

Warning to Lawyers: Choose Your Escrow Bank Carefully

BY LAZAR EMANUEL

The decision of Supreme Court Judge Edward H. Lehner in *Bazinet v. Kluge* (N.Y. Cnty, No. 110143/01, 5/29/03) requires careful study by lawyers who draft contracts providing for the deposit into an IOLA account of funds which may or may not qualify under Judiciary Law § 497 for IOLA treatment. Under Judiciary Law § 497, funds qualified for IOLA accounts are only those funds which, in the judgment of the attorney, are "too small in amount or are reasonably expected to be held for too short a time to generate sufficient interest income to justify the expense of administering a segregated account for the benefit of the client or beneficial owner."

The *Bazinet* decision also instructs lawyers who anticipate holding large escrow funds to be especially careful about the banks they choose as depositories.

Attorney Samuel Reiser represented Galina Kluge in two successive sales of the same two co-op apartments in Manhattan. The purchase price in the first sale, which fell through before closing, was \$14,500,000. The contract drafted by Reiser provided for the deposit by him into a non-interest bearing IOLA account of the contract deposit of \$1,450,000. Unfortunately for Reiser, he picked a New York branch of the Connecticut Bank of Commerce (CBC) as the depository. The bank was shut down by state and federal authorities before the escrow funds could be withdrawn and paid over to the party entitled to the money.

Reiser then represented Kluge in a second sales contract which also provided for the deposit into an IOLA account of the contract deposit, this time the sum of \$1,280,000. As escrow agent, Reiser deposited the funds into an IOLA account at CBC. At title closing of the second contract, Reiser issued checks drawn on the escrow funds. The checks were dishonored by the authorities operating CBC.

In all, the sum of \$2,730,000 was now at issue. Eventually, a total of \$900,000 was recovered out of FDIC insurance and the partial liquidation of CBC's assets. The litigation before Judge Lehner involved claims by and against several parties, including a cross-claim by Kluge against Reiser alleging malpractice, gross negligence and breach of fiduciary duty. The Judge's decision was in response to a motion by Reiser to dismiss Kluge's cross-claim in reliance on the usual exculpatory language, i.e.: the escrowee "shall not be liable for any error in judgment or for any act done or step taken or omitted in good faith, or for any mistake of fact or law, except for escrowee's own gross negligence or willful misconduct."

Judge Lehner disposed of the exculpatory clause on two counts: 1) it applied to Reiser's duties as escrowee, not to his duties and responsibilities as Kluge's lawyer; and 2) an attorney cannot limit his prospective liability for malpractice by contract.

Plaintiff Kluge offered to show by expert testimony that the generally accepted practice of lawyers handling large real estate transactions involving substantial escrow deposits would be to avoid small banks like CBC. The testimony would show that under the circumstances, security for the funds would have required either conversion into treasury bills or supplementary insurance. Judge Lehner rejected Reiser's argument that it was too early to tell whether Kluge would suffer any damage, i.e., that the FDIC might still be able to recover and pay all the money out of CBC's remaining assets. Although "an attorney is not a surety of the safety of a bank depository," Kluge's cross-claim sets forth a viable claim that Reiser committed malpractice in drafting contracts providing for such large escrow deposits without any protection beyond the FDIC's \$100,000 guarantee. The cross-claim might not ultimately survive a motion for summary judgment, but Kluge was at least entitled to offer proof that Reiser had deviated from generally accepted standards for real estate practitioners.

Judge Lehner also rejected Reiser's motion to dismiss on the issues surrounding the IOLA account. If the funds had been placed in accounts earning only 1% per year, they would have earned interest totaling many thousands of dollars. Both of the Kluge sales contracts were either terminated or closed within periods of approximately three-four months. These periods are not uncommon in sales of cooperative apartments which involve board approval of the purchasers.

Kluge is entitled to show that the contracts should not have provided for the use of IOLA accounts and that the funds should not have been deposited into IOLA accounts. Subdivision 5 of Judiciary Law § 497 does provide a safe harbor for attorneys who act in good faith when deciding that funds do or do not qualify for IOLA treatment, but there are limits to this statutory safe harbor. "Considering that it would not appear that these significant amounts of monies deposited constitute 'qualified funds', the motion to dismiss...[the claim of] the alleged malpractice of Reiser in drafting contracts providing for the escrow monies to be held in IOLA accounts is denied."