

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

10-CV-457
(GLS/DRH)

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,

Defendants, and

LYNN A. SMITH,

Relief Defendant.

PLAINTIFF'S MEMORANDUM OF LAW REGARDING
ADVERSE INFERENCES TO BE DRAWN FROM
DEFENDANTS' ASSERTIONS
OF THE FIFTH AMENDMENT

SECURITIES AND EXCHANGE COMMISSION
3 World Financial Center
Room 400
New York, NY 10281

June 16, 2010

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Plaintiff respectfully submits this memorandum of law regarding the adverse inferences to be drawn from the assertions of the Fifth Amendment privilege against self-incrimination by defendants David Smith and Timothy McGinn.

PRELIMINARY STATEMENT

Defendant David Smith and Timothy McGinn have invoked their Fifth Amendment privileges against self incrimination to avoid providing sworn testimony, producing documents and providing a verified accounting. As a result, the SEC has been denied the opportunity to question them about the allegations in the complaint and to receive other Court-ordered discovery. The following adverse inferences, therefore, should be drawn:

First, adverse inferences should be drawn against Smith and McGinn concerning the evidence regarding likelihood of success on the merits.

Second, adverse inferences should be drawn against David Smith concerning the evidence regarding the David and Lynn Smith Irrevocable Trust, the Stock Account, the Checking Account, and the Vero Beach house; and against Timothy McGinn as to the Niskayuna house.

Third, adverse inferences should be drawn against Lynn Smith, based on David Smith's assertion of the Fifth Amendment, with regard to all issues concerning the Trust, the Stock Account, the Checking Account, and the Vero Beach house.

**INVOCATIONS OF THE FIFTH AMENDMENT
BY DEFENDANTS SMITH AND MCGINN**

On April 20, 2010, the Court issued an Order to Show Cause allowing the parties to "[t]ake depositions, subject to two (2) calendar days notice" and to "[o]btain the production of documents, within three (3) calendar days from service." Docket Entry ("DE") 5, Part XX. The Order also required Smith and McGinn to provide verified written accountings. Since then,

Smith and McGinn have refused to provide deposition or hearing testimony, and also have refused to produce documents or a verified accounting.

The Preliminary Injunction Hearing

The SEC named Smith and McGinn as witnesses for the preliminary injunction hearing that began on June 9, 2010. DE 62. Counsel for Smith and McGinn sought to prevent them from testifying and wrote to the Court opposing “the testimony of Mr. McGinn and Mr. Smith in any civil proceeding during the pendency of the federal criminal investigation.” Letter from E. Stewart Jones, Jr. to Judge Homer dated June 7, 2010 (DE 52). A telephonic hearing was held on June 8, 2010, and counsel for McGinn and Smith stated that they “would not answer a single question” if called as witnesses at the hearing. The Court ruled that McGinn and Smith could be called as witnesses at the preliminary injunction hearing, but that they could assert their Fifth Amendment rights through declarations rather than live testimony.

Smith’s and McGinn’s declarations asserting their Fifth Amendment privileges against self-incrimination were admitted into evidence as Plaintiff’s Exhibit (“PX”) 128 and PX 129. The declarations state that Smith and McGinn assert their Fifth Amendment privilege against self-incrimination as to the truth of each of the statements contained in the complaint; as well as all questions concerning 36 specific topics relating to, among other things, the fraudulent securities offerings described in the complaint; the entities owned and controlled by McGinn and Smith; the transfer of assets; and the amount and location of assets.

The Notice of Depositions and Document Requests

Following receipt of the SEC’s notice of depositions on April 28, 2010, and document requests on May 3, 2010, Smith and McGinn filed an emergency motion to stay their depositions and document productions (DE 26). An “Attorney Affirmation” filed with Smith and McGinn’s

emergency motion stated that Smith and McGinn were “in the untenable position of having to decide between exercising their Fifth Amendment rights at the expense of civil exposure and adverse inferences, or foregoing their Fifth Amendment right at the risk of providing prosecutors leads” and that a failure to stay the depositions and document requests “could, inter alia, undermine the protections inherent in a party’s Fifth Amendment and Due Process rights.”

Attorney Affirmation in Support of Motion for Stay of Discovery dated May 21, 2010, ¶ 14 (DE 26-3). Following a hearing on May 25, 2010, the Court issued an order staying the depositions of McGinn and Smith. Order dated May 25, 2010 (DE 29).

The Court-Ordered Accountings

Smith and McGinn invoked their Fifth Amendment rights in response to the Court’s Order dated April 20, 2010, which required them to provide verified written accountings. In a filing dated May 19, 2010, counsel for Smith and McGinn stated that:

[G]iven the parallel investigation being conducted by the United States Attorney’s Office for the Northern District of New York, I am advised by counsels for Messrs. McGinn and Smith in that investigation that it is possible that providing a verified written accounting at this time may implicate Messrs. McGinn’s and Smith’s 1st, 4th, 5th, 6th, and/or 14th Amendment rights, as well as potentially related due process rights. For the foregoing reasons, Messrs. McGinn and Smith will not provide a verified written accounting at this time, but reserve all rights to do so in the future.

Defendants’ Timothy M. McGinn and David L. Smith’s Response to Paragraph III of May 7, 2010 Consent Order, dated May 19, 2010 (DE 22) (PX 71).

ARGUMENT

I. ADVERSE INFERENCES SHOULD BE DRAWN AGAINST DAVID SMITH AND TIMOTHY MCGINN CONCERNING THE LIKELIHOOD OF SUCCESS ON THE MERITS

Smith and McGinn consented to the entry of the proposed Preliminary Injunction Order, DE 61, and they did not submit a brief or present evidence contesting the SEC’s likelihood of

success on the merits. Relief defendant Lynn Smith, however, argues that the SEC has failed to meet its burden of establishing a likelihood of success on the merits. *See* Letter dated June 4, 2010 from James D. Featherstonhaugh to Judge Homer (DE 50). Accordingly, the Court can consider the Smith and McGinn declarations as evidence in determining the likelihood of success on the merits.

By invoking their Fifth Amendment rights, Smith and McGinn “have prevented the Commission from obtaining discovery and evidence relevant to this action.” *SEC v. Cassano*, 2000 U.S. Dist. LEXIS 12152, *3 (S.D.N.Y. June 19, 2000) (granting SEC’s motion to preclude defendants from testifying). Smith and McGinn relied on their Fifth Amendment rights against self-incrimination to avoid answering questions at the preliminary injunction hearing. PX 128, 129. Citing their Fifth Amendment rights, Smith and McGinn also moved for a stay of all discovery pertaining to them, and the Court issued an Order staying their depositions. DE 29. In addition, Smith and McGinn relied on their Fifth Amendment rights and refused to provide the Court-ordered accountings. DE 57. Smith and McGinn knew the consequences of asserting their Fifth Amendment rights because their own attorney’s affirmation recognized that “adverse inferences” could be drawn. DE 26-3.

A Fifth Amendment assertion allows a judge or jury to draw an adverse inference against a defendant. *Baxter v. Palmigiano*, 425 U.S. 308 (1976). The Second Circuit has held that an adverse inference may be drawn “even though . . . the government is a party to the action and would benefit from the drawing of the inference.” *LiButti v. United States*, 107 F.3d 110, 121 (2d Cir. 1997); *see also SEC v. Martino, et al.*, 255 F. Supp.2d 268, 282 (S.D.N.Y. 2003) (“The Commission has appropriately requested that the Court draw a negative inference from [defendant’s] invocation of [the Fifth Amendment]. The Court does draw a negative inference

from [defendant's] assertion of her Fifth Amendment privilege"; granting SEC's motion for summary judgment); *SEC v. Chester Holdings, Ltd.*, 41 F. Supp.2d 505, 525 (D.N.J. 1999) ("Invocation of one's Fifth Amendment privilege in civil cases, either in depositions or at trial, permits an adverse inference to be drawn against the party invoking the privilege"; granting SEC's motion for summary judgment in financial fraud case).

In the Smith and McGinn declarations, they asserted their Fifth Amendment rights against self-incrimination "as to the truth of each of the statements contained in the complaint." PX 128 ¶ 4; PX 129 ¶ 4. In addition, Smith and McGinn asserted their Fifth Amendment rights as to, among other things, 36 specific areas concerning the entities they owned and controlled, communications with investors and potential investors, and the amount and uses of money raised in the relevant offerings. PX 128; PX 129. This provides a sufficient basis to draw an adverse inference against Smith and McGinn on the issue of whether the evidence shows a likelihood of success on the merits.

II. ADVERSE INFERENCES SHOULD BE DRAWN AGAINST DAVID SMITH CONCERNING THE TRUST; THE STOCK ACCOUNT; THE CHECKING ACCOUNT; AND THE VERO BEACH HOUSE

David Smith's declaration makes clear that he invokes the Fifth Amendment with regard to all questions regarding: (1) the David and Lynn Smith Irrevocable Trust (the "Trust"), which David and Lynn Smith created, funded and controlled; (2) the brokerage account maintained in Lynn Smith's name (the "Stock Account"), which funded the Trust's only asset, a brokerage account; (3) the checking account in Lynn Smith's name at Bank of America (the "Checking Account") established in July 2009 to receive David Smith's paychecks after decades of being deposited into a joint account; and (4) the house in Vero Beach, Florida, purchased with funds

from the Stock Account, which David and Lynn Smith transferred to Lynn Smith's name in 2009 after nine years of joint ownership. PX 128.

David Smith's declaration specifically asserts his Fifth Amendment right against self-incrimination as to all questions concerning:

- "Any transfer of money or other assets to my wife, including the transfer to my wife of the house in Vero Beach" (PX 128 ¶ 5.S);
- "The transfer of funds into and out of any and all accounts listed in Exhibit B to the order to Show Cause entered on April 20, 2010" (PX 128 ¶ 5.T);
- "The David and Lynn Smith Irrevocable Trust, including any bank account and brokerage accounts held by the Trust, and my control of the Trust and its assets" (PX 128 ¶ 5.V); and
- "The transfer of funds into and out of" any bank or brokerage account in the name of my wife and me or in the name of my wife, "including but not limited to retirement and trust accounts" (PX 128 ¶¶ 5.W, 5.X).

Accordingly, it is appropriate to draw an adverse inference against David Smith with regard to all issues concerning the Trust, the Stock Account; the Checking Account and the Vero Beach house.¹

¹ For the same reason that the Vero Beach house should remain frozen, the McGinn house at 26 Port Huron Drive, Niskayuna, NY – transferred from Timothy McGinn to Nancy McGinn on October 19, 2009 for \$1 in consideration (*see* PX 117) – should remain frozen. Mr. Koenig's letter to the Court dated June 14, 2010 (DE 71), argues that "the [McGinn] home is solely owned by Nancy McGinn . . . [and] is not a frozen asset." The evidence, however, including PX 117 (deed), PX 67 (internal McGinn Smith e-mails); and McGinn's invocation of the Fifth Amendment as to all questions regarding, among other things, his assets, real property owned by him or his wife, and Nancy McGinn (PX 129, at 4-5), support a finding that the Niskayuna house is within the scope of the asset freeze because it is "held" by McGinn or is held for his "direct or indirect beneficial interest." DE 58, at 5. Plaintiff reserves its rights to amend the complaint to name Nancy McGinn as a relief defendant.

III. ADVERSE INFERENCES SHOULD BE DRAWN AGAINST LYNN SMITH CONCERNING THE TRUST; THE STOCK ACCOUNT; THE CHECKING ACCOUNT; AND THE VERO BEACH HOUSE

The Court should draw an adverse inference as to Lynn Smith with regard to all issues concerning the Trust, the Stock Account, the Checking Account and the Vero Beach house. David Smith's refusal to answer question on these areas should result in an adverse inference being drawn against Lynn Smith, his wife and a relief defendant. *See LiButti v. United States*, 178 F.3d 114, 120 (2d Cir. 1999) ("An adverse inference may be given significant weight because silence when one would be expected to speak is a powerful persuader"; trial court did not abuse discretion in according considerable weight to adverse inference from refusal to testify by non-party, plaintiff's father); *Rad Services, Inc. v. Aetna Casualty and Surety Co.*, 808 F.2d 271, 275-76 (3d Cir. 1986) (assertion by present or former employee of party resulted in adverse inference); *Brink's Inc. v. City of New York*, 717 F.2d 700, 710 (2d Cir. 1983) (assertion by former employee).

This Court has previously applied the Second Circuit's *Libutti* decision in determining whether a party's invocation of the Fifth Amendment may be applied to other parties. *Willingham v. County of Albany*, 593 F. Supp.2d 446, 453 (N.D.N.Y. 2006) ("the rationale and analysis of *LiButti* have equal application to a case, as here, where a party invokes the privilege and the question presented is whether the party's invocation merits application of an adverse inference against other parties"). In *Libutti*, the Second Circuit identified "'a number of non-exclusive factors' to guide this determination, including the nature of the relevant relationships, the degree of control over the non-testifying witness, the compatibility of the interests between the non-testifying witness and the party, and the role of the non-testifying witness in the litigation. However, '[w]hether these or other circumstances unique to a particular case are

considered by the trial court, the overarching concern is fundamentally whether the adverse inference is trustworthy under all of the circumstances and will advance the search for the truth.” *Willingham*, 452 F.Supp.2d at 452-453 (citations omitted).

These factors justify finding as adverse inference against Lynn Smith based on her husband’s assertion of the Fifth Amendment. David and Lynn Smith’s interests are intertwined and clearly aligned both before and after the filing of this case, and not only because they are husband and wife. They are both grantors and donors of the Trust and have an interest in shielding the Trust’s only asset from the asset freeze. David and Lynn Smith also have a commonality of interest in concealing the reason for the creation of the Trust shortly after the launch of the fraudulent Four Funds offerings. They have a shared interest in protecting the Stock Account, which has been used to benefit both spouses and subject to joint control for decades, from the freeze. They also worked together in transferring assets to Lynn Smith’s sole control, such as the Checking Account and the Vero Beach house, after David Smith received a letter from FINRA requesting his testimony under oath. Under all of the circumstances presented here, David Smith’s invocation of the privilege appears trustworthy and the adverse inference against David Smith should also be applied to Lynn Smith.

CONCLUSION

For the foregoing reasons, the Commission respectfully requests that the Court draw adverse inferences from the assertions of the Fifth Amendment privilege against self-incrimination by David Smith and Timothy McGinn, and apply the adverse inferences from David Smith’s assertion of the Fifth Amendment to Lynn Smith, and further requests that the Court consider these inferences, together with the evidence submitted at the hearing held June 9-11, 2010, and find that the Commission has met its burden of showing a likelihood of success on

the merits, and that the asset freeze should continue over the Stock Account, the Trust Account, the Checking Account, the Vero Beach house and the Niskayuna house.

Dated: New York, NY
June 16, 2010

Respectfully submitted,

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