UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

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

Defendants.

10 Civ. 457 (GLS/DRH)

PLAINTIFF'S MEMORANDUM OF LAW IN FURTHER SUPPORT OF ITS MOTION TO MODIFY THE ASSET FREEZE TO PERMIT THE SALE OF DEFENDANTS' SARATOGA SPRINGS PROPERTY AND IN OPPOSITION TO DEFENDANTS' CROSS-MOTION

Dated: August 3, 2012

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Plaintiff Securities and Exchange Commission respectfully submits this memorandum of law in opposition to the motion by defendants David and Lynn A. Smith to release funds from the asset freeze to pay off their mortgage on the property located at [redacted], Saratoga Springs, New York (the "Property"), and in further support of its motion to release the Property from the freeze to permit its sale by the Receiver.

THE PENDING LOAN MODIFICATION

As the Court is aware, Citizens Bank has been considering a loan modification request submitted by the Smiths. Since the SEC filed its motion, the bank has asked the Smiths to schedule an appraisal before it can make a final decision on the loan modification. (Kornstein Declaration, dated August 3, 2012, Dkt. No. 512 at ¶5.) According to the Kornstein Declaration: " [i]f [the bank] approves a loan modification, it will initially be a trial loan modification for three months to determine if the Smiths can fulfill its terms and obligations." *Id.* at ¶ 6. The bank's decision to grant or deny the modification will impact the SEC's motion and the Smiths' cross-motion. The SEC, therefore, respectfully requests that the Court delay its determination of the SEC's motion and the Smiths' cross-motion until the loan modification is decided by the bank. At that time, the SEC requests that the parties be permitted to make supplementary submissions regarding the impact of the bank's determination on the parties' respective motions.

PRELIMINARY STATEMENT

Assuming the Court does not delay its determination of the motions, the SEC respectfully submits that the Smiths' cross-motion should be denied and the SEC's

motion to allow the Receiver to sell the Property should be granted for the following reasons:

First, the Smiths – who have failed to make any mortgage or tax payments on the Property for nearly 18 months – ask in their cross-motion to use funds possessed by the Receiver to pay off their entire $360,000 mortgage note, plus interest and penalties, so that they can live on the Property free from any mortgage obligations. The Smiths admit that they have monthly income of $4,420, and that they received $36,000 from renting out the Property during the racing season in 2011 and 2012. In addition, Lynn Smith received $600,000 in July 2010 on the sale of certain property. Yet, the Smiths have not made any payments on their mortgage since May 2011 and are in arrears on their property tax obligations. Particularly here where the amount of assets currently frozen does not come close to being able to repay investors, the Court should deny the Smiths' cross-motion.

Second, the Smiths' primary defense to the SEC's motion – that the Receiver's sale of the Property would not benefit investors because New York's homestead exemption would allow them $250,000 on the sale of the Property – is not persuasive. New York's homestead exemption does not apply to maintaining a freeze over assets preserved for disgorgement. Accordingly, the SEC's motion to allow the Receiver to sell the Property should be granted.

ARGUMENT

I. THE SMITHS' CROSS-MOTION SHOULD BE DENIED

Using Receivership assets to pay off the Smiths' mortgage obligations, and thereby allowing them to become owners of the Property free and clear of any mortgage

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

There is no benefit to investors in releasing funds to pay off the Smiths' mortgage. Real estate is a risky, illiquid investment. In addition, if Receivership funds were used to pay off the mortgage, the investors' interests would be entirely unprotected as the Smiths would have exclusive control over the Property. Converting secure cash into a risky, illiquid investment under the Defendants' complete control does not benefit investors.

Moreover, the evidence shows that the Smiths have had cash available to pay their mortgage and tax obligations and made the decision not to make such payments. *See* Dkt. Nos. 261-6 (Ex. G); 508-3. The Court previously has denied the Smiths' motions for a release of funds from the asset freeze. *See* Docket Nos. 146 (denying Lynn Smith's motion for release of funds) and 221 (denying release of David Smith's 401(k)). The

result should be the same here. The Court should not release funds to pay off the Smiths' mortgage and pay back-property taxes.

II. THE MOTION TO HAVE THE RECEIVER SELL THE PROPERTY SHOULD BE GRANTED

A. The Homestead Exemption Does Not Apply

The primary defense raised by the Smiths to a sale by the Receiver is their claim to the homestead exemption under New York State law. NY CPLR 5206. It is well established, however, that even where a defendant's assets may be exempt from execution, such assets are considered in determining whether the defendant has an ability to pay disgorgement in a contempt proceeding. In *SEC v. AMX, Int'l, Inc.*, 7 F.3d 71, 76 (5th Cir. 1993), for example, the Fifth Circuit held that the district court could consider the defendant's exempt homestead in deciding whether he had met his burden. *See also SEC v. Huffman,* 996 F.2d 800, 803 (5th Cir.1993) (holding that disgorgement is not a "debt" under the Federal Debt Collection Procedures Act, and defendants could not avail themselves of the state law exemptions under that Act); *SEC v. Bilzerian*, 112 F. Supp.2d 12, 27 n. 29 (D.D.C. 2000) (court may consider defendant's homestead in determining ability to comply with disgorgement orders).

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

In particular, courts can ignore state law exemptions in fashioning disgorgement orders. *Solow*, 682 F. Supp.2d at 1325-26 ("[A] district court can ignore state law exemptions as well as other state law limitations on the ability to collect a judgment in fashioning a disgorgement order." *(citing Huffman,* 996 F.2d at 803; *SEC v. AMX, Int'l, Inc.,* 872 F. Supp. 1541, 1544-45 (N.D.Tex.1994) (homestead exemption not taken into account); *SEC v. Musella,* 818 F. Supp. 600 (S.D.N.Y.1993) (holding exemptions from attachment under New York law did not alter a person's duty to pay under a disgorgement order). "In any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors." Securities Exchange Act of 1934, Sec. 21(d)(5), 15 U.S.C. § 78u(d)(5).

If a disgorgement order is ultimately granted here, the full value of the Property will be important in determining the ability to pay disgorgement, and to satisfying the disgorgement order. Maintaining the asset freeze over the full value of the Property upon its sale would serve "to maintain an asset which may play an integral role in future proceedings." Dkt. No. 221, at 5 (denying Smith's motion to unfreeze his 401(k) account). Accordingly, the homestead exemption should not apply.[1]

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[1] Under these circumstances, the Court also could find that the homestead exemption does not apply because a constructive trust in favor of the investors over the proceeds of the sale should be imposed. "A constructive trust will be erected whenever necessary to satisfy the demands of justice." *Latham v. Father Devine*, 85 N.E.2d 168, 170 (N.Y. 1949). A constructive trust is "the formula through which the conscience of equity finds expression." *Beatty v. Guggenheim Exploration Co.*, 122 N.E. 378, 380 (N.Y. 1919). The Smiths purchased the Property in August 2003 with a $189,000 downpayment from the Stock Account, which the Court already has determined was used by David Smith to 'loan' funds to many McGinn Smith entity defendants and to

B. The Smiths' Do Not Assert Any Defenses to a Foreclosure Action

The Smiths also argue that allowing the Receiver to sell the Property, as opposed to its sale through foreclosure, denies them of certain procedural protections available in a foreclosure proceeding. *See* Dkt. No. 508-2, at 2. The Smiths, however, do not identify any defenses that they would have in a foreclosure proceeding. Moreover, there is no right to have property sold through foreclosure. Accordingly, the SEC's motion to allow the Receiver to sell the Property should be granted.

CONCLUSION

Plaintiff respectfully requests that the Court defer ruling on these motions until Citizens Bank makes a final determination on the loan modification request by the Smiths. Alternatively, if the Court decides to reach the merits of the two pending motions, plaintiff respectfully requests that the Court grant its motion to release the Property from the asset freeze and allow its sale by the Receiver, and deny the Smiths' motion for a release of funds from the asset freeze.

Dated: New York, NY
August 3, 2012

Respectfully submitted,

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defendant MS & Co. during the time of the fraud. (Dkt. No. 86, at 34.) In addition, the mortgage payments were made from David Smith's account, which received many proceeds of the fraud.

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