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,

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/DRH)

MEMORANDUM OF LAW IN OPPOSITION TO SEC'S MOTION TO COMPEL COMPLIANCE WITH CERTAIN SUBPOENAS BASED ON THE CRIME/FRAUD EXCEPTION TO THE ATTORNEY/CLIENT PRIVILEGE

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STATEMENT OF THE FACTS

This Memorandum of Law is submitted in Opposition to the Securities and Exchange Commission's (the "SEC") Motion to Compel compliance with document and testimony subpoenas served on April 7, 2011 and June 21, 2011 on nonparties Martin S. Finn and the law firm Lavelle & Finn LLC. *See* Declaration of David Stoelting dated July 6, 2011, in support of the SEC's Motion to Compel, Exhibits 1, 2 and 3. The attorneys for David L. Smith and Lynn A. Smith respectively objected to the subpoenas on the grounds that the information sought constituted confidential communications between the Smiths and their estate planning attorneys pursuant to the attorney/client privilege.

The SEC has filed the instant motion to compel compliance with the subject subpoenas based on two theories: (1) the crime/fraud exception applies to what otherwise would be confidential communications between the Smiths and their legal counsel at Lavelle & Finn; and (2) the attorney/client privilege was waived when David Smith or the attorney representing him in a 2009 Financial Industry Regulatory Authority ("FINRA") proceeding voluntarily produced a letter to that agency, dated January 28, 2009 which was sent by Lavelle & Finn to the Smiths.

For the following reasons, the Court should deny the SEC's Motion to Compel disclosure of any document held in the file of Lavelle & Finn or the taking of any testimony of any Lavelle & Finn employee or principal as to that firm's legal representation of the Smiths.

POINT I

THE MAGISTRATE JUDGE WAS INCORRECT IN OVERRULING OBJECTIONS BASED ON THE ATTORNEY/CLIENT PRIVILEGE AS TO THE LAVELLE & FINN LETTER DURING THE PRELIMINARY INJUNCTION HEARING.

Prior to the taking of testimony at a preliminary injunction hearing that took place from June 9 through June 11, 2010 the Court entertained objections to certain exhibits being proffered by the respective parties. One of the exhibits being offered by the SEC was a letter dated January 28, 2009 from the law firm of Lavelle & Finn to the Smiths which outlined and proposed a number of asset transfers that could be useful for their estate planning and asset protection goals. The letter referenced "three asset ownership worksheets" as enclosures. The letter and referenced enclosures will hereinafter be referred cumulatively as the "Letter."

Mr. Featherstonhaugh, as counsel to Lynn Smith and Mr. Koenig, then-counsel for Mr. Smith, both raised objections during the preliminary injunction hearing to the Letter being accepted into evidence based on the attorney/client privilege of their respective clients. *See* Declaration of David Stoelting dated July 6, 2011, in support of the SEC's Motion to Compel, Exhibit 6, pp. 1-8. Your Honor overruled these objections on the grounds that David Smith waived his right to assert the attorney/client privilege when he or his attorney produced the Letter in conjunction with a 2009 FINRA investigation of McGinn Smith, of which Mr. Smith was an owner and principal. *Id.* at 8.

It is respectfully submitted that the Court erred in overruling these objections by allowing the introduction of the Letter into evidence during the preliminary injunction hearing and permitting the SEC to illicit testimony from Lynn Smith as to the contents and surrounding circumstances

involving the Letter and the Smiths' attorney/client relationship with the Lavelle & Finn law firm.

In the first instance it is not only appropriate for this Court to re-evaluate its earlier findings as to its ruling to allow such evidence over the objections of Lynn Smith's counsel, but absolutely necessary in light of the SEC's application to obtain her confidential communications by seeking to vitiate the most sanctified privilege known to American jurisprudence. Indeed, the attorney-client privilege is considered "the most sacred of all legally recognized privileges, and its preservation is essential to the just and orderly operation of our judicial system." *United States v. Bauer*, 132 F.3d 504, 510 (9th Cir. 1997).

In addition, this Court is not procedurally precluded from re-evaluating and, if appropriate making a finding within this subsequent proceeding that the Letter and the testimony elicited from that Letter constituted privileged communications. Indeed, it has been well established by the Second Circuit that the factual findings and conclusions of law made by a district court in granting a preliminary injunction are not binding in subsequent proceedings before the court. *Dep't of Health and Human Services v. RxUSA*, 285 Fed. Appx. 809, 810; 2008 U.S. App. LEXIS 14661 *citing Irish Lesbian and gay Org. v. Giuliani*, 143 F.3d 638, 644 (2d Cir. 1998); *Higgins v. Cal. Prune & Apricot Grower, Inc.*, 3 F.2d 896, 898 (2d Cir. 1924); *see also SEC v. McGinn Smith*, 2011 U.S. Dist. LEXIS 49548 *22 (N.D.N.Y. May 6, 2011) *citing City of Anaheim v. Duncan*, 658 F.2d 1326 n.2 (9th Cir. 1981); *Berrigan v. Sigler*, 449 F.2d 514, 518 (D.C. Cir. 1974); *Garten v. Hochman*, No. 08 civ. 9425, 2010 WL 2465479, at *3 n. 1 (S.D.N.Y. June 16, 2010). Certainly, based on this precedent, Mr. Featherstonhaugh, as counsel to Lynn Smith and Mr. Dreyer, as counsel to David Smith will be permitted to assert their objections on behalf of their respective clients during the trial before the Federal District Judge

should the SEC attempt to introduce the Letter into evidence at trial. Therefore, since this motion is being brought in a "subsequent proceeding" during the discovery phase of this matter and outside of the context of the preliminary injunction hearing, it is submitted that your Honor has the authority to re-evaluate his legal conclusions in this regard. As to the Court's substantive findings as to whether David Smith waived the attorney-client privilege when either he or his attorney voluntarily produced the Letter in the FINRA proceeding without raising the privilege, Lynn Smith renews her objection in her capacity as the joint holder of the privilege relating to communications between herself and the firm of Lavelle & Finn.

It is apparent from the Letter that the attorney communication was addressed to both Lynn and David Smith suggesting that both Lynn and David were co-clients sharing the counsel and advice of Mr. Finn. As a co-client of the Lavelle & Finn firm, Lynn Smith and David Smith jointly enjoyed the attorney-client privilege as to their communications, not between themselves, but rather as it relates to third parties. "One co-client does not have authority to waive the privilege with respect to another co-client's communications to their common lawyer." *The Jordan Investment Co., Ltd. v. Hunter Green Investments Ltd, et al.*, 2006 U.S. Dist. LEXIS 69127 (S.D.N.Y. 2006). "Because these privilege claims are held in common, it is generally agreed that none of the joint clients may waive that privilege protection without the consent of the others." *Id.*

Pursuant to the transcript of the preliminary hearing, it is apparent that the Court based its legal conclusion to override the objections of counsel on Mr. Smith's waiver of the privilege but did not consider whether Lynn Smith waived her joint privilege or otherwise consented to the production of the Letter by her husband to FINRA. Nor does the SEC in this application suggest or even acknowledge that Lynn Smith is a holder of the privilege let alone that she waived it or

otherwise consented to the Letter being produced. Without such evidence, it is respectfully submitted that the Court erred during the preliminary hearing in allowing such evidence to be introduced and permitting subsequent testimony to be taken from Lynn Smith as to the particulars of the Letter and the circumstances involving her legal relationship with the Lavelle & Finn firm. While there may not be anything this Court can do about its earlier findings or the implications such ruling may have had on the Court's decision to freeze certain assets, if any, it does have the opportunity to reconsider this point of law. In light of the fact that the SEC is seeking to vitiate Mrs. Smith's confidential communications with her legal counsel and in consideration of the significance and import that attaches to such a request, this Court should re-evaluate its earlier ruling and deny the SEC's Motion to Compel compliance of the Lavelle & Finn subpoenas based on the SEC's theory that the privilege had been waived.[1]

POINT II

THE SEC HAS FAILED TO ESTABLISH A PRIMA FACIE CASE THAT THE CRIME-FRAUD EXCEPTION SHOULD APPLY TO WHAT OTHERWISE IS A PROTECTED COMMUNICATION.

In *United States v. Zolin*, the United States Supreme Court laid out a two-step approach to determine when the crime-fraud exception should be applied in an effort to defeat the attorney-client privilege. First, the moving party must make a threshold showing, using non-privileged evidence, "of a factual basis adequate to support a good faith belief by a reasonable person that in camera review of materials may reveal evidence to establish the crime-fraud exception applies." *United States v. Zolin*, 491 U.S. 554, 572 (1989). More specifically in the

[1] In the event the Court deems that David Smith's disclosure of the Letter in the FINRA effectively waived the privilege enjoyed by Lynn Smith, such waiver should be limited to the Letter alone and not other documents which may be in the custody of their attorneys at Lavelle & Finn. *See Browne, Inc. v. AmBase Corp.*, 150 F.R.D. 465 (S.D.N.Y. 1993)("The scope of the waiver may be affected by whether the disclosure is made in a judicial proceeding or in a non-judicial context. If the latter, the breadth of the waiver may be narrower." [citation omitted])

Second Circuit, the SEC must show "that there is a factual basis for a showing of probable cause to believe that a fraud or crime has been committed and that the communications were in furtherance of the fraud or crime." *United States v. Jacobs*, 117 F.3d 82, 87 (2d Cir. 1997). It is submitted that the SEC has failed to satisfy this initial threshold to warrant the application of the crime-fraud exception or an in camera review of the file.

A. The SEC has Failed to Identify Attorney-Client Communications.

As noted in POINT I, the Letter is a privileged document which Lynn Smith, as a joint holder of that privilege, has not waived. This is significant to the crime-fraud analysis as well because it is the Letter that gives the SEC its factual basis to identify an attorney-client communication from which it alleges Lynn Smith had a fraudulent objective. Indeed, but for the privileged communication in the form of the Letter, the SEC would have no basis whatsoever to believe that there was a communication in the first place let alone establish a "good faith belief by a reasonable person that in camera review of materials may reveal evidence to establish the crime-fraud exception applies." *U.S. v. Zolin, supra.*

Nor should the SEC be permitted to rely on the testimony of Lynn Smith at the preliminary injunction hearing concerning the Letter and the circumstances surrounding her representation by Lavelle & Finn in order to overcome its initial burden to invoke the crime-fraud exception. Indeed, the privileged testimony was taken over the objections of counsel and was derived directly from the Letter constituting, in constitutional parlance, "fruit of the poisonous tree." If this Court finds that the Letter now constitutes a privileged document then it should not permit the SEC to use her testimony taken over the objections of counsel to now undermine her attorney-client privilege with respect to her representation by Lavelle & Finn.

Without this letter, the SEC has failed in its burden to identify an actual communication between the Smiths and the attorneys from Lavelle & Finn from which one can infer a fraudulent objective. Consequently, their attempts to defeat Lynn Smith's attorney-client privilege based on the crime-fraud exception should be denied.

B. The SEC has Failed to Demonstrate that Lynn Smith had a Fraudulent Objective when Seeking the Advice from the Attorneys at Lavelle & Finn.

Since Lynn Smith is the joint holder of the attorney-client privilege with respect to her representation by the Lavelle & Finn firm, to invoke the crime-fraud exception as to her, the Court must analyze the facts of this case in the context of her own fraudulent intent as opposed to implying it by the acts of her husband, David. To that end, the SEC identifies a number of circumstances in which it contends supports a fraudulent objective to defraud creditors – most of which only relate to David. In addition, the majority of allegations appear to be targeted toward establishing the Smiths' fraudulent objectives when it created the David L. and Lynn A. Smith Irrevocable Trust U/A August 4, 2004:

- The FIIN and FEIN offerings in September 2003 and January 2004 raised a total of $40 million and by August 2004 (when the Smiths created the Trust and transferred $4.5 million to it), the liabilities of FIIN and FEIN far exceeded the Smith's assets. (citations omitted)

- David Smith, Lynn Smith, Timothy McGinn, MS & Co...were named as defendants in a securities fraud suit, *Meyers v. Integrated Alarm Services Group, Inc., et al*03 CV 9748 (S.D.N.Y. 2003). The Complaint asserted 23 causes of action and sought $3 million in damages for each claim. The case was settled in 2004 by the payment of $200,000 to the plaintiff. (citation omitted)

- Smith acknowledged that his fraudulent investment schemes could lead to financial ruin. In an undated, handwritten "personal confession," Smith wrote that "I am overwhelmed by the thought of the financial losses." (citation omitted)

- In 2003 and early 2004, the SEC's Broker-Dealer Inspection Program ("BDIP") conducted an examination of MS & Co. In a letter to Smith from the BDIP dated

> February 26, 2004, Smith was advised of several "deficiencies and/or violations of law." (citations omitted)

As to the first bullet point, this factual allegation fails to even substantiate a fraudulent objective of either Lynn or David Smith in that the liabilities of FIIN and FEIN most assuredly exceeded the Smith's personal assets. To the extent, the allegation was intended to make the point that the liabilities of FIIN and FEIN far exceeded the assets of the *McGinn Smith companies* in their payment obligations to investors, there is nothing in the allegation that remotely suggests that Lynn Smith had any knowledge of this alleged financial disparity prior to the creation of the 2004 Irrevocable Trust.

As to the second bullet point, the Court denied the SEC's attempt to introduce this litigation into evidence during the preliminary injunction hearing and the SEC did not ask Lynn Smith any questions as to her knowledge of being named personally in that suit. Moreover, pursuant to the declaration of James Featherstonhaugh, dated September 3, 2010 (Dkt. No. 133), the lawsuit was settled for the nuisance value of the plaintiff's original investment. Attached as Exhibit "A" to that declaration was a letter from the plaintiff to Mr. McGinn in which he admitted that the allegations "were in substance inaccurate" and that "the calculation of my purported damages was grossly erroneous." Accordingly, the Court should ignore this allegation based on the simple fact that it lacks credibility.

As to the third bullet point, Smith's letter specifically states, "I have not shared any of this with Lynn, I assume because I have determined that it won't be helpful." (Smith Letter, p. 5, Dkt. No. 103-2)

As to the final bullet point, there is nothing in the allegation that remotely suggests that Lynn Smith had any knowledge of this investigation particularly when the SEC letter that is referenced is addressed to David Smith at his office on 99 Pine Street.

Not only are these allegations suspect as to Lynn's fraudulent objectives, they provide the Court with no probative value to suggest that the attorney-client privilege should be breached in connection with Lavelle & Finn's representation of the Smiths, particularly if these facts are intended to show that the Smiths acted fraudulently when they created the Trust. The reason for this is because the record does not support that Lynn Smith sought the advice from Lavelle & Finn when she and David created the Trust in 2004. In fact, Lynn Smith testified in the preliminary injunction hearing that she went to see Lavelle & Finn in 2009. She further testified (apparently mistakenly), "I spent the afternoon there and we tried to do the best we could with setting up this irrevocable trust for our kids" and that one purpose of the January 2009 meeting was to "talk about an irrevocable trust for our children." However, this testimony is not consistent with the uncontroverted fact that the Trust was created in *2004*. Accordingly, the SEC has no basis in fact to allege that the Smiths' communications with Lavelle & Finn will likely yield any information concerning the motives of the Smiths when they created the Trust since those communications occurred in 2009. Nor are these facts probative to communications with their counsel that took place in 2009 since the factual allegations referenced are so far removed in time.

With these allegations either unfounded, unrelated to Lynn Smith or having no reasonable timely nexus to the alleged protected communications that took place in 2009, the only other *non-privileged* factual evidence relied by the SEC to infer the Smiths' fraudulent objectives is an e-mail from David Smith in which he states that he was "meeting with my estate attorney tomorrow afternoon and Lynn and I have to shift money around between us." However, the e-mail, even if taken in the context of the privileged Letter or Lynn Smith's testimony resulting from that Letter, is far too ambiguous for a reasonable person to adduce that the Smiths

had a fraudulent objective when meeting with their estate planner. This is particularly evident by the very nature of the type of advice that would be expected from an estate planning attorney where the transfer of assets between husband and wife is a common legal strategy in that kind of representation. The e-mail does not identify a particular document or communication and certainly does not specify or even suggest that David Smith's reference to "shifting money around" was for anything but a legitimate purpose and reason.

Finally, the SEC's reliance on the Court's decision concerning its findings as to the transfer of the Vero Beach property and checking account is also unavailing in its efforts to pierce the Smiths' privilege based on the crime-fraud exception. The Court found that these transfers in 2009 followed "the commencement of the FINRA proceedings in which David Smith faced the distinct possibility that his assets could be seized to pay judgments awarded to investors." *SEC v. McGinn, Smith & Co.*, 2010 U.S. Dist. LEXIS 125862 *57 (N.D.N.Y. July 7, 2010). The FINRA investigation of McGinn Smith appeared to have begun in May of 2009 and David Smith and Timothy McGinn did not give testimony in those proceedings until early 2010. Significantly, these investigations "where David Smith faced the distinct possibility" of being subject to creditors occurred *after* the Smiths sought counsel from Lavelle & Finn and *after* they provided their advice in the form of the January 2009 Letter. The Court did not find that David Smith faced the distinct possibility of losing his assets before 2009. Therefore, the SEC cannot rely on the decision of this Court as it relates to its finding on the Vero Beach property and the checking account transfers to substantiate its initial burden to invoke the crime-fraud exception.

Based on the foregoing, the SEC has failed to establish a prima facie showing that the SEC has satisfied its burden in demonstrating the requisite factual basis to invoke the crime-fraud exception as it relates to the Smiths' legal representation by the Lavelle & Finn law firm.

CONCLUSION

Wherefore, for all of the foregoing reasons, Relief Defendant/Defendant, Lynn A. Smith respectfully requests that the Court deny the SEC's Motion to Compel compliance with the Lavelle & Finn subpoenas.

Dated: August 31, 2011

Respectfully submitted,

Featherstonhaugh, Wiley & Clyne, LLP

By:_____

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