UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,	:	
Plaintiff,	:	
v.	:	10 Civ. 457 (GLS/CFH)
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,	:	
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.	:	

PLAINTIFF'S MEMORANDUM OF LAW IN OPPOSITION TO DEFENDANTS DAVID AND LYNN SMITH'S MOTION TO USE FROZEN ASSETS TO PAY THEIR CRIMINAL TAX OBLIGATIONS

July 2, 2013

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Plaintiff Securities and Exchange Commission respectfully submits this memorandum of law in opposition to the motion of defendants David and Lynn Smith to modify the Court's asset freeze to allow them to use frozen funds to pay their criminal tax obligations.

PRELIMINARY STATEMENT

With David Smith's sentencing date approaching, David and Lynn Smith seek to use the funds in a frozen stock account[1] to pay the $257,601 tax bill they received from the IRS after the jury verdict. As the jury found, Smith and his co-defendant Timothy McGinn helped themselves to investor money which they failed to report as income. The Smiths now seek to victimize the investors a second time by paying the IRS with money that has been frozen in the SEC case. The motion should be denied.

First, the Smiths' claim that the IRS is "first in line" is wrong. No judgment has yet been entered in the criminal case, and the IRS has neither filed a tax lien nor intervened in the SEC case. Indeed, the IRS has given no indication that it intends to look to any Receivership assets to satisfy the tax bill; the Smiths' suggestion that the IRS will do so is speculation.

Second, contrary to the Smiths' unsupported assertions, the stock account is not an asset of Lynn Smith. Instead, it has been found by this Court and the Second Circuit to be a tainted asset of David Smith. Accordingly, the stock account should remain frozen to satisfy the SEC's anticipated judgment against David Smith.

Third, depleting the Receivership to pay the Smiths' tax obligation would obviously harm investors. The investor losses far exceed the Receivership's assets; as a result, every penny in the Receivership must be preserved. Even if interest and penalties do accrue, investors are not harmed because the Smiths should pay these debts from non-Receivership assets.

[1] Although their brief refers generally to "Mrs. Smith's assets," the accompanying attorney declaration makes clear that the only asset from which they seek payment is "Mrs. Smiths' stock account." Declaration of William J. Dreyer filed June 17, 2013, ¶ 6 (Dkt. 576)

Finally, the Smiths' claim that "the IRS must be estopped" from charging interest and penalties against them is barred by the Tax Anti-Injunction Act.

ARGUMENT

I. The IRS Is Not Entitled To Payment From Frozen Assets

The tax bill that the Smiths received from the IRS does not automatically give the IRS rights to frozen Receivership assets, and the IRS is not "the first creditor to conclusively establish entitlement to restitution." Smiths Br. at 4. On the contrary, as Smith has not yet been sentenced and the judgment in the criminal case has not yet been entered, the IRS cannot even be described as a judgment creditor. After sentencing, the IRS must affirmatively file a lien on the receivership assets, intervene in the SEC case, and make a claim on frozen assets.

Receivership assets should not be used to pay the Smiths' criminal tax obligations where the IRS has not moved against these assets, or even expressed an intention to do so. The Smiths, moreover, fail to cite to any authority permitting Receivership assets frozen for the benefit of investors to be used to pay a criminal tax obligation. The only case cited by the Smiths for this proposition, *United States v. McDermott*, 507 U.S. 447 (1993), merely demonstrates the necessity of a filed and recorded tax lien. *Id.* at 449 (under 28 U.S.C. § 6323(a), "the federal lien shall 'not be valid . . . until notice thereof . . . has been filed'"). *See also SEC v. Haligiannis*, 608 F. Supp.2d 444, 454 (S.D.N.Y. 2009) (IRS lien that was never recorded does not have priority).

Even if the IRS were to intervene, the SEC would oppose any motion by the IRS (or any other future creditors) to apply Receivership assets to any debt. As this Court has previously ruled, "[t]he preliminary injunction freezing the defendants' assets was entered to insure the availability of those assets to compensate the alleged victims of defendants' conduct in the event

the SEC prevails in this action." Memorandum-Decision and Order filed Apr. 4, 2012, at 4 (Dkt. 478).

It is the SEC's position that Receivership assets should be preserved for the benefit of investors. In *SEC v. Lauer*, 98 A.F.T.R.2d 2006-6128, 2006 WL 2660752 (S.D.Fla. Aug. 2, 2006), for example, the IRS filed Notice of Federal Tax Lien and intervened in SEC case, along with a bank mortgagor, to foreclose on real property held by a defendant. The Court modified the asset freeze to allow for the house foreclosure; however, with regard to certain bank accounts the Court ruled that "all the funds or securities remaining in the account are tainted by Lauer's alleged fraud and, therefore, should remain available to the investors." *Id.* at *6 n.8.

II. The Stock Account Is An Asset Of David Smith

The Smiths refer to the Stock Account as "Lynn Smith's asset" because they assert that it has "not been shown to have furthered or benefitted from the alleged fraud" and that David Smith's role was "limited to providing investment advice and administering her stock account in accordance with her wishes and duties as her broker." Smiths Br. at 5.

The Smiths are wrong. Three years ago, following an evidentiary hearing in June 2010, this Court ruled that the stock account should remain frozen as an asset of David Smith:

> David Smith had unfettered control over the [stock] account, acting as its broker, for approximately thirty-five years. T. 360. As previously discussed, David Smith directed transfers from the account at his sole option by the blank letters of authorization which Lynn Smith signed. The letters of authorization were used at the direction of David Smith to transfer money from the account into the MS & Co-related businesses for bridge loans and for operating expenses usually in the range of $100,000–$1 million. For these reasons, it is clear that David Smith had complete access to and control over the account and that such access and control were maintained for decades.
>
> Additionally, David Smith benefitted from the Stock Account. First, the account was used to purchase jointly owned residences including their primary residences and vacation homes in Vermont and Florida and finance their children's college educations. Furthermore, the account was used to fund MS & Co.'s operating expenses as MS & Co. increasingly experienced difficulties meeting its obligations in 2008–10. These loans

> ensured that MS & Co. would continue to operate. Thus, David Smith utilized the Stock Account as a personal line of credit for his business interests to further his personal and professional endeavors.
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> * * *
>
> [David] Smith "viewed and treated the [stock] account and his own account[s] interchangeably." *Heden,* 51 F.Supp.2d at 300. Smith had access and control over the account for decades, he had both a personal and professional interest in the Stock Account and benefitted from its funds in both his home-life and career, and he commingled funds between the Stock Account and his business and personal accounts. As such, the SEC need not establish that Lynn Smith is a proper relief defendant but only that there is a likelihood of success against David Smith to continue the asset freeze as to the Stock Account. The SEC has made such a showing. Therefore, in the alternative, the SEC's motion for as to the stock account is granted on this ground as well.

SEC v. McGinn, Smith & Co., Inc., 752 F.Supp.2d 194, 216-217 (N.D.N.Y. 2010) (citations to the hearing record omitted) (Dkt. 86 at 34-36).

Lynn Smith appealed this ruling, and the Second Circuit affirmed the District Court, agreeing that "David Smith treated Lynn Smith's stock account as his own." *Smith v. SEC*, 2011 WL 3428315 (2d Cir. Aug. 8, 2011) ("we conclude that the district court did not abuse its discretion in continuing the asset freeze as to the stock account").

Last year, in response to another motion by the Smiths to modify the asset freeze, this Court ruled that the Stock Account is tainted:

> [The Stock Account and other Smith assets] have previously been the subject of extensive litigation in this action, the SEC has demonstrated that all are properly subject to the asset freeze, and the evidence as to all demonstrates that ***all are tainted either as the proceeds of unlawful activity or as so commingled in unlawful proceeds that any untainted portions cannot reasonable be severed***. See MDO I, MDO II. Smith's motion as to these assets, therefore, is denied.

Memorandum-Decision and Order filed April 4, 2012, at 11 (Dkt. 478) (emphasis added).

As a result of the collateral estoppel effect of the criminal conviction, the SEC expects to obtain a monetary judgment against David Smith. *See* Letter from SEC to Judge Hummel dated Mar. 25, 2013 (Dkt. 563). The stock account is an asset of David Smith, and it should remain

frozen to satisfy the future judgment against him.

III. Modifying The Asset Freeze Is Not In The Best Interests Of Investors

A party seeking to unfreeze assets must also 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)(denying request for release of frozen funds to pay attorneys' fees and funeral and burial expenses since the expenses "bear no relation to the interest of other investors"); s*ee also S.E.C. v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1106 (2d Cir. 1972) (holding that court must weigh "the disadvantages and possible deleterious effect of a freeze . . . against the considerations indicating the need for such relief"); *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."); c*f. SEC v. Coates,* No. 94 Civ. 55361 (KMW), 1994 WL 455558, at *3 (S.D.N.Y. Aug. 23, 1994) (defendant "offers no basis upon which this court could conclude that his legal defense is of critical importance to investors, such that the asset freeze should be modified on that ground, and I decline to do so"); *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).

It would not be in the interests of the victims of David Smith's fraud to allow the Smiths to use some of the few remaining dollars to pay a liability that is only owed because of David Smith's crimes. The balance weighs decidedly in favor of denying the Smiths' motion. As the Court previously held, the "total amount of investors' funds obtained through fraud by defendants [$84 million] dwarfs the value of the assets frozen by the SEC for the benefit of such investors":

> There is no likelihood, then, that a surplus will exist from the frozen assets in the event the SEC prevails in this action. The investors, on whose behalf the assets were frozen, thus possess a heightened interest in having those assets maintained without further diminution pending the outcome of this action. This interest far outweighs that of either the Trust or [the Trust's attorneys] in payment of the charged fees and costs before this action is fully resolved.

Memorandum-Decision and Order filed Feb. 11, 2011, at 5- 6 (Dkt. 277) ("To permit a further depletion of assets available to repay investors would reward that misconduct at the substantial expense of investors").

The Smiths argue that the accrual of penalties and interest will harm investors because investors will be on the hook for the Smiths' tax bill. As argued above, the Smiths fail to cite to any authority for this proposition. If the IRS does impose interest and penalties, then the Smiths must look to their own resources to pay this debt, and not to resources frozen in favor of the investors who have already suffered as a result of David Smith's conduct.[2]

IV. The IRS Cannot Be "Estopped" From Collecting Interest and Penalties

The Smiths argue that "the IRS must be estopped from charging additional penalties and interest," because "they have made all reasonable efforts to pay." Smiths Br. at 6. The Smiths, however, have made no showing of any efforts to pay. Their motion contains no financial accounting and no sworn statements from either of them setting forth their ability or inability to pay their taxes, or any efforts they have made to pay. Even the sworn declaration of their own lawyer avoids making any representations about the Smiths ability to pay or their efforts to pay.[3]

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[2] Even if the IRS could assert a priority position (which it has not), it has discretion to subordinate its claims to those of the defrauded investors.

[3] In support of their estoppel argument, the Smiths cite to *United States v. Madeoy*, 652 F. Supp, 371 (D.D.C. 1987), where a court allowed a pre-judgment defendant's federal and state taxes to be paid from frozen funds. The court emphasized, however, that the defendant's motion was made "*in advance of trial* and *any finding of guilt*." 652 F. Supp. at 377 n.4 (emphasis in

In any event, the Smiths are barred by statute from seeking to estop the IRS from charging penalties and interest. Under the Tax Anti-Injunction Act, 26 U.S.C. § 7421, "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person." *See, e.g., Smith v. Shulman*, 333 Fed.Appx. 607, 2009 WL 1689109 (2d Cir. June 17, 2009) ("Smith's attempt to obtain an injunction against IRS collection of income tax is barred by the Tax Anti-Injunction Act").

CONCLUSION

For the reasons stated above, the Smiths' motion to modify the asset freeze should be denied.

Dated: July 2, 2013
New York, New York

Respectfully submitted,

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original). David Smith, of course, has been found guilty of filing false tax returns, among other crimes, so *Madeoy* is of limited relevance.