UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

No. 10-CV-457 (GLS/DRH)

TIMOTHY M. McGINN; DAVID L. SMITH; LYNN A. SMITH; and NANCY McGINN,

Defendants.

APPEARANCES:

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DAVID R. HOMER
U.S. MAGISTRATE JUDGE

MEMORANDUM-DECISION AND ORDER

Plaintiff Securities and Exchange Commission ("SEC") previously moved for and was granted a preliminary injunction freezing the assets of the defendants. Dkt. No. 4, 5, 96. Included among the frozen assets are a retirement account of defendant David L. Smith ("Smith") and a Florida property of defendant Timothy M. McGinn ("McGinn"). Dkt. No. 96. Presently pending is the motion of Smith and McGinn to (1) release the funds

from Smith's retirement account from the asset freeze and (2) release a portion of McGinn's assets from the freeze to maintain the Florida property and prevent foreclosure. Dkt. No. 176. The SEC opposes the motion. Dkt. No. 197. For the reasons which follow, defendants' motion is denied.

I. Background

Smith maintains a retirement account under a 401(k) plan qualified under the Employee Retirement Income Security Act (ERISA) which has accumulated over $305,000. Dkt. No. 176-6. The account has remained frozen under the terms of the preliminary injunction order, familiarity with which is assumed. Dkt. No. 86, 96; Cohen Decl. (Dkt. No. 176-2) ¶¶ 2-6. The purpose of the asset freeze is to preserve the defendants' assets from dissipation in the event that the SEC prevails in this action and defendants are ordered to make restitution to investors and or to disgorge ill-gotten gains. Dkt. Nos. 4, 5, 96.

McGinn owns a second home in Boca Raton, Florida with a first mortgage of $361,953.51. Cohen Decl. ¶ 7; Dkt. No. 197-1 at 4. This property is also frozen by the preliminary injunction order. Dkt. Nos. 4, 5. The last mortgage payment was made in April 2010 and the bank has since notified McGinn of its intention to begin foreclosure proceedings. Cohen Decl. ¶¶ 9-12. Additionally owing are homeowner's association fees of approximately $4,000, homeowner's insurance, pest control, utility, and taxes. Id. ¶¶ 12-20. As of September 23, 2010, the property has an assessed value of approximately $285,000. Dkt. No. 197-1 at 4.

II. Discussion

A. Smith's 401(k) Account

Smith contends that the present freeze of Smith's 401(k) account is inappropriate because the account "is protected from a judgment levy [and] it simply does not make any sense to allow the SEC to hold [the account] . . . hostage to the asset freeze." Defs. Mem. of Law (Dkt. No. 176-1) at 6. Generally, a 401(k) account may not be seized or forfeited to satisfy a judgment as such accounts are protected from such actions under ERISA. 29 U.S.C. § 1002(2)(A). However, the SEC here also seeks an order of disgorgement. See Am. Compl. (Dkt. No 100) at 43, ¶ VI.

Disgorgement "is an equitable remedy meant to prevent the wrongdoer from enriching himself by his wrongs." S.E.C. v. Huffman, 996 F.2d 800, 802 (5th Cir. 1993). However, a disgorgement order is not "a mere money judgment or a debt but rather more akin to an injunction in the public interest." Id. (internal quotation marks and citations omitted). If a defendant fails to pay disgorgement as ordered, the SEC may then seek to have the defendant held in contempt and to compel compliance. S.E.C. v. Universal Exp., Inc., 546 F. Supp. 2d 132, 134-35 (S.D.N.Y. 2008); S.E.C. v. Solow, 682 F. Supp. 2d 1312, 1324 (S.D. Fla 2010). A common defense proffered after the initiation of a civil contempt procedure is that "the alleged contemnor [has] . . . a present inability to comply [with the disgorgement order] . . . ." Solow, 682 F. Supp. 2d at 1325 (internal quotation marks and citations omitted). Such inability must be substantiated and not be self-imposed. See S.E.C. v. Bilzerian, 112 F. Supp. 2d 12, 23, 28 (D.D.C. 2000) (denying assertions of an inability defense where contemnor "admittedly created his alleged inability

himself.")

A "Court has broad equitable powers to reach assets otherwise protected by state law to satisfy disgorgement [so that] . . . a district court can ignore state law exemptions on the ability to collect a judgment in fashioning a disgorgement order." Solow, 682 F. Supp. 2d at 1325 (citations omitted); see also S.E.C. v. Hickey, 322 F.3d 1123, 1131 (9th Cir. 2003) ("We do not think that state law limitations . . . 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 . . . to enforce the federal securities laws.") (internal quotation marks and citations omitted). "Therefore, th[e] ability to ignore state law limitations and exemptions exists so that state law cannot defeat or limit the scope of remedial orders under federal law." Solow, 682 F. Supp. 2d at 1326 (citations omitted); see also S.E.C. v. Musella, 818 F. Supp. 600, 602 (S.D.N.Y. 1993) ("[T]he extent to which [the contemnor's] assets and income would be exempt from attachment under New York law does not alter his duty to pay the amount he owes under the order."). The same holds true for assets contained in ERISA-qualified retirement accounts.[1] United States v. Jaffe, 417 F.3d 259, 266-67 (2d Cir. 2005) (holding that a restitution order, which "places no restraint on funds that remain

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[1] Generally, 401(k) plans fall within ERISA's definition of a pension plan. See generally In re Bank of Am. Corp., Securities, Derivative, & ERISA Litig., 2010 WL 3448197, at *6 (S.D.N.Y. Aug. 27, 2010) ("It is undisputed that the B[ank of America] 401(k) Plan is an 'employee pension plan' as defined by . . . ERISA . . . ."). "ERISA mandates that each pension plan shall provide that benefits provided under the plan may not be assigned or alienated." United States v. Jaffe, 417 F.3d 259, 267 (2d Cir. 2005) (quoting 29 U.S.C. § 1056(d)(1)). However, "ERISA protects benefits only while they are held by the plan administrator and not after they reach the hands of the beneficiary." Jaffe, 417 F.3d at 267 (internal quotation marks and citations omitted).

in the custody of an ERISA plan administrator," and "does not even specifically direct that restitution payments be from a distribution by the administrator to appellant" was valid despite the contemnor's assertions that the practical effect of the order would be to "require him to alienate all of his pension and retirement distributions . . . ."). Accordingly, assets which otherwise may be exempted by state and federal law may be considered when determining a party's ability to pay the disgorgement order.

In this case, then, the basis for the continued freeze of Smith's 401(k) account is not a debt against which the account is protected by ERISA and state law. It is the potential disgorgement order sought by the SEC. If a disgorgement order is ultimately granted, the amount of money in Smith's 401(k) account will be important in either facilitating repayment or determining whether he has an ability to pay the amount ordered disgorged. Thus, the freeze of the account serves to maintain an asset which may play an integral role in future proceedings.[2] Moreover, if Smith were to deplete the 401(k) account before a disgorgement orders granted and Smith is unable to satisfy that order, Smith cannot prove an inability to pay where that inability is self-imposed.

For these reasons, Smith's motion to lift the asset freeze as to his 401(k) account is denied.

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[2]Both of these contingencies are substantially likely to occur here. first, without objection, it has already been determined that the SEC has demonstrated a substantial likelihood that it will prevail on the merits of its claims against Smith. Dkt. No. 86 at 27-32. Second, the SEC alleges that approximately $85 million of the money obtained by defendants from investors remains outstanding and, to date, the total value of all assets of all defendants under the asset freeze amounts to but a fraction of the total loss alleged. Comare Am. Compl. with Interim Report of Receiver (Dkt. No. 49).

B. McGinn's Florida Property

McGinn seeks release of his assets to maintain his a property in Florida. Defs. Mem. of Law at 9.[3] "It is well settled that this Court has the authority to freeze personal assets temporarily and the corollary authority to release frozen personal assets, or lower the amount frozen." S.E.C. v. Duclaud Gonzalez de Castilla, 170 F. Supp. 2d 427, 430 (S.D.N.Y. 2001) (citations omitted). "[T]he primary purpose of freezing assets is to facilitate compensation of defrauded investors in the event a violation is established at trial . . . ." Id. (citations omitted); see also S.E.C. v. Infinity Group Co., 212 F.3d 180, 197 (3d Cir. 2000) ("A freeze of assets is designed to preserve the status quo by preventing the dissipation and diversion of assets.") (citations omitted). When determining the scope of such relief, a court must weigh "the disadvantages and possible deleterious effect of a freeze . . . against the considerations indicating the need for such relief." S.E.C. v. Manor Nursing Centers, Inc., 458 F. 2d 1082, 1106 (2d Cir. 1972). "In evaluating requests to release those assets, courts commonly look to several factors . . . [including t]he interests of the defrauded investors . . . [the s]ource of the released funds . . . [the b]alance of interests . . . [and t]he expenses [the d]efendant seeks to pay." S.E.C. v. Forte, 598 F. Supp. 2d 689, 692-94 (E.D. Pa 2009).

Funds should not be released for the Florida property for multiple reasons. First, the amount of loss to investors asserted by the SEC far exceeds the total value of

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[3] McGinn also seeks to prohibit foreclosure of the property by the first mortgage holder the filing of liens against the property by other creditors. Id. at 12. The preliminary injunction order already prohibits such actions. Dkt. No. 96 at ¶¶ VII, XVI; see also Dkt. No. 169 (motion of first mortgage holder of another property to lift the asset freeze to permit sale of that property). Therefore, this portion of McGinn's motion is denied as moot.

available assets of the defendants and a further depletion of those assets to maintain McGinn's Florida property would not be in the best interests of the investors. Forte, 598 F. Supp. 2d at 692-93 ("[I]f the frozen assets fall short of the amount needed to compensate consumers for their losses, a court is within its discretion to deny an application for living expenses and attorney fees.") (citations omitted)); S.E.C. v. Current Financial Servs., 62 F. Supp. 2d 66, 68 (D.D.C. 1999) (denying release of funds when the funds available for disgorgement, traceable to illegally gotten gains or not, are grossly diminished so "that the potential disgorgement [the SEC] could receive . . . far exceeds the amount that is frozen.").

Second, the current market value of the property is substantially exceeded by the amount of the first mortgage and there, thus, appears no likelihood that the investors would realize any benefit from the sale of the property in the foreseeable future. See S.E.C. v. Dobbins, No. 04-CV-0605-H, 2004 WL 957715, at *3 (N.D. Tex April 14, 2004). Third, the Court has appointed a receiver to maintain and manage the defendants' frozen assets for the benefit of investors. Dkt. No. 96. The receiver has not joined in McGinn's request here and the request is opposed by the SEC, which also acts in the interests of investors. Thus, absent the agreement of the receiver appointed by the Court that such expenditures of frozen assets are in the best interests of the investors, the balance of factors weighs against McGinn's request.

Finally, as McGinn has declined on Fifth Amendment grounds to provide an accounting of his assets, his true financial condition is unknown. In the absence of facts from which an accurate assessment of McGinn's financial condition can be determined, the depletion of assets frozen for the benefit of investors to maintain a vacation home

cannot be justified. See Duclaud Gonzalez de Castilla, 170 F. Supp. 2d at 430; S.E.C. v. Schiffer, No. 97-CV-5853, 1998 WL 901684, at *1-3 (S.D.N.Y. June 25, 1998) (denying reconsideration of defendant's request to unfreeze assets because his failure to provide financial information on Fifth Amendment grounds "warranted a measure designed to preserve the status quo while the court could obtain an accurate picture of the whereabouts of the proceeds of the [alleged fraud].").

Accordingly, for the reasons stated above, McGinn's request to unfreeze assets for the purpose of maintaining his Florida property is denied.

III. Conclusion

For the reasons stated above, it is hereby **ORDERED** that defendants' motion to lift the preliminary injunction order as to (1) Smith's 401(k) account and (2) McGinn's assets for use in maintaining McGinn's Florida property (Dkt. No. 176) is **DENIED** in all respects.

IT IS SO ORDERED.

DATED: December 15, 2010

David R. Homer
U.S. Magistrate Judge