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.	:	

PLAINTIFF'S MEMORANDUM OF LAW IN OPPOSITION TO ATTORNEY JILL DUNN'S REQUEST FOR A STAY OF SANCTIONS

CONTENTS

Plaintiff Securities and Exchange Commission respectfully submits this memorandum of law opposing the application for a stay filed by attorney Jill Dunn of the sanctions imposed in the Court's Memorandum-Decision and Order dated July 20, 2011 (the "MDO IV"). (The previous relevant decisions of the Court which are referred herein are MDO I filed July 7, 2010, Dkt. 86; MDO II filed November 22, 2010, Dkt. 194; and MDO III filed January 11, 2011 Dkt. 254.)

PRELIMINARY STATEMENT

The motion to stay the sanctions imposed on Jill Dunn should be denied. As explained below, based on the consent of the parties any appeal from MDO IV should be directed to the Court of Appeals, not the District Court. In April and May 2010, the parties consented pursuant to 28 U.S.C. § 636(c) to having Magistrate Judge Homer conduct "any and all proceedings" relating to the SEC's motion for a preliminary injunction. The sanctions motion arose directly from this motion, and Dunn and her client signed a written consent form agreeing that "all proceedings" would be heard and decided by Judge Homer (Dkt. 59). Under Federal Rule of Civil Procedure 73, therefore, any appeal from MDO IV lies in the Second Circuit.

In any event, Dunn has failed to sustain her burden of demonstrating grounds for a sty, even if the District Court had jurisdiction. First, Dunn has failed to demonstrate a strong likelihood of success on the merits. MDO IV was based on an extensive evidentiary record, the proof of the false statements made by Dunn and her client is clear and convincing, and the sanctions are narrowly tailored. Dunn's primary argument, that Judge Homer erroneously characterized documents attached to a key July 21, 2010, email to her as the "Annuity Agreement," is unpersuasive because those documents, however described, informed Dunn of the existence of the Annuity Agreement, thereby rendering her subsequent statements regarding lack of knowledge intentionally false. In addition, Dunn cannot demonstrate irreparable harm in

the absence of a stay because having to disgorge money is not irreparable harm and, as Dunn acknowledges, the non-monetary sanctions have "already occurred." Dunn Br. At 5. Finally, the public interest is not served by a stay under these circumstances in which legal and accounting professionals have made false statements in sworn declarations filed with the Court.

ARGUMENT

I. The Second Circuit Has Jurisdiction Over Any Appeal

Although Dunn has a right to an appeal from MDO IV, that appeal must be directed to the Second Circuit and not the District Court. As Judge Homer found, all parties consented to the jurisdiction of the Magistrate Judge for "any and all proceedings" arising from the SEC's preliminary injunction motion, and the motion for sanctions was part of the preliminary injunction proceedings. Dunn, moreover, filed a notice of appearance in this case, thereby consenting to the Court's jurisdiction for her conduct as an attorney.

There is a significant difference between appeals from referrals under 28 U.S.C. § 636(b) and those made by consent of the parties under 28 U.S.C. § 636(c). Section 636(b) appeals are made to the District Court, but Section 636(c) appeals must be taken to the Court of Appeals. Indeed, this was the reason that Lynn Smith filed three appeals to the Second Circuit, and not the District Court, from MDO I, MDO III and another order. Those three appeals from three orders of Judge Homer were decided on August 8, 2011, when the Second Circuit affirmed the orders in their entirety. *See Smith v. SEC*, 10-3576, 11-684, 11-916 (2d Cir. Aug. 8, 2011); *Smith v. SEC*, __ F.3d __, 2011 WL 3437561 (2d Cir. 2011) (both decisions are attached as Exhibit A hereto).

The parties voluntarily consented in writing to having Magistrate Judge Homer "conduct any and all proceedings and enter a final order" regarding the SEC's motion for a preliminary injunction. Dkt. 12, 59. Judge Sharpe then signed a Reference Order authorizing Judge Homer

"to conduct all proceedings." *Id.* The consent form signed by all parties and entered by the Court described the preliminary injunction motion as a "dispositive motion." *Id.*

At the time the consents were signed, the parties understood that appeals would have to be made to the Second Circuit. The Notice provided to the parties in this action state that, if the parties consent to have proceedings conducted by the magistrate judge, then "[t]he right to appeal is automatically preserved to the United States Court of Appeals[.]" Dkt. 3, at 2. The form entitled "Consent to the Exercise of Civil Jurisdiction by a Magistrate Judge" similarly provides that "an appeal from a judgment entered by a magistrate judge will be taken to the United States Court of Appeals for this judicial circuit[.]" Dkt. 3 (Case Assignment Form), at 3. In addition, MDO II was appealed directly to the Court of Appeals. As the Advisory Committee notes to Rule 73 states, "[u]nder 20 U.S.C. 636(c)(3), the normal route of appeal from the judgment of a magistrate – ***the only available route that will be available unless the parties otherwise agree in advance*** – is an appeal by the aggrieved party 'directly to the appropriate United States court of appeals[.]" (Emphasis added.)

Dunn cites to NDNY Local Rule 72.1(b), Dunn Br. at 1, which allows appeals of "non-dispositive" orders by a magistrate judge to the district court. This rule, however, cannot apply to create a right of appeal in consensual referrals under Section 636(c). If it did then Rule 73, which states that "[in accordance with 28 U.S.C. § 636(c)(3), an appeal from a judgment entered at a magistrate judge's direction, may be taken to the court of appeals as would any other appeal from a district-court judgment," would be rendered meaningless. It is well-settled that local rules must be consistent with the Federal Rules of Civil Procedure. *See, e.g., Baum v. Syracuse Police Officer Carr*, 97-CV-18, 1998 WL 278263 at * 2 (N.D.N.Y. May 18, 1998); *De Silva v. Bluegreen Corporation,* 96-CV-683, 1997 WL 727523 at 4 (N.D.N.Y. October 7, 1997) ("Our

local rules are to be construed so as to be *consistent* with the Federal Rules, *See* Local Rule 1.1(c); Fed. R. Civ. P. 83(a).")(emphasis in original). In addition, Local Rule 72.2(b)(3) provides that when the parties consent to magistrate judge referral authority vests in the magistrate judge as if the district judge were presiding. As a result, any appeal from MDO IV should proceeds in the same manner as if it had been rendered by the district court.

Dunn does not address the issue of whether her appeal was properly filed in the District Court. The only procedural issue she raises is whether Judge Homer's "findings should be reviewed *de novo* or by a more deferential standard." Dunn Br. at 5. But the case Dunn cites to *Kiobel v. Millson,* 592 F.3d 78, 79-80 (2d Cir. 2010), is distinguishable in that it did not involve a motion referred to the magistrate judge by consent pursuant to Rule 636(c). Furthermore, it does not in any way support an argument that the magistrate judge's findings here are subject to appeal to the district court or that the magistrate judge lacked the authority to impose sanctions .

Kiobel involved sanctions that were imposed by a magistrate judge following the district court's referral pursuant to Rule 636(b)(1)(B) for a report and recommendation concerning a motion for class certification.[1] In *Kiobel,* the Court did not even reach the question as to what standard of review a district court should apply when reviewing a magistrate judge's findings regarding sanctions imposed following a referral pursuant to Rule 636(b)(1)(B) because it held that regardless of the standard of review there was no sanctionable conduct . *Id.* 592 F.3d at 83-84. The concurring opinions discussed in *dicta* whether magistrate judges are authorized to impose sanctions under the Section 636(b) process. Even the one concurring opinion that opined that a magistrate judge lacked jurisdiction to impose sanctions under Section 636(b), however,

[1] Dunn recognizes that MDO IV cannot be considered a "report-recommendation" because the relief was "instant . . . . without awaiting further action or review." Dunn Br. at 5. In addition, referrals from the Section 636(c) process cannot result in a "report-recommendation," which only come from Section 636(b) process.

agreed that "***magistrate judges have substantially greater authority when acting with the consent of the parties***." 592 F.3d 84, n.8 (emphasis added). *See also Bennett v. General Caster Service of N. Gordon Co. 976 F.2d 995, 999 fn. 9(6th Cir. 1992)*("Under 28 U.S.C. § 636(c)(1), if the parties consent and the district court so designates, a magistrate judge may exercise plenary jurisdiction. .... In both of these situations, a magistrate judge has the same jurisdiction as would the district court").

Moreover, Judge Leval, in his concurrence in *Kiobel*, found that a magistrate judge is empowered to impose sanctions, 592 F.3d at 98, regardless of whether the parties consent under Rule 636(c)(1), and noted that at least five other circuits had held similarly even prior to the 2000 amendments conferring on magistrates the power to punish contempt. 592 F.3d at 95-96 n.6. Nothing in *Kiobel* calls into question a magistrate judge's plenary power to impose sanctions, without an appeal to the district court, when the referral is pursuant to Rule 636(c)(1).

Judge Homer clearly did not view his MDO as subject to review by the district court before it would be effective, final and appealable. Rather, he ordered certain sanctions to be imposed concurrent with the issuance of the MDO, such as the public admonishment of Dunn and the forwarding by the Clerk of the MDO to the New York State Committee on Professional Standards for the Appellate Division; he ordered that Dunn disgorge $5,355.00 on or before September 1, 2011 and directed entry of judgment in favor of the SEC as to any unpaid amount; and he did not provide the standard notice in this District pursuant to 28 U.S.C. § 636(b)(1) . *See, e.g., Almonte v. New York State Division of Parole*, 9:04-CV-484, 2006 U.S. Dist. LEXIS 2926, at * 5 (N.D.N.Y. January 18, 2006)(citing "standard warning that accompanies all reports issued in this district"). [2]

[2] For this reason, Judge Homer's suggestion in a footnote, MDO at * 12-13, fn. 8, that if his first three basis for jurisdiction to impose sanctions on Dunn are rejected, his decision could alternatively, and contrary to his first three

II. The Court Should Not Exercise Its Discretion to Stay MDO IV Pending Appeal

The "issuance of a stay is left to the court's discretion." *World Trade Center Disaster Site Lit.*, 503 F.3d 167, 170 (2d Cir. 2007). The factors to be considered are "(1) whether the stay applicant has made a strong showing that he is likely to succeed on the merits; (2) whether the applicant will be irreparably injured absent a stay; (3) whether the issuance of the stay will substantially injure the other parties interested in the proceeding; and (4) where the public interest lies ." *Id.* (internal quotation marks and citations omitted). "[T]he degree to which a factor must be present varies with the strength of the other factors, meaning that more of one [factor] excuses less of the other." *Id.* "However, in conducting this analysis, the Supreme Court has instructed that the first two factors are the 'most critical.' A district should only grant a stay "when it is necessary to preserve the status quo pending the appeal." '*Maintaining the status quo* means that a controversy will still exist once the appeal is heard.'" Safeco Ins. Co. of America v. M.E.S., Inc., 2010 WL 5437208 *6 (E.D.N.Y. Dec. 7, 2010) (internal citations omitted).

As to the first factor, Dunn has failed to make a strong showing that she is likely to succeed on the merits. MDO IV found clear and convincing evidence that Dunn made false statements in a declaration filed on September 3, 2010, in opposition to the SEC's motion for reconsideration of MDO I. Specifically, Dunn filed a declaration stating that:

> I did not know of the existence of the private annuity agreement until I received it from Thomas Urbelis on July 27, 2010, the same day the SEC received it. . . .
>
> Neither I nor Mr. Wojeski had any documents in our possession relating to the private annuity agreement [until July 27, 2010]. MDO IV 22-23.

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basis for jurisdiction, be deemed a report-recommendation under § 636(b) and reviewed *de novo* by the district court or the court of appeals, is of no moment as he clearly had jurisdiction pursuant to Rule 636(c).

Both statements were false, and the record contains extensive direct and circumstantial evidence that these statements were false. In fact, Dunn did learn of "the existence of the private annuity agreement" at least by July 21, 2010, when Wojeski forwarded to her an email containing the first page of the annuity agreement and other documents summarizing the annuity's key terms. As a result, when Dunn spoke the SEC counsel the next day, July 22, 2010, she stated that the reason that no gift taxes were due was because of the "private annuity agreement."

Judge Homer held an evidentiary hearing on the July 22 telephone conversation and found that Dunn did disclose the "private annuity agreement" in that call. MDO IV 23-24. This finding was consistent with Dunn's receipt of the email the day before the telephone conversation. Dunn's reference to the "private annuity agreement" in the July 22 conversation certainly shows that she received the July 21 email. In addition, Wojeski's time records show that he spent several hours researching private annuity agreements on July 20 and 21, and Dunn admits that she and Wojeski were together for a real estate closing during those days. Dkt. 261-1, at 17-18.

Dunn's statements in her declaration that before July 27, 2010, neither she nor Wojeski had "any documents in our possession relating to the private annuity agreement" was also false because Dunn and Wojeski both admit that they received documents on July 21 "relating to the annuity agreement" on July 21. Dunn's motive in lying was to support her argument that the Annuity Agreement was not newly discovered evidence that should permit reconsideration of MDO I. The stakes were high: if Dunn had succeeded and the Annuity Agreement was not found to be newly discovered, MDO I likely would not have been reconsidered and the Trust assets would not have been frozen.

Judge Homer found that "[i]t is beyond dispute that Dunn's assertions in her September 2010 declaration . . . were false." MDO IV at24. Dunn, however, argues that Judge Homer's findings were "simply wrong" because the entire Annuity Agreement was not attached to Wojeski's emails. However, Wojeski's email did contain the first page of the annuity agreement as well as related documents showing the key terms of the annuity agreement. The documents were certainly sufficient to inform Dunn as to the "the existence of the private annuity agreement." Dunn also accused Judge Homer of "distortion" because MDO IV collectively describes the documents attached to Wojeski's email as the "Annuity Agreement." This is simply an effort by Dunn to deny the significance of Wojeski's email.

Second, Dunn fails to demonstrate irreparable harm in the absence of a stay. Indeed, imposing a stay pending any appeal will have no effect. As Dunn admits, the "public admonishment has already occurred" and the Clerk of the Court has already been directed to forward the decision to the Committee on Professional Standards. In addition, paying the $5,355 in disgorgement she has been ordered to pay cannot constitute irreparable harm, and Dunn makes no showing that payment of that amount by September 1, 2011 would irreparably harm her.

Finally, staying sanctions imposed in MDO IV is not in the public interest. The bad faith and false statements of Dunn "undermines any system of justice which relies on its participants to assert what they in good faith believe to be true, not merely to ignore or misstate inconvenient facts to obtain a desired result. Tolerance of such conduct undermines confidence in the outcome of judicial proceedings as well as in the professions of those involved." MDO IV at 49.

CONCLUSION

Plaintiff respectfully requests that the Court deny Jill Dunn's request for a stay.

Dated: New York, NY
August 10, 2011

Respectfully submitted,

s/David Stoelting
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EXHIBIT A

10-3576-cv (L)
Smith v. SEC

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

SUMMARY ORDER

RULINGS BY SUMMARY ORDER DO NOT HAVE PRECEDENTIAL EFFECT. CITATION TO A SUMMARY ORDER FILED ON OR AFTER JANUARY 1, 2007, IS PERMITTED AND IS GOVERNED BY THIS COURT'S LOCAL RULE 32.1.1 AND FEDERAL RULE OF APPELLATE PROCEDURE 32.1. WHEN CITING A SUMMARY ORDER IN A DOCUMENT FILED WITH THIS COURT, A PARTY MUST CITE EITHER THE FEDERAL APPENDIX OR AN ELECTRONIC DATABASE (WITH THE NOTATION "SUMMARY ORDER"). A PARTY CITING A SUMMARY ORDER MUST SERVE A COPY OF IT ON ANY PARTY NOT REPRESENTED BY COUNSEL.

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York, on the 8th day of August, two thousand eleven.

Present: ROSEMARY S. POOLER,
REENA RAGGI,
Circuit Judges,
JOHN G. KOELTL,
District Judge.[*]

LYNN A. SMITH,

Relief-Defendant-Appellant,

GEOFFREY R. SMITH, LAUREN T. SMITH,

Defendant-Appellants,

-v-

10-3576-cv(L)
11-0684-cv(CON)
11-0916-cv(CON)

SECURITIES AND EXCHANGE COMMISSION ,

Plaintiff-Appellee,

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[*] Honorable John G. Koeltl of the United States District Court for the Southern District of New York, sitting by designation.

MCGINN, SMITH & COMPANY, INCORPORATED, MCGINN, SMITH ADVISORS, LLC, MCGINN, SMITH CAPITAL HOLDINGS CORPORATION, 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, NANCY MCGINN, DAVID M. WOJESKI, TRUSTEE OF THE DAVID L. AND LYNN A. SMITH IRREVOCABLE TRUST U/A 8/04/04,

Defendants.

For Plaintiff-Appellee:	Christopher Paik, Special Counsel, United States Securities and Exchange Commission (Mark D. Cahn, General Counsel, Ann K. Small, Deputy General Counsel, Jacob H. Stillman, Solicitor, *on the brief*), Washington, DC, Kevin Patrick McGrath, Senior Trial Counsel, United States Securities and Exchange Commission, New York, NY, *for Plaintiff-Appellee*.
For Relief-Defendant Appellant:	James D. Featherstonhaugh, Scott J. Ely, Stephen B. Hanse, Featherstonhaugh, Wiley & Clyne, LLP, Albany, NY.
For Defendant-Appellants:	Stephen B. Hanse, Featherstonhaugh, Wiley & Clyne, LLP, Albany, NY.

Consolidated appeal from three orders of the United States District Court for the Northern District of New York (Homer, *M.J.*).

ON CONSIDERATION WHEREOF, IT IS HEREBY ORDERED, ADJUDGED, AND DECREED that the orders of said district court be and they hereby are **AFFIRMED**.

Appellants appeal from three orders of the United States District Court for the Northern District of New York (Homer, *M.J.*):[1] (1) a July 7, 2010 preliminary injunction continuing an asset freeze as to a stock account owned by Relief-Defendant-Appellant Lynn A. Smith; (2) a January 11, 2011 order denying Lynn Smith's motion to reconsider the magistrate judge's November 22, 2010 order, which froze the corpus of the David L. and Lynn A. Smith Irrevocable Trust U/A 08/04/04 (the "Trust"); and (3) a February 1, 2011 order authorizing the interlocutory sale of a house owned by Lynn A. Smith. The February 1, 2011 order is affirmed

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[1] The parties consented to have these matters heard before the magistrate pursuant to 28 U.S.C. § 636(c).

in an opinion issued today, and accordingly, this summary order addresses only the preliminary injunction continuing the asset freeze as to the stock account and the denial of the motion to reconsider the asset freeze with respect to the Trust. We assume the parties' familiarity with the contemporaneous opinion, including its recitation of relevant facts, as well as the procedural history of the case and issues presented for review.

We review an order freezing assets, or modifying an asset freeze, for abuse of discretion. *See SEC v. Am. Bd. of Trade, Inc.*, 830 F.2d 431, 438 (2d Cir. 1987).

The district court granted a preliminary injunction freezing the assets of a stock account held in Lynn Smith's name based in part upon a finding that David Smith was a joint owner of that account. The magistrate judge reached this conclusion after having considered several independent facts relating to David Smith's control over the account. These facts included that David Smith had assumed management of the account in the 1970s, after which the Smiths used the proceeds of that account to purchase their jointly owned primary residences, to pay the costs of college educations for their two children, to purchase two jointly owned vacation homes in Vermont and Florida, and to fund a trust created in both their names.

The magistrate judge also noted that although the account had always been maintained in Lynn Smith's sole name, for at least ten years, David Smith transacted business through the account using authorizations signed in blank by Lynn Smith or with authorizations containing Lynn Smith's signature that had, in fact, been signed by David Smith or one of his subordinates. David Smith also made deposits into the account, and used the account to make a number of short-term loans to his primary company (McGinn Smith & Co., Inc.) and its related entities. Although Lynn Smith argued before the district court that she was a bona fide creditor and was entitled to repayment with interest on these loans, the magistrate judge declined to credit this assertion based on the fact that Lynn Smith was unaware of how many loans she made, to whom the loans were made or the purpose of the loans. She was also unaware of the loans' interest rates or payment schedules. This failure to recollect, the magistrate judge concluded, "belies any claim of a legitimate creditor-debtor relationship."

We find no clear error in the magistrate judge's findings of fact, and therefore, find no error in the magistrate's conclusion that David Smith treated Lynn Smith's stock account as his own. Accordingly, we conclude that the district court did not abuse its discretion in continuing the asset freeze as to the stock account. *Accord SEC v. Heden*, 51 F. Supp. 2d 296, 300 (S.D.N.Y. 1999) (freezing an account where a defendant "treated [the] Account and his own account interchangeably").

With respect to the Trust, which purported to be for the benefit of the Smiths' children, we also conclude that there was no error in the district court's denial of Lynn Smith's motion to reconsider the order freezing the Trust corpus. We review an appeal from the denial of a motion for reconsideration for an abuse of discretion. *Marrero Pichardo v. Ashcroft*, 374 F.3d 46, 55 (2d Cir. 2004).

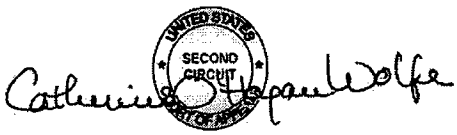
In *In re Vebeliunas*, 332 F.3d 85 (2d Cir. 2003), we assumed that New York courts would

allow the veil of a trust to be pierced in situations where the complete domination of a trust has been shown. We concluded that, too make such a showing, the SEC must establish that (1) the owner of the Trust exercised such control that the Trust had become a mere instrumentality of the owner; (2) the owner used this control to commit a fraud or "other wrong"; and (3) the fraud or wrong resulted in injury or loss. *Id.* at 91-92. To establish the first prong concerning control, it is sufficient to show here that David Smith could be considered the equitable owner of the Trust. such that he acted as though the Trust assets were "his alone to manage and distribute." *Id.* at 92.

Here, the magistrate judge re-froze the Trust corpus in light of an annuity agreement that entitled David and Lynn Smith to annual payments of approximately $500,000 beginning in 2015 and continuing until their deaths or until the Trust was exhausted. Coupled with the fact that David Smith had functioned as an investment advisor for the Trust, had paid approximately $100,000 in taxes owed by the Trust without reimbursement from the Trust, and Lynn Smith had paid expenses incurred by the Smiths' daughter, which would ordinarily have been paid by the Trust, the magistrate judge concluded that "David Smith possessed an equitable and beneficial interest in the Trust." Indeed, the magistrate judge noted that during the nearly six years between the time of the Trust's creation and the present litigation, only one disbursement was made from the Trust, and that was for the benefit of David Smith. We find no error in these conclusions, and therefore, hold that the district court did not abuse its discretion in declining to reconsider its order freezing the Trust assets.

We have considered the remaining issues presented by this appeal and find them to be without merit for substantially the reasons stated by the district court. For the foregoing reasons, the orders of the district court are **AFFIRMED**.

FOR THE COURT:
Catherine O'Hagan Wolfe, Clerk



--- F.3d ----, 2011 WL 3437561 (C.A.2 (N.Y.))
(Cite as: 2011 WL 3437561 (C.A.2 (N.Y.)))

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Only the Westlaw citation is currently available.

United States Court of Appeals,
Second Circuit.
Lynn A. SMITH, Relief–Defendant–Appellant,
Geoffrey R. SMITH, Lauren T. Smith, Defendant–Appellants,
v.
SECURITIES and EXCHANGE COMMISSION, Plaintiff–Appellee,
McGinn, Smith & Company, Incorporated, McGinn, Smith Advisors, LLC, McGinn, Smith Capital Holdings Corporation, 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, Nancy McGinn, David M. Wojeski, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04, Defendants.

Docket Nos. 10–3576–cv(L), 11–0684–cv(CON), 11–0916–cv(CON).
Argued: June 20, 2011.
Decided: Aug. 8, 2011.

Consolidated appeal from, inter alia, an order of the United States District Court for the Northern District of New York (Homer, *M.J.)* lifting an asset freeze for the purpose of authorizing the interlocutory sale of a vacation home owned by relief-defendant Lynn A. Smith. The magistrate judge held in relevant part that the sale was necessary to preserve the value of the asset pending resolution of the merits of the action. We conclude that there was no error in this finding and hold that it was not an abuse of discretion to lift the asset freeze in order to authorize the sale. Accordingly, we affirm. AFFIRMED.

Christopher Paik, Special Counsel, United States Securities and Exchange Commission (Mark D. Cahn, General Counsel, Ann K. Small, Deputy General Counsel, Jacob H. Stillman, Solicitor, on the brief), Washington, DC, **Kevin** Patrick **McGrath**, Senior Trial Counsel, United States Securities and Exchange Commission, New York, NY, for Plaintiff–Appellee.

James D. Featherstonhaugh, Scott J. Ely, Stephen B. Hanse, Featherstonhaugh, Wiley & Clyne, LLP, Albany, NY, for Relief–Defendant–Appellant.

Stephen B. Hanse, Featherstonhaugh, Wiley & Clyne, LLP, Albany, NY, for Defendant–Appellants.

Before POOLER and RAGGI, Circuit Judges, KOELTL, District Judge. [FN*]

FN* Honorable John G. Koeltl of the United States District Court for the Southern District of New York, sitting by designation.

POOLER, Circuit Judge:

***1** Consolidated appeal from, inter alia, an order of the United States District Court for the Northern District of New York (Homer, *M.J.*)[FN1] lifting an asset freeze for the purpose of authorizing the interlocutory sale of a vacation home owned by relief-defendant Lynn A. Smith. The magistrate judge held in relevant part that the sale was necessary to preserve the value of the asset pending resolution of the merits of the action. We conclude that there was no error in this finding and hold that it was not an abuse of discretion to lift the asset freeze in order to authorize the sale. Accordingly, we affirm. In this opinion, we address only the order of the magistrate judge lifting the asset freeze for the purpose of authorizing the liquidation of the Florida vacation home. We affirm the magistrate judge's orders as to the balance of claims on this appeal in a companion summary order also issued by this Court today.

FN1. The parties consented to have these matters heard before the magistrate judge pursuant to 28 U.S.C. § 636(c).

BACKGROUND

In April 2010, the Securities and Exchange Commission ("SEC") commenced a civil securities enforcement action based on allegations of fraud and wrongdoing by Lynn Smith's husband, David Smith, and his business partner, Timothy McGinn. The two men operated an Albany-based financial services company, McGinn, Smith & Co., Inc., and a number of related entities, through which they are alleged to have defrauded investors of more than $80 million in

violation of, inter alia, Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), and Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b). Specifically, the complaint states that Timothy McGinn and David Smith deceived investors in four funds by telling them that their money would be "invested" when instead it was "funneled" into various McGinn–Smith companies where it was used to make unauthorized investments, to support McGinn and Smith's "lifestyles," and to cover the payroll at McGinn, Smith & Co.

Simultaneous with the filing of the initial complaint in this action, the SEC sought a preliminary injunction (1) appointing a receiver to take possession of the defendants' assets; (2) directing defendants to provide verified accountings; (3) freezing the defendants' assets, including those held in the name of Lynn Smith; and (4) prohibiting the destruction, alteration or concealment of documents. *SEC v. McGinn, Smith & Co.*, No. 10–cv–00457–GLS–DRH (N.D.N.Y. Apr. 20, 2010) (Docket No. 4). Magistrate Judge Homer held a three-day hearing on the SEC's motion in June 2010. Because David Smith had already consented to the preliminary injunction by the date of the hearing, the central issue for the hearing was the extent to which assets held by Lynn Smith, as a relief-defendant, could be subjected to a freeze.

At that hearing, Lynn Smith testified that the assets held solely in her name consisted primarily of a stock account inherited from her father, a vacation home in New York, a vacation home in Florida, which had initially been owned jointly by David and Lynn Smith, and a checking account Lynn Smith had opened in her own name in 2009. *SEC v. McGinn, Smith & Co.*, No. 10–cv–00457–GLS–DRH, at *280–83, 326, 355–59, 372–75, 403–04 (N.D.N.Y. July 13, 2010) (Docket Nos. 87–89). The magistrate judge rejected Lynn Smith's testimony, instead concluding that even though the stock account was technically in Lynn Smith's name, the Smiths were "joint owners" of the account because David Smith had "unfettered control" over the account for thirty-five years, deposited money into it, and used it to loan money to McGinn Smith companies to cover operating expenses. In reaching this conclusion, the magistrate judge declined to credit Lynn Smith's testimony, noting that it was "self-serving ... improbabl[e] ... [lacked] credible corroborating evidence ... [and was] inconsisten[t] ... [and] incredible." *SEC v. McGinn, Smith & Co.*, No. 10–cv–00457–GLS–DRH, at *9 n.13 (N.D.N.Y. July 7, 2010) (Docket No. 86).

***2** With respect to the checking account and the Florida house, for two principal reasons, the magistrate judge concluded that both assets were jointly owned by David and Lynn Smith. First, Lynn Smith opened the checking account and transferred the house into her sole name only *after* the commencement of Financial Industry Regulatory Authority ("FINRA") proceedings investigating David Smith. Second, both assets were used jointly, and in particular, the house was "treated no differently" after it was transferred into Lynn Smith's sole name. *Id.* at *34–37. The magistrate judge directed Lynn Smith to "hold and retain within [her] control, and otherwise prevent, any ... encumbrance ... dissipation ... or other disposal of any assets ... including money, real or personal property." *SEC v. McGinn, Smith & Co.*, No. 10–cv–00457–GLS–DRH, at *4–5 (N.D.N.Y. July 22, 2010) (Docket No. 96). The New York vacation home was exempted from the freeze, because the magistrate judge found that it was never controlled by David Smith. At that time, the magistrate judge also declined to freeze the assets of a trust created in the early 1990s for the benefit of David and Lynn Smith's two children, concluding that the "Trust's benefits did not flow to David Smith and he did not exercise control over them such that he treated the corpus as his own." *SEC v. McGinn, Smith & Co.*, No. 10–cv–00457–GLS–DRH, at *40–41 (N.D.N.Y. July 7, 2010) (Docket No. 86).

The SEC later discovered a 2004 annuity agreement relating to the trust that required the trustee to make annual payments of approximately $500,000 to David and Lynn Smith beginning in 2015 and continuing until their deaths or until the trust was exhausted. *SEC v. McGinn, Smith & Co.*, No. 10–cv–00457–GLS–DRH, at *3 (N.D .N.Y. Nov. 22, 2010) (Docket No. 194). In light of this agreement, which David and Lynn Smith had failed to disclose, the SEC filed a motion to reconsider the magistrate judge's earlier order and requested that the magistrate judge re-freeze the trust. In November 2010, the magistrate judge granted the SEC's request. The magistrate judge further determined that Lynn Smith's non-disclosure of the annuity agreement "satisfie[d] the requirements for fraud, misrepresentation, and misconduct," and authorized the SEC to seek sanctions against her. *Id.* at *20 n.17, 24.

One month later, the magistrate judge denied a motion filed by Lynn Smith for release of assets filed. Lynn Smith had sought the release of: (1) $16,431 per month for her "continued well-being," which included expenses surrounding the maintenance of the Smiths' primary residence located in New York; (2) attorneys' fees in the amount of $138,451; and (3) $13,466 per month for "necessary expenses" associated with the Florida home, including mortgage payments. The magistrate judge concluded that Lynn Smith had "failed to demonstrate the financial need required to obtain this relief." *SEC v. McGinn, Smith & Co.*, No. 10–cv–00457–GLS–DRH, at *4–5 (N.D.N.Y. Dec. 2, 2010) (Docket No. 211). Specifically, the magistrate judge noted that Lynn Smith received "at least $440,000" from the July 2010 sale of her New York vacation home, which "should allow payment of all reasonable legal and living expenses ... for the foreseeable future without the necessity of lifting the asset freeze for her in any respect." *Id.* at *5. Lynn Smith has never provided any documentation of her expenditure of the funds received from the sale of the New York vacation home.

***3** After the magistrate judge denied Lynn Smith's motion, the SEC moved to modify the asset freeze to permit the sale of the Florida vacation home. At that time, the mortgage was more than 100 days past due and had an amount owing of $32,178. The SEC filing indicated that in November 2010, Lynn Smith's attorney had contacted the SEC to suggest the sale of the Florida house, because the "bills were piling up." The SEC had agreed to the sale but sought to have a receiver, and not Lynn Smith, oversee it. Shortly thereafter, Lynn Smith told the SEC that she no longer supported the sale.

In support of its motion to lift the asset freeze in order to liquidate the Florida house, the SEC argued that the value of the house would "continue to decline sharply every month as mortgage costs, taxes, and other expenses continue to accrue and remain unpaid," and "the only option that [would] preserve the equity in the [p]roperty for the benefit of investors" was a court-ordered sale. The SEC argued that the magistrate judge had authority to order the sale because Lynn Smith was in violation of the preliminary injunction directing her to "prevent[ ] any encumbrance [or] dissipation ... of any assets ... including ... real or personal property." The SEC also argued that the magistrate judge had "inherent authority" under Section 21(d)(5) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(d)(5), to order the sale of the property in order to preserve the status quo.

On February 1, 2011, the district court entered an order granting the SEC's motion to amend the asset freeze to permit the sale of the Florida house. The magistrate judge determined that the securities laws authorized the court to exercise "broad equitable discretion" to fashion the appropriate injunctions when faced with alleged violations of securities laws. *SEC v. McGinn, Smith & Co.*, No. 10–cv–00457–GLS–DRH, at *4 (N.D.N.Y. Feb. 1, 2011) (Docket No. 263) (quoting *SEC v. Fischbach Corp.*, 133 F.3d 170, 175 (2d Cir.1997)). The magistrate judge found that, using this discretion, "[c]ourts have routinely granted relief from preliminary injunctions freezing assets pending the outcome of an action." *Id.* (citing *SEC v. Haligiannis*, 608 F.Supp.2d 444, 448 (S .D.N.Y.2009)). In Lynn Smith's case, the magistrate judge determined that because the preliminary injunction mandated that her assets be maintained without dissipation of their value, the court could act to prevent such dissipation if it appeared that the value of an asset was at risk. *Id.* at *4–5 (citing, inter alia, *SEC v. Unifund SAL*, 910 F.2d 1028, 1041–42 (2d Cir.1990); *SEC v. Infinity Grp. Co.*, 212 F.3d 180, 197 (3d Cir.2000) (The purpose of an asset freeze is "to preserve the status quo by preventing dissipation and diversion of assets."); *SEC v. Am. Bd. of Trade, Inc.*, 830 F.2d 431, 436 (2d Cir.1987)). Moreover, the magistrate judge determined that he also had the power to enter the proposed order under Section 21(d)(5) of the Exchange Act, 15 U.S.C. § 78u(d)(5), which provides in relevant part that "the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors." *Id.* at *5 (citing *SEC v. Wencke*, 622 F.2d 1363, 1369 (9th Cir.1980) ("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")). The magistrate judge further found that even though a final adjudication of liability had not been rendered, due process was not offended because the Smiths had the opportunity to appear before the court regarding the SEC's preliminary injunction motion to challenge the SEC's evidence. *Id.* at *5–6. Finally, the magistrate judge declined to lift the asset freeze to allow Lynn Smith to maintain the property after finding that she had not demonstrated any "changed circumstances" since the

denial of her previous request to lift the asset freeze. *Id.* at *7. The magistrate judge ultimately concluded that the "balance of the interests" weighed in favor of permitting the sale of the Florida house after finding: (1) the value of the property had decreased from $2.4 million in 2008 to between $1.7 and $1.9 million in 2010 and "[n]o evidence ha[d] been offered to indicate that there exists any reasonable expectation that the market for the property will improve in the foreseeable future"; and (2) it was "likely" that the property's value would continue to diminish over the course of the proceedings as mortgage payments continued to accrue, raising the possibility that the mortgage holder would seek a foreclosure sale "under less favorable circumstances." *Id.* at *7–8. Finally, the magistrate judge directed the receiver to oversee the sale given his "nationwide experience," disinterest in the outcome, and "reasonable" fee. *Id.* at *9.

DISCUSSION

***4** We review an order freezing assets, or modifying an asset freeze, for abuse of discretion. *See SEC v. Am. Bd. of Trade, Inc.*, 830 F.2d 431, 438 (2d Cir.1987).

It is "well established" that Section 22(a) of the Securities Act of 1933 and Section 27 of the Securities Exchange Act of 1934 "confer general equity powers upon the district courts" that are "invoked by a showing of a securities law violation." *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1103 (2d Cir.1972) (citing 15 U.S.C. §§ 77v(a), 78aa). "[O]nce the equity jurisdiction of the district court properly has been invoked, the court has power to order all equitable relief necessary under the circumstances," *SEC v. Materia*, 745 F.2d 197, 200 (2d Cir.1984), "including the impoundment of assets," *Am. Bd. of Trade*, 830 F.2d at 438. The purpose of such an asset freeze is to ensure "that any funds that may become due can be collected." *SEC v. Unifund SAL*, 910 F.2d 1028, 1041 (2d Cir.1990) (describing asset freeze as "ancillary relief to facilitate enforcement of any disgorgement remedy that might be ordered in the event a violation [of securities laws] is established at trial"); *see also SEC v. Infinity Grp. 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.").

Section 20(b) of the Securities Act provides: "Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of [the Securities Act] ... the Commission may, in its discretion, bring an action in any district court ... to enjoin such acts or practices, and upon a proper showing, a permanent or temporary injunction or restraining order shall be granted without bond." 15 U.S.C. § 77t(b). Section 21(d) of the Securities Exchange Act employs nearly identical language. *See* 15 U.S.C. § 78u(d).

In this jurisdiction, injunctions sought by the SEC do not require a showing of irreparable harm or the unavailability of remedies at law. *Unifund SAL*, 910 F.2d at 1036. Rather, the SEC need only make "a substantial showing of likelihood of success as to both a current violation and the risk of repetition." *SEC v. Cavanagh*, 155 F.3d 129, 132 (2d Cir.1998). There is an exception to this rule where the injunction freezes assets. Where an asset freeze is involved, the SEC "must show either a likelihood of success on the merits, or that an inference can be drawn that the party has violated the federal securities laws." *SEC v. Byers*, No. 08 Civ. 7104, 2009 WL 33434, at *3 (S.D.N.Y. Jan. 7, 2009) (footnote omitted); *see also SEC v. Heden*, 51 F.Supp.2d 296, 298 (S.D.N.Y.1999) ("Unlike a preliminary injunction enjoining a violation of the securities laws, which requires the SEC to make a substantial showing of likelihood of success as to both a current violation and the risk of repetition, an asset freeze requires a lesser showing." (citations omitted)). Where something more than an asset freeze is in question, however, the required degree of "likelihood of success" on the merits varies depending upon the nature of the relief sought:

> ***5** [E]ven when applying the traditional standard of "likelihood of success," a district court, exercising its equitable discretion, should bear in mind the nature of the preliminary relief the Commission is seeking, and should require a more substantial showing of likelihood of success, both as to violation and risk of recurrence, whenever the relief sought is more than preservation of the status quo. Like any litigant, the [SEC] should be obliged to make a more persuasive showing of its entitlement to a preliminary injunction the more onerous are the burdens of the injunction it seeks.

Unifund SAL, 910 F.2d at 1039 (emphasis added, citations omitted). Where an asset sale is sought to

preserve the value of the assets, the SEC should be required to make a substantial showing of the likelihood that it will be able to obtain an ultimate sale of the assets in question.

The plenary powers of a federal court to order an asset freeze are not limited to assets held solely by an alleged wrongdoer, who is sued as a defendant in an enforcement action. Rather, "[f]ederal courts may order equitable relief against a person who is not accused of wrongdoing in a securities enforcement action where that person: (1) has received ill-gotten funds; and (2) does not have a legitimate claim to those funds." *Cavanagh*, 155 F.3d at 136. In such cases, "[t]he burden rests with the Commission to show that the funds in the possession of the [relief defendant] are ill-gotten." *FTC v. Bronson Partners, LLC*, 674 F.Supp.2d 373, 392 (D.Conn.2009).

Lynn Smith does not challenge the court order that froze the Florida home as an asset, which was based in part upon the magistrate judge's conclusion that David Smith was a joint owner of the home. Lynn Smith challenges only the magistrate judge's order lifting the asset freeze for the purpose of liquidating that particular asset. Before authorizing the liquidation of the Florida house, the magistrate judge entered certain findings, including the following:

> In 2008, the estimated market value of the property was approximately $2.4 million with an outstanding balance due on the mortgage of approximately $900,000 leaving an equity in the property of approximately $1.5 million. With the downward turn of the country's economy and the Florida real estate market, the property's present market value has diminished to approximately $1.7–$1.9 million. With a mortgage balance due of approximately $900,000, the equity in the property has already shrunk by approximately $500,000–$700,000. No evidence has been offered to indicate that there exists any reasonable expectation that the market for the property will improve in the foreseeable future.
>
> Moreover, it is likely that the current equity in the property will continue to diminish during the pendency of this action. The monthly mortgage payments of over $6,000 are not being paid and the mortgage holder may well seek an order permitting foreclosure and a sale of the property under less favorable circumstances. Those services necessary for the upkeep of the property either have been canceled or are incurring additional debts against the property. In either instance, the equity in the property will be further reduced by the costs of repairs from deterioration and additional liens against the property for unpaid services. Incurring these additional expenses at a rate of over $13,000 per month might make sense if there existed any reasonable likelihood that the value of the property would appreciate sufficiently in the foreseeable future to compensate for the expenses. No such likelihood appears.

***6** *SEC v. McGinn, Smith & Co.*, No. 10–cv–00457–GLS–DRH, at *7–8 (N.D.N.Y. Feb. 1, 2011) (Docket No. 263).

These findings, though not identical, are similar to findings prerequisite to an interlocutory sale of assets through a forfeiture proceeding. In a forfeiture action, property may be subjected to an interlocutory sale "[i]f [that] property ... is perishable, or liable to deterioration, decay, or injury by being detained in custody pending the action, or if the expense of keeping the property is excessive or disproportionate, or if there is unreasonable delay in securing the release of property." *United States v. Esposito*, 970 F.2d 1156, 1160 (2d Cir.1992); *see also United States v. King*, No. 10 Cr. 122, 2010 WL 4739791, at *1 (S.D .N.Y. Nov. 12, 2010). Although the standard applicable in a forfeiture proceeding does not determine the outcome of the action before us, it is instructive. Moreover, although the equitable relief sought goes beyond mere preservation of the status quo, the SEC's showing of its likelihood of success on the merits with respect to both the underlying securities law violation and David Smith's joint ownership of the Florid house constitutes a sufficiently "persuasive showing of its entitlement to a preliminary injunction" to justify the "more onerous burdens of the injunction it seeks." *Unifund SAL*, 910 F.2d at 1039. In light of the "sweeping mandate manifest in the securities laws," *SEC v. Materia*, 745 F.2d 197, 200 (2d Cir.1984), and the district court's broad equitable power to fashion ancillary relief when its jurisdiction under those laws has been involved, *see Unifund SAL*, 910 F.2d at 1041, it is clear that the magistrate judge did not abuse his discretion when he ordered the interlocutory liquidation of Lynn Smith's Florida house in light of its declining value and the diminishing equity in the property. *Accord* 15 U.S .C. § 78u(d)(5) (stating that a "[f]ederal court may grant[ ]

any equitable relief that may be appropriate or necessary for the benefit of investors"). Accordingly, we affirm the order of the magistrate judge.

CONCLUSION

For the reasons stated herein, we **AFFIRM** the judgment of the district court. The magistrate judge's rulings with respect to the claims remaining in this consolidated appeal, including the appeal from a July 7, 2010 preliminary injunction continuing an asset freeze as to a stock account owned by Lynn Smith as well as the January 11, 2011 order denying Lynn Smith's motion to reconsider a November 22, 2010 order, which froze the corpus of the David L. and Lynn A. Smith Irrevocable Trust U/A 08/04/04, are affirmed in the companion summary order also issued by this Court today.

C.A.2 (N.Y.),2011.
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