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, LYNN A. SMITH, GEOFFREY R. SMITH, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04, GEOFFREY R. SMITH, LAUREN T. SMITH, and NANCY McGINN,

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

Defendants,

LYNN A. SMITH and NANCY McGINN,

Relief Defendants, and

GEOFFREY R. SMITH, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04,

Intervenor.

MEMORANDUM OF LAW IN OPPOSITION TO SEC'S MOTION FOR SANCTIONS AGAINST DEFENDANT/RELIEF DEFENDANT LYNN A. SMITH

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STATEMENT OF THE FACTS

This Memorandum of Law is submitted in Opposition to the Securities and Exchange Commission's (the "SEC") Motion for Sanctions against Relief Defendant/Defendant Lynn A. Smith ("Lynn Smith") for alleged fraudulent conduct during the course of preliminary injunctive proceedings before this Court.

This Motion arises from the Court's findings in its Memorandum-Decision and Orders dealing with the issue as to whether the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04 ("Trust") should be the subject of an asset freeze the SEC was seeking to impose through an application for preliminary injunctive relief. Following six weeks of discovery, the Court conducted a hearing on June 9 through June 11, 2010, on the SEC's Preliminary Injunction Motion to maintain the freeze of both Lynn Smith's assets and the assets in the Trust.[1]

On July 7, 2010, the Court issued a Memorandum-Decision and Order ("MDO I") (Dkt. 86) that froze certain assets of Lynn Smith, including her stock account, checking account and her residences in Saratoga, New York and Vero Beach, Florida. The Court released from the asset freeze the Great Sacandaga Lake camp which Lynn Smith inherited from her father. As to the Trust, the Court determined that the assets of the Trust should also not remain frozen since the stock that funded the Trust in 2004 was untainted and severable from the rest of her stock account or, in the alternative there was no evidence that David Smith had a beneficial ownership in the Trust.

[1] The Trust, as a separate legal entity, was represented by Jill Dunn, Esq. having been granted its motion to intervene in the case on May 28, 2010 (Dkt. 39). Lynn Smith, then named in the action only as a Relief Defendant, is represented by James D. Featherstonhaugh, Esq., his appearance having been filed with the Court on April 29, 2010. (Dkt. 13)

Following the decision of MDO I, the SEC filed an Emergency Motion for Temporary Restraining Order to re-freeze the Trust (Dkt. 103) based upon the discovery of an annuity agreement which it apparently obtained from the original Trustee of the Trust ("Annuity Agreement" or "Agreement"). This Agreement entered between the Trust and David and Lynn Smith contractually obligated the Trust to pay Lynn and David annual annuity payments beginning in the year 2015. In an Order dated August 3, 2010 (Dkt. 104), the Court granted the SEC permission to move against the Trust but in the form of a Motion for Reconsideration. As part of its allegations to support its application relating to Lynn Smith, the SEC claimed that Lynn Smith knew of the Agreement but failed to produce it or refer to it in her sworn testimony. (Dkt. 103). Although, Lynn Smith did not file an affidavit in opposition to this application, Mr. Featherstonhaugh's Declaration verified that "[Lynn Smith] had no recollection of [the Agreement] prior to my calling it to her attention, and reaffirmed that her intention when creating the Trust was to provide for her children." (Dkt. 133).

Prior to ruling on the SEC's motion, the Court deemed it necessary to hold an evidentiary hearing to hear testimony concerning a telephone call that took place on July 22, 2010 between the Trust attorney and two SEC attorneys wherein it was alleged that Ms. Dunn disclosed the existence of the Agreement – an allegation that Ms. Dunn has denied. The SEC argued that it was this telephone call that led to the discovery of the Agreement on July 27, 2010 when it was prompted to contact Mr. Urbelis and request the document. Since the Court deemed the issue as to timing and discovery of the Agreement germane to the SEC's pending Motion for Reconsideration, the Court ordered an evidentiary hearing to test the credibility of both parties concerning the substance of

this telephone call. (Dkt. 150). That hearing, originally scheduled for November 4, 2010 took place on November 16, 2010.

On November 22, 2010 Your Honor granted the SEC's Motion for Reconsideration and accordingly "re-froze" those Trust assets on the grounds that David Smith possessed an ownership interest in the Trust based on new evidence in the form of the Annuity Agreement. (Dkt. 194) ("MDO II"). The Court, *sua sponte*[2], also found in the alternative that reconsideration is warranted under Rule 60(b)(3) based on fraud, misrepresentation, or misconduct.

> [T]he conduct of those associated with the Trust – principally Urbelis and Lynn Smith – in failing to disclose the Annuity Agreement satisfies the requirements for fraud, misrepresentation, and misconduct. Their failure to disclose the agreement was exacerbated by their statements and testimony that the Trust was created solely to benefit the Smiths' children without disclosing the additional fact that the Trust was also created to pay a substantial annuity in the future to David and Lynn Smith. MDO II, at 20 n. 17.

In addition to granting the SEC's Motion on Reconsideration, the Court also granted the SEC leave to move for sanctions against Lynn Smith, her attorney, James D. Featherstonhaugh, Esq., the Trust attorney, Jill Dunn, Esq., the former trustee Thomas Urbelis, Esq., and the successor trustee, David Wojeski "based on conduct described herein." (MDO II at 24). This grant of authority was expressly given to avoid the necessity of holding a pre-motion conference required by the local rules. (Id.) On December 6, 2010, the Trust moved for reconsideration of MDO II. The Court denied this motion reiterating its earlier findings.

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[2] The Court in MDO II indicates that "the SEC also seeks reconsideration under Rule 60(b)(3) based on fraud." However, because the Court *sua sponte* changed the SEC application seeking a temporary restraining order to a motion for reconsideration, this point was not specifically raised by the SEC prior to MDO II.

On January 31, 2011, the SEC accepted the Court's invitation in MDO II and moved for sanctions against Lynn Smith, Ms. Dunn, Mr. Wojeski and Mr. Urbelis. The SEC relies on three sources of authority in which the Court may impose sanctions against these individuals: Federal Rule of Civil Procedure 11, 28 U.S.C. §1927, as well as the Court's *inherent authority*. To support its claims, the SEC not only identified and set forth specific facts for each individual which it alleges give rise to sanctionable conduct, but it goes a step further to allege that the misconduct of each was the result of a diabolical scheme amongst those associated with the Trust, including Lynn Smith. Based on this conspiracy theory, the SEC then moved, without leave of Court, for an evidentiary hearing and discovery to determine what part, if any Mr. Featherstonhaugh played in the "scheme" and, even more, requests that his confidential communications with his client, Lynn Smith, be revealed pursuant to a crime-fraud exception.[3]

As to Lynn Smith, the SEC relies on the following facts to warrant sanctions against her:

> **Lynn Smith**
>
> L. Smith submitted three false documents in May 2010 – a statement of assets and two affidavits. Dkt. 19, 23, 34. She also testified falsely during her deposition and in the preliminary injunction hearing. In these filings, and in her deposition and hearing testimony, L. Smith did not disclose the Annuity Agreement; nor did she disclose her right, together with her husband, to receive $489,932.00 annually, or almost $10 million in total, in annuity payments from the Trust. Dkt. 19. As the donor of the Trust and a party to the Annuity Agreement, L. Smith knew that her written statements and testimony were false.

[3] A separate memorandum of law has been filed on behalf of Mr. Featherstonhaugh in opposition to the SEC's motion seeking such relief.

For the reasons that follow, we respectfully disagree with the SEC's interpretation of Lynn Smith's conduct in these proceedings and ask the Court to reject the SEC's application for sanctions.

POINT I

LYNN SMITH'S CONDUCT IS NOT SANCTIONABLE PURSUANT TO FEDERAL RULE OF CIVIL PROCEDURE 11.

In general, in a situation where sanctions are imposed under multiple provisions, "separate consideration of the available sanctions machinery is not only warranted, but necessary for meaningful review." Lapidus v. Vann, 112 F.3d 91, 96 (2nd Cir. 1997) *citing* United States v. Inten. Bhd. of Teamsters, 948 F.2d 1338, 1346 (2nd Cir. 1991). Since the SEC has sought sanctions under multiple authorities, we begin our analysis with Rule 11.

A. Lack of Procedural Compliance with Rule 11 (c).

Pursuant to Rule 11 (c), sanctions against a party may be sought by motion or on the court's own initiative.

In cases where the sanction is sought by way of motion, Rule 11 (c)(2) does not permit such motions to be filed with the Court until 21 days after service of the motion. A motion that fails to comply with the so-called "safe harbor" provision of Rule 11 must be denied. See, e.g., Bryant v. Britt, 420 F.3d 161, 163 n. 2 (2nd Cir. 2005) (because movant "failed to comply with Rule 11(c)(2)" court found "no error in the district court's decision" to deny sanctions).

On the other hand, Rule 11 (c)(3) provides, "[O]n its own, the court may order an attorney, law firm, or party to show cause why conduct specifically described in the order

has not violated Rule 11(b)." Fed. R. Civ. P. 11 (c)(3). In cases where a court seeks sanctions upon its own initiative, the "safe harbor" provision such as is found in Rule 11 (c)(2), does not apply. ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 579 F.3d 143, 150 (2nd Cir. 2009).

In this case, contrary to the SEC's position, this sanction application was not initiated by the Court. Rather, the Court merely granted leave to the SEC to file a motion for sanctions should it choose to do so. This interpretation is supported first by the obvious fact that the Court did not order any party to show cause why it should not be sanctioned as is required by the Rule. Second, it would appear from the Court's order in MDO II that the Court's invitation to the SEC to file sanctions against certain parties was to afford the government the opportunity to make the application "without the necessity of the pre-motion conference required by [Local Rule] 7.1(b)(2)." Third, the Court set a filing deadline for the SEC to seek sanctions on or before January 31, 2011 and thereby implicitly gave the government the *option* to seek sanctions. Finally, the Court's order grants leave to the SEC to file sanctions "for the conduct described herein." MDO at 24. However, the Court does not specify exactly which conduct it describes in its opinion as being subject to sanctions contrary to Rule 11(c)(3) which requires the court to identify the potentially offending conduct with reasonable specificity to afford the party adequate notice. Thorton v. General Motors Corp., 136 F.3d 450, 455 (5th Cir. 1998). Rather, any reference by the Court to alleged misconduct was made in connection with its *sua sponte* findings that authorized the reconsideration of MDO I.

Accordingly, on these facts, one may only conclude that this sanction proceeding was initiated pursuant to Rule 11(c)(2). Since the SEC failed to comply with the safe

harbor provisions set forth in the Rule, decisional law dictates that this Court may not entertain the motion.

B. Rule 11 is not Applicable to Certain Conduct alleged by the SEC to Warrant Sanctions.

Rule 11 applies only to pleadings, motions, or other paper and not to the entire conduct of the proceedings. Curley v. Brignoli Curley & Roberts, Associates et al., 1989 U.S. Dist. LEXIS 15511 6 *citing* Oliveri v. Thompson, 803 F2d 1265, 1275 (2nd Cir. 1986), *cert. denied,* 480 U.S. 918 (1987). While the term "other paper" is somewhat ambiguous, courts have interpreted it to refer only to papers served or filed with the court. Id. at 6-7; Antonious v. Spalding & Evenflo Companies, 281 F.3d 1258, 1261 (Fed. Cir. 2002). Rule 11 does not authorize sanctions for discovery abuses or misstatements made to the court during an oral presentation. Christian v. Mattel, Inc., 286 F.3d 1118 (9th Cir. 2002).

To the extent the Court finds that Rule 11 is applicable from a procedural standpoint, the only documents that the Court may consider are the two affidavits and the list of assets Lynn Smith filed with the Court. Her responses to discovery requests and oral testimony given at her deposition or during the Preliminary Injunction hearing are not appropriate sources for the Court to either consider or conclude that Lynn. Smith's conduct is sanctionable under a Rule 11 analysis.

POINT II

LYNN SMITH IS NOT SUBJECT TO SANCTIONS PURSUANT TO 28 U.S.C. §1927.

28 U.S.C. §1927 provides that:

> Any attorney or other person admitted to conduct cases in any court of the United States or any Territory thereof who so multiplies the proceedings

> in any case unreasonably and vexatiously may be required by the court to satisfy personally the excess costs, expenses, and attorneys' fees reasonably incurred because of such conduct.

Pursuant to its expressed terms, the statute applies only to an attorney's conduct. Lynn Smith is a party to this suit and not an attorney. Lapidus v. Vann et al., 112 F.3d 91 (2nd Cir. 1997). Therefore, it is inappropriate to seek sanctions against her pursuant to this authority.

POINT III

THE SEC HAS FAILED TO DEMONSTRATE THAT LYNN SMITH'S CONDUCT CONSTITUTES SUBJECTIVE BAD FAITH AS REQUIRED FOR SANCTIONS SOUGHT PURUSANT TO RULE 11 OR UNDER THE COURT'S INHERENT POWERS.

Since 28 U.S.C. §1927 does not apply to non-attorneys, the SEC may only seek sanctions against Lynn Smith pursuant to Rule 11 (to the extent it is applicable procedurally and limited to only the filings of two affidavits and a list of assets) or pursuant to the Court's "inherent power." In each case, the SEC must prove with clear and convincing evidence that Lynn Smith's conduct rose to the level of *subjective bad faith.*

A. Standard of Review Under Rule 11.

The SEC has argued that because the Court permitted leave to file a motion for sanctions that such an order was tantamount to the Court seeking such sanctions on its own initiative as is permitted by Rule 11 (c)(3) as opposed to a motion by a party. The procedural distinction has substantive implications in terms of the standard which a Court must apply in its determination as to whether sanctions are appropriate.

In cases where a party brings a motion seeking Rule 11 sanctions, the test is whether the conduct rises to objective unreasonableness. In re Smith, 2011 U.S. Dist. LEXIS 6401 (E.D.N.Y. 2011). Where, however, a district court considers Rule 11 sanctions *sua sponte*, the test becomes one of subjective bad faith. In re Penne & Edmonds LLP, 323 F.3d 86 (2nd Cir. 2003). "This is generally because when a court considers sanctions on its own, the offending party cannot avail itself of Rule 11 'safe harbor' and withdraw an unreasonable submission prior to judicial intervention." In re Smith *supra* at 6-7.

Accordingly, if the Court agrees with the SEC that this Rule 11 proceeding was initiated by the Court *sua sponte*, it must apply the higher evidentiary standard by incorporating a *mens rea* standard to its analysis. Since the Rule 11 filings apply only to court filings, the Court must look at Lynn Smith's subjective bad faith at the time of filing. Lapidus *supra* at 96. (misconduct under Rule 11 must be judged as of the time the paper was signed).

B. Standard of Review Under the Court's "Inherent Authority".

It is also well settled that a Court which elects to impose sanctions based on its "inherent authority" must base those findings on bad faith. DLC Management Corp. v. Town of Hyde Park, 163 F.3d 124, 136 (2nd Cir. 1998); Sakon v. Andreo, 119 F.3d 109, 114 (2nd Cir. 1997; Militex Indus. Corp. v. Jacquard Lace Co., 55 F.3d 34, 41 (2nd Cir. 1995); and Oliveri *supra* at 1272. In Penne & Edmunds LLP, the Court relied on the decisional law in the Second Circuit relating to its application of the bad faith standard under its inherent authority to support its finding that a similar standard should be applied to court initiated Rule 11 proceedings. Penne & Edmunds LLP *supra* at 90.

Accordingly, the subjective bad faith standard is the same whether it is applied under a Rule 11 or under the Court's "inherent authority."

C. The Subjective Bad Faith Standard as Applied to Lynn Smith's Conduct.

"Because of their very potency, inherent powers must be exercised with restraint and discretion." Chambers v. NASCO, Inc., 501 U.S. 32, 44 (1991):

> A troublesome aspect of a trial court's power to impose sanctions, either as a result of a finding of contempt, pursuant to the court's inherent power, or under a variety of rules such as Fed. R. Civ. P. 11 and 37, is that the trial court may act as accuser, fact finder and sentencing judge, not subject to restrictions of any procedural code and at times not limited by any rule of law governing the severity of sanctions that may be imposed. The absence of limitations and procedures can lead to unfairness or abuse.

Mackler Prods., Inc. v. Cohen, 146 F.3d 126, 128 (2nd Cir. 1998).

The Second Circuit has adhered to certain principles to limit the potential for unfairness or abuse by the sanctioning court. As to an evidentiary standard, findings of bad faith must be shown by clear evidence that the actions taken are for improper purposes and requires a "high degree of specificity." Schlaiber Nance & Co. v. Estate of Warhol, 194 F.3d 323, 338 (2nd Cir. 1999). The intent and motive of the individual whose conduct is in question is essential to a finding of bad faith.

> [I]n a misstatement of fact case the falsity and scienter requirements present separate inquiries... That is because a material misstatement of *fact* is alleged by pointing to the true fact about the world that contradicts the misstatement. But even if the statement of fact ("the company made x million dollars in profit last year") turns out to be objectively false, it could have been made in good faith; subjective intent to commit fraud is a wholly separate inquiry from whether the statement is objectively true. As with all inquiries into someone's state of mind, plaintiffs must typically rely on circumstantial evidence for the defendants' words and actions.

Podany v. Stephens, 318 F. Supp.2d 146, 154 (S.D.N.Y. 2004).

To impose sanctions under the Court's inherent authority, the court must make a finding that: "(1) the offending party's claims were entirely without color, and (2) that the claims were brought in bad faith – that is, *motivated* by improper purposes such as harassment or delay." Zlotnick v. Hubbard, 572 F.Supp. 2d 258, 272 (N.D.N.Y. 2008) (emphasis added).[4] In *Penne & Edmunds LLP*, the Court characterized the application of sanctions under a bad faith standard is "akin to a contempt of court." Penne & Edmunds LLP, *supra* at 90. Neglect that is excusable forecloses a finding of bad faith. Sakon v. Andreo, 119 F. 3d 109, 115 (2nd Cir. 1997).

In the case of Lynn Smith, the SEC has not alleged any facts or provided any clear evidence that demonstrates Lynn Smith's conduct in this litigation rises to the level of bad faith. The SEC relies on the filing of two affidavits and a list of assets each of which the SEC characterizes as "false." The SEC also points to testimony given by Lynn Smith in a deposition and in the preliminary injunctive hearing where it is alleged that she had made false statements by failing to disclose her interests in the Annuity Agreement. The SEC is now asking this Court to impose sanctions based on the conclusory position that "L. Smith knew that her written statements and testimony were false." SEC MOL, p. 4.

It is not surprising that the SEC has attempted to infer this knowledge based on this Court's findings in MDO II, that ..."the conduct of those associated with the Trust...principally Urbelis and Lynn Smith – satisfies the requirements for fraud,

[4] In its Memorandum of Law, footnote three, the SEC attempts to link the scienter for conduct subject to sanctions to the scienter to commit fraud, concluding that the actor's wrongful conduct could be demonstrated by reckless disregard. However, a finding of bad faith in the context of sanctions is a more stringent standard than a finding of negligence or recklessness. Excess Insurance Co., Ltd. v. Odyssey America Reinsurance Corp., 2007 U.S. Dist. LEXIS 88441, 8 (S.D.N.Y. 2007) (the Second Circuit has recognized an exception to the bad faith requirement when attorney misconduct is not related to the course or substance of a litigation, but is rather a "negligent or reckless failure to perform his or her responsibility as an officer of the Court").

misrepresentation and misconduct." MDO II, at 20, n. 17.[5] The SEC's position is further buttressed by the Court's rejection of Mr. Featherstonhaugh's explanation that Lynn Smith had no recollection of the Agreement prior to the SEC's discovery of the document on or about July 27, 2010. However, as the case law clearly demonstrates, to prove sanctionable conduct under either Rule 11 (on the Court's own initiative) or pursuant to the Court's inherent authority, there must be clear evidence to a high degree of specificity that Lynn Smith was motivated by bad faith to conceal this document.

Significantly, absent in the SEC's motion is any evidence, circumstantial or otherwise, that remotely suggests that Lynn Smith acted in bad faith when she submitted affidavits and testimony in support of releasing the Trust from the asset freeze. The SEC merely relies upon their own perception of the *objective* facts that Lynn Smith must have acted in bad faith since a reasonable person could assume she had knowledge of the Agreement since she was a party to it. The Court, in its MDO II decision also applies an objective analysis to dispel Mr. Featherstonhaugh's explanation that Lynn Smith did not recall the existence of the Agreement until he became aware of it in late July 2010. Simply finding her failed recollection to be "incredible" does not provide the requisite subjective evidence necessary to hold Lynn Smith accountable for sanctions.

Instead the SEC seeks to impute a subjective bad faith intent on Lynn Smith based upon a conspiracy theory that other individuals' conduct evidences a broader fraudulent scheme for which she was an active participant. However, other than the SEC's characterization of a "common interest" among the defendants' attorneys, experts and parties, it cannot point to a single shred of evidence that would remotely suggest that

[5] It is significant to note that this finding was made in the context of the Court granting the SEC's motion for reconsideration and not pursuant to a bad faith finding amounting to conduct subject to sanctions.

there was a collective intent to conceal the Agreement. Rather, the SEC's motion is based on pure speculation and conjecture along with the incredible assumption that these parties, particularly the professionals, would stake their reputations to commit such fraud upon this Court.

In this case there is a distinction that must be made between a misstatement of fact made in good faith and a fraudulent intent to conceal and mislead this Court. Pursuant to Lynn Smith's affidavit in opposition to the SEC's application for sanctions, it is clear that Lynn Smith had no recollection of the Annuity Agreement until Mr. Featherstonhaugh brought it to her attention in late July 2010 after the conclusion of the preliminary hearing and submission of the alleged falsified court filings. Until that time, Lynn Smith was unaware that the document she signed was associated with the Trust or that she or her husband had a future interest in the Trust as a result. See Smith Affidavit, dated March 21, 2011. This affidavit is consistent with her previous testimony and Court filings.

While the Court has found her lack of recollection as "incredible" because the Agreement was to be the source of large future payments, MDO II at 20 n. 17, the record does not support that Lynn Smith's filings and testimony was motivated by bad faith. Rather, any misstatements of fact were made in good faith and were based on mistake or plain misunderstanding due to the complexities and availability of the instruments involved.

Apart from simply not believing Lynn Smith, this Court must acknowledge that the instruments relevant to this litigation are extremely technical and complex and that few individuals other than tax and estate planning experts can easily comprehend them.

And even those individuals are far and few between based on the fact that these instruments and tax planning strategies associated with them existed only for a short period of time in or around 2004. Indeed, because of the complexity involved, both the Trust and the SEC were forced to retain their own experts to analyze the implications of these documents as to David and Lynn's interest in the Trust. Only after such analysis have the lawyers been able to mount their respective legal interpretations as to how the Annuity Agreement impacts on the question whether those future interests warranted the freezing of the Trust corpus.

By all accounts and with no intent to disparage our client, Lynn Smith does not, and never has had the sophistication to understand the comprehensive nature of these planning documents. While the Court may deem the Annuity Agreement as the "proverbial smoking gun" for purposes of re-freezing the Trust, for purposes of imposing sanctions, the SEC and this Court should be considering the more obvious reality in that Lynn Smith did not understand what the Annuity Agreement was, or its implications on her future interests or how the document was tied in with the Trust. To be sure, her affidavit supports the fact that her husband David Smith handled their financial matters.

Moreover, Lynn Smith had in her possession the Declaration of Trust that she correctly testified in good faith was created for the benefit of her children. She did not have the benefit of having the Annuity Agreement in her possession. Rather, that document had been confiscated along with a number of other personal files during the FBI raids in the spring of 2010. She did not have, nor did her advisors have the benefit of having in their possession an Annuity Agreement that could have implications in the kind of disclosures being made or the testimony being given. Therefore, with the passing of

more than six years and not having physical access to this Agreement, Lynn Smith was left with nothing more than her memory and understanding of what the purpose of the Trust was when it was set up.

Her lack of recollection is further supported by the fact that the Declaration of Trust and the Annuity Agreement were not executed in contemporaneous events. As set forth in Exhibit A of Lynn Smith's Affidavit in opposition to this motion, it is apparent that the Declaration of Trust, which was created for the express intention to benefit their children, Geoffrey and Lauren, was signed by the parties August 4, 2004. The Annuity Agreement on the other hand is effective August 31, 2004 but there is no date as to when Lynn or her husband actually signed this document. As set forth as Exhibit A to Lynn Smith's Affidavit in opposition to this motion is a Policy Delivery Receipt for a Private Annuity Contract that David Smith signed on October 19, 2004. This document suggests that the Annuity Agreement was not received and likely not signed by the Smith's until sometime after October 19th, despite the earlier effective date of the Agreement. Therefore, apart from the fact that these documents were executed more than six years ago, it appears that a total of more than three months likely expired between the executions of the two documents. This substantiates why she did not remember the Agreement or its implication to the Trust. Moreover, it is likely that Lynn Smith would not have remembered the existence of a separate agreement that included future annuity payments because she did not need such payments in order to finance a comfortable retirement. As indicated in Lynn Smith's affidavit, she and her husband's combined wealth in 2004 was more than enough to fund their retirements without the need of additional annuity payments from the Trust.

Finally, Lynn Smith did not have a motive to conceal the Annuity Agreement and the SEC has failed to allege any facts that would remotely suggest that she had a malicious motive. It is undisputed that Lynn Smith continues to have no present interest in the Trust. Thus if the Trust were to have remained outside of the asset freeze, neither she nor her husband would have access to its corpus. Granted, Lynn Smith was able to sell her interests in the Sacandaga Camp to the Trust in exchange for its market value of $600,000 so that she could fund her living expenses and finance accumulating legal fees. However, that sale was for fair consideration and was a single one time event. She does not and never did have any access to the Trust or its proceeds at any time from the date of its creation to the present day.

In fact, the discovery of the Annuity Agreement has always been in her best interest. First, where once she did not believe she had any interest in the Trust, the discovery of the Annuity Agreement has given her a future interest in annual payments if she survives until 2015. The payments to her will not be subject to disgorgement because the monies that funded the Trust have been deemed by this Court to come from an untainted source. MDO I. That portion of the Court's opinion has remained undisturbed from its subsequent opinions and orders.

The discovery of the Agreement also forecloses a very real possibility that she could be the subject of a civil or criminal action from the IRS since she failed to pay gift or capital gains taxes at the time she transferred assets to the Trust. The Agreement served as the instrument which enabled her to avoid the legal obligation to pay those taxes and, without the discovery of that document, she would be liable for enormous

taxes and civil penalties that very well could have consumed the value of her entire stock account.

Since the SEC can offer no direct evidence that Lynn Smith deliberately and in bad faith sought to conceal the existence of the Annuity Agreement or any clear circumstantial evidence that suggests any purposeful wrongdoing, the Court should reject the SEC's Motion for Sanctions as against Lynn Smith under both its inherent authority and Rule 11 (*sua sponte*) jurisdiction.

POINT IV

THE APPLICATION OF THE CRIME FRAUD EXCEPTION.

The SEC has stated in its motion papers that the Court does not need an evidentiary hearing to determine whether or not sanctions are appropriate as to Jill Dunn, L. Smith, D. Wojeski and T. Urbelis. However, as to Lynn Smith's attorney, James Featherstonhaugh, the SEC seeks an evidentiary hearing and further discovery to determine his role in the alleged scheme to conceal the Annuity Agreement. As part of the SEC's application for such relief, it goes one step further by seeking to pierce the attorney/client privilege between Lynn Smith and her attorney. Since Lynn Smith is the holder of the privilege, she objects to such an obtrusive attempt to breach one of the most sacred and oldest of the privileges for confidential communications known to common law. Upjohn Co. v. United States, 449 U.S. 383, 389 (1981).

A. A Determination of the Crime-Fraud Exception is Not Ripe.

Whether an evidentiary hearing is found by this Court to be necessary for Mr. Featherstonhaugh, the SEC's motion to invoke a crime/fraud exception to the attorney/client privilege is not ripe. The attorney-client privilege protects against the

required disclosure of any confidential information given by a client to his attorney during the course of seeking professional legal advice. "Required" implies that for the attorney-client privilege to be invoked, there must be a demand for information by subpoena or other demand sanctioned by the law. A client may not, at least from a technical legal perspective, invoke the attorney-client privilege without first receiving a demand to produce information. Once there is a request for information from an adversary, a client has the privilege to refuse to disclose and/or to prevent another person from disclosing confidential communications between that client and his attorney. For the crime-fraud exception to apply, the SEC will have the burden to first demonstrate that there is probable cause to believe that: (1) a fraud or crime has been committed; and (2) the communications *in question* were in furtherance of the fraud or crime. In re Richard Roe, Inc., 168 F.3d 69, 70 (2nd Cir. 1999) (quoting In re Richard Roe, Inc., 68 F.3d 38, 40 (2nd Cir. 1995). (Emphasis added).

Currently, there is no demand from the SEC for any confidential communications between Smith and Featherstonhaugh and no privilege has been invoked. In other words, there is no justiciable controversy that warrants the Court's determination on this issue presently. Instead the SEC is merely seeking an advisory opinion from this Court as to whether or not the attorney client privilege should apply...should there be a discovery request or an evidentiary hearing concerning Lynn Smith's communications with her attorney. If there is a need for an evidentiary hearing or document discovery, and at that time, the SEC seeks to illicit confidential communications, only then can Lynn Smith invoke her privilege as to the particular communication being solicited at which time the

Court's opinion as to whether the crime-fraud exception applies will be justiciable based upon the particular communication being elicited.

B. If the Crime-Fraud Exception is Applicable, All further Discovery on This Collateral Issue and Any Evidentiary Hearing Should be Postponed Until the End of Trial of the Underlying Matter.

If this Court should presently determine that the crime-fraud exception applies to communications between Lynn Smith and her attorney, Mr. Featherstonhaugh, any subsequent discovery or proceedings contemplated by the SEC against Mr. Featherstonhaugh should be postponed until the end of this litigation in order to ensure Lynn Smith can continue to mount an effective defense in the underlying litigation.

In most cases, the crime-fraud exception is applied during the course of litigation when the protected communication being sought between a defendant and his counsel is integrally intertwined with the underlying claims being made by the party seeking to impose the exception. SEC v. Herman, 2004 U.S. Dist. LEXIS 7829 (S.D.N.Y. 2004) (crime-fraud exception applied to attorney-client communication concerning a private offering that was alleged to be used to defraud investors in an underlying claim of fraud in an SEC action); Sackman v. Liggett Group, 167 F.R.D. 6 (E.D.N.Y. 1996)(crime-fraud exception applies to privileged research documents conducted by cigarette manufacturer that was alleged to be used to mislead the public as to the dangers of smoking). In these cases, the alleged misconduct and the assertion of the privilege are integrally intertwined with the underlying claims of fraud and the evidence derived therefrom can be used in furtherance of those claims.

In the case at bar, the SEC seeks to apply the crime-fraud exception to privileged communications to alleged litigation conduct that is completely unrelated to the SEC's underlying claim for fraud. The distinction is important because the collateral matter the SEC is attempting to litigate for purposes of pursuing sanctions against Mr. Featherstonhaugh does not have to be decided in order for the SEC to continue pursuit of its underlying claims. Thus the SEC will not be prejudiced if the collateral dispute is delayed until the underlying matter is fully litigated and resolved. On the other hand, Lynn Smith's defense of the underlying action could be severely compromised if this Court permits the SEC to proceed in its fact investigation of Mr. Featherstonhaugh on a simultaneous tract. Indeed, it is conceivable that a communication is indisputably a privileged communication as it relates the defense of Lynn Smith in the underlying action but would have to be disclosed pursuant to the crime-fraud exception as to the collateral action against Mr. Featherstonhaugh. In light of the fact that the attorney/client privilege is the most sacred of all confidential communications recognized by common law, Upjohn Co. *supra*, this Court should weigh in on the side of the privilege and permit the collateral action to be suspended until the end of this litigation.

POINT V

THE AMOUNT OF FEES THE SEC IS SEEKING AS A SANCTION AGAINST LYNN SMITH IS SPECULATIVE AND EXCESSIVE AND SHOULD BE REDUCED OR REJECTED ACCORDINGLY.

The SEC is seeking a total of $164,000 in attorney and expert fees that they claim arose from the discovery of the Annuity Agreement. Although Lynn Smith believes that sanctions are not warranted against her, to the extent the Court finds otherwise, it should be extremely skeptical of the SEC's speculative and excessive fees that it seeks to recoup.

The SEC alleges that at least four senior attorneys spent a total of 368 hours researching, preparing and engaging in other legal efforts to re-freeze the Trust in light of the discovery of the Annuity Agreement. It assumes an hourly rate of $500 for three of those attorneys and $325 for the other. They admit that there are no contemporaneous time records but the SEC assures the Court that their estimates "are intended to be conservative estimates."

These estimates should be significantly reduced if not rejected by the Court based on the unreasonableness of the demand. First, reliance of the hourly rate of Mr. Iseman does not reflect the market rates prevailing in Albany and the surrounding areas encompassing the Northern District for attorneys working in the private sector. Any award by this Court for attorney fees should be based on a significantly lower hourly rate. Second, the rates should also be significantly reduced because of the absence of contemporaneous time records. While Courts have the discretion to award attorney fees when such records are absent, it should reduce the demand by a significant percentage due to the lack of any reliable information that substantiates the amount the SEC is seeking. See e.g., Termite Control Corp. v. Horowitz, 28 F.3d 1335 (2nd Cir. 1994). Finally, the demand for reimbursement of expert fees should be rejected since these are fees the SEC would have had to incur regardless of when the Annuity Agreement was discovered based on the complexity and uniqueness of the planning instruments involved.

For these reasons, and for the general unreasonable number of hours the SEC has alleged it has expended on matters dealing with the Annuity Agreement, the Court should reject or significantly reduce any award for attorney fees that it might be entitled to.

POINT VI

THE COURT DOES NOT HAVE DISCRETION TO UNWIND TRANSACTIONS OF THE TRUST IN THE CONTEXT OF THIS SANCTION MOTION.

In addition to its request that this Court impose monetary sanctions, the SEC has also sought the return of any monies expended by the Trust during the period it was not subject to an asset freeze. Presumably, this would include the return of monies that were used by the Trust to purchase the Sacandaga camp, to invest in Geoffrey Smith's new business venture and to pay certain debts of the Trust beneficiaries, Geoffrey and Lauren Smith.

It is submitted that this type of relief is beyond the discretion of the Court in a sanction proceeding since the purpose of imposing sanctions is to deter similar violations by the offender. See e.g. DiPaolo v. Moran, 407 F.3d 140 (3rd Cir. 2005). While courts have wide discretion in tailoring appropriate sanctions based on the circumstances of the case including non-monetary orders, there must be a nexus between the remedy being sought and obtrusive conduct the Court is trying to deter. Id. In this case, the unwinding of the transactions dealing with the camp and Geoffrey Smith's business as well as the transfers to the individual children would have no deterrent value and would have the unintended effect of punishing individuals whose conduct has not been brought into question in the litigation. Moreover, at least as it relates to the purchase of the camp and the investment into Geoffrey Smith's business, the Trust received a valuable consideration for the funds disbursed for these transactions. Since the Trust merely exchanged one asset for the comparable value of another, there is no justifiable basis to disturb either conveyance.

For these reasons, the Court should not impose this remedy as part of the SEC's sanction application.

CONCLUSION

Wherefore, for all of the foregoing reasons, Lynn Smith respectfully requests that the Court deny the SEC's motion in its entirety.

Dated: March 21, 2011

Respectfully submitted,

Featherstonhaugh, Wiley & Clyne, LLP

By:_____

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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, LYNN A. SMITH, GEOFFREY R. SMITH, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04, GEOFFREY R. SMITH, LAUREN T. SMITH, and NANCY McGINN,

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

Defendants,

LYNN A. SMITH and NANCY McGINN,

Relief Defendants, and

GEOFFREY R. SMITH, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04,

Intervenor.

AFFIDAVIT OF DEFENDANT AND RELIEF DEFENDANT LYNN A. SMITH

LYNN A. SMITH, being duly sworn, deposes and says:

1. I respectfully submit this affidavit in opposition to the motion by Plaintiff, Securities and Exchange Commission (the "SEC") seeking an Order for sanctions against me based on allegations that I fraudulently conspired to conceal the existence of an annuity agreement and the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04. The SEC seemingly justifies its application for sanctions, with court approval, based on a

misguided perception that I had an incentive to conceal the disclosure of the annuity agreement since its discovery was allegedly detrimental to my interests. I respectfully disagree with these allegations as well as the Court's belief that I perpetrated a fraud upon the Court.

2. I have reviewed the Court's Memorandum-Decision and Orders dealing with the Trust and related issues which the SEC has referenced in its moving papers as "MDO I" rendered on July 7, 2010, Dkt. 86; "MDO II" rendered on November 22, 2010, Dkt. 194; and "MDO III" rendered on January 11, 2011, Dkt. 254. Based on these opinions, it is apparent to me that your Honor has found little credibility as to my previous testimony and in fact has already determined that I fraudulently concealed the annuity agreement. See MDO II, at 20, n. 17; MDO II, at 6-7. In addition, your Honor has rejected my counsel's explanation as to why I never mentioned or otherwise produced an annuity agreement as being "incredible." MDO II, at 20, n. 17. As a result you have invited the SEC to seek sanctions against me without, until now, giving me an opportunity to provide my side of the story.

3. I am hoping that with the facts presented in this affidavit, I will be successful in persuading your Honor to reconsider your prior findings as it relates to my credibility and hope that you will reject the SEC's efforts to sanction me based on allegations that I intentionally misled the Court by failing to disclose the existence of the annuity agreement.

4. As the Court is well aware, I testified in a deposition and in open court and submitted at least one affidavit in which I stated that the Irrevocable Trust created in 2004 was intended to benefit my children and that neither I, nor my husband, had any

interest in the Trust. During the preliminary injunction hearing, I testified that I never attempted to withdraw money from it or use that account for my own purpose or interest. PI Hearing Transcript, July 7, 2010, p. 392, 2-25; 393, 1-7. My testimony has been entirely consistent in light of the fact that at the time of my Court submissions and testimony, I truly believed that I had no present or future interest in the Trust.

5. I ask the Court to remain mindful of the fact that I did not have access to the annuity agreement since all of my husband's files were confiscated by the federal government in the spring of 2010. Therefore, everything that I produced to the SEC or testified by way of affidavit or in open court was based on my memory and understanding of legal documents that I executed more than six years ago. To this day, I do not recall signing the annuity agreement, although it is clearly my signature on the agreement, and until it was produced in late July 2010 and explained to me by Mr. Featherstonhaugh, I did not recall that this agreement even existed or that I had a future interest in the Trust in the form of annuity payments beginning in 2015.

6. While the Court can deem this testimony as "incredible" in light of the fact that, on paper, the annuity agreement gave me future rights to payments, in the joint amount of $489,932 annually, I believed at the time when I funded the Trust that I retained no interest and my testimony and court filings substantiates that belief. Indeed, there was no agreement that I had in my possession to alter my understanding of the Trust. Therefore, with the passing of more than six years and not having physical access to this agreement, I was left with nothing more than my memory and my understanding of what the purpose of the Trust was for when it was set it up.

7. In 2004, my stock account and other investments were valued at approximately $6,000,000 and my joint net worth was approximately $10 million after I transferred my Charter One stock to initially fund the Trust. I always viewed my stock account along with my other assets and the assets of my husband including his 401K as the sources that would fund our retirement. I never viewed the Trust as being one of those sources. I was genuinely surprised to learn upon the discovery of the annuity agreement that I was now entitled to certain payments from that account beginning in 2015. I have depended on my husband to handle our financial affairs the entire forty-two years of our marriage, and quite frankly, I have never concerned myself with the details of our investments. While my husband discussed our investments with me at the time of making them, I subsequently paid little attention to them, not unlike most wives in my situation. I felt that we were financially secure. I had a high level of confidence and trust in my husband's ability to successfully handle our financial affairs and had little interest in financial concepts that I considered to be terribly complex.

8. What I have learned since the discovery of the annuity agreement is that this was a tool that my husband implemented, with the help of financial experts to avoid capital gains and gift tax liability. This was a perfectly legal tax planning strategy and was particularly useful at a time when a large percentage of my stock was being sold and converted to cash. My husband's motive was to avoid these large tax consequences and to maximize the value of the asset for the benefit of our children not to create a future funding source for our individual retirement interests.

9. It appears to me that the Trust Indenture and the Private Annuity Agreement were executed on different dates. The Trust being executed by my husband

and I together on August 4, 2004 in the presence of a Notary and the annuity agreement being signed on some unspecified date subsequent to October 14, 2004, likely in the presence of my husband alone. I make this statement based on my review of the policy delivery receipt annexed hereto and made a part hereof as deponent's Exhibit A. I have no current recollection of any discussion or explanation of the annuity agreement prior to my testimony, nor can I think why I would have connected it to the Declaration of Trust which I had signed months earlier. In addition, I am quite sure that I had no discussions with anyone about any annuity agreement from 2004 until it was initially mentioned in connection with this litigation. I cannot understand why anyone would have expected me to remember the annuity agreement without prompting.

10. I did not know what a private annuity trust was and never heard of such a Trust until this litigation. I was under the impression that what I created in 2004 was an irrevocable trust over which neither I nor my husband had any interest. Therefore, I had no reason to believe there were any other documents in my custody or anybody else's custody which would give rise to my having a contractual interest in the Trust.

11. In realty, the discovery and disclosure of this agreement was and is completely in my interest and there would never have been any reason for me to have concealed its existence. As I have come to learn, the annuity agreement was the vehicle that was used to avoid the taxable events that would have occurred had the stock I used to fund the Trust been merely gifted. In fact, I have everything to gain personally from the existence of the annuity agreement because although I still have no interest in the irrevocable Trust, I clearly have a contractual right to future payments well into my retirement years which I believe, based on this Courts findings concerning the source of

the funds, will never be subject to disgorgement even if the SEC is successful in its claims against my husband.

12. On the other hand, I had no incentive to conceal the annuity agreement. During the preliminary injunction hearing, Ms. Dunn defended the Trust from being included in the asset freeze. I provided an affidavit at the request of the new Trustee, David M. Wojeski, dated May 21, 2010, which was notarized by Ms. Dunn and stated, based on my belief at that time, that I did not have any interest in the Trust and that it was set up to benefit my children. Dkt. 34. While the discovery of the annuity agreement provides me with a contractual right which may or may not choose to exercise in 2015, depending on my circumstances, it does not alter the purpose of the trust.

13. After the Court released the Trust from the asset freeze as a result of its July 7, 2010 decision, I sold my Sacandaga camp to the Trust in an arms length transaction to fund legal fees and living expenses. Even though I received money from the Trust in exchange for the market value of the camp, I never believed that I could access that Trust for my own pecuniary interest regardless of whether its assets were frozen or not.

14. The discovery of the annuity agreement is a relief to me even though it resulted in the re-freezing of the Trust assets.

15. Accordingly, I affirm in this affidavit that I did not intentionally conceal this agreement and I did not conspire with any other party including my husband, Mr. Featherstonhaugh, Ms. Dunn, Mr. Urbelis or Mr. D'Aleo to conceal this agreement. I also affirm that I did not intentionally give false statements under oath but rather gave honest testimony that was to the best of my knowledge at that time.

16. I respectfully request the Court to deny the SEC's motion for sanctions against me.

LYNN A. SMITH

Sworn to before me this 21st
day of March, 2011.

Notary Public – State of New York

Christine E Reed
Notary Public - State of New York
No. 01RE6117531
Qualified in Schenectady County
My Commission Expires October 25, 2012

Exhibit A

Policy Delivery Receipt

PRIVATE ANNUITY CONTRACT

Annuitant(s): David L. & Lynn A. Smith

Contract Date: August 31, 2004

Face Amount: $4,447,000

Rate: 4.6%

I acknowledge that I received the above number contract certificate on the date of this receipt.

Owner's Signature _____ Date 10/1/04

Agent's Signature _____