

## SEC ALJ Decision Shows Agency’s “Home Field Advantage” Has Its Limits

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In a dense, nearly 60-page decision issued on September 27, 2017, SEC Administrative Law Judge Carol Foelak rejected all claims asserted by the SEC Enforcement Division (the “Division”) in *In the Matter of Lynn Tilton, et al.* The case involved a series of distressed debt funds that issued notes to institutional investors, using investor proceeds to acquire commercial debt. The Division generally charged that the funds’ manager, Lynn Tilton, and the advisory firms she controlled deceived investors by over-valuing troubled loans held by the funds and collecting excessive fees as a result. The Division also charged that Tilton and her firms falsely told investors that the funds’ periodic financial statements complied with generally accepted accounting principles (“GAAP”) when, in fact, they did not follow GAAP rules governing the fair valuation of assets. Having conducted a lengthy evidentiary hearing late last year, Judge Foelak found for Tilton and her entities on all of the Division’s claims. While the facts of the case are unique and complicated, there are several points worth highlighting.

Most significant, of course, is the total defense victory. While commentators often lament that the Division has a “home field advantage” in its in-house administrative proceedings, the outcome in *Tilton* suggests that that advantage may be overstated. In the course of a 14-day hearing, the Division put on nine witnesses, including three highly-credentialed experts. The evidence apparently demonstrated that Tilton made arrangements with portfolio companies to reduce their interest obligations to allow them to remain afloat; that she did not reduce the valuation of such loans as a result; that this practice had a favorable impact on her fees; and that information on the actual interest payments being made by portfolio companies, while discernible from the funds’ financial statements, was not easy to find. It is not hard to imagine a judge with a “home field” bias siding with the Division in such a case, especially given the fiduciary duties owed by investment advisers to their clients.

Judge Foelak, however, dismissed all of the Division’s charges, including charges that require no proof of fraudulent intent. In so doing, she carefully parsed the disclosures in complex fund documents, took into account the sophistication of the funds’ investors, and applied a healthy dose of common sense about the expectations of investors who put their money into such vehicles. While SEC administrative proceedings certainly pose challenges for defense counsel, *Tilton* is a reminder that those challenges are not insurmountable.

The opinion also offers some interesting procedural takeaways. First, Judge Foelak rejected Tilton’s argument that the Division violated its “*Brady*” obligations by failing to disclose that it had retained its experts before bringing the case, enlisting their help in reviewing evidence and shaping the Division’s theories (which Tilton contended was evidence of witness “bias”). Distinguishing this case from one in which a purportedly neutral trial witness had been extensively involved in an underlying criminal investigation, Judge Foelak ruled that such post-investigation/pre-filing expert consultation was insufficient to impose any affirmative disclosure obligation on the Division.

Judge Foelak also rejected Tilton’s arguments that the Division violated its “Jencks” obligation to produce witness statements by withholding notes of witness interviews, observing that there was no evidence to suggest that any witness had actually “adopted or approved” such notes as reflecting their own statements. Finally, while finding that Tilton had failed to prove an affirmative defense of “reliance on accountants,” Judge Foelak noted that such reliance was nonetheless relevant to the “degree of culpability for any violations” – i.e., whether the Division had carried its own burden of proving fraudulent intent, recklessness, or negligence.

Under SEC Rules of Practice, the Division may appeal Judge Foelak’s decision to the Commission itself within 21 days. If it does so, and the Commission grants review, then it may make any findings of fact and conclusions of law that it deems to be supported by the record. One might reasonably wonder why the Division can appeal an adverse ALJ decision to the very body that authorized its enforcement action in the first place. That, however, is a much larger topic for another day.

*Elizabeth Weil Shaw contributed to this post.*

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