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.

NOTICE OF OBJECTIONS

Notice is hereby given that, pursuant to 28 U.S.C. §636(B) (1), Rule 72(a) and (b), Fed. R. Civ. P., and Local Rule 72.1(a) and (b), Relief Defendant/Defendant Lynn A. Smith objects and appeals to the United States District Court for the Northern District of New York (Hon. Gary L. Sharpe, *U.S.D.J.*) from the Memorandum-Decision and Order issued by United States Magistrate Judge David R. Homer filed on July 20, 2011 (Dkt. No. 342), and upon all prior proceedings and filings herein, Defendant/Relief Defendant

Lynn A. Smith will move on Thursday, September 15, 2011, at 9:00 a.m., or at any other date convenient to the Court, before the United States Magistrate Judge, United States District Court for the Northern District of New York, 445 Broadway, Albany, New York.

Dated: August 3, 2011

Featherstonhaugh, Wiley & Clyne, LLP

By: s/ James D. Featherstonhaugh
Bar Roll No. 101616
Attorneys for Relief Defendant/Defendant Lynn A. Smith
99 Pine Street
Albany, New York 12207
Tel: (518) 436-0786

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.

RELIEF DEFENDANT/DEFENDANT, LYNN A. SMITH'S OBJECTIONS TO MAGISTRATE JUDGE DAVID R. HOMER'S JULY 20, 2011 MEMORANDUM-DECISION AND ORDER AND MEMORANDUM OF LAW IN SUPPORT OF OBJECTIONS

Featherstonhaugh, Wiley & Clyne, LLP
Attorneys for Relief Defendant/Defendant
Lynn A. Smith
Albany, New York 12207
Tel. No.: (518) 436-0786

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page

Cases

Statutes and Rules

PRELIMINARY STATEMENT

Pursuant to 28 U.S.C. §636(b)(1), Rule 72(a) and (b) of the Federal Rules of Civil Procedure, and Local Rule of Practice 72.1 for the United States District Court for the Northern District of New York, Relief Defendant/Defendant Lynn Smith respectfully submits this memorandum of law in support of Relief Defendant/Defendant's objections to the Magistrate Judge David R. Homer's Memorandum-Decision and Order dated July 20, 2011 ("Order") which granted the Securities and Exchange Commission's ("SEC" or "Commission") February 1, 2011 motion for sanctions[1] against Mrs. Smith and ordered her to disgorge $996,080[2] by September 1, 2011. (Dkt. No. 342).

As set forth below, the Order should be reversed or revised because it is contrary to law in three significant respects: First, the Magistrate's Order erroneously concluded that Lynn Smith acted with subjective bad faith in failing to disclose the existence of the Annuity Agreement in her Statement of Net Assets (Dkt. No. 19). Pursuant to Paragraph V of the April 20, 2010 Order to Show Cause, Temporary Restraining Order, and Order Freezing Assets and Granting Other Relief ("Paragraph V"), Lynn Smith had three days to file with the Court specific information concerning her accounts at banks, brokerage firms or financial institutions under her direct or indirect control. (Dkt. No. 5). In compliance with Paragraph V, Mrs. Smith filed a Statement of Net Assets (Dkt. No. 19) that disclosed all information required by the Court and available to her. Mrs. Smith's Statement of Assets complied with the specific terms of Paragraph V. Mrs. Smith never retained physical possession of the Annuity Agreement and there is no evidence in the

[1] Dkt. No. 261.

[2] The Magistrate's July 20, 2011 Order orders Lynn Smith to disgorge to the Receiver on behalf of the Trust a total of $944,848 jointly and severally with Dunn and Wojeski to the limited extent set forth in the Order, and pay the SEC a total of $51,232 for attorneys' fees and costs incurred by the SEC. (Dkt. No. 342 at 50).

Record to substantiate any finding that Lynn Smith intentionally or deliberately withheld information concerning her share of a future annuity which she may or may not receive beginning in 2015.

Second, the Magistrate's Order erroneously concluded that Lynn Smith should be subject to sanctions for "falsely asserting that the trust was created by she and David Smith solely for the benefit of their children." (Dkt. No. 342 at 13). It is uncontroverted that the express terms of the David L. and Lynn A. Smith Irrevocable Trust ("Trust" or "Irrevocable Trust") states that "[t]he Donors [David Smith and Lynn Smith] have two (2) children, Geoffrey R. Smith and Lauren T. Smith. This Trust is created for the benefit of the Donors' children and their issue." (Dkt. No. 32-1). Neither David nor Lynn Smith are beneficiaries of the Irrevocable Trust. Pursuant to the express terms of the Trust and New York's Estates, Powers and Trusts Law, it is unambiguous that the Irrevocable Trust – an independent legal entity – was created by David Smith and Lynn Smith for the benefit of their two children. The Annuity Agreement is a wholly separate and distinct contract that is governed not by New York's Estates, Powers and Trusts Law but by the law of contracts. Lynn Smith's statement that the Irrevocable Trust was created solely for the benefit of her two children – the only two named beneficiaries – is supported both by the language of the Irrevocable Trust and New York's Estates, Powers and Trusts Law.

Third, the Magistrate's Order erroneously concluded that Lynn Smith "falsely denied that she and David Smith had any ongoing interest in the Trust." (Dkt. No. 342 at 13). The Magistrate's Order wrongly construed the Irrevocable Trust and the Annuity Agreement as indistinguishable documents. This conclusion is neither supported in law

nor fact. The language of the Annuity Agreement establishes Lynn Smith as an independent annuitant creditor and does not vest any "ongoing interest" in the Irrevocable Trust in any manner. As a matter of law, the "determining characteristic of an annuity is that the annuitant has an interest only in the payments themselves and not in principal fund or any source from which they may be derived." *In re Lynch*, 321 B.R. 114, 118 (Bankr. S.D.N.Y. 2005), citing, *Commonwealth v. Beisel*, 338 Pa. 519, 521 (Pa. 1940). Lynn Smith's Annuity Agreement provides her only a contract right to possible fixed future payments should she survive – a contract right that that does not bestow any interest in any manner in the Irrevocable Trust. As such, the Record does not support the Magistrate's conclusion that Lynn Smith "falsely denied that she and David Smith had any ongoing interest in the Trust." (Dkt. No. 342 at 13). Because the Magistrate's Order is founded in the erroneous conclusion that Lynn Smith possesses an "ongoing interest in the Trust"[3] the Order for sanctions against Lynn Smith is contrary to law.

STATEMENT OF FACTS

This action was commenced by the Plaintiff, Securities and Exchange Commission ("Commission" or "SEC") by the filing of a Summons, Complaint, Order to Show Cause, and related papers on April 20, 2010 against seven corporate defendants and two individual defendants alleging violations of the Securities Act of 1933, the Securities Act of 1934, the Investment Advisors Act of 1940, and the Investment Company Act of 1940.[4] The Commission's Complaint also named Lynn Smith as a Relief Defendant alleging that she has received and retained ill-gotten gains from Defendants' alleged fraud. (Dkt. No. 1). Simultaneously on April 20, 2010, the District

[3] Dkt. No. 342 at 13.

[4] Prior to its April 20, 2010 filing, the SEC did not issue a Wells Notice notifying the parties that it intended to recommend enforcement proceedings be commenced.

Court issued an Order to Show Cause, Temporary Restraining Order, and Order Freezing Assets and Granting Other Relief that, among other things, froze the Relief Defendant's assets and directed the Relief Defendant to provide verified accounts.

On April 29, 2010, the Relief Defendant filed a Statement of Net Assets pursuant to Part V of the Temporary Restraining Order. (Dkt. No. 19). On May 21, 2010, Lynn Smith submitted an affidavit in which she stated that "[i]n August 2004, to provide security for my children's future apart from my stock account, my husband and I created the David L. Smith and Lynn A. Smith Irrevocable Trust. My children were adults, had completed college, and could begin making financial decisions on their own. I alone personally funded this irrevocable trust by transferring 100,000 shares of Charter One Financial Inc. stock from my stock account to the trust's account. This irrevocable trust had been managed since its inception by Tom Urbelis, a longtime friend." (Dkt. No. 23). Also on May 21, 2010, Lynn Smith, at the request of the Irrevocable Trust which was seeking to intervene in the action, signed an affidavit in which she 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." (Dkt. No. 34).

On July 7, 2010, the Magistrate issued a Memorandum-Decision and Order ("MDO I") (Dkt. No. 86) that froze certain of Mrs. Smith's assets. The Magistrate released from the asset freeze Mrs. Smith's Great Sacandaga Lake camp which she inherited from her father in 1969. Also in the July 7, 2010 Order, the Magistrate held that the assets of the Irrevocable Trust should also not remain frozen since the stock that funded the Trust in 2004 was untainted and severable from the rest of Mrs. Smith's stock

account, and that there was no evidence that David Smith possessed a beneficial ownership in the Trust.

Following the decision of MDO I, the SEC filed an Emergency Motion for Temporary Restraining Order to re-freeze the Trust (Dkt. No. 103) based upon the discovery of an annuity agreement which it obtained from the original Trustee of the Trust. This Annuity Agreement was entered into by the Irrevocable Trust and David and Lynn Smith and contractually obligated the Irrevocable Trust to pay Lynn and David Smith an annuity payment of $489,932 beginning in 2015, of which Lynn Smith's share was to be one-half or $244,966. In an Order dated August 3, 2010 (Dkt. No. 104), the Magistrate 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 Annuity Agreement but failed to produce it or refer to it in her sworn testimony. (Dkt. No. 103). At no point in time did Lynn Smith retain physical possession of the Annuity Agreement. The Record shows only that Lynn Smith signed the Annuity Agreement in 2004, sometime after October 14 when it was presented to her for signing by her husband some two plus months after she had executed the Trust Agreement.

Prior to ruling on the SEC's motion, the Magistrate held an evidentiary hearing to consider testimony concerning a telephone call that took place on July 22, 2010 between the Trust's previous attorney Jill Dunn and two SEC attorneys wherein it was alleged that Ms. Dunn disclosed the existence of the Annuity Agreement. The SEC argued that it was this telephone call that led to the discovery of the Annuity Agreement on July 27, 2010 when it was prompted to contact Mr. Urbelis and request the document. Since the

Magistrate deemed the issue as to timing and discovery of the Contract germane to the SEC's Motion for Reconsideration, the Magistrate ordered an evidentiary hearing to determine the credibility of both parties concerning the substance of this telephone call. (Dkt. No. 150). That hearing took place on November 16, 2010.

On November 22, 2010 the Magistrate granted the SEC's Motion for Reconsideration and "re-froze" the Trust's assets on the grounds that David Smith possessed an equitable and beneficial ownership interest in the Trust based on the Annuity Agreement. (Dkt. No. 194) ("MDO II"). The Magistrate, *sua sponte*[5], also found in the alternative that reconsideration was warranted under FRAP § 60(b)(3). In addition to granting the SEC's motion on reconsideration, the Magistrate also granted the SEC leave to move for sanctions against several individuals, including Lynn Smith, for failing to disclose the Annuity Agreement. (MDO II at 24). On January 31, 2011, the SEC accepted the Magistrate's invitation in MDO II and moved for sanctions against Lynn Smith. On July 20, 2011, the Magistrate issued a Decision and Order which held, among other things, that Lynn Smith acted with subjective bad faith in failing to disclose the Annuity Agreement and ordered Mrs. Smith to disgorge $996,090 by September 1, 2011. (Dkt. No. 342).

ARGUMENT

Objections to a magistrate judge's ruling on a motion for sanctions should be sustained when the district judge, upon independent review of the merits, determines that any portion of the order is "of clear error or contrary to law." Fed. R. Civ. P. 72(a); 28

[5] The Court in MDO II indicated that "the SEC also seeks reconsideration under FRCP 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.

U.S.C. §636(b)(1)(A). Relief Defendant/Defendant Lynn Smith respectfully submits that, with respect to his ruling that "the SEC has demonstrated by clear and convincing evidence that Lynn Smith acted with subjective bad faith in failing to disclose the existence of the Annuity Agreement in the Statement of Assets (Dkt. No. 19), her affidavit (Dkt. No. 34), and in her testimony at her deposition and evidentiary hearing," the Magistrate Judge's Order is of clear error and contrary to law.

POINT I

The Magistrate's Sanction Order Is Contrary To Law In That The Record Is Void Of Any Proof That Lynn Smith Deliberately Failed To Disclose The Annuity Agreement In Her Statement Of Net Assets.

A finding of subjective bad faith requires proof of intentional or deliberate misconduct. *United States v. Pangburn*, 983 F.2d 449, 454 (2nd Cir. 1993). "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 a sanctioning court. 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." *Podany v. Stephens*, 318 F. Supp.2d 146, 154 (S.D.N.Y. 2004).

Paragraph V of the April 20, 2010 Order to Show Cause, Temporary Restraining Order, and Order Freezing Assets and Granting Other Relief stated that:

> "IT IS FURTHER ORDERED that Individual Defendants and Relief Defendant shall file with the Court and serve on the Commission, within three (3) business days following service of this Order, a list of all accounts at all banks, brokerage firms or financial institutions (including the name of the financial institution and the name and number on the account), tax identification numbers, telephone or facsimile transmission numbers (including numbers of pagers and mobile telephones), electronic mail addresses, World Wide Web sites or Universal Records Locators, Internet bulletin board sites, online interactive conversational spaces or chat rooms, Internet or electronic mail service providers, street addresses, postal box numbers, safety deposit boxes, and storage facilities used or maintained by them or under their direct or indirect control, at any time from January 1, 2005 to the present including but not limited to information concerning MS Entities, including but not limited to, those entities listed on Exhibit A.[6]

Dkt. No. 5, Paragraph V.

In order to submit a timely response to the Court's Order, Mrs. Smith gathered all available information concerning her accounts and worked with a CPA to set forth a detailed Statement of Net Assets under her direct and indirect control as of January 1,

[6] Exhibit A set forth a 2 page "List of Known Entities Controlled By McGinn and/or [David] Smith."

2005. (Dkt. No. 19). Notwithstanding that the plain language of Paragraph V does not envisage the disclosure of a possible future annuity based upon a contract entered into in 2004, there is an absence of any proof in the Record that Mrs. Smith intentionally or deliberately failed to disclose the Annuity Agreement in her Statement of Assets. Mrs. Smith responded in good faith on short notice and filed with the Court and the SEC a list of all her accounts at banks, brokerage firms or financial institutions. There is no proof in the Record that Lynn Smith retained, or ever had, physical possession of the Annuity Agreement other than for the brief time necessary to execute it in 2004 or that she intentionally excluded it from her Statement of Net Assets for improper purposes. Based on the Record, not only was the Annuity Agreement not contemplated by the Court in Paragraph V, there is no degree of specificity (other than mere speculation) that its exclusion was for an improper purpose. It is clear error to find that the SEC has demonstrated by clear and convincing evidence that Lynn Smith acted with subjective bad faith in failing to disclose the existence of the Annuity Agreement in the Statement of Assets. Consequently, this Court should sustain Mrs. Smith's objections to the Magistrate's Order.

POINT II

The Magistrate's Sanction Order Is Contrary To Law In That The Language Of The Irrevocable Trust Clearly States That It Was Created For The Benefit of Lynn Smith's Children.

It is well established under New York's Estates, Powers and Trusts Law ("EPTL") that a trust creates a fiduciary relationship in which the trustee holds legal title to specific property under a fiduciary duty to manage, invest, and safeguard the trust assets for the benefit of designated beneficiaries, who hold legal title. EPTL Art. 7. A

trust may be created for any purpose that is not illegal or contrary to public policy. EPTL §7-1.4. New York is a state with rigid formalities, and as such, in order for a trust to be valid it must be in writing, signed by the settelor and the trustee and acknowledged by a notary public. §7-1.17 EPTL. In this matter, the Irrevocable Trust is valid and its language is clear in that the second paragraph definitively states that:

> **The Donors have two (2) children, Geoffrey R. Smith and Lauren T. Smith. This Trust is created for the benefit of the Donors' children and their issue.**

Dkt. No. 32-1.

Each statement made by Lynn Smith in her two affidavits, in her deposition testimony, and in her testimony at the June 9-11, 2010 preliminary injunction hearing stating that the Irrevocable Trust was created for the benefit of her two children are consistent with the express terms of the Irrevocable Trust. The Irrevocable Trust was created for the benefit of her two children – the Trust's two named beneficiaries. However, in complete contrast to the express language of the Trust, the Magistrate's July 20, 2011 Order disregards the EPTL and the express terms of the Irrevocable Trust and interprets the Irrevocable Trust and the Annuity Agreement as indistinguishable. This conclusion is of clear error and contrary to law.

Moreover, a reading of the Trust agreement, which has been in the possession of the SEC from the earliest stages of this action, shows that it authorizes the Trustee "[t]o purchase property from the Donors in exchange for a private annuity agreement." (Trust Paragraph SIXTH (10)). The SEC, with its staff of attorneys and experts, never once asked Mrs. Smith a single question regarding this paragraph. Mrs. Smith is not a lawyer. Mrs. Smith is not trained in reading substantive documents and discerning the narrow

import of words as lawyers are trained to do. The SEC simply proffered broad brush questions upon which Lynn Smith's inability to respond with an answer disclosing the existence of the Annuity Agreement is incredulously deemed by the Order as demonstrative of clear and convincing evidence that she acted with subjective bad faith. To be sure, the Magistrate cites the following broad questions by the SEC and the subsequent answers by Lynn Smith as a basis for his sanction Order:

> Q. So, the trust was created, you would agree, for your children not for you and your husband?
> A. Exactly.

Dkt. No. 342 at 14 citing Dkt. No. 46-3 at 40.

> Q. Did you believe any time after September 1, 2004, when you transferred this stock, at any time did you believe that the money in the irrevocable trust account was yours?
> A. No.

Dkt. No. 342 at 14 citing T. 392.

As a matter of law, Mrs. Smith's testimony reflects the legally binding language of the Irrevocable Trust and there is no substantive evidence in the Record to the contrary. The Magistrate's decision seems to imply some kind of "Brady" like obligation on Mrs. Smith's part to come forward and discuss the Annuity Agreement regardless of whether or not counsel for the SEC thought to inquire about it. As a matter of law, no such obligation exists. The plain language of the Irrevocable Trust states that it was created for the benefit of the Donors' children, Geoffrey and Lauren Smith, and their issue. Contrary to the Magistrate's Order, the Irrevocable Trust and the Annuity Agreement are wholly separate and distinct. A trust is a separate legal entity. A contract is a contract. If sophisticated securities lawyers trained in analyzing documents and

discerning their legal nuances were unable or uninterested in asking a single question regarding the Annuity Agreement, an untrained homemaker such as Mrs. Smith, who relied on her stockbroker husband for managing her finances, should not be subjected to severe sanctions based upon the Record before this Court. The Magistrate finds it "impossible" for Mrs. Smith to have forgotten about a document she apparently saw once briefly in 2004, did not have in her possession, and was not reminded of at any point. One cannot help but wonder if the Magistrate should find it "impossible" to believe that over the course of in excess of six hours of trial and deposition testimony, counsel for the SEC, in possession of the August 4, 2004 letter from David Smith to Thomas Urbelis referring to the "Private Annuity Trust" and the Trust Agreement itself which in paragraph SIXTH (10) empowers the trustee "to purchase property from the donors in exchange for a private annuity payable to the donor," NEVER asked one question about an annuity. As between the lawyer and the housewife it seems unduly harsh to blame the housewife for the lawyer's neglect. The Record does not support the Magistrate's finding of subjective bad faith based upon intentional or deliberate misconduct. Consequently, this Court should sustain Mrs. Smith's objections to the Magistrate's Order.

POINT III

The Magistrate's Sanction Order Is Contrary To Law In That Lynn Smith Does Not Possess An Ongoing Interest in the Trust.

In finding that "Lynn Smith...falsely denied that she and David Smith had any ongoing interest in the Trust" the Magistrate erroneously construed the Annuity Agreement in such a way as to disregard its independent contractual nature deem it as one and the same with the Irrevocable Trust. (Dkt. No. 342).

The Annuity Agreement establishes Lynn Smith as an independent annuitant creditor. As a matter of law, the "determining characteristic of an annuity is that the annuitant has an interest only in the payments themselves and not in principal fund or any source from which they may be derived." *In re Lynch*, 321 B.R. 114, 118 (Bankr. S.D.N.Y. 2005), citing, *Commonwealth v. Beisel*, 338 Pa. 519, 521 (Pa. 1940). Lynn Smith is not a beneficiary of the Irrevocable Trust and the Annuity Agreement provides her only a contract right to possible fixed future payments should she survive – a contract right that, contrary to the Magistrate's findings in support of his sanctions Order, does not bestow upon her any "ongoing interest in the Trust."

When parties to a contract have set down their agreement in a clear and complete document, the document should, as a rule, be enforced according to its terms. *Henrich v. Phazar Antenna Corp.*, 33 A.D.3d 864 (N.Y. App. Div. 2d Dep't 2006). Such agreements must be read as a whole and interpreted to give effect to their general purposes without undue emphasis on particular words and phrases, as the meaning of the agreement may be distorted where undue emphasis is given to certain words or phrases and not others. *Westmoreland Coal Co. v. Entech, Inc.*, 100 N.Y. 2d 352, 358 (N.Y. 2003). A court may not rewrite into a contract conditions the parties did not insert by adding or excising terms under the guise of construction, nor may it construe the language in such a way as would distort the contract's apparent meaning. *Slamow v. Delcol*, 174 A.D.2d 725, 727 (N.Y.App. div. 2d Dep't 1991), *aff'd* 79 N.Y.2d 1016 (N.Y. 1992). Neither the terms of the Annuity Agreement nor the terms of the Trust establish an "ongoing interest in the Trust" for Lynn Smith. Any conclusion to the contrary is contrary to law.

The clear and complete terms of both the Annuity Agreement and the Irrevocable Trust confirm that Lynn Smith does not possess an ongoing interest in the Trust. It is the substance of the law rather than the Magistrate's erroneous conclusions that preclude Lynn Smith from being sanctioned pursuant to the Record in this matter. The law is clear. As an annuitant, Lynn Smith has only a contract right in possible future annuity payments themselves and not in the principal fund or source from which they may be derived – namely the Trust. An annuity agreement does not spring to life an "ongoing interest" in a trust and both the Trust document and the Annuity Agreement are void of any language supporting the Magistrate's conclusion that Lynn Smith has an "ongoing interest in the Trust." Because the Magistrate concluded that the Annuity Agreement vested an ongoing interest in the Trust, the Order for sanctions as to Lynn Smith is contrary to law. Consequently, this Court should sustain Mrs. Smith's objections to the Magistrate's Order.

POINT IV

The Magistrate's Order Is Contrary To Law In That It Imposes the Remedy Of Disgorgement Which Is Not A Proper Remedy.

The Order erroneously imposes the remedy of "disgorgement" upon the Lynn Smith. Specifically, the Order requires the Lynn Smith to "disgorge to the Receiver on behalf of the Trust a total of $944,848..." It is well established that the primary purpose of disgorgement is to force a defendant to give up the amount he or she was unlawfully enriched following the determination by a district court that a party has violated federal securities laws. *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1474 (2nd Cir. 1996). *See also, SEC v. Seibald*, 1997 WL 605114 (S.D.N.Y Sept. 30, 1997); *SEC v. Blue Bottle*

Ltd., 2007 U.S. Dist. LEXIS 95992 (S.D.N.Y. 2007), *citing*, *SEC v. Patel*, 61 F.3d 137 (2nd Cir. 1995).

Each and every decision relied upon by the Magistrate to support his July 20, 2011 disgorgement Order against the Lynn Smith concerns defendants subject to disgorgement as a remedy for being found guilty of violating federal securities laws. To be sure, *SEC v. China Energy Sav. Tech., Inc.*, No. 06-CV-6402 (ADS)(AKT), 2008 WL 6572372 (E.D.N.Y. Mar. 28, 2008) requires defendants found to have violated federal securities laws to disgorge over $29 million; *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450 (2nd Cir. 1996) upheld a disgorgement order from the United States District Court for the Southern District of New York against certain defendants found by the District Court to have violated federal securities laws; *SEC v. Posner*, 16 F.3d 520 (2nd Cir. 1994) upheld a disgorgement order from the United States District Court for the Southern District of New York against two defendants found by the District Court to have violated federal securities laws; *SEC v. Robinson*, No. 00 Civ. 7452, 2002 WL 1552049, at *7 (S.D.N.Y. July 16, 2002) concerns a magistrate's recommendation that a defendant found guilty of violating federal securities law pursuant to a default judgment be required to disgorge $420,000; *SEC v. McCaskey*, No. 98 Civ. 6153, 2002 WL 850001, at *4 (S.D.N.Y. Mar. 26, 2002) concerns a magistrate's recommendation that a certain defendant found guilty of violating federal securities laws be subject to a civil penalty and not an order of disgorgement.

The Magistrate's July 20, 2011 Order concluded that the Lynn Smith acted with subjective bad faith in failing to disclose the existence of the Annuity Agreement. (Dkt. No. 342 at 19-20). However the remedy imposed by the Order is contrary to law in two

critical aspects. First, contrary to every case cited by the Magistrate, the Lynn Smith was not found guilty of violating any federal securities laws. Moreover, the Lynn Smith is not even alleged to have violated any federal securities laws. Consequently, his Order requiring her to "disgorge" $944,848 is an erroneous remedy as a matter of law and fact.

Second, contrary to the underlying basis for the Magistrate's disgorgement and sanctions Order, the clear language of the Annuity Agreement establishes defendant David Smith and the Relief Defendant/Defendant as independent annuitant creditors. (Dkt. No. 103-3). The Annuity Agreement does not establish them as beneficial and equitable owners of the Trust or grant them any power to exercise any authority or control over the Trust's principal. *Id.* As a matter of law, the "determining characteristic of an annuity is that the annuitant has an interest only in the payments themselves and not in principal fund or any source from which they may be derived." *In re Lynch*, 321 B.R. 114, 118 (Bankr. S.D.N.Y. 2005), citing, *Commonwealth v. Beisel*, 338 Pa. 519, 521 (Pa. 1940). An annuity contract provides an annuitant only a contract right to possible fixed future payments should the annuitant survive – a contract right that that does not bestow beneficial and equitable ownership or any property rights in an annuities principal.

As a matter of law, it is clear error to order the remedy of disgorgement against a party who has neither been found guilty of violating federal securities laws nor is alleged to have violated such laws. Consequently, this Court should sustain the Trust's objections to the Magistrate's Order.

CONCLUSION

For each of these reasons, this Court should sustain Relief Defendant/Defendant's objections to the Magistrate Judge's July 20, 2011 Order granting the SEC's motion for sanctions against Lynn Smith.

DATED: August 3, 2011

Respectfully submitted,

Featherstonhaugh, Wiley & Clyne, LLP

By: s/ James D. Featherstonhaugh
Bar Roll No. 101616
Attorneys for Relief Defendant/Defendant Lynn A. Smith
99 Pine Street
Albany, New York 12207
Tel: (518) 436-0786

TO: David Stoelting
Securities and Exchange Commission
Attorney for Plaintiff
3 World Financial Center, Room 400
New York, NY 10281
stoeltingd@sec.gov

Kevin McGrath
Securities and Exchange Commission
Attorney for Plaintiff
3 World Financial Center, Room 400
New York, NY 10281
mcgrathk@sec.gov

William J. Dreyer
Dreyer Boyajian LLP
Attorneys for David L. Smith
75 Columbia Place
Albany, New York 12207
wdreyer@dreyerboyajian.com

E. Stewart Jones, Jr.
E. Stewart Jones Law Firm

Attorneys for Timothy M. McGinn
28 Second Street
Troy, New York 12181
esjones@esjlaw.com

Nancy McGinn
29 Port Huron Drive
Schenectady, NY 12309
nemcginn@yahoo.com

William Brown, Esq.
Phillips Lytle LLP
Attorneys for Receiver
3400 HSBC Center
Buffalo, N.Y. 14203
WBrown@phillipslytle.com