

## CFTC v. WALSH: “FINALITY”, JUSTICE FOR FINANCIAL SCAM VICTIMS

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In *Commodity Futures Trading Commission v. Walsh* (CFTC), 17 N.Y.3d 162 (2011),<sup>1</sup> the Court of Appeals answered two certified questions by the Second Circuit Court of Appeals, 618 F3D 218 (2d Cir. 2010). The questions arose from lawsuits brought by the CFTC and the Securities and Exchange Commission (SEC) against, inter alia, Stephen Walsh and his former spouse, Janet Schaberg. The actions were grounded in violations of the anti-fraud provisions of the Commodity Exchange Act and the Securities Exchange Act; *i.e.*, that Walsh and his partner misappropriated as much as \$554 million from investors’ funds during the period 1996 to 2009.

Although the Agencies alleged no wrongdoing by Schaberg, they proceeded against her as a relief defendant seeking disgorgement of whatever proceeds had come into her possession from Walsh’s criminal enterprise by way of their marital settlement agreement. Under the agreement, Schaberg conveyed her ownership interest in jointly held real property to Walsh, only to receive ownership of other real property, valued at nearly \$5 million, and \$12.5 million payable over ten years. The two certified questions were:

- 1) “Does ‘marital property’ within the meaning of New York Domestic Relations Law (DRL) § 236 include the proceeds of fraud?”, and
- 2) “Does a spouse pay ‘fair consideration’ according to the terms of New York Debtor and Creditor Law (DCL) § 272 when she relinquishes in good faith a claim to the proceeds of fraud?”

The Court unanimously answered the first question in the affirmative. The second question was also answered in the affirmative with two dissenting opinions. Thus the spouse of the perpetrator of the fraud was endowed with a superior claim to the proceeds of the fraud than the victims of the fraud. This result is neither anchored

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<sup>1</sup> N.Y.L.J. Oct. 25, 2011. The authors and three other attorneys submitted an amicus brief to the Court of Appeals in support of the Agencies’ position.

soundly within two statutory schemes, the Equitable Distribution Law (EDL) and the Debtor Creditor Law (DCL), nor is it a salutary expression of public policy.

### Schaberg's Argument

The thrust of Schaberg's contention to the Second Circuit was:

[A]lthough the money was held in an account in her name [], it was held-and used-for the benefit of the marital estate, to pay expenses that were not hers alone, but of the marital unit...it was only when pursuant to the execution of a separation agreement with Walsh in 2006 she was permitted to retain the remaining funds in her checking accounts, that the funds were transferred from the marital estate, a transfer which could serve to give rise to a 'legitimate claim',<sup>2</sup>,

[T]he district court erred in focusing its analysis on transfers of investor funds to her checking account over the course of the marriage.”

Schaberg [also] contend[ed] that because she relinquished valuable claims to the Walsh marital estate in this negotiated and arms-length separation agreement, she holds whatever she derived from the agreement as a good faith purchaser for value.<sup>3</sup>

Schaberg had been in possession of the money throughout the marriage and participated, innocently or not, as it journeyed back and forth from cash to real and personal property. Notably, the Second Circuit emphasized that parties “should not benefit from commingling their ill-gotten gains with other assets,”<sup>4</sup> which tackles her

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<sup>2</sup> *CFTC*, 618 F.3d 218, at 227.

<sup>3</sup> *Id.*, at 227.

<sup>4</sup> *Id.*, at 226, n. 4.

argument that one of the homes had been purchased with, now, unidentifiably clean monies years before the inception of the criminal enterprise.<sup>5</sup>

### Criminal Assets as “Marital Property”

The Court of Appeals applied a literal, “expansive”, and “broad”<sup>6</sup> definition to the term “all property acquired by either or both spouses during the marriage” (DRL § 236B(1)(c)), and held that “the proceeds of fraud can constitute marital property.”<sup>7</sup> Although the Court addressed the concern about ill-gotten money and the victims, the Court, nevertheless, justified its holding that these funds could still be marital property by reference to commercial settings where funds obtained illegally could not be recovered by the victims from innocent third parties who received those funds in good faith for fair consideration: *Stephens v. Board of Education*, 79 N.Y. 183 (1879); *Hatch v. Fourth National Bank*, 147 N.Y. 184 (1895); and *Banque Worms v. Bank America International*, 77 N.Y.2d (1991).

In *Stephens*, the Court ruled that a plaintiff who was given a fraudulent mortgage in exchange for funds, could not recover those funds from a creditor of the person who had committed the fraud. *Stephens*’ concern devolved about the need for unimpeded commercial dealings:

It is absolutely necessary *for practical business transactions that* the payee of money *in due course of business shall not* be put upon inquiry at his peril as to the title of the payor . . . . It would introduce great confusion into *commercial dealings* if the creditor who receives money in payment of a debt is subject to the risk of accounting therefore to a third person who may be able to show that the debtor obtained it from

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<sup>5</sup> *CFTC*, 17 NY3d, at 177.

<sup>6</sup> *Id.*, at 172.

<sup>7</sup> *Id.*, at 172.

him by felony or fraud. The law wisely, from considerations of public policy and convenience, *and to give security and certainty to business transactions*, adjudges that the possession of money vests the title in the holder as to third persons dealing with him *and receiving it in due course of business and good faith upon a valid consideration*.<sup>8</sup>

►► **Allan, I apologize but I don't understand this sentence.**

**Thanks.** Unlike *Stephens*, the bank had been no more than a conduit, the bank did not keep the money.

Similarly, in *Hatch*, the Court, citing *Stephens*, barred recovery from an innocent recipient of ill-gotten gains reasoning, again, that “to permit in every case of the payment of a debt an inquiry as to the source from which the debtor derived the money, and a recovery if shown to have been dishonestly acquired, would *disorganize all business operations and entail an amount of risk and uncertainty which no enterprise could bear*.”<sup>9</sup>

More recently, in *Banque Worms*, the Court, citing *Hatch*, again, based its rule protecting innocent third-parties in a commercial transaction from recovery on “considerations of public policy and convenience *for the protection and encouragement of trade and commerce by guarding the security and certainty of business transactions, since to hold otherwise would obviously introduce confusion and danger into all commercial dealings*.”<sup>10</sup>

The Court's parallel to business transactions is uneasy because *Walsh* did not arise from a commercial transaction. The considerations incidental to protecting the free flow of business do not pertain to marital agreements with keenly unique social implications. The imposition of commercial doctrine to protect a spouse at the expense of victims of a

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<sup>8</sup> 79 N.Y. at 187-88 (emphasis supplied).

<sup>9</sup> 147 N.Y. at 192 (emphasis supplied).

<sup>10</sup> 77 N.Y.2d at 372-3 (emphasis supplied).

fraud is misplaced in the matrimonial context. It is virtually impossible for a victim of fraud to establish conclusive complicity between spouses given the recipient spouse's incentive and motivation to retain the wealth.

Sophisticated swindles render the rule of fungibility, that "money has no ear mark",<sup>11</sup> antiquated especially once cash has morphed into hard assets.

### Spousal Rights, Debtor Creditor Law

Interspousal rights derive exclusively from the Equitable Distribution Law (EDL), not any other statutory scheme, including DCL. Under EDL, spouses are partners.<sup>12</sup> The marital relationship does not posture spouses as debtors or creditors.<sup>13</sup> There was, therefore, no reason to have reached the issue of Schaberg's status as a potential BFP. Even under DCL, Schaberg could not have been a BFP who paid fair consideration:

- lawful consideration was impossible: she exchanged/transferred jointly held stolen property (consideration), real and personal, for different stolen property, real and personal. She was thus not only a purchaser but a transferor – DCL §§ 272 and 278 only protect purchasers not transferors.
- nor had she discharged a debt, claim, or obligation under DCL because spouses are partners not debtor-creditors.
- the defrauded victims never received fair consideration each time that money entered Schaberg's account.

### Fair Consideration

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<sup>11</sup> *Stephens*, at 187.

<sup>12</sup> *Price v. Price* 69 N.Y.2d 8 (1986).

<sup>13</sup> *Murphy v. Murphy* 56 Misc.2d 946, 949 (N.Y.Sup.1968).

Under New York contract doctrine, marital agreements are contracts governed under the principles of contract law,<sup>14</sup> thus requiring consideration.<sup>15</sup> Illegal consideration is no consideration.<sup>16</sup> DCL §§ 272 and 278 also address “fair consideration.”

The majority was required to “accept for purposes of answering this [second certified] question the Second Circuit’s assumption that the marital estate [] ‘consisted almost entirely of the proceeds of fraud’ (618 F.3d at 230).’ ”<sup>17</sup> Equity could have thus voided the agreement and reunited the victims with their money. Rather, the majority reformulated the second question, holding that the wife had given “fair consideration” because, in matrimonial settlements, there are potentially other rights that may be foregone such as rights to support or inheritance.

The Court seemingly accepted Schaberg’s contention that her release of maintenance constituted valid consideration. However, since Walsh’s criminal enterprise was the source of all the marital assets, Schaberg will be unable to enforce the support provision of the agreement when Walsh defaults. By parallel reason, she cannot petition for increased support. If convicted, Walsh will also be unable to earn the remaining \$12 million while in prison. Her recourse will, of necessity, trace to the original illegal transactions.<sup>18</sup> Accordingly, her release/waiver was worthless consideration.

Judge Eugene F. Pigott, joined by Judge Robert S. Smith, who dissented in part, focused on this obvious point, emphasizing that no “fair consideration” could have been

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<sup>14</sup> *Rainbow v. Swisher*, 72 N.Y.2d 106 (1988).

<sup>15</sup> *O'Malley v. O'Malley*, 41 A.D.3d 449 (2nd Dept.,2007).

<sup>16</sup> *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (Sup.Ct.,1941); *Village of Upper Nyack v. Christian and Missionary Alliance*, 143 Misc.2d 414 aff'd, 155 A.D.2d 530 (2nd Dept.,1989).

<sup>17</sup> CFTC, 17 N.Y.3d, at 176.

<sup>18</sup> *Janke v. Janke*, 47 A.D.2d 445 (4th Dept.,1975), aff'd, 39 N.Y.2d 786 (1976).

given because relinquishing rights to other fraudulently obtained funds does not constitute valid consideration:

[T]he question is, assuming that the marital estate consists almost entirely of the proceeds of fraud, does an “innocent spouse” like Schaberg, by virtue of relinquishing future claims to those proceeds, pay fair consideration? The answer is, of course, “no,” as the majority essentially acknowledges: “consideration cannot be predicated on a spouse's relinquishment of a claim to a greater share of the proceeds of fraud.”<sup>19</sup>

Incidentally, in enumerating various forms of consideration, the State’s highest court, sitting as *parens patriae*, astonishingly postulated that even custody or visitation may constitute “valuable” consideration. The best interest of children “barterable”!? Holy *Friederwitzer*,<sup>20</sup> Batman! Stay tuned!

#### Legislative Intent, Statutory Construction

When the Legislature crafted the Equitable Distribution Law, it did so consistent with the canons of statutory construction which do not permit statutory readings that expand a category or class to include either illegal means. It is incongruous to state that the Legislature meant to interdict economic wrongdoing only between spouses (DRL § 236B(5)(d)(12); *Blickstein v. Blickstein*, 99 A.D.2d 287 (2nd Dept., 1984)), while imputing a legislative intent that insulates interspousal partitions of criminally derived proceeds to the detriment of the victims, irrespective of one party’s lack of culpability. *Walsh*’s imputation of such legislative intent is in contravention of the canons of statutory construction, which demand extraordinary caution so that statutes not be read to result in injustice. This is evidenced by the many statutes, written by the Legislature, as a guide to statutory construction (the entirety of which cannot be reproduced here), McKinneys Statutes:

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<sup>19</sup> CFTC, at 17 NY3d 178.

<sup>20</sup> *Friederwitzer v. Friederwitzer*, 55 NY2d 89 (1982).

§ 146: “An interpretation of an act should be avoided which would injuriously affect the rights of others, and that sense should be attached to its provisions which will harmonize its objects with the preservation and enjoyment of all existing rights.” “Thus, a construction is to be avoided which enables a debtor to keep and enjoy his property in defiance of the claims of creditors.”

“It will be presumed that the Legislature did not intend that a statute would have an unjust effect, and, unless the language forbids, it must be given an interpretation and application consistent with such presumption...

Accordingly, courts will disregard the letter of the law and follow its spirit when the letter causes hardship or injustice.”

§ 141: “To sum the matter up, courts will avoid a construction which is contrary to the fundamental principles of good conscience and morals.”

“The Legislature is presumed to have intended that good will result from its laws, and a bad result suggests a wrong interpretation. Among the consequences considered objectionable: hardship, injustice, and mischief or disaster.”

§ 213 addresses consideration of public policy and maxims of natural justice.

§ 111: “The Legislature instructs courts to examine their consciences and ponder as to how they believe Legislators would respond if asked about the issue at hand”; --  
Imagine the outcry were the Legislature polled regarding its intent to allow interspousal property distribution of proceeds derived from drug or human trafficking, arms sales, or distribution of child pornography simply because it is a husband and wife distributing such proceeds rather than crime bosses. Society has become desensitized to financial scandals.



## Finality

The Court justified its sanctioning of the division of illegally obtained property by extolling the virtues of finality in divorce judgments and settlements. Undoubtedly, finality is an important consideration which correctly dictates against the frivolous re-opening of settlements, of any kind. That such repose is particularly important in marital situations cannot be gainsaid. Old wounds should not be lightly exhumed after spouses and families have moved forward with their lives and changed their positions based on court-sanctioned settlements. But at what cost to justice for victims who neither voluntarily intruded into the marital affairs of the perpetrator nor participated in the interspousal carving of their assets?

Finality, however, should not have commanded the conclusion in *Walsh*. This genre of litigation, where defrauded victims have been identified, uniquely militates against a fear of widespread opening of floodgates of litigation to re-examine judgments and settlements, a fact not considered by the Court. Finality between spouses is sharply different from the arbitrary imposition of “finality” upon victims of a crime.

## Conclusion

*Walsh* distills into the logic stressing thesis that a spouse can acquire by marital agreement that which could not have been achieved by marriage thus allowing marital agreements to elevate stolen assets to a higher plane of protection, especially because a court could not have distributed the stolen assets upon having learned their origin.

That the victims of fraud were so easily thwarted by such ephemeral claims of “consideration” and “finality” in the face of a marital estate which consisted virtually of stolen funds is hard to justify. It reflects the distance the Court was prepared to travel in order not to resuscitate dead matrimonial disputes, under almost any circumstances.

Given the overwhelming importance accorded to “finality”, reasonable speculation wonders whether *Walsh* is the rough draft for *Simkin v. Blank*,<sup>21</sup> wherein the Court must consider reopening a divorce settlement, albeit on the less exotic ground of mutual mistake in the wake of the Madoff fraud.

By defining marital property to include the proceeds of fraud, has the Court of Appeals paved the way for the next logical step in the progression, to wit, that courts may actively distribute illegally obtained funds?

Victims of fraud now have a new judicially fashioned obstacle in their path, the marital agreement. It is one thing for a court to protect an independent recipient of illegally obtained funds, when that recipient received the funds in exchange for palpable goods or services from the perpetrator of the crime. It is quite another for the Court to allow the Equitable Distribution statute to serve as a shelter for illegally obtained funds to the detriment of the victim by recasting a spouse as an independent provider of goods or services.

Other states forbid outcomes such as here by imposing constructive trusts on assets derived from stolen funds.<sup>22</sup> *Sheridan v. Sheridan* 247 N.J.Super. 552 (N.J.Super.Ch.,1990), stated:

A court of equity, as a court of conscience, can never permit itself to become party to the division of tainted assets nor can it grant the request of an admitted wrongdoer to arbitrate such a distribution.

The Court’s conclusion that fraudulently obtained funds are “marital property” subject to equitable distribution is simply bad law and unfortunate policy.

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<sup>21</sup> 80 A.D.3d 401 (1<sup>st</sup> Dept.,2011).

<sup>22</sup> *Sheridan v. Sheridan* 247 N.J.Super. 552 (N.J.Super.Ch.,1990); *In re Marriage of Allen*, 724 P.2d 651 (Colo.1986); *McMerty v. Herzog* 702 F.2d 127 (1983); *American Ry. Exp. Co. v. Houle* 169 Minn. 209 (1926); *Namow Corp. v. Egger* 99 Nev. 590 (Nev.,1983).