UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION, *Plaintiff,* *- against -* McGINN, SMITH & CO., INC., McGINN, SMITH ADVISORS, LLC, McGINN, SMITH CAPITAL HOLDINGS CORP., FIRST ADVISORY INCOME NOTES, LLC, FIRST EXCELSIOR INCOME NOTES, LLC, THIRD ALBANY INCOME NOTES, LLC, THOMAS M. McGINN, DAVID L. SMITH, DAVID M. WOJESKI, Trustee of the David L and Lynn A. Smith Irrevocable Trust U/A 8/04/04, GEOFFREY R. SMITH, LAUREN T. SMITH, and NANCY McGINN, *Defendants,* LYNN A. SMITH and NANCY McGINN, *Relief Defendants,* DAVID M. WOJESKI, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04, *Intervenor*.	:	10 Civ. 457 (GLS/DRH)

MEMORANDUM OF LAW OF PLAINTIFF SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION TO REQUEST TO RELEASE CERTAIN ASSETS BY DEFENDANTS TIMOTHY M. McGINN AND DAVID L. SMITH

s/ Lara Shalov Mehraban
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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Statutes

Plaintiff Securities and Exchange Commission (the "SEC") submits this Memorandum of Law in opposition to the request by defendants Timothy M. McGinn ("McGinn") and David L. Smith ("Smith") to "unfreeze" certain assets.

PRELIMINARY STATEMENT

Smith's request that the Court lift the asset freeze with respect to over $305,000 should be denied. Defendants Smith and McGinn orchestrated a wide-ranging fraud in which investors are currently owed more than $85 million in principal. The amount of assets currently frozen does not come close to being able to repay investors. Yet Smith now asks the Court to release over $305,000 in an account established under § 401(k) of the Internal Revenue Code (the "401(k) Account") that Smith contends is exempt from levy under both the anti-alienation provision of ERISA, 29 U.S.C. § 1056(d)(1), and the provision of New York Civil Practice Law and Rules ("NYCPLR") 5205.

Smith's motion should be denied. Neither ERISA nor state law exemptions provide that 401(k) accounts are immune from pre-judgment freeze orders. The provisions that Smith relies on serve to protect 401(k) accounts from ***post-judgment*** seizure, and do not immunize 401(k) accounts from pre-judgment freezes. Smith's argument that the funds in the 401(k) Account could never be considered in a post-judgment remedy is, in this case, not correct. In fact, if Smith fails to pay a disgorgement order, and is found in contempt of such order, then the 401(k) Account could be considered an asset available for payment of the disgorgement. In addition, Smith has refused to provide an accounting of his assets and liabilities, despite being ordered to do so; therefore, Smith should not be given access to the $305,000 in the 401(k) Account. Moreover, state law exemptions do not apply. In addition, when funds are distributed to Smith

from the 401(k) Account, the funds are no longer exempt and would in any event be subject to the Court's broad freeze order. Accordingly, the 401(k) Account should remain frozen.

McGinn seeks to have funds released to prevent the foreclosure of, and to maintain, his property in Boca Raton, Florida (the "McGinn Florida Property"). The amount owed on the mortgage of the McGinn Florida Property exceeds the fair market value of this property. As such, foreclose is inevitable, there is no benefit to investors to preserving this asset and no further funds should be expended on its upkeep. Moreover, McGinn's request should be denied even if the McGinn Florida Property were worth more than the amount owed on the mortgage. McGinn requests that over $45,000 (plus $4,241.71 per month going forward) of funds currently frozen be released to make various payments on the McGinn Florida Property, including back payments on a mortgage, homeowners association fees, taxes, electric bills, pest control and insurance. Because McGinn has asserted his Fifth Amendment rights and has never provided a list of his assets or a verified accounting, neither plaintiff nor the Court can meaningfully evaluate McGinn's motion.

The motion by defendants McGinn and Smith to "unfreeze" certain assets should therefore be denied.

STATEMENT OF FACTS

Smith's 401(k) Account. As of the end of June 2010, there was over $305,000 contained in Smith's 401(k) Account at John Hancock. (*See* Cohen Decl., Ex. D.) The McGinn Smith Incentive Savings Plan was established effective January 1, 1987. (*See* Cohen Decl., Ex. B.)

The source of the funds deposited into the 401(k) Account is unclear and may include fraudulently obtained funds.[1]

McGinn's Florida Property. According to an appraisal of the property sent to the SEC by the law firm representing the mortgagor, the McGinn Florida Property is worth significantly less than the principal due on the mortgage. (Declaration of Lara Shalov Mehraban ("Mehraban Decl."), Ex. 1.) There would be therefore no benefit to investors in preserving this asset for eventual disgorgement.

Moreover, even though all of McGinn's assets are frozen, his current motion makes clear that he has made payments on certain expenses in connection with the Florida Property. He has paid at least $525 in homeowners association fees. (*See* Smith/McGinn Br., at 10). He also has made approximately $700 payments on his electric bill. (*See id.* at 11, and Cohen Decl. Ex. K).[2] McGinn has asserted his Fifth Amendment rights and not provided plaintiff or the Court with a verified list of his assets or an accounting. Without this documentation, the Court cannot meaningfully assess the merits of McGinn's request.

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[1] The SEC sent a subpoena for documents, including all account statements, to John Hancock Life Insurance on October 4, 2010 but has not yet received documents responsive to the subpoena.

[2] McGinn asserts that his electric bill is approximately $149.60 per month. (*See* Cohen Decl. ¶ 17). His electric bill through September 16, 2010 (due October 7, 2010) shows that $136 was paid the previous month. (*Id.* at Exhibit K). In addition, the bill shows a balance of $188.91 before new charges. Assuming a monthly bill of approximately $149.60 per month, there would have been approximately $750 due on his electric bill from April 20, 2010 through the bill attached as Exhibit K. Only $188.91 is shown as past due, which means that McGinn has paid approximately $562 on his electric bills from April 20, 2010 to September 7, 2010. As $136 was paid between September 7 and October 7, a total of approximately $698 has been paid on the electric bill from the date the asset freeze was imposed.

ARGUMENT

I. The Funds in Smith's 401(k) Plan Should Not Be "Unfrozen"

The SEC seeks a final judgment requiring that Smith disgorge his ill-gotten gains. Disgorgement is an equitable remedy, enforceable by contempt. Although inability to pay is a defense to a contempt proceeding, exempt assets – like the 401(k) Account –may be considered by a court in deciding whether a defendant has the ability to make a payment. *SEC v. AMX, International, Inc.*, 7 F.3d 71, 76 (5th Cir. 1993). Moreover, once the funds in the 401(k) Account are paid to Smith, they lose their exempt character and are subject to levy and execution. *E.g., United States v. Jaffe*, 417 F.3d 259, 267 (2d Cir. 2005). Because the purpose of the asset freeze entered in this action is merely to preserve Smith's assets pending the determination of this action on the merits, the Court should deny Smith's motion to "unfreeze" the 401(k) Account.

Disgorgement is an equitable remedy used "to prevent wrongdoers from unjustly enriching themselves through violations, which has the effect of deterring subsequent fraud." *SEC v. Cavanaugh*, 445 F.3d 105, 117 (2d Cir. 2006). "[T]he primary purpose of disgorgement is not to compensate investors. Unlike damages, it is a method of forcing a defendant to give up the amount by which he was unjustly enriched." *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 102 (2d Cir. 1978) (Friendly, J.). "[T]he SEC's purpose in seeking disgorgement of ill-gotten profits has always been deterrence." *Official Committee of Unsecured Creditors of WorldCom, Inc. v. SEC*, 467 F.3d 73, 83 (2d Cir. 2006) (Sotomayor, J.).

If a defendant fails to pay disgorgement as ordered, the SEC may then seek to have the court hold the defendant in contempt to compel compliance. *SEC v. Universal Express Inc.*, 546 F. Supp.2d 132, 134-35 (S.D.N.Y. 2008); *SEC v. Musella*, 818 F. Supp. 600, 602 (S.D.N.Y.

1993). On a motion for contempt for failure to pay disgorgement, the SEC has the burden of showing that the judgment was clear and that the defendant did not make the payment ordered. *Musella*, at 602. Upon such a showing, the burden shifts to the defendant, who must show an inability to comply:

> When an order requires a party to pay a sum certain, a mere showing that the party was unable to pay the entire amount by the date specified is insufficient to avoid a finding of contempt. When a party is absolutely unable to comply due to poverty or insolvency, inability to comply is a complete defense. [Citation omitted.] Otherwise, the party must pay what he or she can.

Id.

It is well established that, even where a defendant's assets may be exempt from execution, such assets are considered in determining whether the defendant has an ability to pay disgorgement in a contempt proceeding. In *SEC v. AMX, Int'l, Inc.*, 7 F.3d 71, 76 (5th Cir. 1993), for example, the Fifth Circuit held that the district court could consider the defendant's exempt homestead in deciding whether he had met his burden. *See also SEC v. Huffman*, 996 F.2d 800, 803 (5th Cir.1993) (holding that disgorgement is not a "debt" under the Federal Debt Collection Procedures Act, and defendants could not avail themselves of the state law exemptions under that Act); *SEC v. Bilzerian*, 112 F. Supp. 2d 12, 27 n. 29 (D.D.C. 2000) (court may consider defendant's homestead in determining ability to comply with disgorgement orders).

Further, "[a] Court has broad equitable powers to reach assets otherwise protected by state law to satisfy a disgorgement." *SEC v. Solow*, 682 F. Supp.2d 1312, 1325 (S.D. Fla. 2010), *aff'd* 2010 WL 3623172 at *1 (11th Cir., Sept. 20, 2010) (*citing SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1103 (2d Cir.1972) ("Once the equity jurisdiction of the district court has been properly invoked by a showing of a securities law violation, the court possesses the necessary power to fashion an appropriate remedy.")).

In particular, courts can ignore state law exemptions in fashioning disgorgement orders. *Solow*, 682 F. Supp.2d at 1325-26 ("[A] district court can ignore state law exemptions as well as other state law limitations on the ability to collect a judgment in fashioning a disgorgement order." *(citing Huffman*, 996 F.2d at 803; *SEC v. AMX, Int'l, Inc.*, 872 F.Supp. 1541, 1544-45 (N.D.Tex.1994) (homestead exemption not taken into account); *SEC v. Musella*, 818 F.Supp. 600 (S.D.N.Y.1993) (holding exemptions from attachment under New York law did not alter a person's duty to pay under a disgorgement order); *see also Pension Benefit Guaranty Corp. v. Ouimet Corp.*, 711 F.2d 1085, 1093 (1st Cir.1983) (ignoring state law limitations on alter ego theory in ERISA context)).[3]

Courts have similarly found that equitable orders for criminal restitution do not protect a defendant's assets contained in an ERISA-qualified retirement account. In *United States v. Jaffe*, for example, 417 F.3d 259, 266-67 (2d Cir. 2005), the defendant argued that a restitution order was invalid because, in order to comply, he would have to liquidate his ERISA-protected retirement accounts. The Court of Appeals held, however, that the restitution order was valid:

> [T]he restitution order here places no restraint on funds that remain in the custody of an ERISA plan administrator. The order does not even specifically direct that restitution payments be from a distribution by the administrator to appellant. As already noted, it simply orders payments by appellant from whatever source he chooses.

Jaffe at 267. Moreover, as the court continued:

> ERISA "protects benefits only while they are held by the plan administrator and not after they reach the hands of the beneficiary." *Robbins v. DeBuono*, 218 F.3d

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[3] *Solow* also quoted from *SEC v. Hickey*, 322 F.3d 1123, 1131 (9th Cir. 2003):

> We do not think that state law limitations on the alter ego theory or doctrine are necessarily controlling in determining the permitted scope of remedial orders under federal regulatory statutes. Instead, federal courts have inherent equitable authority to issue a variety of ancillary relief measures in actions brought by the SEC to enforce the federal securities laws.

> 197, 203 (2d Cir. 2000) (holding ERISA's anti-alienation provision did not bar wife from receiving her institutionalized husband's pension benefits after they have left the plan administrator's hands). *See also United States v. Jackson*, 229 F.3d 1223, 1225 (9th Cir. 2000) ("ERISA's anti-alienation clause does not apply to pension funds that have already been distributed to the beneficiary."); *Trucking Employees of N. Jersey Welfare Fund, Inc. v. Colville*, 16 F. 3d 52, 56 (3d Cir. 1994) (same).

Id.; Guidry v. Sheet Metal Workers Nat'l Pension Fund, 39 F.3d 1078, 1081 (10th Cir. 1994) (*en banc*) (anti-alienation provisions of ERISA do not apply to benefits once paid to beneficiary), *cert. den.* 514 U.S. 1063 (1995).[4] *Cf. United States v. Smith*, 47 F.3d 681, 683-84 (4th Cir. 1995) (ERISA's anti-alienation provision protects pension funds from being applied to restitution ordered under VWPA).

The purpose of the asset freeze is to preserve assets from dissipation during the course of the litigation. Were Smith able to use these assets now, it would reduce his ability to pay whatever disgorgement the Court may award later.[5] Continuing the asset freeze on the 401(k) Account does not therefore violate ERISA.

Nor does the asset freeze violate NYCPLR 5205(c), which exempts retirement plans from execution under New York law. As stated above, state law exemptions do not apply. Moreover, as also stated above, the SEC is not seeking to levy upon this asset.

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[4] Because the SEC is not seeking to levy upon Smith's 401(k) Account, the case law cited by Smith (Br. at 5-7) and the earlier decision in *Guidry v. Sheet Metal Workers Nat'l Pension Fund*, 493 U.S. 365 (1990), are not applicable.

[5] The Court has the power, in the sound exercise of its discretion, to release funds from the asset freeze if necessary and appropriate. This is a fact-based determination driven by the need of the defendant and his dependents, however, and not a blanket exemption for any class of assets. Here, where Smith has asserted his Fifth Amendment rights and not provided any accounting of his assets and expenses, a release of funds is not warranted. (*See* Plaintiff's Memorandum of Law in Opposition to Cross-Motion by Lynn A. Smith and in Further Support of Plaintiff's Motion to Amend the Preliminary Injunction Order, DE #151). Alternatively, if the Court is inclined to release the funds in Smith's 401(k) Account, the SEC requests that the funds be deposited into a Court account and only be released upon a sworn statement by Smith as to the use of those funds.

Furthermore, Smith's claim that the proceeds of the 401(k) Account will be exempt even after the distribution is made to him under NYCPLR 5205(d) is incorrect, even if state law were applicable. NYCPLR 5205(d) applies to the payment made from the fund administrator to the beneficiary, but it does not continue the exemption once the funds arrive in the hands of the beneficiary. Such a result is made clear by the very limited exemption provided in NYCPLR 5205(l), which exempts up to $2,500 of exempt funds (such as distributions from a retirement account) directly deposited in a bank account within 45 days before the service of a restraining notice or execution.

For these reasons, the Court should continue the asset freeze against Smith's 401(k) Account.

II. The Court Should Deny McGinn's Request to Relax the Asset Freeze to Pay Expenses on His Florida Property

A party seeking to unfreeze assets must show that doing so would be "in the interests of the defrauded investors." *SEC v. Grossman*, 887 F. Supp. 649,661 (S.D.N.Y. 1995), *aff'd*, 173 F.3d 846 (2d Cir. 1999); *see also SEC v. Dobbins*, No. 04 Civ. 0605, 2004 WL 957715, at * 2 (N.D. Texas 2004) ("[T]he Court must assess whether a modification … is in the best interests of the defrauded investors."); *SEC v. Coates*, No. 94 Civ. 55361 (KMW), 1994 WL 455558, at *3 (S.D.N.Y. August. 23, 1994); *FTC v. Ameridebt, Inc.*, 373 F. Supp. 2d 558,564-65 (D.Md. 2005) (denying carve-out where public interest in preserving proceeds of fraud outweighed defendant's alleged personal hardship).

There is no benefit to investors here in releasing funds in connection with the McGinn Florida Property. The principal due on the mortgage is over $360,000. (Mehraban Decl., Ex. 1). The current appraised value of the home is $285,000. (*Id.*) Accordingly, funds spent on the

McGinn Florida Property in fact would deplete the amount available to compensate the victims of the fraud.

Moreover, courts have routinely denied requests for carve-outs where defendants have not provided a full accounting of their assets. *E.g.*, *SEC v. Stein*, 07 Civ. 3125, 2009 WL 1181061, at *1 (S.D.N.Y. Apr. 30, 2009) (denying carve-out application in the absence of a full accounting); *see also SEC v. Cherif*, 933 F.2d 403, 417 (7th Cir. 1991) (affirming denial of carve-out where district court drew adverse inferences from defendants' refusal pursuant to the Fifth Amendment to provide an accounting). Here, McGinn has asserted his Fifth Amendment rights and not provided any accounting. Until now -- over six-months' after the asset freeze was imposed -- he has not made any request for a carve out. All of his assets are frozen, yet he appears to have paid some expenses on his Florida home. These facts raise significant questions about McGinn's finances and expenses, including the existence of undisclosed assets, the expenses McGinn has been incurring and paying since the asset freeze was imposed, the funds used to pay those expenses, and the availability of financial support from immediate family and friends. Neither plaintiff nor the Court can meaningfully evaluate the merits of McGinn's request on this record. Accordingly, the record does not support any release of funds.

CONCLUSION

For the reasons set forth above, the Court should deny the requests by defendants McGinn and Smith to release certain assets from the asset freeze.

Dated: New York, New York
November 22, 2010

Respectfully submitted,

s/ Lara Shalov Mehraban
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John J. Graubard

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,	
Plaintiff,	
v.	**10 Civ. 457 (GLS/DRH)**
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, DAVID L. SMITH, LYNN A. SMITH, DAVID M. WOJESKI, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04, GEOFFREY R. SMITH, LAUREN T. SMITH, and NANCY MCGINN,	
Defendants,	
LYNN A. SMITH, and NANCY MCGINN,	
Relief Defendants, and	
DAVID M. WOJESKI, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04,	
Intervenor.	

DECLARATION OF LARA SHALOV MEHRABAN

I, Lara Shalov Mehraban, pursuant to 28 U.S.C. § 1746, declare as follows:

1. I am an attorney in the Enforcement Division of the New York Regional Office of the Securities and Exchange Commission (the "Commission"). I have been employed with the Commission since September 2007. I make this declaration in opposition to the motion to release certain assets from the asset freeze by defendants Timothy M. McGinn and David L.

Smith.

2. Attached as Exhibit 1 is an email I received on September 23, 2010 from the attorney representing M&T Bank, attaching an appraisal for the property located at [redacted] Boca Raton, Florida.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on: November 22, 2010
New York, New York

Lara Shalov Mehraban

Exhibit 1

Mehraban, Lara

From: Frederic J. DiSpigna [fdispigna@dstern.com]
Sent: Thursday, September 23, 2010 6:24 PM
To: Mehraban, Lara
Subject: SEC v. McGinn, Smith & Co., Inc., et al., Case No. 1:10-cv-00457-GLS-DRH (DJS#10-47093)
Attachments: Property Appraiser's Valuation.pdf

Hello Lara:

Pursuant to our telephone conversation, attached is a printout from the County Property Appraiser's website showing the current value of the property to be $285,000.00. Our client is owed a principal balance of $361,953.51, with interest due from 4/1/10 so, it should be apparent that there is no equity in the property. Please advise if we are free to proceed with our foreclosure and who we should name as the owner of the property?

Frederic J. "Ric" DiSpigna
Chief Counsel, Bankruptcy Litigation
Law Offices of David J. Stern, P.A.
900 South Pine Island Road, Suite 400
Plantation, Florida 33324-3920
Phone: (954) 233-8000 ext 1207
Direct Fax: (954) 233-8648
fdispigna@dstern.com

From: Frederic J. DiSpigna
Sent: Thursday, September 23, 2010 11:24 AM
To: 'stoeltingd@sec.gov'
Cc: 'mcgrathk@sec.gov'; 'mehrabanl@sec.gov'; Tom Macarounis
Subject: SEC v. McGinn, Smith & Co., Inc., et al., Case No. 1:10-cv-00457-GLS-DRH (DJS#10-47093)

Hello David:

We represent M&T Bank for a foreclosure against property at [redacted], Boca Raton, FL 33487, owned by Timothy McGinn. Because the *Order to Show Cause, Temporary Restraining Order and Order Freezing Assets and Granting Other Relief* (Document 5) was recorded in the Public Records of Palm Beach County, Florida, we are unsure if we can proceed with our foreclosure action or not. If you believe that we are enjoined from proceeding, please point me to the specific language of an Order that has that effect and please advise what we would need to do to get relief from such injunction to proceed with our foreclosure? If we are not enjoined, who should we name in our foreclosure as the owner of the property?

Frederic J. "Ric" DiSpigna
Chief Counsel, Bankruptcy Litigation
Law Offices of David J. Stern, P.A.
900 South Pine Island Road, Suite 400
Plantation, Florida 33324-3920
Phone: (954) 233-8000 ext 1207
Direct Fax: (954) 233-8648
fdispigna@dstern.com

Property Appraiser's Public Access System

Home

Property Information

Location Address: [redacted]

Municipality: BOCA RATON

Parcel Control Number: 06-43-46-32-46-006-0030

Subdivision: ROYAL POINCIANA

Official Records Book: 21863 Page: 587 Sale Date: Jun-2007

Legal Description: ROYAL POINCIANA LT 3 BLK 6

View Map | Calculate Portability | 2010 Proposed Tax Notice | Reverse Side | Help

Owner Information

Name: MCGINN TIMOTHY M

Mailing Address: 99 PINE ST
ALBANY NY 12207 2776

All Owners

Sales Information

Sales Date	Book/Page	Price	Sale Type	Owner
Jun-2007	21863/0587	$630,000	WARRANTY DEED	MCGINN TIMOTHY M

Exemptions

Exemption Information Unavailable.

Appraisals

Tax Year:	2010 P	2009	2008
Improvement Value:	$285,000	$410,000	$535,500
Land Value:	$0	$0	$0
Total Market Value:	$285,000	$410,000	$535,500

Use Code: 0110- RESIDENTIAL

All values are as of January 1st each year

Property Information
Number of Units: 1
*Total Square Feet: 2410
Acres: 0.0788
* May indicate living area in residential properties.

P = Preliminary Values

Assessed and Taxable Values

Tax Year:	2010 P	2009	2008
Assessed Value:	$285,000	$410,000	$535,500
Exemption Amount:	$0	$0	$0
Taxable Value:	$285,000	$410,000	$535,500

Structure Detail

Taxes

Tax Year:	2010 P	2009	2008
Ad Valorem:	$5,811	$7,905	$9,421
Non Ad Valorem:	$154	$127	$87
Total Tax:	$5,965	$8,032	$9,508

Tax Collector WebSite

Tax Calculator | Details

NOTE: Lower the top and bottom margins to 0.25 on File->Page Setup menu option in the browser to print the detail on one page.