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TEST # 69

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LEGAL ETHICS

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Duties To Third Parties

A recent appellate opinion exposed the hidden risks in handling non-client funds and property

By **ELLEN R. PECK**

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Cali!" boomed a deep voice over a cell phone from a moving automobile. "I hear you are the legal ethics partner in the firm." That deep voice has to be Wheeler Dealer, thought California Joan. He's that new client of the firm, a lawyer who brokers billion dollar deals in transactional matters.

"I just attended an MCLE seminar," Wheeler continued without pause. "The speaker said that my practice of serving as an escrow holder of funds and property for both my clients and third parties in a business transaction is full of unseen ethical risks!"

Cali speculated, "Wheeler, the instructor must have been referring to the recent Court of Appeal opinion *Virtanen v. O'Connell* (2006) 140 Cal.App.4th 688; reh. den. (Jul 12, 2006), rev. den. (Oct 11, 2006)."

"Cali, please tell me about *Virtanen* and its impact on my practice! I'm feeling sick to my stomach, not knowing what the ethical traps are, whether they can be prevented and what to do to prevent them," Wheeler wheedled.

"In *Virtanen*," Cali explained, "Lawyer agreed to serve as an escrow holder for his client, the purchaser of stock (Client), and a non-client, the seller of the stock (Seller). After escrow instructions were provided to Lawyer by Seller and Client, the stock certificates were tendered to Lawyer. Time passed and Seller grew weary, waiting for the transaction to close. Before the conditions of transfer of the stock were met, Seller terminated the transaction and sent written notice of rescission to Lawyer and Client. Thereafter, Lawyer closed the transaction and delivered the stock certificates to Client (*Virtanen*, at p. 692).

“The next day, Seller sued Lawyer and Law Firm for breach of fiduciary duty, negligence and conversion of the stock. After a judgment of almost \$2 million against Lawyer and his Law Firm, Lawyer and Law Firm appealed and Seller appealed the trial court denial of a motion for retrial on punitive damages. The Court of Appeal for the Fourth Appellate District affirmed the judgment, remanded for a partial retrial on punitive damages against Lawyer and affirmed a denial of retrial on punitive damages against Lawyer’s firm (*Virtanen*, at pp. 696, 715-717).

“First, it noted that even when a lawyer represents a client, a lawyer serving as escrow holder owes fiduciary duties to the third parties to the escrow (*Virtanen*, at p. 703). Second, when a lawyer/escrow holder is faced with competing demands, the lawyer must either hold the property in trust until the dispute is resolved or interplead it (*Virtanen*, at p. 697),” Cali continued. “The purpose of an interpleader action is to preserve the fund or property; to discharge the escrow holder from further liability; and to retain the fund or property in the court’s custody until the rights of the potential claimants can be adjudicated (*Virtanen*, at p. 698).”

“What about Lawyer’s overarching duty of loyalty to Client? Didn’t that trump Lawyer’s duty to Seller?” Wheeler wondered.

“No,” Cali said. “The Court observed that Lawyer’s duties to Client did not excuse his violation of his duty to Seller and conversion of the stock certificates. If Lawyer believed that no mutual resolution of the conflicting demands was imminent, he could have filed an interpleader action (*Virtanen*, at p. 701).”

“How could Lawyer have converted the stock certificates, since he gave them to Client?” Wheeler wheezed uncomfortably.

“Conversion is the wrongful exercise of dominion over the property of another, in which good faith, lack of knowledge and motive are generally immaterial. Conversion occurs even if a party regains possession of the converted property. Lawyer committed conversion, the Court reasoned, by (1) exercising control over Seller’s stock certificates, and (2) disbursing them to Client’s agent, where (a) none of Seller’s conditions to close had been met, (b) the parties had not reached written agreement on material contract terms, (c) Lawyer knew that Seller had delivered a notice of rescission and demand to return stock documents, and (d) Seller’s lawyer had expressly warned Lawyer against exercising dominion and control over the stock certificates (*Virtanen*, at pp. 707-708).”

“Is acting in a dual capacity as an escrow holder and attorney inherently unethical?” Wheeler whispered.

“No!” Cali exclaimed. “The Court underscored that it did not intend to discourage lawyers from acting as escrow holders and that it is ‘useful and commonplace for attorneys to act as escrow holders with respect to closing documents, settlement agreements, releases, funds and other items’; but cautioned that a lawyer should be aware of the duties of an escrow holder before serving as one (*Virtanen*, at p. 693).”

“Cali, what practice pointers can you give me to help manage the risk of liability to my clients and third parties when I act as an escrow holder?” Wheeler asked.

“Even before a lawyer accepts the role of escrow holder or has similar duties to third parties, as a matter of risk management, a lawyer should disclose to the client the potential and actual consequences to the representation of acquiring duties to third parties,” Cali replied.

“You can’t be suggesting that there is a conflict of interest in my serving as an escrow holder?” Wheeler whooped.

“Since a number of my fellow risk managers, who often serve as expert witnesses, have suggested that there is a potential conflict of interest in the dual capacity of escrow holder/lawyer in the same transaction, I am concerned that you not be the subject of such an attack,” Cali said. “Even though I am aware of no California published case addressing the potential conflict of interest, the issue is fluttering around in *Virtanen* like a shadowy butterfly and may pose some risk in the future,” she added.

“A conflict of interest exists whenever ‘. . .there is a substantial risk that the lawyer’s representation of the client would be materially and adversely affected by the lawyer’s own interests or by the lawyer’s duties to. . . a third person.’” Vapnek, et al, 1 Cal. Pract. Guide: *Professional Responsibility* (The Rutter Group 2006) 4-1, ¶4.1 citing to Rest.3d Law Governing Lawyers §121.)

“Hold on there!” Wheeler wailed. “Rule 3-310(C)(1), Rules of Professional Conduct, states that ‘a member shall not, without the informed written consent of each client: (1) Accept representation of more than one client in a matter in which the interests of the clients potentially conflict . . .’ Therefore, I can’t have a concurrent conflict of interest unless both parties are represented in an attorney-client relationship. As an escrow holder/ lawyer, I only represent one party. . .”

Cali cut in, “Although rule 3-310(C) does not facially appear to apply to the concurrent representation of a client in an attorney-client relationship and a non-client third party in an ancillary role, case law has. At least one published California attorney breach of fiduciary duty case held that application of rule 3-310(C) ‘does not require representation of both clients as an attorney.’ (*American Airlines Inc. v. Sheppard, Mullin, Richter & Hampton* (2002) 96 Cal.App. 4th 1017, 1032-1033 — applying rule 3-310(C) to the concurrent representation of a client in a related matter and serving as a “person most knowledgeable” witness on behalf of another third party.)”

Cali put these three puzzling pieces together and explained:

First, based upon the Restatement position and the *American Airlines* case, she supposed that rule 3-310(C)(1) and (2) might be held to apply to the concurrent (1) representation

of a client in a business transaction and (2) service as an escrow officer for the client and the third party in the same transaction.

Second, based upon *Virtanen*, she further supposed that in every escrow in which a lawyer served in a dual capacity as attorney/escrow holder, it was reasonably foreseeable that the lawyer might face conflicting demands from the client and the third party to the escrow.

Third, based upon *Virtanen*, if such conflicting demands are made, the lawyer cannot favor the client and completely disregard the rights of the non-client third party, to whom the lawyer owes a fiduciary duty as an escrow holder.

If the lawyer's fiduciary duties to a third party interfere with the lawyer's duties to follow the client's instructions, this falls into the classic conflict of interest definition. Even if the lawyer fulfills the duties owed to the third party under the *Virtanen* case, without prior disclosure and informed written consent of the client, the lawyer may risk exposure from client claims of nonconsensual conflicts in fee arbitration, civil or disciplinary proceedings.

"Cali," Wheeler wavered, "should I have some provision in my fee agreement or separate documentation?"

"If, at the outset of representation of a transactional client, you also contemplate serving as an escrow holder, put it in the fee agreement. If the request to serve as an escrow holder arises after the client representation has commenced, generate a written disclosure and obtain the client's written consent before commencing any ancillary duties as an escrow holder," Cali replied.

"What should the content of the written disclosure be?" Wheeler wondered.

Cali explained to Wheeler that generally, the written disclosure should inform the client of the relevant circumstances and of the actual and reasonably foreseeable adverse consequences to the client and be signed by the client. (Rule 3-310(A)(1)-(3).)

She also suggested that Wheeler disclose (1) the request that he serve as an escrow agent concurrently with serving as the client's lawyer in the same transaction; (2) any arrangements for fees for the escrow holder services; (3) that by serving as an escrow holder, Wheeler would acquire fiduciary duties to the parties to the escrow that might compete with his duties to the client; (4) that Wheeler might not be able to follow Client instructions respecting escrowed property, if inconsistent with written escrow instructions or the direction of other escrow parties; (5) that if Wheeler were to receive conflicting demands from escrow parties, Wheeler not only could not favor Client, but could only hold the funds/ property or file an interpleader action if the dispute were not resolved.

Cali pointed out that issues of duties to other parties commonly arose in other fields of practice. For example, in family law, parties to a dissolution of marriage commonly

agree, or a court orders, that the funds representing the sale of a community asset be held in trust by one of the parties' lawyers, until further order of the court or until agreement of the parties. In these circumstances, should a lawyer disregard the rights of the opposing party in favor of the client or to satisfy his or her fees, professional discipline has been imposed. (*Guzzetta v. State Bar* (1987) 43 Cal.3d 962, 976 — lawyer disciplined for commingling funds which he had agreed to hold in trust for both the client husband and the non-client wife in a dissolution action; *Codiga v. State Bar* (1978) 20 Cal.3d 788, 794-795.)

Third party liens (statutory, tripartite contractual [e.g., signed by lawyer, client and medical provider] and equitable) can create civil and disciplinary liability for failure to notify, hold or interplead funds subject to preserve third party rights.

(See e.g., *Matter of Respondent P* (Rev. Dept. 1993) 2 Cal. State Bar Ct.Rptr. 622, 630 and Vapnek, et al, 2 Cal. Pract. Guide: Professional Responsibility (The Rutter Group 2006) 9.313 — statutory liens; *Matter of Riley* (Rev. Dept. 1994) 3 Cal. State Bar Ct.Rptr. 91, 113–114 — tripartite lien; and re equitable liens: *Kaiser Foundation Health Plan Inc. v. Aguiluz* (1996) 47 Cal.App.4th 302, 307, overruled on other grounds in *Snukal v. Flightways Manufacturing Inc.* (2000) 23 Cal.4th 754, 775-776; *Miller v. Rau* (1963) 216 CA2d 68, 75; but see *Farmers Ins. Exchange v. Smith* (1999) 71 Cal.App.4th 660, 666 [no equitable lien arises where attorney disburses settlement proceeds to client without first paying an insurer under its reimbursement agreement with the client].)

Whenever a lawyer may have a legal obligation to a third party in the handling of funds or property which may compete with obligations to the client, the lawyer should have similar provisions in his or her fee agreement or separate document signed by the client warning them of the potential for conflict. Not only will this prevent liability arising from the potential client, but it is more likely to prevent competing instructions, since the client will have been forewarned about the consequences.

“Are there other risks to acting in a dual capacity as attorney/escrow holder?” Wheeler worried.

Cali listed some other potential risks:

- First, professional discipline can be imposed for failing to hold funds in a client trust fund for the benefit of third parties when acting as both escrow holder and lawyer. (See e.g., *Crooks v. State Bar* (1970) 3 Cal.3d 346, 358; *In the Matter of Lilly* (Review Dept.1992) 2 Cal. State Bar Ct. Rptr. 185, 191.)
- Second, professional discipline can be imposed for a lawyer's unilateral withdrawal of escrow funds as a set off for fees and costs, even if earned, in the absence of the agreement of all parties to an escrow. (*Crooks v. State Bar* (1970) 3 Cal.3d 346, 358.)

■ Third, lawyers serving as escrow holders must provide an accounting to all escrow parties for the handling of the funds in the escrow. (*Hamilton v. State Bar* (1979) 23 Cal.3d 868, 879 — lawyer disciplined for breaching fiduciary duties by failing to account as an escrow officer.)

“Cali, when I first talked to you, the risks seemed too high. However, I am going back to my office and develop a risk management plan for serving as escrow holder/lawyer that includes all of these points so that I can be as bulletproof as possible,” Wheeler said. “Wheeler,” Cali advised, “good risk management includes not only doing the right thing but also being able to prove that you have done the right thing.”

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Test — Legal Ethics
1 Hour MCLE Credit

This test will earn one hour of MCLE credit in Legal Ethics.

- 1.** Lawyer's agreement to simultaneously serve as an escrow holder for client, the purchaser of stock (Client) and a non-client, the seller of the stock (Seller) is inherently unethical.
- 2.** A lawyer who represents a client in a transaction while serving as escrow holder in that same transaction owes fiduciary duties to other parties to the escrow.
- 3.** When a lawyer/escrow holder is faced with competing demands regarding escrowed funds, the lawyer may return funds claimed by a third party upon the unilateral instruction of that party.
- 4.** When a lawyer/escrow holder is faced with competing demands from a client and other escrow parties, the lawyer may interplead the escrowed funds or property.
- 5.** One of the purposes of an interpleader action is to discharge the escrow holder from further liability.
- 6.** One purpose of an interpleader action is to retain the fund or property in a court's custody until the rights of the potential claimants can be adjudicated.
- 7.** A lawyer's higher duties to a client trumps and excuses any duty to other parties to an escrow, where a lawyer is serving in a dual capacity as lawyer and escrow holder.
- 8.** A lawyer who represents a client in a transaction while serving as escrow holder in that same transaction, who transmits escrow funds to her client when the escrow conditions have not been met, violates her fiduciary duties to other parties to the escrow.
- 9.** A lawyer who represents a client in a transaction while serving as escrow holder in that same transaction, who transmits escrow funds to her client when the escrow conditions have not been met, is not liable for conversion.
- 10.** Conversion is the wrongful exercise of dominion over the property of another and a complete defense is the owner's regaining of possession of the converted property.
- 11.** A lawyer commits conversion by (1) exercising control over escrow property and (2) disbursing them to a client, where (a) none of the escrow conditions to close were met, (b) the parties had not reached written agreement on material contract terms, (c) Lawyer knew that Seller had delivered a notice of rescission and demand to return stock documents, and (d) Seller's lawyer had expressly warned Lawyer against exercising dominion and control over the stock certificates.

12. Prior to accepting a dual role as lawyer and escrow holder, risk management suggests that the lawyer disclose to the client the potential and actual consequences to the representation of serving as an escrow holder.

13. A conflict of interest can only exist when there is a substantial risk that the lawyer's representation of the client would be materially and adversely affected by the lawyer's duties to other clients.

14. The concurrent representation of multiple clients (Rule 3-310(C), Rules of Professional Conduct) has been interpreted to also apply to the concurrent representation of a client in an attorney-client relationship and a non-client third party in an ancillary role.

15. Generally, informed written consent to a potential or actual conflict requires a written disclosure informing the client of the relevant circumstances and of the actual and reasonably foreseeable adverse consequences to the client.

16. It is useful and commonplace for attorneys to act as escrow holders regarding closing documents, settlement agreements, releases, funds and other items provided that they are aware of the duties of an escrow holder before serving as one.

17. Lawyer, who represented client Husband in a dissolution of marriage action, commingled funds he had agreed to hold in trust for Husband and non-client Wife. Lawyer is subject to discipline.

18. Professional discipline may be imposed for failing to hold funds in a client trust fund for the benefit of third parties when acting as both escrow holder and lawyer.

19. A personal injury lawyer has a duty to pay settlement funds claimed by a third party, arising by operation of statute, where the client has promised to pay the statutory lien from the funds paid to the client.

20. Professional discipline may never be imposed where a lawyer unilaterally withdraws escrow funds as a set off for fees which were earned, but to which a non-client party to an escrow objects.

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