

**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, 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/CFH)

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.

**REPLY MEMORANDUM OF LAW TO PLAINTIFF'S OPPOSITION TO
DAVID L. SMITH'S AND LYNN A. SMITH'S JOINT MOTION FOR
MODIFICATION OF THE JULY 22, 2010 PRELIMINARY INJUNCTION
ORDER TO RELEASE CERTAIN ASSETS TO PAY TAX OBLIGATIONS**

In reply to the SEC's Opposition to David L. Smith's and Lynn A. Smith's Joint Motion for Modification of the July 22, 2010 Preliminary Injunction Order to Release Certain Assets to Pay Tax Obligations, dated July 2, 2013, David L. Smith and Lynn A. Smith assert the following:

ARGUMENT

POINT I

THE IRS IS ENTITLED AS A MATTER OF LAW TO A PRIORITY LIEN ON THE FROZEN ASSETS AS OF THE DATE OF ASSESSMENT SUPERIOR TO ANY FUTURE CIVIL JUDGMENT.

The SEC neglects to acknowledge 26 U.S.C. §§ 6321 and 6322 which establish that the Revenue Agent Reports issued to the Smiths assessing their tax liabilities created an IRS lien on the Smiths' frozen assets. Contrary to the SEC's broad assertions, these provisions of the Internal Revenue Code do give the IRS rights to frozen receivership assets, making it the first creditor to conclusively establish entitlement to the restitution. Specifically, 26 U.S.C. § 6321 provides:

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

Furthermore, under 26 U.S.C. § 6322, "the lien imposed by section 6321 shall arise at the time the assessment is made[.]" Thus, under these provisions, the IRS obtained a lien on the Smiths' assets as a matter of law on the date the amount of taxes due and owing was assessed. This lien predates any judgment that may be obtained in these proceedings, and therefore, must be the first to be paid out of the frozen assets.

In S.E.C. v. Levine, the Second Circuit considered competing claims between the SEC and IRS for funds disgorged from a securities fraud defendant. 881 F.2d 1165, 1174 (2d Cir. 1989). There, the SEC argued that the IRS did not have a claim to the frozen assets of the defendant under 26 U.S.C. § 6321 because the defendant had lost all property rights to which an IRS lien would attach, as the result of the preliminary freeze. Id. at 1177. The court rejected the SEC's argument and found that, although the defendant's assets were frozen, he maintained a property right that was subject to an IRS lien. Id. As such, under 26 U.S.C. §§ 6321 and 6322, the IRS had obtained a priority lien on the frozen assets, superior to other creditors, on the date the taxes were assessed. Id.

Here, the SEC seeks to postpone payment of the Smiths' taxes due and owing and replay Levine after the conclusion of this case, with the obvious consequences being the loss of funds available to investors due to the accrual of interest and penalties. As in Levine, under 26 U.S.C § 6321 the IRS has obtained a lien on the Smiths' frozen assets by virtue of the Smiths' failure and inability to pay the taxes due and owing. Additionally, because the lien arises on the date the taxes were assessed, the Smiths' tax obligation clearly pre-dates any future potential civil judgment on behalf of the allegedly defrauded investors. Thus, the only possible outcome of postponing the payment of the Smiths' taxes due and owing from the frozen assets is that the remaining amount of money available to investors will be greatly diminished by virtue of interest charges and penalties. The SECs insistence on this "no-win" course of action is indicative of their true motivations in contesting this Motion: to heap penalties upon the Smiths rather than protect the interests of investors.

POINT II

THE PRELIMINARY INJUNCTION ORDER IS NOT A FINAL ADJUDICATION THAT SUBJECTS LYNN A. SMITH'S ASSETS TO DISGORGEMENT.

The SEC continues to rely on the Preliminary Injunction Order freezing the assets of Lynn A. Smith to support its misplaced assertion that "[t]he Stock Account is an asset of David Smith, and it should remain frozen to satisfy the future judgment against him." Dkt. 579, at 4–5. Despite this, the SEC is well aware that the standard of proof necessary to obtain a preliminary injunction is by no means equivalent to an ultimate finding that those assets were ill-gotten. S.E.C. v. McGinn, Smith & Co., Inc., et al., 752 F. Supp. 2d 194, 205 (N.D.N.Y. 2010) (explaining that a preliminary freeze is not a finding of wrongdoing but rather, shows that the relief defendant is "merely in possession of assets or property that the SEC *claims* is ill-gotten and seeks to recover." [emphasis added]). There has been no finding of wrongdoing on the part of Mrs. Smith, nor has the SEC obtained a final adjudication that her assets are subject to disgorgement to the allegedly defrauded investors. This Court is free to modify the freeze as circumstances require after weighing "the disadvantages and possible deleterious effect of a freeze . . . against the considerations indicating the need for such relief." S.E.C. v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1106 (2d Cir. 1972).

POINT III

THE SMITHS ARE UNABLE TO SATISFY THE TAXES DUE AND OWING WITHOUT THE COURT RELEASING FUNDS FROM THE ASSET FREEZE.

The SEC again asks this Court to adopt an unrealistic view of present circumstances when it asserts that "the Smiths must look to their own resources to pay this debt[.]" Dkt. 579, at 6. The SEC purposely ignores the fact that, as a result of the freeze, the Smiths no longer have

control of their own finances. Despite possessing substantial assets prior to any allegations of wrongdoing, any funds that they could have used to satisfy their tax due and owing have been swept up in the freeze and are currently under the control of the Receiver. Dkt. 456-1, at 2–3. Even those funds that clearly do not stem from any alleged fraud, such as the \$100,000 inherited from Lynn Smith’s father in 1968, are now being held out of their reach. *Id.* The SEC’s accusation that “[t]he Smiths . . . have made no showing of any efforts to pay” further defies reality in that this Motion is in and of itself an effort to pay, and in fact, the only reasonable attempt to pay that the Smiths could undertake under present circumstances. Dkt. 579, at 6. Without the intervention of this Court in releasing funds from the asset freeze, the Smiths will inevitably be unable to satisfy their federal tax obligations, and the amount due will accrue interest and penalties, thus cutting into the amount available to investors.

POINT IV

THE RECEIVER LACKS STANDING TO RESPOND TO THE MOTION AND JOIN IN THE SEC’S OPPOSITION.

It is respectfully submitted that the Receiver, William J. Brown, lacks standing to respond to the Smiths’ Motion and his (I) Reply to Smiths’ Joint Motion for Modification of the Preliminary Injunction Order to Release Assets to Pay Criminal Tax Obligations and (II) Joinder in SEC’s Memorandum of Law in Opposition as the current Motion before this Court does not affect any of the Receiver’s duties pursuant to the freeze order in place. As such, the Receiver’s response and joinder should not be considered by this Court.

CONCLUSION

Based on the foregoing, the defendants David L. Smith and Lynn A. Smith respectfully request that their Motion to Modify the July 22, 2010 Preliminary Injunction Order to Release Funds to Pay Taxes Due and Owing be granted.

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