NEW YORK STATE BAR ASSOCIATION
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Committee on Professional Ethics

NYSBA

Opinion #532 - 5/27/81 (39-80)

Topic: Escrow funds; fee agreements; conflicts of interest; appearance of impropriety.

Digest: Lawyer escrow agent may not retain interest earned on funds during escrow.

Clarified by N.Y.State 570 (1985)

Code: Canons 5 and 9;
EC 2-17, 2-18, 5-3, 9-5, 9-6;
DR 2-106(A), 5-104(A); 9-102(A) and (B).

QUESTION

May a lawyer representing a client in a transaction in which the lawyer serves as an escrow agent accept or seek as compensation for such service the interest earned on funds held in escrow?

OPINION

The question comes to this Committee in the context of a specific inquiry as to the ethical propriety of a lawyer including in a real estate contract a clause that provides:

> The deposit monies received pursuant to this contract shall be held in escrow by Seller's attorneys _____ _____ ESQS., pending close of title or until earlier termination pursuant to the terms hereof, in an interest bearing savings account with the interest accruing thereon, if any, to belong to and to be retained by said attorneys to cover the cost and expense of administrating [sic] such escrow account, without being required to account for the amount of interest to either Seller or Purchaser.

In the opinion of the Committee it would be ethically improper under the Code for a lawyer to accept or seek the interest earned on funds held in an escrow account as compensation for serving as an escrow agent. Such a fee arrangement presents so great a danger of unfairness, deception, overreaching and conflict of interest, or the appearance thereof, that we find any such arrangement per se improper under the standards incorporated into such Code provisions as Canons 5 and 9, EC 2-17, EC 2-18, EC 5-3, EC 9-5, EC 9-6, DR 2-106 (A), and DR 9-102(A) and (B). Cf., DR 5-104(A).

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A recent opinion, N.Y. City 79-48 (1980), identified a number of the ethical dangers involved where a lawyer seeks to enter into an agreement which would permit the lawyer to retain escrow interest as compensation for "the cost and expense of administering [an] escrow account." This opinion, inter alia, states:

> [B]ecause of the fiduciary nature of the attorney-client relationship, agreements between lawyer and client where the attorney may be in the superior bargaining position, present a clear danger of overreaching .... The attorney bears the burden of demonstrating that the agreement was fair and that it was made by the client with full knowledge of all material circumstances known to the attorney.
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> Several aspects of the proposed clause present problems of fairness and adequacy of disclosure. Use of the phrase "to defray the cost and expense of administering such escrow account" may well mislead the client, since it is likely that in all but the most unusual situations, the costs of administration would be negligible and the interest accrued would far exceed such costs. For the same reason, the clause might result in a violation of DR 2-106(A), which prohibits a lawyer from entering into an agreement for, charging or collecting a clearly excessive fee.
>
> Use of the proposed clause may also impair the lawyer's ability to exercise independent professional judgment on behalf of a client as required by Canon 5, since the lawyer will have a financial interest in delaying the event which would terminate the escrow.

N.Y. City 79-48 then concluded:

> [W]hile ... use of the proposed clause would [not] be improper per se, we do believe that it cannot properly be used without the exercise of extreme caution to ensure that it is fair under the particular circumstances of the representation and that the client has given his or her fully informed consent to the arrangement.

CON'T---

Our Committee agrees that N.Y. City 79-48 correctly identifies the serious dangers of unfairness, deception, overreaching and conflict of interest involved in agreements permitting a lawyer to retain the interest on escrowed funds. We disagree, however, with the opinion's conclusion that the dangers are not so great as to require interpreting the Code as imposing a per se prohibition against such fee arrangements. In serving as an escrow agent the lawyer is a fiduciary. Any provision which permits possible self-dealing with an escrow fund should be rejected unless there is some strong countervailing consideration. None has been shown here. The potential for abuse, or at least the appearance thereof, is great. We can find no countervailing interest which would justify this type of arrangement.

When a lawyer serves as an escrow agent, his obligations are those of a trustee. Farago v. Burke, 262 N.Y. 229, 233, 186 N.E. 683,684 (1933); see also, Helman v. Dixon, 71 Misc. 2d 1057,1059,338,N. Y.S. 2d 139, 142 (Civil Ct. N.Y.C. 1972) and cases therein cited. The lawyer escrow agent must meet the same fiduciary and professional standards that are mandated for lawyers as well as for trustees with respect to the preservation, safekeeping and use of client funds and of trust property. These include maintaining proper trust accounts for all such funds, not commingling them with his own funds, and not using them for his own benefit. EC 9-5, DR 9-102(A) and (B). See also former Canon 9; Drinker, Legal Ethics, pp. 89-92 (1953); Scott on Trusts, §§ 170.17, 180.2 (3rd ed. 1967).

Ethics opinions either requiring an accounting to clients for interest earned on client funds or condemning the retention of such interest "to defray expenses of maintaining the account" or "to offset ... the expense of running the account" include N.Y. State 90 (1968); N.Y. City 181 (1931); ABA Inf. 991 (1967); ABA Inf. 545 (1962); Arizona 225, 6 Ariz. B.J. 36 (1970), Maru 5979 (1970 Supp.); Florida 72-13 (1972), Maru 8157 (1975 Supp.); Massachusetts 74-6, 59 Mass. L.Q. 298 (1974), Maru 8653 (1975 Supp.); North Carolina Opinion CPR 30, 21 N.C. Bar 15 (1974), Maru 9624 (1975 Supp.); and Los Angeles Inf. 1961-7, Maru 7782 (1975 Supp.)

Although we recognize, as do some of the above cited opinions, that no impropriety would be involved in a lawyer making a reasonable charge for escrow or administrative expenses, the fiduciary nature of the lawyer's role makes it especially inappropriate for a lawyer to ask parties to a real estate transaction, one of whom the lawyer represents, to approve an escrow compensation agreement measured by interest earned on escrowed funds.

While we interpret the Code as requiring a per se prohibition against retaining interest earned on escrowed funds in the circumstances stated, we recognize a possible distinction where interest is paid on a special account in which a lawyer deposits such non-escrow

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client funds as advances for costs, expenses or fees not yet earned, or on other client funds which are to be promptly and routinely disbursed. Such funds should, of course, be kept in an identifiable client account, in which the funds of a number of different clients may properly be deposited. EC 9-5, DR 9-102 (A). Where the amount of interest allocable to any one client's account is relatively small in relation to the bookkeeping expense which would be required to determine the precise amount of interest earned as of any given date, it would not be inappropriate for a lawyer and client to agree that the amount of interest earned could be approximated and applied against any fees or charges owed to the lawyer. Cf., Massachusetts 74-6, supra, with N.Y. State 90, supra.

For the reasons stated, the question posed is answered in the negative.
