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INFORMAL OPINION 2010 – 05

Counsel's Responsibilities under Rules 1.15 (e) and (f) with Respect to Escrowed Client Funds as to which Third Party Asserts Claims, and as to which Client Asserts Defenses, Including Bankruptcy Discharge, to Third Party Claims

We have been asked for an opinion regarding the disposition of certain funds currently held by a lawyer, L, in his clients funds account. The funds were acquired under the circumstances described below.

FACTUAL BACKGROUND

Litigation Resulting in a Recovery for L's Clients. L represented H and W, then husband and wife, as joint plaintiffs in a litigation (the "Smith Case") with a third party, Smith. H and W ultimately (*i.e.,* after an initial judgment, then an appeal and remand that resulted in augmentation of the initial judgment) obtained a judgment against Smith for $15,000, plus attorney's fees.

Second Litigation Resulting in Recovery against L's Clients. In addition, L represented H and W as defendants in a second, unrelated litigation - the "Creditor Case." In the Creditor Case, the plaintiff Creditor obtained a garnishment of the indebtedness of the Smith Case defendants to H and W on account of the Smith Case. H and W ultimately stipulated to a judgment in the Creditor Case against them and in

favor of Creditor. L reports that an express condition of that stipulated judgment is that Creditor's recovery would be limited by a mathematical formula stated in the stipulated judgment (when ultimately applied, the formula yielded an obligation of $4,000) and, further, that Creditor's recovery would be limited solely and exclusively to monies recovered in the Smith Case; Creditor was also granted "an attachment lien on L's file."[1]

L's Clients Obtain a Divorce. Between the outset of the Smith Case and the receipt of proceeds that satisfied the judgment, H and W, proceeding *pro se*, are divorced. In conjunction with the divorce, H and W specifically agreed in writing[2] to split the eventual Smith Case recovery on a 50%/50% basis.

Bankruptcy Filing by One of L's Clients. During the appeal in the Smith matter[3], H (but not W) filed, *pro se*, for bankruptcy relief under Chapter 7 of Title 11 of the United States Code. In his bankruptcy case, H listed as an asset his entitlement to receive a portion of the Smith Case recovery. H also listed his debt to the Creditor as a liability. H apparently claimed a bankruptcy exemption(s) for his share of the proceeds of the Smith Case. H eventually received a bankruptcy discharge in the ordinary course, which discharge as a matter of law eliminated any further *in personam* responsibility of H to, *inter alia*, Creditor.[4]

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[1] L has not provided the Committee with a copy of the garnishment order or the stipulation to judgment.

[2] L has not provided the Committee with a copy of this agreement.

[3] Subsequent to the divorce, L obtained informed consents from both H and W with respect to his continued representation of both H and W in the Smith Case and the Creditor Case.

[4] As a matter of well settled bankruptcy law, a bankruptcy discharge only extinguishes *in personam* claims against the particular debtor who obtains the discharge; it does not affect *in rem* claims against that debtor's property (*e.g.,* liens on specific property). Johnson v. Home State Bank, 501 U.S. 78, 84 (1991).

L Receives and Disburses, in Part, the Smith Case Proceeds. L received from Smith's attorney the full recovery amount in the Smith Case. Upon full disclosure and agreement of all parties with an interest in the matter, L properly deducted the agreed upon attorneys fees due to him. L set aside $4,000 on account of the stipulated judgment in the Creditor Case. L then paid half of the remaining funds to each of H (after clearing that distribution with H's bankruptcy trustee) and W. L then distributed to H, again with the knowledge of H's bankruptcy trustee and, apparently, Creditor, an additional $2,000 of the $4,000 that was being held back on account of Creditor's claim. That left L in possession of $2,000 – ostensibly W's remaining share of the Smith Case proceeds-- in his clients funds account.

L Unsuccessfully Seeks Acknowledgement from Creditor of No Further Interest in the Remaining Smith Case Proceeds. L sent several letters to the attorney representing Creditor in the Creditor Case requesting a specific acknowledgement that "the judgment was discharged and is no longer an enforceable debt." Creditor's counsel responded that "the debt was discharged by H's bankruptcy, but … even though the judgment debt was discharged, there is still a lien on [L's] file." [5] Creditor's

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Equally well settled is a corollary concept: valid liens pass through bankruptcy unaffected by discharge. Dewsnup v. Timm, 502 U.S 410, 418 (1992).

Beyond that, it should be appreciated that, pursuant to the express terms of the Bankruptcy Code, the discharge of an *in personam* claim against a debtor generally has no effect upon the *in personam* liability of a non-debtor party also liable on the debt: "[except for certain community property related circumstances not applicable here]… discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." 11 U.S.C § 524(e).

[5] Although Creditor's counsel has not explicitly expressed it as such in his recent communications, Creditor would also appear to assert rights on account of the garnishment and stipulated judgment entered in the Creditor Case, and based upon the settled bankruptcy principle that a discharge does not affect a non-bankrupt co-debtor's liability. See, footnote 4, above. The fact that Creditor's counsel may not have articulated his claim as artfully, or accurately, as he might have is immaterial if L has actual knowledge of a valid legal interest. See, *e.g.*, Informal Opinion 95-20.

counsel declines to provide a release of Creditor's interest in the remaining Smith Case proceeds.

H Asserts a New Claim against Funds. H now demands that the $2,000 be sent *to him*, and not to either W or Creditor. H claims that "… it was his efforts in bankruptcy which had the judgment discharged, and he still has unused exemptions."

W's Position. W makes no demand. W indicates she is content to wait for the funds to be paid over either to W or to Creditor. Her position with respect to H's claim is not disclosed.

In view of the foregoing facts, L inquires of the Committee as to what his ethical obligations are with respect to the $2,000 remaining in his client's funds account.

DISCUSSION

A lawyer's ethical obligations with respect to property in which a client or a third party asserts an interest in property are addressed within Rule 1.15 of the Rules of Professional Conduct. More specifically, Rules 1.15 (e) and 1.15 (f) state as follows:

> (e) Upon receiving funds or other property in which a client or a third person has an interest, a lawyer shall promptly notify the client or third person. Except as stated in this Rule or otherwise permitted by law or by agreement with the client or third person, a lawyer shall promptly deliver to the client or third person any funds or other property that the client or third person is entitled to receive and, upon request, shall promptly render a full accounting regarding such property.
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> (f) When in the course of representation a lawyer is in possession of property in which two or more persons (one of whom may be the lawyer) claim interests, the property shall be kept separate by the lawyer until the dispute is resolved. The lawyer shall promptly distribute all portions of the property as to which the interests are not in dispute.

This Committee has addressed the scope of these provisions on several previous occasions, most notably for our purposes here in Informal Opinions 95-20, 99-6, 01-08, and 2010-1, and to which the Requestor is specifically referred for additional guidance in connection with the instant inquiry. [6]

As a threshold matter, our recent Informal Opinion 2010-1 (addressing the matter in the context of assertion of a statutory ERISA lien, and drawing largely upon the Official Commentary to Rule 1.15) provides instruction as to what constitutes an "interest in property" for purposes of Rule 1.15:

> …an interest must be a valid interest recognized by law and it must pertain directly to the property, the property being the client's funds. Each of the examples given in the commentary is verifiable on a preliminary basis. A valid judgment must be in writing and of record. A statutory lien can be verified on a preliminary basis by studying the statute. A valid judgment lien must also be in writing and available for inspection. Any "other lien recognized by law" can be verified on a preliminary basis by reviewing the law claimed to be applicable, such as an order or opinion of a court or administrative agency. A letter of representation or written assignment signed by the client is verifiable on a preliminary basis by demanding a copy. In none of the examples given is the lawyer required merely to "take a person's word for it" that he has a valid interest in the client's funds. In each example there is something in writing, something created by a court or legislature, or a writing signed by the client, something independent of the person claiming the interest, something that enables the lawyer on a preliminary basis to distinguish between interests of the type illustrated in the commentary and those that do not have those basic characteristics.

Thus as an initial matter, with respect to Creditor's claim, L should examine the garnishment order, the stipulated judgment, and related documentation to determine to

[6] In Informal Opinions 95-20, 99-6 and 01-08, current Rules 1.15 (e) and 1.15 (f) were designated as Rules 1.15 (b) and 1.15 (c). Despite renumbering, the substance of the rules remains unchanged.

whether and to what extent there exists a judgment adjudicating ownership of the disputed funds, a valid judgment lien with respect to the funds, or a valid written assignment of rights. With respect to H's claim, L should consider generally applicable law to determine whether there exists a plausible basis in law for the lien H now alleges. With respect to W's interest, an examination of the divorce documents should confirm her interest in the funds, while an examination of the stipulated judgment should reveal whether W finally and irrevocably relinquished her claim to those funds.

Assuming *arguendo* that the foregoing threshold analysis does not result in a clear determination that one and only one party holds a plausible interest in the funds, Informal Opinions 95-20, 99-6, 01-08 provide additional guidance respecting L's ethical obligations as to disposition of the funds. In sum, our Committee's prior opinions establish that a lawyer is obligated to deliver property in which the client asserts an interest *to the client* on demand, except in four limited situations. Those exceptions arise:

> - Where the lawyer knows of a valid judgment judicially and finally establishing ownership of the property in the non-client (in which case the lawyer is ethically obligated to honor that final determination and deliver the property accordingly)[See, Informal Opinion 95-20]
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> - Where the lawyer knows of a valid statutory or judgment lien against the property (but since such liens create only presumptive rights, and are not *final determinations* of rights to the property [7], in the face of a client challenge to payment of the lien, the lawyer should not himself purport to arbitrate the dispute but should instead hold the property as a fiduciary

[7] For example, a lien to which property is subject could conceivably be discharged by payment from another source. In that case, an attorney should not be required to pay the funds over to the putative lienholder.

and encourage judicial resolution thereof) [See, Informal Opinion 95-20]

- Where the lawyer knows of a letter of protection or similar obligation that is both (i) directly related to the property held by the lawyer and (ii) specifically entered into to aid the lawyer in obtaining the property (funds should be delivered to assignee, unless client colorably or plausibly objects, in which case funds should be held in escrow) [See, Informal Opinion 95-20]

- Where the lawyer knows of a written assignment, signed by the client, conveying an interest in the funds or other property to another person or entity (as to present relinquishment of client's rights by assignment, lawyer may not ignore the assignment) [See, Informal Opinion 01-08 [8]]

Thus, for purposes of determining ethical responsibilities with respect to the $2,000 remaining in L's client's finds account, L should review the respective claims of Creditor, H, and W through the prism of Informal Opinions 95-20, 99-6, 01-08, and 2010-1.

Should Creditor's claim fit into one of the recognized exceptions to the rule requiring delivery of client property to the client on demand, then L must not distribute the funds to either H or W. If as a result of this review it is concluded that Creditor holds merely a lien, and if one of the clients H or W challenges

[8] Citing expressly to Silver v. Statewide Grievance Committee, 242 Conn. 186, 196 (1997) (Borden, J., concurring): "If there was, for example, a valid assignment by the client of an interest in the settlement proceeds, then that, of course, would be binding on the lawyer and it would be unethical for the lawyer to ignore it once it has been brought to his or her attention." 242 Conn. at 196 (in turn citing to Bonanza Motors, Inc. v. Webb, 104 Idaho 234, 657 P.2d 1102 (1983)(upholding judgment in favor of client's creditor against law firm that released funds to client with knowledge of assignment to creditor); Berkowitz v. Haigood, 256 N.J. Super. 342, 606 A.2d 1157 (1992)(attorney who fails to honor present assignment of portion of client litigation proceeds to third party found liable to third party); Leon v. Martinez, 84 N.Y.2d 83, 638 N.E.2d 511, 614 N.Y.S.2d 972 (1994)(observing that ethical obligation to turn litigation proceeds over to third party arises where assignment is valid and *present*; client no longer has an interest in assigned funds)).

payment of the lien, then L should hold the funds as a fiduciary pending judicial determination of rights to the fund.[9] In the event or that the funds are subject to a valid, present and irrevocable assignment to Creditor, the assignment may not be ignored by L. See, fn. 8, above. In the event the review yields the conclusion that a valid, final and binding judgment mandates ownership of the funds irrevocably in Creditor, the funds should be distributed to Creditor. [10]

L should also consider applicable Connecticut law and federal bankruptcy law, as well as the divorce documents and the Smith Case and Creditor Case resolution documents, to determine if client H has any retained interest in the funds and/or any colorable basis to claim an equitable lien or other similar lien in

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[9] As this Committee has previously stated: "the lawyer's first duty is to the client. The rules should not be interpreted to place the lawyer in a conflict situation, Rule 1.7 (b), whenever a third party has or may have a claim to property in the lawyer's possession." See, Informal Opinion 95-20. Moreover, in the situation where a client challenges payment of a third party claim, "the lawyer has an obligation to recognize the rights of both the third party and the client. However, the lawyer may not unilaterally assume to arbitrate a dispute between the client and the third party. Comment [4], Rule 1.15. Therefore the lawyer must hold the property as a fiduciary, Rule 1.15 (a), and encourage a judicial resolution of the competing claims." Id.

[10] If the stipulated judgment or garnishment entered in the Creditor Case mandates ownership of the Smith Case proceeds in the Creditor or expressly directs payment over to Creditor, no client conflict arises because the disputed property does not belong to the client. Informal Opinion 95-20. That is arguably true with respect to a present, irrevocable written assignments, but the relevant authorities do not seem to have gone quite as far in mandating turnover to the assignee, at least where plausible objections are raised. See, e.g., Informal Opinion 01-08, Silver v. Statewide Grievance Committee, 242 Conn. 186 (1997); and Harrington v. Dyer, 50 Conn. Supp 460,463 (Conn. Superior Court 7/27/07) ("ordinarily, in a garnishment, the court can only order that the garnishee secure the assets pending judgment. Conn. Gen. Stat. § 52-329.") If the stipulated judgment or garnishment were merely to establish a lien interest in favor of Creditor, and a client challenges payment of the lien, the property can properly be held by L as a fiduciary pending a judicial resolution of the competing claims. Informal Opinion 95-20; see also Scharf v. Statewide Grievance Committee, 1995 Ct. Sup. 5563, 5568, Conn. Sup. Ct. J.D. Hartford-New Britain at Hartford Docket No. 940536033 (5/7/95) (Levine, J.)("an escrow agent must do with the fund whatever the principal (the client) directs, absent a legal obligation (*i.e.,* lien or garnishment) to do otherwise.")

the remaining proceeds, or any cognizable basis to contest Creditor's claim or W's claim. If L concludes that H may have such an interest, and should L further conclude that that interest has not been terminated by either a judgment or an irrevocable assignment, then L must not distribute the funds to either Creditor or W.

L should also consider whether client W has any basis to contest Creditor's claim in whole or in part, (or, for that matter, to contest H's claim), or to assert additional rights (for example, a statutory exemption from claims of creditors) in the escrowed funds. If L concludes that W may have such an interest or such additional rights, then L should not distribute the portion of the funds as to which W may assert such rights, but rather should hold such funds as a fiduciary and encourage a judicial determination of the parties' respective rights. [11]

THE COMMITTEE ON PROFESSIONAL ETHICS

By Wick R. Chambers
Wick R. Chambers, Chair

[11] Judicial resolution might be initiated in a number of ways. A few possibilities are: L could himself commence an interpleader action, or Creditor could seek post judgment execution on the disputed funds, or any of H, W or Creditor could commence a suit seeking a declaration of rights and priorities in the disputed funds.