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Via Email and UPS Overnight Delivery

Hon. Jason S. Patil
Administrative Law Judge
U.S. Securities and Exchange Commission
100 F Street, NE
Mail Stop 1090
Washington, DC 20549

Re: Matter of RD Legal Capital, LLC, et al. File No. 3-17342

Dear Judge Patil:

The Division of Enforcement ("Division") writes to set forth the record evidence that supports its claims that Respondents "withdr[ew] money from the [Flagship] [F]unds using valuations based on unreasonable assumptions, thereby draining the [Flagship] [F]unds of liquidity at the expense of investors." Order Instituting Proceedings ("OIP") ¶ 1(b); see also id. ¶¶ 60-74 (related allegations). Respondents applied the same valuation assumptions to the Peterson, Osborn and Cohen positions (the "Contested Receivables") as they did the virtually riskless (from a litigation perspective) receivables in settled cases. This valuation method assumed the only risks to be duration and credit risk, not collectability due to litigation risk. As a result, Respondents were able to withdraw more than $40 million in cash from the Funds, with the investors having no recourse to the money if the dominant positions in the portfolio did not pay as Respondents' valuation method assumed they would. In other words, the valuation method Respondents used created a real and substantial risk of harm to investors. Indeed, this point is driven home by the fact that, at the end of the day, Mr. Dersovitz, in effect, had to restore some of the money he had previously withdrawn just to keep the Funds afloat – cash infusions he now somewhat remarkably claims make him the only loser in this venture.

As a threshold matter, and as the Division explained at the outset of the proceedings, there is no separate valuation case or claim. Tr. 15:14-18. Nor has the Division ever alleged that Respondents "cooked the books," Tr. 6481:24-6842:2, and the Division does not oppose summarily disposing of such a (nonexistent) claim. Rather, as explained herein, and as all parties seem to agree, the amount that Respondents were able to withdraw from the Funds was tied to the assigned value of those Funds' assets. Accordingly, such values are directly relevant to remedies in this case because the methodology used to value the assets is what permitted Respondents to withdraw larger amounts from the Funds sooner, which, coupled with the different risk profiles of the assets Respondents were actually purchasing, increased the risk investors would suffer substantial losses if those assets did not perform.

The parties seem to agree that, as alleged, all of the non-line-of-credit assets in the Flagship Funds' portfolio were valued using the discounted cash flow method ("DCF"). See OIP ¶ 61; Tr. 1830:19-1831:1; Ex. 256-1. The DCF consisted of discounting to present value the supposed repayment amount by estimating duration until repayment and then discounting that supposedly known payment over that duration period using a discount rate. Tr. 1830:13-18. That discount rate was derived based on market interest rate yield spread curves, the credit rating of the payor, and historic yields achieved by Respondents on past sales of actually settled receivables. Tr. 1881:15-1889:6; 1987:4-24 (Robak testimony regarding derivation of discount rates from yield matrix, which in turn is based on RD Legal credit ratings for payors, the sale of Brevet positions, and the yield curve on BBB rated corporate bonds). As detailed further below, that discount rate did not account for collection risk arising from litigation risk.

As Mr. Dersovitz testified, "because of th[at] valuation methodology . . . you could deploy a dollar and all of a sudden it would be worth three." Tr. 6604:15-18. In other words, one dollar spent on a case with a long duration resulted in an immediate "huge bump in value." Ex. 308-2; see also id. at 3 (Dersovitz describing "significant markup" in value for assets of long duration).[1] Thus, the valuation used for the assets of long duration at issue in this case—the Contested Receivables—resulted in a quick jump in their value.

Investor witness Asami Ishimaru explained how Respondents were able to capitalize on this quick jump in value. See, e.g., Tr. 294:7-19. Respondents explained to her that "the new NAV . . . was higher than the NAV obtained using the straight-line method," Ex. 268-1, and that after the switch, Respondents' were able to collect their "fee according[] to a higher valuation." Tr. 297:25-298:2. Doing so with respect to cases where collection "was just a matter of the duration" was not problematic because "the law firm had won a settlement" such that any amounts withdrawn upfront by Respondents would be amounts not withdrawn in the future. Tr. 299:16-19. But taking out fees with respect to cases over which, for example, "there was a risk that the defendant would not have to pay the settlement" was problematic because "Mr. Dersovitz would collect incentive fees on interest[s] that didn't materialize," leaving investors with no recourse given the lack of claw back available against Respondents' draws. Tr. 299:20-300:4. Because investors understood that once Respondents took money out of the Flagship Funds they were under no obligation to give it back, investors especially did not want to invest in assets where collection was exposed to any litigation risk. See, e.g., Tr. 294:7-300:4 (testimony of investor witness A. Ishimaru); see also Ex. 277-3 (investor Paul Craig asking Respondents whether, given the illiquidity of the assets and the lack of claw-back, and "[e]ven if FASB 157 requires the new method of valuing assets . . . why can't [RDLC] go back to its old way of calculating its cut on a straight-line basis"); Tr. 668:10-671:23 (investor witness Alan Mantell explaining that a portfolio with litigation risk would make investors subject to Respondents' "beliefs about contingent future recoveries in some cases" and that accordingly his "investment position has no more validity than the way in which somebody is marking these assets").

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1 Mr. Dersovitz's use of the words "significant markup" and "huge bump in value" should make clear that when the Division uses the words "high" or "inflated" values, it similarly does not mean "cooked" or "invented" or "incorrect" values.

Given the unresolved nature of the Contested Receivables, Respondents' decision to take cash out of the Funds based on valuations that assumed the Flagship Funds "were going to recover every single dollar on the then-anticipated payment date," OIP ¶ 69, even before the fact of and the amount of collection of the Contested Receivables was actually known, exposed investors significant risks that did not exist for the kinds of receivables in resolved legal cases that fell within the strategy Respondents described to Flagship Fund investors.

The record evidence supports the Division's allegations that (a) Respondents withdrew funds after valuing the Contested Receivables as having no litigation risk and (b) this led to a liquidity crisis. First, the evidence supports the Division's contentions that the valuation methodology did not account for litigation risk.

(1) The expected date of payment and a discount rate were the primary inputs affecting the DCF calculation and litigation risk was not counted. See OIP ¶ 62; Ex. 16-16 (Funds' financials explaining that the value is determined based on "current interest rate environment, the rates relating to the enterprise responsible for payment of the settlements . . . and the risk characteristics of the attorney business relationship"); Tr. 1918:1-5 (Mr. Robak explaining that the "possibility of winning a case" is not a number Pluris can determine); Tr. 1942:15-1946:10; 1961:23-1962:7 (Mr. Robak explaining that because of model's focus on duration, grant of certiorari of Peterson case actually and perversely "might have increased the value" of those receivables because the discount rate did not change when certiorari was granted); Ex. 2 (Cells N53 & N54 showing fair value of overall Peterson position increasing during the month the Supreme Court granted certiorari). Essentially, Pluris took the same approach as Respondents' expert witness Leon Metzger, who admitted that for purposes of his analysis, he ignored the turnover risk relating to Peterson based on Mr. Dersovitz's representations that such risks were "virtually nil." Ex. 2396-38 at ¶111; see also Tr. at 5345:17-22 (any conclusions about risks in the Peterson cases assumed turnover risk was "next to nil").[2]

(2) The discount rate was derived based on the implied rate of return RD Legal Capital had achieved on the sale of receivables that related to settled or otherwise resolved cases, see OIP ¶ 64; Tr. 1836:1-1827:3; 1839:5-1841:15; 1858:24-1859:12; 1885:25-1186:12; 1887:16-1889:6 (Robak testimony); Ex. 247-1 (Pluris letter describing the receivables as "loan arrangements with certain lawyers" who are "able to monetize their contingent share of legal settlements reached with defendants"); Ex. 243 (Respondents sending to Pluris information on Brevet receivables); Ex. 247-3 (describing that "an analysis of interest rates for similar illiquid instruments was performed, primarily with reference to Receivables sold historically"); Ex. 2476; 2480; 2481, 2483 (Marcum's analysis of Pluris' valuation model explaining that the "primary assumptions"

2 In other words, Pluris did not analyze the legal issues underlying the ongoing litigations in the Funds' portfolios. See OIP ¶ 65; Tr. 1840:8-15; 1841:9-15; see also Resps' Mem. of L. in Supp. of Mot. for Summ. Disp. at 19 ("the source of the independent check on Respondents' evaluation of the *legal* claims underlying the Funds' position was never meant to be Pluris"). The marketplace, by contrast, assigned a different measure of risk to these very same assets, in the form of lower interest rates to Mr. Perles, "after the conclusion of the Supreme Court case . . . [when] the attendant litigation risk was gone from the process." Tr. 1600:3-21.

in the model are the book value, the time to collection, and the discount rate, which was "developed . . . based upon the historic collections" of past assets considering "credit rating, the case type, and size of the investment").

(3) Accordingly, Respondents treated all of the assets as cases where collection was "just a matter of duration," Tr. 299:16-19 (Ishimaru), as if duration was the only factor that had to be assessed—not amount or viability of collection. Thus, even though RD Legal did not know (and does not claim to have known) exactly how much, for example, Mr. Osborn would collect on the ONJ litigation if and when a settlement was reached, Mr. Zatta still explained to Pluris that with respect to the assets in its portfolio, RD Legal "know[s] the purchase price as well as the amount to be collected" and, accordingly, "[d]uration is the remaining item which must be estimated." Ex. 354-2.

Second, as Mr. Dersovitz explained, this methodology leads to quick increases in value upon deploying one dollar. Consider, for example, the $7,441,964 deployed to purchase the first receivables directly from the Peterson plaintiffs in September of 2012. Ex. 86-6; Ex. 8P (sum of column G, rows 46-56, 63-73 & 82-88). The fair value of those assets under the DCF method jumped immediately to $10,261,814. Ex. 8P (sum of column Q, rows 46-56, 63-73 & 82-88). Of that approximate $2.8 million increase in value, a return equal to 13.5% in the first year of the $7.4 million deployed (approximately $1 million) would be allocated to the investors' accounts, but the rest, $1.8 million, would go to RD Legal Capital LLC's account. Thus, simply by deploying $7,441,964 to the Peterson plaintiffs, RD Legal Capital could immediately withdraw approximately $1.8 million from the Flagship Funds, based on a method that assumed the amount of and fact of collection was known, leaving investors with nothing but paper returns which would provide cold comfort should collection on the Peterson receivables not materialize due to the failure of the turnover litigation.[3]

Third, withdrawing funds based on the foregoing put cash "further out of reach of investors," OIP ¶ 70, when collection on the Contested Receivables did not occur or occurred at values lower than expected, and when longer collection litigation efforts combined with increasing redemption requests.

(1) All or nearly all of the allocation to RD Legal Capital's capital account based on the foregoing increases in value was withdrawn from those funds in cash every year. See, e.g., Ex. 12-7 (2011 financials for onshore fund showing $5.2 million cash withdrawal by RDLC after $5.2 million allocation to its account); Ex. 14-8 (withdrawal of $2.4 million cash after $2.4 million allocation in 2012); Ex. 16-8 (2013: $6.7 million allocation and $6.9 million

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[3] Or take, for example, Respondents' values of the Cohen receivables, over which the amount and date of collection were subject to litigation risk. The assigned value of these positions went from approximately $12.5 million at the end of June 2011 to $25.2 million at the end of June 2015. Ex. 2 (compare Cell J2 to Cell J50). An investor purchasing those assets by investing in the Funds on June 30, 2011 would have been entitled to a paper return of 13.5% for four years, or approximately $20.7 million total, leaving Respondents to withdraw approximately $4.5 million in real funds with respect to these uncollectable and un-collecting assets alone.

withdrawal); Ex. 19-8 (2014: $11 million withdrawal after $12.9 million allocation); Ex. 22 (2015: $9.3 million withdrawal after $15.6 million allocation); see also Ex. 13-9 (2012 allocation of $6.1 million to RDLC account from offshore fund); Ex. 15-10 (2013 allocation of $6.9 million to RDLC from offshore fund); Ex. 18-8 (2014 allocation of $1.7 million to RDLC from offshore fund); Ex. 172 (showing cash withdrawals from offshore fund of $6.3 million, $6.5 million, and $2.3 million for 2012, 2013, and 2014 respectively).

(2) Respondents "pulled cash out of the Funds," OIP ¶ 70, over $40 million from the Flagship Funds from 2012-2015, see Ex. 2379, as well as approximately $4.5 million in 2011, see Ex. 11-7 & 12-7 (showing draws of $5.2 million and contribution of $652,303 for 2011); see also Ex. 2378 (showing over $9 million in net draws for Mr. Dersovitz alone in 2011-2015).

(3) The Flagship Funds' available cash was low from the outset and diminished over time. See Ex. 12-4; 14-5; 16-5; 19-5; 22-5 (2011 through 2015 financial statements for onshore fund showing decrease in available cash from over $3 million in 2011 to $564,671 at the end of 2015).

(4) Despite their own foregoing withdrawals, Respondents kept cash "further out of reach of investors," OIP ¶ 70, by freezing redemptions from the Funds in May of 2015, Ex. 451. As of July 2015, without counting redemptions due to a large Japanese investor, the Flagship Funds had approximately $9 million in outstanding redemption requests, see Ex. 171-2 (nearly $8 million total); 172-2 (over $1 million total), without even counting filed but not as-of-then effective additional redemptions such as the Magna Carta redemption of its $10 million investment, see Tr. 2045:24-2046:25 (Mr. Furgatch describing redemption on or around May of 2015), or of Ballentine's request for $3 million, see Tr. 1133:9-1134:6 (same for Mr. Schaffer).

(5) When the various litigations surrounding the Contested Receivables were finalized, the amounts realized at times did not cover the value Respondents had assigned to them:

a. The Novartis litigation settled for less than the value Respondents placed on those assets, compare Ex. 2 (cell F47 showing value of $16.2 million for Novartis receivables) with Ex. 715-52 (explaining that even if it recouped all of the attorneys' fees for the Novartis settlement, the fund would receive less than $9 million), while Pluris' adjustment of the discount rates with respect to those receivables did not occur until April of 2015, compare Ex. 115-6 & 116-6 (14.49% to 16.49% discounts for Novartis litigation receivables in February and March of 2015) with Ex. 117-5 & 117-6 (20% discount in April of 2015).[4]

b. Respondents lost the litigation over the building from which they hoped to collect on the Cohen receivables, Tr. 5797:23-5799:7 (Buchman testimony), and thus wrote

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[4] This confirmed the concerns of the accountants who gave Respondents a qualified opinion with respect to the 2010 financials when in 2011 they noted to Respondents the incongruity between increasing the value of a position at the same time that they were extending its duration due to uncertainty of collection because of ongoing litigation. See Ex. 241A (comments on Beatie & Osborn position in black).

down their value from over $26 million to approximately $14 million in October of 2015, see Ex. 2 at Cell J54, nearly three years after they had commenced litigation against Mr. Cohen claiming loss over these assets, see Complaint in RD Legal Funding v. Cohen, No. 13 Civ. 77 (JLL) (DE 1) (D.N.J. Jan. 3, 2013).

c. The advances to some of the Peterson plaintiffs did not net the Flagship Funds the amounts they thought they were purchasing (i.e., the "expected repayment amount" Mr. Zatta certainty about for purpose of the DCF calculation). See, e.g., Ex. 499-8 (describing over $20,000 shortfall to be paid to RD Legal Funding on Ian Guy's advance); see generally Ex. 625-5 (explaining that "[i]n many cases . . . the amount owed to an Advance Company exceeds the amount of the respective Plaintiff's initial distribution").

The foregoing facts validate the concerns expressed by Ms. Ishimaru, Mr. Craig, Mr. Mantell, and Rothstein Kass. For example, at the time Respondents wrote down $12 million in value for the Cohen positions, they had already withdrawn millions from the Flagship Funds based on those now-evaporated values. Thus, so long as the Funds were going to continue to pay actual positive returns to redeeming investors (as opposed to merely show positive returns on paper, e.g., Ex. 2396-67), there would be a shortfall in cash, unless collections from other assets were sufficiently large to cover the shortfall (which could not occur in 2015 when most of the Funds' value was tied up waiting for the resolution of the Peterson litigation), or unless Respondents temporarily covered those amounts themselves. Indeed, in 2016, the Funds received over $90 million from the Perles and Fay Peterson receivables alone, see Ex. 2339-3, but Respondents assert the Funds still had insufficient cash to fund their operations, Ex. 2378 (describing loan of $7.7 million from Mr. Dersovitz to operating companies). The fact that such a large collection was achieved but Respondents still had to lend money to the Funds is further indication of the connection between illiquidity and he too-early withdrawals based on the valuation method used—of the "IOU" to investors described in the OIP. See OIP ¶ 70.

Respondents have at times suggested their DCF approach was reasonable because the values derived from that methodology were the values at which Respondents were able to sell those assets to third parties. See, e.g., Ex. 2393-22 ¶ 55 (Martin report stating participation agreements between Respondents and third parties provided "pricing data" that "supported RD Legal's assessments regarding the value of the Peterson receivables . . . at fair market value as determined by Pluris"). However, the evidence in the record is contrary to that contention. To the extent any of the Peterson or Novartis litigation assets were sold, they were sold at the much more modest net book value ("NBV") (representing the old method of value based on straight-line appreciation).[5] That Respondents were selling the assets at NBV is further evidence that it was unreasonable for them to extract money from the Funds based on the higher DCF values.[6]

[5] See, e.g., Ex. 3148 (for Osborn receivable participation percentage multiplied by NBV results in nearly exact or exactly participation purchase price by CCY); Ex. 3149-28 (same); Ex. 3149-31 (same); Ex. 3150 at 19, 21, 23, 25, 27, 29 & 31 (same); Ex. 3151 at 19, 21, 23 & 25 (same); Ex. 3152-3 (same); see also Ex. 3150 at 1, 3, 5, 7, 9, 11, 13, 15, 17 (same calculation for various Peterson receivables shows purchase prices were all at NBV); Ex. 3151 at 27, 29, 31, 33,

For the foregoing reasons, the Division contends that Respondents put investors at substantial risk by valuing the Contested Receivables as if they were riskless, depleting the Funds' liquidity with the investors having no recourse if the positions ultimately failed.

Respectfully submitted,

Jorge G. Tenreiro

cc: Respondents' counsel (via e-mail only)

35, 37 & 39 (same). Not only did the participations of certain Peterson assets occur at NBV, so did the outright sales of Peterson assets to Cedar's Funding, as confirmed by bank records and by Mr. Larochelle's Dashboard. Compare Ex. 167 (list of sale of Peterson plaintiff receivables sold to Cedar's Funding) with Ex. 518 at 2, 4, 5, 7 & 8 (bank statements showing credits to RD Legal bank accounts in amounts equal to the book values listed in Exhibit 167); see also Ex. 463A; Tr. 2314:1-2321:5 (explaining how the dashboard confirms what the bank records show, that the receivables were sold at NBV, not fair value).

[6] Respondents' agents all explained that the amount a third-party would be willing to pay for a receivable would be a "good sign of . . . the true value" of that position. Tr. 4163:5-4164:3 (Respondent Expert Martin); see also Tr. 1958:18-1959:16 (Pluris' Espen Robak explaining he would want to consider sales to third parties and would "adjust our models for that"). There is no evidence in the record that Pluris ever considered the plethora of sales at NBV described in the preceding footnote, let alone that the models were ever adjusted to consider that information.