Escrow Accounts After 'Galasso': You Are Your Brother's Keeper

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July 29, 2014

A lawyer who steals escrow funds commits a crime, an ethical violation, and a tort. If the lawyer is a partner in a firm, the firm itself may be liable for damages and disciplinary sanctions. But what of partners in the firm who were not complicit in the theft but made it possible by failing to supervise the firm's escrow accounts? While these partners are unlikely to face criminal prosecution, a recent decision by the Court of Appeals suggests they may face severe disciplinary sanctions. Another decision by the First Department suggests they may be liable to the victim in damages.

Disciplinary Repercussions

Disciplinary committees have a long history of prosecuting lawyers in small firms who fail to safeguard escrow funds, whether or not the failure was intentional. These lawyers have been charged with violating the Rules of Professional Conduct for making escrow money vulnerable to thefts by negligently supervising the account. See, e.g., *Matter of Ponzini* (partner disbarred for failing to monitor small firm's escrow account, a sanction later modified to suspension). Such prosecutions no longer are controversial: Lawyers must and do accept that they have a duty to monitor their firm's escrow accounts. Yet, few lawyers were prepared for the Court of Appeals' decision in *Matter of Galasso*, 19 N.Y.3d 688, (2012), a case that imposes (or appears to impose) a heavy new burden of financial oversight on lawyers who practice in small firms.

Galasso arose from a series of thefts from the escrow accounts of a small Nassau County limited liability partnership (LLP). The thief turned out to be the firm's bookkeeper and office manager, Anthony Galasso, who was the brother of name partner Peter Galasso. In less than three years, "Anthony Galasso stole about $5 million in client funds, hiding the thefts by replacing the original bank statements for the firm's escrow accounts with fabricated statements on which his defalcations didn't appear." With this scheme, which the Court of Appeals acknowledged to be "relatively sophisticated," the bookkeeper not only fooled the firm's partners (including his brother) but also fooled the firm's outside accountant.

After an investigation in which Peter Galasso cooperated, the Nassau County District Attorney convicted Anthony Galasso of a series of felonies including grand larceny and falsifying business records. During a grievance investigation of Peter Galasso, which had been commenced while the criminal investigation was proceeding, the district attorney provided an unsolicited letter directly to the Grievance Committee asserting that no one else at the law firm had known about the bookkeeper's thefts and "nothing in the documents presented to the firm by Anthony Galasso would have raised any suspicion about the thefts." This letter of exoneration, so unusual for a prosecutor to submit, had no significant impact on the Court of Appeals when it reviewed the Appellate Division Galasso disciplinary decision.[1]

The court described the district attorney's assessment as only "a factor [to be] considered in mitigation, but not probative of whether he [Peter Galasso] has failed to preserve client funds." Cf: *Matter of Lodes*, __ A.D.3d __ (2d Dept. 2014) (a federal prosecutor's finding that a lawyer was a "victim/witness" was not a defense to a disciplinary prosecution for kickbacks). The limited weight accorded the prosecutor's letter reflects the gravity with which the Court views escrow account supervision.

There was, of course, no real dispute as to whether Galasso and his firm had failed to preserve client funds. Of course they had failed: $5 million was taken from the firm's escrow accounts in less than three years. The real question was whether this failure was excusable, given the sophistication of the fraud and the district attorney's contention that there were no obvious "red flags."

The Court of Appeals found that it was not excusable: Galasso, according to the court, had "ceded an unacceptable level of control over the firm accounts to his brother, thereby creating the opportunity for the misuse of client funds." The court did not deny that attorneys may delegate certain tasks associated with the supervision of escrow accounts, but insisted that "any delegation must be made with an appropriate degree of oversight. We stress that it is the ethical responsibility of the attorney—not the bookkeeper, the office manager or the accountant—to safeguard client funds."

In fact, as the Court of Appeals itself noted, Galasso did engage in some oversight—he read monthly financial reports that his brother provided, and had the firm's outside accountant do the same. These reports, however, were devised to hide the bookkeeper's thefts, as were the account statements the bookkeeper fabricated to support the reports. By confining his oversight to secondary documents provided by the thief, neither Galasso nor the firm's accountant was able to determine what actually was happening with escrowed funds.

According to the court, had Galasso engaged in a "personal review of the bank statements, personal contact with the bank and improved oversight of the firm's books and records [he] likely would have mitigated, if not avoided, the losses."

On these considerations, the court found that Galasso was guilty of a failure to supervise. At the same time, the court stressed that the lawyer was not being sanctioned merely because his brother had stolen escrow funds. "Rather, it is his own breach of his fiduciary duty and failure to properly supervise his employee, resulting in the loss of client funds entrusted to him, that warrant this disciplinary action." Galasso was suspended for two years for this lack of supervision.

'Galasso's' Significance

Some lawyers have responded to *Galasso* with alarm, expressing the fears that henceforth, even honest lawyers will find it difficult to avoid sanctions if client funds have been lost or stolen, and that lawyers now will have to personally inspect the original records of their firm's escrow accounts, and personally verify the authenticity of those records by dealing with the banks that produced them. We believe these fears are misplaced.

The court never stated that the loss of client funds, in and of itself, violates the Rules of Professional Conduct, nor did it state that, to comply with the rules, each attorney at a firm must conduct an "eyeball" review of the original account documents for each of the firm's escrow accounts. Since either holding would have constituted a very significant departure from prior law, the fact that the court insisted it was not establishing a "new or heightened degree of liability for attorneys" suggests that Galasso's significance lies elsewhere.

What then does the decision hold? To answer this question, we must look at the context in which *Galasso* arose. The case presents a classic example of a fox appointed to guard a henhouse. Galasso and his firm selected a single person to oversee its escrow accounts; when that person turned out to be dishonest, the firm and its clients were left without protection.

In discussing this problem, the Court of Appeals opined that client losses would have been "mitigated if not avoided" had the firm appointed a second person to review the original records of its escrow accounts. In this the court almost certainly was correct: a second reviewer would

have caught the fact that the account records Anthony Galasso presented to the partnership differed from the records produced by the firm's banks.

The court also implied that the second reviewer should have been a law partner, although the implication was never incorporated into a formal holding. This was fortunate, since enlisting an attorney as a second reviewer will not always be the best way to safeguard escrowed funds. To be sure, in small firms, or firms that only engage in occasional, straightforward transactions involving client money, a law partner may provide a competent second review.

In firms above a certain size, however, escrow accounts commonly host hundreds or even thousands of yearly transactions, many of them unrelated and hard to disentangle. To untangle these transactions requires specialized training. A certified public accountant typically will have such training; a lawyer typically will not. For this reason, it is likely that law partners will be found to comply with *Galasso* when they employ an internal bookkeeper to maintain and reconcile the original records of an escrow account, and then retain a CPA (or other qualified professional) to conduct a second reconciliation of the firm's escrow accounts.

These outside professionals, of course, should report to the partnership, but there is no reason to involve a lawyer in the inspection of original account records. What lawyers should be required to do is ensure that both in-house and outside reviewers have been properly trained to reconcile account records and to identify warning signs that funds have been mishandled. One such "red flag," mentioned in *Galasso* itself, is a shortfall in escrowed funds that cannot be identified to a legitimate transaction.

Lawyers also must make sure that the in-house bookkeeper reviews escrow accounts on a monthly basis, and that the outside reviewer conducts audits on a quarterly or at most a semi-annual basis. Finally, both inside and outside auditors must be instructed to report discrepancies and/or red flags to the proper supervisory attorney immediately; the more time that elapses before corrective action is taken the more opportunity a thief will have to cover his tracks, to make additional defalcations and to secrete assets in order to make himself judgment-proof.

The use of a system with checks and balances, conducted by employees and outside professionals who have been trained to identify financial discrepancies and red flags, should go a long way to solving the "fox in the henhouse" problem and provide a firm and its partners with protection from disciplinary sanctions. It cannot, however, provide complete protection: It always is possible that a grievance committee or an appellate court will use 20/20 hindsight to determine that a partner's "oversight" was somehow deficient.

One final question deserves mention. It is the normal practice at large firms to delegate oversight responsibility to a committee of lawyers, and small firms of three or four partners presumably may delegate such responsibility to a single partner. Yet there is an obvious tension between this practice and the ruling in *Galasso* that every partner has an individual, non-delegable duty of oversight.

Assuming, as we do, that the court did not intend to prohibit the delegation of oversight responsibility among partners inter sese, the question inevitably arises: When a group of partners delegates oversight responsibility to a committee or to a single partner, who bears the risk of discipline if the committee or partner proves dishonest? Theoretically, a law firm may be disciplined for institutional failures (see, e.g., 22 N.Y.C.R.R. 603.2(b)), but historically disciplinary committees have focused upon particular partners.

Civil Liability

A partner in a traditional or "common law" partnership is "vicariously liable" for damages caused by another partner's professional misconduct. Such liability, which extends to personal assets,

does not require a showing of fault: "any member of [the] partnership may be liable for a conversion of property committed by [another] member of the firm, even where the other members of the firm had no knowledge of the offending partner's action." *Client Security Fund of the State of New York v. Grandeau*, 72 N.Y.2d 62, 67 (1988). Thus, if Partner A steals escrowed funds belonging to a client, the client may recover from Partner B even if B were not complicit in the theft and in fact worked diligently to safeguard the client's assets. *Connell v. Hayden*, 83 A.D.2d 30; 443 N.Y.S.2d 383, 394 (2d Dept. 1981).

Until fairly recently, all group practice in New York was conducted through common law partnerships. Thus, there was no pressure to recognize a cause of action in "negligent oversight of escrowed funds," since the recovery it could provide from a negligent partner already was available, on much simpler proof, from the entire partnership. Over the last generation, however, New York has established a number of "limited liability entities" for the group practice of law, the most familiar of which is the limited liability partnership.

These new entities have abolished the doctrine of vicarious liability; while a limited liability partner remains responsible for his own torts, he or she is only liable for the misconduct of other persons if they were acting "under his or her direct supervision and control while rendering professional services on behalf of [the] partnership." Partnership Law §26(c)(i).

A client whose funds have been stolen by a limited liability partner thus is in a weaker position than a comparable client of a common law partner. The latter may recover from any and all co-partners in the firm without having to demonstrate fault or causation. The former only may recover from a lawyer who: (1) personally engaged in misconduct that was a proximate cause of the client's loss, or (2) exercised direct supervision and control over someone else whose misconduct was a proximate cause of the client's loss.

Until the First Department's 2013 decision *Cooke-Zwiebach v. Oziel*, 103 A.D.3d 558 (1st Dept. 2013), these categories of liability had never been invoked in a Galasso-type context, that is, by a client seeking compensation for the theft of funds that had been entrusted to a limited liability entity. The defendants in *Cooke-Zwiebach* were members of a small LLP that had commenced a wrongful death action on behalf of the Zwiebach family. The action settled for approximately $2 million, most of which was deposited in the firm's escrow account by Partner A. When, after three years, the Zwiebachs had not received their full distribution, they complained to the grievance committee; this complaint triggered an investigation that culminated in Partner A's suspension from practice.

At roughly the same time, the Zwiebachs commenced a damage action against Partner A and his law firm alleging, inter alia, that A had converted their funds. The suit also joined Partner B on the theories that: (1) B would have "thwarted" the theft had he competently monitored the firm's escrow account, and (2) B was the firm's "managing partner" and thus exerted direct supervision and control over A at the time of A's defalcation. *Cooke-Zwiebach v. Oziel*, 33 Misc. 3d 1232(A) (Sup. Ct., NY County, 2011).

Plaintiffs moved for summary judgment, which the trial court denied on the grounds that "there are issues of fact as to whether: (1) [A's] failure to discover and/or thwart [B's] misappropriation of funds was the product of negligence or (2) that [B] operated under [A's] direct supervision and control." 33 Misc.3d at 1232(A). On appeal, the First Department affirmed this decision, holding that the existence of negligence and/or direct supervision and control could not be determined from the existing record as a matter of law. The case was remanded for trial, and the parties settled.

By requiring a trial on both categories of liability, *Cooke-Zwiebach* (on which the authors of this article participated) established two important points, both in favor of clients. First, "negligent oversight" represents a cause of action in damages and not simply an ethical violation subject to

disciplinary sanctions. It remains to be seen to what extent this new tort and the ethical violation described in*Galasso* overlap, e.g., whether a "failure of oversight" sufficient to violate the Rules of Professional Conduct also constitutes negligence.

The second point is slightly more complicated. The statutes governing both limited liability partnerships and professional service corporations make a person liable when he or she exercises "direct supervision and control" over a subordinate who commits professional misconduct, with the caveat that the subordinate must do so "while rendering professional services on behalf of the [entity]."

It is not facially obvious that the "while rendering" clause applies to the conversion of client funds; put otherwise, it is at least linguistically awkward to say that a person who steals funds entrusted to a partnership thereby renders professional services on behalf of the partnership. By referring *Cooke-Zwiebach* to trial on the issue of Partner A's liability as Partner B's supervisor, the First Department implicitly resolved this question in favor of an expansive construction of the "while rendering' clause, under which supervisory liability may extend to the theft of client funds.

Finally, we have proposed that the original records of all escrow accounts be regularly examined and reconciled by at least two independent reviewers. We have suggested that such a system of dual reviews, with appropriate attorney oversight, will provide considerable protection against disciplinary sanctions. It may provide some protection against damage liability as well: If neither the firm's internal bookkeeper nor its outside accountant identifies warning signs that escrow funds have been mishandled, a court is likely to find that such signs were not flagrant, and that the failure to identify them was not the product of negligence. Cf. *In Re IKON Office Solutions,* 277 F.3d 658, 669 (3d Cir. 2002) (the fact that a second outside auditor reached the same conclusion as the first "is highly probative of the competence" of the first auditor's opinion).

Conclusion

Together, *Galasso* and *Cooke-Zwiebach* clarify the importance of maintaining close supervision of a law firm's escrow account and the consequences a lawyer may face if he or she disregards that duty. The use of a proper system of checks and balances conducted by a trained firm employee and a competent outside professional, under the supervision of a firm partner, is a good way for a small firm to protect itself against those consequences.

ENDNOTES:

1. Hal R. Lieberman and Katie Lachter, "The Galasso Case and the Duty of Supervision," NYLJ, May 30, 2012, p. 3., col. 1.

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