

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,
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.

**Case No.: 1:10-CV-457
(GLS/DRH)**

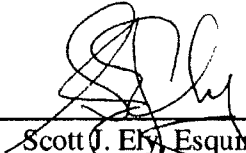
**RELIEF DEFENDANT AND
DEFENDANT LYNN A. SMITH'S
NOTICE OF MOTION TO
DISMISS**

PLEASE TAKE NOTICE that upon all the pleadings and proceedings heretofore had herein, the Relief Defendant/Defendant Lynn A. Smith will move before a term of this Court to be held for the United States District Court for the Northern District of New York 445 Broadway, Albany, New York on the 20th day of January, 2011, for an Order pursuant to FRCP Rules 12(b)(1) and 12(b)(6) dismissing the Plaintiff's Amended

Complaint for lack of subject matter jurisdiction and failure to state a claim upon which relief can be granted.

DATED: December 15, 2010

Featherstonhaugh, Wiley & Clyne, LLP

By: 
Scott J. Ely, Esquire
Bar Roll No. 511635
Attorneys for Relief Defendant,
Lynn A. Smith
99 Pine Street, Suite 207
Albany, NY 12207
Tel: (518) 436-0786
Fax: (518) 427-0452

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,
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,

**Case No.: 1:10-CV-457
(GLS/DRH)**

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.

**MEMORANDUM OF LAW IN SUPPORT OF RELIEF DEFENDANT AND
DEFENDANT LYNN A. SMITH'S MOTION TO DISMISS**

Purported "Relief Defendant" and Defendant Lynn A. Smith moves this Court pursuant to Fed. R. Civ. Proc. 12(b)(1) and 12(b)(6), to dismiss the Amended Complaint for lack of subject matter jurisdiction and failure to state a claim upon which relief can be granted.

PRELIMINARY STATEMENT

Lynn A. Smith (“Lynn Smith”) is not a properly named “relief defendant” in this action since the Securities and Exchange Commission (“SEC” or “Commission”) has failed to allege any facts with any degree of specificity that suggest that any money Lynn Smith allegedly received from the Defendants were derived from illegal profits. As a result, it has failed to state a claim upon which relief may be granted against Lynn Smith and consequently, the Court may not invoke subject matter jurisdiction over this non-culpable relief defendant.

Lynn Smith is also not a properly named Defendant in this action. The Court does not retain subject matter jurisdiction over Lynn Smith because the Court does not have subject jurisdiction of Lynn Smith as a relief defendant. In addition, the state claim does not share a common nucleus of facts with the underlying federal matter to warrant exercising pendent jurisdiction and it presents a novel issue of state law. Even if it were determined the Court has pendent jurisdiction over the state claim, the Plaintiff has failed to state a claim for which relief can be granted because the plaintiff cannot stand in the shoes of alleged wronged investors in order to claim itself as a legitimate creditor under the New York State Creditor Debtor law. It also fails to state a cause of action under the state law because the law of the case is that the stock Lynn Smith allegedly fraudulently transferred to the trust account were hers and hers alone and were not derived from any ill-gotten gains. Since this stock does not constitute a tainted asset, no present or future creditor of her husband, including the SEC, has a legitimate claim to such funds.

STATEMENT OF THE FACTS

This securities action was originally against seven corporate defendants and two individual defendants alleging violations of the Securities Act of 1933, the Securities Act of 1934, the Investment Advisors Act of 1940, and the Investment Company Act of 1940 (“Securities Defendants”). The original complaint was filed on April 20, 2010 naming Lynn Smith as a “relief defendant” alleging that she received and retained ill-gotten gains without consideration from the Securities Defendants’ alleged fraud (Doc. 1). Lynn Smith, being the wife of one of the Securities Defendants, is alleged to have utilized her personal account as a mere repository of gratuitous transfers of illegal profits derived from her husband and the other Securities Defendants’ alleged fraudulent conduct. Significantly, the original Complaint did not assert any causes of action against Lynn Smith nor did it allege that she violated any federal laws or participated in the alleged acts that sought to defraud investors. A Motion to Dismiss the original Complaint was subsequently filed with the Court (Doc. 69) on June 9, 2010 by Lynn Smith.

Simultaneous with the filing of its original Complaint, the Court issued an Order to Show Cause, Temporary Restraining Order, and Order Freezing Assets and Granting Other Relief that, among other things, froze the relief defendant’s assets, including a Stock Account (“Stock Account”) that has been individually owned and maintained by Lynn Smith since 1969 when she inherited it upon her father’s passing. The freeze also included her checking account, the Vero Beach home that was in her name and funds that were transferred from her Stock Account to the David L. Smith and Lynn A. Smith Irrevocable Trust U/A on August 4, 2004 (“Trust”). The Trust, as a separate legal entity, was permitted by the Court to intervene in this action on June 1, 2010.

Following six weeks of discovery, the Court conducted a hearing on June 9 through June 11, 2010, on the SEC's Preliminary Injunction Motion to maintain the freeze of both Lynn Smith's assets and the assets in the Trust. On July 7, 2010, the Court issued a Memorandum-Decision and Order ("Order") that, among other things, granted the Commission's motion as to Lynn Smith's Stock Account, checking account and her Vero Beach house based on two separate theories that Lynn Smith was the recipient of ill-gotten gains or, alternatively, her husband Securities Defendant David Smith was a joint owner of the Stock Account and her other frozen assets.¹ However, the Court denied the SEC's application as it relates to the Trust finding that the source of stock that was used to originally fund the Trust were the untainted assets of Lynn Smith. It also found, in the alternative that David Smith had no equitable ownership in the Trust to warrant the preservation of the freeze on those assets.

The SEC thereafter filed a Motion to Reconsider the Court's decision relating to the Trust. That decision was handed down on November 22, 2010 in which Magistrate Judge Homer granted the SEC's Motion for Reconsideration and accordingly froze those Trust assets on the grounds that David Smith possessed an ownership interest in the Trust based on new evidence in the form of an Annuity Agreement. *The decision however did not change the Magistrate's findings that the stock originally used to fund the Trust was an untainted asset in the name of Lynn Smith* (Doc. 194).

At approximately the same time the SEC filed its Motion for Reconsideration, it also filed an Amended Complaint as of right on August 3, 2010, and consequently, Lynn Smith voluntarily withdrew her Motion to Dismiss. The Amended Complaint once again

¹ The portion of the Order that authorized the on-going freeze of Lynn Smith's assets has been appealed to the U.S. Court of Appeals, Second Circuit.

names Lynn Smith as a “relief defendant” along with the wife of another named defendant, Nancy McGinn. However, this time the SEC also names Lynn Smith as a defendant based on a new and novel allegation that she intentionally defrauded present or future creditors when she transferred stock from her account in 2004 to fund the Trust in violation of the New York State Debtor and Creditor Law. This is the same stock that Judge Homer determined was Lynn Smith’s legitimate and untainted asset. Significantly, and once again, the Amended Complaint does not assert any federal cause of action against Lynn Smith nor does it allege that she has violated any federal laws.

Lynn Smith now tenders this Motion to Dismiss the Amended Complaint both in her capacity as a named relief defendant and as a defendant to this action.

POINT 1

**THE SEC HAS NOT ADEQUATELY ALLEGED THAT
LYNN SMITH IS A PROPER RELIEF DEFENDANT**

A relief defendant, sometimes referred to as a “nominal defendant,” is a mere custodian of ill-gotten property received gratuitously from the true defendant and to which the relief defendant has no legitimate right. SEC v. Cavanaugh, 155 F.3d 129, (2nd Cir. 1998). Because such a party is functionally just a repository of the defendant’s assets, it is deemed to fall within the Court’s subject matter jurisdiction over the defendant’s conduct and property and it may be required to disgorge assets that are in truth the defendant’s “ill-gotten” assets. This is not the case here.

The critical inquiry, for both subject matter jurisdiction and the availability of disgorgement from Lynn Smith is whether she is properly named as a relief defendant. A proper relief defendant “has no legitimate claim to the disputed property.” SEC v. Ross, 504 F.3d 1130 (9th Cir. 2007). Rather, a relief defendant is joined “purely as a means of facilitating collection” of the defendants assets in its custody when the defendant’s liability is ultimately established. SEC v. Colello, 139 F.3d 674, 676 (9th Cir. 1998). See also, CFTC v. Kimberlynn Creek Ranch, Inc., 276 F.3d 187, 191 (4th Cir. 2002) (a nominal defendant is joined as a means of facilitating collection at the resolution of the matter). Since a relief defendant is not accused of any wrongdoing and is joined to aid in the recovery of the defendant’s property, it is not necessary to set forth a separate basis for subject matter jurisdiction beyond that over the action involving the defendants’ alleged violations. See, Kimberlynn Creek Ranch, Inc., at 191-92.

However, the relief defendant doctrine applies only in limited circumstances in that a federal court may order equitable relief against such a person where that person (1)

has received ill-gotten funds, and (2) does not have a legitimate claim to those funds. CFTC v. Walsh, 2009 U.S. Dist. LEXIS 71617 (S.D.N.Y. Aug. 4 2009), citing, SEC v. Cavanaugh, supra at 136. It is the SEC's burden to show this test is met, because the existence of ill-gotten gains and "the lack of a legitimate claim to the funds is the defining element of a nominal defendant." See, Colello at 677. See also, FTC v. Bronson Partners, LLC 674 F.Supp. 2d 373, 392 (D. Conn. 2008) (the burden rests with the Commission to show that the funds in the possession of [the relief defendant] are ill-gotten). Significantly, "the ill-gotten gains must be linked to the unlawful practices of the liable defendants." SEC v. McGinn, Smith & Co. et al, 2010 U.S. Dist. LEXIS 125862, 24 (N.D.N.Y. July 7, 2010) citing, FTC v. Bronson Partners, LLC, 674 F. Supp. 2d 373, 392 (D. Conn. 2009) (citations omitted).

Here, the SEC's Amended Complaint does not allege that the assets Lynn Smith allegedly received from the Defendants were the result of fraud or otherwise ill-gotten. While the SEC does identify a number of incidents in which Lynn Smith is the recipient of assets allegedly without consideration from various defendants, they fail to allege that these assets were derived from fraudulently obtained investments or ill-gotten profits. Consequently, the SEC has failed to meet its burden to establish both a substantive foundation for an ancillary disgorgement remedy and subject matter jurisdiction.

A. Plaintiff Fails to Allege a Valid Basis for a Disgorgement Remedy Against Lynn Smith pursuant to F.R.C.P. 12(b)(6)

Under Rule 12(b)(6), a complaint should be dismissed for failure to state a claim if the allegations in the complaint, taken as true, do not constitute a valid claim. Mills v. Foremost Ins. Co., 511 F.3d 1300, 1303 (11th Cir. 2008). "[A] plaintiff's obligation to provide the grounds of his entitlement to relief requires more than labels and conclusions,

and a formulaic recitation of the elements of a cause of action will not do.” Bell Atl. Corp. v. Twombly, 550 U.S. 544 (2007). “To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to ‘state a claim to relief that is plausible on its face.’” Teamsters Allied Benefit Funds v. McGraw-Hill Companies, Inc., 2010 U.S. Dist. LEXIS 23052 (S.D.N.Y. Mar. 10, 2010), citing, Ashcroft v. Iqbal, 129 S. Ct. 1937, 1949 (2009). The SEC here fails to state a valid basis for the ancillary disgorgement remedy it seeks against Lynn Smith as an alleged holder of the Securities Defendants’ assets in that it does not plead a proper basis for treatment as a relief defendant. Also, the SEC does not state any substantive claim of securities violations by Lynn Smith that could give rise to a disgorgement remedy based upon her own conduct.

Normally, disgorgement is obtained from a culpable defendant, its primary purpose being “to ensure that those guilty of securities fraud do not profit from their ill-gotten gains.” SEC v. One Wall Street, Inc., 2008 U.S. Dist. LEXIS 97387, *3 (E.D.N.Y. Nov. 26, 2008) (quoting SEC v. Wang, 944 F.2d 80, 81 (2d Cir. 1991)). It is imposed upon those who commit violations “for the purpose of depriving the wrongdoer of his ill-gotten gains and deterring violations of the law.” CFTC v. American Metals Exchange Corp., 991 F.2d 71 (3d Cir. 1993); SEC v. Better Life Club of Am., Inc., 995 F.Supp. 167, 179 (D.D.C. 1998). See also, SEC v. ETS Payphones, Inc., 408 F.3d 727, 735 (11th Cir. 2005) (the “power to order disgorgement extends only to the amount with interest by which the defendant profited from his wrongdoing”).

Here, it is evident from the Commission’s Amended Complaint that the SEC has failed to allege that any of the named Securities Defendants actually “profited” by their alleged fraudulent activities making the Commission’s demand for disgorgement on these

parties as suspect as its demand for the same equitable relief on Lynn Smith. A review of the Complaint reflects the Commission's effort to advance its theories of fraud and misrepresentation perpetrated by the Securities Defendants in violation of the federal statutes cited. However, the Complaint is silent as to how the Defendants' illegally profited by these alleged fraudulent activities. For example, paragraphs 34-62 outline the alleged fraudulent scheme behind the Four Funds. The allegations are essentially summarized in paragraph 2 of the Complaint:

McGinn, Smith, MS & Co., MS Advisors and MS Capital deceived investors in the Four Funds. They told investors that their money would be invested and that the McGinn Smith Entities' profits would depend on the spread between the cost of the investment and the rate of return. Instead, the Defendants secretly funneled investor money to entities they owned or controlled, even though this was not permitted by offering materials. Defendants concealed from investors the truth about the Four Funds, including the fact that investor money was being routed to in-house entities controlled by Smith and McGinn and to other non-public and illiquid investments, and that these actions were having a disastrous impact on the investors.

Of those 38 paragraphs only one paragraph alleges that certain fees and commissions were received as part of those offerings but significantly does not characterize or otherwise allege that those fees constituted ill-gotten gains.

The same holds true for the Trust Offerings. Unlike the allegations set forth relating to the Four Funds, the Commission does in fact allege that the Defendants were the recipients of "excessive" commissions, transaction fees and other material benefits resulting from these Trust offerings. (SEC Amended Cplt. ¶¶67, 73, 81, 92, 99, 100 and 101). However, the Commission never alleges that these "excessive fees" and other material benefits translate to "ill-gotten gains" or found their way into any account owned by Lynn Smith.

As for Lynn Smith, she is not a defendant alleged to have violated any securities laws. The only possible basis for disgorgement against her would be if she met the two-part “ill-gotten gains” and “no legitimate claim” test articulated in Cavanaugh. The Amended Complaint fails to allege facts that satisfy the first prong of this test. As with the case of the Securities Defendants, there are no allegations that support the supposition that ill-gotten gains resulted from the Securities Defendants’ alleged conduct and certainly no allegations that Lynn Smith was the recipient of such funds.

The SEC’s 44 page Amended Complaint consists of 173 numbered paragraphs of which four reference the terms “ill-gotten gains” or “illegal proceeds”. These four paragraphs set forth only conclusory statements that rise to nothing more than “a formulaic recitation of the elements of a cause of action” necessary to disgorge funds from a relief defendant, Bell Atl. Corp. v. Twombly, 550 U.S. 544 (2007), and are consequently insufficient to hold Lynn Smith as a relief defendant. To be sure, the following is the universe of allegations and statements proffered by the Commission against the relief defendant alleging that she is the recipient of ill-gotten gains:

¶ 16. L. Smith and N. McGinn, as relief defendants, have received and retained ill-gotten gains from defendants’ fraud.

109. L. Smith maintained a brokerage account as MS & Co. which in 2010 was transferred to NFS/RMR Capital Management (the “Stock Account”). Smith exercised beneficial ownership and unfettered control over the Stock Account for at least fifteen years. L. Smith allowed Smith, McGinn and the McGinn Smith Entities to draw upon the Stock Account for business and personal needs without restrictions, and the Stock Account served as a de facto financing arm for Smith and McGinn and the McGinn Smith Entities during the period of the fraud. L. Smith allowed Smith to use the Stock Account as a personal line of credit to further his personal and professional interests. Internal e-mails during the period of the fraud show McGinn Smith employees freely transferring money into and out of the Stock Account, which contained ill-gotten gains.

¶167. Relief Defendants L. Smith and N. McGinn were recipients, without consideration, of proceeds of the fraudulent and illegal sales of securities alleged above. The Relief Defendants profited from such receipt or from the fraudulent and illegal sales of securities alleged above by obtaining illegal proceeds under circumstances in which it is not just, equitable, or conscionable for them to retain the illegal proceeds. Consequently, L. Smith and N. McGinn have each been named as a Relief Defendant for the amount of proceeds by which she has been unjustly enriched as a result of the fraudulent scheme or illegal sales transaction.

142. By reason of the foregoing, Lynn Smith should disgorge her ill-gotten gains, plus prejudgment interest.

The SEC does make a number of allegations that Lynn Smith was the recipient of assets “without consideration” presumably with the intent of alleging sufficient facts to satisfy the second element of the Cavanaugh test. In fact there is even a separate section in the Amended Complaint entitled, “**Transfers to L. Smith and N. McGinn Without Consideration**”. However, the SEC fails to tie the receipt of these assets to any fraudulent act on the part of the Securities Defendants to even remotely suggest that the funds were derived from illegal profits resulting from the alleged fraud on investors. See paragraphs 78, 81, 107, 108, 110-118. Instead, the SEC is *presuming* that any assets that came from the Securities Defendants, including the husband of Lynn Smith must have been derived from illegal profits. Movants submit that making this assumption is a gross departure from what is required to state a valid claim under the law.

To the extent that the SEC can show that ill-gotten gains were in fact received by the Defendants from its alleged fraudulent activities which it has failed to do in its Amended Complaint, it has failed to further demonstrate the reasonable and approximate value of such gains. The SEC bears the ultimate burden of persuasion that its ultimate disgorgement figure, if realized, reasonably approximates the amount of unjust enrichment. SEC v. Aimsi Techs., Inc., 650 F.Supp. 2d 296, 304 (S.D.N.Y. 2007), citing,

SEC v. Opulentica, 479 F.Supp. 2d 319 (S.D.N.Y. 2007). Only after the SEC has made a reasonable showing of defendants' illicit profits, does the burden shift to the defendant to show that the disgorgement figure was not a reasonable approximation. SEC v. Aimsi Techs., Inc. at 304.

In this case, the SEC has made no effort to allege the reasonable value of Defendants' alleged ill-gotten gains or even to identify what "gains" it alleges were "ill-gotten" but rather has elected to seek disgorgement of all Securities Defendants' assets including all of the individual assets of the relief defendant. Granted, the SEC does allege that "Lynn Smith received more than \$1.8 million from Smith and the Securities Defendants during the period of the fraud," they do not allege the source of the funds, the dates the funds were allegedly transferred or the accounts from which they were transferred all of which is necessary to make the critical determination whether these assets are in fact derived from ill-gotten funds.

Because the SEC has failed to plead facts sufficient to support its claim that Lynn Smith was the recipient of ill-gotten gains which is a defining element of valid nominal defendant status, the Commission's Amended Complaint seeking a disgorgement remedy on a nominal defendant theory must be dismissed.

B. Plaintiff Has Failed to Establish Subject Matter Jurisdiction Over Lynn Smith as a Relief Defendant.

Whether Lynn Smith is properly named as a relief defendant is also critical in determining whether or not this Court has subject matter jurisdiction over this non-culpable party. If a party is a properly named relief defendant, it falls within the jurisdiction covering the substantive claims against the actual defendants, but if not, then there must be a separate basis for subject matter jurisdiction, and full due process, prior to

any final equitable relief being ordered against the relief defendant. SEC v. Cherif, 933 F.2d 403, 413-14 (7th Cir. 1991). The court in CFTC v. Kimberlynn Creek Ranch, Inc., 276 F.3d 187 (4th Cir. 2002) explains the jurisdictional theory behind this “obscure common law concept”:

A ‘nominal defendant’ is a person who can be joined to aid the recovery of relief without an [additional] assertion of subject matter jurisdiction only because he has no ownership interest in the property which is the subject of the litigation. Because a nominal defendant has no ownership interest in the funds at issue, once the district court has acquired subject matter jurisdiction over the litigation regarding the conduct that produced the funds, it is not necessary for the court to separately obtain subject matter jurisdiction over the claim to the funds held by the nominal defendant; rather, the nominal defendant is joined purely as a means of facilitating collection. In short, a nominal defendant is part of a suit only as the holder of assets that must be recovered in order to afford complete relief; no cause of action is asserted against a nominal defendant.

The plaintiff bears the burden of establishing subject matter jurisdiction. Taylor v. Appleton, 30 F.3d 1365 (11th Cir. 1994); see, SEC v. Colello, 139 F.3d 674, 677 (9th Cir. 1998) (SEC’s burden to show the test for nominal defendant status is met); United States CFTC v. Sarvey, 2008 U.S. Dist. LEXIS 54566, *7 (N.D. Ill. 2008) (the party asserting jurisdiction must establish it by competent proof).

Challenges to subject matter jurisdiction under F.R.C.P. Rule 12(b)(1) may be raised “facially” and “factually.” Under a “facial” challenge, if the allegations in the complaint, taken as true, do not allege a sufficient basis for subject matter jurisdiction, then the complaint should be dismissed. Lawrence v. Dunbar, 919 F.2d 1525, 1529 (11th Cir. 1990).

The SEC has failed to meet its burden pursuant to a facial challenge under F.R.C.P 12(b)(1) by showing that Lynn Smith received ill-gotten funds under the same

analysis as set forth in Point I(A). Since that showing is the “defining element” of proper relief defendant status, see, Colello at 677, without it the SEC has no basis to bring Lynn Smith within the Court’s subject matter jurisdiction over the Securities Defendants or ultimately obtain the equitable disgorgement remedy it seeks against Lynn Smith as a non-culpable party.

POINT II

THE COURT DOES NOT HAVE JURISDICTION OVER LYNN SMITH, AS A DEFENDANT, BASED ON ALLEGATIONS SHE VIOLATED THE NEW YORK STATE DEBTOR AND CREDITOR LAW

- A. Without having subject matter jurisdiction over Lynn Smith as a relief defendant, the Court cannot maintain supplemental jurisdiction over the state claim against Lynn Smith, as a defendant.**

Under 28 U.S.C. §1367(a), district courts have supplemental jurisdiction over all other claims that are so related to claims in the action within such original jurisdiction that they form part of the same case or controversy under Article III of the United States Constitution. While the district court may, at its discretion, exercise supplemental jurisdiction over state law claims even where it has dismissed all claims over which it had original jurisdiction (see 28 U.S.C. §1367(c)(3)), it cannot exercise supplemental jurisdiction unless there is first a proper basis for original federal jurisdiction. Nowak v. Ironworkers Local 6 Pension Fund, 81 F.3d 1182, 1187 (2nd Cir. 1995) citing, Cushing v. Moore, 970 F.2d 1103, 1106 (2nd Cir. 1992).

Because the SEC has failed to adequately allege that Lynn Smith is the recipient of ill-gotten gains, a key element in this Court obtaining original jurisdiction over her as a relief defendant, there can be no supplemental jurisdiction over the state law claim nor does the Court have the discretion to exercise such pendent jurisdiction.

- B. Even if the Court finds that it has original jurisdiction over Lynn Smith, the nature of the federal claim and the state claim are so far removed that the Court should not exercise pendent jurisdiction over the state claim concerning Lynn Smith.**

Congress has authorized district courts to exercise jurisdiction supplemental to their federal question jurisdiction in 28 U.S.C. §1367(a). Pursuant to paragraph (a) of that statute, supplemental jurisdiction is appropriate if the claims are so related...that they

form part of the same case or controversy. To be part of the same case or controversy, the U.S. Supreme Court has held “the state and federal claims must derive from a common nucleus of operative fact.” United Mine Workers v. Gibbs, 383 U.S. 715, 725 (1966); Achtman et al. v. Kirby, Mcinerney & Squire, LLP et al., 464 F.3d 328, 335 (2nd Cir. 2006). In most instances the question whether Article III is satisfied is obvious. For example, when the same acts violate parallel federal and state laws, the common nucleus of operative facts is clear and federal courts routinely exercise supplemental jurisdiction over the state law claims. See, e.g., Pueblo Int’l, Inc. v. DeCardona, 725 F.2d 823, 826 (1st Cir. 1984) (“finding jurisdiction over claims under Puerto Rico constitution, civil rights laws and antitrust laws where federal jurisdiction was established under parallel laws, observing that “[t]he facts necessary to prove a violation of one are practically the same as those needed to prove a violation of the other”). In other cases the line is not so clear and courts have relied on certain principals to guide this fact sensitive inquiry. For example, supplemental jurisdiction is lacking where the federal and state claims rest on essentially unrelated facts. McConnell et al. v. Costigan, et al., 2000 U.S. Dist. LEXIS 16592 (S.D.N.Y. 2000). However, where facts underlying the federal and state claims substantially overlap or where the presentation of the federal claim necessarily brings the facts underlying the state claim before the court, the court may exercise pendent jurisdiction to hear the state claim. Id.

In this case, no one could argue in good faith that the federal security claims brought against the Securities Defendants are in any way parallel in nature to the state claim of fraudulent conveyance particularly as it relates to Lynn Smith as a relief defendant. This conclusion is supported by the following uncontested facts as it relates to

Lynn Smith both in the context of the SEC's lawsuit against the Securities Defendants including her husband David Smith and the Stock Account that is the subject of SEC's claim under New York State fraudulent conveyance statute.²

Lynn Smith has been the wife of David Smith since 1968. In 1969, Lynn Smith's father died and she was left a Stock Account then valued at approximately \$60,000.00 and a camp on Great Sacandaga Lake. It is undisputed that these inheritances have always been maintained solely in Lynn Smith's name. The Stock Account was managed for the first few years by the firm retained by Lynn Smith's father. When David Smith became a licensed broker in the mid-1970's, he assumed management of the account first with the firm Bache & Co. and then with several other brokerage houses where David worked during that time period. In 1980, David Smith and Tim McGinn formed McGinn, Smith & Co. and Lynn Smith's account was thereafter managed by the McGinn, Smith & Co. firm and in particular, her husband/stockbroker up and until the SEC initiated its civil action against the Securities Defendants. During the period since the account was first opened, the value of the account grew from a low \$100,000 in the 1970's to a high of over \$7 million in 2001.

It was not until September 2003 when the SEC alleges that the first acts of fraud occurred by the Securities Defendants. Significantly, at no time prior to 2003 or any time thereafter including up to the present day has Lynn Smith been alleged to have engaged in any securities fraud violations or do the facts reveal she had any knowledge of any alleged illicit practices as evidenced by an undated handwritten note referenced as David Smith's "personal confession" by the SEC's in its Amended Complaint at ¶129 and as set

² Many if not all of these facts are set forth in Magistrate Judge David Homer's Memorandum-Decision and Order for Preliminary Injunctive Relief, dated July 7, 2010, Doc. 86, reported as SEC v. McGinn, Smith & Co. et al, 2010 U.S. Dist. LEXIS 125862 (N.D.N.Y. July 7, 2010)

forth in full in Doc. 117. In that note, David Smith explicitly states that he “had not shared any of this [his concern over the company’s business dealings] with Lynn, I assume because I have determined that it won’t be helpful.” Furthermore, as one might expect, prior to 2003, there has been no question that Lynn Smith was the absolute owner of the Stock Account. This is particularly true as it relates to the specific Charter One stock that was used to fund the Trust on August 4, 2004 and which constitutes the funds that the SEC now allege Lynn Smith had a hand in fraudulently conveying.

Magistrate Judge Homer determined that the stocks used to fund the Trust were originally purchased at the initial offering of an Albany-area bank in the early 1990s for \$400,000. Through various bank mergers and acquisitions, the number of shares of this stock increased dramatically and by 2004 the value of the stock was \$4 million. Judge Homer specifically found that the stock which funded the Trust was owned by Lynn Smith alone and did not constitute an “ill gotten gain” resulting from her husband’s or other Securities Defendants’ alleged fraudulent conduct. Homer Decision, dated July 7, 2010, p. 37, Doc. 86, as reported cite (page 58 of reported decision).³

In consideration of these facts, the question becomes, from a pendent jurisdiction perspective, whether the federal securities law violations that provide the Court with subject matter jurisdiction over Lynn Smith as an alleged relief defendant shares a

³ In analyzing whether to maintain the asset freeze as to the Trust pursuant to a temporary restraining order, Judge Homer considered two separate theories. The first was whether the SEC demonstrated a likelihood that it could prove the Trust was a Relief Defendant. The second was whether the SEC could prove David Smith had a joint ownership interest in the Trust. In his July 7, 2010 decision, he found that the Trust was neither an appropriate relief defendant nor that David Smith had any ownership interest in the Trust and therefore released the Trust from the freeze. Upon reconsideration, Judge Homer overturned his ruling as to David Smith’s equitable ownership interests in the Trust but significantly he did not disturb his findings that the Trust was not the recipient of ill-gotten gains (since the stock used to fund the Trust was not ill-gotten) and therefore the Trust was not named as an appropriate relief defendant. (Judge Homer’s Order Upon Reconsideration dated November 22, 2010 (Doc. 194). Accordingly, since this determination was not reversed upon the Court’s reconsideration and the SEC has not taken an appeal on this issue, Judge Homer’s ruling that the Trust is not an appropriate relief defendant is dispositive.

“common nucleus” of facts over Lynn Smith as a defendant in a state fraudulent conveyance claim. Here, the SEC’s claims brought against the Securities Defendants certainly cannot be deemed parallel in nature to the state claim of fraudulent conveyance as it relates to Lynn Smith as a relief defendant. Therefore a more rigorous analysis is warranted. Indeed, in this case the Court must not only consider the relationship between the securities laws violations with the state fraudulent conveyance statute but, and most importantly, it must do so in the context of Lynn Smith, as an innocent and nominal party to the federal litigation and as the absolute owner of untainted funds that were allegedly fraudulently conveyed to the Trust.

The federal claims essentially allege that the Securities Defendants violated several securities laws by engaging in an orchestrated effort to defraud their investors for their own personal gain. The SEC’s Complaint alleges that the fraud began no earlier than September, 2003. All the facts necessary to prove the fraud of the Securities Defendants will have arisen well after Lynn Smith inherited her Stock Account and maintained it as her own throughout her relationship with her husband David Smith. Furthermore, it was only a matter of months after the first allegation of fraud that Lynn Smith transferred her untainted stock to the Trust.

In addition, as a nominal defendant in the federal lawsuit, the only relevant fact as it relates to Lynn Smith is whether she is the recipient of ill-gotten gains for which she received for no consideration. See SEC v. Cavanaugh, supra. Despite the limited scope of her involvement in the federal securities claims, the SEC now seek to find her liable for fraudulently conveying certain assets from her individual Stock Account, her individual checking account and the Vero Beach property based on the New York State

Debtor and Creditor Law. However to find Lynn Smith liable of a fraudulent conveyance under New York State law, it must be proven that she had “actual intent...to hinder, delay, or defraud either present or future creditors...” N.Y. Debtor and Creditor Law §276. Whether Lynn Smith is the recipient of ill-gotten gains without consideration as opposed to one who intentionally committed fraud by conveying certain property are factually distinct claims and accordingly are not derived from a common nucleus of operative facts. Indeed, in order to prove Lynn Smith liable under the state statute, a much broader scope of proof will be required. Her intent to defraud for example is an element that is not relevant to the government’s claim against her in the capacity of a relief defendant but now becomes a major factor in holding her liable under the State claim. Since the federal and state claims rest on essentially unrelated facts, supplemental jurisdiction is lacking. McConnell supra at 13.

Furthermore, as set forth in more detail in Point III herein, the state claim presents a novel issue as to whether the SEC can bring an action as a “Creditor” as defined and interpreted under New York State law. “Even where a court may exercise supplemental jurisdiction ...it may nonetheless decline to exercise that jurisdiction where the state law claims raise novel or complex issues of state law.” Id. Significantly, a determination by this Court as to whether the SEC is an appropriate Creditor under New York State law is unnecessary in order to resolve the federal claims against the Securities Defendants or Lynn Smith as a relief defendant. Id.

Finally, it is questionable that this Court can maintain pendent jurisdiction over a claim of fraudulent conveyance when the law of the case is dispositive that the funds alleged to have been fraudulently conveyed from the Stock Account have been deemed to

have been owned free and clear by Lynn Smith rather than constituting ill-gotten gains arising from the Securities Defendants' alleged securities law violations.

POINT III

THE SEC IS NOT A CREDITOR UNDER THE N.Y. STATE DEBTOR CREDITOR LAW

The definition of the term “Creditor” as used in the New York State Debtor and Creditor law “is a person having any claim, whether matured or unmatured, liquidated or unliquidated, absolute, fixed or contingent.” N.Y. Debtor and Creditor Law §276. While it would appear that this definition is broad in scope, the Second Circuit has made it clear the term “Creditor” has its limitations and is an element that must be substantiated before a party can prosecute a claim under this statute:

In keeping with centuries of common law and statutory tradition, state and federal courts construing section 276 have continued to allow only creditors to set aside fraudulent transactions. Non-creditors can find no relief in a statute whose “object...is to enable a creditor to obtain his due despite efforts on the part of a debtor to elude payment.” [citation omitted] “[E]ven if a transfer is made with actual intent to defraud creditors, one must be a creditor in order to complain. [citations omitted] Eberhard v. Marcu, 530 F.3d 122, 132-133 (2nd Cir. 2008) (emphasis added)

In addition, New York State law is clear that even a creditor, as defined under the Debtor and Creditor Law, may not institute a civil action in a representative capacity...Plaintiff may act in his own right only. Lazar v. Towne House Restaurant Corp. et al., 142 N.Y.S.2d 315, 321-322 (Sup. Ct. Queens Cty 1955), aff’d 171 N.Y.S.2d 334 (2nd Dep’t 1958) citing Guenbaum v. Lissauer, 57 N.Y.S.2d 137, 145, aff’d 61 N.Y.S. 2d 372 (1st Dep’t 1946).

It is the contention of Defendant Lynn Smith that the SEC does not constitute a “Creditor” for purposes of prosecuting a claim under New York law. Rather it is only the individual creditors who have standing to seek the remedies afforded under Debtor and Creditor law against Lynn Smith.

The SEC is a federal agency which holds primary responsibility for enforcing the federal securities laws and regulating the securities industry, the nation's stock and options exchanges and other electronic securities markets in the United State. SEC Webpage, <http://www.sec.gov/about/whatwedo.shtml>. The responsibility of the SEC's Division of Enforcement includes investigations into possible violation of the federal securities laws, and the prosecution of the Commission's civil suits in federal courts as well as its administrative proceedings. SEC Webpage, <http://www.sec.gov/divisions/enforce/about.htm>. According to its webpage, "The Division of Enforcement's mandate is to protect investors," but adds the following caveat:

While in some cases, ill-gotten gains disgorged by [sic] defendants are returned to defrauded investors, the Commission is *not authorized to act on behalf of individual investors*. If you believe you have been defrauded, you should discuss the matter with a private attorney who is familiar with securities laws to ensure that your rights are protected under federal and state law.

Furthermore, case law confirms that making defrauded investors whole is secondary to the goal of depriving violators the unjust enrichment of their illegal profits:

Although disgorged profits may be distributed to defrauded investors, the primary purpose of disgorgement orders is to deter violations of the securities laws by depriving violators of their ill-gotten gains. Official Committee of Unsecured Creditors of Worldcom, Inc. v. SEC et al., 467 F3d 73 (2nd Cir. 2006), See also Cavanaugh supra. (the primary purpose of disgorgement is not to compensate investors); SEC v. Absolute Future.com, 393 F3d 94 (2nd Cir. 2004) (the primary purpose of disgorgement is to correct unjust enrichment rather than to compensate investors).

Both sources of authority clearly demonstrate that the SEC does not in and of itself have a viable claim to secure the remedies under the Debtor and Creditor law since it neither "steps in the shoes" of defrauded victims nor does it represent their individual interests. Even if somehow the SEC could argue that it is acting in a representative

capacity, the law in New York State as alluded to above clearly does not allow the statute to be used for such purposes.

In the event the SEC attempts to argue that its state fraudulent conveyance claim against Lynn Smith can be brought in its own right based on a claim of disgorgement, the law of the case again proves otherwise. As previously noted, Magistrate Judge Homer, in his original Order granted the Trust's motion to lift the temporary restraining order based in part that funds used to fund the Trust in 2004 were with stock that was *untainted, easily identifiable and severable* from the Stock Account as a whole. Order, dated July 7, 2010, p. 38 citing SEC v. Heden, 51 F. Supp.2d 296 (S.D.N.Y. 1999) (explaining that it is inappropriate to freeze assets initially used to purchase legitimate investments, regardless of the authenticity of the later transfers with the stock, but, the subsequently earned proceeds of the stock, if fraudulently obtained, may represent ill-gotten gains). In addition, Judge Homer determined that:

There is no evidence that the purchase or sale of the bank stock was fraudulent or otherwise illegal. By all accounts, the stock was purchased for value. Thus, appropriate consideration was provided for the purchase and the Smiths had a legitimate interest in the eventual growth, sale, and proceeds of the bank stock at a time predating the commencement of the scheme alleged herein. [citation omitted] Id.

Despite Judge Homer's Order on Reconsideration to "re-freeze" the Trust based on the discovery of what the Judge deemed "new evidence" in the form of an Annuity Agreement, he did not disturb his findings that the stock that was originally used to fund the Trust came from untainted funds from Lynn Smith's account. Rather the Judge rested his decision entirely on the fact that David Smith, based on the prospect of obtaining annuity payments in the future from the Trust, now had a joint or equitable interest in that Trust.

The SEC now alleges that Lynn Smith fraudulently conveyed these funds in 2004 and that the transaction that caused the Trust to be created should be voided. However, since the law of the case remains that the Trust was not created with ill-gotten gains, by voiding the 2004 transaction that created the Trust it would mean that the monies used to fund it would revert back into Lynn Smith's account and consequently, the SEC would have no grounds for the disgorgement of those funds.

Whether the SEC portrays itself as the champion of defrauded victims or whether it deems itself as having its own right to sue Lynn Smith under the New York State Debtor and Creditor law, it is not a "Creditor" as that term is intended to apply under the law. Accordingly, the Court should dismiss the state claim as it relates to Lynn Smith.

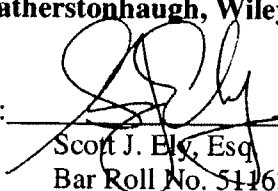
CONCLUSION

The Amended Complaint should be dismissed against Lynn Smith, as a relief defendant, for both lack of subject matter jurisdiction and failure to state a claim on which relief can be granted. The Amended Complaint should be dismissed against Lynn Smith, as a defendant, since as a matter of law the Court should not exercise pendent jurisdiction over the State claim or, in the alternative, the SEC has failed to state a claim upon which relief may be granted under the New York State Debtor and Creditor law.

DATED: December 15, 2010

Featherstonhaugh, Wiley & Clyne, LLP

By: _____


Scott J. Elg, Esq.
Bar Roll No. 511635

*Attorneys for Relief Defendant/Defendant,
Lynn A. Smith*
99 Pine Street, Suite 207
Albany, NY 12207
Tel: (518) 436-0786
Fax: (518) 427-0452

TO: David Stoelting
Securities and Exchange Commission
Attorney for Plaintiff
3 World Financial Center, Room 400
New York, NY 10281
stoeltingd@sec.gov

Kevin McGrath
Securities and Exchange Commission
Attorney for Plaintiff
3 World Financial Center, Room 400
New York, NY 10281
mcgrathk@sec.gov

Jill A. Dunn
The Dunn Law Firm PLLC
Attorney for Defendant and Intervenor

David M. Wojeski, Defendants
Geoffrey R. Smith and Lauren T. Smith
99 Pine Street, Suite 210
Albany, New York 12207-2776
Jdunn708@nycap.rr.com

Martin P. Russo
Alison B. Cohen
Gusrae, Kaplan Law Firm
Attorneys for Defendants Timothy M. McGinn
and David L. Smith
120 Wall Street
New York, New York 10005
mrusso@gkblaw.com

Nancy McGinn
29 Port Huron Drive
Schenectady, NY 12309
nemcginn@yahoo.com

William Brown, Esq.
Phillips Lytle LLP
Attorneys for Receiver
3400 HSBC Center
Buffalo, N.Y. 14203
WBrown@phillipslytle.com