UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,	:	
Plaintiff,	:	
v.	:	**10 Civ. 457 (GLS/DRH)**
McGINN, SMITH & CO., INC., et. al.,	:	
Defendants.	:	

MEMORANDUM OF LAW IN SUPPORT OF PLAINTIFF'S APPLICATION FOR AN ORDER TO SHOW CAUSE AND EMERGENCY RELIEF

SECURITIES AND EXCHANGE COMMISSION
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August 3, 2010

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Plaintiff respectfully submits this memorandum of law in support of its application for an order to show cause and for emergency relief.

PRELIMINARY STATEMENT

On July 27, 2010, the SEC received a previously undisclosed "Private Annuity Agreement," a binding contract requiring the David L. and Lynn A. Smith Irrevocable Trust to pay $489,932 per year to the Smiths beginning in 2015.[1] The Annuity Agreement proves that the Smiths retained a beneficial interest in the Trust, contrary to the evidence presented by Lynn Smith and the Trust at the preliminary injunction hearing.

In view of the Annuity Agreement, the factual findings in the July 7 order pertaining to the Trust are no longer supported by the evidence. Indeed, the Annuity Agreement shows that much of the evidence presented by Lynn Smith and the Trust is false or materially misleading. For example, Lynn Smith represented that after the "transfer," the Charter One stock existed "solely, exclusively and permanently for the benefit of our children." Decl. ¶ 21 (Docket Entry ("DE") 34 ¶ 6). The Annuity Agreement, however, provides that Lynn and David Smith ***sold*** the Charter One stock to the Trust, and in return received the right to receive from the Trust annual payments of $489,932 per year beginning in September 2015. Decl. Ex. 1. As a result, the Smiths have had a direct pecuniary interest in the Trust. The Trustee, for his part, was under a

[1] The SEC received the Annuity Agreement five days after the telephonic conference with the Court on Thursday, July 22, 2010, described in the Order dated July 23, 2010 (DE 95). As set forth in the Declaration of David Stoelting dated August 3, 2010 ("Decl."), at ¶¶ 35-40, the circumstances leading to the production of the Annuity Agreement arose from that telephonic conference.

duty to preserve the Trust's assets in view of the future annuity payments owing to the Smiths.

The Court vacated the asset freeze as to the Trust in the July 7 order, before the critically important Annuity Agreement was finally produced. Since the July 7 order, significant withdrawals have been made from the Trust account, including four transfers totaling $475,574.40 between July 14 and 16. Decl. ¶ 54, Ex. 17. Another $2 million is believed to have been transferred to another financial institution. Decl. ¶ 55. As a result, this order to show cause seeks emergency relief to freeze the Trust account to prevent further withdrawals, as well as other relief.[2]

For any of the following reasons, the Court should freeze the Trust's assets:

First, the Annuity Agreement demonstrates that the Smiths are beneficial owners of the Trust's assets. The Smiths never intended to relinquish their ownership of the assets transferred to the Trust. Rather, they intended to conceal their actual ownership by transferring the stock to the Trust while retaining a right to full repayment from the Trust corpus later. The Annuity Agreement allowed the Smiths to hide the bulk of their liquid assets behind an illusory irrevocable trust by appearing to make a generous gift to their children. In fact, however, the Trust has a hidden contractual obligation to pay all its funds to the Smiths. The fact that the nominal beneficiaries, the Smiths' children, never received a distribution from the Trust shows that the real beneficiaries of the assets of the

[2] The July 7 order also declined to impose an asset freeze over Nancy McGinn's residence, notwithstanding the evidence that the residence had been fraudulently conveyed to her by Timothy McGinn, because Nancy McGinn was not a party to the complaint. DE 86 at 41-42. For that reason, and also due to evidence of receipt of ill-gotten gains, Nancy McGinn is a party to the Amended Complaint. *See infra* at 20.

Trust are David and Lynn. As David Smith never relinquished ownership, the freeze should cover the Trust's assets.

Second, the Smiths' transfer of their bank stock was a fraudulent conveyance. The transfer to the Trust occurred when David and Lynn Smith had numerous reasons to fear creditors. S*ee infra* at 7 – 9 (evidence showing intent to hinder, delay or defraud creditors). As is the case with the Smiths 2009 fraudulent transfers, the property conveyed should remain subject to the asset freeze. There are sufficient "badges of fraud" to support the conclusion that David Smith made the transfer with intent to hinder, delay or defraud creditors.

Third, the Trust should be frozen under piercing/alter ego theory because the Annuity Agreement allowed David Smith to control the Trust and Smith used that control for a fraudulent purpose.

Fourth, the Annuity Agreement is an asset of David Smith's and therefore subject to the existing freeze over all of his assets, which prohibits any "encumbrance" or "dissipation" of Smith's assets. DE 96 at 5 (Preliminary Injunction Order). Any payments from the Trust account will necessarily encumber the Annuity Agreement; as a result, the Trust account should be frozen to prevent future encumbrances.

STATEMENT OF FACTS

The Annuity Agreement

The Annuity Agreement provides, in relevant part, that:

> The Transferors [previously defined as David and Lynn Smith] are the owners of 100,000 shares of stock (the "Property") of Charter One Financial, Inc. and the Transferors desire to sell the property to the Transferee to be relieved of the burden and risk associated with owning and managing the Property in order to receive investment income and a portion of the principal on a regular basis.

Decl. Ex. 1 at 1.

The Annuity Agreement further provides that in return for the Smiths selling to the Trust all right, title and interest in the Charter One stock, the Trust "agrees to pay or cause to be paid to the Transferors the sum of $489,932 per year, commencing on September 26, 2015 and shall continue on the 26th day of each September thereafter for and during the full term of the natural life of the last to die of the Transferors." The Agreement further imposes "a late penalty of four percent" if payment is not made within ten days. Decl. Ex. 1 ¶¶ 1, 2.

A separate one-page document entitled "Private Annuity" references David and Lynn Smith's ages as 58 and 59 at the time they sold the stock to the Trust, and sets forth a joint life expectancy of 31 years from August 2004. Decl. Ex. 2. The Smiths therefore have a joint life expectancy of 20 years from the date the payment obligations are scheduled to begin in 2015. The annual payment of $489,932, if paid out over the twenty-year joint life expectancy, will therefore entitle David and/or Lynn Smith to receive payments of approximately $9,798,640 from the Trust.

The SEC's Efforts to Discover the Annuity Agreement

During weeks of discovery related to the Trust and three hearing days, neither Lynn Smith nor the former Trustee, who knew of the Annuity Agreement, nor any other witness, including the current Trustee, produced the Agreement or even referred to it.

Lynn Smith. Lynn Smith's "Statement of Net Assets" failed to identify her annuity interest in the Trust. Decl. ¶ 5. Lynn Smith also did not produce the Annuity Agreement in response to the Commission's document request, or disclose it in response to questions at her deposition and at the hearing. Decl. ¶¶ 12-14.

Lynn Smith provided two Affidavits regarding the Trust. Her Affidavit in opposition to the order to show cause dated May 21, 2010, stated that the purpose of the Trust was "to provide security for my children's future." Decl. ¶ 20. In her other Affidavit of the same date in support of the Trustee's motion to intervene, she stated that the Trust's purpose was "to fund a trust for my children, from which they could benefit during my lifetime" and that "I provided the initial and, to date, only asset transferred to the trust. On September 1, 2004, I transferred 100,000 shares of Charter One stock, then valued at $44.50 per share, to the trust." Decl. ¶ 21. This Affidavit further stated that "[f]rom the time the trust was created in August 2004, my husband and I have had no interest in or expectation of an interest in the David L. and Lynn A. Smith Irrevocable Trust. It exists solely, exclusively and permanently for the benefit of our children." Decl. ¶¶ 45-48 (DE 34 ¶ 6).

Ms. Smith made numerous misrepresentations during her deposition with an apparent intention to conceal the Annuity Agreement. For example, Ms. Smith testified that the purpose of the Trust was to enable her children "to have the rewards, reap the rewards of my husband's business." Decl. ¶ 23 (DE 46, Ex. 2 at 39-40). During the hearing, Ms. Smith was asked "what was your understanding as to what your interest in that stock would be after that date of transfer?" Her response failed to acknowledge the interest created by the Annuity Agreement; instead, Ms. Smith just said"[i]t belonged to Jeffrey and Lauren." Decl. ¶ 28. These responses fail to disclose that a critical purpose of the Trust was to provide an income stream to the Smiths, and that the Annuity Agreement does create a present and future interest of the Smiths in the Trust's assets.

Thomas Urbelis. Mr. Urbelis, the Trustee for nearly six years from the creation of the Trust until two days after this action began, concealed the Annuity Agreement. Urbelis received a subpoena asking for, among other things, all documents concerning the Trust, but he failed to produce the Annuity Agreement. Decl. ¶ 15, Ex. 5. Urbelis also failed to disclose the Annuity Agreement during his deposition, despite being asked numerous questions regarding the Trust's nature and purpose. For example, he testified as to his duties as Trustee: "my first duty as I saw it was if they [Goeff or Lauren] needed money or some kind of assistance was to provide it. . . . I wanted the money to be fairly secure for, if and when the kids needed it." Decl. ¶¶ 25-26 (DE 46, Ex. 11 at 11-12). Mr. Urbelis failed to disclose that he also had duties and responsibilities with regard to the Annuity Agreement.

Geoffrey Smith. Smith testified that the Trust was an irrevocable Trust, and never disclosed the Annuity Agreement or the Trustee's future payment obligations to his parents. Decl. ¶ 30.

David Wojeski. The new Trustee did not make any reference to the Annuity Agreement or the obligations it imposes on the Trust and the Trustee. Decl. ¶¶ 31-32.

Counsel. In her closing, Jill Dunn, counsel for the Trust, represented categorically that when Lynn Smith transferred the Charter One stock into the Trust account "all title, ownership, control, beneficial, equitable, actual, or legal any interest whatsoever in that stock was gone from [Lynn Smith's] hands the moment she transferred it." Decl. ¶ 34.

The Charter One Bank Stock Was Sold and Loaned Out to Advance the Smiths' Interests and Was Not Held as a Separate and Unchanging Asset[3]

The Charter One bank stock which funded the Trust account was not held by the Smiths as an unchanging and segregable asset. Instead, the Smiths used the Charter One stock like the rest of the Stock Account. In particular, the Charter One stock was used to help fund a $6 million loan in 2003 to facilitate the public offering of Integrated Alarm Services Group. ("IASG") Decl. ¶¶ 41-50. On October 14, 2002, all 105,000 shares were wired out of the Stock Account to an account for KC Acquisition Corp., an entity controlled by McGinn and Smith. Decl. ¶¶ 45-46. These 105,000 shares were not returned to the Stock Account until July 29, 2003. Decl. ¶¶ 48-49.

The Smiths also sold a significant amount of the Charter One stock from 2001 through 2004, receiving gross proceeds of more than $1 million. Decl. ¶ 44.

Evidence of Fraudulent Conveyance of the Charter One Stock

There is extensive evidence of Smiths' intent to hinder, defraud or delay creditors as of September 2004.

1. The FIIN offering dated September 15, 2003 and the FEIN offering dated January 16, 2004 each raised $20 million from investors, for a total of $40 million. The private placement memoranda for both offerings did not permit investments in affiliates but Smith from the beginning invested with affiliates. As of December 31, 2003, 11% of the investments were with affiliates, and this grew to 32% by December 31, 2004. PI Hearing Ex. 70 ¶ 26; PI Hearing Tr. at 61-62. Smith therefore knew that he was

[3] This evidence was available during the PI hearing. However, counsel for the Trust and Lynn Smith did not specifically argue that the Charter One stock had been unchanged or untouched prior to its transfer to the Trust Account. As a result, the SEC did not develop the evidence regarding how the Smiths in fact used the Charter One stock prior to transfer.

conducting a fraudulent scheme because he was using the offering proceeds in violation of the terms of the private placement memorandum.

2. At the time of the transfer to the Smith Trust, the liabilities of FIIN and FEIN far exceeded their assets. PI Hearing Tr. at 62; PI Hearing Exs. 31; 70 ¶ 23. Smith knew or should have known that his ongoing fraud was causing the funds to be losing money and that as a result Smith and his companies would be unable to meet the payment obligations to investors.

3. David Smith, Lynn Smith, McGinn, MS & Co. and other entities controlled by Smith and McGinn had been named as defendants in a securities fraud suit filed in the United States District Court for the Southern District of New York arising from the June 2003 initial public offering of IASG, *Meyers v. Integrated Alarm Services Group, Inc., et al.* 03 CV 9748 (S.D.N.Y. 2003). Decl. Ex. 6. One focus of the factual allegations in this complaint was two $3 million loans by L. Smith to certain entities to facilitate a public offering of a company affiliated with Smith and McGinn. Decl. Ex. 6 ¶¶ 126-129. The Stock Account, specifically, the Charter One stock, was in connection with these loans. Decl. ¶ 50. The complaint asserted 23 causes of action and sought $3 million in damages for each claim. The case was settled in 2004 by the payment of $200,000 to the plaintiff. Decl. ¶ 43.

4. Smith had a keen personal awareness that his fraudulent investment schemes could lead to financial ruin. In an undated, handwritten "personal confession" to McGinn, that appears to have been written in 2000, Smith wrote that "if the trusts go into default, everything else will come apart. Decl. ¶ 51. The business has become addicted to the cash flow from the trust business, and without that we will have a difficult time

surviving. . . . The default of the trusts will drastically reduce revenues, cause us to lose brokers and at least their confidence in us, bring on crushing litigation and devastating publicity and I am convinced persecution by regulators or worse. . . . I am overwhelmed by the thought of the financial losses, the humiliation, the perceived betrayal of trust. . . . I, unlike you, feel that we are vulnerable to criminal prosecution. . . . [W]e are now in possession of indisputable empirical evidence that the new investments have no chance of ever being repaid in full. . . . For us not to allow for these deficits by setting up adequate reserves is, in my judgment, bordering on fraud[.]" Decl. ¶ 51.

Smith further wrote that "we are misleading both our own employees and customers. . . . This is wrong. I strongly believe that in civil or criminal litigation we would lose badly on this point. . . . [B]oth you and I are violating the high standards of integrity and ethics that have been the historical standard for us. That bothers me very very much. But what terrifies me is the possibility of being indicted for such conduct, and worse, the prospect of conviction. I cannot emphasize enough how strongly I feel about this point." Decl. ¶ 51.

The course of conduct described by Smith in this letter to McGinn is identical to the fraudulent scheme they continued to employ in 2004 and later years, as alleged in the Amended Complaint.

5. In 2003 and early 2004, the Broker-Dealer Inspection Program ("BDIP") of the SEC conducted an examination of MS & Co. In a letter to Smith from the BDIP dated February 26, 2004, Smith was advised of several "deficiencies and/or violations of law." Decl. Ex. 15.

6. The Smiths' intent to shield their assets from creditors was heightened with the sharp increase in value of the Charter One stock after May 4, 2004, when the impending buy-out of Charter One was announced. Smith and L. Smith knew that their stock holdings would become cash as of the closing of the merger, which would result in approximately $4.5 million in cash in the Stock Account, a significant appreciation in the value of the stock just six months previous. On the day of the buy-out, Lynn Smith transferred the stock into the Trust and, after the stock was in the Trust account, the 100,000 shares of stock was converted into approximately $4.5 million in cash. The creation of the Smith Trust and the transfer of the stock through the "Private Annuity Agreement" therefore was designed to shelter this large sum of cash from the Smiths present and future creditors.

7. The Smiths' intent to hinder, delay or deceive creditors is seen by the concealment of the Annuity Agreement during the course of this litigation. The Smiths went to great lengths in an effort to prevent the disclosure of the Annuity Agreement, in order to hide their interests in the Trust.

8. David Smith invoked his Fifth Amendment right against self-incrimination as to all questions concerning the Trust and his assets (Hrg. Ex. 128), and the July 7 order found that "adverse inferences from the invocation of the Fifth Amendment privilege by David Smith . . . will be drawn[.]" DE 86 at 27.

ARGUMENT

I. THE ASSET FREEZE SHOULD COVER THE TRUST

A. The July 7 Order Vacating the Asset Freeze as To the Trust Should Be Reconsidered Based On Newly Discovered Evidence, or the Fraudulent Conveyance Evidence, Under Federal Rule of Civil Procedure 54(b)

Federal Rule of Civil Procedure 54(b) provides that "any order or other decision, however designated . . . may be revised at any time before the entry of a judgment adjudicating all the claims and all the parties' rights and liabilities." Fed. R. Civ. P. 54(b). The Second Circuit has found that Rule 54(b) allows a district court to change a decision when "'new evidence'" has been discovered or when there is a "'need to prevent a clear error or prevent a manifest injustice.'" *Official Committee of Unsecured Creditors of Color Title, Inc. v. Coopers & Lybrand LLP*, 322 F.2d 147 (2d Cir. 2003) (quoting *Virgin Atl. Airways, Ltd. v. Nat'l Mediation Bd.*, 956 F.2d 1245, 1255 (2d Cir.1992)); *see also System Mgt. Arts Inc. v. Avesta Tech., Inc.*, 160 F.Supp.2d 580 (583 (S.D.N.Y. 2001) ("A Rule 54(b) motion is not untimely . . . if the evidence upon which the motion is based on newly-discovered.").

The Annuity Agreement constitutes newly discovered evidence justifying reconsideration of the July 7 order vacating the asset freeze as to the Trust. The SEC exercised due diligence in an effort to discover the Agreement. Had it been disclosed, the Agreement would have changed the outcome of the preliminary injunction hearing because the factual conclusions behind the Court's July 7 order as to the Trust are no longer supported by the evidence. For example, the decision states that David Smith acted only "as an adviser and broker" for the Trust. DE 86 at 39. The Annuity Agreement, however, shows that David Smith had a far more significant role over the

trust than just "adviser and broker." David Smith and his wife had a direct pecuniary interest in the Trust, potentially worth up to $10 million if they live to their life expectancy, far in excess of the Trust's current assets. Through their power to cancel, annul or enforce the Annuity Agreement, the Smiths have a tool with which they can exercise total control over the disposition of the assets of the Trust.

When the Court granted the SEC's motion for a TRO on April 20, 2010, the Trust account held approximately $3.6 million. In view of the Trust's future obligation to pay up to $10 million and possibly more to David and Lynn Smith over the remainder of their lives, it is inconceivable that the Trustee, Thomas Urbelis, Smith's trusted lifelong friend, would make distributions to the children, thereby compromising the Trust's ability to meet its obligations to the Smiths, without first consulting with David and Lynn Smith.

Numerous portions of the July 7 order as to the Trust now are inconsistent with this new evidence. For example, the July 7 order states that "[w]ith that [Charter One] stock, David and Lynn Smith created the Trust for the benefit of their two children[.]" DE 86 at 11. The Annuity Agreement, however, shows that the Smiths did not simply gift the stock to their children, rather they sold the stock to the Trust in exchange for annual annuity payments from the Trust of $486,000 beginning in 2015.

The Court also found that "David Smith did not distribute assets to himself," and noted that the only payments from the Trust account were to reimburse Smith for paying the Trust's taxes. DE 86 at 39-40. Smith, however, knew that the money would be returned to him beginning in 2015. The Annuity Agreement shows the Trust to be essentially a mechanism for Smith to park temporarily millions of dollars in the Trust, to shield it from creditors, until 2015.

The July 7 order notes that Smith paid the Trust's taxes and concluded that these payments were "for the stated benefit of conserving the trust corpus and assisting their children." DE 86 at 43. The Annuity Agreement, however, suggests that Smith's motivation of "conserving the trust corpus" was to ensure that the Trust had the financial wherewithal to make the annuity payments to him.

The July 7 order stated that "the Trust had virtually no limits on the types of distributions the beneficiaries could request." DE 86. The Trustee's obligation to the Smiths to make the annuity payments, however, means that there is a significant limitation on the amount that the Trustee can distribute.

Finally, the July 7 order found that there was no evidence that "David Smith considered the Trust his property." DE 86 at 39-40. David Smith and his accountants, who were also the Trust's accountants, however, prepared financial statement listing the Trust as a cash asset of the Smiths, showing that David Smith did consider the Trust to be his cash asset. PI Hearing Exs. 79, 80. Before the production of the Annuity Agreement, there was no explanation for why David Smith would consider the Trust as his cash asset. The Annuity Agreement provides a clear explanation.

B. The Trust Should Be Within the Scope of the Asset Freeze

The Trust and its assets should be included within the scope of the asset freeze for any of these reasons.

First, David Smith's ownership and control of the assets transferred to the Trust was unchanged by the transfer. David Smith continued to exercise ownership over the Trust's assets through the Annuity Agreement, and these assets remained the Smiths until

their deaths. The Trustee had nominal ownership of the assets, but the reality of the arrangement was that the Smiths kept ownership and control of the Trust assets.

Indeed, under the Annuity Agreement, the Trustee's primary responsibility is his duty to preserve sufficient assets so that the Trust will be able to make the $489,932 annual payments that begin in 2015. This duty overshadows the Trustee's nominal duty to the Smith's children.

Smith's ownership and control over the Trust's assets was easily exercised in the parameters established by the Trust/Annuity vehicle. The Trustee, Thomas Urbelis, was David Smith's boyhood friend who had continued to be a close personal friend of the Smiths for decades. Urbelis refused to accept payment for his services as Trustee, viewing his appointment as a favor to his close friend. Urbelis did in fact preserve the Trust assets for the benefit of the Smiths. The nominal beneficiaries never received a dime, even though there is evidence one of the beneficiaries, Lauren Smith, was unemployed for one year, leading to support payments directly from Lynn Smith, which had the benefit of leaving the Trust assets untouched.

The original funding of the Trust account was done with stock from the Stock Account, which (as the July 7 order finds) David Smith beneficially owned (DE 86 at 34-36). The Charter One stock had previously been used to advance Smith and McGinn's business interests (contrary to the finding in the July 7 order that the Charter One stock transferred to the Trust was "untouched for the fourteen years it remained in the Stock Account," DE 86 at 38). In fact, all 105,000 Charter One shares were wired out of the Stock Account in October 2003 and into an account controlled by KC Acquisition Corp., a company controlled by Smith and McGinn. The shares were not returned until July

2003. Decl. ¶¶ 45-48, Exs. 11, 16-17. The Smiths also sold a significant number of Charter One shares, generating profits in excess of $1 million. Decl. ¶ 44 Ex. 8.

Second, the transfer to the Trust was a fraudulent conveyance by David Smith. At the time of the transfer, David Smith has an actual intent to defraud present or future creditors. *See* NY CLS Dr & Cr § 276 (2010). Smith's intent to defraud is shown through eight categories of evidence showing an intent to hinder or delay future creditors. *Supra* at 7-9.

Section 276 of the New York Debtor and Creditor Law requires evidence of an "actual intent to hinder, delay, or defraud either present or future creditors." However, "[t]he relevant intent may be inferred from the facts and circumstances surrounding the transfer. Such facts and circumstances, which may be considered 'badges of fraud,' include (1) lack or inadequacy of consideration; (2) family, friendship or close associate relationship between the parties; (3) retention of possession, benefit, or use of the property in question; (4) financial condition of the party sought to be charged both before and after the transaction in question; (5) existence or cumulative effect of a pattern or series of transactions or course of conduct after the incurring of debt, onset of financial difficulties or pendency or threat of suits by creditors; and (6) general chronology of the events and transactions under inquiry" *Kittay v. Flutie,* 310 B.R. 31, 59 (S.D.N.Y. Bkrtcy. 2004) (relying on *Salomon v. Kaiser (In re Kaiser),* 722 F.2d 1574, 1582-83 (2d Cir.1983)). *See also In re Jacobs,* 349 B.R. 646, 667 (E.D.N.Y. Bkrtcy. 2008) (holding that badges of fraud showing intent to hinder or delay creditors include lack of consideration, family relationship, "the associated prospect of retention of control over the property, and the timing" which coincides with increased risk of liability).

Almost all of the badges are present in this case. The Trustee was a close personal friend of David and Lynn Smith and the nominal beneficiaries were their children. The Smiths also retained possession, benefit and use of the Trust assets after the fraudulent conveyance through the Annuity Agreement. In addition, there is evidence of financial difficulties and incurring of debt by Smith, and the general chronology of events shows the intent to hinder, delay or defraud present or future creditors. This evidence is a sufficient basis to find a likelihood of success on the Section 276 claim.

Third, the Trust should be pierced under New York law based on David Smith's control and interest in the trust and the evidence of fraudulent conveyances.[4] *See In re Vebeliunas*, 332 F.3d 85, 91 (2d Cir. 2003) (a trust can be pierced under New York law where the "respective parties used trusts to conceal assets or engage in fraudulent conveyances to shield funds from adverse judgments"); *see also In re Yerushalmi*, 2009 WL 2982964 (Bkrtcy.E.D.N.Y. Sept. 14, 2009) ("the Second Circuit has noted that New York state courts would pierce the trust where the court found that the parties used the trusts to conceal assets or engage in fraudulent conveyances to avoid adverse judgments").

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[4] Paragraph 5 of the Annuity Agreement purports to protect the rights of the Smiths to the annuity payments from judgment creditors. However, even assuming the validity of this provision or an applicable state law exemption, a "court can ignore state law exemptions as well as other state law limitations on the ability to collect a judgment [for disgorgement in an action by the Commission]." *SEC v. Solow*, 682 F. Supp.2d 1312, 1325 (M.D. Fla. 2010) (noting purpose: "Disgorgement is an equitable remedy designed to deprive a wrongdoer of his unjust enrichment and to deter others from violating the securities laws. A disgorgement order is more like an injunction for the public interest than a money judgment.") (internal citations omitted); *see also Steffan v. Gray, Harris & Robinson, P.A.*, 283 F. Supp.2d 1272, 1282 (M.D. Fla. 2003) (in SEC cases, "a district court can ignore state law exemptions as well as other state law limitations on the ability to collect a judgment in fashioning a disgorgement order").

The Smiths' intent to defraud is plainly shown by their efforts to conceal the Annuity Agreement from the SEC and the Court in this case, which alone should justify including the Trust's assets as David Smith's. Courts will find liability under a piercing analysis when doing so would achieve an equitable result. *Brunswick Corp. v. Waxman,* 599 F.2d 34, 35 (2d Cir. 1979). Considering all the variables that must be factored into a decision to pierce the corporate veil, the Second Circuit has declared that the determination must be based on the specific facts of the case. *Mag Portfolio Consult, GmbH v. Merlin Biomed Group LLC,* 268 F.3d 58, 63 (2d Cir. 2001).

The July 7 order relied on the *Vebeliunas* case to find that Smith had no equitable ownership in the Trust. *Vebeliunas*, however, now can be distinguished in view of the newly discovered Annuity Agreement and the fraudulent conveyance evidence. In *Vebeliunas*, the Court reversed a lower's court's ruling allowing a creditor to pierce an irrevocable trust because, although the trustee's husband enjoyed certain benefits from the trust, "those [are] benefits that would naturally flow to the spouse of the property's equitable owner [the trustee]". 332 F.3d at 93. As a result, the Second Circuit held that the trustee's husband did not have equitable ownership of the Trust and the husband's creditors could not reach the trust. The July 7 order, citing *Vebeliunas*, found that David Smith's services as broker/adviser to the Trust, and his payment of the Trust's taxes, were insufficient to establish equitable ownership.

The July 7 order reasoned that David Smith was similarly situated to the trustee's husband in *Vebeliunas*. Unlike the trustee's husband in *Vebeliunas*, however, David Smith does have a direct pecuniary interest in the Trust. David Smith's interest is not something he receives simply by virtue of the "benefits that would naturally flow to the

spouse," 332 F.2d at 93. Rather, Smith's interest flows directly to him personally by virtue of his rights under the Annuity Agreement. For this reason, the *Vebeliunas* case is inapposite.[5]

In the piercing/alter ego analysis, the Court should look at the economic realities and relationships of the parties rather than the corporate formalities. *See LiButti v. United States*, 107 F.3d 110, 119 (2d Cir. 1997) ("'we must avoid an over-rigid 'preoccupation with questions of structure,' and 'apply the preexisting and overarching principle 'that liability is imposed to reach an equitable result.'"). This was the approach taken in *Maghazeh v. Maghazeh Family Trust,* 310 B.R. 5 (E.D.N.Y.Bkrtcy. 2004), where the Court held that an alter ego theory could be applied to pierce an irrevocable trust that a debtor had created for his children. The trust in *Maghazeh* is similar to the Smith Trust: it was an irrevocable trust ostensibly set up to benefit the adult children of the grantor, and the trust never made a distribution to the beneficiaries. Also like the Smith Trust, "there is no evidence to support a finding that the trustees acted in any way other than as nominees for the Debtor with respect to the Maghazeh Trust." 310 B.R. at 18. The court rejected the argument that the trust was formed for estate planning purposes and that the trust maintained a separate existence:

> Even if the Court were to accept that the Maghazeh Trust was formed for proper purposes, the Debtor's subsequent treatment of the Maghazeh Trust as his own personal vehicle to shield his assets from his creditors and to perpetuate a fraud on this Court warrant piercing the Maghazeh Trust.

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[5] Another distinguishing factor is that in *Vebeliunas* the wife/trustee purchased the trust's property "with her own assets." 332 F.3d at 92. In contrast, the Trust was funded with a joint asset, the Charter One stock, which the Annuity Agreement acknowledges. In addition, the Second Circuit noted that the wife/trustee "played no role" in the wrongdoing. 332 F.2d at 87. Here, Lynn Smith was a participant in the 2004 fraudulent conveyance and concealed the Annuity Agreement.

310 B.R. at 18.

Finally, the Preliminary Injunction Order, as well as the TRO order, prohibits the "encumbrance" or "dissipation" of assets of the defendants, and the Annuity Agreement is an asset of David Smith's. Any payments from the Trust account will impair the Trust's ability to meet its payment obligations to the Smiths. The Trust account therefore should be within the scope of the asset freeze to prevent it from encumbering the value of the Annuity Agreement.

C. The Funds Paid Out By The Trust After July 7 Should Be Returned; In The Alternative, The Court Should Freeze The Assets Of Geoffrey And Lauren Smith In The Amount Received from the Trust

As an equitable remedy, the Court should order that all funds paid from the Trust account on or after July 7, 2010, should be immediately returned to the Trust, and that the Trust provide a verified written accounting of all payments. This is an appropriate use of the Court's equitable powers because had the Annuity Agreement not been concealed prior to and during the preliminary injunction hearing, those funds would not have been removed from the Trust account.

Alternatively, the assets of Geoffrey and Lauren Smith should be frozen to the extent of the payments they received from the Trust. They would not have received these payments if the Annuity Agreement had been produced, and they should not benefit from the concealment of the Annuity Agreement. Goeffrey Smith, moreover, testified at the hearing as if he had no knowledge of the Annuity Agreement, which appears suspect given that the Annuity Agreement directly related to the Trust.

The Court has broad equitable powers in SEC enforcement cases to impose these remedies. Under Section 21(d)(5) of the Exchange Act, "[i]n 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." In addition, district courts have "broad equitable powers to grant ancillary relief ... where necessary and proper to effectuate the purposes of the securities laws." *SEC v. American Bd. of Trade, Inc.*, 830 F.2d 431, 438 (2nd Cir.1987). The ancillary remedy of an asset freeze ensures that sufficient funds are available to satisfy any final judgment the Court might ultimately enter. *See, e.g., Int'l Controls Corp. v. Vesco*, 490 F. 2d 1334, 1347 (2d. Cir. 1974) (noting that "an asset freeze may be appropriate to assure compensation to those who are victims of a securities fraud"); *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1106 (2d Cir. 1972) (fraudulent nature of appellants' violations and uncertainty regarding amount and location of proceeds warranted asset freeze to preserve the status quo); *SEC v. Vaskevitch*, 657 F. Supp. 312, 315 (S.D.N.Y. 1987) (the Court has the ability to ensure that defendants' assets are not secreted or dissipated before the entry of a final judgment); *see also SEC v. General Refractories Co.*, 400 F. Supp. 1248, 1259 (D.D.C. 1975) (it is within the Court's authority to grant effective equitable relief by temporarily freezing assets "in order to assure a source to satisfy that part of the final judgment which might [ultimately] be ordered"). When there are concerns that defendants might dissipate assets, a court need only find some basis for inferring a violation of federal securities laws in order to impose a freeze order. *SEC v. Unifund, SAL*, 910 F.2d 1028, 1041 (2d Cir. 1990).

The return of the funds paid from the Trust would benefit investors. Most of the millions of dollars raised from investors have been dissipated and the funds in the Trust

account represent a significant portion of the few remaining available assets. The Court therefore should exercise its equitable powers to restore those funds to the Trust or, at a minimum, to freeze the payments that have been made to the beneficiaries.

II. THE CONVEYANCES TO NANCY MCGINN

In a deed dated October 19, 2009, Timothy McGinn transferred his residence at 26 Port Huron Drive, Niskayuna, NY, to his wife Nancy McGinn for consideration of "less that $100.00" Hrg. Ex. 117. The July 7 order found that, based on the circumstances of the transfer, "the SEC would appear to have demonstrated sufficient cause to include the residence in the asset freeze . . . [but that] Nancy McGinn is not a party to this action in any capacity. Unless and until she is, this Court lacks jurisdiction to restrain her actions[.]" DE 86 at 42.

With the filing of this Amended Complaint, Nancy McGinn is now a party to this action and the Court may properly include the Niskayuna house within the scope of the asset freeze.

Nancy McGinn also received payments of approximately $65,000 from Timothy McGinn during the period of the fraud. Declaration of Roseann Daniello dated August 2, 2010. These payments appear to be without consideration and are therefore subject to disgorgement. Therefore, Ms. McGinn's assets should be frozen to the extent of the transfers without consideration.

CONCLUSION

For the foregoing reasons, the Commission respectfully requests that the Court grant the order to show cause and application for emergency relief; find that the Trust is subject to the asset freeze; order that all payments from the Trust account since July 7, 2010, be returned to the Trust or, alternatively, that the assets of Goeffrey Smith and Lauren Smith be frozen in the amount of the payments they received from the Trust; order the Trust to provide a verified written accounting; and order that Nancy McGinn's residence in Niskayuna, NY is subject to the asset freeze and that Nancy McGinn's assets should be frozen to the extent of the ill-gotten gains she received.

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