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, GEOFFREY R. SMITH, 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

GEOFFREY R. SMITH, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04,

Intervenor.

MEMORANDUM OF LAW IN FURTHER OPPOSITION TO THE SEC'S MOTION TO SELL THE SMITHS' SARATOGA HOME AND IN FURTHER SUPPORT OF THE SMITHS' CROSS-MOTION SEEKING THE RELEASE OF FUNDS FROM THE ASSET FREEZE TO SATISFY THE HOME'S EXISTING MORTGAGE

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PRELIMINARY STATEMENT

On July 11, 2012, the SEC filed a motion seeking an order modifying the current asset freeze so that it may, through the Receiver, pursue a forced sale of the Smiths' primary residence in Saratoga Springs, New York. Defendant David Smith and Defendant/Relief Defendant Lynn Smith have opposed this motion and have filed a cross-motion to unfreeze assets to satisfy the mortgage on the Saratoga home as a more equitable alternative. This submission on behalf of Lynn Smith is being made in further opposition to that motion and in further support of the Smiths' cross-motion as permitted by the Court in its Text Order dated August 7, 2010.

THE PENDING LOAN MODIFICATION

In its reply to the Smiths' opposition papers, the SEC has requested that the Court delay its determination on its pending motion and the Smiths' cross-motion since the bank has yet to make a determination on the Smiths' application to modify its existing mortgage so as to stave off a foreclosure action. While Lynn Smith does not oppose this request per se, we remind the Court that during the telephone conference with the Court on June 11, 2012 concerning the SEC's intent to file this motion, counsel for Lynn Smith opposed the request since a favorable determination on the pending application to modify their mortgage would render the application moot. Notwithstanding, the SEC and Citizens Bank were adamant about forging ahead with its motion forcing the Smiths' to defend an action and incur additional costs and legal fees on an issue that may never be ripe for adjudication. Now the SEC seeks to have your Honor suspend a decision on the merits for the same reasons that were articulated in the initial court conference. Again, we do not necessarily oppose the request to stay a decision until a determination for a modification has been made, we merely wish to highlight the potential waste of resources and

unnecessary litigation costs that will be incurred if the modification is ultimately approved by Citizens Bank.

I. SUR-REPLY IN OPPOSITION TO SEC'S MOTION SEEKING THE FORCED SALE OF THE SMITHS' SARATOGA HOME.

POINT I

THERE IS NO ORDER OF DISGORGEMENT PENDING AT THIS JUNCTURE OF THE LITIGATION THEREFORE THE HOMESTEAD EXEMPTION LAWS ARE APPLICABLE TO A FORCED SALE.

The SEC has argued that the Homestead exemption does not apply as a defense to its motion for a forced sale because the remedy of disgorgement does not constitute a "debt" under the Federal Debt Collection Procedures Act. However, the cases the SEC relies upon all involve defendants who either were found liable for securities fraud or consented to a judgment and *where disgorgement orders had been issued by the Court*. According to representatives of the SEC:

> The homestead exemption arises in Commission litigation when a defendant fails to pay disgorgement *ordered*, and the Commission files an action in federal district court asking the court to hold the defendant in contempt of court for that failure to pay. In contempt actions, defendants often assert that they cannot pay some or all of the owed disgorgement because they lack sufficient assets. As a result, during the contempt proceeding, the court must determine which of a defendant's assets are available to pay disgorgement. In the case of exempted assets, such as a homestead, the court has considerable discretion in determining whether or not that exempted asset must be used to pay disgorgement. See *Testimony of Stephen M. Cutler, Director of the Division of Enforcement, U.S. Securities and Exchange Commission, concerning The Securities Fraud Deterrence and Investor Restitution Act, H.R. 2179, June 5, 2003.*
> (emphasis added).

In this case, there has been no judgment rendered against David Smith and therefore no disgorgement order has been issued against him or any other party. The SEC has no pending lien

on the property with which to exercise its creditor rights. Therefore, if the SEC wishes to force a sale at this juncture of the proceeding, the Smiths' Homestead exemption rights cannot be extinguished by the Court until an actual order of disgorgement is issued.

Finally, on information and belief, the SEC's position is inconsistent when it agreed to the sale of Ms. McGinn's primary home where her Homestead exemption rights were considered as part of that transaction.

POINT II

THE COURT SHOULD NOT PERMIT A FORCED SALE OF THE SARATOGA HOME SINCE LYNN SMITH MAINTAINS A PROPERTY RIGHT AS A TENANT BY THE ENTIRETY.

Even if the Court ignores the fact that there is no disgorgement order and denies the Smiths' right to their Homestead exemptions, the Court should consider Lynn Smith's interest in the property as a tenant by the entirety and deny the SEC's application for a forced sale.

Courts typically take into consideration state law property rights, and issues of fairness, in reaching their decisions whether to force defendants to disgorge their primary residences. For instance, in *SEC v. Antar*, defendant Sam Antar and his wife, relief defendant, Rose Antar, owned their marital home in New Jersey as tenants by the entirety. While the SEC was pursuing Mr. Antar, he transferred his interest in the home to his wife. The court essentially voided the transfer because it was a fraudulent device designed to frustrate the SEC's collection efforts. Nonetheless, the court, in the exercise of discretion, refused the SEC's request to satisfy its disgorgement judgment by forcing foreclosure or partition of the home. The court took notice that New Jersey courts historically were reluctant to permit interference by creditors with marital homes owned as a tenancy by the entirety, and ruled it would be unfair to dispossess Mrs. Antar

from her marital home because the SEC's judgment was against Mr. Antar only. *SEC v. Antar et al.,* 120 F.Supp. 2d 431, 450 (D.Ct. New Jersey 2000).

While Lynn Smith has been named as a defendant in this action based on allegations of fraudulent transfers of other real and personal property, she is essentially a relief defendant in all respects, and any judgment potentially reached will be against David Smith alone. Lynn Smith has owned the Saratoga property with David L. Smith, as husband and wife[1], continuously since 2003. *Smith Declaration, dated July 27, 2012, paragraph 2.* (Dkt. No. 508-5 at 2).

This case is similar to Antar because the law in New York State is similar to that of New Jersey in that so long as the couple remains married, the survivorship right of each spouse cannot be terminated. Accordingly, while a creditor of one tenant by the entirety can obtain a lien on that spouse's interest in the property, the lien will only survive if that particular spouse is the surviving spouse. *Kahn v. Kahn,* 43 NY2d 203 (1977).

Again, the SEC is seeking to force a sale of the Smiths' home without a judgment or lien or an order of disgorgement, which will essentially result in the displacement of Lynn Smith from her marital home despite the fact there are no allegations that she participated in the perpetration of securities fraud. With the SEC not even being a creditor of David Smith at this point, it would be unjust and contrary to New York State law to order a forced sale based on Lynn Smith's rights as a tenant by the entirety.

[1] When a deed indicates that title is held as husband and wife, it is presumed to be a tenancy by the entirety. See, §6-2.2 of the E.P.T.L (a disposition of real property to a husband and wife creates in them a tenancy by the entirety unless expressly declared to be a joint tenancy or tenancy in common).

II. REPLY IN SUPPORT OF SMITHS' CROSS-MOTION SEEKING MODIFICATION OF THE ASSET FREEZE TO SATISFY THE MORTGAGE ON THE SARATOGA PROPERTY.

POINT I

THE MOTION TO HAVE THE RECEIVER SELL THE PROPERTY SHOULD NOT BE GRANTED BECAUSE A FORCED SALE IS NOT IN THE BEST INTEREST OF THE ALLEGED DEFRAUDED INVESTORS.

The Court should not be persuaded by the SEC's arguments that the satisfaction of the Smiths' mortgage is not in the best interest of the alleged defrauded investors for the following reasons:

First, a forced sale will likely yield to a purchase offer well below the true market value of the home.

Second, since New York law recognizes spousal survivorship interests in a tenancy by the entirety, any forced sale of the property must accurately reflect the value of Lynn Smith's right of survivorship as a tenant by the entirety or recognize the allocated $250,000 homestead exemption. In either case, a significant portion of the sale proceeds would be subtracted from the total amount available to the investors.

Additionally, the SEC's argument that there would be a "windfall at the expense of the victims" is factually inaccurate. The SEC motion fails to recognize that by paying off the mortgage of the Saratoga Property; taxes, interest, and penalties will cease to accumulate until a decision on a forced sale is made by this Court or and if necessary, confirmed by an appellate court. Interest is accruing on the mortgage at 4.75%, plus penalties. The cash being held by the Court order is, on information and belief, earning approximately 1% or less. Thus, there is currently an approximate negative spread of 4% on a loan balance of approximately $360,000 or $14,400 per year. Such negative interest will continue to accrue until the mortgage is paid either

by release of funds or by the sale of the house. Since a final determination to force the sale of the house may take some time in addition to ultimately finding a buyer, paying off the mortgage now will result in immediate savings to be preserved for the investors should the SEC be successful in its claims against David Smith.

Finally, the SEC's claim that the Saratoga Springs real estate market is risky and illiquid is suspect and lacks any expert support. The SEC has never moved to liquidate the Smiths' investment portfolios, which certainly contain far less liquid and more risky investments than the Smith primary residence. Moreover, the Saratoga Springs real estate market has previously been attested to as being a stable and increasing desirable market. See *Smith Declaration, Exhibit "A"*. (Dkt. No. 508-4 at 2). Thus, satisfying the mortgage and not forcing the sale of the Saratoga home would maintain a stable asset. The SEC's attempt to argue otherwise is simply not persuasive.

POINT II

THE SEC'S OPPOSITION TO THE SMITHS' CROSS-MOTION IS FILLED WITH FACTUAL INACCURACIES THAT THE COURT SHOULD DISREGARD.

The SEC states in their motion that the Smiths have had the cash available to make proper mortgage payments but have chosen not to. This is incorrect. Currently, the Smiths' entire monthly income, including renting the property for the Saratoga racing season, is insufficient to meet the monthly mortgage obligations, let alone the taxes. The limited monthly income the Smiths do receive presently is being used for living expenses and upkeep of the Saratoga home. *Smith Declaration, paragraph 9.* (Dkt. No. 508-3 at 5).

To support its argument the SEC references the proceeds of the sale of the Sacandaga Lake property, formerly owned by Lynn Smith. Although the Smiths did receive $600,000 in

July of 2010 due to the sale of such property to the Smith Trust, the SEC, on information and belief is aware that the majority of those proceeds were allocated for outstanding attorney fees. Additionally, the proceeds of the Sacandaga property was used to pay the mortgage on the Saratoga property for 15 months until those funds were eventually exhausted. See *Smith Declaration, Exhibit C.* (Dkt. No. 508-5 at 7). Since that time, the Smiths have been unable to meet their current mortgage obligations due to the asset freeze.

It should also be pointed out that the Smiths have not made a mortgage payment since June 1, 2011. See *Kornstein Declaration paragraph 5.* (Dkt. No. 505-3 at 2). This represents a 14 month period. The SEC inaccurately argues that the Smiths have not made any payment for 18 months.

POINT III

THE SMITHS ARE UNABLE TO ASSERT WHAT FORECLOSURE RIGHTS THEY ARE ENTITLED TO BECAUSE THEY HAVE NOT HAD THE BENEFIT OF DISCOVERY OR THE OPPORTUNITY TO OTHERWISE EXERCISE THEIR DUE PROCESS RIGHTS IN A FORMAL FORECLOSURE PROCEEDING.

The Smiths have not established what foreclosure rights they are entitled to because the issue is not yet ripe. Since there is a loan modification pending and a current asset freeze, the foreclosure process has yet to be commenced and the Smiths should not be forced to litigate a foreclosure action essentially blind without the benefit of procedural due process rights. Due to these circumstances, the Smiths have not been entitled to any discovery through formal foreclosure proceedings and therefore it is impossible to express to the Court what rights and defenses may be available to them. The Smiths could potentially argue that the bank has not negotiated in good faith which could estop the bank from proceeding with the foreclosure action.

They could also have a defense that the bank lacks standing to even proceed to foreclosure on the Saratoga property. These are just a few of the potential defenses that could arise in a more formal proceeding once the Smiths have the opportunity to identify the issues.

POINT IV

THE RECEIVER'S RESPONSE TO THE SMITHS' CROSS-MOTION IS OF NO CONSEQUENCE BECAUSE THE SARATOGA PROPERTY IS NOT PART OF THE RECEIVERSHIP ESTATE.

The Receiver's request for "compensation to the receivership for the Smiths living at the premises for free since defaulting" should not be granted in the event the Smiths are successful on their cross-motion. Although the Court has granted the Receiver control over certain McGinn Smith entities, the Saratoga property continues to belong to the Smiths, and not to the Receiver.[2] The house has never been included in the Receiverships estate and no Court order has ever assigned the Saratoga property to the Receiver. Due to the asset freeze currently in place, the Smiths are simply prevented from selling or transferring the property until the allegations against David Smith are resolved. In the event the Smiths are successful in their cross-motion and the Court agrees to satisfy the existing mortgage, title and legal ownership will remain with the Smiths. Significantly, the Receiver provides no legal authority to substantiate his request for the Smiths to subsidize the Receivership estate with unquantified payments since they defaulted on their loan. Consequently, the Court should reject this application.

Furthermore, the Court should also reject the Receivers request for "[a]n inspection of the premises by the Receiver and his professionals which would examine the condition,

[2] The Order Freezing Assets and Granting Other Relief, signed by Northern District Judge David R. Homer on April 20, 2010, does not mention any personal property of the Smiths, and more specifically does not refer to the Saratoga residence. Additionally, there is no reference to the Receiver's capabilities in controlling and or liquidating personal assets held by the Smiths.

marketability and value of the premises since no on-property inspection by the Receiver has been conducted." Due to the Receiver's limited jurisdiction, he should not be permitted access to the Smiths' real or personal property for whatever inspections he deems necessary.

CONCLUSION

For the foregoing reasons, Defendant/Relief Defendant Lynn Smith respectfully request that the SEC/Citizens' application seeking a modification to the asset freeze enabling them to either foreclose or sell the Saratoga home privately by the Receiver be denied in all respects and that the cross-motion seeking a modification to the asset freeze to satisfy the existing mortgage lien or such other relief the Court deems appropriate to maintain the asset be granted in all respects.

Dated: August 15, 2012

Respectfully submitted,

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