

## [Securities Regulation Daily Wrap Up, ENFORCEMENT—ALJ says Enforcement Division case against Tilton unproven, \(Sept. 28, 2017\)](#)

Securities Regulation Daily Wrap Up

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By [Mark S. Nelson, J.D.](#)

An SEC administrative law judge has dismissed the Enforcement Division's in-house case against Lynn Tilton. The agency had alleged that Tilton and her firm Patriarch Partners, LLC ran afoul of the Investment Advisers Act's antifraud provisions as a result of disclosure issues and accounting irregularities regarding collateralized loan obligations (CLOs). But the ALJ concluded after a lengthy hearing that the Division's allegations were unproven (*In the Matter of Lynn Tilton*, [Release No. ID-1182](#), September 27, 2017).

Tilton and Patriarch had set up a series of entities that were either investment advisers or relying investment advisers to act as collateral managers for three funds designated Zohar I, II, and III. The funds consisted of CLOs and issued notes to investors whose funds were then used to buy or to make loans to a portfolio of distressed companies. Investors included large institutions known as qualified institutional buyers or qualified purchasers, entities the ALJ would refer to as "...not, in the words of Commission Chairman Jay Clayton, 'Mr. and Ms. 401(k)'" (referring to a [speech](#) Clayton gave outlining his principles of securities regulation).

**Unique approach and star witness.** During the 14-day hearing nearly a year ago, the ALJ heard testimony from nine experts: three for the Division and six for Tilton and Patriarch. The Division's experts collectively opined that Tilton and Patriarch received \$208 million in improper fees for a variety of reasons, including providing financials that were hard for investors grasp, employing a method of categorizing loans contrary to fund governing documents, and by deviating from GAAP accounting principles.

Three of Tilton's and Patriarch's experts focused on one Division expert's opinion that Tilton did not "amend" loans when she accepted interest amounts below what was due under contract. Tilton's and Patriarch's experts said Tilton and her firm possessed wide discretion to modify loans to avoid defaults. One of these experts included a legal analyst for the Zohar II and III funds, who was accepted by the ALJ as an expert on interpretation of the Zohar indentures.

But Tilton and Patriarch also brought out the star power. [R. Glenn Hubbard](#), Dean of Columbia University's Graduate School of Business and former chairman of the President's Council of Economic Advisers during the second Bush Administration, and who is often mentioned as a candidate for Fed chairman if Janet Yellen is not re-nominated, offered a set of four conclusions about the Zohar funds.

Hubbard agreed with another Tilton/Patriarch expert that the Zohar funds were atypical CLOs (the other expert had said the Zohar funds should be viewed through the lens of funds with Zohar-like characteristics, not a "typical CLO manager"). Hubbard also noted Tilton's unique approach to investing in distressed properties and disputed a Division expert's conclusions that some metrics were hard to replicate from fund valuation reports. Hubbard also disputed the completeness of calculations performed by a Division expert because they did not consider future periods.

Based on the testimony, the ALJ first concluded that items allegedly not disclosed to investors were disclosed and that Tilton and Patriarch had amended loan agreements. As a result, there was no material misrepresentation or omission of a material fact. The ALJ also found the Division's GAAP allegations similarly unproven. For one, the facts did not support charges regarding impairment. Moreover, GAAP violations by themselves cannot establish securities fraud (the ALJ noted that even if Tilton and Patriarch violated GAAP, there was no material misrepresentation).

With respect to accounting standards for fair value, the ALJ observed that the types of assets Tilton and Patriarch dealt with were Level 3 assets because of the lack of observable inputs. Still, the ALJ concluded that the fund's financial statements disclosed the variable nature of the fair value techniques employed by the funds.

**Appointments clause.** For a time, Tilton became one of the more prominent targets of SEC probes to challenge the constitutionality of in-house proceedings before the SEC's ALJs. These cases were brought in multiple district courts around the U.S. and achieved some initial traction in a few court rooms only to falter in a series of appellate decisions denying access to the federal district courts to respondents seeking to halt the SEC's proceedings. Tilton pursued her case until the Supreme Court [declined](#) to hear it.

But the Appointments Clause issue that Tilton and others had raised may yet find its way to the Supreme Court in one or more cases that followed the statutory scheme of the federal securities laws and, thus, present fewer vehicle issues than did the earlier district court cases. Currently, there is a split of authority between the [D.C. Circuit](#) (upholding the SEC's ALJs and later producing a *per curiam* order denying the respondent's petition for review by an equally divided en banc court) and the [Tenth Circuit \(rehearing denied\)](#), which found the agency's ALJs were appointed in violation of the Appointments Clause.

The respondent in the D.C. Circuit case petitioned the Supreme Court to decide whether prior circuit law correctly interpreted the Court's *Freytag* decision, which had prompted a concurrence the circuit's seminal [Landry](#) opinion upholding the FDIC's ALJs against constitutional challenge. That petition is still pending. The Tenth Circuit case also could reach the Supreme Court if the government opts to appeal. As of publication, the government had received two extensions of time to file a certiorari petition, the [most recent](#) until September 29.

**Alleged Division misconduct.** The ALJ's initial decision also rejected assorted claims by Tilton that the Division had engaged in prosecutorial misconduct. Tilton's claims focused on the Division's use of experts during the pre-OIP period before the agency brought formal charges against her, alleged failures to disclose information to Tilton, a concurrent engagement with Tilton's only accounting firm in another matter, and alleged collusion between the Division and one of the fund's investors in a related matter brought by the investor against Tilton.

The release is [No. ID-1182](#).

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Companies: Patriarch Partners, LLC; Patriarch Partners VIII, LLC; Patriarch Partners XIV, LLC; Patriarch Partners XV, LLC

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