laws. Moreover, a monetary penalty is unnecessary to deter the purported misconduct here, which was based upon a reasonable interpretation of a complex, unique contract. *See id.* § 80b-3(i)(3)(D), (E). Accordingly, monetary penalties are not available here.

Finally, even if Your Honor were to impose monetary penalties, the Division has vastly overreached by suggesting that it would be appropriate to "impose a penalty for each improperly represented OC Ratio." Div. Br. 58. The charges against Respondents relate to a single course of alleged misconduct: Respondents' purported failure to disclose that they were categorizing loans using "subjective" methods, rather than in accordance with the purportedly objective standards set forth in the Indentures. As Your Honor has found, omissions and misstatements

[27] Those factors are: (i) whether the misconduct involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (ii) the resulting harm to others; (iii) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior; (iv) whether the respondent previously has been found to have violated the securities laws; (v) the need for deterrence; and (vi) such other matters as justice may require. 15 U.S.C. § 80b-3(i)(3).

that are part of "one course of action result[] in one unit of violation" for penalty purposes. *Mohammed Riad*, Initial Decision Release No. 590, 2014 WL 1571348, at *34 (ALJ Apr. 21, 2014) (Foelak, J.); *accord, e.g.*, *Nat. Blue Res., Inc.*, Initial Decision Release No. 683, 2015 WL 4929878, at *33 (ALJ Aug. 18, 2015) (Foelak, J.).[28] Accordingly, the very most that would be appropriate would be a single, first-tier penalty.[29]

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

Although the Division seeks one of the largest awards of disgorgement in SEC history, it offers no reasonable approximation of net profits obtained through Respondents' purported misconduct. *See Ambassador Capital Mgmt., LLC*, Initial Decision Release No. 672, 2014 WL 4656408, at *82 (Sept. 19, 2014) (finding that "the Division ha[d] not carried its initial burden . . . of proving an appropriate amount of disgorgement"); *see also* Div. Br. 56 (acknowledging its burden). The Division's request for over $200 million in so-called "disgorgement" rests solely on the unreliable, erroneous calculation of its expert, Michael G. Mayer. Further, the Division fails to calculate Respondents' *net* profits—the appropriate measure of disgorgement, *see* Resp. Br. 115-16, 119-20—which were nil. Under these circumstances, *any* amount of "disgorgement" would constitute an improper penalty, beyond the scope of Your Honor's equitable powers, *see SEC v. McCaskey*, 2002 WL 850001, at *8-10 (S.D.N.Y. Mar. 26, 2002) (disgorgement "not

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[28] Neither of the cases on which the Division relies in suggesting multiple units of violation are relevant here, as both involve penalties under the Exchange Act, not the Investment Advisers Act. *See* Div. Br. 58-59 (citing *Kevin H. Goldstein*, Initial Decision Release No. 243, 2004 WL 69156, at *19 (ALJ Jan. 16, 2004) and *Steven E. Muth*, Initial Decision Release No. 262, 2004 WL 2270299, at *39, *41 (ALJ Oct. 8, 2004)).

[29] If, however, Your Honor does assess multiple penalties, they must be limited to acts or omissions that occurred prior to March 30, 2010, pursuant to the five-year statute of limitations set forth in 28 U.S.C. § 2462.

appropriate" where it would "work a punishment"), and the amount sought here, over $200 million, would constitute a penalty so disproportionate to Respondents' purported misconduct as to violate the Eighth Amendment's Excessive Fines Clause, *cf. United States v. Bajakajian*, 524 U.S. 321, 334 (1998); *United States v. Philip Morris USA*, 310 F. Supp. 2d 58, 64 (D.D.C. 2004).

The only basis for the Division's disgorgement request is the testimony of its expert, Mayer, but that testimony should be afforded little, if any, weight. *See* Resp. Br. 117 n.69; Resp. FOF ¶¶ 320-31. Mayer purported to calculate what the OC Ratio should have been for each quarter "had Respondents properly categorized the loans based on whether the Portfolio Companies were current in their interest payments," Div. Br. 18; then determined that Zohar II and Zohar III would have failed their monthly OC Ratio tests beginning in July 2009 and June 2009, respectively, *id.* at 19-20, 57; and, finally, calculated that Respondents were paid $208 million in subordinated collateral management fees and preference share distributions that should have been "re-directed . . . away from Respondents and toward investors," *id.* at 20. That calculation, which is tainted by fundamental errors and flawed assumptions, is inherently unreliable. *See* Resp. Br. 116-20.

Mayer did not recognize that failure of the OC Ratio in one period triggers, under the Indentures, a mandatory repayment of principal, which decreases the likelihood of an OC Ratio Test failure in subsequent periods. *See* Resp. Br. 116-17; *see also, e.g.*, Resp. FOF ¶¶ 328-31. When Mayer's error is corrected to account for the mechanical redirection of proceeds, the OC Ratio Test passes in many of the periods in which Mayer says it should have failed, rendering distributions during those periods unquestionably proper. *See* Resp. Br. 117; Resp. FOF ¶ 330. After correcting Mayer's error, Respondents' expert, Hubbard, determined that at least $61 million of the $208 million that Mayer characterized as "improperly received" was, in fact,

proper—even under the Division's theory of the case—revealing the fundamental unsoundness of Mayer's analysis. *See* Resp. Br. 117-18; Resp. FOF ¶¶ 329-30. Additionally, Mayer ignored various potential consequences of an OC Ratio Test failure, including options for the collateral manager to bring the test back into compliance in future periods (*e.g.*, by repaying principal or exercising other contractual rights). *See* Resp. Br. 118; Resp. FOF ¶ 328. Accordingly, Mayer's figure is not "causally related to the proven wrongdoing," and it must be rejected. *See, e.g.*, *Clarke T. Blizzard*, Initial Decision Release No. 229, 2003 WL 21362222, at *24 (ALJ June 13, 2003) (Foelak, J.) (reducing requested disgorgement amount by nearly three-quarters based on Division's failure to prove any greater "profits Blizzard obtained that are causally related to his proven wrongdoing").

Even if Mayer's figure were credited, it would represent only Respondents' *gross* profits; the Division failed to offer a reasonable approximation of Respondents' *net* profits, which is the proper measure of disgorgement. *See* Resp. Br. 115-16, 119-20. The evidence adduced at trial established that Respondents returned to the Zohars and the Portfolio Companies (and through them, to the noteholders) more than $500 million in value, including by transferring hundreds of millions of dollars from their own coffers and forgoing fees due. *See* Resp. Br. 119; Resp. FOF ¶¶ 92, 195-96, 212-18. That amount (already double what the Division seeks to disgorge) is in addition to the equity upside that Ms. Tilton gifted to the Zohars—which, due to Respondents' active management, is now worth billions of dollars. *See* Resp. Br. 114, 120; *see also* Resp. FOF ¶¶ 92, 193, 195; Tr. 1934:7-11, 2261:19-21, 2727:4-7 (Tilton); RX 495. When those returns are taken into account, as they must be, Respondents' disgorgement liability is reduced to zero. *See* Resp. Br. 119-20.

Although the Division argues that "Respondents have put forward no competing calculation," Div. Br. 57, that is false. *See, e.g.*, Resp. Br. 117-20; Resp. FOF ¶¶ 193, 195, 212-17, 330. Despite having no obligation to set forth a competing calculation where, as here, the Division has failed to offer in the first instance a reasonable approximation of net profits causally related to the alleged wrongdoing, *see Ambassador Capital*, 2014 WL 4656408, at *82, Respondents have nevertheless offered a competing calculation, and do so again here:

> $0 (No Disgorgement): The proper amount of disgorgement is zero, in light of the numerous errors that pervade Mayer's analysis and render his disgorgement figure incurably unreliable, and Respondents' returns to the Zohars and noteholders, which total more than $500 million in value (in addition to the equity upside that Ms. Tilton gifted to the Zohars, which is now worth billions of dollars) and reduce Respondents' net profits subject to potential disgorgement to nil.[30]

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[30] In the event that Your Honor were to credit some part of Mayer's calculation and to dismiss Respondents' offsets entirely, the Division's proposed disgorgement figure would still need to be adjusted to no more than $104,075,204 to take account of: (i) $45,447,417 in fees and distributions paid to Respondents based on conduct outside the statute of limitations period, *i.e.*, prior to March 30, 2010, that Mayer improperly includes, *see* Resp. Br. 118-19 & n.71; DX 17 (Mayer Rep.) at figs. 60, 61, 65, 68; and (ii) $58,893,249 in payments properly distributed to Respondents within the statute of limitations period, *see* RX 24 (Hubbard Rep.) App'x 8; *see also* Resp. Br. 117-18.

The U.S. Supreme Court has made abundantly clear that the five-year statute of limitations imposed by 28 U.S.C. § 2462 should be construed broadly to avoid "leav[ing] defendants exposed to Government enforcement action not only for five years after their misdeeds, but for an additional uncertain period into the future." *Gabelli v. SEC*, 133 S. Ct. 1216, 1223 (2013). The best interpretation of the statute is, accordingly, that "§ 2462's statute of limitations applies to disgorgement." *SEC v. Graham*, 823 F.3d 1357, 1363 (11th Cir. 2016). While some courts have found otherwise, *see* Resp. Br. 119 n.71, the Supreme Court earlier today granted certiorari to review the Tenth Circuit's decision departing from *Graham* and declining to apply § 2462's statute of limitations to a disgorgement award, *see* Order List at 2 (S. Ct. Jan. 13, 2017) (granting certiorari in *Kokesh v. SEC*, No. 16-529).

CONCLUSION

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

Dated: New York, New York
January 13, 2017

GIBSON, DUNN & CRUTCHER LLP

By: /s/ Randy Mastro /RB

Randy M. Mastro
Reed Brodsky
Caitlin J. Halligan
Mark A. Kirsch
Monica Loseman
Lawrence J. Zweifach
Barry Goldsmith
Lisa H. Rubin

200 Park Avenue
New York, NY 10166-0193
Telephone: 212.351.4000
Fax: 212.351.4035

Susan E. Brune
BRUNE LAW P.C.
450 Park Avenue
New York, NY 10022
Telephone: 212.668.1900
Fax: 212.668.0315

Counsel for Respondents

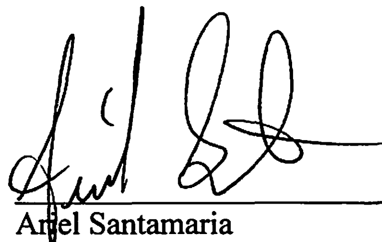
<u>**CERTIFICATE OF SERVICE**</u>

I hereby certify that I served a true and correct copy of Respondents' Post-Hearing Opposition Brief on this 13th day of January, 2017, in the manner indicated below:

United States Securities and Exchange Commission
Office of the Secretary
Attn: Secretary of the Commission Brent J. Fields
100 F Street, N.E.
Mail Stop 1090
Washington, D.C. 20549
Fax: (202) 772-9324
(By Facsimile and original and three copies by Federal Express)

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

Dugan Bliss, Esq.
Division of Enforcement
Securities and Exchange Commission
Denver Regional Office
1961 Stout Street, Ste. 1700
Denver, CO 80294
(By Email pursuant to parties' agreement)



Ariel Santamaria