

## NOTE

# LEFT OUT IN THE COLD: FREEZING INNOCENT SPOUSES' ASSETS IN SEC ACTIONS

Zoe A. Jones\*

*Securities fraud not only has a large effect on the innocent victims of the fraud but also on the innocent spouses and children of culpable defendants. In some cases, innocent spouses may have their assets frozen even when such assets are personal and not traceable to the fraud. This Note suggests potential solutions that would make Securities and Exchange Commission (SEC) actions fairer and more efficient without compromising the enforcement goals of the SEC.*

*While innocent spouses may have equitable remedies available to them—requesting a modification of the temporary restraining order (TRO) or showing that frozen assets are untainted by the fraud—these remedies may not be enough. To pursue any of these remedies, the spouse must have funds to cover attorney's fees. This may prove impossible and effectively prevent the spouse from obtaining relief.*

*The solution suggested in this Note is to narrow the scope of the TRO granted to the SEC when they bring an action. While the proceeding could remain ex parte, the court should require that the SEC make a showing that the assets to be frozen are tainted by the fraud. Such a solution is in the interests of both fairness and efficiency. Furthermore, courts could include a balancing of the hardships that would occur if the TRO is granted. As evidenced by tax fraud provisions, it is possible to maintain an effective system of recovering funds that have been obtained illegally without punishing those who are innocent. Similar concessions can be made to protect innocent spouses in securities fraud cases.*

INTRODUCTION .....	382
I. OVERVIEW OF ASSET FREEZES AND REMEDIES .....	384
A. Freezing of Assets in Cases of Fraud .....	384
B. Remedies for the Spouse Once Assets Are Frozen ....	386

---

\* Candidate for J.D., Cornell Law School, 2015. I would like to thank Professor Marion Bachrach for her advice and guidance in writing this Note and for introducing me to this important issue. I would also like to thank Kevin Quilty for his thoughtful comments and criticisms as I worked toward publication. Finally, thank you to Eric DiMuzio, a Managing Editor of the *Cornell Journal of Law and Public Policy*, for his diligence throughout the editing process.

1. Requesting Modification of the Order ..... 387

2. Showing of Untainted Property ..... 388

3. Deals with the Government ..... 390

4. Divorce ..... 391

II. ANALYSIS ..... 393

    A. *Difficulties in Accessing Assets to Pay for Attorney’s Fees* ..... 393

    B. *Procedural Due Process Considerations* ..... 396

    C. *The Inefficiency and Unfairness in Granting Broad TROs* ..... 397

    D. *Innocent Spouse Relief in the Context of Tax Fraud*.. 398

CONCLUSION ..... 400

INTRODUCTION

In a world where securities fraud enforcement actions are increasingly common,<sup>1</sup> it is important to analyze the impact that such actions have on victims. There are the obvious victims—those who are defrauded—who often end up losing their hard-earned assets and in some cases their entire life savings. However, there are also victims who are indirectly affected—the innocent spouses and families of culpable defendants. Imagine an innocent spouse losing her home, her assets, and any funds she may have had to support herself and her children solely because her husband committed a crime of which she had no knowledge. Undoubtedly, there must be a way of punishing criminals for their wrongdoing without forcing their innocent family members to give up everything they own.

At first glance, it may be easy to assume a defendant’s spouse is equally culpable, reasoning that the spouse “must” or “should” have known. It is even easier to make such an assumption when that spouse may have been living off of the spoils of a defendant’s reprehensible actions. But what about cases where it is uncontested that the spouse is innocent of wrongdoing and had no knowledge that a fraud was being perpetrated? Is it fair to deprive a defendant’s spouse of all untainted assets when that spouse is just as blindsided as the defrauded investors?

In many cases, once the government brings an action against a fraud defendant, a court will order a very broad temporary restraining order (TRO) or injunction, restraining the defendant and those acting in “participation” with the defendant from accessing their assets. Although it may be uncontested that a spouse is innocent, the spouse will still be prevented from accessing any joint assets because the spouse is consid-

---

<sup>1</sup> See, e.g., Jean Eaglesham, *SEC Cases Climb for the First Time Since 2011*, WALL ST. J., Sept. 30, 2014, at C1.

ered to be acting in participation with the defendant. Furthermore, the court can name a spouse as a nominal defendant—even when the court recognizes that spouse as innocent of wrongdoing—and gain access to the spouse’s personal assets for potential recovery.

It is surely true that a defendant should not be allowed to keep the spoils of fraudulent, criminal activity. The thought of allowing a defendant to continue living in the lap of luxury while innocent people suffer would enrage most anyone. While in the face of a large-scale securities fraud it is easy to demand that justice be served, we must stop to ask ourselves, at what cost? A defendant may be stripped of liberty and any profit derived from the fraud, but is it fair to punish innocent people simply because they had the misfortune of being a family member of that defendant? Certainly one could think of no other crime where society calls for deprivation of an innocent person’s property to provide restitution to victims.

Depriving an innocent spouse of assets becomes even more illogical in light of the fact that such assets may be frozen even when they were not derived from the proceeds of the fraud. The broad nature of the TRO includes those assets that may have been acquired before the fraud began; bought with funds from a legal source (such as lawful employment); or obtained through an inheritance completely unrelated to the fraud.

Focusing solely on actions brought under federal law by the United States Securities and Exchange Commission (SEC), this Note will analyze the remedies that innocent spouses may have when their assets are frozen. There are certain steps that a spouse may take after the TRO is issued. If not named as a nominal defendant, the spouse may seek to intervene in the suit. Then the spouse may request a modification to the TRO or request release of funds upon a showing that they are untainted by the fraud. In some situations, a spouse may even seek to strike a deal with the government to retain a certain (limited) amount of assets, or decide to divorce the defendant.

Finding ways around an asset freeze requires time and, most importantly, money. However, inability to access such funds may, in practice, make remedies nearly impossible to obtain. Given that the spouse’s assets are inaccessible, the spouse may find it difficult to retain an attorney to pursue available remedies. Moreover, the assets may not be released even when it can be shown that they came from a legal source and were not a product of the fraud. As a result, assets may not be available even when necessary to cover basic living expenses, leaving innocent spouses without any way to support themselves and their children.

This Note will consider the unfairness of depriving an innocent person of property based on the crimes of their spouse. Given that untainted assets are frozen by broad TROs, the simplest solution may be to analyze

the source of the funds prior to issuing the TRO. Furthermore, the current standard for granting a TRO in SEC actions is much lower than other standards, and in the interest of fairness, the standard could be raised by including a balancing of the hardships.

Part I of this Note explains how and why assets are frozen in a securities fraud case and the remedies that an innocent spouse has to regain access to frozen funds. Part II discusses the difficulties a spouse may have in pursuing different remedies (both equitable and non-equitable) and the fairness concerns in freezing all of a defendant's assets, including those belonging to the defendant's spouse.<sup>2</sup> Part II advocates that courts should take a lenient approach when deciding whether to unfreeze assets to cover attorney's fees. Additionally, Part II suggests that a solution to policy and fairness concerns would be the narrowing of the initial TRO against the defendant to exclude untainted assets and include a consideration of the balance of the hardships.

## I. OVERVIEW OF ASSET FREEZES AND REMEDIES

### A. *Freezing of Assets in Cases of Fraud*

When trying to stop securities fraud, the SEC is very likely to freeze a defendant's assets by seeking a TRO or preliminary injunction.<sup>3</sup> The rationale behind this is that the freeze can help ensure that there are assets available to compensate victims of the securities fraud if the defendant is found liable.<sup>4</sup> There is nothing requiring all of a defendant's assets to be frozen, and logically, all that should be required is that the court order enough assets to be frozen to ensure that any potential payments or penalties can be fulfilled.<sup>5</sup> Nevertheless, courts are most likely to initially freeze all of a defendant's assets,<sup>6</sup> even if not all of those assets are "tainted" by the fraud.<sup>7</sup>

When granting the freeze, the court not only has the option to prevent defendants from accessing the assets for an indefinite period of

---

<sup>2</sup> This Note will not address the complicated issue of receivership. There is most certainly a fairness concern in allowing a receiver to collect a large payment from the defendant's frozen assets while refusing to grant assets to an innocent spouse. This issue, however, is beyond the scope of this Note.

<sup>3</sup> 6 ALAN R. BROMBERG ET AL., *BROMBERG & LOWENFELS ON SECURITIES FRAUD* § 12:74, at 12-217 to 12-218 (2d ed. 2014).

<sup>4</sup> See e.g., *SEC v. Gen. Refractories Co.*, 400 F. Supp. 1248, 1259 (D.D.C. 1975) ("[T]he SEC is seeking the freezing of certain specific assets that are clearly related to the alleged scheme in order to assure a source to satisfy that part of the final judgment which might be ordered specifically by this Court.").

<sup>5</sup> BROMBERG ET AL., *supra* note 3, at 12-220.

<sup>6</sup> *Id.*

<sup>7</sup> See, e.g., *SEC v. Vaskevitch*, 657 F. Supp. 312, 315 (S.D.N.Y. 1987) (freezing all of a defendant's assets and noting that "if at some later stage the freeze appears too broad, it can be appropriately narrowed").

time, but it can also prevent a wide range of others from accessing them.<sup>8</sup> These others can include the defendant's officers, employees, or attorneys and any persons considered to be "in active concert or participation with them."<sup>9</sup> Once served on the defendant and anyone who may hold his assets,<sup>10</sup> the TRO is issued very broadly against third persons.<sup>11</sup> Because spouses often share all assets, especially large ones such as houses or bank accounts, a broad TRO will be particularly restrictive for them. Once a TRO is granted, the burden shifts to the defendant to show that the freeze is excessive or to request that the court modify the TRO.<sup>12</sup>

These very broad TROs are "almost routinely granted" without any consideration given to the harmful effects they may cause to a defendant's family who may rely on the frozen assets.<sup>13</sup> Additionally, the balancing of hardships that is used when considering other injunctions is not considered when the SEC moves to freeze assets.<sup>14</sup>

Furthermore, a court may issue a TRO freezing assets of a third party against whom no wrongdoing is alleged—such as an innocent spouse—by making that third party a nominal defendant.<sup>15</sup> The third party need only have funds that are a part of the subject of the litigation—here, funds tainted by the fraud—in order to be named as a nominal defendant against whom a judgment may be collected.<sup>16</sup>

The next section of this Note outlines the potential remedies that an innocent spouse has and whether such remedies are realistic or fair. This Note will then suggest certain changes that could be made to the injunction process so that a balance is struck between the need to ensure that there are assets available to compensate victims of the defendant's fraud and the need to ensure that the family is not left without adequate means to live.

---

<sup>8</sup> BROMBERG ET AL., *supra* note 3, at 12-218.

<sup>9</sup> *See, e.g., Vaskevitch*, 657 F. Supp. at 316.

<sup>10</sup> BROMBERG ET AL., *supra* note 3, at 12-218.

<sup>11</sup> *See id.* at 12-219.

<sup>12</sup> *Id.* at 12-220.

<sup>13</sup> *See id.* at 12-224.

<sup>14</sup> SEC v. Hedén, 51 F. Supp. 2d 296, 298 (S.D.N.Y. 1999) ("Unlike a preliminary injunction enjoining a violation of the securities laws, which requires the SEC to make a substantial showing of likelihood of success as to both a current violation and the risk of repetition, an asset freeze requires a lesser showing."). For the SEC to obtain an injunction freezing a defendant's assets, it need only show that "it is likely to succeed on the merits." *Id.* (quoting SEC v. Cavanagh, 155 F.3d 129, 132 (2d Cir. 1998)) (internal quotation marks omitted). Additionally, "[u]nlike a private litigant, the SEC need not show that there is a risk of irreparable injury." *Id.*

<sup>15</sup> *See* SEC v. Cherif, 933 F.2d 403, 414 (7th Cir. 1991); *see also* discussion *infra* Part I.B (discussing how a spouse becomes a party to such an action).

<sup>16</sup> *See Cherif*, 933 F.2d at 414.

### B. Remedies for the Spouse Once Assets Are Frozen

There are two ways that a spouse may become a party to the SEC action. First, the spouse of a defendant can be joined in the suit as a nominal defendant.<sup>17</sup> The SEC may name a spouse as a nominal defendant in order to freeze assets belonging solely to the spouse.<sup>18</sup> Although the court may recognize nominal defendants as innocent of any wrongdoing, they are named as defendants because they have received funds or property that are traceable to the illegal activity.<sup>19</sup> For a spouse to be named a nominal defendant in a securities enforcement action, the spouse need only “(1) ha[ve] received ill-gotten funds; and (2) . . . not have a legitimate claim to those funds.”<sup>20</sup> This ultimately allows the SEC to recover property from the nominal defendant.<sup>21</sup>

Second, in the event that a spouse is not named as a nominal defendant, the spouse may seek to intervene under Federal Rule of Civil Procedure 24(a).<sup>22</sup> This may be the case when a couple’s joint assets are frozen under the TRO. Such deprivation may be particularly acute if the spouse does not have any assets that are solely her own.<sup>23</sup> Under Rule 24(a), an applicant seeking to intervene as of right must demonstrate that:

- (1) it has a significant protectable interest relating to the property or transaction that is the subject of the action;
- (2) the disposition of the action may, as a practical matter, impair or impede the applicant’s ability to protect its interest;
- (3) the application is timely; and
- (4) the existing parties may not adequately represent the applicant’s interest.<sup>24</sup>

If the spouse is either named as a nominal defendant or intervenes under Rule 24(a), she can use the equitable remedies discussed below, namely

<sup>17</sup> See Camisha L. Simmons, *Defrauded Parties’ Recovery of Funds from Innocent Third Parties: The Relief Defendant*, BANKR. LITIG. COMMITTEE (Am. Bankr. Inst., Alexandria, VA), Aug. 2009, available at <http://www.abiworld.org/committees/newsletters/litigation/vol6num5/defrauded.html>; see also *Cherif*, 933 F.2d at 414 (explaining the use of a nominal defendant in an SEC action).

<sup>18</sup> See, e.g., *SEC v. Cavanagh*, 155 F.3d 129, 136–37 (2d Cir. 1998) (upholding an injunction freezing funds in the account of a defendant’s wife that were the proceeds of fraud, even though she was not accused of any wrongdoing).

<sup>19</sup> Simmons, *supra* note 17.

<sup>20</sup> *Cavanagh*, 155 F.3d at 136.

<sup>21</sup> See Simmons, *supra* note 17 (citing *Cavanaugh*, 155 F.3d at 137).

<sup>22</sup> See FED. R. CIV. P. 24(a)(2); see also *SEC v. Lefebvre*, No. C 02–3704 JSW, 2004 WL 2696731, at \*2 (N.D. Cal. Mar. 31, 2004) (outlining when an applicant may seek to intervene in an SEC action).

<sup>23</sup> It is plausible that a married couple could share all assets, including houses, bank accounts, etc. This scenario may be more likely in cases where the spouse is a homemaker, such as our example spouse, Anne, introduced in Part II.

<sup>24</sup> *Lefebvre*, 2004 WL 2696731, at \*2 (quoting *United States v. Los Angeles*, 288 F.3d 391, 397 (9th Cir. 2002)).

requesting modification of the order and arguing that certain assets are untainted.<sup>25</sup>

### 1. Requesting Modification of the Order

Just as a court has the authority to issue an order temporarily freezing a defendant's assets, it also has the authority to release frozen assets or to modify the amount frozen.<sup>26</sup> In many cases, defendants seek a modification of a TRO to cover attorney's fees.<sup>27</sup> Defendants also seek to access funds for other expenses.<sup>28</sup> Courts, however, may be disinclined to grant such modifications when they are faced with a significant number of defrauded investors.<sup>29</sup>

When a defendant requests that the court modify an existing TRO, courts will commonly look to several factors. These factors include (1) what is in the best interests of the defrauded investors, (2) the source of the released funds,<sup>30</sup> (3) the balance of the defendant's interests versus the government's interests, and (4) the expenses that the defendant seeks to pay.<sup>31</sup> Some courts hold that the defendant has the burden to show that "such a modification is in the interest of the defrauded investors."<sup>32</sup>

In some situations, releasing funds from a freeze may actually benefit defrauded investors. This would be the case if the TRO was causing such a disruption to a defendant's business that it was at risk of financial ruin, and therefore lessening the value of the assets available to compensate defrauded investors.<sup>33</sup>

When deciding whether to modify a TRO to release funds for living expenses, the court must balance "[t]he defendant's interest in having

---

<sup>25</sup> *Cf. Cavanagh*, 155 F.3d at 136–37 (noting that any named defendant, even if named only as a nominal defendant, has a "full opportunity to litigate her rights").

<sup>26</sup> *See, e.g., SEC v. Duclaud Gonzalez de Castilla*, 170 F. Supp. 2d 427, 429 (S.D.N.Y. 2001) (releasing assets to pay for legal expenses).

<sup>27</sup> For examples of cases that sought to release frozen funds to pay for attorney's fees (among other things), see *Duclaud Gonzalez de Castilla*, 170 F. Supp. 2d at 429 and *SEC v. Coates*, No. 94 Civ. 5361 (KMW), 1994 WL 455558 (S.D.N.Y. Aug. 23, 1994).

<sup>28</sup> *See, e.g., SEC v. Forte*, 598 F. Supp. 2d 689, 691 (E.D. Pa. 2009) (discussing defendant's request for release of frozen assets for a variety of expenses including mortgage payments, health insurance, and groceries); *SEC v. Dobbins*, No. Civ.3:04–CV–0605–H, 2004 WL 957715, at \*3 (N.D. Tex. 2004) (discussing defendant's request for release of frozen assets for a variety of expenses including business, living, and accounting expenses).

<sup>29</sup> *See Dobbins*, 2004 WL 957715, at \*1, \*4 (denying a defendant's motions where over fifty investors were allegedly defrauded).

<sup>30</sup> *See discussion infra* Part II.B.2.

<sup>31</sup> *See, e.g., Forte*, 598 F. Supp. 2d at 692–94 (weighing the interests of the defendant against those of the defrauded investors).

<sup>32</sup> *SEC v. Grossman*, 887 F. Supp. 649, 661 (S.D.N.Y. 1995), *aff'd sub nom. SEC v. Estate of Hirshberg*, 101 F.3d 109 (2d Cir. 1996); *see also Coates*, 1994 WL 455558, at \*3 (declining to modify an asset freeze on investor protection grounds).

<sup>33</sup> *Forte*, 598 F. Supp. 2d at 692 (citing *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1105 (2d Cir. 1972)).

access to funds needed to pay ordinary and necessary living expenses . . . against the government's interest in preventing the depletion of potentially forfeitable assets."<sup>34</sup> The court will look to factors such as the defendant's current funds, expenses, and the defendant's ability to obtain financial support from friends and family.<sup>35</sup> Often, a court will decline to release assets for living expenses if the defendant does not provide sufficient and detailed documentation.<sup>36</sup> Therefore, it is extremely important for defendants to include thorough documentation if they hope for their request to be granted.

Finally, the court will consider the nature of the expenses that the defendant seeks to pay. Courts will generally deny requests when the evidence before them indicates that the defendant is "requesting funds for luxuries, not necessities."<sup>37</sup> Expenses that may be considered necessities include "those types of bills which would be considered ordinary such as phone companies, the electric company, life insurance companies, and doctors."<sup>38</sup> Expenses that courts have considered to be luxuries include aesthetic expenses, such as hair care or lawn care, and the costs of upkeep on multiple properties.<sup>39</sup> Where a defendant is not seeking the release of assets to pay for luxuries and has shown, by sufficient documentation, that he has no other sources of income, some courts may grant a release of funds to cover necessary living expenses.<sup>40</sup>

## 2. Showing of Untainted Property

Once a court grants a broad TRO freezing all of a defendant's assets, the defendant may argue that "untainted" assets—those that were not derived from the fraud—should be released from the order. Courts

---

<sup>34</sup> *Dobbins*, 2004 WL 957715, at \*3 (internal quotation marks omitted).

<sup>35</sup> For cases noting a defendant's lack of documentation to support a request for modification of a TRO, see *Forte*, 598 F. Supp. 2d at 63–94 and *Dobbins*, 2004 WL 957715, at \*3.

<sup>36</sup> See *Forte*, 598 F. Supp. 2d at 693 (denying a defendant's motion to release funds because the defendant did not provide an accounting of all assets held by him, his spouse, and members of his household); *Dobbins*, 2004 WL 957715, at \*3 (denying a defendant's motion to release funds because he did not provide information "sufficient for the Court to determine the legitimacy of the request").

<sup>37</sup> SEC v. Dowdell, 175 F. Supp. 2d 850, 854 (W.D. Va. 2001).

<sup>38</sup> *Id.*

<sup>39</sup> See, e.g., *Forte*, 598 F. Supp. 2d at 694 (denying release of funds to pay for expenses such as satellite television and high-speed internet); SEC v. Duclaud Gonzalez de Castilla, 170 F. Supp. 2d 427, 430 (S.D.N.Y. 2001) (partially denying a defendant's motion, where defendant requested funds to pay for living expenses including a monthly expense of "\$1,800 for a nanny, housekeeper, handy-man, and nurse"); SEC v. Coates, No. 94 Civ. 5361 (KMW), 1994 WL 455558, at \*2 (S.D.N.Y. Aug. 23, 1994) (denying a defendant's motion for release of funds to cover mortgages on three properties, hair care, lawn service, and pool service).

<sup>40</sup> See, e.g., *Dowdell*, 175 F. Supp. 2d at 854–55.



may release frozen assets if it can be shown that they were not the product of the defendant's fraud.<sup>41</sup>

Upon such a motion by the defendant, a court can—and must in some cases—order that the TRO may not be continued until an adversary hearing is held on “whether (1) the SEC has established a prima facie case of securities law violations, and (2) the SEC has made a showing that the frozen assets are traceable to fraud.”<sup>42</sup> If the defendant prevails in the adversary hearing, the court may release some or all of the untainted assets from the freeze and make them available to the spouse for things such as attorney's fees and living expenses. When a defendant requests that a court release untainted funds from a TRO, the defendant must provide sufficient documentation to allow the court to make a determination that the frozen assets contain such untainted funds.<sup>43</sup>

The release of untainted funds, however, is not a certainty. Some courts may hold that where “it appears likely that investor losses dwarf [the] [d]efendant's remaining assets,” no funds should be released.<sup>44</sup> The rationale for this is that where a defendant may be held jointly and severally liable for a judgment, “[i]t is irrelevant whether the funds affected by the Assets Freeze are traceable to the illegal activity,” because those funds would go towards compensating victims regardless of if they were untainted by the fraud.<sup>45</sup> Thus, a court may even use this rationale to uphold a freeze on the assets of a nominal defendant that are not traceable to illegal activity.<sup>46</sup> In practice, this means that a court can uphold a TRO freezing the assets of a spouse, even where the spouse is recognized as innocent of any wrongdoing and maintained personal assets separate from proceeds of the fraud. If such a TRO may be upheld, there may be no hope of remedy for some spouses even though they are innocent and

---

<sup>41</sup> See *Forte*, 598 F. Supp. 2d at 693; cf. *SEC v. Cavanagh*, 155 F.3d 129, 136 (2d Cir. 1998) (upholding an injunction freezing the proceeds from the sale of stock at issue in a fraud case).

<sup>42</sup> *Coates*, 1994 WL 455558, at \*3 (citing *United States v. Monsanto*, 924 F.2d 1186, 1203 (2d Cir. 1991)). This standard comes from *United States v. Monsanto*, in which a criminal defendant was facing drug and conspiracy charges. See 924 F.2d at 1203. The *Coates* court, however, recognized that many of the reasons for holding a hearing that were cited in *Monsanto* were equally applicable in a securities fraud case. *Coates*, 1994 WL 455558, at \*3. The reasoning from *Monsanto*, however, applies only where the SEC brings a companion criminal case. The complexities that arise from a companion criminal case and the Sixth Amendment right to counsel that are implicated, while briefly addressed, are not the focus of this Note.

<sup>43</sup> See *SEC v. Current Fin. Servs.*, 62 F. Supp. 2d 66, 68 (D.D.C. 1999) (denying a defendant's motion to release funds from a freeze because “[n]early all of [defendant]’s supporting documentation is inconclusive, or even detrimental, as to his claim that the frozen account contains personal funds”).

<sup>44</sup> *Forte*, 598 F. Supp. 2d at 693.

<sup>45</sup> *SEC v. Grossman*, 887 F. Supp. 649, 661 (S.D.N.Y. 1995), *aff’d sub nom.* *SEC v. Estate of Hirshberg*, 101 F.3d 109 (2d Cir. 1996).

<sup>46</sup> *Id.* (upholding a freeze of the personal assets of a defendant's wife and daughter).

were responsible enough to acquire and maintain personal assets in their marriage.

### 3. Deals with the Government

One alternative that a spouse may have to seeking an equitable remedy is to strike a deal with the government. In such a deal, a spouse gives up any possible claim to untainted assets in exchange for a payment from the seized assets, which the government will not contest. One example of a spouse making such a deal is the case of Ruth Madoff. Ruth Madoff is the wife of the infamous Bernie Madoff,<sup>47</sup> the investor who defrauded his clients out of billions of dollars in what is arguably the most famous Ponzi scheme in history.<sup>48</sup> In March 2009, Bernie Madoff pled guilty to eleven criminal charges filed against him by the United States Attorney's Office for the Southern District of New York.<sup>49</sup> In June 2009, he was sentenced to a 150-year prison term and entered into a forfeiture agreement.<sup>50</sup> Ruth Madoff's situation differs from the situation described throughout this Note, however, because her innocence was not legally conceded.<sup>51</sup> Although it is unclear whether Ruth Madoff was involved in her husband's business dealings, she maintained that she "did not know of or participate in her husband's wrongdoing."<sup>52</sup>

In June 2009, Ruth Madoff entered into a settlement with the U.S. Attorney's Office in the Southern District of New York.<sup>53</sup> In this settlement, Ruth Madoff agreed to give up any claim she had to \$80 million worth of assets that she stated were untainted.<sup>54</sup> In exchange, the U.S. Attorney's office agreed not to contest Ruth Madoff's claim to \$2.5 million worth of assets that had been seized.<sup>55</sup>

Striking a deal with the prosecution is an appealing option because it can prevent a spouse from going through an extensive (and expensive) legal battle in order to obtain frozen or seized assets. A large risk in such

<sup>47</sup> Mark Seal, *Ruth's World*, VANITY FAIR, Sept. 2009, at 216, 229, available at <http://www.vanityfair.com/politics/features/2009/09/ruth-madoff200909-2>.

<sup>48</sup> See, e.g., Aaron Smith, *Madoff: 'I Knew This Day Would Come'*, CNN MONEY (Mar. 12, 2009, 3:33 PM), [http://money.cnn.com/2009/03/12/news/newsmakers/madoff\\_courtappearance/index.htm?iid=EL](http://money.cnn.com/2009/03/12/news/newsmakers/madoff_courtappearance/index.htm?iid=EL) (describing Madoff's crime as "[o]ne of Wall Street's biggest swindles").

<sup>49</sup> Complaint at 6, *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 496 B.R. 744 (Bankr. S.D.N.Y. 2013) (No. 08-01789), 2009 WL 2730174, at ¶15.

<sup>50</sup> *Id.*

<sup>51</sup> See, e.g., David Segal & Alison Leigh Cowan, *Madoffs Shared Much; Question Is How Much*, N.Y. TIMES, Jan. 15, 2009, at A1 (discussing the possibility that Mrs. Madoff had knowledge of the crime).

<sup>52</sup> See Seal, *supra* note 47, at 229.

<sup>53</sup> 7 ALAN R. BROMBERG ET AL., BROMBERG AND LOWENFELS ON SECURITIES FRAUD § 19:5, at 19-23 (2d ed. 2014).

<sup>54</sup> *Id.*; see also Complaint, *supra* note 49, at 2.

<sup>55</sup> See BROMBERG ET AL., *supra* note 53, at 19-23.

a deal, however, is that it does not protect the spouse from civil claims.<sup>56</sup> Although Ruth Madoff's deal did not protect her from civil claims, in cases where a spouse's innocence is uncontested there would likely be no basis for a civil claim. The spouse would likely be able to keep the full sum allotted in the settlement.

Another risk in striking a deal is that the spouse may end up having to settle for assets worth significantly less than those that were allegedly untainted, as was the case in Ruth Madoff's deal. In deciding whether to enter into a deal, a spouse will have to weigh the value of a lesser lump-sum payment against the potential difficulties in waging a legal battle to show that seized assets were untainted by fraud.

#### 4. Divorce

In cases where an innocent spouse has divorced a fraud defendant, the spouse may be able to keep assets recovered in the divorce settlement, even if tainted. In 2011, the Second Circuit Court of Appeals vacated a district court's holding that granted a preliminary injunction freezing the assets of a fraud defendant's ex-wife.<sup>57</sup>

Janet Schaberg and Stephen Walsh separated in 2004 and finalized a divorce settlement in 2006.<sup>58</sup> The settlement required Walsh to pay Schaberg \$12.5 million in biannual installments until 2020; allowed her to keep \$5 million held in checking accounts during their marriage; gave her an interest in a New York home; and gave her sole ownership of other real property.<sup>59</sup> In exchange, Schaberg waived her right to "any further equitable distribution, maintenance, or inheritance."<sup>60</sup> The CFTC and the SEC sued Walsh, and sued Schaberg as a relief defendant, in the Southern District of New York.<sup>61</sup> The suit sought to freeze the majority of Schaberg's assets because they were the proceeds of Walsh's fraud.<sup>62</sup> Neither agency alleged that Schaberg was a participant in the fraud or had any knowledge of it.<sup>63</sup> The district court rejected Schaberg's argu-

---

<sup>56</sup> Mrs. Madoff's agreement with the government expressly provided that the trustee for the liquidation of Bernie Madoff's business would not be precluded from seeking to recover from Mrs. Madoff. Complaint, *supra* note 49, at ¶3. The trustee did file such a suit, alleging that he was entitled to recover the \$44 million that Mrs. Madoff received in fraudulent transfers from Bernie Madoff's business. *Id.*; accord BROMBERG ET AL., *supra* note 53, at 19-24 (noting that after Mrs. Madoff's settlement, she was sued to recover funds that she had allegedly improperly received).

<sup>57</sup> Commodity Futures Trading Comm'n v. Walsh, 658 F.3d 194, 196, 200 (2d Cir. 2011).

<sup>58</sup> *Id.* at 196.

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> See *id.* at 197.

<sup>62</sup> See *id.*

<sup>63</sup> See *id.*

ment that a divorce decree could cleanse tainted funds transferred pursuant to the divorce and granted the freeze.<sup>64</sup>

On interlocutory appeal, the Second Circuit certified two questions to the New York Court of Appeals.<sup>65</sup> The Court of Appeals answered the first question, whether proceeds of fraud are included in the definition of marital property, in the affirmative.<sup>66</sup> The Court of Appeals answered the second question, whether “a determination that a spouse paid ‘fair consideration’ . . . [is] precluded, as a matter of law, where all or part of the marital estate consists of the proceeds of fraud,” in the negative.<sup>67</sup>

The Second Circuit then vacated the district court’s ruling and remanded the case.<sup>68</sup> A basis for vacating was that the district court granted the freeze on the grounds that the divorce decree did not cleanse the tainted assets.<sup>69</sup> Because the Court of Appeals clearly answered the certified questions contrary to the district court’s reasoning, the freeze had to be vacated.<sup>70</sup> On remand, the district court would have to consider whether Schaberg had given valid consideration for the assets, which could include giving up her right to maintenance, inheritance, child custody, or visitation.<sup>71</sup> Valid consideration does not include giving up a claim to a greater sum of tainted assets.<sup>72</sup>

The Second Circuit stated only that a prior finalized divorce decree could cleanse the taint from assets.<sup>73</sup> It did not, however, address the question of whether a divorce decree could still cleanse the taint if the divorce occurs after the investigation has begun or if the freeze is already in place. However, this recent ruling would seem to affect only those spouses who have divorced the defendant and received the tainted assets before charges are brought against him. Although a divorce decree cleansing tainted assets would make it much easier for innocent spouses to regain their frozen assets, courts would not likely unfreeze such assets. The obvious reason would be that too many spouses might then abuse the access that a divorce could grant to their assets, and divorces would be encouraged as an easy way to regain frozen assets.

Nevertheless, there may be some hope that the ruling could apply to divorces initiated after investigations have begun or assets have been fro-

<sup>64</sup> See *id.* at 198.

<sup>65</sup> See *id.* at 197.

<sup>66</sup> See *id.*

<sup>67</sup> *Id.* at 198.

<sup>68</sup> See *id.* at 200.

<sup>69</sup> See *id.* at 198.

<sup>70</sup> See *id.*

<sup>71</sup> See *id.*

<sup>72</sup> See *id.*

<sup>73</sup> See *id.* at 196, 198.

zen, at least in New York, given that the Court of Appeals noted that a divorce decree may cleanse tainted assets “at least where the innocent spouse acted in good faith and gave fair consideration.”<sup>74</sup> This reasoning opens the possibility that the ruling would apply in such cases, allowing the spouse to move on with her life away from the defendant.

## II. ANALYSIS

Let us consider an example. For ease of reference throughout this part of the Note, we will call our innocent spouse “Anne.” Anne’s husband is a defendant in a securities fraud case. It is undisputed in this case that Anne had no knowledge of her husband’s wrongdoings. The court has granted a very broad TRO that freezes all of the defendant’s assets and is in effect for anyone who holds assets of or shares assets with the defendant. Because Anne is the spouse of the defendant, this TRO covers her assets. Furthermore, Anne has been named as a nominal defendant in the suit, potentially leaving her personal assets open to recovery.<sup>75</sup> Let us also assume that because Anne has been a homemaker since marrying the defendant, she has few assets that are entirely her own. Anne is now left without assets to cover attorney’s fees or living expenses to support herself and her two young children.<sup>76</sup>

### A. *Difficulties in Accessing Assets to Pay for Attorney’s Fees*

Assuming that Anne is entitled to one or more of the aforementioned remedies, she will need an attorney in order to pursue any of them. In reality, however, attorney’s fees can be a crippling cost that may prevent Anne from pursuing any of these remedies.

In cases where an attorney is not paid in advance, the issue will be whether frozen assets may be released to pay for attorney’s fees. When the court imposes an asset freeze, it is not required to set aside separate funds to cover attorney’s fees.<sup>77</sup> The SEC generally opposes any motion to release funds to pay attorney’s fees<sup>78</sup> and courts often deny such re-

---

<sup>74</sup> *Id.* at 198.

<sup>75</sup> See Simmons *supra* note 17.

<sup>76</sup> Although the situation may seem exaggerated, it is, in fact, a scenario that does occur in real life. See, for example, the case of Maria Gonzalez-Miranda. Reply Memorandum of Law in Support of Motion by Maria Gonzalez-Miranda for Interim Relief and Modification of the Temporary Order Freezing Assets, SEC v. Illarramendi, No. 3:11-CV-00078 (JBA), 2011 WL 2457734 (D. Conn. June 16, 2011). In that case, all of Ms. Gonzalez-Miranda’s assets were frozen when the SEC charged her husband. See *id.* at 2. Ms. Gonzalez was left with no funds to “feed, clothe, and educate her children and heat the home where she [resided].” *Id.* at 1 (note that she was seeking to heat her home in November in Connecticut). Ms. Gonzalez-Miranda was rendered so destitute that she was awarded state-provided assistance, specifically “food stamps, HUSKY insurance, and fuel.” *Id.* at 3.

<sup>77</sup> See *id.*

<sup>78</sup> BROMBERG ET AL., *supra* note 3, at 12-221.

quests by defendants.<sup>79</sup> The reasoning behind this is that the frozen assets may represent funds that belong to those who have been defrauded, and the defendant has no right to use “other people’s money” to retain the attorney of his choice. For example, the Seventh Circuit has stated, “Just as a bank robber cannot use the loot to wage the best defense money can buy, so a swindler in securities markets cannot use the victims’ assets to hire counsel who will help him retain the gleanings of crime.”<sup>80</sup> This may effectively leave spouses such as Anne with no possibility of paying an attorney to help her to obtain any of these equitable remedies.

Although the argument against using “other people’s money” in a securities fraud case is appealing, upon further analysis, the logic is circular. Assuming that some of the frozen assets are untainted, a defendant would require an attorney to make a showing that the assets are untainted. Yet such a showing could not be made without having funds released to pay for an attorney in the first place.

*SEC v. Dowdell*<sup>81</sup> provides an example of a court’s recognition of the unfairness in denying a defendant’s motion to release assets to cover attorney’s fees. The *Dowdell* court noted that the case law in this area is “anything but consistent on whether defendants in this type of civil enforcement action may be permitted to pay attorney’s fees with a portion of their frozen assets.”<sup>82</sup> In referencing the different views taken by courts, the court made note of the strict approach taken by the Seventh Circuit: “On one end of the spectrum is the Seventh Circuit which has not minced words in expressing its opposition to such requests.”<sup>83</sup> The *Dowdell* court, however, took a different approach than that of the Seventh Circuit:

This court’s central concern is the fairness of the proceedings. The court does not believe that it could achieve a fair result at the preliminary injunction hearing were it to deny defendants the ability to retain counsel. This is a complex legal matter, and lawyers are essential to the presentation of issues related to it.<sup>84</sup>

The court then held that it would approve a “reasonable” estimate of attorney’s fees necessary for the hearing on the SEC’s motion for a preliminary injunction.<sup>85</sup>

<sup>79</sup> *Id.*

<sup>80</sup> *SEC v. Quinn*, 997 F.2d 287, 289 (7th Cir. 1993).

<sup>81</sup> 175 F. Supp. 2d 850 (W.D. Va. 2001).

<sup>82</sup> *Id.* at 855.

<sup>83</sup> *Id.*

<sup>84</sup> *Id.* at 856.

<sup>85</sup> *Id.*

In *United States v. E-Gold, Ltd.*,<sup>86</sup> the District of Columbia Court of Appeals also seemed to be in favor of releasing assets to cover the cost of attorney's fees for a post-seizure hearing. Although the seizure of assets was not in the context of securities fraud,<sup>87</sup> the analysis of whether to release funds to pay attorney's fees would apply regardless of why the assets were frozen by the government. The D.C. Circuit recognized that although there may be an immediate need to issue an injunction to prevent the defendant from hiding the assets, this need must be balanced against the right to counsel of choice.<sup>88</sup> The D.C. Circuit applied the test set out by the Supreme Court in *Mathews v. Eldridge* to determine the due process rights of a defendant whose property has been seized, weighing three interests:

First, the private interest that will be affected by the official action; second, the risk of an erroneous deprivation of such interest through the procedures used, and the probable value, if any, of additional or substitute procedural safeguards; and finally, the Government's interest, including the function involved and the fiscal and administrative burdens that the additional or substitute procedural requirement would entail.<sup>89</sup>

The D.C. Circuit noted that, under the first prong of the *Mathews* test, the defendant's private interest is not merely in using his property as he sees fit but is "augmented by an important liberty interest: the qualified right, under the sixth amendment, to counsel of choice."<sup>90</sup> The qualified right to counsel of choice is established where "the defendants are not financially capable of retaining counsel of choice without the seized property."<sup>91</sup> The D.C. Circuit further echoed that "[t]he defendant needs the attorney *now* if the attorney is to do him any good."<sup>92</sup>

As evidenced by the foregoing discussion, there is no one standard that compels a court to act in any particular way regarding the unfreezing of assets for attorney's fees. The differing views, however, make it clear

---

<sup>86</sup> 521 F.3d 411 (D.C. Cir. 2008).

<sup>87</sup> In *E-Gold*, the government obtained an ex parte seizure warrant to seize for forfeiture the funds in the defendant companies' accounts, after indicting the defendants for operating an unlicensed money transmitting business. *Id.* at 412–13.

<sup>88</sup> *See id.* at 415–16.

<sup>89</sup> *Id.* at 416 (quoting *Mathews v. Eldridge*, 424 U.S. 319, 335 (1976)).

<sup>90</sup> *Id.* at 417 (internal quotation marks omitted). The D.C. Circuit chose to follow the Second Circuit in recognizing the right to counsel of choice where assets have been seized. *Id.* at 416 (noting that the Second Circuit's precedent was "instructive"). As noted above, the Sixth Amendment is only implicated where the SEC brings a companion criminal case, and therefore does not apply in all situations that might arise in this Note. *See supra* note 42.

<sup>91</sup> *Id.* at 417.

<sup>92</sup> *Id.* at 418 (quoting *United States v. Moya-Gomez*, 860 F.2d 706, 726 (7th Cir. 1988)) (internal quotation marks omitted).

that it is entirely possible to release reasonable funds from an assets freeze to cover attorney's fees. Given the compelling circumstances of nominal defendants such as Anne, courts should be more lenient in releasing assets. Courts should follow the rationales set forward in cases such as *Dowdell*, which advocate for consideration of the unfairness of denying defendants the assets necessary to cover reasonable attorney's fees.

### B. Procedural Due Process Considerations

A broad TRO freezing all of the assets of a spouse such as Anne might lead to the question of whether such a seizure amounts to a due process violation.<sup>93</sup> There are some indicia of a violation, such as the ex parte nature of the hearing. The answer, however, seems to be that there is no such violation. Given that the TRO will be lifted should the accused be found not guilty, the TRO is technically only a temporary deprivation of property.<sup>94</sup> Regardless, the temporary deprivation is still "subject to the constraints of due process."<sup>95</sup> Normally, due process requires that, before a deprivation of property can occur, there is "notice and an opportunity to be heard."<sup>96</sup> In some "extraordinary situations," however, notice and a hearing may be postponed until after the deprivation occurs.<sup>97</sup> These "extraordinary situations" are governed by the three-prong test in *Mathews*.<sup>98</sup>

Under the *Mathews* test, freezing assets would not require a pre-deprivation hearing to comport with the requirements of due process. The interests of the SEC meet the extraordinary situation exception, because the freeze will serve recognized government interests including, "(1) 'separating a criminal from his ill-gotten gains,' (2) obtaining substantial funds for furtherance of law enforcement, [and] (3) permitting recovery of assets by their 'rightful owners.'"<sup>99</sup> These government interests outweigh the defendant's private interests and the risk of erroneous deprivation.<sup>100</sup> Unfortunately, Anne is not entitled to a hearing before her assets are frozen; the granting of the TRO will remain an ex parte proceeding.<sup>101</sup>

---

<sup>93</sup> The due process violation would be the deprivation of property without the due process of law. U.S. CONST. amend. V.

<sup>94</sup> See *United States v. Monsanto*, 924 F.2d 1186, 1192 (2d Cir. 1991).

<sup>95</sup> *Id.*

<sup>96</sup> *Id.* (internal quotation marks omitted).

<sup>97</sup> *Id.* (internal quotation marks omitted).

<sup>98</sup> See discussion *supra* Part II.A.

<sup>99</sup> *Monsanto*, 924 F.2d at 1192 (quoting *Caplin & Drysdale, Chartered v. United States*, 491 U.S. 617, 629 (1989)).

<sup>100</sup> See *id.*

<sup>101</sup> *But see* *Goldberg v. Kelly*, 397 U.S. 254, 264 (1970) ("[W]hen welfare is discontinued, only a pre-termination evidentiary hearing provides the recipient with procedural due



### C. *The Inefficiency and Unfairness in Granting Broad TROs*

It is necessary to consider the rationale behind ordering broad TROs that prevent spouses from accessing joint assets that may be necessary for them to live off of. There is an interest in assuring that victims of the fraud are compensated. If, however, there were to be a later showing that some assets were untainted, in many cases those assets would be released and would not be used towards the payment of any penalties. Therefore, it seems excessive to freeze such assets from the start of the case.

There is a strong argument that society does not benefit when untainted funds are frozen. In extreme cases, spouses might be rendered so helpless that they qualify for help from the state.<sup>102</sup> Thus taxpayers support individuals who would otherwise be able to support themselves, if it were not for their funds being frozen due to a broad TRO.

An alternative option, the one advocated for by this Note, is to require a showing that the assets to be frozen are tainted at the ex parte hearing—before the TRO is granted. Although the SEC must have power to ensure a recovery, a freeze on an innocent spouse's untainted assets is surely an overreach. Because in most cases the defendant has not been perpetrating the fraud for his entire career, there are very likely untainted assets that are being frozen. The court should be required to make a preliminary inquiry into—and the SEC should be required to present evidence of—what assets are untainted and to leave those assets out of the TRO. While it may be simple for the court to freeze one hundred percent of a defendant's assets, it would not be overly inefficient to require the court to make an inquiry into what assets are untainted before granting the order. Such an inquiry would prevent spouses like Anne from being deprived of all joint assets in cases where some assets are untainted.

Furthermore, defendants are likely to raise the issue of untainted assets when seeking to modify the order.<sup>103</sup> Therefore, not only would the requirement serve the interest of fairness, it would also serve the interest of efficiency. First, the SEC will have already determined which assets are tainted. Second, if untainted assets are left out of the freeze initially, defendants may have enough funds to cover attorney's fees and living expenses and may not seek to modify the TRO. This solution would be particularly just for spouses like Anne, who have only a financial interest in the case (as opposed to the liberty interests of a culpable defendant who could potentially be facing imprisonment). This solution

---

process.”). There may be an argument that the seizing of funds necessary to pay for housing, food, and childcare may constitute the type of deprivation that was found to require a pre-termination hearing in *Goldberg*. *Id.* at 262.

<sup>102</sup> See *supra* note 76.

<sup>103</sup> See discussion *supra* Part I.B.2.

is fair because it would not cause innocent spouses like Anne to be deprived of the funds they need for trial and would still freeze tainted funds that rightfully belong to the defrauded investors.

Another option that would lead to less unfairness in granting the TRO would be for the court to include a consideration of the hardships that would be placed on innocent spouses when granting the TRO. It is unrealistic to disregard dependents who will be impacted. In some cases, spouses may be deprived of their homes and funds to pay for their most basic living expenses. This is even more relevant in cases, such as that of Anne, where the defendant has young children.

The SEC's burden for obtaining an asset freeze is very low when compared to standards for an injunction in other types of cases, including other kinds of SEC cases.<sup>104</sup> For a TRO to be granted, the SEC need only show that it is "likely to succeed on the merits."<sup>105</sup> The SEC need not make a showing of irreparable harm.<sup>106</sup> In civil litigation between private litigants much weight is given to a balancing of the hardships. For example, the Fourth Circuit uses a standard that requires balancing "the 'likelihood' of irreparable harm to the plaintiff against the 'likelihood' of harm to the defendant."<sup>107</sup> Only when there is no clear difference in the hardships should the court look to the merits of the case, and in such cases relief is "more likely to require a clear showing of a likelihood of success."<sup>108</sup>

Granted, the nature of securities fraud cases may not make them conducive to only a balance of the hardships test for a preliminary injunction. The interests of the defrauded investors may require a lower standard for granting the TRO to protect against a defendant hiding a large amount of tainted assets. There is room, however, for *some* consideration of the hardships, especially when freezing the assets of innocent spouses like Anne. Furthermore, a balance of the hardships would be very pertinent for spouses whose personal assets have been frozen, even though they are innocent.

#### D. *Innocent Spouse Relief in the Context of Tax Fraud*

The law has recognized exceptions for innocent spouses for another type of fraud—tax fraud. Spouses often file joint tax returns because it allows them to take advantage of benefits that may not be available to

---

<sup>104</sup> See *supra* note 14.

<sup>105</sup> SEC v. Hedén, 51 F. Supp. 2d 296, 298 (S.D.N.Y. 1999) (quoting SEC v. Cavanagh, 155 F.3d 129, 132 (2d Cir. 1998) (internal quotation marks omitted).

<sup>106</sup> See *id.*

<sup>107</sup> Direx Israel, Ltd. v. Breakthrough Med. Corp., 952 F.2d 802, 808 (4th Cir. 1991) (quoting Blackwelder Furniture Co. v. Seilig Mfg. Co., 550 F.2d 189, 195 (4th Cir. 1977)).

<sup>108</sup> *Id.*

those filing individually.<sup>109</sup> The downside to this is that both spouses may be held jointly and severally liable for the entire tax liability.<sup>110</sup> This is true even if only one spouse earns all of the household income or if the spouses later divorce.<sup>111</sup> The Internal Revenue Service (IRS), however, will relieve spouses from paying tax, interest, or penalties if they meet certain criteria.<sup>112</sup> One type of relief is aptly named “Innocent Spouse Relief.”<sup>113</sup>

Four conditions are necessary to make an individual eligible for Innocent Spouse Relief.<sup>114</sup> First, the spouses must have filed a joint return.<sup>115</sup> Second, the return must have an understated tax due to the non-claimant spouse’s errors.<sup>116</sup> Third, the spouse claiming relief must show that at the time the return was filed, she had no actual knowledge of, and no reason to know of, the understated tax.<sup>117</sup> And finally, unfairness would have to result if, “[t]aking into account all the facts and circumstances,” the claimant spouse were to be held liable for the understated tax.<sup>118</sup>

Furthermore, the IRS has made it even simpler for innocent spouses to escape liability in tax fraud cases by allowing two additional categories of relief for those spouses who do not meet the standard for Innocent Spouse Relief. Under “Separation of Liability Relief,” the IRS will only require the innocent spouse to pay for the portion of taxes she is liable

---

<sup>109</sup> See, e.g., Dan Caplinger, *Married Filing Separately: When Does It Make Sense?*, DAILY FINANCE (Mar. 29, 2014), <http://www.dailyfinance.com/2014/03/29/taxes-married-filing-separately/> (noting that for the “vast majority” filing joint tax returns saves money).

<sup>110</sup> I.R.S. Publication 971 (July 17, 2012), at 1, available at <http://www.irs.gov/pub/irs-pdf/p971.pdf>.

<sup>111</sup> Jason Alderman, “*Innocent Spouse Relief*” Protects Against Tax Fraud, HUFFINGTON POST, [http://www.huffingtonpost.com/jason-alderman/innocent-spouse-relief\\_b\\_1631665.html](http://www.huffingtonpost.com/jason-alderman/innocent-spouse-relief_b_1631665.html) (last updated Aug. 28, 2012).

<sup>112</sup> I.R.S., *supra* note 110, at 2.

<sup>113</sup> *Id.*

<sup>114</sup> I.R.C. § 6015(b) (2012) (a timeliness requirement also applies).

<sup>115</sup> § 6015(b)(1)(A) (2012).

<sup>116</sup> § 6015(b)(1)(B), (C) (2012); see also I.R.S., *supra* note 110, at 5 (stating that an understated tax may take the form of either unreported income or an incorrect deduction, credit, or basis).

<sup>117</sup> § 6015(b)(1)(C) (2012); see also *Erdahl v. Comm’r*, 930 F.2d 585, 590 (8th Cir. 1991) (“The standard we adopt for innocent spouse cases asks ‘whether a reasonably prudent taxpayer under the circumstances of the spouse at the time of signing the return could be expected to know that the tax liability stated was erroneous or that further investigation was warranted.’” (quoting *Stevens v. Comm’r*, 872 F.2d 1499, 1505 (11th Cir. 1989))). Whether a spouse had reason to know of an understated tax is based on the facts and circumstances of the situation. Considerations may include the claimant’s financial situation, her educational background, any failure to inquire, and departures from a recurring pattern, among other things. I.R.S., *supra* note 110, at 6.

<sup>118</sup> § 6015(b)(1)(D) (2012). Facts and circumstances to be taken into consideration include whether the claimant spouse received a benefit from the understated tax and whether the non-claimant spouse has left or divorced the claimant spouse. I.R.S., *supra* note 110, at 6.

for (rather than holding the spouses jointly and severally liable).<sup>119</sup> The IRS may also grant “Equitable Relief” to innocent spouses who do not qualify for either Innocent Spouse Relief or Separation of Liability Relief.<sup>120</sup>

The fact that the law has recognized an exception for innocent spouses in tax fraud cases suggests that the same could be possible in securities fraud cases. In both situations, an innocent spouse faces liability for the fraudulent actions of her spouse. Furthermore, in both situations the innocent spouse would be liable to a third party—to defrauded investors and to the government. Requiring courts to consider undue hardships caused to innocent spouses in fraud cases seems analogous to the “out” given to innocent spouses based on the unfairness that would result if they were held liable for an understated tax. Given the feasibility of granting Innocent Spouse Relief in federal tax fraud cases, a hardship inquiry prior to granting a freeze of assets in a securities fraud case is certainly possible.

Innocent Spouse Relief in the tax fraud context also suggests another pathway to protecting the innocent spouse in securities fraud cases: legislation. While this Note argues mainly for change through the judicial process, protection through legislation is also a viable option. Because legislators felt it was necessary to codify innocent spouse protections in IRS law, legislators may also be open to protecting innocent spouses through changes to SEC statutes. Legislators could put in place a clearly defined burden of proof for the innocent spouse, akin to the IRS’s innocent spouse relief. Such a rule would make it easier for innocent spouses to understand what is required to prove their innocence and would solve the procedural and financial burdens surrounding the release of untainted assets.

#### CONCLUSION

The increased occurrence of securities fraud enforcement necessitates a reevaluation of how such cases affect innocent spouses. In fact, such cases may have a large effect on not only the innocent victims of the fraud, but also the innocent spouses and children of culpable defendants. In some cases, spouses may have their assets frozen even when they have not been accused of any wrongdoing and where such assets are personal and not traceable to the fraud.

---

<sup>119</sup> I.R.S., *supra* note 110, at 7.

<sup>120</sup> *Id.* at 8; *see also* Alderman, *supra* note 111 (discussing the leeway granted under Equitable Relief, including the IRS’s elimination of the two year filing requirement, which aids innocent spouses who were unaware of the fraud, or were afraid to come forward for reasons such as domestic abuse).

Innocent spouses may have equitable remedies available to them—requesting a modification of the TRO or showing that frozen assets are untainted by the fraud. But these remedies may not be enough. Courts are often unwilling to modify a TRO, even in cases where the defendant has made a showing that the assets are untainted by the fraud. Innocent spouses may also be able to enter into a deal with the government to retain some assets; however, the amount of assets retained may be very limited. Such a deal also may not protect the spouse from civil claims. Moreover, even if spouses like Anne divorce the defendant, they will likely be unable to retain any assets granted in the divorce decree if they are deemed to be tainted by fraud.

Furthermore, to pursue any of the equitable remedies that spouses such as Anne may have available requires that the spouse have funds to cover attorney's fees. For many this may prove very difficult, even impossible. Thus, a spouse may be effectively prevented from pursuing any remedies. Although some courts have realized that this is inherently unfair, other courts continue to refuse to allow assets to be released from a freeze. While denial of a motion to release assets may be fair where the assets are tainted, maintaining a freeze on the untainted assets of an innocent spouse is an overreach that should be remedied.

The solution suggested in this Note is to narrow the scope of the TRO granted to the SEC when they bring an action. This Note recognizes that there is a strong interest in maintaining an *ex parte* proceeding so that the defendant will not find a way to hide any assets before they are served with the order. However, the proceeding could still require that the SEC make a showing that the assets are tainted by the fraud. Currently, the SEC would have to make such a showing in a later preliminary hearing upon the defendant's request; therefore, this simply moves up the timing.

Such a solution is in the interests of both fairness and efficiency. The solution is fair because it allows an innocent spouse to make a showing that the assets frozen are untainted without preventing the spouse from using those very assets to pay an attorney. Furthermore, this solution would be in the interest of efficiency because it could reduce the need for a later hearing to show that the assets are untainted.

The court could also raise the standards for granting a TRO. Currently, the standard is very low in comparison with injunctions in other contexts. Raising the standard to include a balancing of the hardships that would occur if the TRO is granted would help to remedy some of the unfairness experienced by spouses such as Anne.

Clearly, it is possible to maintain an effective system of freezing funds that have been obtained illegally without punishing those who are innocent. This is evidenced by the fact that the government has found a

way to do so in other situations, namely in cases of tax fraud. Innocent spouses are granted multiple forms of relief if, unbeknownst to them, their spouse commits tax fraud. Surely, if such broad exemptions have been made in the context of tax fraud, concessions can also be made to protect innocent spouses in securities fraud cases.

In conclusion, there are multiple ways that the court could protect the interests of innocent spouses in securities fraud cases. Furthermore, the *ex parte* nature of the proceedings could be maintained, thereby guarding against the possibility of the defendant hiding assets, while offering more fairness in the scope of the assets frozen—granting reasonable attorney’s fees. Most importantly, these potential solutions offer a way to make SEC actions fairer and more efficient without forfeiting the key goals of the SEC.