UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,	:	
Plaintiff,	:	
v.	:	**10 Civ. 475 (GLS)**
McGINN, SMITH & CO., INC., et al.,	:	
Defendants.	:	

PLAINTIFF'S MEMORANDUM OF LAW IN OPPOSITION TO DEFENDANT DAVID SMITH'S MOTION TO MODIFY THE ASSET FREEZE TO PERMIT THE RELEASE OF FUNDS TO PAY CRIMINAL TRIAL TRANSCRIPT COSTS

Securities and Exchange Commission
New York Regional Office
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November 22, 2013

Plaintiff Securities and Exchange Commission respectfully submits this memorandum of law in opposition to the motion of defendant David Smith to modify the asset freeze to permit the release of funds to pay for the costs of his criminal trial transcript so that he may appeal his conviction.

PRELIMINARY STATEMENT

Smith initially moved to modify the asset freeze in this case to permit the release of $14,000 from the frozen Stock Account to pay for the transcript of his criminal trial. However, the undersigned attorneys have requested authorization for $16,000 in funding to obtain a copy of the criminal trial transcript. If that funding request is approved, we have been advised by the court reporter that defendants McGinn and Smith will be entitled to purchase a duplicate copy of the transcript, estimated to be approximately 4,000 pages, at a rate of .90 cent per page, for a total of $3,600. Smith's law firm, Dreyer Boyajian, has already paid a deposit of $2,000, so their additional out-of-pocket cost would be $1,600. By letter dated November 21, 2013, Smith modified his motion to request $3,600. Dkt. 643. Smith's motion should be denied.

It is well-settled that a defendant is not entitled to use tainted assets to fund his criminal defense. Implicitly conceding this point, Smith argues that the Stock Account was initially funded from $60,000 Mrs. Smith received as an inheritance in 1968 after her father's death, before the fraud alleged in this case. (Br. at 3-4; Smith Decl. ¶¶ 10-13). Smith then argues that this $60,000 should be severed from the others monies in the Stock Account, currently totaling approximately $1.5 million, and that the Court should release $3,600 of that amount to pay for

the criminal trial transcript, because neither Smith nor his wife have any other assets available to pay for the transcript. Br. at 5-6.[1]

However, this Court has already held on numerous occasions that the Stock Account is comprised of tainted assets of a massive fraud, that Smith repeatedly used the Stock Account to fund his fraudulent business activities, and "commingled funds between the Stock Account and his business and personal accounts" (Dkt. 86 at 36), such that no portion of the assets can severed. Also, Smith is simply wrong in stating that $60,000 can be traced to his wife's inheritance. By Mrs. Smith's own admission, that $60,000 dropped to only $10,000 in the 1970's. Moreover, given the overwhelming evidence that Smith has used the Stock Account to further his business interests and the Smiths used it to fund numerous personal expenditures, there is no evidence that any of money currently in the Stock Account is traceable to the initial inheritance.

Thus, Smith has failed to sustain his burden of demonstrating why the asset freeze should be modified to fund any portion of his criminal appeal, whether it be the $16,000 he originally sought, the reduced $3,600 amount he will only need to pay if the undersigned's funding request is approved, or any likely far larger amounts he may seek in the future, which he almost certainly will do, if this motion is granted even in part. (See Smith Br. at 5, fn. 2:"Mr Smith does not waive his right to make future motions for a release of assets for attorneys' fees related to the criminal appeal and/or his civil case.")

[1] We note that while David Smith continues to maintain that the Stock Account is not his asset, only his wife's (Br. at 6, Smith), he fails to submit an affidavit from his wife agreeing to the release of $14,000.00 from "her" Stock Account to pay for the criminal trial transcript. This is just one more example of how David Smith continues to treat the Stock Account as his own.

LEGAL ANALYSIS

A party seeking to unfreeze assets must 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). A court must weigh "the disadvantages and possible deleterious effect of a freeze . . . against the considerations indicating the need for such relief." *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1106 (2d Cir. 1972). Courts regularly have denied or limited the payment of attorneys' fees from frozen assets. *See, e.g., SEC v. Private Equity Mgmt. Group, Inc.*, No. CV 09-2901, 2009 WL 2058247, at *2 (C.D. Cal. July 9, 2009) (denying request to amend asset freeze to allow payment of attorneys' fees); *SEC v. Sekhri*, No. 98 CIV. 2320, 2000 WL 1036295, at * 2 (S.D.N.Y. July 26, 2000) (denying motion to release funds from asset freeze for attorneys' fees).

Under Second Circuit law, to modify an asset freeze to provide for counsel fees, "the defendant must establish that the funds he seeks are untainted and that there are sufficient funds to satisfy any disgorgement remedy that might be ordered in the event a violation is established at trial." *SEC v. Stein,*2009 WL 1181061 (S.D.N.Y. Apr. 30, 2009); *see also SEC v. Roor,* 1999, WL 553823 at *3 (S.D.N.Y. July 29, 1999). It is also well-settled that a defendant may not use tainted assets to fund his criminal defense. *See, e.g., United States v. Monsanto,* 491 U.S. 600 (1989)(defendant may not use funds obtained from criminal activity to fund his defense); *SEC v.* Cherif, 933 F.2d 403, 416-17 (7th Cir. 1991)(defendant may not "spend another person's money" to retain counsel); *United States v. Monsanto*, 924 F.2d 1186, 1203 (2d Cir. 1991); *SEC v. Coates,* 1994 WL 455558 (S.D.N.Y. Aug. 23, 1994)(defendant in civil enforcement action may not access assets traceable to criminal activity to fund defense of parallel criminal case); *United States v. Bonventre,* 2011 WL 1197853, at * 6 (S.D.N.Y. Mar. 30, 2011)(same).

This Court has already found on multiple occasions that the Stock Account funds are tainted, and that the Smiths' frozen assets, including the Stock Account and the Trust assets, together with the assets held by the Receiver, are woefully insufficient to satisfy the amount likely to be owed to investors, who have lost over $100 million. *See, e.g.,* Dkt. 86 at 32-33(initial Order freezing Stock Account), affirmed on appeal, *Smith et al. v. SEC,* 2011 WL 3438315 at * 1-2 (2d Cir. 2011). *See also,* Dkt. 211 at 4-5 (denying Mrs. Smith motion to release funds to pay legal fees and living expenses); Dkt. 592 at 14-15(denying David and Lynn Smith's motion to unfreeze the stock account to pay certain taxes due to the Internal Revenue Service).[2] Indeed, in denying Smith's prior motion to unfreeze the Stock Account, the trust account and other assets to fund his criminal defense, this Court stated "All of these assets have previously been the subject of extensive litigation in this action, the SEC has demonstrated that all are tainted either as the proceeds of unlawful activity or as so commingled in unlawful proceeds that any untainted portions cannot reasonably be severed. See MDO I [DKT. 86], MDO II[Dkt. 194]. Smith's motion as to these assets, therefore, is denied. " Dkt. 478 at 11;

Moreover, in its initial decision freezing the Stock Account, the Court made detailed findings rejecting precisely the argument Smith advances here, that $60,000 of the Stock Account is severable because it was funded from a $60,000 inheritance Lynn Smith received in the 1960's. Dkt. 86 at 7-10; 31-36. The Court found that the Stock Account was treated as a joint asset by the Smiths, that David Smith "commingled funds between the Stock Account and his business and personal accounts," (Dkt. 86 at 36) and that over $1.7 million in loans were made by David Smith from the Stock Account to both MS & Co companies and MS & Co employees

[2] *See, also,* Dkt. 277 at 4-5(denying law firm's motion to unfreeze trust assets to pay legal fees; "The investors … possess a heightened interest in having those assets maintained without further diminution …"); Dkt 478 at 24-27(denying Trust's motion to release sufficient assets to pay certain current and future expenses, including legal fees).

during the period of the fraud. (Dkt 86 at 10, fn. 15). The Court also found that since 2003, Mrs. Smith, through the Stock Account, has received over $1 million from MS & Co and its related entities and individuals in "loan" repayments (for which "loans" there was scant if any documentation), and found that these repayments "derived from fraudulently obtained investments." Dkt. 86 at 32. The Court held that: "Because all of these payments were commingled with potentially legitimate funds, separating the legitimately held funds in the Stock Account and the checking account from the fraudulently obtained funds would be nearly impossible and the SEC is entitled to freeze the entirety of the accounts." Dkt. 86 at 32.

In addition, while not necessary to the Court's resolution of the instant motion, Mrs. Smith has previously admitted that her $60,000 inheritance dropped to a low of $10,000 in the 1970's (Dkt. 86 at 9; citing to Mrs. Smith's testimony at the preliminary injunction hearing). Thus, Smith's argument now that $60,000 of the funds currently in the Stock Account is clearly traceable to Mrs. Smith's inheritance, and therefore easily severable, is factually incorrect.

Furthermore, although again not necessary to the Court's decision here, the earliest available records from the Stock Account only go back to August 1999 (see Dkt. 34, Mrs. Smith Affidavit, at 2, ¶3). There is overwhelming evidence that David Smith has always treated the Stock Account as his own, going back decades before 1999 (See Dkt. 86 at 8-10), and that both Smiths used the Stock Account to fund both their personal and professional activities. For example, the Smiths used the Stock Account to pay for their children's education, purchase their residence and vacation homes, etc. (Dkt. 86 at 8-10). These personal expenditures alone surely easily consumed more than the $10,000 remaining from the inheritance in the Stock Account in

the 1970's. Thus, there is no evidence that any of the monies currently in the Stock Account have any connection whatsoever to Mrs. Smith's original inheritance.[3]

Accordingly, Smith has failed to sustain his burden of establishing that the funds in the Stock Account are untainted by his fraud.

Smith has also failed to establish that "there are sufficient funds to satisfy any disgorgement remedy that might be ordered in the event a violation is established at trial." It is irrefutable that the Smiths' frozen assets, including the Stock Account and the Trust assets, together with the assets held by the Receiver, are woefully insufficient to satisfy the amount likely to be owed to investors. This Court has already noted that the total claims against the McGinn Smith Estate amount to at least $100 million "with cash on hand value of $14 million, with just under $3.4 million coming from frozen assets of the relief defendants." Dkt. 592 at 16 ("There still remains no likelihood that a surplus will exist from the frozen assets in the event the SEC prevails in this action.")

The Court's reasoning in denying the prior motions to unfreeze the Stock Account and the Trust assets has even more force now that David Smith has now been found guilty of numerous counts of securities fraud arising from the same conduct charged in the Amended Complaint in this case. He will likely be estopped from contesting his liability in this case based on his criminal convictions. "[I]t is well-settled that a criminal conviction, whether by jury verdict or guilty plea, constitutes estoppel in favor of the United States in a subsequent civil

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[3] Indeed, even the evidence that the Stock Account was initially funded by a $60,000 inheritance of Mrs. Smith's is not "indisputable" as Smith claims. Br. at 4. That evidence is dependent entirely on the word of David Smith, a convicted felon guilty of multiple counts of securities fraud, and Mrs. Smith, who has repeatedly lied under oath concerning the origin and terms of the Smith Trust (Dkt. 194 at 3-8; Dkt. 342 at 13-20) and whose credibility regarding the Stock Account this Court found to be "unfailingly self-serving;" improbab[le] in material respects," "inconsisten[t] and "incredible." (Dkt. 86 at 9, fn. 14).

proceeding as to those matters determined by the judgment in the criminal case" *United States v. Podell*, 572 F.2d 31, 35 (2d Cir. 1978) (citing cases).[4] Thus, his liability for a disgorgement order reflecting the at least $100 million in investor losses is even more certain than when the Court issued the above orders.

Mrs. Smith has argued in a recent filing that any judgment against David Smith in this case will be limited to the $5,748,722 in restitution ordered against Smith in the criminal case. (Dkt. 636 at 6; Reply Memorandum of Law). This is unlikely for multiple reasons, including that the SEC is not barred from seeking a larger disgorgement amount and a separate civil penalty in the criminal case. (*See, e.g., SEC v. Rosenthal,* 2011 U.S. App. LEXIS 11732, at *6-7 (2d Cir. Jun. 9, 2011) (district court did not abuse its discretion in imposing civil penalty equal to two times the defendants' illegal insider trading profits where defendants already sentenced to 60 month and 33 month prison terms and $100,000 and $75,000 criminal fines); *SEC v. Rajaratnam,* 822 F.Supp. 2d 432, 435-36 (S.D.N.Y. 2011)($92,805,705 civil penalty imposed on defendant sentenced to 11 years' imprisonment, ordered to forfeit $53.8 million and fined $10 million in parallel criminal case).

Moreover, given that Smith and his wife only have $3.4 million in frozen assets available (the rest are assets of the McGinn Smith entities who will be subject to a separate judgment in connection with the over $100 million in investor proceeds they wrongfully received) and part of

[4] *See, also, SEC v. Shehyn*, No. 04 CV 2003, 2010 U.S. Dist. LEXIS 84882, at *9 (S.D.N.Y. Aug. 9, 2010) (defendant's admissions by guilty plea to mail and wire fraud charges establish requisite elements of securities fraud charges); *SEC v. Roor*, No. 99 CV 3372, 2004 U.S. Dist. LEXIS 17416, at * 24 (S.D.N.Y. Aug. 30,2004) ("[I]t matters not what the precise charges in the indictment and civil complaint are, so long as they are predicated on the same factual allegations"); *SEC v. Dimensional Ent. Corp.*, 493 F. Supp. 1270 (S.D.N.Y. 1980) (factual allegations underlying wire fraud convictions sufficient to establish violation of securities law provisions). *SEC v. Namer*, 183 Fed. Appx. 120, 121,2006 U.S. App. LEXIS 13772, at **2 (2d Cir. June 1, 2006); *SEC v. Dimensional Ent. Corp.*, 493 F. Supp. 1270 (S.D.N.Y. 1980); *SEC v. Everest Mgmt. Corp.*, 466 F. Supp. 167 (S.D.N.Y. 1979).

the $3.4 million may be used to satisfy a separate judgment against Lynn Smith, David Smith has not met his burden of showing there are sufficient assets available to satisfy any disgorgement or penalty ordered against him, even assuming, *arguendo,* it were limited to $5,748,722.

In addition, the Smiths have not established that they have no other means to pay for the transcript or that they have made reasonable expenditures of the monies they had available from the frozen Trust assets to warrant unfreezing more assets to them. The Smiths have made no effort to seek permission to sell their home, which still has a sizeable equity in it to pay legal fees. Also, it is unclear what assets Mrs. Smith currently has and how she spent the $600,000 she received when the Trust's assets were temporarily and wrongfully unfrozen, or whether she spent that money responsively. For example, Mrs. Smith claims she paid $150,000 in legal fees to a law firm Gusrae, Kaplan for services rendered in this case but the bills she attaches to her Declaration raise more questions than they answer. The SEC raised numerous questions about these payments in its brief in opposition to Mrs. Smith's motion to modify the asset freeze (Dkt. 630 at 12-14), none of which were even addressed in Mrs. Smith's Reply Brief (Dkt 636). Thus, it is unclear how the Smiths spent this $150,000 or why they ostensibly chose to pay $150,000 to a law firm that had minimal involvement in this case and no ongoing involvement.

Thus, the Smiths have not established that they have no other means to pay for the transcript or that they have made reasonable expenditures of the monies they had available from the temporarily unfrozen Trust assets to warrant unfreezing more assets to them.

Furthermore, if the Smiths truly have no more assets to fund David Smith's criminal appeal, Smith can apply to the Second Circuit to proceed *in forma pauperis* and seek reimbursement of legal fees and the costs of transcript from the Second Circuit. See F.R.A.P.

Rule 24 and CJA Form 24(authorization and voucher for payment of transcript). This would be preferable to invading the limited frozen assets available to repay the defrauded investors.

Finally, if the Smiths prevail in their case, the assets from the Stock Account and the Trust will be available to pay attorney fees and expenses. In contrast, any money paid to Smith's attorney now will be irretrievably lost to investors. That prejudice to investors outweighs any harm resulting from delaying payments to Smith's attorneys.

CONCLUSION

For the foregoing reasons, Smith's motion should be denied in its entirety.

Dated: New York, NY
November 22, 2013

Respectfully submitted,

Securities and Exchange Commission

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