

## What Lawyers Must Know Before Acting As Escrow Agents

By **Scott Watnik and Michael Contos**

(April 11, 2019, 2:08 PM EDT)

There is a strong case to be made that the moment an attorney agrees to serve as an escrow agent for a client, the attorney assumes some of the most important obligations attorneys are charged with in the legal profession.

All too often, however, an attorney who serves as an escrow agent for a client is unaware of these obligations. Rather, the attorney views the escrow agent role as purely ministerial and ancillary to the underlying substantive work that he or she is performing for the client.

The following scenario, and countless variations of it, play out every day in the legal profession. An attorney represents a client in litigation. The case settles. A settlement agreement is executed, pursuant to which the attorney's client is to receive a substantial settlement payment. At the time the settlement agreement is executed, the client owes the attorney substantial legal fees.

The client asks the attorney if all outstanding legal fees can be paid from the settlement proceeds. The attorney agrees. To make things as easy as possible, attorney and client enter into an escrow agreement, pursuant to which the attorney serves as the client's escrow agent, and the settlement proceeds are deposited into an escrow account maintained by the attorney's law firm.

The client instructs the attorney to pay the outstanding attorney's fees from the escrowed settlement proceeds, and to distribute the remainder of those proceeds to the client, other parties or both. Without thinking twice, the attorney complies with the client's instructions.

Attorneys enter into situations of this sort each day without realizing that they are traps for the unwary. In New York, attorneys who act as escrow agents must follow, among other things, Rule 1.15 of the New York Rules of Professional Conduct, 22 NYCRR Part 1200, which confers special obligations on attorneys holding funds as an escrow agent. Significantly, these obligations potentially extend to third parties who are not clients.

For instance, Rule 1.15(a) provides:



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A lawyer in possession of any funds or other property belonging to another person, where such possession is incident to his or her practice of law, is a fiduciary, and must not misappropriate such funds or property or commingle such funds or property with his or her own.

Rule 1.15(b)(4) provides:

Funds belonging in part to a client or third person and in part currently 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.

Rule 1.15(c)(1) provides that when a lawyer possesses funds belonging to a third person or a client, the lawyer

shall: (1) promptly notify a client or third person of the receipt of funds, securities, or other properties in which the client or third person has an interest[.]

Rule 1.15(c)(3) provides that a lawyer shall

maintain complete records of all funds, securities, and other properties of a client or third person coming into the possession of the lawyer and render appropriate accounts to the client or third person regarding them[.]

Taken together, these rules, which are by no means exhaustive, make it clear that it is incumbent on an attorney serving as an escrow agent for a client to determine whether any persons apart from the client can claim an ownership interest in the escrowed funds. If such persons exist, the attorney should promptly notify all such persons — not just the client — that the attorney has received the escrowed funds, and render an accounting of the escrowed funds to all such persons.

In the event that persons apart from the client have a potential ownership interest in the escrowed funds, even if the client instructs the attorney to the contrary, the attorney should not distribute any of the disputed or potentially disputed escrowed funds out of the escrow account to pay the client, satisfy the unpaid legal fees that the client owes or for any other reason — at least not until all competing claims and interests in the escrowed funds are resolved.

All too often, attorneys readily agree to serve as an escrow agent for a client without giving it a second thought, in order to facilitate the client's payment of outstanding legal fees from the escrowed funds — entirely unaware of their potential obligations to third parties under the rules. Before taking on this role, attorneys should first evaluate whether or not any third persons who are not clients can claim or have claimed an ownership interest in the funds to be escrowed (for instance, any secured or contractual creditors that the client might have may have priority to the escrowed funds), and the duties that the attorney could owe to such third persons as an escrow agent.

Before agreeing to serve as an escrow agent for a client, attorneys should also consider that if, and to the extent that, such third persons exist, an attorney might be required to act contrary to the client's interests, and his or her law firm's interests, with respect to the escrowed funds.

Reasonable steps that attorneys should take upon receiving and before distributing escrowed funds

include searching reasonably available public records to ensure that there are no liens, judgments or other encumbrances to which the escrowed funds may be subject. In addition, attorneys should also seek written confirmation from the client, and any other known, interested persons that there is no dispute (potential or actual) relating to the escrowed funds.

In the event that such a dispute is discovered, as discussed above, attorneys should keep the disputed portion of the funds in escrow until the dispute is resolved. Alternatively, although it may involve additional time, effort and resources, attorneys who discover such a dispute may withdraw as escrow agent and deposit the disputed portion of the escrowed funds with an appropriate court.

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