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,

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.

Case No.: 1:10-CV-457

(GLS/DRH)

REPLY MEMORANDUM TO PLAINTIFF'S OPPOSITION OF DAVID L. SMITH'S MOTION TO MODIFY THE ASSET FREEZE TO PERMIT THE RELEASE OF THE IRREVOCABLE LIFE INSURANCE TRUST

In reply to the SEC's Opposition to David L. Smith's Motion to Modify the Asset Freeze to Permit the Release of the Irrevocable Life Insurance Trust, dated May 9, 2012, David L. Smith asserts the following:

ARGUMENT

I. A LOAN AGAINST A LIFE INSURANCE POLICY IS PROTECTED FROM CREDITORS BECAUSE LYNN SMITH DOES NOT OWN THE TRUST BUT IS MERELY A NAMED BENEFICIARY.

The proceeds within an irrevocable life insurance trust are protected from creditors, including the policy's cash surrender and loan values. *See Schwartz v. Seldon*, 153 F.2d 334 (2d Cir. 1945), N.Y. INS. LAW § 3212(a)(1) (McKinney 2006 & Supp. 2012). The proceeds and avails of the life insurance policy are not owned by the beneficiaries, but rather by the trust itself as a separate entity. "[T]he term proceeds [refers] to the cash surrender value to which the owner of the policy would be entitled while alive and not the funds payable to the beneficiary on death of the owner." *In re Rundlett*, 153 B.R. 126, 130 (S.D.N.Y. 1993) (internal citations omitted). Therefore, "the creditors of a beneficiary who is not also the owner of an insurance policy cannot attach the policy's surrender value because the beneficiary has no interest in the surrender value and only an inchoate interest in the death benefit proceeds." *Id.*

Mr. Smith is seeking permission from this Court to permit the primary beneficiary of the irrevocable life insurance trust ("insurance trust"), Lynn Smith, to seek a loan of the cash surrender value of approximately $161,000. See Dkt. No. 484-2, at ¶¶ 17-18. This amount should not be considered an asset subject to the reach of a judgment creditor as the policy proceeds of the insurance trust are not being cashed out, there is no intention to terminate the trust or the policy, and Lynn Smith is only seeking loan monies from an asset that is statutorily beyond the reach of creditors. Furthermore, the insurance trust is not a defendant in this action

and the sought application is being disclosed to both the SEC and the Court without any intent to defraud creditors.

II. THE TRUSTEE HAS THE SOLE DISCRETION TO PROVIDE FUNDS FOR THE SUPPORT AND MAINTENANCE OF THE BENEFICIARIES.

The SEC's argument that David Smith is using Lynn Smith as a "pass-through" to use the irrevocable trust for himself rather than the beneficiaries is misplaced. See Dkt. No. 487, p. 2. It is not disputed that when the insurance trust was created, Mr. Smith transferred and assigned his right, title and interest in the insurance policy to the Trustee; however, the determination of issuing funds for the well-being, comfort, and support of the beneficiaries is within the Trustee's discretion, and not a determination that can be made by this Court. See Dkt. No. 482-2, Ex. B.

Although it is not for either party to decide, it is asserted that there are obvious benefits to the beneficiaries if the loan moneys are used towards retaining counsel of choice for Mr. Smith's criminal defense. It is advanced that it is in the best interests of the beneficiaries that Mr. Smith obtain competent legal counsel so that he may be properly defended in his parallel criminal case and should he prevail, not only will there be clear emotional benefits to the beneficiaries, but also financial benefits in Mr. Smith avoiding any criminal penalties and returning to the workplace.

III. THE TRUST AGREEMENT PROVIDES FOR ALTERNATIVE OPTIONS FOR ISSUING LOANS.

The trust agreement provides the Trustee, as the absolute owner of the policy, the right to borrow upon the policy and to pledge the funds for loans. See Dkt. No. 482-2, Ex. B., pp. 9, 14. The options available to the Trustee include: (1) obtaining a loan and providing the funds directly towards Mr. Smith's criminal defense, (2) permitting the other beneficiaries of the insurance trust to obtain a loan against the policy, and (3) loaning funds directly to David Smith.

While it is averred that Lynn Smith may apply for a loan against the cash surrender value of the policy and those funds, if released, are unreachable by creditors; the trust agreement provides for other permissible ways for a loan to be obtained. Should the Court find otherwise, the Trustee may instead provide the loan monies directly to Dreyer Boyajian LLP for Mr. Smith's criminal defense or, Geoffrey Smith and Lauren Smith, as the additional beneficiaries of the insurance trust, may apply to the Trustee for a loan. David Smith may also apply; however, this should be considered a last resort as he may be subject to additional interest charges as provided by the terms of the trust agreement.

IV. THE SEC HAS FAILED TO MEET ITS BURDEN UNDER *MONSANTO* IN MAKING A PROBABLE CAUSE SHOWING THAT THE REQUESTED FUNDS ARE TRACEABLE TO ANY ALLEGED FRAUD.

The SEC has not advanced that the proceeds of the insurance trust are related to any alleged fraud as it undisputed that the policy was purchased in 1984 and the trust was created in 1989, well in advance of any of the allegations at issue in this matter. See Dkt No. 482-2, ¶ 7, Dkt. No. 487, pp. 2-3. Moreover, this Court has previously reviewed the documents related to the insurance trust and found that it "contain[s] no indication that [it was] made in the furtherance of any crime or fraud." See Dkt. 424, p. 24. The SEC proffers only that the estimated $7,500 in premiums were paid by Mr. and Mrs. Smith during the alleged period of fraud. See Dkt. No. 487, pp. 2-3. This assertion, without more, is insufficient to satisfy the SEC's burden of making a probable cause showing that these contributions are traceable to any alleged fraud. *See U.S. v. Monsanto,* 924 F.2d 1186 (2d Cir. 1991) (*Monsanto IV*), *cert denied* 112 S.Ct. 382 (1992); *S.E.C. v. Coates*, 1994 WL 455558 at *3 (S.D.N.Y. Aug. 23, 1994), Dkt. No. 440-1.

It was never conceded that the $7,500 paid in premiums between 2004 and 2007 were traceable to the alleged fraud. Mr. Smith provided the amounts personally contributed towards the premiums in order to make full disclosure to the Court. See Dkt. No. 482-2, ¶ 11. Furthermore, it would be difficult, if not impossible for the SEC to determine that the $7,500 was paid with any alleged ill-gotten gains, considering that during the time period in question, the Smith family possessed substantial assets and sources of income from which to pay the annual premiums, unrelated to the matters related to the civil case. Not only has the SEC failed to demonstrate that the disputed funds are tainted, the SEC's assertions that the loan proceeds are attachable or subject to an asset freeze are without merit and especially so in the event that the loan is provided in one of the above-referenced alternative methods.

CONCLUSION

For the aforementioned reasons and the reasons stated in Mr. Smith's initial submissions, it is respectfully requested that this Court grant his Motion to Modify the Asset Freeze to Permit the Release of the Irrevocable Life Insurance Trust and allow a loan against the cash surrender value be used for Mr. Smith's attorneys' fees and costs in his parallel criminal action.

Dated: May 16, 2012
Albany, New York

Respectfully submitted,

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