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The New York State Court of Appeals Provides “Crystal Clear” Guidance On Fiduciary Duties

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Issue

What are an attorney’s professional responsibility and fiduciary duties with regard to client’s funds and property?

Rule

The New York Rules of Professional Conduct

The practice of law requires that every attorney adhere to a strict code of professional conduct. In New York State that code is found in Part 1200 Rules of Professional Conduct, [22 NYCRR 1200.]. It is Part 1200 Rule 1.15 that applies in this case. Rule 1.15 concerns an attorney’s fiduciary duties with regards to client’s property and money. The title itself spells out the attorney’s responsibility: Preserving Identity of Funds and Property of Others; Fiduciary Responsibility; Commingling and Misappropriation of Client Funds or Property; Maintenance of Bank Accounts; Record Keeping; Examination of Records.

Introduction

Meinhard v. Salmon, 249 N.Y. 458 (1928), best surmises the sacrosanct view of the fiduciary relationship as it applies in all fiduciary situations to lawyers and non-lawyer alike. Meinhard and Salmon were business partners engaged in a joint venture with regards to a 20-year lease for the Hotel Bristol at 5th Avenue and 42nd Street in New York City. Meinhard provided the financing for the project and Salmon managed the business. An opportunity arose to renew the lease during the course of the joint venture. Salmon, without Meinhard’s knowledge or consent took advantage of that opportunity in his own name. Litigation between the partners ensued ultimately reaching New York’s highest court, the Court of Appeals and a landmark decision written by then Chief Judge Benjamin Cardozo.

Partners in a partnership are in a principal-agent relationship with each other. Partners are fiduciaries and owe each other fiduciary duties. Salmon breached his fiduciary duty by taking the lease renewal opportunity without sharing the benefit with Meinhard. Salmon owed Meinhard the duties of disclosure and loyalty and both

were breached. From the Cardozo opinion “Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty” (*Wendt v. Fischer*, 243 N. Y. 439, 444, 1926). To quote Cardozo again, “Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.” Fiduciaries of all types will thus be held to this high and uncompromising standard.

It is well established that fiduciaries must carry out their duties zealously. There exists for fiduciaries an expectation of total and complete performance of their duties. For the fiduciary, no deviation from fiduciary duties will be tolerated. A breach of fiduciary duties has serious consequences. A great example of what is expected of a fiduciary and the consequences for breach of fiduciary duties can be seen in the attorney disciplinary proceedings in *Matter of Galasso*, 19 N.Y.3d 688, 978 N.E.2d 1254, 2012 N.Y. LEXIS 2740, 954 N.Y.S.2d 784, 2012 NY Slip Op 7050 (2012), and *Matter of Langione*, 131 A.D.3d 199; 11 N.Y.S.3d 256; 2015 N.Y. App. Div. LEXIS 5359; 2015 NY Slip Op 05479 (2015). The professional conduct of attorneys in New York are under the regulatory authority of the Appellate Division of the Supreme Court of which there are four departments geographically divided within the state. Each of the departments have Grievance or Disciplinary Committees which hear complaints about the professional conduct of attorneys and in appropriate cases investigate and prosecute charges emanating from those complaints.

Background

In June 2004, Peter Galasso represented Steven Baron in a matrimonial action commenced by Wendy Baron. The parties entered into an escrow agreement in which Peter Galasso would act as escrow agent for the proceeds from the sale of commercial property owned by Steven Baron. Peter Galasso agreed to hold the sale proceeds of \$4,840,862.34 in an interest-bearing escrow account in Signature Bank pending further order of the court in the matrimonial action.

Anthony Galasso, Peter’s brother, in his capacity as office manager, deposited the funds into an escrow account at

Signature Bank. Anthony Galasso, was a long-time employee of the firm, having started as an entry-level file clerk and messenger and worked his way up to become the firm's bookkeeper and office manager. Peter Galasso and fellow partner James Langione as attorneys were the only authorized and permissible signatories on the original escrow account application. However, Anthony Galasso, a non-attorney, altered the application and included himself as a signatory for electronic fund transfer purposes.

Soon thereafter the following headline appeared in the New York Daily News, "Lawyer's Brother Skimmed \$4.3 million from firm fund" (Weir, 2007). It was reported that Anthony embezzled the escrow funds and spent the funds on a lavish lifestyle. Anthony Galasso had set up a relatively sophisticated system to perpetrate the fraud which went undetected by the attorneys and accountant reviewing the documents he produced. The funds were spent on private jets to Atlantic City and other gambling resorts, family vacations, stays at the Ritz-Carlton hotel in Manhattan, tickets for concerts, sporting events, Broadway shows, extensive improvements to his West Babylon home, his son's tuition to New York University and a Mercedes-Benz E350. Anthony Galasso confessed to the embezzlement. Upon discovery of the theft, it was reported to authorities and Anthony was arrested and pled guilty to two counts of grand larceny in the first degree, ten counts of falsifying business records in the first degree and ten counts of criminal possession of a forged instrument in the second degree. He was sentenced and went to prison. Peter cooperated fully with the criminal investigation that put his brother in prison. The Nassau County District Attorney's Office concluded that no one else in the firm had knowledge of the theft and that nothing in the documents presented to the firm by Anthony Galasso would have raised any suspicion regarding the accounts. The District Attorney and others submitted letters of support to the Grievance Committee investigating this matter for attorney disciplinary purposes. Regardless of the letters of support and statements of good character, the Grievance Committee brought a disciplinary proceeding against Peter on ten charges of professional misconduct based on his failure to safeguard the funds in his fiduciary capacity. The matter was referred to a Special Referee who sustained all ten charges. The Appellate Division granted the Committee's motion to confirm the Referee's report and denied respondent's cross motion to disaffirm the report (*Matter of Galasso*, 94 A.D.3d 30, 940 N.Y.S.2d 88, 2012 N.Y. App. Div. LEXIS 1443 [N.Y. App. Div. 2d Dep't, 2012]). As a result, Peter was suspended from the practice of law for a period of two years. Peter appealed his suspension to the New York Court of Appeals arguing that he had done nothing wrong and was in fact a victim and that he was being held responsible for the

criminal behavior of his brother. The New York State Court of Appeals granted leave to hear the appeal.

For many years, the New York court decisions in attorney disciplinary matters lacked detailed and specific guidance on the ethical behavior required of attorneys in matters like the one presented in Galasso. In this case, the New York State Court of Appeals provided the long needed guidance.

The standard communicated by the court in this case is crystal clear and unambiguous. The court said "Few, if any, of an attorney's professional obligations are as crystal clear as the duty to safeguard client funds" (*Matter of Galasso*, 19 N.Y.3d 688, 978 N.E.2d 1254, 2012 N.Y. LEXIS 2740, 954 N.Y.S.2d 784, 2012 NY Slip Op 7050 [2012]). This is not a new or heightened degree of liability for attorneys, that the Appellate Division was imposing on Galasso but one completely consistent with existing standards pertaining to the safeguarding and oversight of client funds. In the court's words, "a reasonable attorney, familiar with the Code and its ethical strictures, would have notice of what conduct is proscribed" (*Matter of Holtzman*, 78 N.Y.2d 184, 191, 1991).

Although Galasso did not steal the money, his actions and inactions permitted his employee to do so. Peter failed to protect and preserve client funds. There was a lack of basic internal controls (see e.g. *Matter of Wilkins*, 70 A.D.3d 1119, 1119–1120, 895 N.Y.S.2d 552 [3d Dept. 2010]; *Matter of Abato*, 51 A.D.3d 225, 228, 853 N.Y.S.2d 660 [2d Dept. 2008]). Peter was not being held responsible for the criminal behavior of his brother but his own breach of his fiduciary duty and failure to properly supervise his employee, resulting in the loss of client funds entrusted to him. The breach of fiduciary duty brought about the disciplinary action.

Peter Galasso's lack of internal controls and lack of supervision created the opportunity for the embezzlement of client funds. The simple act of supervising the accounts and his employee would have alerted Peter at the very start. Carrying out his fiduciary duty as required could have substantially mitigated the losses. The slightest discrepancy in an attorney escrow account should be a matter of great concern to a reasonably prudent attorney.

Although attorneys are not prohibited from delegating responsibility like bookkeeping to firm employees, the attorney must supervise. The New York State Court of Appeals clearly states in this case "We stress that it is the ethical responsibility of the attorney, not the bookkeeper, the office manager or the accountant—to safeguard client funds." (*Matter of Galasso*, 19 N.Y.3d 688, 978 N.E.2d 1254, 2012 N.Y. LEXIS 2740, 954 N.Y.S.2d 784, 2012 NY Slip Op 7050 [2012]). Personal review of the bank statements, personal contact with the bank, oversight of firm's books and records are all measures that could have mitigated and

maybe even avoided the embezzlement of the funds.

The standard of behavior is best summed up by the New York State Court of Appeals in a quote from Cardozo. “Respondent is not bound to his clients solely by the contractual language of the escrow agreement, but also by a fiduciary relationship”. “A trustee (fiduciary) is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior” (*Meinhard v. Salmon*, 249 N.Y. 458, 464, [1928]; see *Matter of Wallens*, 9 N.Y.3d 117, 122, [2007]).

Application of Matter of Galasso to Matter of Langione

The court now applied the crystal clear standard outlined in Galasso to the disciplinary action against his partner Langione, even though the latter was not directly involved in the Baron case or that embezzlement. Langione was never a party to the Baron escrow agreement between Galasso and the clients involved in that misappropriation, but the embezzlement included the transfer of funds from the firm’s general escrow or trust account involving other firm clients. Langione’s only direct involvement in the matter was limited to his being a signatory on the escrow account. He contended that in being a signatory on the escrow account, he was merely fulfilling a bank requirement, not acting as a fiduciary and had no fiduciary duty to Galasso’s clients. Nonetheless, the Grievance Committee for the Ninth Judicial District began a disciplinary proceeding against Langione, based upon the acts of professional misconduct and breach of fiduciary duties. A total of 12 charges of professional misconduct were raised and sustained by the Special Referee assigned to the case. The Special Referee found that the record was, “bereft of any oversight”... exercised by Langione with respect to the escrow accounts. Just like his partner Galasso, Langione breached his fiduciary duties. He breached his duty as a fiduciary to exercise appropriate oversight of the firm's escrow accounts, books and records, and the firm's bookkeeper. Langione, like Galasso, was suspended from the practice of law.

Conclusion

Galasso and Langione both learned a lesson in fiduciary duties the hard way. Rule 1.15 of Part 1200 of the Rules of Professional Conduct [22 NYCRR 1200] are only the minimum standards of attorney responsibility with regard to client’s money. The actual standard is much higher. Again the words of Benjamin Cardozo from his opinion in *Meinhard v. Salmon*, 249 N.Y. 458 (1928), summarize the standard of one acting in a fiduciary capacity. “Many forms of conduct permissible in a

workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.” Therefore, for attorneys and fiduciaries in all businesses and professions the standard is the “punctilio of an honor the most sensitive”, not just observing the law, or adherence to ethical principles but to be above reproach in all matters concerning those they represent.

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