

The Ethics Hotline

Who Controls Your Trust Account? Your Client Or His Creditor?

BY ROY SIMON

I staff the Nassau Bar Ethics Hotline, and several lawyers a week call to ask ethics questions. A question that arises often is the degree to which a client can control the funds in an attorney's trust account.

A typical inquiry will be prompted by a claim on the funds by a creditor of the client. A recent question went something like this: Our client was in financial trouble and was forced to sell some real property to raise cash to pay his creditors. At the closing, after the client paid off liens against the property, about \$25,000 was left from the settlement proceeds. The real estate broker who arranged the sale demanded that we pay her commission, but the client said, "Don't pay the broker — give the money to me. I'll take care of paying the broker." Should we have followed the client's instructions? Or were we obligated to pay the broker? Or was there some middle ground?

The Starting Point: The Code

The best place to start with any ethics question is the New York Code of Professional Responsibility. It doesn't cover everything, but if it ~ follow -it! In this case, DR 9-102(B)(4), (C)(1), and (C)(4) are all relevant, and all prominently protect the rights of third parties. They provide:

(B)(4)

Funds belonging in part to a client or third person and in part presently or potentially to the lawyer or law firm shall be kept in such special account or accounts, but the portion belonging to the lawyer or law firm may be withdrawn when due unless the right of the lawyer or law firm to receive it is disputed by the client or third person, in which event the disputed portion shall not be withdrawn until the dispute is finally resolved.

(C) A lawyer shall:

(1) Promptly notify a client or third person of the receipt of funds . . . in which the client or third person has an interest.

(4) Promptly pay or deliver to the client or third person as requested by the client *or third person* the funds, securities, or other properties in the possession of the lawyer which the client *or third person* is entitled to receive.

Client Has Limited Rights

The bottom line is that a client has only a limited right to control a lawyer's disposition of escrow funds. If a third party has an "interest" in funds held by the lawyer, then the lawyer must notify the third party

as soon as the lawyer receives the funds. If a third party is “entitled” to receive the funds and the client doesn’t dispute the third party’s entitlement, then the lawyer must also pay the funds to the third party. The client has no right to instruct the attorney to pay all of the money to the client in disregard of a third party’s entitlement to the funds. If the attorney does give all of the escrow money to the client and the client fails to pay the third party, the third party may look to the lawyer for recovery.

Bank Of India v. Weg & Meyers

A recent example of this is the First Department decision in *Bank of India v. Weg & Myers, P.C.*, 691 N.Y.S. 439 (1st Dep’t 1999). Weg & Myers, a Manhattan law firm, represented Pali Fashions in a suit against an insurance company to recover on a policy insuring against water damage to goods Pali was holding in a warehouse. To obtain a loan from the Bank of India, Pali executed a “General Security Agreement, ensuring the Bank a security interest in all of Pali’s assets.” When Pali sued the insurance company, the Bank notified Weg & Myers that it had a security interest in any recovery Pali might obtain through the suit. In fact, the Bank sent Weg & Myers a copy of the General Security Agreement, spoke with Weg & Myers on the phone, and exchanged correspondence with Weg & Myers. Moreover, when Pali defaulted on its loan, the Bank sued Pali and obtained a judgment for more than \$1 million. And all during Pali’s lawsuit against the insurance company, the Bank “consistently repeated the demand that the proceeds be remitted to the Bank as part of the collateral for the debt.”

After this extensive exchange of correspondence, phone calls, and documents between Weg & Myers and the Bank, the lawsuit between Pali and its insurer was settled for \$90,000. On August 27th the insurance company issued a \$90,000 check payable jointly to Weg & Myers and Pali. Two days after receiving the check, Weg & Myers wrote a letter to the Bank saying that the Bank was not entitled to the insurance proceeds. The letter cited defects in the Bank’s General Security Agreement. The very next day, the Bank informed Weg & Myers that “any disbursement of the insurance proceeds would violate the Bank’s lien on Pali’s assets, for which it would seek to hold Weg & Myers liable for treble damages” under Sec. 487 of the Judiciary Law. Nevertheless, Weg & Myers maintained its position that “the law firm would not deliver the proceeds — now \$110,000 — to the Bank until the Bank’s rights had been adjudicated.” Pali then asked for its share of the insurance settlement, whereupon Weg & Myers disbursed the entire settlement proceeds to itself and Pali.

Law Firm Sued For Conversion

At that point, the Bank sued Weg & Myers for conversion and for impairing its security interest, seeking \$110,000 in damages. The Bank moved for summary judgment. Weg & Myers defended on grounds that, as Pali’s attorney, it owed no duty to the Bank and could not remit the proceeds to the Bank in the face of Pali’s instructions to the contrary — and that in any event the Bank’s lien was subject to Weg & Myers’s statutory charging lien of \$31,000. The trial court denied the Bank’s summary judgment motion, but the First Department reversed and instructed the trial court to enter summary judgment for the Bank on several counts.

The court scolded Weg & Myers: “At the very least, in this case, Weg & Myers should have sought judicial direction before disposing of the disputed proceeds...” The court noted that to establish a conversion claim, [i]t need only be shown that a plaintiff had ... an immediate superior right of possession to the identifiable fund and the exercise by defendants of unauthorized dominion over the money in question to the exclusion of plaintiff’s rights.” The court then found that standard met here, stating:

Once Weg & Myers had notice of an outstanding right of possession to the proceeds by a secured creditor, it became a stakeholder as to those proceeds, notwithstanding its additional role as attorney for the debtor (see, e.g., Bankers Trust Co., supra). To hold otherwise would invite unscrupulous debtors to simply arrange for contested property to be placed in counsel's custody as a means of insulating it from being claimed by the party with a superior right of possession. Our conclusion here is buttressed by this law firm's own conduct of ensuring that its own, subordinate, interest would be satisfied, by making itself a payee on the check, in direct contravention of the entire purpose of securing collateral. Here, as a matter of law, Weg & Myers' conduct was the direct cause of the Bank's damages.

The court summarized by saying: "Since defendant here had notice of the Bank's equitable claim but disbursed the proceeds notwithstanding the Bank's interest, the Bank can recover from defendant to the extent of its lien."

Recognizing A Creditor's Equitable Lien

In the *Bank of India* case the Bank had a formal written security interest, and the First Department described this as an "equitable lien" in the settlement proceeds disbursed by Weg & Myers. How important was that lien? What are a law firm's obligations to a client's creditors who do not have a lien, or who have a disputed lien?

N.Y. State Op. 717 (1999): A Systematic Approach To DR 9-102(C)

The New York State Bar Association Committee on Professional Ethics addressed the effect of a lien earlier this year. In N.Y. State Op. 717 (1999), the inquiring attorney asked how he should disburse settlement proceeds from a personal injury case when five medical bills for treatment as a result of the injuries remained unpaid. The medical providers fell into four separate categories: (a) a provider with a lien who was still in business; (b) a provider with a lien who was no longer in business; (c) two providers without liens who were still in business; and (d) a provider without a lien who was no longer in business. The ethics committee phrased the key question as follows: "May the attorney turn the check over to the client, relying on the client to pay the providers from the proceeds of the check?"

The Committee's answer depended on the nature of the creditor. The Committee began by quoting DR 9-102(C)(1) and (C)(4), stating that an attorney "should make a reasonable effort to ascertain whether the provider has an interest in or is entitled to receive payment from the funds in the attorney's possession." The Committee then addressed medical providers in three distinct categories: (1) no lien or assignment; (2) an undisputed lien or assignment; (3) a disputed lien or assignment.

State Bar Defines Liens

Regarding category one — no lien or assignment — the Committee said: "Absent an assignment or lien, a provider would not have an interest in and be entitled to payment from the funds." The Committee explained that an attorney is not "ethically bound to prefer providers without liens or assignments over the client because those providers would simply be creditors of the client." The Committee therefore opined that an "attorney who honored the claims of such creditors over the client's clear entitlement would run afoul of DR 9-102(C)(4)."

Regarding category two — an undisputed lien — the Committee said,

“...DR 9-102(C)(4) requires the attorney to pay a provider from the proceeds of the check if the provider asserts that it has a lien or assignment from the client, the attorney is satisfied that the assertion is correct, and the client does not dispute that assertion.. .An attorney who fails to honor a lien or assignment may be held liable to the provider if he or she pays out money in disregard of the lienor or assignor’s entitlement to the funds...”

Regarding category three — disputed liens — the Committee said: “If a provider asserts that it has a valid lien or assignment, but the client disputes the provider’s assertion, the attorney should hold the check or its proceeds, pending resolution of the dispute.” The Committee suggested that to bring about a resolution: “The attorney may attempt to resolve disputes by way of negotiation or, alternatively, commence an interpleader action to enable a court to resolve the dispute.”

When Lien Holder Is Out Of Business

What about the lien holder who has gone out of business? The Committee recognized that no provision of DR 9-102 expressly addressed this situation. But the Committee suggested that if a reasonable search fails to locate a valid successor to the lien of the provider who has gone out of business, several options might be viable: (a) the attorney could give the money to the client, or (b) by analogy to DR 9-102(F) (which governs missing clients), apply to the Supreme Court for an order directing the money to be paid to the Lawyers’ Fund for Client Protection, or (c) if the lienor is a hospital, the attorney could pay the money to the Commissioner of Finance in New York City or the applicable County Treasurer where the lien was filed, pursuant to N.Y. Lien Law Sec. 189(9).

***Leon v. Martinez* And Nassau Bar Op. 96-13**

N.Y. State Op. 717 relied on two main sources: *Leon v. Martinez*, 84 N.Y. 2d 83 (1994), and Nassau Bar Op. 96-13. In *Leon*, amazingly not cited in *Bank of India* (which also failed to cite DR 9-102), *Martinez* had assigned part of his prospective recovery in a personal injury action to *Leon*, who had cared for *Martinez* after an accident rendered *Martinez* a quadriplegic. The law firm handling the personal injury action in *Leon* knew about the assignment to *Leon* because it had drafted the assignment documents. When the law firm received the settlement check, however, it sent the proceeds directly to *Martinez*, without notifying *Leon*. *Martinez* then refused to pay *Leon*, and *Leon* sued the law firm for failing to honor the assignment. The law firm argued that complying with the assignment would have breached its duties under DR 9-102. The Court of Appeals rejected this argument, stating:

[D]efendants’ argument fails for two reasons. First, the cited rule mandates only that an attorney pay to the client those funds in the possession of the attorney “which the client ... is entitled to receive”...which is not the case to the extent that the client has conveyed a right to those funds by an enforceable assignment. Second, DR 9-102 explicitly creates ethical duties running to third parties as to funds in the possession of the attorney to which those third parties are entitled.

The Court of Appeals further said in *Leon* that if *Martinez* made an enforceable assignment, his lawyer “was then ethically obligated not only to notify the plaintiffs upon his receipt of the funds but also to pay the funds to the plaintiffs as the persons entitled to receive them.”

Lawyer Must Notify & Pay Lien Holder

The *Leon* case is discussed at length in Nassau Bar Op. 96-13 (1996), which addressed an inquiry from a personal injury attorney who was bewildered by the flurry of medical provider liens that poured into his office. The attorney, frustrated with his role as a “collection agent” for health care providers, said he did not want to be “saddled with the extra burden of ascertaining the precise amount due to a particular health care provider at the time a case is settled” and did not want to find himself “in the middle of any possible dispute between a client and a health care provider.”

The Nassau Bar Ethics Committee had bad news for him: the obligations imposed on lawyers by DR 9-102 “may be onerous, but a lawyer cannot escape them. . . . [A] lawyer who knows of a valid lien by a health care provider must notify the health care provider when the lawyer receives the settlement proceeds and must pay the health care provider the amount that the health care provider is entitled to receive under the lien.”

Nassau Bar Op. 96-13 also cited *Kaiser Foundation Health Plan Inc. v. Aguiluz*, 47 Cal. App.4th 302, 54 Cal. Rptr. 2d 665 (Calif. App. 1st Dist. 1996), in which a personal injury lawyer disbursed settlement proceeds directly to his client even though he knew that the client had signed a reimbursement agreement promising to pay Kaiser for its medical services out of anticipated settlement proceeds. The trial court rendered a \$23,000 judgment against the attorney. On appeal, the attorney did not dispute the finding that the reimbursement agreement gave Kaiser an “equitable lien” enforceable against the client, but contended that the lien was not enforceable against himself as attorney. The appeals court disagreed and affirmed the judgment. The court made clear that the health care provider’s case against the attorney would have been even stronger if the provider had served the attorney with a formal lien.

Answering The Hot Line Question

Back to the Hotline question: should the lawyers who called me pay the broker’s commission?

Where does all of this leave the lawyer who wants to know whether he has to pay his client’s real estate broker or instead honor his client’s request to give the money to the client and let the client take care of the broker? It leaves him in a dangerous spot. If the broker has a valid lien and the attorney knows about it and the client doesn’t dispute the amount, then the lawyer must pay the broker’s commission out of the sale proceeds in his attorney escrow fund. If the broker doesn’t have a formal lien but the client has promised to pay the broker either orally or via a written contract (which is usually the case), then the broker may have an equitable lien on the sale proceeds. If the lawyer doesn’t know for sure that the broker is entitled to the full amount of the claimed commission, the lawyer should keep enough of the sale proceeds in his escrow account to cover the broker’s claim. The lawyer can then either sit back and wait for the broker and the client to resolve the dispute through negotiation, or the lawyer can deposit the funds in court pursuant to CPLR § 2601 and let the broker and the client fight it out there.

But if the lawyer follows the client’s instructions to pay all of the sale proceeds directly to the client, the lawyer had better start looking for four-leaf clovers. If the client doesn’t promptly pay the broker, the broker is likely to sue not only the client but the lawyer as well, citing *Bank of India v. Weg & Myers*; *Leon v. Martinez*; N.Y. State Op. 717; and Nassau Bar Op. 96-13. (If the client does pay the broker promptly, there’s no problem — but if that’s the client’s intention, wouldn’t the client tell the lawyer to pay the broker?) The broker will have a strong suit and is likely to recover from the lawyer personally. But even if

the lawyer has a valid legal defense against the broker's suit, no lawyer wants to spend time and energy defending a lawsuit. As an advertisement in a recent issue of the ABA Journal said: "Don't let your law firm become your biggest client." So be smart. Don't let your client control your escrow fund when a third party asserts a claim or an interest.

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