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, GEOFFREY R. SMITH, Individually and as Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04, LAUREN T. SMITH, and NANCY McGINN, *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.*	Case No. 1:10-CV-457 (GLS/CFH)

MEMORANDUM OF LAW IN SUPPORT OF THIRD MOTION OF WILLIAM J. BROWN, AS RECEIVER, FOR AN ORDER DISALLOWING CERTAIN CLAIMS (BROKER CLAIMS)

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William J. Brown, as Receiver ("Receiver") of McGinn, Smith & Co., Inc. ("MS & Co."), respectfully submits this Memorandum of Law in support of his Motion ("Motion") for an Order disallowing or equitably subordinating the claims of certain Brokers and a related party (as defined in this Memorandum).

PRELIMINARY STATEMENT

From 2003 to 2010, David L. Smith and Timothy M. McGinn orchestrated an elaborate Ponzi scheme through which more than 900 investors were defrauded. Altogether, Smith and McGinn raised over $136 million in over twenty unregistered debt offerings and funneled that money into other entities controlled by McGinn and Smith. The implementation of this scheme would not have been possible without the efforts of the registered representatives of MS & Co., who recklessly sold private placements in the Four Funds and the Trust Offerings to unsuspecting investors. Although the registered representatives claim to have been ignorant of the Ponzi scheme, they were aware of several "red flags" surrounding the offerings and the operations of MS & Co. that should have suggested to each of them that something was amiss.

Indeed, in a Securities and Exchange Commission proceeding initiated against certain of the registered representatives, the Chief Administrative Law Judge held that the registered representatives - including Frank H. Chiappone, William F. Lex, and Philip S. Rabinovich - violated the Securities Act and the Exchange Act by selling the Four Funds and the Trust Offerings without any independent investigation of the offerings, despite their knowledge of red flags that should have indicated something was wrong, or at least prompted independent investigation.

Chiappone, Lex, and Rabinovich should not be permitted to share in investor recoveries after recklessly selling MS & Co. offerings to innocent investors in complete disregard of their duty owed to their customers. Accordingly, the claims of Chiappone, Lex and Rabinovich, as well as the claims transferred to Kathleen Lex, should be disallowed or, in the alternative, equitably subordinated.

STATEMENT OF FACTS

MS & Co. was a broker-dealer registered with the Securities and Exchange Commission ("SEC") with its headquarters in Albany, New York from 1981 to 2009. From 2003 through 2010, the broker-dealer was owned by David L. Smith ("Smith"), Timothy M. McGinn ("McGinn"), and Thomas E. Livingston.

On April 20, 2010, the SEC filed a Complaint initiating the above-captioned action (Docket No. 1). Also, on April 20, 2010, this Court granted a Temporary Restraining Order (Docket No. 5), which, among other things, froze certain assets of the above-captioned Defendants and Relief Defendants, and appointed the Receiver as temporary receiver with respect to numerous entities controlled or owned by Defendants McGinn and Smith, including those listed on Exhibit A to the Preliminary Injunction Order entered in this action (Docket No. 96) (collectively, the "MS Entities"). At the time of the Receiver's appointment, total bank account balances (not including some remote business operations whose bank accounts were not immediately visible to the Receiver's staff) were $485,491.63. Brown Dec'l. ¶6.[1]

[1] "Brown Dec'l. ¶ __" refers to the Declaration of William J. Brown dated March 19, 2018 filed in support of the Motion.

On July 26, 2010, following a hearing, the Court entered an order granting the SEC's Motion for a Preliminary Injunction and appointing the Receiver as receiver, pending a final disposition of the action ("Preliminary Injunction Order") (Docket No. 96).

On August 3, 2010, the SEC filed an Amended Complaint (Docket No. 100). On June 8, 2011, the SEC filed a Second Amended Complaint (the "Complaint") (Docket No. 334). On February 17, 2015, the Court issued its Memorandum-Decision and Order (Docket No. 807) ("MDO") granting the SEC's motion for summary judgment. The Court entered judgments in favor of the SEC in 2016 (Docket Nos. 835, 836, 837).

Generally, McGinn and Smith "orchestrated an elaborate Ponzi scheme, which spanned over several years, involved dozens of debt offerings, and bamboozled hundreds of investors out of millions of dollars." MDO at 7. McGinn and Smith raised over $136 million between 2003 and 2010 in over twenty unregistered debt offerings, including the Four Funds -- FAIN, FEIN, FIIN, and TAIN -- and various Trust Offerings, by representing that investor money would be "invested," when instead it was "funneled" into various entities owned or controlled by McGinn and Smith. That money was then used to fund unauthorized investments and unsecured loans, make interest payments to investors in other entities and offerings, support McGinn's and Smith's "lifestyles," and cover the payroll at MS & Co. MDO at 7.

A. Broker Proceedings

On September 23, 2013, the SEC issued an Order Instituting Administrative and Cease-and-Desist Proceedings ("OIP") as to certain registered representatives who sold MS & Co. private placements in the Four Funds and the Trust Offerings. *Donald. J. Anthony, Jr., et al.,* Order Instituting Proceedings Release No. 33-9454 (Sept. 23, 2013), 107

SEC Docket 5, attached to the Brown Dec'l as Exhibit A. Among those registered representatives named in the OIP were Frank H. Chiappone ("Chiappone"), William F. Lex ("Lex"), and Philip S. Rabinovich ("Rabinovich" and collectively with Chiappone and Lex, the "Brokers"). The SEC alleged that the Brokers violated the securities laws by knowingly or recklessly recommending MS & Co. unregistered offerings to clients with no reasonable basis for the recommendation and knowing of red flags, and misrepresenting and omitting material information. OIP at 5. The SEC did not allege that the Brokers had actual knowledge of the fraud.

On February 25, 2015, the Chief Administrative Law Judge ("ALJ") entered an Initial Decision ("ID") finding that each of the Brokers willfully violated the Securities Act, the Exchange Act and Rule 10b-5 through their sales of private placements in the Four Funds and the Trust Offerings.[2] *Donald. J. Anthony, Jr., et al.,* Initial Decision Release No. 745 (Feb. 25, 2015), 110 SEC Docket 19, *modified by* Order on Motions to Correct Manifest Errors of Fact in the Initial Decision, Administrative Proceedings Release No. 2528 (Apr. 9, 2015), 111 SEC Docket 5, attached to the Brown Dec'l as Exhibit B. The Brokers petitioned the SEC for review of the ALJ's Initial Decision and, on May 21, 2015, the SEC granted the Brokers' petitions. *Frank Chiappone, et al.*, Order Granting Petitions for Review and Scheduling Briefs Release No. 33-9790 (May 21, 2015), 111 SEC Docket 11. On August 15, 2017, oral argument on the Brokers' appeals was held before the SEC. *Frank Chiappone, et al.*, Order Scheduling Oral Argument Release No. 33-10382 (Jun. 30, 2017), 117 SEC Docket 1. The SEC has not yet ruled on the Broker's appeals.

[2] On November 30, 2017, the SEC remanded the proceeding to the ALJ, directing that the ALJ reconsider the record and determine whether to ratify the determination reached in the Initial Decision. *Pending Admin. Proc.*, Securities Act of 1933 Release No. 10440, 2017 SEC Lexis 3724. The ALJ has extended the deadline to make a determination on ratification to March 30, 2018. *Donald. J. Anthony, Jr., et al.*, Administrative Proceedings Rulings Release No. 5609 (Feb. 15, 2018), 118 SEC Docket 14.

The ALJ found that in September 2003, the Brokers began offering and selling unregistered notes issued by the Four Funds, which were non-specific asset offerings in which Smith chose the investments. ID at 5. The private placement memoranda ("PPMs") for each of the Four Funds were almost identical. The PPMs stated that the Four Funds "could acquire . . . [i]nvestments directly, or from . . . an affiliate." *Id.* at 6. The PPMs for the Four Funds also included cautionary statements, warning that an investment in the Four Funds involved "significant risks." *Id.* at 6-7.

In November 2006, the Brokers began offering and selling certificates in certain MS & Co. specific purpose entities ("Trust Offerings"). MS & Co. entities controlled the activities of each of the Trust Offerings. The PPMs for the Trust Offerings stated that the offering proceeds would be invested in burglar alarm contracts; broadband, cable, and telephone services contracts; or luxury cruise bookings. *Id.* at 8. The PPMs of the Trust Offerings also stated that MS & Co. or a related entity had performed a due diligence examination, but that such due diligence review could not be considered independent due to various conflicts. *Id.* at 9.

The ALJ's factual findings and rulings with respect to each of the Brokers are as follows:

1. Frank H. Chiappone

Chiappone worked as a registered representative at MS & Co. from August 1998 to December 2009. ID at 10. Between October 2003 and November 2009, Chiappone sold $13,522,000 of the Four Funds and the Trust Offerings, for which he earned commissions of $531,844. *Id.* at 15.

The ALJ found that Chiappone had relied on others at MS & Co. to perform due diligence on the suitability of the offerings and that he did not undertake any independent due diligence on or investigation into the offerings. Chiappone read the PPMs for the Four Funds but did not question the risk factors described in the PPMs. *Id.* at 11.

At one point, Chiappone discovered that the investors in Firstline Trust, a Trust Offering, were being paid with proceeds from other trusts, inconsistently with the PPMs. Notwithstanding these concerns, and after receiving assurance from Smith, Chiappone sold $80,000 in Firstline notes in May 2008. *Id.* at 14.

As early as November 2007, Chiappone was aware that MS & Co. would not honor redemption requests for the Four Funds unless replacement investors were brought in. *Id.* at 12. However, Chiappone continued to market and sell the Four Funds until early 2008. *Id.* at 13. On January 8, 2008, Chiappone attended a meeting with other registered representatives during which Smith announced that the interest on the Four Fund's junior notes would be reduced, due to a lack of liquidity in the Four Fund's investments caused by a market meltdown. Chiappone then wrote an email to Smith in August 2008, accusing Smith of mismanaging the Four Funds' assets and lying about the cause of the liquidity problems. Although Chiappone stopped selling placements in the Four Funds after the January 2008 meeting, he continued selling placements in the Trust Offerings and did not mention his misgivings to his clients. *Id.* at 13.

The ALJ ruled that Chiappone was reckless in offering and selling securities based on material misrepresentations and omissions that he made to investors purchasing private placements. Chiappone recommended investments without any investigation of certain red flags that were known to him and he did not inform investors of his concerns

about MS & Co. *Id.* at 100. The ALJ ruled that Chiappone's sales of the MS & Co. private placements constituted a necessary part of MS & Co.'s fraud and were part of a device, scheme or artifice to defraud in willful violation of Securities Act Section 17(a)(1) and Exchange Act Section 10(b)(5) and Rule 10b-5. Further, the ALJ ruled that Chiappone willfully violated Securities Act Section 17(a)(2) and (a)(3) by obtaining money by means of untrue material statements. *Id.*

2. William F. Lex

Lex worked as a registered representative at MS & Co. from 1983 to December 2009. Between September 2003 and July 2009, Lex sold $45,536,000 of MS & Co. private offerings for which he earned $1,766,000 in commissions. ID at 31.

Lex counted on Smith to conduct due diligence with respect to the Four Funds. Lex read the PPMs for the Four Funds and attended presentations for the Four Funds but did not question the PPMs. *Id.* at 31. Lex approached sales of the Trust Offerings similarly, reading only the PPMs and attending presentations given by McGinn, but conducting no independent diligence. *Id.* at 34. Lex sold private placements in the Four Funds from 2003 to 2006 without requesting financial statements or a statement of operations. *Id.* at 32. Eventually, in March 2006, Lex received a list of investments in the Four Funds, but he did not ask any questions regarding these investments, even though the list showed, among other things, investments in MS & Co. affiliates and in pre-2003 notes. *Id.* at 32-33.

Lex knew of liquidity problems in the Four Funds in late 2007 but continued to sell placements in the Four Funds. In December 2007, Lex offered to extend the offerings of his own Four Funds notes to help MS & Co. with its cash flow problems. *Id.* at

33-34. In March 2009, Lex and Smith exchanged emails by which Lex learned that redemptions were being approved only if enough replacement sales were made. Lex continued to sell placements in the Trust Offerings after this email exchange. *Id.* at 35.

The ALJ ruled that Lex was reckless in offering and selling securities based on material misrepresentations and omissions that he made to investors. *Id.* at 103. Lex recommended and sold risky private placements without resolving any of the red flags posed by the investments and did not disclose this material information to his clients. *Id.* at 103. The ALJ ruled that Lex's sales of the MS & Co. private placements constituted a necessary part of MS & Co.'s fraud and were part of a device, scheme or artifice to defraud in willful violation of Securities Act Section 17(a)(1) and Exchange Act Section 10(b)(5) and Rule 10b-5. The ALJ also ruled that Lex willfully violated Securities Act Section 17(a)(2) and (a)(3) by obtaining money by means of untrue material statements. *Id.*

3. Philip S. Rabinovich

Rabinovich was a senior vice president, registered representative, and an investment advisor with MS & Co. from 2006 to 2009. From 2004 to 2009, Rabinovich sold $16,206,500 of private placements and earned $587,000 in commissions on those sales. ID at 55.

Rabinovich knew of the major investments made by the Four Funds from September 2003 to late 2008 but did not conduct any independent examination of the underlying investments. Rabinovich was aware that the Four Funds were investing in ways inconsistent with their PPMs (for example, by providing a bridge loan to a start-up company called alseT). *Id.* at 56.

In late 2007, Rabinovich was aware that there were issues with redemption of the Four Funds offerings when a client complained that her redemption had not been honored. In early 2008, Rabinovich became aware that redemptions were not being honored without a new buyer in place. *Id.* at 59. Rabinovich attended the January 8, 2008 meeting with McGinn, Smith, and other registered representatives, where he learned of the liquidity problems with the Four Funds and the poor condition of the Four Funds' investments. However, Rabinovich did not discuss these problems with clients when presenting investments in the Trust Offerings. *Id.* at 57-58. Rabinovich's father provided bridge loans in October 2007 and again in January 2009 to certain of the Trust Offerings to ease MS & Co.'s liquidity issues. *Id.* at 59.

The ALJ ruled that Rabinovich was reckless in offering and selling securities based on material misrepresentations and omissions that he made to investors purchasing private placements. *Id.* at 108. The ALJ ruled that Rabinovich failed to investigate several red flags that became known to him and instead continued to sell placements in the Four Funds and the Trust Offerings. *Id.* at 107. The ALJ ruled that Rabinovich's sales of the MS & Co. private placements constituted a necessary part of MS & Co.'s fraud and were part of a device, scheme or artifice to defraud in willful violation of Securities Act Section 17(a)(1) and Exchange Act Section 10(b)(5) and Rule 10b-5. The ALJ also ruled that Rabinovich willfully violated Securities Act Section 17(a)(2) and (a)(3) by obtaining money by means of untrue material statements. *Id.* at 108.

B. The Claims Objection Motions

On September 21, 2017, the Receiver filed a Motion (Docket No. 937) ("First Claims Motion") to seek disallowance of certain filed paper claims that were duplicative of

the corresponding claims granted by the Receiver. On November 9, 2017, the Receiver filed a Statement (Docket No. 957) in furtherance of the First Claims Motion, adjourning the First Claims Motion with respect to those duplicative investor paper claims filed by investors whose Receiver-granted claims have been disputed by the Receiver. On December 28, 2017, the Court entered an Order granting the First Claims Motion and disallowing the duplicative paper claims other than with respect to those filed by investors with disputed claims (Docket No. 966).

On February 15, 2018, the Receiver filed a Motion (Docket No. 974) ("Second Claims Motion") to seek disallowance of certain filed paper claims for which there is no basis for payment in the books and records of MS & Co. The return date of the Second Claims Motion is April 19, 2018.

C. The Broker Claims

Each of the Brokers and, in the case of Lex, his wife-transferee, hold disputed claims against certain of the MS Entities and, as required by the Court-approved claims procedures, have filed duplicative paper claims on account of those investments as required by the Court-approved claims procedure, as well as paper claims for amounts in excess of their disputed claims or for investments for which there is no record in the books and records of MS & Co. (collectively, the "Broker Claims"). The Broker Claims are listed in detail on Exhibit A to the Motion. Altogether, there are fourteen Broker Claims (exclusive of the duplicate paper claims). Brown Dec'l ¶ 13.

Among the Broker Claims listed on Exhibit A are certain claims belonging to Kathleen C. Lex, who, upon information and belief, is the wife of Lex. Ms. Lex holds four claims, three on account of investments made in TAIN and one account of an investment in

FAIN. Copies of the original investment registers for the FAIN Secured Senior Subordinated Notes and the TAIN Secured Senior Notes, which were excel spreadsheets maintained internally at MS & Co. to track investments, are attached to the Brown Dec'l as Exhibit C (the "Investment Registers"). The Investment Registers have been redacted to protect certain personal information, as well as to remove certain extraneous information. Brown Dec'l ¶ 14.

The Receiver is seeking disallowance, or equitable subordination, of Ms. Lex's claims along with Lex's claims because the investment registers show that these investments were originally made by Lex and Ms. Lex as joint investors. The Investment Registers show that in 2006 and 2007, Lex and Ms. Lex jointly made three investments in TAIN and one investment in FAIN. Those investments were subsequently transferred on or after April 23, 2009, for the TAIN investments, and September 10, 2009, for the FAIN investment. Three investments for TAIN and one investment for FAIN, each in the same amount as the joint investments, were transferred into Ms. Lex's name on or after April 23, 2009, for the TAIN investments, or September 10, 2009, for the FAIN investment. The investments transferred to Ms. Lex's name were the same investments originally made jointly by Ms. Lex and Lex. Brown Dec'l ¶ 15.

ARGUMENT

A. Applicable Standard

The district court has broad power and discretion to determine relief in an equity receivership. *See S.E.C. v. Elliott*, 953 F.2d 1560, 1566 (11th Cir. 1992); *S.E.C. v. Basic Energy & Affiliated Res., Inc.*, 273 F.3d 657, 668 (6th Cir. 2001). This includes the discretion of district courts to classify claims sensibly in order to achieve and equitable result. *See*

S.E.C. v. Enter. Trust Co., 559 F.3d 649, 652 (7th Cir. 2009); *S.E.C. v. Infinity Grp. Co.*, 226 Fed. Appx. 217, 218 (3d Cir. 2007).

District courts have used their broad equitable powers to disallow claims in equity receiverships based on the conduct of the claimants. For example, the courts have permitted equity receivers to exclude claimants from receiving distributions where such claimants were involved in the "development, implementation, and/or marketing" of a fraudulent Ponzi scheme. *See S.E.C. v. Byers*, 637 F.Supp.2d 166, 183 (S.D.N.Y. 2009) (approving distribution plan where employees who actively participated in a Ponzi scheme were excluded from receiving distributions). Courts have also approved distribution plans disallowing claims of investors who recklessly participated in a Ponzi scheme. *See S.E.C. v. Forte*, Civil Nos. 09-63, 09-64, 2012 WL 1719145 at *3 (E.D.Pa. May 16, 2012). A person acts recklessly if "he or she realizes or, from the facts which he [or she] knows, should realize that there is a strong probability that harm may result." *Id.* at *3. Investors who, by their reckless behavior, further a Ponzi scheme "are not 'innocent' and so are not entitled to the same relief as truly innocent investors." *Id.*

A district court also has "the authority to subordinate the claims of certain investors to ensure equal treatment." *S.E.C. v. Wealth Mgmt. LLC*, 628 F.3d 323, 333 (7th Cir. 2010). While equitable subordination is a concept that derives from bankruptcy case law, the district court has "the equitable power to subordinate one claim to another if it finds that the creditor's claim, while not lacking a lawful basis nonetheless results from inequitable behavior on the part of that creditor." *S.E.C. v. Am. Bd. of Trade*, 719 F.Supp. 186, 196 (S.D.N.Y. 1986) (internal quotation omitted). To equitably subordinate a claim, (1) the claimant must have engaged in some type of inequitable conduct and (2) the

misconduct must have caused injury to the creditors. *S.E.C. v. Spongetech Delivery Sys., Inc.*, 98 F. Supp. 3d 530, 551 (E.D.N.Y. 2014). Inequitable conduct includes "breach of fiduciary or other legally recognized duties." *Id.* at 553.

Brokers have a duty to investigate the securities that they recommend to their clients: "Brokers and salesmen are under a duty to investigate . . . . Thus, a salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant." *Hanly v. S.E.C.*, 415 F.2d 589, 594-96 (2d Cir. 1969).[3] "When recommending specific securities, a broker . . . cannot rely solely on the materials submitted by the issuer or given to him by his employer." *S.E.C. v. Platinum Inv. Corp.*, No. 02 Civ. 6093(JSR), 2006 WL 2707319 at *3 (S.D.N.Y. Sept. 20, 2006). While the amount of independent investigation required will vary depending upon circumstances, the duty to investigate is greater whenever the legitimacy of the investment is in some way questionable. *Id.* at *3.

B. The Broker Claims Should be Disallowed or, Alternatively, Equitably Subordinated

The Broker Claims should be disallowed or subordinated due to the Brokers' role in the Ponzi scheme orchestrated by McGinn and Smith. As set forth below, despite the presence of red flags that indicated that something was amiss with the MS & Co. private placements, each of the Brokers actively participated in the Ponzi scheme by selling private

[3] Courts have distinguished the holding in *Hanly*, holding that a broker's duty to investigate may not be applicable in private civil actions brought for damages against brokers predicated on the broker's negligence. *See*, *e.g.*, *Anwar v. Fairfield Greenwich Ltd.*, No. 09-cv-118 (VM), 2015 WL 10791912 at *3 (S.D.N.Y. Aug. 13, 2015) (holding that *Hanly* was not applicable to case at hand, where damages were being sought in a civil action); *Smith v. Questar Capital Corp.*, No. 12-cv-2669 (SRN/TNL), 2013 WL 3990319 at *12 n.5 (D. Minn. Aug. 2, 2013) (holding *Hanly* inapplicable to private civil action seeking damages based on negligence of broker firm); *BNP Paribas Mortg. Corp. v. Bank of Am., N.A.,* 866 F.Supp.2d 257, 267 (S.D.N.Y. 2012) (same). In the case at bar, the Receiver is not seeking damages due to the broker's negligence in failing to fulfill their duty to investigate, but rather is seeking to equitably subordinate the Broker Claims due to the Brokers' inequitable conduct.

placements in the Four Funds and the Trust Offerings to unsuspecting investors without any independent investigation. The Brokers failed to carry their duty to investigate the offerings and instead continued to sell the offerings in the face of numerous red flags. This inequitable conduct resulted in investors investing - and losing - millions of dollars in the Ponzi scheme.

The ALJ's findings and holdings with respect to each of the Brokers support the disallowance or subordination of the Broker Claims. The ALJ held that, despite the appearance of numerous red flags, the Brokers failed to carry out their duty to independently investigate the private placements and instead relied solely on the representations of Smith and McGinn when selling the private placements to unsuspecting investors. *Supra* Stmt. of Facts at 5-9. Moreover, the ALJ held that each Broker was reckless in offering and selling securities based on material and/or fraudulent misrepresentations in violation of the securities laws and that each Broker engaged in fraud in violation of the securities laws. *Id.* Accordingly, the ALJ's holdings, as set forth in the Initial Decision, further support the disallowance or the subordination of the Broker Claims.

1. The Claims of Frank H. Chiappone Should be Disallowed or Subordinated

Chiappone's claims should be disallowed or subordinated because he furthered the implementation of the Ponzi scheme by selling $13,522,000 of the Four Funds and the Trust Offerings between 2003 and 2009. ID at 15. Chiappone made these sales without conducting any independent diligence or investigation of the investments, notwithstanding his knowledge of red flags surrounding the private placements and MS & Co. Specifically, Chiappone was aware that proceeds from certain of the Trust Offerings were being used to pay investors in the Firstline Trust. He also knew that MS & Co. would

not honor investor redemptions unless new investor money came in and that the Four Funds were suffering severe liquidity problems. *Id.* at 12-14. Moreover, Chiappone had accused Smith of lying to the registered representatives and mismanaging assets, but still continued to sell MS & Co. private placements without mentioning his misgivings to his clients. *Id.* at 13. Based on these facts, Chiappone should have realized that there was a "strong probability" for harm to result to investors purchasing the private placements and acted recklessly by selling these private placements. *See S.E.C. v. Forte*, Civil Nos. 09-63, 09-64, 2012 WL 1719145 at *3. Further, Chiappone acted inequitably by failing to fulfill his duty to independently investigate the MS & Co. offerings in the face of red flags, causing harm to his customers, who will recover only a fraction of the millions that they invested through Chiappone. Accordingly, Chiappone's claims should be disallowed or, in the alternative, equitably subordinated.

2. The Claims of William F. Lex and Kathleen C. Lex Should be Disallowed or Subordinated

Lex's claims, including those claims for investments he made jointly with his wife, Kathleen C. Lex, should be disallowed or subordinated because, through his sales of private placements in the Four Funds and the Trust Offerings, Lex furthered the implementation of the Ponzi scheme. Between 2003 and 2009, Lex sold $45,536,000 of the Four Funds and the Trust Offerings. ID at 31. Lex relied completely on Smith to conduct due diligence with respect to the Four Funds and the Trust Offerings, and failed to conduct any independent investigation even though he knew the offerings were making investments inconsistent with the PPMs. *Id.* at 32-34. Lex continued to advise his clients as to the availability of placements in the Four Funds, even though he knew of the severe liquidity problems with the Four Funds - Lex even offered to extend the maturities on his own Four

Funds notes to ease the liquidity problems at MS & Co. *Id.* at 33-34. Lex was aware that redemptions were not being honored unless replacement investors were brought in, but he continued selling MS & Co. private placements. *Id.* at 35. Based on these facts, Lex should have realized that there was a "strong probability" for harm to result to investors from his sales of the Four Funds and the Trust Offerings and Lex acted recklessly by continuing to sell these private placements to investors. *See S.E.C. v. Forte*, Civil Nos. 09-63, 09-64, 2012 WL 1719145 at *3. In addition, Lex had a duty to independently investigate the private placements once he became aware of the red flags described above, instead of relying blindly on Smith's and McGinn's representations. Due to his failure to fulfill his duty, his customers invested and lost millions of dollars Accordingly, Lex's claims, and Kathleen C. Lex's, claims should be disallowed or, in the alternative, equitably subordinated.

3. The Claims of Philip S. Rabinovich Should be Disallowed or Subordinated

Rabinovich's claims should be disallowed or subordinated because, through his sales of private placements in the Four Funds and the Trust Offerings, Rabinvoich furthered the implementation of the Ponzi scheme. Between 2004 and 2009, Rabinovich sold $16,206,500 of the Four Funds and the Trust Offerings. ID at 55. Like the other Brokers, Rabinovich failed to conduct any independent investigation of the Four Funds, though he was aware that the Four Funds were making investments inconsistent with their PPMs. *Id.* at 56. Rabinovich also knew that redemptions were not being honored without replacement investors. In addition to the redemption issues, Rabinovich was aware of the severe liquidity issues with the MS & Co. offerings - in fact, his father made at least two bridge loans to certain of the Trust Offerings to help ease the liquidity issues at MS & Co. *Id.* at 58-59. Despite the red flags, Rabinovich continued to sell the private placements.

Based on these facts, Rabinovich should have realized that there was a "strong probability" for harm to result from his sales of the Four Funds and the Trust Offerings and he acted recklessly by continuing to sell these private placements to investors. *See S.E.C. v. Forte*, Civil Nos. 09-63, 09-64, 2012 WL 1719145 at *3. Although the red flags gave rise to a duty to independently investigate the offerings he was selling, Rabinovich acted inequitably by failing to carry out this duty and permitted unsuspecting investors to make investments in the Ponzi scheme. Accordingly, Rabinovich's claims should be disallowed or, in the alternative, equitably subordinated.

4. Summary Proceedings are Appropriate

The Receiver has sought to provide the Brokers[4] with listed on Exhibit A appropriate notice and sufficient time to respond to the Motion. Accordingly, the Receiver has complied with the claim objection and notice procedures set forth in the Federal Rules of Bankruptcy Procedure ("Bankruptcy Rules") as a form of best expression of law. Bankruptcy Rule 3007 requires that a claim objection must be filed and served at least thirty days before any scheduled hearing and that the objection must be served on the claimant by first class mail. Fed. R. Bankr. P. 3007(a)(1), (2).

In accordance with Rule 7.1 of the Local Rules of Practice for the United States District Court for the Northern District of New York, the Receiver has filed and will serve the Motion on each of the Brokers listed on Exhibit A at least thirty-one days in advance of the scheduled return date of April 19, 2018. The Receiver will give notice of the Motion to the Securities and Exchange Commission, all parties who have filed a Notice of Appearance in this action by ECF, and all creditors and parties in interest via the Receiver's

[4] Kathleen C. Lex and Kimellen Lex (who holds a joint claim with Lex) will receive the same notice and time to respond as the Brokers.

website (www.mcginnsmithreceiver.com), as well as posting at the top of the Receiver's website an explanation of the Motion. Additionally, notice by first class mail will be given to each of the Brokers including Kathleen Lex and Kimellen Lex listed on Exhibit A. Brown Dec'l. ¶16.

The Receiver requests that the Court enter an order granting the relief requested in this Motion without a hearing with respect to those Broker Claims for which an objection is not timely interposed. Disallowance of a claim without a hearing where there is no factual dispute is an appropriate and preferred procedure in federal receivership cases. *See S.E.C. v. Elliott*, 953 F.2d 1560, 1566 (11th Cir. 1992) (holding that summary proceedings are favored in federal receivership cases because a summary proceeding "reduces the time necessary to settle disputes, decreases litigation costs, and prevents further dissipation of receivership assets"); *United States v. Fairway Capital Corp.*, 433 F. Supp. 2d 226, 241 (D. R.I. 2006) ("Receivership courts can employ summary procedures in allowing, disallowing and subordinating claims of creditors").

CONCLUSION

The Receiver requests that the Court enter an Order substantially in the form attached to the Motion as Exhibit B disallowing, or, in the alternative, equitably subordinating the Broker Claims, together with such other and further relief as the Court deems just and proper.

Dated: March 19, 2018

PHILLIPS LYTLE LLP

By /s/ Catherine M. Eisenhut
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Doc #01-3106310.6

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, GEOFFREY R. SMITH, Individually and as Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04, LAUREN T. SMITH, and NANCY McGINN, *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.*	Case No. 1:10-CV-457 (GLS/CFH))

CERTIFICATE OF SERVICE

I, Karen M. Ludlow, being at all times over 18 years of age, hereby certify that on March 19, 2018, a true and correct copy of the Notice of Motion and Third Motion of William J. Brown, as Receiver, for an Order Disallowing Certain Claims (Broker Claims) ("Motion") was caused to be served by e-mail upon all parties who receive electronic notice in this case pursuant to the Court's ECF filing system, and by First Class Mail to the parties indicated below:

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And, I hereby certify that on March 19, 2018, I mailed, via first class mail using the United States Postal Service, a copy of the Motion to the individuals listed below:

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Dated: March 19, 2018

/s/ Karen M. Ludlow
Karen M. Ludlow

Doc #01-3108635.1