UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

No. 10-CV-457 (GLS/DRH)

TIMOTHY M. McGINN; DAVID L. SMITH; LYNN A. SMITH; and NANCY McGINN,

Defendants.

APPEARANCES:	**OF COUNSEL:**
DAVID STOELTING, ESQ. Attorney for Plaintiff Room 400 3 World Financial Center New York, New York 10281	ANDREW CALAMARI, ESQ. MICHAEL PALEY, ESQ. KEVIN McGRATH, ESQ. LARA MEHREBAN, ESQ, LINDA ARNOLD, ESQ. JACK KAUFMAN, ESQ.
GUSRAE, KAPLAN, BRUNO & NUSBAUM PLLC Attorney for Defendants Timothy M. McGinn and David L. Smith 120 Wall Street New York, New York 10005	MARTIN P. RUSSO, ESQ. MARTIN H. KAPLAN, ESQ. ALISON B. COHEN, ESQ.

DAVID R. HOMER
U.S. MAGISTRATE JUDGE

MEMORANDUM-DECISION AND ORDER

Presently pending is the motion of plaintiff Securities and Exchange Commission ("SEC") for an order finding defendants Timothy M. McGinn ("McGinn") and David L. Smith ("Smith") in contempt of the preliminary injunction order enjoining them from violating § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a); § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b); Rule 10b-5 under the 1934 act, 17 C.F.R. § 240.10b-5; and

related provisions. Dkt. Nos. 168, 173. McGinn and Smith oppose the motion. Dkt. No. 185. For the reasons which follow, the SEC's motion is granted in part and denied in part.

I. Background

Until this action was commenced on April 20, 2010, McGinn and Smith operated a business in Albany, New York offering financial services to clients, including investment advice and stock brokerage services as well as investments in securities which they sold. Am. Compl. (Dkt. No. 100) at ¶ 22-24. The SEC alleges that McGinn, Smith, and others violated the anti-fraud provisions of §§ 17(a), 10(b), and Rule 10b-5 in its offering of various securities to investors. Id. at ¶¶ 10-16. On April 20, 2010, the SEC obtained a temporary restraining order enjoining McGinn and Smith from continued violations and moved for a preliminary injunction seeking the same relief. Dkt. Nos. 4, 5. On that motion, McGinn and Smith each asserted his Fifth Amendment privilege against self-incrimination in response to the SEC's demands for testimony and each consented to the entry of a preliminary injunction. Dkt. No. 86 at 20-31. The preliminary injunction order was filed on July 22, 2010. Dkt. No. 96. That order directed in pertinent part that McGinn and Smith were restrained and enjoined form violating, directly or indirectly, the provisions of §§ 17(a), 10(b), and Rule 10b-5. Id. at 3-4.

It appears that following the entry of the preliminary injunction, a corporation was formed named Security Alarm Credit, LLC ("SAC") located at the residence of Carolyn Gracey ("Gracey") in Rensselaer, New York. Dkt. No. 168-6 at 5. Gracey was listed as the sole owner, Chairman, and Chief Executive Officer. Id. McGinn and Smith were each listed as an executive Vice President. Id. However, Gracey has advised that McGinn was

responsible for everything, Smith resigned his position with the company, and Gracey's only function was to type documents. Stoelting Decl. (Dkt. No. 168-7) at ¶¶ 12, 13.

SAC advertised its functions as "providing financial advice and capital solutions to businesses engaged in various elements of the Security Alarm industry." Dkt. No. 168-6 at 5. In private Placement Memoranda ("PPMs") dated September 22 and November 1, 2010, SAC offered notes to potential investors which would pay interest at an annual rate of 11% on the principal amount of the investment. Id. at 2, 6. SAC expected to raise approximately $545,000 through the notes, would loan approximately $425,000 to Anchor Alarm Center, Inc. ("Anchor") at an interest rate of 19.62%, and the remainder would be disbursed for "corporate purposes." Dkt. No. 168-14 at 6-7. McGinn circulated the PPMs to potential investors in an effort to solicit funds. Zindell Decl. (Dkt. No. 168-2) at ¶¶ 6-11. On October 12, 2010, Gracey also executed loan documents on behalf of SAC with Anchor. Dkt. Nos. 168-19-21. The next day, McGinn advised Anchor that it could expect the funds from the loan within the week. Dkt. No. 168-18 at 2. To date, it appears that SAC has not received funds from any investor or disbursed any funds to Anchor.[1] This motion followed.

II. Discussion

A. Legal Standard

A court retains the inherent power to enforce compliance with its lawful orders through civil contempt. Shillitani v. United States, 384 U.S. 364, 370 (1966). Moreover, § 20(b) of the Securities Act of 1933 and § 21(d) of the Securities Exchange Act of 1934

[1]According to one potential investor, McGinn presented the Anchor offering as the first of eight planned offerings. Dkt. no. 168-4 at 2-7.

create "broad equitable powers to grant ancillary relief . . . where necessary and proper to effectuate the purposes of the securities laws." S.E.C. v. Am. Bd. of Trade, Inc., 830 F.2d 431, 438 (2d Cir. 1987); 15 U.S.C. § 77t(b); 15 U.S.C. § 78u(d)(5) ("In any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors.").

Civil contempt is "wholly remedial," and serves to coerce compliance with a court order. McComb v. Jacksonville Paper Co., 336 U.S. 187, 191 (1949). A sanction is considered "civil" if it compels compliance with a court order or compensates for losses sustained. International U.M.W. of Am. v. Bagwell, 512 U.S. 821, 827 (1994). Thus, a party may be found in civil contempt if the moving party shows by clear and convincing evidence that the order in question is clear, the proof of noncompliance is clear and convincing, and the defendant has not been reasonably diligent in complying with the order. See E.E.O.C. v. Local 638, 753 F.2d 1172, 1178 (2d Cir. 1985) (citation and internal quotation marks omitted); United States v. Schulz, No. 1:07-cv-0352, 2008 WL 2626567, at *1 (N.D.N.Y. Apr. 28, 2008). To meet this initial burden, the moving party need only present a prima facie case. United States v. Rylander, 460 U.S. 752, 755 (1983). A showing of willfulness is not required. See S.E.C. v. Universal Express, Inc., 546 F. Supp. 2d 132, 134 (S.D.N.Y. 2008) (quoting E.E.O.C. v. Local 638, 753 F.2d at 1178). Once this initial burden is satisfied, the burden then shifts to the responding party to demonstrate why he is unable to comply with the court's order. Rylander, 460 U.S. at 755.

If the moving party establishes a contempt, a court has "broad discretion to fashion an appropriate coercive remedy . . . based on the nature of the harm and the probable

effect of alternative sanctions." E.E.O.C. v. Local 28, 247 F. 3d 333, 336 (2d Cir. 2001) (quoting N.A. Sales Co. v. Chapman Indus. Corp., 736 F.2d 854, 857 (2d Cir. 1984)). In determining the appropriate remedy, a court should consider "(1) the character and magnitude of the harm threatened by the continued contumacy; (2) the probable effectiveness of any suggested sanction in bringing about compliance; and (3) the contemnor's financial resources and the consequent seriousness of the burden of the sanction." S.E.C. v. Bremont, No. 96 Civ. 8771 LAK, 2003 WL 21398932, at *7 (S.D.N.Y 2003) (quoting Dole Fresh Fruit Co. v. United Banana Co., 821 F.2d 106, 110 (2d Cir. 1987)). Remedies may range up to incarceration. See, e.g., Local 28, 247 F.3d at 336; S.E.C. v. Margolin, 1996 WL 447996, at *5.

B. The SEC's Prima Facie Evidence

The SEC contends that McGinn and Smith violated the preliminary injunction in the SAC offering by misrepresenting and omitting material facts regarding Anchor's financial condition, how the proceeds of the offering would be used, and the status of the instant action.

1. Smith

A threshold issue is presented whether, assuming the truth of the SEC's assertions regarding the SAC offering, the SEC has met its initial burden of proof as to Smith. The SEC alleges Smith's involvement in the SAC offering based on two facts. First, the September PPM lists Smith as an Executive Vice President of SAC. Dkt. No. 168-6 at 5.

Second, McGinn stated in two communications that he and Smith jointly had developed the offering and were both marketing it. Zindell Decl. at ¶ 11; Dkt. No. 168-4 at 2. This evidence fails to establish the SEC's prima facie case against Smith for two reasons.

First, the evidence of Smith's involvement derives solely from others. No evidence has been offered that Smith himself made any statements or took any action in furtherance of the SAC offering. While evidence of the PPM and McGinn's representations are considered here, they fail by themselves to constitute clear and convincing evidence that Smith has joined in the SAC offering. Second, according to Gracey, Smith resigned his position with SAC on October 22, 2010. Stoelting Decl. at ¶ 13; Dkt. No. 168-4. As noted, the purpose of this and all civil contempt proceedings is coercive. Even if Smith participated in the SAC offering at an early stage, his involvement has ended, there has been presented no evidence of Smith's ongoing involvement, and, therefore, there exists no basis for coercing Smith to comply with the preliminary injunction order.

Accordingly, the SEC's motion as to Smith is denied.

2. McGinn

a. The SEC's Initial Burden

First, the preliminary injunction order is clear and unambiguous. It was entered with the consent of McGinn and prohibits him from violating §§ 17(a), 10(b), and Rule 10b-5. Dkt. No. 96 at 3-4. Second, the SEC has proffered clear and convincing evidence that McGinn is acting in violation of those provisions in the SAC offering. As an initial matter, the SAC notes constitute securities within the scope of the applicable statutes. See Reves v.

Ernst & Young, 494 U.S. 56, 64-67 (1990). The investors would primarily be motivated to purchase notes by the 11% return on their investment. The plan to market the notes declared a relatively low minimum investment of $10,000, which makes them available to a broad section of the investing public. Moreover, McGinn has stated that he is actively marketing the notes. See Dkt. No. 168-13 at (McGinn states on October 13, 2010 that he has been "pitching" the SAC offering). Furthermore, the PPMs refer to those who would purchase the notes as "investors," reasonably suggesting to the investing public that the notes being offered are securities. Finally, nothing other than the securities laws in question here exist to regulate the risk to the investing public. Thus, the notes offered by McGinn in the SAC offering satisfy the requirements of Reves to constitute securities.

Second, the SEC has demonstrated by clear and convincing evidence that the SAC offering violates §§ 17(a), 10(b), and Rule 10b-5, which generally prohibit fraud in the sale of securities. McGinn previously stipulated that the securities offerings described in the SEC's prior motion for the preliminary injunction violated those provisions and the SAC offering is remarkably similar to those prior offerings. See, e.g., Dkt. Nos. 4-2; Stoelting Decl. at ¶¶ 2-18. The PPMs contain material misrepresentations and omissions as to Anchor's present financial condition,[2] how funds raised by the SAC offering will be used,[3]

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[2]For example, Anchor has incurred late charges almost monthly for the past year on its principal outstanding loan. Dkt. No. 168-8. Anchor also made no payments on principle on that loan for seven of the last twelve months. Dkt. No. 168-9. The PPMs also fail to disclose Anchor's current actual revenues, its non-debt related expenses, or the value of the assets promised as collateral for the Anchor loan once its existing primary loan is satisfied.

[3]For example, approximately 25% of the proceeds will be used to pay two personal loans of Anchor's President. Dkt. No. 168-15.

the present action against McGinn,[4] and McGinn's true role in SAC. Thus, it appears that the SAC offering would bring over $100,000 to McGinn at the outset for "corporate purposes" and leave the investors to the faint hope that Anchor will repay this loan where it has been unable to repay previous loans. This evidence suffices to meet the SEC's initial burden of demonstrating the fraud prohibited by §§ 17(a), 10(b), and Rule 10b-5.

Finally, the evidence offered by the SEC shows by clear and convincing evidence that McGinn has not been reasonably diligent and energetic in attempting to comply with the preliminary injunction order. The evidence demonstrates in fact that McGinn has recklessly and willfully initiated and participated in violations of the anti-fraud provisions of the securities laws. Accordingly, the SEC has met its initial burden on this motion.

b. McGinn's Defenses

i. Conduct Not Prohibited

McGinn opposes this motion on numerous grounds. First, he contends that the conduct alleged in the SAC offering is not prohibited by §§ 17(a), 10(b), Rule 10b-5, or any other provision of law. McGinn argues that the SEC has failed to demonstrate that his conduct was "in connection with the purchase or sale of any security"[5] as required by these

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[4]For example, as described below, the PPMs provide a link to the website of the Receiver appointed in this case which, with several more connections, would lead an investor to the docket of this case from which the investor could obtain access to the filings. While asserting that they are vigorously defending this action, however, the PPMs fail to disclose that McGinn consented to a finding that SEC will likely demonstrate that he committed fraud in prior offerings or that his assets have been frozen pending the outcome of this action.

[5]No meaningful distinction exists between the "in the offer or sale" language in § 17(a) and the "in connection with the purchase or sale" language of Rule 10b-5. See, e.g.,

provisions because the SEC has failed to show that the SAC offering resulted in any completed sale. Thus, McGinn contends that in the absence of proof of a completed sale of a SAC note, the SEC has failed to prove a violation of the preliminary injunction order.

First, this interpretation runs contrary to the purpose of these provisions and to cases decided under them. To require proof that an investor has actually completed payment for a fraudulent security before corrective action can be taken would defeat the plain purpose of these provisions to protect the investing public. These provisions protect against fraudulent schemes, not merely completed transactions, and the SEC here satisfies its burden on this element by demonstrating that McGinn engaged in such a scheme in connection with the SAC offering. Proof of a completed sale is not required. See S.E.C. v. Wolfson, 539 F.3d 1249, (10th Cir. 2008) (holding that misrepresentations and omissions satisfied the "in connection with" requirement because the documents were designed to reach investors, and were material to investors' decisions to invest).[6]

The SEC has offered proof, uncontradicted by McGinn, that PPMs were prepared, they were presented to at least one potential investor, McGinn was actively seeking other investors, and SAC executed contracts with Anchor which obliged SAC to provide the funding for which it was offering the notes. With the misrepresentations and omissions in the PPMs, this sufficed to demonstrate by clear and convincing evidence that McGinn is

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S.E.C. v. Tambone, 417 F. Supp. 2d 127, 131 (D. Mass. 2006); S.E.C. v. Solucorp Indus., 274 F. Supp. 2d 379, 418-19 (S.D.N.Y. 2003).

[6] Moreover, as noted supra, a court may also enjoin an offering under §§ 20(b) and 21(d), which give "broad equitable powers to grant ancillary relief where necessary and proper to effectuate the purposes of the securities laws." American Bd. of Trade, 830 F.2d at 438.

involved in a scheme prohibited by §§ 17(a), 10(b), and Rule 10b-5 even in the absence of proof of a completed sale or purchase. Accordingly, McGinn's contention in this regard is rejected.

ii. Defects in Pleadings

McGinn next contends that the SEC's motion fails to meet the pleading requirements of Fed. R. Civ. P. 9 and fails to give adequate notice of the basis for the motion. Rule 9(b) provides that "[i]n alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally." However, Rule 9 governs pleadings, which are defined to include complaints and answers and are distinct from motions. Fed. R. Civ. P. 7(a); Kassner v. 2nd Ave. Delicatessen, Inc., 496 F.3d 229, 242 (2d Cir. 2007); Gaymon v. Tarscio, No. 3:10-CV-653 (JCH), 2010 WL 4340689, at *2 (D. Conn. Oct. 26, 2010). Rule 9 is, therefore, inapplicable. Moreover, the SEC's motion asserts in substantial detail the documents, alleged misrepresentations and omissions, dates, and participants to the events underlying the motion such that McGinn has been given sufficient notice of the conduct alleged to constitute the contempt. Finally, proceeding by motion in seeking an order of civil contempt rather than commencing a separate proceeding constitutes the general practice in federal courts. See, e.g., Farish v. State Banking Bd. of State of Okla., 235 U.S. 498, 504 (1915) (motion for contempt); Bowens v. Atlantic Maint. Corp., 546 F. Supp. 2d 55, 71-72 (E.D.N.Y. 2008) (same); United States v. Dist. Council of N.Y. City, No. , 2002 WL 3187346, at *3 (S.D.N.Y. Dec. 24, 2002) (same); Church v. Steller, 35 F. Supp. 2d 215, 217 (N.D.N.Y. 1999) (same). Accordingly, McGinn's contention here is also rejected.

iii. Discovery and an Evidentiary Hearing

McGinn next contends that a decision on the SEC's motion must await the completion of discovery and an evidentiary hearing. McGinn states that he wishes to conduct numerous depositions, including several out-of-state. However, McGinn has offered no evidence which would place in issue any fact offered by the SEC and offers no reason beyond mere speculation why proceedings on this motion should be substantially delayed to allow such extensive discovery. Furthermore, an evidentiary hearing would be required if there exists a dispute as to any material fact. See Charette v. Town of Oyster Bay, 159 F.3d 749, 755 (2d Cir. 1998). Here, McGinn contests the sufficiency of the facts proffered by the SEC but not the facts themselves. Accordingly, no basis exists to permit discovery on this motion or to hold an evidentiary hearing. McGinn's argument to the contrary is rejected.

iv. Materiality of Misrepresentations and Omissions

Finally, McGinn contends that the misrepresentations and omissions asserted by the SEC in support of this motion were not material. A misrepresentation or omission is material if there exists a substantial likelihood that "a reasonable investor might have considered [the misrepresented or omitted fact] important in the making of this decision." Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153-54 (1972); see also Operating Local 649 Annuity Trust Fund v. Smith, 595 F.3d 86, 92 (2d Cir. 2010). The SEC has satisfied this requirement as to multiple misrepresentations and omissions although any single one would suffice on this motion.

First, the success of the SAC offering rests on the ability of Anchor to repay the loans as scheduled. The SAC offering fails to disclose Anchor's history of late payments in the last two years, its interest-only payments from September 2009 to May 2010, and the fact that Anchor posted net operating losses in 2008 and 2009. Compare Dkt. No. 168-6 at 5 (PPM stating that Anchor has "grown revenues by 6% per year over the last three years) with Dkt. No. 168-8-10. Given the singular importance of Anchor's successful repayment of the SAC loan, there exists a substantial likelihood that Anchor's recent history in repaying loans might be deemed important to a potential investor in the SAC offering. Moreover, over 25% of the loan proceeds to Anchor will be utilized to repay personal obligations of Anchor's President. It may be true, as McGinn contends, that these loans to the President were used for the benefit of Anchor. Nevertheless, a reasonable investor would likely wish to know this fact.

Finally, McGinn contends that he fulfilled his obligation of disclosure regarding this action by acknowledging its pendency, denying the allegations, and providing a link to the website of the receiver appointed to manage defendants' assets. However, McGinn fails to disclose in the PPMs that he consented to a preliminary injunction by conceding a substantial likelihood that the SEC would ultimately succeed in proving its allegations against him and that his assets have been frozen pending the outcome of this action. Further, for an investor to learn more about this action, he or she would need to access the receiver's website, connect to the link to the docket of this case, and find the relevant documents from among the more than 200 docket entries to date. Providing a tortuous route to relevant information does not equate to the adequate disclosure a reasonable investor is entitled to expect.

Accordingly, McGinn's argument as to materiality also fails.

C. Remedies

Thus, the SEC has met its burden of demonstrating by clear and convincing evidence that McGinn has acted in violation of the preliminary injunction order and is continuing to do so. As McGinn has acted in contempt of the preliminary injunction order, sanctions appropriate to the conduct must be determined. As noted supra, the purposes of such sanctions for civil contempt are to coerce compliance with the preliminary injunction order and to address any harm caused by the contemptuous conduct.

The conduct at issue here is McGinn's involvement in the SAC offering which includes misrepresentations and omissions of material facts. McGinn has stipulated that the SEC will be able to prove similar conduct in the offerings giving rise to the preliminary injunction order. The preliminary injunction failed to deter McGinn from continuing that conduct and, therefore, Court approval for McGinn to participate in any future offerings will be required. As to any harm, the principal consequence of McGinn's conduct would be loss of money paid to SAC by any investor or received by McGinn. While it appears from the record that no investors have paid any money to SAC, it remains possible that this occurred. Accordingly, McGinn will also be directed to return any such money to SAC which he received and any assets of SAC shall be frozen pending the outcome of this action.

III. Conclusion

For the reasons stated above, it is hereby

ORDERED that as to the motion of the SEC for an order of contempt (Dkt. No. 168), the motion is:

1. **GRANTED** as to McGinn and:

    A. McGinn is found in contempt of the preliminary injunction order;

    B. McGinn is enjoined from proceeding with the SAC offering;

    C. McGinn is enjoined from having any involvement in the offering or sale of any securities without the prior approval of the Court;

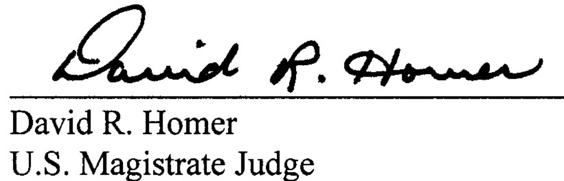
    D. The assets of SAC are hereby frozen; and

    E. McGinn shall return all distributions, payments, or transfers made out of accounts held by SAC; and

2. **DENIED** as to Smith in all respects.

IT IS SO ORDERED.

DATED: December 1, 2010
Albany, New York



David R. Homer
U.S. Magistrate Judge