

SPOUSE GETS CONFIRMATION FROM THE FEDERAL COURTS THAT PERMITS HER TO RETAIN FRAUDULENTLY OBTAINED MARITAL ASSET BY HER HUSBAND

By: Elliot D. Samuelson, Editor

If any practitioner had doubts whether a spouse could retain ill gotten marital assets fraudulently acquired by their spouse and later divided by their marital settlement agreement, it should be dispelled by the decision and order of Judge George B. Daniels of the US District Court in *Commodity Future Trading Commission v. Stephen Walsh and Janet Walsh, et al* and *Securities and Exchange Commission v. Janet Walsh, et al*ⁱ

Judge Daniels found that Janet Walsh (now by marriage Janet Schaberg) could retain millions of dollars of marital funds acquired by her husband through a Ponzi scheme that amounted to about \$554,000,000 in fraudulently obtained investments from his clients. By comparison to the Madoff caper, it was less than a blip on a radar screen, but nevertheless significant.

Procedural History

It is interesting that the initial litigation began in the federal courts, and not in the Supreme Court matrimonial part. The fight began in 2009 some three years after the parties entered into a valid separation agreement that was incorporated into a divorce decree. Essentially the wife received a lump sum payment of \$12.5 million dollars that was to be paid to her in bi-annual installments for fourteen years, while the husband retained another \$5 million dollars in various bank accounts, as well as his business assets. In addition, the wife retained ownership of two condominiums - one in Florida and the other in New York City. The parties waived any further equitable distribution, maintenance and inheritance from each other. Both the Security and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) commenced actions against Janet Schaberg and her former husband Stephen Walsh to disgorge any monies from either or both of them obtained by Walsh and his business partner swindling their investors. At the time of the suits, the Walsh's had been divorced for several years following a twenty five year marriage.

There is no consensus in other states as to whether an innocent purchaser for value can retain funds acquired from a thief. States differ whether an innocent purchaser of the ill gotten funds can retain such monies or would have to give them up when a lawsuit was started and a verdict in their favor was obtained. This case touches upon this issue and makes clear that at least in New York, an innocent spouse with no knowledge of the fraud, and for fair consideration, can withstand any attempts to disgorge such assets.

When both the SEC and CFTS commenced the disgorgement suit, they sought and

obtained ex parte restraining orders and later a preliminary injunction that froze the Walsh's ability to transfer or dispose of any assets without prior approval of the court. It was then that the wife appealed to the Second Circuit Court of Appeals that apparently tussled with the law regarding the right of a spouse to retain stolen property in New York. As a result, and before deciding the case, the court certified two questions to the New York State Court of Appealsⁱⁱ. The first was whether the proceeds of a fraudulent transaction can constitute marital property. The other, whether relinquishing a claim to the proceeds of fraud can constitute the payment of fair consideration. Matrimonial attorneys following the case were deeply perplexed as to how our high court would decide these certified questions.

The State Court of Appeals ruled that the proceeds of fraud can constitute marital property and, with regard to the latter issue held that the question of whether fair consideration was paid by the wife was not precluded where all or part of the marital estate consists of the proceeds of fraudⁱⁱⁱ. When it received the decision of the State Court of Appeals answering the certified questions, the Second Circuit vacated the preliminary injunction issued by the district court and remanded the case to the Federal District Court to determine whether the wife provided fair consideration when she obtained these funds pursuant to the parties' separation agreement^{iv}. Extensive discovery followed, and the wife, believing there were no further issues to be determined, moved for summary judgment dismissing both agencies' suit against her. On remand to, Judge Daniels, after reviewing the entire history of the case, and the full decision of the Court of Appeals, granted the motion. To fully grasp the facts of the case and why it is important to the matrimonial practitioner, the reader is recommended to read the decisions in detail^v.

The State Court of Appeals, in answering the certified questions of the federal court held that an innocent spouse can retain such status and the money she obtained - provided *she acted in good faith and without the knowledge of the fraud and gave fair consideration for the transferred property*. In other words, as long as she was an innocent purchaser for value, she could retain the tainted assets. The state high court first reviewed the facts and noted that neither the SEC or the CFTC alleged that the wife was aware of or participated in the fraud, but argued that a sizeable portion of such funds went into her possession pursuant to a separation agreement made between the husband and wife the terms of which were incorporated into a divorce decree.

The Second Circuit Court of Appeals, in order for it to determine whether the wife has a legitimate claim to retain those funds and therefore prevent the governmental agencies from obtaining disgorgement from her, proffered the certified questions to the New York Court of Appeals⁵. To answer these questions, the state court had to decide if either the Domestic Relations Law or Debtor and Creditor Law or a public policy consideration would prevent disgorgement by the agencies.

The Underlying Factual History

The Walsh's had been married for 25 years and had two children. The husband during the marriage obtained substantial interests in a number of highly successful businesses. The couple acquired a home in Port Washington as well as condominiums in Florida and New York City. They separated in 2004, and executed a separation agreement in 2006. Under its terms the wife conveyed to the husband her ownership to the marital residence valued at \$7.5 million dollars and received sole ownership of their two condos with an alleged value of \$6.7 million. In addition, the wife waived all claims to the husband's business interest and spousal support, apparently in exchange for \$5,000,000 in various bank accounts and a distributive award of \$12.5 million in bi-annual installments through 2020 - approximately fourteen years. The wife moved to Florida and married Schaberg two years later. Two years after the wife's remarriage, the SEC and CFTC filed a disgorgement suit against the Walsh's (named a "relief defendant") alleging the perpetration of a large scale fraud by the husband and the main defendants, seeking monetary damages from them. A disgorgement claim was asserted against the wife who was alleged to be in possession of the proceeds from the fraudulent securities scheme. The District Court (Daniels, J.) initially granted a preliminary injunction freezing the wife's brokerage and bank accounts valued at \$7.6 million dollars and restrained her from transferring any real property, jewelry, or artwork without court approval. The wife appealed, arguing that the injunction was wrongfully granted because the property restrained was not subject to disgorgement, alleging that because she obtained these monies and assets pursuant to a valid separation agreement she was a good faith purchaser for value. The Second Circuit Court of Appeals also acknowledged that the district courts have the power to direct disgorgement from a relief defendant provided that the party is in possession of ill gotten funds and also lacks a legitimate claim to those funds. In this case the pivotal issue is whether as a matter of law the wife lacked a legitimate claim to those funds, and to determine this issue it needed to forward the two questions to the State Court of Appeals which were set forth above.

The New York State Court of Appeals' Analysis of the Certified Questions

In deciding the first question - whether assets obtained from fraud constitute "marital property" - the Court of Appeals looked to the wife's contention that because she obtained the tainted property pursuant to a separation agreement she became a good faith purchaser for value, and the Agencies' argument that monies derived from securities fraud could not be part of the marital estate nor could it be retained or transferred through equitable distribution pursuant to Domestic Relations Law Section 236. The high court noted that these respective legal arguments "raise difficult policy questions, requiring us to weigh the competing interests of the original owners of funds stolen in a fraudulent scheme against the innocent former spouse of the defrauder." This statement is particularly interesting and one cannot resist questioning why the court used the phrase "innocent former spouse" rather than an innocent purchaser for value. Was this a way to accord to an innocent *spouse*, a preferred status as to other innocent purchasers for value? It took the Court several pages of its decision to conclude that monies obtained through

fraud cannot be followed by the original owner into the hands of an innocent *spouse* that obtains such property in good faith and without knowledge of the fraud and gave “fair consideration” for the property acquired pursuant to the terms of their separation agreement. The Agencies’ argument that (1) a victim of embezzlement and not a mere creditor had an absolute right to disgorgement and (2) the issue of whether fair consideration had been given, was irrelevant. It acknowledged that such contentions have appeal, but held that it was unable to approve such rule. It went on to discuss the second question that requires fair consideration to be given in order to sustain the status of innocent spouse.

The wife argued that she provided fair consideration and thereby became a good faith purchaser for value by executing an arm’s length separation agreement. She also argued that she had no knowledge of her husband’s illegal actions, pointing out that he had a history of being a respected and successful entrepreneur and securities trader and did not engage in collusion with her husband to deprive defrauded customers recovery of their moneys. The Agencies counter-argument was that the wife as a matter of law could not have given fair consideration because in exchange for acquiring marital assets which were later determined to be the product of fraud, she only released a claim to a larger portion of the marital estate, which also included the husband’s proceeds of his fraud -- accordingly her consideration had to be viewed as illusory. The court once again noted that both parties raised compelling arguments.

In deciding whose argument was more compelling and perhaps recalling the famous quote from Orwell’s *Animal Farm* that “all animals are equal, but some animals are more equal than others”, the court turned to an analysis of Debtor and Creditor Law Sections 272 and 278. Pointing out that a defrauded creditor can have a fraudulent conveyance set aside against anyone but a good faith purchase for value -- defined as a “a purchaser for fair consideration without knowledge of the fraud,” -- the court then explains that fair consideration is given when property obtained is exchanged for a fair equivalent of remaining assets, and the property is conveyed in good faith, citing DCL §272 [a]. Of course, the resolution depends upon the peculiar facts of each case. The court then held that to determine whether a spouse paid fair consideration in the context of a separation agreement a court must first determine whether the spouse gave up and waived any rights to any untainted assets in the marital estate. If she did, this alone would constitute fair consideration. It then went on to another aspect of fair consideration which could include spousal contribution to the marriage, release of maintenance or child support payments as well as the waiver of inheritance and other rights or remedies conferred by law. In addition, it mentioned that concessions made as to custody or visitation is another example of valid consideration, and cited cases that hold that transfers made pursuant to a separation agreement are presumed to be made for fair considerations^{vi}. The State Court of Appeals found that the Second Circuit erred in presuming that the only consideration the wife could have given for obtainment of the tainted property was her release of a claim to other proceeds of the fraud, which would make her claim illusory. Since the Court already

determined that there were other forms of valid consideration that are relevant to the determination of whether what the wife gave up could be considered having paid a fair consideration, a further determination was unnecessary. It then noted that the Second Circuit's assumption that the marital estate consisted of almost entirely the proceeds of fraud, must be accepted by them in deciding the issue. The state court therefore reformulated the certified question to "is a determination that a spouse paid "fair" consideration according to the terms of the ...Debtor and Creditor Law Section 272 precluded, as a matter of law, where part or all of the marital estate consists of the proceeds obtained from fraud" Finally the court held that based upon its analysis, the reformulated question had to be decided in the negative - leaving the door open for the wife to defeat the disgorgement action. It also acknowledged that the determination of whether the wife gave fair consideration pursuant to DCL §272, under all of the facts and circumstances, was a matter to be decided by the federal courts.

In dictum though, the court took pains to recite facts which they believed to be controlling, without saying so in so many words. They noted that the wife contended she surrendered more than her right to claim through equitable distribution a greater portion of fraudulently obtained funds constituting the marital estate. She also included the waiver of maintenance which can be based on a variety of considerations including her rights of inheritance, the length of the marriage, and the marital residence she claimed was obtained with separate funds not part of the fraud. The court added "Furthermore, even where a spouse does not relinquish a fair equivalent for the aggregate of assets, it is possible that fair consideration may be exchanged for at least some of the asset."^{vii}

Again the court commented, perhaps a little insecure of this holding after their analysis, "...we are not unsympathetic to the interest of the parties who were fraudulently deprived of their investments and who, understandably, seek the return of a portion of their stolen monies." It went on to explain that victims of fraud were free to pursue disgorgement proceedings when it is shown that the spouse who received these fraudulently obtained funds was aware of or participated in the fraud or failed to act in good faith. They postulated that an example would be two spouses who enter into a collusive divorce agreement in an effort to conceal stolen assets from their rightful owners. It then reminded us that even though a spouse was blameless and entered into the agreement in good faith and without any knowledge of the fraud, the defrauded parties could nevertheless recover these funds, if the spouse did not give fair consideration pursuant to DCL §272. Accordingly, an innocent spouse should prevail over the rightful owners "...consistent with this State's strong public policy of ensuring finality in divorce proceedings." where it is determined that he or she provided fair consideration.. The case was remanded to the district court to make the factual determination of whether she paid fair consideration by waiving, in good faith, a claim to the proceeds of the unknown fraud.

Judge Eugene Pigott dissented in part because he believed that DCL §278 required the wife to prove that the consideration she gave to obtain her property pursuant to their

separation agreement was a fair equivalent to what she had obtained. He explained that , “One cannot reasonably argue that a spouse—even an innocent one with no knowledge of her husband’s fraud—could be said to have given “fair equivalent” value by giving up future claims to the equitable distribution of proceeds in which she has no legitimate interest. In such a case , the innocent spouse “has not given value for the misappropriated property, but rather has gained an interest in the property **simply by virtue of being married to the person who misappropriated” such funds.** (Emphasis supplied.)

This dissent created a new test, not recognized by the majority, that would prevent an innocent spouse to retain the property she received pursuant to their separation agreement. This dissenting opinion was concurred in by Judge Robert Smith.

The Federal Court Determination

These differing views were returned to the Circuit Court of Appeals who in turn remanded it to the federal district court for its final determination of the factual question of fair consideration. It was then that Mrs. Schaberg moved for and obtained summary judgment to dismiss the pending disgorgement proceeding as a matter of law, arguing that she obtained her share of marital assets in good faith and for fair consideration - specifically that she had conveyed her interest in the marital residence valued at \$7.5 million and waiving her claim for inheritance and maintenance which constitutes fair equivalent value. As such, to survive summary judgment the Agencies had to show, by probative evidence, that the wife did not pay fair consideration to obtain her share of the marital estate, which is presumed to be made for a fair consideration, when transfers were made pursuant to a valid separation agreement. The court held that the Agencies failed to meet this standard, and granted the wife summary judgment, also pointing out that New York’s public policy of ensuring finality to divorce cases should also be applied because the alleged fraud of the husband did not occur until three years following the execution of their separation agreement and after the wife moved to Florida and remarried.

A Matter of Equity

Whether an appeal will be sought by the Agencies remains to be seen. But it seems clear to me that the principles of equity had to be leaned upon, and an innocent spouse given a superior status, to other unmarried persons or entities that disgorgement is sought in other fraudulent situations. Perhaps also, the fact that the Receiver appointed in this Ponzi scheme had already recovered and paid out 94.3% of investors claims, entered into the equation - allowing the spouse to retain these tainted assets. We welcome readers’ reaction to this result and any contrary views.

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i. 2014 WL 847900 (S.D.N.Y. Feb. 28, 2014).

ii. 618 F.3d 218 (2d Cir. 2010).

iii. 17 N.Y.3d 162 (2011)

iv. 658 F.3d 194 (2d Cir. 2011).

v. See endnote 2.

vi. 17 N.Y.3d 162, 174-76 (2011).

vii. 17 N.Y.3d at 176-77.