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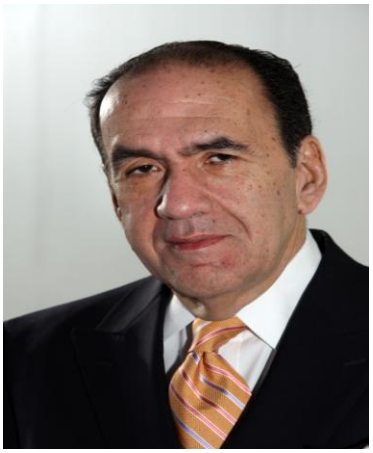

# Difficult Times Sometimes Create Desperate People Who Do Desperate Things: Loss Prevention in Handling Client Escrow Funds

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My copy of the Model Code of Professional Responsibility runs to some 500 pages, with sundry commentaries. The Code plumbs virtually aspect of a practicing law and details that which can be done by lawyers and that which may not. One relatively brief section deals with lawyers handling of client funds held in the law firm's escrow account, sometimes called "Escrow Accounts," "Special Accounts," "Trust Accounts" or "IOLTA (Interest on Lawyers Trust Accounts – but this one is a long and irrelevant boring story). Cut to the quick, the Model Rules say just three things: (1) Don't co-mingle these funds with any other account; (2) deal with these funds exactly as instructed by the client and affected parties, as detailed in an appropriate escrow agreement and (3) if you even think about screwing around with these rules, you're gonna fry.

In New York City, the Departmental Disciplinary Committee, the judicial authority having authority over lawyers' compliance with applicable rules, investigates thousands of

complaints filed against lawyers for all sorts of alleged violations of the applicable rules. Yet, perhaps 80% of all suspensions and disbarments result from either defalcations or co-mingling of client funds. Here, justice is swift and certain. The Committee has long had a zero tolerance policy with regard to any impropriety concerning client funds, a view held by all governing bodies. Suspension or disbarment is the only result.

These facts are well known to all practitioners and may even strike some as a

hackneyed topic. But recent reports of significant defalcations by a former counsel at a BigLaw firm of what may be as much as $20,000,000 and in another instance of the chair of a global law firm's Asian gaming group having allegedly slipped out some $2,000,000 from client escrow funds to allegedly cover his own gambling losses suggest that this topic requires careful review. Indeed in year-end reviews by several of our law firm clients, prompted by the recent tawdry headlines, controls over client escrow funds were studied and found to be lacking. There have also been a recent spate of unsubstantiated rumors concerning of escrow account improprieties that are, simply put, more than troubling.

Some law firms dispense with the entire issue by simply eschewing, as a general rule, the maintenance of any escrow accounts. Where funds are required to be escrowed, these firms advise the retention of an independent trust company, bank, title company or where permitted, a duly licensed escrow agent. However, often, local custom and usage requires law firms to maintain escrow accounts, which are fraught with peril, if not subject to stringent controls by the law firm. These controls should be described in writing and the firm's policies regarding client funds should be in writing and part of its employee handbook. These rules should also be part of every new lawyer's orientation session as he or she arrives at the law firm.

The required controls begin with the commencement of the client relationship. Every engagement letter must contain a disclosure regarding the law firm's escrow policies. The letter should describe the firm's policies concerning escrowed funds and, particularly, the requirement that all funds released from escrow require two partner signatures. Funds released by wire transfer require a separate email confirmation from a law firm partner to the escrowee. The engagement letter should require the client to report any departure from these rules to the firm's managing partner. The need for the double signature and reporting is best demonstrated by the fact that in one of the recently reported instances of trust fund defalcation, a counsel of a national law firm is reported to have taken a check drawn payable to his law firm, as escrow agent, walked across the street and simply opened an account in the firm's name, making himself the sole signatory, without the bank requiring any certification from any partner at the law firm.

The law firm should not allow the deposit of any escrow funds without an accompanying escrow agreement. Thus, the firm should have a tightly drafted model form of escrow agreement, with appropriate exculpatory language, from which there should be no material departure, except upon written consent from department head, an office head or an executive committee member. Each such agreement should also require the signature of such a member of management. When funds are deposited in to the escrow agreement, the requested deposit should only be permitted to be made to the accounting department of the escrow agreement, the underlying agreement, stipulation or other instrument giving rise to the creation of the escrow, as well as a memo (or standard form) from the responsible lawyer describing underlying transaction and the conditions precedent for the ultimate release of the escrow. This initiating memo should also include the client's contact information. The memo form should be countersigned by a member of management. A member of the accounting department should examine the entire submission for regularity and completeness. Any departure from the firm's escrow policies must be reported in writing by the escrow clerk to the responsible lawyer, as well as to a member of management (optimally, if the firm has an in-house general counsel, the mater should be addressed to him or her), even if the departure seems to be only clerical or ministerial.

When funds are mature and are required to be released, the responsible lawyer should prepare a new memo (or standard form), describing the transaction should be prepared by the responsible lawyer and countersigned by two partners with management responsibilities, such as an office head, department chair or member of the executive committee. The submission should again include the underlying escrow agreement and governing instrument. Again, the escrow clerk should examine the entire submission for completeness and be obligated to report in writing any irregularities to each of the lawyers who have already put their fingerprints on the escrow arrangement as well as general counsel or a designated separate member of management. As I mentioned above, all checks drawn on the escrow account should require the signature of two partners, neither one of which is directly involved with the matter. If a wire transfer is required, the clerk should send a confirmatory email to the client, using the email address originally provided at the time of the original submission.

Where law firms sometimes screw up is in connection with smaller branch offices, at which smaller support staffs and reduced lawyer headcounts often breeds shortcuts, for the sake of expediency. The fact is that far greater scrutiny is essential for smaller branch offices, which often takes on a degree of laxness and informality, primarily because of the greater sense of intimacy such smaller offices promote. In the age of the Internet, emails and paperless offices, there is no excuse for departing from the required controls. There simply must be zero tolerance for any departure from these controls. After all, bar associations and other governing bodies have none.

The law firm's general counsel, chief financial officer and its chief risk manager should be responsible for regularly monitoring activities in the firm's escrow accounts and its escrow clerical staff. As much as law firms are allergic to certified financial audits, the law firm's outside accounting firm should be required to annually audit its escrow funds and provide written certification that all controls are in place and there is full compliance with the firm's stated policies.

Finally, as too few lawyers realize, defalcations from escrow funds are not covered by a law firm's malpractice policies. A separate fiduciary policy is required. Insurance carriers tend to be rather chintzy on these policies, often limiting coverage to $5,000,000. That may be far too low, if your firm's escrow balances or individual escrow accounts exceed that amount. You should explore increased coverage or excess coverage with your insurance adviser. And, finally, always be prepared for the public relations hailstorm that will assuredly ensue if you are indeed the victim of a nefarious lawyer with your firm.



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