UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION

Plaintiff-Appellee,

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,

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

Defendants, and

LYNN A. SMITH,

Relief Defendant-Appellant.

DAVID M. WOJESKI, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04,

Intervenor.

SURREPLY MEMORANDUM OF LAW IN OPPOSITION TO PLAINTIFF'S MOTION FOR RECONSIDERATION

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PRELIMINARY STATEMENT

Permission was given to the Trust defendants to file a surreply to address (1) the SEC's suggestion that the sworn declarations of counsel are insufficient to refute the SEC's unsubstantiated claim that a private annuity agreement constitutes newly discovered evidence; (2) the SEC's argument, advanced without statutory or case law support, that the Court should exercise "broad equitable powers" in the absence of any jurisdictional basis or statutory authority to freeze assets under the New York Debtor and Creditor Law; (3) the SEC's arguments regarding the Trust's investment in a business created and operated by a beneficiary of the Trust; and (4) the SEC's mischaracterization of David Evans' report and conclusions.

POINT I

THE PRIVATE ANNUITY AGREEMENT IS NOT NEW EVIDENCE BECAUSE IT COULD HAVE BEEN DISCOVERED BY THE PLAINTIFF IN THE EXERCISE OF DUE DILIGENCE

The scope of the current motion is severely limited, and Plaintiff has failed to carry its burden of proving the existence of "new" evidence not in its possession prior to the issuance of the decision on July 7, or that could not have been discovered in the exercise of due diligence. Plaintiff has also failed to prove that the availability of the private annuity agreement would have changed the outcome of the preliminary injunction hearing as to the Trust. Indeed, Plaintiff has not even attempted to refute the expert analysis rendered by David Evans, JD, CPA on the meaning and effect of the private annuity.

With respect to the annuity agreement, in its reply memorandum, Plaintiff dismisses the sworn declarations of counsel as "second-hand" affidavits, which is odd, given the fact that Plaintiff's counsel, in his own sworn declaration, accused defense counsel of withholding or concealing evidence from it and the Court. See, Plaintiff Reply Mem. at p. 4, footnote 1. While counsel's declarations should be sufficient to refute Plaintiff's false accusations, the Trust defendants have submitted sworn declarations of David Wojeski and Geoffrey Smith documenting their lack of knowledge or possession of an annuity agreement until it was received by counsel in late July.

Although Plaintiff may not have been in possession of the annuity agreement at the time of the hearing, Plaintiff's counsel was on notice that such an annuity may have existed. In an August 4, 2004 transmittal letter to trustee Thomas Urbelis, which was in evidence at the hearing, David Smith specifically referred to the Trust as a "Private Annuity Trust." SEC counsel took the sworn deposition of Mr. Urbelis, yet never asked him about a private annuity.

SEC counsel inquired of Mr. Urbelis as to his understanding of just about every sentence in David Smith's transmittal letter, except the one in which he called it a Private Annuity Trust. The undisputed fact is that the SEC never asked anyone about an annuity agreement despite being on notice that one of the Trust's creators referred to it as a "Private Annuity Trust" and that the Trustee was specifically empowered to enter into an annuity agreement. SEC counsel conceded that the power to enter into annuity agreements was explicitly stated in the Declaration of Trust, yet dismisses this fact as trivial. See Plaintiff Reply Mem. at p. 7.

Plaintiff was seeking an injunction against a $4.5 million dollar asset, and they should have analyzed the Declaration of Trust more carefully to determine the nature of the Trust. The evidence was available to it, and Plaintiff cannot be heard to argue that it didn't realize that an annuity agreement may have existed. Plaintiff bore the burden of proof and its counsel simply missed the signs and failed to ask the right questions. Notably, when Plaintiff's counsel did ask Thomas Urbelis about a private annuity on July 22, he stated that he "vaguely recalled something about an annuity but he was not sure." See, Stoelting Declaration ¶ 37 (Document 103-2). Plaintiff could have elicited this vague recollection when Mr. Urbelis was deposed on June 1.

The SEC's only answer to its counsel's glaring mistake is a glib assertion that "David Smith's one reference to a private annuity 'trust' was most reasonably understood to be either a misunderstanding or mischaracterization by him. See Plaintiff Reply Mem. at p. 7. Were these not such serious matters, one might take the SEC's suggestion as a feeble attempt at humor. If the Court accepts the SEC's proffered excuse that David Smith misunderstood the import of the words he chose to use in his August 4, 2004 transmittal letter, then the Court should apply that same assumption to the handwritten notes attributed to David Smith and contained in Exhibit 14

to the Declaration of David Stoelting and dismiss them as a misunderstanding or mischaracterization. Plaintiff cannot have it both ways.

Second, the Plaintiff insists that Thomas Urbelis was under subpoena to produce documents and appear at a deposition and asserts that he withheld evidence. Plaintiff fails to cite any legal authority for its peculiar argument that it can lawfully serve a subpoena by electronic mail to a non-party witness in Boston, Massachusetts, and compel him to produce documents the next day to SEC counsel's home in Manhattan and then to appear at a deposition in the Northern District of New York on the next business day. Plaintiff ignores the failure of its counsel to effectuate proper service, asks the Court to find that Urbelis failed to comply with a subpoena, and then has the audacity to argue that the failure of the Trust defendants to compel Mr. Urbelis to submit an affidavit regarding the circumstances of Plaintiff's lack of service should be held against the Trust. The Trust defendants have no control over the former trustee. He was voluntarily deposed by the SEC and they never asked him whether he had additional documents or whether he was ever a party to a private annuity agreement with the donors of the Trust until July 22, 2010. That is the fault of SEC counsel and Plaintiff cannot walk away from its burden of proof in this proceeding by facetiously suggesting that because the Trust's counsel did not discover the document, that the Plaintiff should be allowed to relitigate the hearing now.

Finally, the discovery of the private annuity should not change the Court's July 7 decision. The SEC has not even marginally attempted to rebut the detailed expert opinion and report produced by David Evans, JD, CPA following his review of the Trust documents. Mr. Evans has opined that David and Lynn Smith have no property rights in the assets of the Trust, either in its income or for the principal of the Trust. He clearly stated, and has not been contradicted by the SEC, that the only rights of annuitant-creditors to this Trust are contract

rights to payments in the future. This evidence is more than enough to demonstrate that, even if the annuity agreement had been available at the preliminary injunction hearing, the Trustee would still have been entitled to an order vacating the temporary restraining order and denying the Plaintiff's motion for a preliminary injunction. Any rights to future payments can be subject to a restraining order that does not impinge on the Trustee's ability to pay taxes, make investments and provide a defense to the Trust in this action.

POINT II

PLAINTIFF HAS NOT OFFERED ANY OTHER "NEW" EVIDENCE TO WARRANT RECONSIDERATION OF THE COURT'S JULY 7 ORDER

In its Reply Memorandum, Plaintiff finally concedes that, with the exception of the annuity agreement, it was in possession of all of the evidence on which it based its motion seeking "emergency relief" on August 3, 2010. Plaintiff's counsel chose to footnote this concession in its Reply Memorandum, attempting to minimize its significance when compared to the initial hysterical allegations in its opening motion papers in early August. In seeking that emergency TRO, which was granted without opposing counsel being heard, the SEC's memorandum asserted that the "new evidence" included the annuity and (1) a multi-page handwritten letter attributed to David Smith (Exhibit 14 to Stoelting Declaration) which the SEC obtained from the U.S. Attorney's office, who had obtained it pursuant to a search warrant in a parallel criminal investigation; (2) a lawsuit commenced and settled by Ian Meyers prior to the August 2004 creation of the Trust (Exhibit 6 to Stoelting Declaration); (3) the one-time hypothecation of Lynn Smith's Charter One stock for a loan related to Integrated Alarms Services Group; and (4) the existence of an SEC audit of McGinn Smith which concluded in February 2004 (Exhibit 15 to Stoelting Declaration).

As the Trust defendants asserted in response and as the Plaintiff now concedes, none of the foregoing evidence was newly discovered; rather, it was in the possession of the SEC at the time of the hearing in June. The SEC relies heavily on Exhibit 14 as purported evidence of fraudulent intent, an element of a fraudulent conveyance claim under New York State law. Based on a decision rendered last week, however, the Court cannot consider Exhibit 14 or other evidence gleaned from the U.S. Attorney's office for purposes of this civil enforcement action. The Second Circuit ruled that it is an abuse of discretion for a district court to allow the disclosure and use in an SEC civil enforcement action of evidence obtained pursuant to a search warrant in a parallel criminal investigation prior to a ruling on the legality of the search and without limiting the disclosure to relevant information. SEC v. Rajaratnam, Docket No. 10-CV-462 (2d Cir., Sept. 29, 2010) (opinion attached hereto). No such analysis has occurred in this case.

In fact, unlike in the Rajaratnam case, where criminal charges had already been filed, there has been no action by a grand jury and no criminal charges have been filed against any defendant in this case. Consequently, no defendant has been afforded access to the documents obtained by the U.S. Attorney, nor have they been afforded the protections of the constitution and the opportunity to challenge the search warrant or its execution or the relevance of the evidence obtained thereby. Nevertheless, the SEC has admitted, during the preliminary injunction hearing, during discovery conferences and in the context of the instant motion that it has been and continues using evidence to advance this civil enforcement action which it obtained from the U.S. Attorney's office as a result of search warrants executed on April 20, 2010, all while the defendants have been denied access to the same evidence and their due process rights. This is a shocking abuse of justice and cannot be rewarded by the granting of this motion. In

rendering its decision in the Rajaratnam case[1] last week, the Second Circuit took the unusual step of issuing a writ of mandamus to prevent further manifest injustice by the SEC in using the evidence which was unlawfully obtained.

For the foregoing reasons, the Court should not consider Exhibit 14 in deciding this motion, nor should it consider any evidence offered by the SEC which was obtained from the U.S. Attorney's office. The burden remains on the SEC to prove grounds for a preliminary injunction and it must prove those grounds based solely on evidence lawfully obtained and relevant to its claims. The Trust defendants respectfully submit that the SEC's evidence has been so tarnished by its improper use of evidence obtained from the execution of a search warrant, that this motion must be dismissed entirely.

POINT III

PLAINTIFF HAS OFFERED NO AUTHORITY FOR THE COURT TO FREEZE THE TRUST DEFENDANTS' ASSETS UNDER THE NEW YORK DEBTOR AND CREDITOR LAW

In its Reply Memorandum, the SEC contends that the "Court's broad equitable powers to avoid manifest injustice and protect investors far exceed the restrictions in the New York Debtor and Creditor laws. See, Plaintiff's Reply Mem. at p. 10. The Trust defendants submit that the Court cannot exercise jurisdiction where none currently exists. The SEC has not cited any legal basis for imposing an asset freeze against the Trust defendants, who have only been named in this lawsuit in a supplemental state law claim under the New York Debtor and Creditor Law. Plaintiff has not cited a single statute or court decision, either federal or state, on which the Court can base an asset freeze under this cause of action.

[1] The lead counsel for the SEC in the Rajaratnam case is Kevin McGrath, who is serving as co-counsel in the instant action.

None of the Trust defendants have been named as defendants in any securities law claim, nor have they been named as relief defendants as a result of an alleged securities law violation by another party for which they are alleged to be holding ill-gotten gains. The law is clear that, to be subject to an injunction against its assets, a party must have been accused of a securities law violation, or be in possession of ill-gotten gains. See SEC v. Cavanagh, 155 F.3d 129 (2d Cir. 1998) (federal courts may order equitable relief against a person who is not accused of wrongdoing in a securities enforcement action where that person has received ill-gotten gains and does not have a legitimate claim to those funds). Unlike in private actions, which are rooted wholly in the equity jurisdiction of the federal courts, SEC suits for injunctions are 'creatures of statute.'" Management Dynamics, 515 F.2d 801, 808 (2d Cir. 1975). Thus, the SEC must demonstrate a statutory basis for the relief it seeks.

Here, the SEC acknowledges that it does not seek the injunction against the Trust defendants pursuant to the authority of any securities law, but solely under the New York Debtor and Creditor Law. Although §279 of the Debtor and Creditor specifically permits a court to restrain a defendant from disposing of his property, §278, on which the SEC relies to maintain its asset freeze over the Trustee and Geoffrey and Lauren Smith, does not provide creditors with the same statutory remedy to restrain funds. The SEC's only remedy under §278 is to either attach or levy on the property alleged to have been fraudulently conveyed pursuant to the New York Civil Practice Law and Rules. Save Way Oil Co. v. 284 Eastern Parkway Corp. et al., 453 N.Y.S. 2d 554 (Civil Ct Kings County 1982).

The use of the Debtor and Creditor Law to set aside a fraudulent conveyance is available only to creditors of the defendants. Eberhard v. Marcu, 530 F.3d 122 (2d Cir. 2008). Under New York Debtor and Creditor Law § 270, a "creditor" is defined as "a person having any claim,

whether matured or unmatured, liquidated or unliquidated, absolute, fixed or contingent." The shares of Charter One stock which funded the Trust were owned by Lynn Smith at the time they were transferred to the Trust. The SEC was not a creditor or future creditor of Lynn Smith at the time she transferred the stock to the Trust and the SEC cannot assert this claim in a representative capacity on behalf of investors of McGinn Smith. Lynn Smith is named as a relief defendant, and "the SEC has not cited any authority for the proposition that a relief defendant's assets may be frozen to ensure payment of a penalty." See, SEC v. Heden, 51 F. Supp. 2d 296, 302 (SDNY 1999). In keeping with centuries of common law and statutory tradition, there is no basis for an asset freeze against the Trust defendants under sections 276 and 278 of the Debtor and Creditor Law.

CONCLUSION

Under the preliminary injunction order currently in place, it appears that any right of David Smith to receive payments in the future would already be frozen. Otherwise, the Trust defendants have no objection to the Court clarifying the preliminary injunction order to prohibit the Trustee from making annuity payments to David or Lynn Smith at the time the payments become due. Freezing the Trust from now until the end of this case will prevent the Trustee from making the investments necessary to grow the corpus to a point where annuity payments could be made.

In its Order dated July 7, 2010, the Court found in favor of releasing the Trust from the asset freeze based on the factual finding that the SEC "failed to demonstrate that David Smith exercised considerable authority over [the Trust] to the point of completely disregarding its form and acting as though its assets [were] his alone to manage and distribute." SEC v. McGinn, Smith & Co., et al., *citing* In re: Vebeliunas, 332 F.3d at 92. Nothing about that finding has

changed. For all of the foregoing reasons, the Trust defendants respectfully request that the Plaintiff's motion for reconsideration of the July 7 decision as it relates to the Trust be denied.

Dated: October 6, 2010

s/Jill A. Dunn

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