

**UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK**

SECURITIES AND EXCHANGE
COMMISSION,

Plaintiff,

v.

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

DAVID L. SMITH and LYNN A. SMITH,

Defendants.

APPEARANCES:

OF COUNSEL:

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**DAVID R. HOMER
U.S. MAGISTRATE JUDGE**

WILLIAM J. DREYER, ESQ.

JAMES D. FEATHERSTONHAUGH, ESQ.
SCOTT J. ELY, ESQ.

WILLIAM J. BROWN, ESQ.

MICHAEL A. KORNSTEIN, ESQ.

MEMORANDUM-DECISION AND ORDER

Presently pending are the (1) joint motion of plaintiff Securities and Exchange Commission ("SEC") and Citizens Bank for an order modifying the preliminary injunction as to the Saratoga Springs residence of defendants David L. Smith and Lynn A. Smith to permit the sale of that residence by Receiver William J. Brown, Esq. ("Receiver") (Dkt. No. 505), and (2) cross-motion of the Smiths to release certain assets frozen under the preliminary injunction to permit payment of costs associated with their residence (Dkt. No. 508). For the reasons which follow, both motions are denied.

I. Background

In prior proceedings, the assets of David and Lynn Smith were frozen in a preliminary injunction for the benefit of investors in the event that the SEC prevails in this action. See Dkt. Nos. 4, 5, 96. The Receiver was appointed to take control of and manage the defendants' assets pending a final resolution of this case. Dkt. Nos. 4, 5. Familiarity with the various decisions addressing issues under the preliminary injunction is assumed. See, e.g., Dkt. No. 263 (granting leave for the Receiver to sell the Smiths' Florida vacation home to avoid further diminishment of value), aff'd, 653 F.3d 121 (2d Cir. 2011).

Among the assets frozen by the preliminary injunction was a residence in Saratoga Springs, New York owned jointly by the Smiths. Kornstein Decl. (Dkt. No. 505-3) at ¶ 3. The Smiths took title to the property on August 7, 2003 for the payment of \$789,900.00. D. Smith Decl. (Dkt. No. 508-3) at ¶ 2. The Smiths financed \$600,000 of the purchase

price through a mortgage now held by Citizens Bank. Kornstein Decl. at ¶ 4; D. Smith Decl. at ¶ 2. Since this purchase, the Smiths have used the Saratoga Springs property as their primary residence. D. Smith Decl. at ¶ 3 (“From October 2003 to the present, the Property has been used as our primary residence.”).¹ By April 2010, the balance due on the mortgage had been reduced to approximately \$360,000.00. D. Smith Decl. at ¶ 7.²

Beginning in April 2010, a federal criminal investigation against David Smith and others as well as this action by the SEC were commenced. See Dkt. No. 86 at 6 n.10. The Smiths became unable to pay their monthly mortgage payments of approximately \$4,667.00 or the taxes on the residence. D. Smith Decl. at ¶ 7. As a result, the Smiths are now in arrears to Citizens Bank for approximately \$71,500.00. Kornstein Decl. at ¶ 5.³

¹There has been no dispute throughout this action that the Smiths used the Saratoga Springs property as their primary residence. See, e.g., Smith v. S.E.C., 653 F.3d at 125 (referring to the Saratoga Springs property as “the Smiths’ primary residence”). However, in 2011 and 2012, the Smiths leased their residence to tenants during the six-week Saratoga race track season. D. Smith Decl. at ¶ 6. The temporary use of the residence as a rental property has caused the SEC and Citizens Bank to question whether this temporary rental of the property refutes the Smiths’ assertion that the property remains their primary residence. See Kornstein Decl. at ¶ 19. The rental of this property lasted only six weeks in each of two years, the Smiths assert without contradiction that they continued to utilize the property as their primary residence at all other times, and the property will, therefore, be deemed the primary residence of the Smiths for purposes of these motions. See D. Smith Decl. at ¶ 9 (asserting, without contradiction, that the Smiths continue living at the Saratoga Springs residence, maintaining insurance coverage, and performing all necessary maintenance).

²The Smiths also obtained a home equity line of credit now held by Citizens Bank with a credit limit of \$115,400.00. Kornstein Decl. at ¶ 6. The Smiths have never drawn funds against this account, but the bank asserts a claim for \$751.00 for various fees incurred on the account. Id.

³The bank asserts that “[t]he total amount due on the [mortgage] as of July 11, 2012 is approximately \$372,500.00.” Kornstein Decl. at ¶ 5. A total of approximately \$32,000.00 in unpaid taxes is also owed. Id. at ¶ 13.

Since April 2010, the Smiths have applied to the bank on several occasions for a modification of their payment schedule. D. Smith Decl. at ¶ 8. Their most recent application remains pending with the bank and, while not withdrawing its motion herein, the bank states that it may agree to a trial modification of the terms for a three-month period to determine if the Smiths are able to comply with the modified terms. Kornstein Decl. at ¶ 17; D. Smith Decl. at ¶ 8. However, the application remains pending and no final decision has yet been made. Kornstein Decl. at ¶ 17; D. Smith Decl. at ¶ 8. The present fair market value of the property appears to be approximately \$1 million. D. Smith Decl. at ¶¶ 4, 12; Kornstein Decl. at ¶ 12 (“Upon information and belief, the Property may have a value substantially in excess of the amounts due Citizens Bank.”).

II. Discussion

A. Sale of Residence

This Court may modify the preliminary injunction to permit the sale of a frozen asset where the value of the asset may be impaired by time or circumstances. See Smith v. S.E.C., 653 F.3d at 128-29. In exercising such discretion, however, the Second Circuit Court of Appeals has cautioned that

[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.

S.E.C. v. Unifund SAL, 910 F.2d 1028, 1039 (2d Cir. 1990) (emphasis added and citations omitted). Moreover, “[w]here 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.” Smith v. S.E.C., 653 F.3d at 128.

Here, the asset for which the SEC and Citizens Bank seek leave to sell is the Smiths’ primary residence. The relief requested is not simply the preservation of the status quo but the sale of two defendants’ primary residence. The burden which the SEC and Citizens Bank must meet to establish entitlement to such relief is, therefore, heightened beyond that applicable to, for example, a motion seeking leave to sell a vacation property. For several reasons, the SEC and Citizens Bank have failed to meet that high standard of proof.

First, because it is the Smiths’ primary residence, it is likely beyond the reach of the SEC in this action at least to the extent of the New York homestead exemption. Under N.Y. C.P.L.R. § 5206, real property owned and occupied as the principal residence is, to a certain degree, exempt from the satisfaction of money judgments. In 2010 the law was changed, increasing the homestead exemption depending on the county in which the property is situated. For Saratoga County the exemption amount is \$125,000. Id. New York allows married couples to double the homestead exemption, allowing each spouse to claim the full amount on the property. John T. Mather Mem. Hosp. of Port Jefferson, Inc. v. Pearl, 723 F.2d 193, 193-94 (2d Cir. 1983). Therefore, a married couple living in Saratoga County, such as the Smiths, is exempt up to \$250,000.00. The existence of the

homestead exemption also underscores the significantly heightened interest accorded homeowners in any proceedings such as this for collection or disgorgement.

Second, the financial circumstances of the sale militate against the relief sought. The fair market value of the property far exceeds that which is owed to the bank, even when outstanding tax liabilities, interest, and penalties are included. Thus, while the bank is temporarily harmed by the loss of income from the payment of the mortgage and taxes, and while the bank incurs an ongoing risk that its security interest may be impaired if the value of the property is diminished, there appears little reasonable likelihood of this occurring. The market value of the property so far exceeds the amount owed that the bank's interests appear reasonably secure at this time. Moreover, the Smiths continue to maintain both the insurance and the physical integrity of the property, thereby preserving its value. It thus appears reasonably certain that Citizens Bank will receive what it is owed on the Smiths' mortgage even though the date when that will occur cannot yet be determined with precision.

Third, in this regard, it is noted that the criminal investigation has resulted in an indictment of Smith and one co-defendant on criminal charges paralleling the civil claims brought by the SEC in this action. See United States v. McGinn, No. 12-CR-28 (DNH) (N.D.N.Y. filed Jan. 26, 2012). The indictment contains a forfeiture allegation generally paralleling the asset forfeiture sought here. See Indictment (Crim. Dkt. No. 1) at 27-28. The trial of the criminal case is scheduled to commence on November 13, 2012. Crim Dkt. Entry dated 7/2/2012. While the standard of proof applicable in a criminal case differs from that applicable in a civil case such as this, resolution of the criminal charges (1) may have a material impact on the claims in this action and (2) will permit the stay now in effect

in this action to be lifted and the claims here to proceed to conclusion. Thus, it appears that the claims in this action will likely be resolved in the foreseeable future and that the risk now imposed on the bank by the asset freeze will not continue without end or for an unreasonable period of time.

It would appear at this time that the interests of the SEC and Citizens Bank and those of the Smiths are aligned. All assert that they are and will be entitled to the Saratoga Springs property and it thus remains in the best interests of each for the property to remain insured and in marketable condition. Because they occupy the property, responsibility for insurance and maintenance falls to the Smiths. They assert that insurance and marketable condition have been maintained to date. See D. Smith Decl. at ¶ 9 (stating that the Smiths have maintained the property “as any typical homeowner.” The SEC and Citizens Bank are entitled to assurance that insurance and maintenance continue in the future. Accordingly, while the motion of the SEC and Citizens Bank is denied, it is ordered that the Smiths provide proof of insurance coverage in the future when requested by the SEC or Citizens Bank. As to maintenance, it is noted that the Smiths concede that the mortgage grants both the bank and the SEC the authority to inspect the property to assess its condition. Id. (“At no time prior to this application has Mr. Kornstein, his client or any representative of the SEC visited the Property to substantiate these conclusions despite having the explicit authority to do so in the mortgage.” (emphasis added)).

B. Release of Assets

As an alternative to granting the SEC and Citizen Bank leave to sell the Saratoga

Springs property, the Smiths move for an order releasing certain frozen assets from the preliminary injunction to permit the Smiths to satisfy their outstanding mortgage and tax obligations. Since the motion of the SEC and Citizens Bank is denied and the status quo continues, however, no basis appears for the Smiths' cross-motion and it is also denied.


III. Conclusion

For the reasons stated above, it is hereby

ORDERED that:

1. The motion of the SEC and Citizens Bank to modify the preliminary injunction to permit the sale of the Smiths' Saratoga Springs residence (Dkt. No. 505) is **DENIED** except that the SEC and Citizens Bank are granted leave to demand and receive from the Smiths proof of continued insurance coverage on the property; and
2. The Smiths' cross-motion to modify the preliminary injunction to permit the release of assets sufficient to pay their outstanding mortgage and tax obligations on their Saratoga Springs residence (Dkt. No. 508) is **DENIED**.

DATED: August 24, 2012



David R. Homer
U.S. Magistrate Judge