

Looking for a Solution To Misuse of Client Funds

BY LAZAR EMANUEL

[Editor's note: This is the first of a series on misappropriation of client funds by lawyers holding escrow deposits.]

Although the number of offending lawyers is small, and the total of funds disbursed is not great [The New York Lawyers' Fund for Client Protection reports that in the year 2005, only 227 client claims were recognized - involving a total of only 56 lawyers - and that a total of \$8.1 million dollars was reimbursed to clients], several Bar Associations have begun to review and assess seriously the current practice of allowing lawyers to deposit, manage, and disburse funds belonging to clients.

Obviously, stories about lawyers who misappropriate their clients' funds are reported with special glee by the news media. They know that the public relishes these stories, especially because the stories stimulate the common human reaction to the misfortunes and transgressions of the seemingly privileged. The front page of the New York Times on Saturday March 24, for example, carried an extended story about lawyers in Kentucky who had allegedly withheld a larger share of a settlement fund than the 30-33% provided in their retainer agreement.

Although only 51% of the 2005 losses in New York were real-estate related, the focus of the Bar Association studies has been on lawyers who deposit funds in connection with real estate transactions. In November 2005, A. Vincent Buzard, then-President of the NYSBA, asked the Real Property Law Section of the Association to report on the alternatives available to prevent theft of real property escrow funds by lawyers. Joshua Stein, chair of the Section, appointed Ira S. Goldenberg, a White Plains lawyer, to head a Task Force to study and report on the alternatives.

At virtually the same time, an Escrow Task Force of the Nassau County Bar Association issued a report (October 11, 2005) responding to comments by the Lawyers' Fund in its 2004 Report attributing a disproportionately high number of real estate escrow thefts to Long Island lawyers. The NYSBA Task Force summarized the conclusions of the Nassau County Task Force as follows:

This Task Force concluded that no new regulatory measures are needed. They rejected dual signature arrangements and joint escrows, finding them largely unworkable for sole practitioners. They rejected a shift to title company escrows, noting that the title industry has experienced its own defalcations. They recommended that the Lawyers' Fund study and report on the causes of lawyer misappropriation so that educational programs could be fashioned.

The NYSBA Task Force delved considerably more deeply into other alternatives for the retention and management of client funds. It considered in some detail the use of title companies, real estate brokers, and banks as "possible alternative escrow agents." It concluded that of the three, only the banks represented a practical and viable alternative.

Composed as it was of real property lawyers, the Task Force recognized that because of the number of interests involved - seller, lender, broker, purchaser, title company, condominium or co-op agent - and the possibility that multiple transactions would have to be closed on the same day, it was necessary to insure speed and accuracy in the disbursement of funds.

...any alternative escrow agent needs to be ready, willing and able to disburse escrow funds at a moment's notice, sometimes in the form of multiple bank or certified funds, to avoid delaying or adjourning the closing and inconveniencing or causing financial hardship to the parties.

The Task Force also considered the following and their impact on the choice of other escrow agents than lawyers.

Cost. The cost of supporting other escrow agents would inevitably be greater than the cost of continuing the present system and might, in a particular transaction, become prohibitive. On the other hand, "Lawyers who act as escrow agents and charge a fixed fee do not charge their clients extra for providing escrow accounts." Further, under the present system, IOLA accounts - the mandatory depository for client funds which are too small in amount or which will be held for too short a time to generate sufficient interest to justify creating a separate interest-bearing account - are now a vital source of funds for low income legal assistance programs, and the Task Force was concerned that that source might be jeopardized under a different system.

Pros & Cons. Most of the Task Force agreed that "serving as escrow agent in a real estate transaction is a thankless task," and many of them admitted that they would just as soon avoid it. On the other hand, the members felt that the lawyer's role was "a time honored practice that facilitates closings and works well in most situations."

Title Companies and Real Estate Brokers. A) Title companies do hold escrow funds in some transactions and they are regulated by the Insurance Department, but they are not equipped to handle the administrative details for the many transactions that occur in a given day, especially the smaller transactions. They would have to charge substantial fees to institute and sustain the changes required. Further, some real estate transactions (e.g. coop sales) do not involve title companies. The risks of defalcation by title company agents are at least as great as by attorneys, and there is no compensating Lawyers' Fund to pay client claims. B) Use of real estate brokers as escrow agents for contract deposits is traditional in upstate New York, where real estate prices and contract deposits are considerably lower than in the downstate counties. (Even the contract deposit is usually less than 10%). Nevertheless, the Task Force concluded:

...Partly due to the smaller amounts, there are not many reported cases of brokers stealing the escrow deposits. Extending the practice of broker escrows downstate, where the deposits are typically substantially higher than they are upstate, would not reduce the risk of theft, and would eliminate the protection of the Lawyers' Fund and the ethical rules by which attorneys are bound.

Banks as Escrow Agents.

Having rejected the other alternatives, the Task Force turned to banks as a possible choice. Describing this part of its work, the Task Force said, "[We] spent a great deal of time and effort exploring how to set up an

alternative system for banks to hold escrow deposits instead of attorneys." In the process, the Task Force determined that it needed to outline the terms of an escrow agreement that would control the relationship with the banks as escrow agents. It decided to call the agreement "a Bank Escrow Deposit Agreement" or BEDA. Among other matters, the BEDA would provide for:

- _ execution by the bank and either i.) Both the seller and buyer, or ii) both their attorneys;
- _ issuance of W-9s and other documents normally required of banks;
- _ deposit of the contract deposit into the bank's BEDA account;
- _ disbursement of the deposit by the bank at the closing as directed in the joint written instructions of the parties;
- _ in the event of a dispute or termination of the contract, payment of the deposit to the party entitled to the proceeds under the contract, as directed in writing by the parties; or retention of the deposit by the bank; or payment of the deposit into court - until the matter is resolved by settlement or legal action;
- _ protection of the bank under "industry-standard provisions" confirming that the bank is a stakeholder with no duties other than to hold and disburse funds; that the bank will be held harmless from liability except for its gross negligence; and that the bank may resign at any time.

After considering the implications of the BEDA, the Task Force recommended that the NYSBA present the BEDA as a voluntary rather than mandatory requirement for real estate escrows, and that BEDA accounts apply only to deposits in excess of \$25,000. It also conceded that use of the banks instead of lawyers would create many potential problems at closing, e.g., resolution of disputed adjustments; the need for multiple checks; delays in delivery of checks; possible adjournments; phone calls and faxes to bank officials; etc.

The Task Force reviewed the BEDA with a representative of Chase Bank's national escrow department. He did not regard the bank's role as difficult or controversial. The bank apparently reviewed the BEDA and found it generally acceptable. Both the Task Force and the bank seemed to feel that all measures to implement the provisions of BEDA could be managed and put in place. The Task Force also contacted other banks, "which expressed interest." Its intent is to present BEDA as a viable alternative to attorney escrows "only if multiple banks statewide are willing to act in this capacity." To that end, the Task Force has asked the New York Bankers Association to measure the range of interest.

Task Force Conclusion

Although the Task Force did not conclude that the current system of lawyer escrow accounts required immediate salvage ["To the extent that problems exist, they can be mitigated..."], it did recommend the continuing study of the state's banks as a possible potential alternative:

We believe that banks may become interested in acting as escrow agents on a widespread basis in New York...if BEDA is introduced and implemented on a voluntary basis initially, it may obtain, over time, general acceptance. It may become the industry standard, or at least a widely used alternative, especially in residential transactions downstate.