UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK
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SECURITES AND EXCHANGE COMMISSION,

Plaintiff,

-against-

10 Civ. 457 (GLS/CFH)

McGINN, SMITH & CO., INC., *et al.*,

Defendants.

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DAVID L. SMITH'S REPLY
IN SUPPORT OF RULE 60(b) MOTION

ALEX LIPMAN
LIPMAN LAW PLLC
45 West 29th Street, Suite 303
New York, NY 10001
212-401-0070
alexlipman@lipmanpllc.com

JUSTIN S. WEDDLE
BRIAN WITTHUHN
WEDDLE LAW PLLC
250 West 55th Street
30th Floor
New York, NY 10019
(212) 997-5518
jweddle@weddlelaw.com

Attorneys for David L. Smith

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INTRODUCTION

The SEC's opposition to our motion asserts that four and a half years prior to *Liu*, this Court issued a joint and several order of "disgorgement" of nearly $100 million (representing the difference between amounts invested in McGinn Smith entities and amounts returned to investors) that is entirely consistent with *Liu*, and that, at the same time, *Liu* was a change in the law. In other words, the SEC argues that *Liu* was a change in the law that *changed nothing*.

To articulate the argument is to refute it. *Kokesh* and *Liu* did not *change* the law (15 U.S.C. § 78u(d)), they applied the longstanding principles of equity which Congress incorporated into the statute authorizing *properly-constituted* disgorgement as "equitable relief" when it was enacted in the 1930s. These cases recognize that disgorgement has *always* been limited to established principles of equity, and that the expanded, extra-legal "disgorgement" that the SEC had sought and obtained for years pre-*Liu* did not conform to those principles and thus transformed "disgorgement" into an unauthorized penalty. In this case, the Court, relying on pre-*Liu* caselaw approving the unauthorized "disgorgement" the SEC had extracted for years from wrongdoers, issued a disgorgement order that violated precisely the equitable limitations that the Supreme Court has since identified in *Liu*. This was an unauthorized penalty never prescribed by Congress and which this Court therefore lacked power—or 'jurisdiction'—to impose on Smith, and, as such, was void *ab initio*. The imposition of a penalty which the SEC was literally powerless to seek, and the Court was powerless to impose, is a structural, due process, separation-of-powers defect. Smith, an individual litigant, cannot have conferred upon the SEC and this Court a power that Congress never provided in a duly enacted law, and therefore the imposition of an unauthorized penalty here is not subject to waiver (nor is it subject to cure by the passage of time or the inapplicable bankruptcy doctrine of equitable mootness). The disgorgement order should be vacated.[1]

ARGUMENT

I. RELIEF UNDER RULE 60(B)(4) IS APPROPRIATE BECAUSE THE DISGORGEMENT ORDER IS VOID

The SEC has (and had) authority to seek, and courts have (and had) authority to impose, "disgorgement" as equitable relief. 15 U.S.C. § 78u(d)(5). "Equitable relief" does not mean whatever disgorgement amount the SEC or a court thinks is fair in a particular circumstance; it means that any disgorgement must adhere to the limitations on the equitable remedy of disgorgement or else it is not disgorgement at all, but an unauthorized penalty. *Kokesh v. SEC*, 137 S. Ct. 1635 (2017); *Liu v. SEC*, 140 S. Ct. 1936 (2020). The disgorgement order here exceeds permissible disgorgement-as-equitable-relief in almost every way and, therefore, constitutes an unauthorized penalty. *See* Smith Memo. of Law in Supp. of 60(b) Motion (ECF 1195)

[1] The SEC and the Receiver argue that the money has been largely distributed, and thus it is impossible, or at least impractical, to restore to Smith and his family the assets taken from them. Even if this argument is correct, it does not apply to hundreds of thousands of dollars still in the control of the receiver (ECF 1199), and it provides no justification for maintaining the extra-legal judgment imposed. At the very least, *those* funds should be returned to Smith, and he should be relieved of any obligations under the disgorgement order. Indeed, both the SEC and the receiver acknowledge that there is little to no chance that any further money will be paid toward the judgment, and thus to maintain it serves only to penalize Smith, not to benefit investors.

at 5-15. The SEC had no power to extract, and the Court had no power to impose, a penalty on Smith that Congress has never authorized (and, indeed, chose to withhold again this year in its amendment of 15 U.S.C. § 78u(d)). *See Whalen v. United States*, 445 U.S. 684, 689 (1980) (stating that it is a "basic principle" that "within our federal constitutional framework the legislative power, including the power to define criminal offenses and to prescribe the punishments to be imposed upon those found guilty of them, resides wholly with the Congress"); *La. Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 374 (1986) (recognizing that "an agency literally has no power to act" absent a conferral of power upon it by Congress). *Cf. AMG Capital v. FTC*, 141 S. Ct. 1341, 1345-52 (2021) (holding that agency had no authority to obtain, and court had no authority to order, equitable monetary relief provided for by statute in administrative enforcement proceedings, but not in court enforcement proceedings).

The disgorgement is therefore void under Federal Rule of Civil Procedure 60(b)(4). Because it is an illegal penalty—not properly-constituted disgorgement—this Court had no power to impose it. *See Combs v. Nick Garin Trucking*, 825 F.2d 437, 442 (D.C. Cir. 1987) (stating that a judgment is void under 60(b)(4) where "the rendering court was powerless to enter it"). Another way to say this is that the Court lacked jurisdiction, i.e., statutory authority, to exact this penalty. *See United States v. U.S. Fidelity & Guaranty Co.*, 309 U.S. 506 (1940) (voiding a judgment against the United States where the court lacked jurisdiction, *i.e.*, statutory authority, to impose it, even though the United States had not directly challenged the judgment).

The SEC's arguments that Rule 60(b)(4) does not apply here are incorrect and misconstrue Smith's assertions. *First*, the SEC draws a distinction without a difference between situations in which a court "proceeded beyond the powers granted to it by law," *McRae v. District of Columbia*, Civ. Action No. 05-2272 (RBW) (D.D.C. Mar. 19, 2007) (citing *Eberhardt v. Integrated Design & Constr., Inc.*, 167 F.3d 861, 871 (4th Cir. 1999)),[2] and circumstances in which a court proceeded beyond its 'jurisdiction,' *see* SEC Opposition (ECF 1198) at 7-8. There is no substantive difference, however, between the D.C. Circuit's formulation—a judgment is void under 60(b)(4) where "the rendering court was powerless to enter it," *Combs*, 825 F.2d at 442—and the Second Circuit's formulation—"A judgment is void under [Rule 60(b)(4)] only if the court that rendered it lacked jurisdiction of the subject matter, or of the parties, or if it acted in a manner inconsistent with due process of law," *Grace v. Bank Leumi Trust Co. of N.Y.*, 443 F.3d 180, 193 (2d Cir. 2006) (quotations omitted).[3] Indeed, it is hard to conceive of a *better* example of a court acting beyond its jurisdiction or in violation of due process of law than when a court enters a judgment that it had no power to enter, such as here, where the Court imposed an unauthorized penalty. The SEC's position—that Rule 60(b)(4) does not apply to orders which courts were powerless to enter—also seeks to rewrite Rule 60(b)(4), which, by

[2] *Available at* https://casetext.com/case/mcrae-v-district-of-columbia.

[3] The Court should also reject the SEC's argument because it seeks to create a Circuit split whereby a judgment would be void in the D.C. Circuit, but not in the Second Circuit, if the court had no power to enter it. *See, e.g.*, *United States v. Games-Perez*, 695 F.3d 1104, 1115 (10th Cir. 2012) (Murphy, J., concurring) (collecting cases demonstrating maxim that "the circuits have historically been loath to create a split where none exists").

its plain terms, requires relief from "void" judgments. *See* Void, *Black's Law Dictionary* (11th ed. 2019) (defining 'void' as "[o]f no legal effect").

Second, this is not a change-in-the-law case. *Liu* delineated the limitations on the "equitable relief" of disgorgement that have *always* been present under 78u(d), as enacted in the 1930s (as well as the ways that the SEC and courts, for decades, impermissibly expanded that circumscribed remedy). 140 S. Ct. at 1940-50, 1946 ("*By incorporating these longstanding equitable principles into § 78u(d)(5)*, Congress prohibited the SEC from seeking an equitable remedy in excess of a defendant's net profits from wrongdoing.") (emphasis added). In other words, *Liu* and *Kokesh* did not address a *change* to 78u(d)(5) (there was no change); *Liu* and *Kokesh* made clear that disgorgement orders precisely like this one do not satisfy the longstanding requirements of "equitable relief" under the statute. The Court should not be confused, as the SEC apparently has been, by the fact that *on top of this*, Congress has since decided to more expressly incorporate (and further narrow) the parameters set forth in *Liu* through its recent amendment of 78u(d) to permit disgorgement only of "any unjust enrichment by the person who received such unjust enrichment as a result of the violation." 15 U.S.C. § 78u(d)(3)(A)(ii); *see* Smith Memo. of Law in Supp. of 60(b) Motion (ECF 1195) at 9-12.[4]

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[4] Smith believes the Court must follow the amended statute in this pending case, *see* National Defense Authorization Act for Fiscal Year 2021, H.R. 6395, § 6501 (applying the statutory amendments "with respect to any proceeding that [was] pending on, or commenced on or after, the date of enactment . . . ."), but even if the Court disagrees, the limitations inherent in "equitable relief" under 78u(d)(5) described in *Liu* and *Kokesh* have *always* been present (including in 2015), as discussed. The SEC's statement, "Smith does not claim that the Court was powerless in 2015 when the Final Judgment was

Third, Smith cannot have waived his arguments that the disgorgement order is void by failing to preserve them or even through an express, written waiver. The SEC lacked the authority to seek, and the Court lacked the power (or 'jurisdiction') to impose, this extra-legal penalty. The purported waiver of an individual litigant cannot confer on an agency or the court a power which Congress has not provided (and, indeed, has now *twice* carefully withheld). *See Liu*, 140 S. Ct. at 1940-50, 1946 ("By incorporating these longstanding equitable principles into § 78u(d)(5), *Congress prohibited the SEC* from seeking an equitable remedy in excess of a defendant's net profits from wrongdoing.") (emphasis added); *Durant, Nichols, Houston, Hodgson, & Cortese-Costa, P.C. v. DuPont*, 565 F.3d 56, 62 (2d Cir. 2009) ("It is a fundamental precept that federal courts are courts of limited jurisdiction and lack the power to disregard such limits as have been imposed by the Constitution or Congress.") (quotation omitted). Put another way, this case presents an unwaivable structural violation: based on an incorrect understanding of what constitutes permissible disgorgement (which *Liu* and *Kokesh* since clarified), the Court and agency here exacted a penalty that Congress never established through a duly enacted law. *See La. Pub. Serv. Comm'n*, 476 U.S. at 374 ("To permit an agency to expand its power in the face of a congressional limitation on its jurisdiction would be to grant to the agency power to override Congress. This we are both unwilling and unable to do.");

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entered," SEC Opposition (ECF 1198) at 8, is simply wrong and, indeed, ignores the very basis of Smith's motion.

CFTC v. Schor, 478 U.S. 833, 850-51 (1986) (litigants cannot waive a structural separation of powers violation).

II. THE DISGORGEMENT ORDER DOES NOT ADHERE TO THE EQUITABLE LIMITATIONS ON DISGORGEMENT

Little about the disgorgement order here resembles the permissible, properly-constituted equitable relief of disgorgement. The SEC itself identified $1,736,000 that David Smith received as "proceeds of fraud," but the disgorgement order holds him liable for tens of millions of dollars more that he never received or benefitted from.[5] This contravenes the plain holding of *Liu*: "The Court holds today that a disgorgement award *that does not exceed a wrongdoer's net profits* . . . is equitable relief permissible under § 78u(d)(5). 140 S. Ct. at 1940 (emphasis added). This also contravenes Congress's express codification of the limiting principles on disgorgement described in *Liu* and *Kokesh*: the SEC is authorized "to seek, and the court shall have jurisdiction to . . . require disgorgement . . . of any *unjust enrichment by the person who received such unjust enrichment* as a result of such violation." 15 U.S.C. § 78u(d)(3)(A)(ii). In the SEC's telling, however, the *Liu* decision accomplished nothing other than to waste paper—the agency apparently still believes that it is free to obtain disgorgement from an individual wrongdoer of seemingly every dollar connected to that individual or a corporate entity with which he or she is associated, regardless of the limitations inherent in the equitable relief of disgorgement,

[5] Smith has accepted the SEC's $1,736,000 figure for purposes of this motion even though, presumably, some amount of this money represents legitimate salary payments or other compensation.

including without analysis of whether the wrongdoer ever actually received the funds at issue. *See, e.g.*, SEC Opposition (ECF 1198) at 17 (still insisting that "the proper metric for calculating disgorgement in actions such as this is subtracting the amount returned to investors from the total amount raised through fraudulent offerings") (quotation omitted).[6]

For purposes of this reply, take just one (important) example—the SEC's treatment of joint-and-several liability. As *Liu* describes, "to avoid transforming an equitable remedy into a punitive sanction, courts restricted the remedy *to an individual wrongdoer's net profits* to be awarded for victims." 140 S. Ct. at 1942 (emphasis added); *see also id.* at 1945 ("The rule against joint-and-several liability for profits that have accrued to another appears throughout equity cases awarding profits."); *id.* at 1949 (the SEC's practice of imposing "disgorgement liability on a wrongdoer for benefits that accrue to his affiliates, sometimes through joint-and-several liability" is "sometimes seemingly at odds with the common-law rule requiring individual liability for wrongful profits" and risks "transform[ing] any equitable profits-focused remedy into a penalty."). *Liu* contains a limited exception, based on circumstances akin to *Ambler v. Whipple*, 87 U.S. 546 (1874), for circumstances in which partners, who together engaged in wrongdoing, jointly own

[6] If this calculation represents *any* relevant figure, it would be investor *losses* and not disgorgement of a defendant's *gains*. However, as a measure of investor losses, it does not distinguish between fraud-related losses and simple market losses, or even circumstances where legitimate expenses exceed market gains. Thus, investor losses that constitute fraud losses are a small fraction of this gross figure.

and benefit from the wrongfully-obtained assets to be disgorged. *See* Smith Memo. of Law in Supp. of 60(b) Motion (ECF 1195) at 7-9.[7]

In the SEC's view, however, it appears as though merely the first part of the analysis suffices—it is enough that individual wrongdoers engaged in misconduct together, or used an entity along the way, to hold each individual liable for all the funds the entities or other partners took in, regardless of whether the individual defendant (or even his "partner") personally benefited from the net profits, some fraction of the net profits, or whether there were net profits at all. *See* SEC Opposition (ECF 1198) at 14-16. Under this reading, the limited exception in *Liu* swallows the rule, i.e., the "longstanding equitable principle[]," which Congress "incorporate[ed] . . . into § 78u(d)(5)" when it enacted the statute, "against joint-and-several liability for profits that have *accrued to another*." 140 S. Ct. at 1945 (emphasis added), 1946. The SEC seems to take this view in large part based on its belief that "Smith has failed to even attempt to apportion liability between himself and McGinn for receipt of investor proceeds," and that doing so would be difficult, SEC Opposition (ECF 1198) at 15, but this fails to recognize that the SEC's own accountant has already completed this task and determined that whatever the "net profits" from wrongdoing in this case totaled, David Smith received—and was therefore unjustly enriched by—only a relatively small fraction of them ($1,736,000), *see* ECF 712 at 88-134 (Exhibit 26). Nor is it sufficient to claim that Smith or McGinn "controlled" the money—any control

[7] As also previously set forth, the 2021 amendment of 15 U.S.C. § 78u(d) appears to have done away with even this limited exception. *See* Smith Memo. of Law in Supp. of 60(b) Motion (ECF 1195) at 9-10.

they had over corporate entities and investment trusts was by virtue of their positions at those corporate entities, and that control did not convert all assets into assets personally benefitting Smith (or McGinn). After all, any control of assets was *temporary* and ceased well before they personally benefitted Smith—the assets were seized by order of the Court, placed under the control of the Receiver, liquidated, and distributed to investors and other stakeholders of the corporate entities, *not David Smith*.[8]

CONCLUSION

For the foregoing reasons, and for the reasons contained in defendant's motion and supporting papers, the Court should declare the disgorgement order void under Federal Rule of Civil Procedure 60(b)(4) and order the return by the Receiver of $4,372,508 to David Smith and his family—the difference between the amount collected by the Receiver from the Smiths and the amount David Smith received as proceeds of fraud.[9]

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[8] Although both the SEC and the Receiver state that Smith conducted a "Ponzi" scheme, it is beyond dispute that the entities involved here made investments and incurred and paid legitimate expenses, such as salaries and rent. Indeed, if there were no such investments and expenses, it would be difficult to understand how the Receiver and accountants and lawyers assisting him incurred more than $2,750,000 in fees managing and liquidating the assets and liabilities. Over the course of years, Smith received less than $1.8 million.

[9] Again, at a minimum, the Court should order the Receiver to return the remaining funds under his control to Smith and relieve Smith of his obligations under the disgorgement order. *See supra*, 2 n.1.

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New York, New York

Respectfully submitted,

Justin S. Weddle

Justin S. Weddle
Brian Witthuhn
WEDDLE LAW PLLC
250 West 55th Street, Fl. 30
New York, NY 10019
212-997-5518
jweddle@weddlelaw.com

Alex Lipman
LIPMAN LAW PLLC
45 West 29th Street, Suite 303
New York, NY 10001
212-401-0070
alexlipman@lipmanpllc.com

Attorneys for David L. Smith