

**UNITED STATES DISTRICT COURT  
NORTHERN DISTRICT OF NEW YORK**

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SECURITIES AND EXCHANGE COMMISSION,

*Plaintiff,*

**Case No.: 1:10-CV-457  
(GLS/DRH)**

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,

*Defendants, and*

LYNN A. SMITH,

*Relief Defendant.*

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**MEMORANDUM OF LAW OF RELIEF DEFENDANT, LYNN A. SMITH,  
IN OPPOSITION TO THE APPLICATION OF ADVERSE INFERENCES  
PROPOSED TO BE DRAWN FROM DEFENDANTS' ASSERTIONS  
OF THE FIFTH AMENDMENT**

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### PRELIMINARY STATEMENT

At the conclusion of the Preliminary Injunction hearing in the above-captioned matter, the Court instructed the parties to brief the issue of what, if any, adverse inferences should be drawn against Defendants and the Relief Defendant as a result of the declarations filed by Defendants David L. Smith, and Timothy M. McGinn, in the exercise of their Fifth Amendment privilege against self-incrimination. The Court instructed Plaintiff Securities and Exchange Commission (“SEC” or “Commission”) to detail the specific inferences they were requesting, the party against whom they were requesting the inference and the legal basis supporting it. Of particular interest in the instant case is the fact that the record includes four days and 1,091 transcript pages, of testimony under oath, of Defendant David Smith, provided at a FINRA hearing and submitted to the Court, by Plaintiff SEC. In addition, Relief Defendant Lynn A. Smith, has been able to find no recorded case in the 2<sup>nd</sup> Circuit or elsewhere where any adverse inference has ever been held against a Relief Defendant in a SEC proceeding. In the instant case the SEC requests “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.” The SEC pointedly fails to identify with any specificity what “issues” it discerns in connection with the trust, the stock account, the checking account and the Vero Beach house or the nature of the inference which it seeks.

We believe it is instructive to review the SEC’s burden with regard to the Relief Defendant in addressing this request. As a Relief Defendant, Lynn Smith has been accused of no wrong doing. Her presence in the case is solely to allow the Court to effectuate equitable relief should the SEC be eventually successful in its underlying case

against the main Defendants. Indeed, the subject matter jurisdiction which the Court exercises over Relief Defendant Lynn A. Smith is directly dependent upon the nature of the claim asserted against her.

The only issue ever raised in the proceeding against Lynn Smith is that she is somehow, the recipient of ill-gotten gains for which she does not have a legitimate ownership claim. The only relevant adverse inference which could be drawn against Lynn Smith would be that some specific or approximated portion of illegally obtained profits were transferred into Lynn Smith's account and that those profits resulted from Defendant's alleged fraud and further that Lynn Smith had no legitimate ownership claim to the funds. It is difficult if not impossible to imagine how any such series of inferences could be drawn from Defendant, David Smith's silence which may well explain why no cases can be found applying an adverse influence to a relief defendant.

To the extent that one may wish to speculate on what it was the SEC was attempting to prove against Relief Defendant Lynn Smith during the preliminary injunction hearing and now seeks to bolster by its inference request, one's curiosity must be tempered by the well settled law governing relief defendants.

The critical inquiry for the Court is whether Lynn Smith is properly named in the SEC's Complaint as a relief defendant. This inquiry turns upon the "legitimate claim" test, that is, whether Lynn Smith is a mere custodian of assets received gratuitously from the Defendants or whether she has a legitimate interest of her own in assets that were received for consideration. Consequently, the Court must search the Complaint to ascertain the specific "ill-gotten gains" alleged to have been received by Lynn Smith and

search the Record to determine whether the SEC carried its burden of proof as to those specific amounts at the preliminary injunction hearing.

It is clear on its face that the SEC's Complaint fails to allege beyond generalized statements that the funds at issue were received without consideration nor did it offer substantiated facts showing the absence of a legitimate claim to the funds at issue.

A proper relief defendant "has no legitimate claim to the disputed property." SEC v. Ross, 504 F.3d 1130 (9<sup>th</sup> Cir. 2007). Rather, a relief defendant is joined "purely as a means of facilitating collection" of the defendant's assets in its custody when the defendant's liability is ultimately established. SEC v. Colello, 139 F.3d 674, 676 (9<sup>th</sup> Cir. 1998). See also, CFTC v. Kimberlynn Creek Ranch, Inc., 276 F.3d 187, 191 (4<sup>th</sup> Cir. 2002) (a nominal defendant is joined as a means of facilitating collection at the resolution of the matter). Since a relief defendant is not accused of any wrongdoing and is joined to aid in the recovery of the defendant's property, it is not necessary to set forth a separate basis for subject matter jurisdiction beyond that over the action involving the defendants' alleged violations. See, Kimberlynn Creek Ranch, Inc., at 191-92.

However, the relief defendant doctrine applies only in limited circumstances in that a federal court may order equitable relief against such a person where that person (1) has received ill-gotten funds, and (2) does not have a legitimate claim to those funds. CFTC v. Walsh, 2009 U.S. Dist. LEXIS 71617 (S.D.N.Y. Aug. 4 2009), citing, SEC v. Cavanagh, 155 F.3d 129, 136 (2<sup>nd</sup> Cir. 1998). It is the SEC's burden to show this test is met, because "the lack of a legitimate claim to the funds is the defining element of a nominal defendant." See, Colello at 677. See also, FTC v. Bronson Partners, LLC 674 F.Supp. 2d 373, 392 (D. Conn. 2008) (the burden rests with the Commission to show that

the funds in the possession of [the relief defendant] are ill-gotten). This analysis also determines subject matter jurisdiction in that if the third party is a proper relief defendant, it falls within the jurisdiction covering the substantive claims against the actual defendants, but if not, then there must be a separate basis for subject matter jurisdiction, and full due process, prior to any final equitable relief being ordered against the relief defendant. SEC v. Cherif, 933 F.2d 403, 413-14 (7<sup>th</sup> Cir. 1991). See also, United States CFTC v. Sarvey, 2008 U.S. Dist. LEXIS 54566 (N.D. Ill. 2008) (complaint dismissed where parties were not proper nominal defendants). As to such a party with a legitimate claim to the property at issue, equitable remedies may not be obtained unless the SEC can obtain true jurisdiction by asserting a substantive securities claim against that party as a defendant. See, Cherif at 413-415; Ross at 1142; Sarvey at 5.

In this proceeding, the SEC has not established with sufficiency that either the funds are ill-gotten or that Lynn Smith lacks a “legitimate claim” to the funds at issue. Since that showing is the “defining element” of proper relief defendant status, see, Coello at 677, without it the SEC has no basis to name Lynn Smith as a Relief Defendant or ultimately obtain the equitable disgorgement remedy it seeks against her as a non-culpable party. The SEC attempts to bridge this cavernous gap in evidence with speculation and an unfathomable request for an incomprehensibly general adverse inference.

In this matter, it is apparent that the SEC, in seeking to continue the asset freeze imposed upon Lynn Smith, is asking the Court to make an adverse inference to vitiate its failure to establish a likelihood of success on the merits. See SEC v. Cavanagh, 155 F.3d 129, 133 (2<sup>nd</sup> Cir. 1998). Courts have continuously acknowledged “the basic principle

that burdensome forms of interim relief require correspondingly substantial justification.” SEC v. Unifund SAL, 910 F.2d 1028, 1042 (2<sup>nd</sup> Cir. 1990). Moreover, “like any litigant, the Commission should be obliged to make a more persuasive showing of its entitlement to a preliminary injunction the more onerous are the burdens of the injunction it seeks.” Id. at 1039. The blanket asset freeze currently in place upon the personal assets of Lynn Smith is an enormous and devastating burden. After years of investigation, the SEC’s demand that the Court somehow draw an adverse evidentiary inference against Lynn Smith as a consequence of Defendant David Smith’s invocation of the Fifth Amendment fails to meet the required persuasive showing of its entitlement to a preliminary injunction, fails to meet the “substantial justification” standard, and ultimately stands as an admission of its failure to establish that it is likely to succeed on the merits.

Consequently, the request by the SEC to draw an adverse evidentiary inference against Relief Defendant Lynn Smith as a consequence of Defendants’ declaration should be rejected.

## POINT I

### **THERE IS NO BASIS FOR DRAWING AN ADVERSE INFERENCE AGAINST A RELIEF DEFENDANT BASED UPON A DEFENDANT’S ELECTION TO INVOKE THEIR FIFTH AMENDMENT CONSTITUTIONAL RIGHT AGAINST SELF INCRIMINATION**

Adverse inferences have been sought and utilized routinely by the SEC’s Division of Enforcement when individual defendants in SEC matters choose to exercise their Fifth Amendment right against self-incrimination rather than testify. *See, e.g., SEC v. Cherif*, 933 F.2d 403, 417 (7<sup>th</sup> Cir. 1991), cert denied, 502 U.S. 1071 (1992); SEC v. Musella,



578 F. Supp. 425, 429 (S.D.N.Y. 1984). The adverse inference is often utilized when the invocation of the privilege against self-incrimination during SEC actions is used as a means of obstructing or otherwise hindering the SEC's efforts to enforce the federal securities laws.

Once there is a finding that an adverse inference is applicable to a given case, the focus of the inquiry then turns to the relevance of the refusals and their probative value under Fed. R. Evid. 403, and the weight they should be accorded in the context of all of the other evidence. Libutti v. United States, 178 F.3d 114, 120 (2d Cir. 1999).

The SEC now seeks, in a case of first impression, to extend an adverse inference to a relief defendant, who by the SEC's own admission is an innocent party to this litigation being joined for the sole purpose to aid the recovery of relief. By its very definition, a relief defendant is one who is not accused of any wrongdoing but against whom equitable relief may be sought if it is demonstrated that such a person (1) has received ill-gotten funds, and (2) does not have a legitimate claim to those funds CFTC v. Walsh, 2009 U.S. Dist. LEXIS 71617 (S.D.N.Y. Aug. 4, 2009), citing, SEC v. Cavanagh, 155 F.3d 129, 136 (2<sup>nd</sup> Cir. 1998). Significantly, the government does not cite to a single case where an adverse inference has been drawn against a relief defendant based on a party or non-party's invocation of the Fifth Amendment nor has the Relief Defendant's counsel been successful in their own diligent search for such authority. Instead, the SEC relies on Libutti v. United States, 178 F.3d 114, 120 (2d Cir. 1999) for the principal that an adverse inference can be drawn against a party to an action based upon the invocation of Fifth Amendment right by a non-party witness.

In *Libutti*, a daughter filed suit against the IRS seeking to have a tax lien released on a thoroughbred race horse that was filed by the government to secure delinquent taxes that were due from her father. The father was not a party to his daughter's action and the issue was whether his pleading of the Fifth should draw an adverse inference as to her ownership rights in the horse. As the plaintiff, the daughter had the burden of proof to demonstrate her ownership interests and that the tax lien filed by the IRS was unjustified. The adverse inference was used as probative evidence that her burden was not met. In this case, it is the government who has the burden to prove that a relief defendant is the recipient of ill-gotten gains and does not have a legitimate claim to those funds. Here the SEC is apparently attempting to use the adverse inference as a method of avoiding its own evidentiary burden as to the specific elements it must show that demonstrate Lynn Smith is a properly named relief defendant. It is submitted that *Libutti* does not stand for this proposition.

## POINT II

### **THE SEC HAS FAILED TO OFFER SUFFICIENT INDEPENDENT EVIDENCE TO SUPPORT ITS REQUEST FOR AN ADVERSE INFERENCE AGAINST RELIEF DEFENDANT, LYNN SMITH**

The Court should adhere to a strict 'relief defendant' analysis to determine what facts are relevant by (1) searching the Complaint to ascertain the specific "ill-gotten gains" alleged to have been received by Lynn Smith without any ownership interest, then (2) search the record to determine whether the plaintiff carried its burden of proof as to those amounts at the hearing. Only then can the Court make a determination as to the



probative value and proper weight, if any, to be given to any adverse inference resulting from Defendants' refusal to testify pursuant to its Fifth Amendment rights.

The SEC has failed to offer sufficient corroborated evidence to support its demand for an adverse inference against either the Relief Defendant or Defendant David Smith. Courts have continuously held that the use of the Fifth Amendment in civil proceedings, alone, may not support an adverse inference. United States v. Stelmokas, 100 F.3d 302, 311 (3<sup>rd</sup> Cir. 1996); see also, United States v. Incorporated Village of Island Park, 888 F.Supp. 419, 431 (E.D.N.Y. 1995) (the government may seek to rely on a defendants' assertion of their Fifth Amendment right to confirm matters supported by other independent evidence). While an adverse inference may be drawn in a proceeding against a defendant who invokes the privilege against self-incrimination, United States v. Private Sanitation Indus. Ass'n, 811 F.Supp 808, 812 (E.D.N.Y. 1992), aff'd 995 F.2d 375 (2<sup>nd</sup> Cir. 1993), liability may not be imposed based solely on the adverse inference and the government must produce independent corroborative evidence of the matters to be inferred before liability will be imposed, United States v. Bonanno Organized Crime Family of La Cosa Nostra, 683 F. Supp. 1411, 1451-52 (E.D.N.Y. 1988), citing, Baxter v. Palmigiano at 317-18.

The Court in Beland v. Cunningham, 365 B.R. 352 (Bankr. D. Mass 2007), in citing Trustmark Nat'l Bank v. Curtis, 177 B.R. 717 (Bankr. S.D. Ala. 1995) stated succinctly that:

A plaintiff seeking to rely on a Fifth Amendment inference must first offer evidence which at least tends to prove each part of the plaintiff's case. Once that has been done, the Court can then add to the weight of the other evidence by use of the inference. However, the invocation of the Fifth Amendment privilege, standing alone, is not sufficient to constitute probative proof of a plaintiff's case.

Beland v. Cunningham at 362.

In this matter, the SEC in their Second Point disregards all decisional law and states that by simply asserting his Fifth Amendment right against self-incrimination “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.” The SEC failed, however to offer the necessary corroborated evidence to support their claims at the hearing. A review of the SEC’s Complaint and the Record in this proceeding shows that the SEC has failed to prove or in most cases even allege with legally sufficient specificity that Lynn Smith possesses ill-gotten funds and lacks a legitimate claim to the funds. In its Complaint the SEC merely set forth “a formulaic recitation of the elements of a cause of action” necessary to disgorge funds from a relief defendant, Bell Atl. Corp. v. Twombly, 550 U.S. 544 (2007).

The same is true upon review of the Record, wherein the SEC’s only evidence relevant to Relief Defendant receipt of funds relates to a \$335,000 payment made by one of the defendant entities. (Complaint ¶ 99). However, there was no proof offered by the SEC in any manner that substantiated these funds were derived from ill-gotten gains. To the contrary, the Relief Defendant presented testimony and demonstrative evidence that this payment was in fact a partial repayment for a \$366,000 loan thereby rebutting any possible inference sought by the SEC.

There was not even an attempt on the Record to substantiate an amount of ill-gotten gains which the SEC seeks to disgorge from the Relief Defendant. The SEC bears the ultimate burden of persuasion that its ultimate disgorgement figure, if realized, reasonably approximates the amount of unjust enrichment. SEC v. Aimsi Techs., Inc.,

650 F. Supp2d 296, 304 (S.D.N.Y. 2007), citing, SEC v. Opulentica, 479 F. Supp2d 319 (S.D.N.Y. 2007). Consequently, an adverse inference that all the assets cited by the SEC in Lynn Smith's name are somehow ill-gotten is simply not supported by either the SEC's allegations set forth in its Complaint or of its evidence in the Record.

### POINT III

**HAVING OFFERED THE SWORN TESTIMONY OF DAVID L. SMITH, TO THE COURT, FOR ITS CONSIDERATION THE SEC SHOULD BE PRECLUDED FROM SEEKING AN ADVERSE INFERENCE AGAINST RELIEF DEFENDANT LYNN SMITH**

In the preliminary injunction hearing in this matter the SEC placed into evidence as Exhibits 20, 21, 22 and 23 sworn testimony of Defendant David Smith provided before the Financial Industry Regulatory Authority on February 1, 2010; February 2, 2010; February 3, 2010; and February 12, 2010. In all the exhibits comprised 1,091 pages of sworn testimony given to representatives of the Financial Industry Regulatory Authority were investigating the very issues which are the subject of this litigation and whose investigation is in fact the basis of this proceeding.

In the course of the testimony offered by Mr. Smith on the four days in question there are two instances in which Mr. Smith is examined in connection with his wife's finances. In each of these instances Mr. Smith testifies clearly that it was his wife Lynn Smith who had the assets and that he and his wife maintain separate finances. (transcript pp 277-292). As this Court stated in the strikingly similar case of Wanda Willingham v. County of Albany, 593 F. Supp 2d 446 (N.D.N.Y.):

The circumstances presented here, however, include not only Gilkey's invocation of his privilege during his deposition but also his unrestricted testimony during the *DeWitt* hearing. The purpose underlying the

allowance of an adverse inference in civil cases is equitable, not punitive, and serves to vitiate the prejudice to the party denied discovery by invocation of the privilege. See United States v. 4003-4005 5<sup>th</sup> Ave., 55 F.3d 78, 82-83 (2d Cir. 1995). In those instances where Gilkey answered a question during the *DeWitt* hearing, plaintiffs have not been denied discovery as to an answered question and no basis exists for an adverse inference against Gilkey. Therefore, plaintiffs are entitled to adverse inferences from Gilkey's invocation of his Fifth Amendment privilege only to the extent that the questions to which he asserted the privilege were not otherwise answered during his testimony in the *DeWitt* hearing.

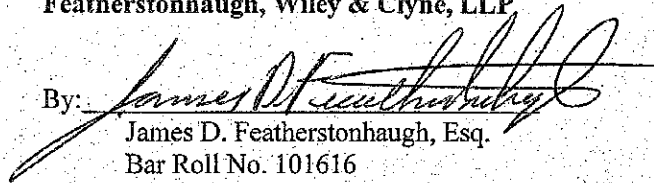
Id. at 452.

In this matter, virtually all of the areas of inquiry which were explored by the SEC at trial or articulated in the Smith declaration were testified to, at length, in the FINRA proceeding, and accordingly the SEC is entitled to no adverse inferences in those areas.

DATED: June 18, 2010

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