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,

Defendants, and

LYNN A. SMITH,

Relief Defendant.

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

INTERVENOR'S MEMORANDUM OF LAW REGARDING DEFENDANTS McGINN AND SMITH'S INVOCATION OF THEIR CONSTITUTIONAL RIGHTS

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TABLE OF CONTENTS

PRELIMINARY STATEMENT

On June 8, 2010, Plaintiff identified Timothy McGinn and David Smith among its witnesses to be called at the hearing on its motion for a preliminary injunction. Later that day, in a conference conducted telephonically, the Court ordered that Plaintiff could call McGinn and Smith as witnesses in the hearing and allowed that, if McGinn and Smith sought to invoke their constitutional rights and refused to testify, they could do so in a sworn declaration signed in advance rather than in response to questions posed at the hearing.

In that conference, Plaintiff's counsel further stated that he intended to ask the Court to draw adverse inferences against the parties participating in the hearing, that is, the Relief Defendant Lynn Smith and the Intervenor David Wojeski, as Trustee of the David L. and Lynn A. Smith Irrevocable Trust ("the Trust"), by virtue of the invocation of rights by and absence of McGinn and Smith as witnesses in the hearing. Counsel for the Relief Defendant and the Intervenor objected to that request. Counsel for McGinn and Smith indicated that both men would consent to the entry of a preliminary injunction order against them and the entities named in the Complaint and would not otherwise participate in the hearing. The Court ordered that all counsel would brief the issue of whether any inferences could or should be drawn at the close of the hearing based upon McGinn and Smith's invocation of their constitutional rights.

Following the June 8 telephonic conference, in an effort to secure the testimony of McGinn and Smith, Intervenor's attorney served witness subpoenas on Defendants McGinn and Smith through their attorney, Michael Koenig, who agreed to accept service on their behalf and reaffirmed that they would not appear or testify at the hearing. Timothy McGinn and David Smith did not testify at the hearing. At the close of its proof, Plaintiff's counsel offered into evidence sworn declarations of Smith and McGinn. See Plaintiff's Ex. 128 and 129. Counsel for

the Relief Defendant and the Intervenor had not seen the declarations before the time that Plaintiff offered them into evidence on June 10, 2010, nor had counsel been privy to any negotiations between counsel for the Plaintiff and counsel for McGinn and Smith regarding the content of the declarations.

At the hearing on Plaintiff's motion for a preliminary injunction, the Court directed Plaintiff to file a legal brief to support its request for the admission of Plaintiff's Exhibits 128 and 129 into evidence and its request that the Court draw an adverse inference against Relief Defendant Lynn Smith and the Intervenor as a result of the invocation of rights by Timothy McGinn and David Smith and their refusal to appear and testify at the hearing on the preliminary injunction motion. The Court directed Plaintiff to identify the proposed facts as to which it sought to apply a negative inference and the basis for its request. For the following reasons, the Intervenor respectfully submits that the Court should deny Plaintiff's request to admit the declarations into evidence and refuse to draw any negative inference as a result of the execution of the declarations.

Plaintiff's brief seeks negative inferences in three respects: (1) "against Smith and McGinn concerning the evidence regarding likelihood of success on the merits;" (2) "against David Smith concerning the evidence regarding the David and Lynn Smith Irrevocable Trust, the Stock Account, the Checking Account, and the Vero Beach home; and against Timothy McGinn as to the Niskayuna house;" and (3) 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." Plaintiff's Memorandum of Law dated June 16, 2010, p. 1. Plaintiff does not ask the Court to draw any negative inferences against the Intervenor for any purpose. However, because Plaintiff implicates the Trust in its requests as to

Defendant David Smith and Relief Defendant Lynn Smith, the Intervenor addresses the "negative inference" issue herein.

POINT I

THE COURT SHOULD NOT DRAW ANY NEGATIVE INFERENCES AGAINST TIMOTHY McGINN AND DAVID SMITH BECAUSE THEY HAVE CONSENTED TO THE ENTRY OF A PRELIMINARY INJUNCTION ORDER AND PLAINTIFF'S REQUEST SERVES ONLY TO PREJUDICE THE REMAINING PARTIES

The Court is well aware that Defendants Timothy McGinn and David Smith, through their counsel, and the Entity Defendants, through the Receiver, have consented to the entry of a preliminary injunction order. None of those parties contested Plaintiff's motion for a preliminary injunction or participated in the hearing, other than the Receiver's appearance as a witness. Moreover, the parties to the hearing, including the Plaintiff, only presented proof relating to the request for a preliminary injunction against the Relief Defendant and the Intervenor. Nevertheless, for the first time in the Preliminary Statement of its Memorandum of Law, Plaintiff asserts that adverse inferences should be drawn against McGinn and Smith concerning evidence relating to "the likelihood of success on the merits" and against Smith concerning "evidence regarding the David and Lynn Smith Irrevocable Trust, the Stock Account, the Checking Account, the Vero Beach house." This request only serves to prejudice the Relief Defendant and the Intervenor and, for the following reasons, the request should be denied.

The Court need not reach the issue of whether to draw any adverse inferences against McGinn and Smith or any of the Entity Defendants because they have all consented to the entry of a preliminary injunction order against them. Nor can Plaintiff seek to draw the inference now to preserve it for use later in the litigation, as the invocation by those defendants would have to recur in the litigation of the underlying lawsuit for it to be used against them outside this

preliminary injunction hearing. See, *United States v. Gary*, 74 F.3d 304, 312 (1st Cir. 1996) (it is "hornbook law" that a witness' waiver of his right against self-incrimination is limited to the particular proceeding in which the witness appears). Moreover, Plaintiff is asking the Court to conclude that McGinn and Smith's invocation of their privileges with respect to this preliminary injunction motion constitutes a concession as to the Plaintiff's likelihood of success on the merits. In fact, by agreeing to this preliminary injunction, the main Defendants are avoiding having to conduct a mini-trial on the merits of a complex case without the benefit of the discovery process. See *Smith v. DeTella*, No. 95 C5129, 2000 US Dist. LEXIS 4777 (N.D. Ill. Mar. 9, 2000) (trial witness who invoked the right against self-incrimination…had so many possible motivations for that invocation that the court could not reasonably infer that the witness invoked his right against self-incrimination because his earlier testimony was perjurious).

Plaintiff's new request to draw adverse inferences against McGinn and Smith, a request not made at the hearing, is apparently either a precursor to or perhaps a substitute for drawing inferences against the Relief Defendant and the Intervenor. This is a feeble attempt to take an adverse inference which would be permissible but not mandatory as applied against the individuals who actually invoked their own constitutional rights, and vicariously transfer that inference to parties who have not invoked and who, in fact, have fully litigated the issues at bar and subjected themselves to cross-examination by the Plaintiff, both in pre-hearing depositions and in open court before the trier of fact. This classic "bootstrapping" effort is prejudicial and inherently reliable, and it demonstrates the obvious weaknesses in Plaintiff's legal argument on this issue. The request should be rejected outright, as the determination of any inferences to be drawn against McGinn and Smith, as the invoking parties, is unnecessary to resolving the evidentiary issue presently before the Court.

POINT II

TO THE EXTENT THAT PLAINTIFF'S MEMORANDUM OF LAW IS CONSTRUED TO REQUEST AN ADVERSE INFERENCE TO BE DRAWN AGAINST THE TRUST, THAT REQUEST SHOULD BE DENIED IN ITS ENTIRETY

It is settled law that the "[i]nvocation of the right against self-incrimination in a civil proceeding may authorize an adverse inference against the invoking party." *Baxter v. Palmigiano*, 425 U.S. 308, 318-19 (1976). In general, "the adverse inference that may be drawn is that if the invoking party had testified, that testimony would have been unfavorable to his case." See, *Poplar Grove Planting & Refining Co. v. Bache Halsey Stuart, Inc*., 465 F. Supp. 585, 591 (M.D. La. 1979). The jury instruction which results is that the jury is "*permitted, but not required*," to infer from the party's silence that the party's answers would have been adverse to his interests in the civil litigation, and that any inference drawn should be based on all of the facts and circumstances in the case. See, 4 Modern Federal Jury Instructions §75.01 (Matthew Bender 2000); see also, *Pyles v. Johnson*, 136 F.3d 986, 997 (5th Cir. 1998) ("However, the fact that the Fifth Amendment does not *prohibit* such inferences does not imply that the fact-finder is *required* to make them.") (emphasis in original). Thus, the Court, as the trier of fact in this preliminary injunction motion hearing, may, but is not required to, draw an adverse inference against McGinn and Smith. As to the Relief Defendant and the Intervenor, however, the Court should be far more reluctant to impute an adverse inference against them which derives, not from their own conduct, but from the refusal of a party not under their control to testify.

The invocation by one party being used against another party has arisen most often in an employer/employee situation, where an individual employee's invocation is sought to be used

against the corporate employer in civil litigation. See, *Brinks Inc. v. City of New York*, 717 F.2d 700 (2d Cir. 1983). The Second Circuit has permitted an adverse inference to be drawn against a party in civil litigation when another non-party individual has invoked his privilege against self-incrimination. *LiButti v. U.S.*, 107 F.3d 110 (2d Cir. 1997). In considering whether to do so, the Court must test the persuasiveness of the proposed adverse inference against other evidence. *LiButti v. U.S.*, 178 F.3d 114 (2d Cir. 1999). Plaintiff is required to put forth independent evidence supporting the fact to which the party is invoking his Fifth Amendment privilege not to answer. See, *LaSalle Bank Lake View v. Seguban*, 54 F.3d 387, 391 (7th Cir. 1995). Here, Plaintiff has not submitted the proposed factual findings for which it seeks adverse inferences against the Trust, nor has it identified any corroborating evidence to support any such findings.

In *LiButti II*, the Second Circuit suggested four non-exclusive factors to be considered in determining whether an adverse inference drawn from one witness' refusal to testify can be admitted into evidence and used adversely against another party who has appeared and testified. *Libutti v. U.S.*, 107 F.3d 110. That four-factor test has not been met here. In evaluating whether the particular circumstances of this case warrant an adverse inference being drawn against the Trust, the Court is guided by: (1) the nature of the relationship between the Trust and David Smith; (2) the degree of control of the Trust over David Smith; (3) the compatibility of the interests of the Trust and David Smith in the outcome of the litigation; and (4) the role of David Smith in the litigation.

With respect to tthe nature of the relevant relationship, David Smith was merely a creator of the Trust. Contrary to Plaintiff's unsupported assertion, David Smith did not fund the trust; he was a "Donor" in title only. It is uncontroverted that the Trust was funded solely by Lynn Smith with assets originally acquired by inheritance. David Smith is not the trustee or beneficiary of

the Trust, nor did he receive any benefit from the Trust. Plaintiff conceded at oral argument that every withdrawal from the Trust account was used either for investments or to pay taxes. Plaintiff did not offer a single piece of evidence to contradict the undisputed fact that David Smith did not fund the Trust and that Thomas Urbelis authorized every withdrawal from the Trust account.

Although Plaintiff asserted for the first time near the end of the hearing that the trust was created to shield assets from creditors, not one single piece of evidence was admitted to support this absurd contention, either in its case in chief or on rebuttal. Even in its Complaint, the earliest time when Plaintiff alleges that any of the Four Funds loaned money to "McGinn Smith affiliated entities" was 2005 (Complaint ¶ 32-34), and the earliest time when Plaintiff alleges that the Defendants "knew or recklessly disregarded that the Four Funds would not redeem investor notes when they became due" was "no later than 2006" (Complaint ¶ 35). Clearly, Plaintiff's assertion that the Trust was created in August 2004 to shield assets from creditors was belatedly offered to salvage its failure of proof and is without any basis whatsoever. Lynn Smith retained $2.5 million in her brokerage account after the trust was funded, she had no reason to believe that her funding of the Trust would render her judgment-proof, and she testified without contradiction that the Trust was created as an estate planning tool to provide a benefit to her children.

Similarly, although David Smith had a longstanding relationship with the initial trustee, Thomas Urbelis, Urbelis is a lawyer with an MBA and fully understood his fiduciary duties to the beneficiaries of the Trust. Plaintiff was unable to prove that Urbelis was anything but an independent trustee who utilized the services of David Smith as a stock broker. Urbelis voluntarily traveled here at Plaintiff's counsel's request to provide sworn testimony at a

deposition which Plaintiff offered into evidence. In that deposition, Urbelis contradicted Plaintiff's theory and testified that he understood that he and he alone controlled the Trust's brokerage account and its investments, unlike a situation where a stock broker might have discretion to make investments and report back to the investor. He acknowledged that David Smith made recommendations of investments for the Trust, as he did for other clients, including Urbelis and other trusts in which Urbelis is the trustee. Plaintiff submitted reams of documentary proof, which included page after page of Urbelis' written authorizations for money to be transferred out of the Trust's brokerage account for investments and to pay taxes, authorizations which Urbelis corroborated in his deposition testimony. According to the Trust Declaration, David and Lynn Smith reserved no powers in the trust other than the power to appoint a successor trustee, a power which they exercised by appointing David Wojeski, the current Trustee. Wojeski is a independent, Certified Public Accountant who is known in the business community as a person of integrity and a responsible accountant. He has no loyalty to or relationship with David Smith, such that his independence can be questioned.

With respect to the degree of control of the Trust over David Smith, the analysis of this factor works similarly to that used in determining whether testimony would be admissible under Federal Rules of Evidence 801(d)(2), and focuses on whether the degree of control is sufficient to allow the invocation to function as a vicarious admission. In this case, the Trust does not control David Smith, or it would have compelled him to testify, as we attempted to do by serving him with a witness subpoena on the eve of the hearing, after learning of Plaintiff's intention to seek an adverse inference against the Trust for his refusal to testify. On the contrary, Plaintiff's witness, Brian McQuade, the person responsible for managing letters of authorization from brokerage accounts, testified on direct examination that he "very rarely received direction from

David Smith" on the Trust's brokerage account, but that he spoke with Tom Urbelis on several occasions. Because David Smith has and had no control or authority over the Trust's account, his invocation of the privilege cannot be used in the nature of a vicarious admission against the Trust's interests, particularly since it is not in the Trust's interests to leave a negative inference unchallenged, as it would result in substantial damage to the Trust's position and that of its beneficiaries.

In determining the compatibility of interests in the outcome of the litigation, the court should evaluate whether the assertion of the privilege advances the interests of both the invoking witness and the affected party in the outcome of the litigation. Clearly, the assertion of the privilege by David Smith may advance his interests, but it does not benefit, and actually harms the interests of the Trust, because it prevents the Trust from examining him concerning his role with respect to the Trust and, through his testimony, further establishing that he did not have control or authority over the Trust. The Intervenor's role in this litigation is limited to the instant motion, and he has no interest in the broader underlying matters which may have prompted the invocation of the Fifth Amendment. Based on the pre-hearing deposition of Lynn Smith and Thomas Urbelis, it was very clear that the Trust was an independent entity created for estate planning purposes with assets acquired by Lynn Smith in 1992 with the use of her inheritance. David Smith's testimony on this subject would likely have corroborated the testimony of Lynn Smith and Thomas Urbelis. Smith's refusal to testify does not advance the interests of and is not compatible with the Trust. Because the Trust has been denied the ability to examine him, an inference could equally be drawn in favor of the Trust on those issues on which the Trust has submitted substantial evidence to prove that the Trust was created as an estate planning tool and that Urbelis controlled the Trust account.

Whether David Smith was a key figure in the litigation and played a controlling role in respect to any of its underlying aspects also logically merits consideration by the trial court. Here, David Smith clearly is a key figure in this litigation, but he was not the only figure and he was not a key figure in this preliminary injunction hearing. Plaintiff submitted thousands of pages of sworn testimony that Smith gave to the Financial Industry Regulatory Authority in its investigation of him which resulted in the instant lawsuit against him. The Trust was not a factor in that investigation, and Smith's role, if any, with respect to the Trust, was likely not the motivating factor for his invocation of the Fifth Amendment in this preliminary hearing. The Plaintiff's own witness, Brian McQuade, testified that David Smith "very rarely" gave him instructions about the Trust and that he spoke with Trustee Tom Urbelis on several occasions regarding letters of authorizations for the Trust. Thus, even the SEC's own witness demonstrated that David Smith did not play a controlling role with respect to issues concerning the Trust.

POINT III

IF THE COURT DRAWS AN ADVERSE INFERENCE AGAINST THE TRUST, INTERVENOR SUBMITS THAT NO WEIGHT SHOULD BE GIVEN TO THE INFERENCE, AS INTERVENOR HAS SUFFICIENTLY REBUTTED ANY NEGATIVE IMPACT

Finally, if the Court decides to draw a negative inference against the Trust, Intervenor submits that the Court should give it little if any weight. The deposition transcript of Thomas Urbelis, the longtime Trustee of the Trust, is before the Court in evidence. Mr. Urbelis refuted the Plaintiff's claim that he was a mere figurehead who signed anything David Smith put in front of him. Mr. Urbelis understood his fiduciary duty to protect the trust and to act with the highest level of responsibility, just as he does with client funds maintained in his law firm escrow account. Mr. Urbelis, who lives beyond the subpoena power of this Court, traveled here from

Boston to provide deposition testimony in order to explain to the Court that he always knew that he, not David Smith, controlled the Trust account. The Court is urged to read the transcript of his testimony, as it, along with substantial evidence presented at the hearing, rebuts any negative inference drawn by David Smith's absence from this proceeding.

In determining whether to draw an adverse inference against a party, the Second Circuit has cautioned that "Whether 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. *LiButti*, 107 F.3d at 124; see, *Idaho v. Wright*, 497 U.S. 805, 819, 110 S. Ct. 3139, 3148 (1990); *Willingham v. County of Albany*, 593 F. Supp. 2d 226 (N.D.N.Y. 2006) (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 the invocation of the privilege).

Here, Plaintiff has not submitted to the Court any proposed factual findings that would be supported by an adverse inference against the Trust, nor has it identified any other evidence that would corroborate a proposed factual finding. In its summation, Plaintiff's counsel was asked numerous times by the Court to identify its theory on which it seeks an injunction against the stock brokerage account owned by the Trust. In oral argument and in its written briefs, Plaintiff has vacillated between alleging that the Trust should be treated as a relief defendant or quasi-relief defendant, and alleging that the Trust should be pierced and treated as the alter ego of David Smith. Plaintiff has not met its evidentiary burden on either theory, and in its memorandum of law requesting an adverse inference based on Smith's invocation, Plaintiff has not identified a single proposed finding of fact that could be supported by drawing an adverse inference against the Trust.

As has been previously briefed by the Relief Defendant and the Intervenor, Plaintiff is required to make a specific allegation and establish that specific amounts of "ill-gotten gains" have been transferred to a relief defendant in order to obtain an asset freeze over its assets, and said freeze must be limited to the amount of those "ill-gotten gains." Plaintiff has never alleged that any ill-gotten gains have been transferred into the Trust account by anyone, that David Smith has transferred so much as a dollar into the Trust, or that the Trust was funded with any asset other than stock purchased by Lynn Smith in 1992 with money from an inherited stock account. Similarly, Plaintiff has failed to demonstrate a sufficient basis for piercing the Trust, which, under New York law, requires evidence either that there was fraud in the creation of the trust or that the trust form itself was used to perpetrate a fraud on the plaintiff, and then finds that the beneficial owner and the trustee are indistinguishable. See *Babitt v. Vebeliunas (In re Vebeliunas)*, 332 F.3d 85, 90 (2d Cir. 2003), citing *National Union Fire Ins. Co. of Pittsburgh, PA v. Eagle Equip. Trust*, 221 A.D.2d 212 (1st Dep't 1995).

The main concern of the Court in determining whether to draw an adverse inference should be the reliability of the inference as it is applied to the proposed findings of fact. See *Smith*, infra. An adverse inference is not, without more, a sufficient basis to enter judgment against a party that does not bear the burden of proof. See, *Baxter*, 425 U.S. at 317. Here, while Plaintiff has not identified any specific findings of fact on which it seeks an inference, it has suggested a general adverse inference should be drawn on a broad issue by issue basis. This approach is mired in unreliability and is wholly without precedent. Unlike the cases cited by Plaintiff, the case at bar does not present the Court with a situation where the witness took the stand and, in the presence of the trier of fact and in response to a specific question, invoked his Fifth Amendment right against self-incrimination. In that type of situation, the trier of fact has

the benefit of, not just the question posed which prompted the invocation, but the context of the particular question among an entire line of questioning and presentation of exhibits to the witness.

In the case at bar, McGinn and Smith invoked their rights in sworn declarations without taking the stand at all. In a unique approach, the declarations were drafted by Plaintiff's counsel, rather than counsel to Smith and McGinn, and they were prepared without input from counsel for the Relief Defendant or the Intervenor Trust, who received the declarations for the first time when they were offered into evidence. Plaintiff's counsel had every opportunity to include specific facts in those declarations which might have been adverse to the interests of Relief Defendant or the Trust. Instead, Plaintiff affirmatively chose to proceed with a broader, issue-based invocation. As a result, the trier of fact does not have before it any specific question whose answer could be inferred to damage the interests of the parties against whom the inference is now sought, and Plaintiff has not supplied any proposed findings of fact in its briefing, as the Court directed. Thus, Plaintiff is asking this Court to predict what the questions might have been had David Smith testified on the identified issues, and apparently to presume that such testimony would not have been vigorously cross-examined, and then to infer a factual finding that has not even been proposed by the Plaintiff. Clearly, if the Court decides to draw a negative inference against the Trust, any such inference would be highly speculative and seriously lacking in probative value, particularly when weighed against the wall of evidence presented by the Trust, both through Plaintiff's witnesses and in the Trust's case in chief.

CONCLUSION

The Trust's interests should not be impaired by David Smith's refusal to testify. The Plaintiff had the benefit of thousands of pages of sworn testimony given by David Smith to

FINRA, which shares a unity of interest with the Plaintiff with respect to the transactions at issued in the underlying Complaint. Plaintiff submitted that testimony at the hearing on this motion, yet none of the testimony related to the Trust at issue here. The instant motion is one for preliminary relief which, if granted against the Trust, would tie up the Trust's assets for an indefinite period of time, without the Trust having any standing in the underlying litigation to contest the substantive allegations. The Trustee and the beneficiaries of this Trust should not be deprived of their property for an indeterminate period of time while the complexities of a large securities case wind their way through the trial and appellate courts.

For the foregoing reasons, the Intervenor respectfully submits that the Plaintiff's request for an adverse inference against the Trust be denied and that the motion for a preliminary injunction against the Trust's account be denied.

Dated: June 18, 2010

s/Jill A. Dunn

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