UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION *Plaintiff,* vs. McGINN, SMITH & CO., INC., McGINN, SMITH ADVISORS, LLC McGINN, SMITH CAPITAL HOLDINGS CORP., FIRST ADVISORY INCOME NOTES, LLC, FIRST EXCELSIOR INCOME NOTES, LLC, FIRST INDEPENDENT INCOME NOTES, LLC, THIRD ALBANY INCOME NOTES, LLC, TIMOTHY M. McGINN, AND DAVID L. SMITH, GEOFFREY R. SMITH, Individually and as Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04, LAUREN T. SMITH, and NANCY McGINN, *Defendants,* LYNN A. SMITH and NANCY McGINN, *Relief Defendants. and* GEOFFREY R. SMITH, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04, *Intervenor.*	Case No. 1:10-CV-457 (GLS/CFH)

MEMORANDUM OF LAW IN SUPPORT OF FOURTH CLAIMS MOTION OF WILLIAM J. BROWN, AS RECEIVER, FOR AN ORDER (A) DISALLOWING PREFERRED INVESTOR PAPER CLAIMS AND (B) APPLYING PREFERENTIAL PAYMENT OFFSET

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William J. Brown, as Receiver ("Receiver") of McGinn, Smith & Co., Inc. ("MS & Co."), respectfully submits this Memorandum of Law in support of his Fourth Claims Motion ("Motion") for an Order (a) disallowing Preferred Investors' paper claims listed on Exhibits A-1 through A-3 to the Motion and (b) applying the Preferential Payment Offset to certain Preferred Investor Claims (each as defined in this Memorandum) as set forth on Exhibits B-1 and B-2 to the Motion.

PRELIMINARY STATEMENT

From 2003 to 2010, David L. Smith and Timothy M. McGinn orchestrated an elaborate Ponzi scheme through which more than 900 investors were defrauded. In late 2007, when the Four Funds were revealed to have a massive deficit, Smith and McGinn decided to first reduce, and then eliminate entirely, the interest payments owed to investors in the Four Funds Notes. Notwithstanding that most investors ceased receiving the interest payments that they were entitled to, the Receiver's due diligence discovered that a certain subset of Preferred Investors continued to receive full payments of interest on their Four Funds investments. For no legitimate reason, McGinn and Smith elevated the Preferred Investors to a "preferred" status and provided them with supplemental, "lulling" payments. It would be inequitable to permit the Preferred Investors to retain these Preferential Payments. Accordingly, the Receiver proposes to reduce the distributions made to the Preferred Investors on account of the Four Funds investments by the amount of Preferential Payments received on a dollar-for-dollar basis. Such a reduction would return the Preferred Investors to the position they would have otherwise occupied had they been treated like the majority of investors that McGinn and Smith defrauded.

The Receiver also seeks to disallow the paper claims filed by the Preferred Investors. The Preferred Investors filed paper claims which are exact duplicates of Receiver-granted claims, paper claims which vary in amount from Receiver-granted claims, and/or paper claims for which there is no basis for the Receiver to make a distribution. If the paper claims filed by the Preferred Investors are not disallowed, then the Preferred Investors who filed such paper claims would receive additional distributions to which they are not entitled to the detriment of investors with Receiver-granted claims.

STATEMENT OF FACTS

MS & Co. was a broker-dealer registered with the Securities and Exchange Commission ("SEC") with its headquarters in Albany, New York from 1981 to 2009. From 2003 through 2010, the broker-dealer was owned by David L. Smith ("Smith"), Timothy M. McGinn ("McGinn"), and Thomas E. Livingston.

On April 20, 2010, the SEC filed a Complaint initiating the above-captioned action (Docket No. 1). Also, on April 20, 2010, this Court granted a Temporary Restraining Order (Docket No. 5), which, among other things, froze certain assets of the above-captioned Defendants and Relief Defendants, and appointed the Receiver as temporary receiver with respect to numerous entities controlled or owned by Defendants McGinn and Smith, including those listed on Exhibit A to the Preliminary Injunction Order entered in this action (Docket No. 96) (collectively, the "MS Entities"). Brown Dec'l. ¶4.[1]

On July 26, 2010, following a hearing, the Court entered an order granting the SEC's Motion for a Preliminary Injunction and appointing the Receiver as receiver, pending a final disposition of the action ("Preliminary Injunction Order") (Docket No. 96).

[1] "Brown Dec'l. ¶ __" refers to the Declaration of William J. Brown dated July 6, 2018 filed in support of the Motion.

On August 3, 2010, the SEC filed an Amended Complaint (Docket No. 100). On June 8, 2011, the SEC filed a Second Amended Complaint (the "Complaint") (Docket No. 334). On February 17, 2015, the Court issued its Memorandum-Decision and Order (Docket No. 807) ("MDO") granting the SEC's motion for summary judgment. The Court entered judgments in favor of the SEC in 2016 (Docket Nos. 835, 836, 837).

Generally, McGinn and Smith "orchestrated an elaborate Ponzi scheme, which spanned over several years, involved dozens of debt offerings, and bamboozled hundreds of investors out of millions of dollars." MDO at 7. McGinn and Smith raised over $136 million between 2003 and 2010 in over twenty unregistered debt offerings, including the Four Funds -- FAIN, FEIN, FIIN, and TAIN -- and various Trust Offerings, by representing that investor money would be "invested," when instead it was "funneled" into various entities owned or controlled by McGinn and Smith. That money was then used to fund unauthorized investments and unsecured loans, make interest payments to investors in other entities and offerings, support McGinn's and Smith's "lifestyles," and cover the payroll at MS & Co. MDO at 7.

A. The Four Funds

The Four Funds—FAIN, TAIN, FIIN, and FEIN— were single-purpose, New York limited liability companies formed between September 2003 and October 2005. The private placement memoranda ("PPMs") for each of the Four Funds were substantively identical, and each offered $20 million worth of Notes, with the exception of TAIN, which offered $30 million. The offerings had three tranches of Notes, which paid quarterly interest of 5% to 10.25%, and promised a return of principal at maturity in one, three or five years. MDO at 10.

McGinn and Smith engaged in a course of conduct and dealings that were contrary to the PPMs issued for the Four Funds. First, investor proceeds from the Four Funds were used to purchase contracts from pre-2003 trusts for the purpose of redeeming or making interest payments to investors. Second, the Four Funds used investor money to directly invest in, rather than purchase investments from, affiliates. Many of the affiliated investments provided no cash flow to the Four Funds and were ultimately considered worthless. Finally, proceeds from the Four Funds were funneled through McGinn Smith Transaction Funding Corporation ("MSTF") and then used to pay MS & Co.'s payroll. MDO at 11-12.

In late 2007, David Smith received an e-mail from David Rees, MS & Co.'s comptroller, which showed a $48.8 million deficit in the Four Funds. Notwithstanding that deficit, Smith continued to solicit new investments in the Four Funds. MDO at 12. In January 2008, Smith sent a letter to investors in the Four Funds notifying investors that interest payments on the junior tranches of Notes were being reduced to from 10.25% to 5%. *See* Exhibit A to Brown Dec'l; *see also* MDO at 12. By April 2008, interest payments on the junior tranches of Notes were eliminated entirely. *See* Exhibit B to Brown Dec'l; *see also* MDO at 12. The reduction, and subsequent elimination, of interest payments were attributed by McGinn and Smith to the collapse of various debt and credit markets and the "sub prime mess." In October 2008, David Smith sent a letter to all Note holders in the Four Funds outlining a restructuring plan which extended the maturity dates of the Notes, reduced interest payments for all tranches, and forfeited all future fees due to MS & Co. *See* Exhibit C to Brown Dec'l; *see also* MDO at 12-13.

B. Preferential Interest Payments

All investors in the junior tranches of the Four Funds Notes, except a subset of preferred investors ("Preferred Investors"), received reduced interest payments in January 2008 and stopped receiving interest payments altogether by April 2008. The Preferred Investors, however, continued to receive interest payments on their junior Notes ("Preferential Payments") in excess of what other investors were receiving. In February 2008, certain Preferred Investors received the same reduced 5% interest payment that other investors received, and, in addition, they received Preferential Payments making up the difference between the reduced 5% interest payment and the full 10.25% interest payment that all investors were supposed to receive. Brown Dec'l. ¶ 11 Beginning in April 2008, and in some instances after all interest payments on all tranches of the Four Funds Notes were suspended in October 2008, the Preferred Investors continued to receive interest payments on their Four Funds Notes, while the remaining investors received nothing. *Id.*

The Preferential Payments came from MSTF funds, not proceeds from the Four Funds. MDO at 12-13. These Preferential Payments were designed to be "lulling" payments, meant to keep the Preferred Investors satisfied with their investments and to prevent the Preferred Investors from seeking redemptions of their investments. Brown Dec'l. ¶ 12. A total of seventeen Preferred Investors received Preferential Payments totaling $510,671.96 in connection with their investments in the Four Funds. The Preferential Payments were made between February 2008 and November 2008. *Id.*

The Receiver's Claims Website (defined below) includes all of the claims of the Preferred Investors ("Preferred Investor Claims"), including claims arising out of investments in the Four Funds ("Four Funds Claims"). All of the Preferred Investor

Claims, including the Four Funds Claims, have been adjusted for pre-Receivership distributions of principal and interest like all other investor claims. The Four Funds Claims, however, have not been adjusted to account for the Preferential Payments. Brown Dec'l. ¶ 12.

C. Claims Procedure

On March 9, 2012, the Receiver filed a Motion ("Claims Procedure Motion") (Docket No. 466) for entry of an Order approving, among other things, the Receiver's proposed procedure for the administration of claims against the MS Entities.

On March 27, 2012, the Court entered an Order granting the Claims Procedure Motion (Docket No. 475), which was subsequently amended by an Order dated April 17, 2012 ("Claims Procedure Order") (Docket No. 481). Each investor and known creditor of the MS Entities was mailed on May 1, 2012 an Access Notice describing the claims process and enclosing (i) Notice of the Claims Bar Date and Claims Procedure and (ii) a Claim Form. Brown Dec'l. ¶14. A confidential password providing access to the Receiver's Claims Website at www.mcginnsmithreceiver.com ("Claims Website") was also provided. *Id.* If an investor or creditor agreed with the description and amount of their claim(s) as listed on the Claims Website and the claim(s) were not listed as disputed, contingent or unliquidated, the investor or creditor did not need to take any further action. *Id*. All other investors and creditors needed to timely file a paper claim before the bar date of June 19, 2012, as further described in detail on the Claim's Website. The Receiver listed each Preferred Investor's claim as "Disputed." *Id.*

The Claims Procedure Order established June 19, 2012 ("Bar Date") as deadline for creditors and investors to file claims against the MS Entities. Brown Dec'l. ¶15.

In accordance with the Claims Procedure Order, nearly six hundred creditors and investors timely filed paper claims prior to the Bar Date. Brown Dec'l. ¶16. In addition, more than 3,127 claims of investors and creditors were included on the schedules posted by the Receiver on the Claims Website in accordance with the Claims Procedure Order. *Id.*

The Receiver conducted an initial review of the paper claims timely filed by creditors and investors in accordance with the Claims Procedure Order and determined it was necessary to establish a reserve as to investor claims totaling approximately $23,617,190 since those claims have been listed by the Receiver as disputed, contingent or unliquidated. Brown Dec'l. ¶17.

D. Paper Claims

Certain of the Preferred Investors submitted paper claims ("Paper Claims") because they did not agree with the claims granted by the Receiver and listed on the Claims Website and presumably also because the Claims Procedure Order required a claimant to file a Paper Claim to have their claim considered if it had been categorized as disputed, contingent, or unliquidated on the Receiver's Claims Website. The Preferred Investors submitted a total of one hundred forty-four Paper Claims, which are described on Exhibits A-1, A-2 and A-3 to the Motion. Brown Dec'l. ¶ 18. The Paper Claims can be categorized as Duplicate Claims, Discrepant Claims, Non-Receivership Claims, No Liability Claims, and Excluded Claims, as described in further detail below.

E. Plan of Distribution Process

On December 30, 2015, the Receiver filed a Motion (Docket No. 847) ("Plan Distribution Motion") to seek approval of (i) a plan of distribution of assets of the MS

Entities to investors ("Plan of Distribution"); and (ii) interim distributions to investors with allowed claims scheduled or timely filed in accordance with the Claim Procedure Order. On October 31, 2016, the Court entered a Memorandum-Decision and Order (Docket No. 904) ("Plan Distribution Order") granting the Plan Distribution Motion, overruling objections, approving the Plan of Distribution, and allowing the Receiver to make interim distributions as set forth in the Plan Distribution Motion.

Among other things, the Plan of Distribution provides for a reserve for disputed claims to allow the Receiver to make initial distributions, but to also provide for funds to be reserved until any objections to disputed claims can be heard and decided by final order of the Court. As of July 6, 2018, $6,308,887 has been distributed to investors with allowed claims as a First Distribution. Brown Dec'l. ¶21.

The Plan of Distribution provides that all investor claims would be calculated by using the "Net Investment" methodology, i.e., the claim amount is equal to the amount of the initial investment made less any distributions received prior to the appointment of the Receiver, including any distributions of principal or interest. Plan of Distribution, Art. IV. The Plan of Distribution further provides for a collateral recovery offset ("Collateral Recovery Offset"), where distributions made on account of investor claims will be reduced on a dollar-for-dollar basis to the extent the investor has received a recovery from a source other than the Receivership in connection with their claimed loss. *Id.* Art. II.

F. Claims Motions

On September 21, 2017, the Receiver filed a Motion (Docket No. 937) ("First Claims Motion") to seek disallowance of certain filed paper claims that were duplicative of the corresponding claims granted by the Receiver. On November 9, 2017, the Receiver filed

a Statement (Docket No. 957) in furtherance of the First Claims Motion, adjourning the First Claims Motion with respect to those duplicative investor paper claims filed by investors whose Receiver-granted claims have been disputed by the Receiver. On December 28, 2017, the Court entered an Order granting the First Claims Motion and disallowing the duplicative paper claims other than with respect to those filed by investors with disputed claims (Docket No. 966).

On February 15, 2018, the Receiver filed a Motion (Docket No. 974) ("Second Claims Motion") to seek disallowance of certain filed paper claims for which there is no basis for payment in the books and records of MS & Co. On April 13, 2018, the Court entered an Order granting the Second Claims Motion and disallowing the paper claims.

On March 19, 2018, the Receiver filed a Motion (Docket No. 984) ("Third Claims Motion") to seek disallowance of certain claims of former MS & Co. brokers. On May 4, 2018, the Receiver filed a Reply (Docket No. 1002) to the Response of Frank Chiappone (Docket No. 995) to the Third Claims Motion.

ARGUMENT

A. The Paper Claims Should be Expunged

The Paper Claims should be expunged because there is no basis in the books and records of MS & Co. to justify a distribution on account of the Paper Claims. Expunging the Paper Claims will further the main objective of equality in Receivership distributions by preserving amounts for distribution to investors with legitimate claims.

Exhibit A-1 is comprised of Duplicate Claims, which represent Paper Claims filed by Preferred Investors that are exactly duplicative and are in the exact amount of the claims listed on the Claims Website. The Duplicate Claims should be disallowed because there is no legal or equitable basis for payment of the same claim more than once. The

Duplicate Claims can be disallowed since the Motion deals with the claims of those Preferred Investors who are scheduled on the Receiver's Claims Website, as described in Sections B and C below.

Exhibit A-2 is comprised of Discrepant Claims, which are paper claims filed by Preferred Investors for the same investments as their Receiver-granted Preferred Investor Claims but in different amounts. Like all other investors, the Preferred Investor Claims are based upon the records of McGinn Smith and represent principal balances.[2] The differences in the amounts of the Preferred Investor Claims and the Discrepant Claims filed by Preferred Investors are likely due to one or more payments previously received by the Preferred Investor in the form of principal or interest (exclusive of any Preferential Payments). If the Discrepant Claims are not disallowed, the Preferred Investors will receive distributions in excess of the principal balance of their investments reflected in the books and records of McGinn Smith. This will dilute the pool of receivership funds available to pay investors with valid claims and will result in disparate treatment of Preferred Investors holding Discrepant Claims as compared to other investors. As such, the Discrepant Claims should be disallowed.

Exhibit A-3 is comprised of No Liability Claims, Non-Receivership Claims, and Excluded Claims. No Liability Claims represent filed paper claims for investments which are not reflected in the books and records of McGinn Smith for a variety of reasons, including investments that were redeemed before the Receivership and claims for

[2] The Receiver-granted Preferred Investor Claims do not reflect any adjustment or offset in connection with the Preferential Payments received by the Preferred Investors. To account for the receipt of Preferential Payments, the Receiver is seeking to adjust the *distributions* made on account of the Preferred Investors' Four Funds Claims by applying the Preferential Payment Offset, as described with greater detail in Section C.

investments for which there is no record. No Liability Claims should be disallowed because there is no basis in the books and records of McGinn Smith for the payment of such claims.

Non-Receivership Claims represent filed paper claims for investments in entities that are not part of the Receivership. Because these entities are not included in the Receivership, the Receiver cannot make distributions on account of these claims with Receivership funds. Accordingly, Non-Receivership Claims should be disallowed.

Finally, Excluded Claims represent paper claims filed for investments in entities that were excluded from the Receivership by the Plan Distribution Order. These entities include SAI Trust 00 and SAI Trust 03, which were foreclosed on and liquidated before the commencement of the Receivership. The Excluded Claims should be disallowed because holders of such claims are not entitled to any further distribution following the foreclosure and liquidation of these entities.

Elimination of the Paper Claims furthers the main objective of equality in the distribution of Receivership assets because there is no legal or equitable basis to make distributions to Preferred Investors on account of the Paper Claims. It would be inequitable and inappropriate for Preferred Investors to receive any distributions on account of the Paper Claims because such recoveries would dilute the pool of receivership funds available to pay investors with valid claims in Receivership entities. Further, any such distributions would be in contravention of the procedures for calculating investor claims set forth in the Plan of Distribution and the Plan Distribution Order.

B. Rising Tide Accounting Methodology Should be Applied to Promote Equality Among Investors

The district court has broad power and discretion to determine relief in an equity receivership. *See S.E.C. v. Elliott*, 953 F.2d 1560, 1566 (11th Cir. 1992); *S.E.C. v. Basic*

Energy & Affiliated Res., Inc., 273 F.3d 657, 668 (6th Cir. 2001). "In equity receiverships resulting from SEC enforcement actions, district courts have very broad powers and wide discretion to fashion remedies and determine to whom and how the assets of the Receivership Estate will be distributed." *S.E.C. v. Detroit Mem'l Partners, LLC*, No. 1:13-cv-1817-WSD, 2016 WL 6595942 at *5 (N.D. Ga. Nov. 8, 2016) (internal quotation omitted). A receiver's choice among allocation schemes in the course of administering a receivership is within the discretion of the district court to approve or disapprove. *S.E.C. v. Huber*, 702 F.3d 903, 908 (7th Cir. 2012).

Of the methodologies available for the distribution of receivership, two common methodologies are the Net Investment method and the Rising Tide method. "Courts regularly employ these methodologies in distributing receivership assets." *S.E.C. v. Forte*, Nos. 09-63, 09-64, 2012 WL 1719145 at *3 (E.D. Pa. May 16, 2012). When applying the Net Investment method, pre-receivership payments received by an investor are subtracted from the investor's total principal amount before determining that investor's pro rata distribution. *In re S.E.C. v. Coadum Advisors, Inc.*, No. 1:08-CV-11-ODE, 2009 WL 10664889 at *6 (N.D. Ga. Sept. 24, 2009). The Court already approved the Net Investment method for the calculation of investor claim amounts pursuant to the Receiver's Plan of Distribution. *See* Plan Distribution Order at 15. The Court also approved the use of the Rising Tide methodology in the calculation of the Collateral Recovery Offset. *See* Plan Distribution Order at 12-13.

The Rising Tide method is also commonly approved for the apportionment of assets in an equity receivership. *See S.E.C. v. Huber*, 702 F.3d at 906 ("Rising tide appears to be the method most commonly used (and judicially approved) for apportioning receivership

assets."). The Rising Tide method subtracts pre-receivership payments received by an investor from the investor's pro rata distribution, reducing that investor's pro rata distribution on a dollar-for-dollar basis. *U.S. Commodity Futures Trading Comm'n v. Lake Shore Asset Mgmt. Ltd.*, No. 07 C 3598, 2010 WL 960362 at *7 (N.D. Ill. Mar. 15, 2010). The Rising Tide methodology "brings the recovery of claimants who received no payments during the course of the Ponzi Scheme equal to those claimants who did receive payments during the course of the Ponzi Scheme." *In re Receiver*, No. 3:10-3141-MBS, 2011 WL 2601849 at *2 (D.S.C. July 1, 2011). Otherwise, a straight pro rata distribution of funds, irrespective of pre-receivership payments, "would be inequitable because it would unfairly elevate investors who received those pre-receivership payments." *Lakeshore*, No. 07 C 3598, 2010 WL 960362 at *9.

Courts have not approved the use of the Rising Tide methodology where a significant amount of investors would not recover any distribution as a result of applying that methodology. *S.E.C. v. Huber*, 702 F.3d 903, 907 (7th Cir. 2012) (approving Rising Tide where only 18% of investors would receive no recovery); *U.S. Commodity Futures Trading Comm'n v. Barki, LLC*, No. 3:09 CV 106-MU, 2009 WL 3839389 (W.D.N.C. Nov. 12, 2009) (refusing to approve Rising Tide where 55% of investors would receive no recovery); *see also S.E.C. v. Byers*, 637 F. Supp. 2d 166, 182 (S.D.N.Y. 2009) (approving the Net Investment methodology after receiver did not recommend using Rising Tide because 45% of investors would not receive a recovery). In this Receivership, the Receiver is making distributions to all investors with allowed claims. *See* Third Written Status Report of the Receiver, at 6 (Docket No. 925).

C. Preferred Investor Distributions Should be Adjusted with the Rising Tide Methodology

Distributions made to Preferred Investors on account of the Four Funds Claims should be adjusted to account for the receipt of Preferential Payments using the Rising Tide methodology ("Preferential Payment Offset"). After January 2008, when interest payments on the junior tranches of Four Funds Notes were reduced and ultimately eliminated for all other investors, the Preferred Investors continued to receive Preferential Payments. The Preferred Investors were elevated to a preferred position by MS & Co. over all other investors in the Four Funds.

The Net Investment method was applied to all investor claims, including the Preferred Claims, to account for pre-receivership payments of principal and/or interest made to all investors, as approved by the Plan Distribution Order. *See* Plan Distribution Order at 15. Unlike the rest of the investors in the Four Funds, however, the Preferential Investors recovered the Preferential Payments while ordinary investors ceased receiving anything on account of their Four Funds investments. The Preferential Payments thus reduced amounts available for distribution to all investors defrauded by McGinn and Smith and unfairly increased total recoveries of the limited subset of Preferred Investors.

Applying the Preferential Payment Offset to the Four Funds Claims to account for the receipt of Preferential Payments will put *all* investors in a more equal position. For example, assume that a non-preferred investor and a Preferred Investor both have claims, calculated using the Net Investment method to account for pre-Receivership payments of principal and interest, of $10,000 on account of investments made in one of the Four Funds. Assume further that the Preferred Investor received a $500 Preferential Payment after the non-preferred investor ceased receiving any interest payments on account

of his investment. Without applying any adjustment, both the Preferred Investor and the non-preferred investor would receive a pro rata distribution of 10% of their claim, or $1,000. The Preferred Investor, however, would have a total recovery of $1,500, inclusive of the Preferential Payment. Although both investors should be in the same position, the Preferred Investor will actually have recovered $500 more than the non-preferred investor, for no rationale other than that McGinn and Smith directed a Preferential Payment to the Preferred Investor. By applying the Preferential Payment Offset to reduce the Preferred Investor's distribution by the amount of the Preferential Payment, the Preferred Investor and the non-preferred investor are returned to the same position, having received total recoveries on account of their Four Funds Claims in the amount of $1,000.

Even use of the Net Investment methodology results in a disparity between the Preferred Investor and the non-preferred investor. Under Net Investment, the Preferred Investor's claim would result in a reduced claim amount of $9,500. The Preferred Investor would receive a pro rata distribution of $950, plus the Preferential Payment of $500, resulting in a recovery of $1,450. Meanwhile, the non-preferred investor receives a distribution of $1,000. The Preferred Investor still retains more on account of his investment than the non-preferred investor.

Although courts have not approved the use of the Rising Tide methodology where a large percentage of investors would not receive a recovery as a result of the application of Rising Tide, this is not the case here. After application of the Preferential Payment Offset, only nine Preferred Investors, approximately 1% of all MS & Co. investors, would not receive an interim first distribution on certain of their Four Funds Claims and would have a credit against future distributions in the amount of the excess of the

Preferential Payment over the amount of the interim first distribution. This credit would not prevent them from receiving further distributions if the credit were to be consumed by the amount of the distribution. Use of the Preferential Payment Offset, however, would increase the pool of proceeds available for pro rata distribution to all investors by at least $450,000.

To permit the Preferred Investors to retain the Preferential Payments, without a corresponding dollar-for-dollar reduction in the amount of their pro rata distribution, would result in the Preferred Investors retaining excess amounts for no reason other than that they were arbitrarily selected by MS & Co. to receive supplemental Preferential Payments while other investors received nothing. The Preferential Payment Offset promotes equality among all investors by accounting for the arbitrary treatment of the Preferred Investors.

To apply the Preferential Payment Offset, the Receiver has used the books and records of MS & Co. to determine when the Preferential Payments were made, to whom, and on account of which specific investment the Preferential Payment was made. The Preferential Payment Offset was then applied to the distribution for the particular Four Funds Claim for which the Preferred Investor received the Preferential Payment. In instances where a Preferred Investor has several claims for the same Four Funds entity, the Preferential Payment Offset has been applied to the aggregate distribution for those Four Funds Claims. In certain instances, the Receiver has evidence that Preferential Payments were made to Preferred Investors, but is unable to determine which of the Four Funds such Preferential Payments were made in connection with. The Receiver has elected to apply those Preferential Payments ("Unspecified Preferential Payments") to further reduce the

aggregate distribution on all of that Preferred Investor's Four Funds Claims, as shown in Exhibit B-2 to the Motion. Brown Dec'l ¶ 27.

D. Summary Proceedings are Appropriate

The Receiver has sought to provide the Preferred Investors with appropriate notice and sufficient time to respond to the Motion. Accordingly, the Receiver has complied with the claim objection and notice procedures set forth in the Federal Rules of Bankruptcy Procedure ("Bankruptcy Rules") as a form of best expression of law. Bankruptcy Rule 3007 requires that a claim objection must be filed and served at least thirty days before any scheduled hearing and that the objection must be served on the claimant by first class mail. Fed. R. Bankr. P. 3007(a)(1), (2).

In accordance with Rule 7.1 of the Local Rules of Practice for the United States District Court for the Northern District of New York, the Receiver has filed and will serve the Motion on each of the Preferred Investors at least thirty-one days in advance of the scheduled return date of August 16, 2018. The Receiver will give notice of the Motion to the Securities and Exchange Commission, all parties who have filed a Notice of Appearance in this action by ECF, and all creditors and parties in interest via the Receiver's website (www.mcginnsmithreceiver.com), as well as posting at the top of the Receiver's website an explanation of the Motion. Additionally, notice by first class mail will be given to each of the Preferred Investors. Brown Dec'l. ¶26.

The Receiver requests that the Court enter an order granting the relief requested in this Motion without a hearing with respect to those Preferred Investor Claims for which an objection is not timely interposed. Disallowance or adjustment of a claim without a hearing where there is no factual dispute is an appropriate and preferred

procedure in federal receivership cases. *See S.E.C. v. Elliott*, 953 F.2d 1560, 1566 (11th Cir. 1992) (holding that summary proceedings are favored in federal receivership cases because a summary proceeding "reduces the time necessary to settle disputes, decreases litigation costs, and prevents further dissipation of receivership assets"); *United States v. Fairway Capital Corp.*, 433 F. Supp. 2d 226, 241 (D. R.I. 2006) ("Receivership courts can employ summary procedures in allowing, disallowing and subordinating claims of creditors").

CONCLUSION

The Receiver requests that the Court enter an Order substantially in the form attached to the Motion as Exhibit C (a) disallowing the Paper Claims and (b) applying the Preferential Payment Offset to Preferred Investor distributions, together with such other and further relief as the Court deems just and proper.

Dated: July 6, 2018

PHILLIPS LYTLE LLP

By /s/ Catherine N. Eisenhut
William J. Brown (Bar Roll #601330)
Catherine N. Eisenhut (Bar Roll #520849)
Attorneys for Receiver
Omni Plaza
30 South Pearl Street
Albany, New York 12207
Telephone No. (518) 472-1224

and

One Canalside
125 Main Street
Buffalo, New York 14203
Telephone No.: (716) 847-8400

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