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ETHICAL DUTIES RELATING TO A CLIENT'S PROPERTY HELD BY A LAWYER IN WHICH A THIRD PARTY HAS AN INTEREST

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Introduction and Scope

This opinion addresses the ethical issues faced by a lawyer holding client funds to which a third party claims entitlement. Although the problem can arise in many contexts, it typically arises where a lawyer recovers funds as a result of a client's personal injury and a medical provider claims some right to those funds. Often the third party has had some contact with the lawyer which may place additional responsibilities on the lawyer.

Syllabus

1. Where the third party does not hold an interest as a result of a statutory lien¹ or a contract² or a court order, the property should be promptly distributed to the client.

2. Where the third party holds an undisputed interest as a result of a statutory lien, contract, or court order, the property should be distributed in accordance with the terms of the statutory lien, contract or court order.

3. If the validity or amount of the third party's claim is subject to dispute, any undisputed portion should be promptly distributed to the client, or if appropriate, to the third party in accordance with the terms of the lien, contract or court order. The balance should be subject to a negotiated settlement or a court proceeding.

4. Where the third party has been induced by the conduct of the lawyer to believe the third party will be paid from the property held by the lawyer, but the client disputes the third party's entitlement, the lawyer should advise the client and the third party to attempt to resolve the dispute. The lawyer should distribute the undisputed portions of the property. If the client and the third party are unable to resolve their dispute, the lawyer should file an interpleader action with regard to the portion in dispute.

5. (a) Where there is a statutory lien or court order and the client demands that the lawyer not disclose the fact that the lawyer is holding the property, Rule 1.15(b) requires the lawyer to distribute the funds in accordance with the statutory lien or court order, notwithstanding the client's wishes.

(b) Where the third party holds an interest pursuant to a contract with the client, but the client disputes the validity of the contract or the amount of the third party's claim and further demands that the lawyer not disclose that the lawyer is holding the property, the lawyer should maintain the confidentiality of the information, pursuant to Rule 1.6(a) and distribute the property to the client pursuant to Rules 1.2(a) and 1.15(b).

(c) Where the circumstances exist as described in (b) above, but in addition the third party has been induced by the lawyer to believe that the contract will be honored, the lawyer should attempt to have the client consent to disclosure and should further advise the client to attempt to resolve the dispute. If the client refuses, pursuant to Rule 1.15(b), the lawyer should interplead the disputed portion of the property, notwithstanding the client's request for confidentiality.

Discussion: Overview of Lawyer's Duty

A lawyer holding property on behalf of a client can be faced with ethical issues when a third party makes a claim to that property.³ The ethical dilemma is compounded where the client "directs" the lawyer not to reveal the existence of the property to the third party and to distribute the property pursuant to the client's instructions. Rule 1.15(b) (concerning distribution of client's property), Rule 1.6 (concerning confidentiality of information) and Rule 1.2 (concerning scope of representation) of the Colorado Rules of Professional Conduct guide the lawyer's ethical conduct in these situations.

When a lawyer receives property on behalf of the client, the lawyer's duty (absent other agreement or law) is to *promptly* deliver the property to the client and/or third parties who (1) have an interest,⁴ and (2) who are entitled to receive the property. Rule 1.15(b) provides:

Upon receiving funds or other property in which a client or third person *has an interest*, a lawyer *shall promptly* or otherwise as permitted by law or by agreement with the client, 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 by the client or third person, render a full accounting regarding such property. (Emphasis added).

With respect to the client's property in a lawyer's possession, a lawyer's duty is generally to the client and not to third parties. *See, e.g., Klancke v. Smith*, 829 P.2d 464 (Colo. App. 1991) (lawyer's duty is to act in the best interest of the client; in the absence of fraud or malice, a lawyer is not liable to third parties for distribution of funds to the client). This general rule may be altered by statute, contract, or by court order.

With regard to confidentiality, Rule 1.6(a) provides that:

A lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, *except for disclosures that are impliedly authorized in order to carry out the representation*, and except as stated in paragraphs (b) and (c). (Emphasis added).

With regard to scope of representation, Rule 1.2(d) provides that:

A lawyer shall not counsel a client to engage, or assist a client, in conduct that a lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

1. *Distribution where the third party does not hold an interest as a result of a statutory lien, a contract or a court order.*

Distribution to the client should be made promptly where the third party does not hold an interest as a result of a statutory lien, contract or court order. Rule 1.15(b) obligates the lawyer to distribute the funds or property only to parties "entitled to receive" the property. The Alaska Bar Association Ethics Committee has noted that under Rule 1.15(b), a lawyer has no duty to third parties unless there is either "[1] a valid assignment on its face or [2] a statutory lien which has been brought to the lawyer's attention." Alaska Bar Association Ethics Committee Opinion 92-3 (6/1/92).

Further, the lawyer is not required to allow the third party time to obtain a court order before delivering the property to the client. California State Bar Standing Committee on Professional Responsibility and Conduct, Opinion 1988-101; and *Klancke*, 829 P.2d at 464. In the absence of a statutory lien, contract or court order, the lawyer must distribute the property to the client, and the lawyer cannot rely on how a future court will view the strength of the third party's claim.⁵

2. *Distribution where the third person holds an undisputed interest as a result of a statutory lien, contract or a court order.*

Where the third person holds an undisputed interest as a result of a statutory lien, contract or court order, the lawyer is required to abide by Rule 1.15(b). The existence of a statutory lien or a contract creates a presumption that the client is not entitled to the property.⁶ The lawyer should promptly deliver the property to the third person in accordance with the statutory lien, contract or order, and deliver the balance to the client.

3. *Distribution where there is a dispute about the validity or amount of the third party's claim.*

Where there is a dispute as to the validity or amount of the third party's claim, the lawyer should promptly distribute the undisputed portions. The balance should then be subject to a negotiated settlement between the client and the third party. The lawyer, however, should not unilaterally assume to arbitrate a

dispute between the client and the third party. *See* Committee Comment to Rule 1.15. The lawyer should encourage the client and the third party to resolve their differences promptly and amicably.

The lawyer cannot unilaterally hold the disputed property without the permission of the client and the third party.⁷ Where the client and third party consent, the lawyer may retain the disputed property in a trust account pending resolution of the dispute between the client and third party. If the client and the third party cannot reach an agreement, the lawyer should interplead the property for disposition by the court. Filing fees and costs of service may be deducted from the property in dispute.

4. *Distribution to a third party where the lawyer has induced reliance by the third party, when there is no statutory lien, or court order.*

A lawyer may be contacted by a third party asserting a claim to the client's property. The lawyer should not engage in conduct which induces a third party to expect to share in the property and then later distribute the property solely to the client. The lawyer's conduct which may induce reliance can be explicit, *i.e.*, an express acceptance of the third party claim by the lawyer, or reliance can be induced by the lawyer's silence; *i.e.*, an implicit or tacit acceptance of the third party claim either by the lawyer's actions or inaction.

The Colorado Supreme Court privately censured a lawyer for inducing a third party to rely on the lawyer's assurance that her claim would be paid and then later distributing the property solely to the client. The client had provided a written assignment to the third party of a portion of his expected personal injury proceeds. The lawyer explained the workings of the assignment to the third party. When the third party became concerned about whether the assignment would be honored, she had her lawyer write a letter inquiring whether the client intended to be bound by the assignment. The client's lawyer did not respond, and instead, disbursed the proceeds of the personal injury claim to the client.

The Colorado Supreme Court concluded that the lawyer knew that the third party "was relying on the lawyer's representations that the assignment would be honored." 19 Colo. Law. 268 (Feb. 1990). The lawyer's conduct constituted "conduct involving dishonesty" in violation of the then applicable Code of Professional Responsibility.⁸

The Alaska Bar Association Ethics Committee has concluded that it is improper for a lawyer to induce such reliance, and that the lawyer had an affirmative duty to respond in a clear, unequivocal manner to a third party's inquiry. The Alaska Opinion 92-3, *supra*, noted that "it is inappropriate for the lawyer to remain silent after having received notice of such a potential claim." The Alaska Bar Association Ethics Committee suggested that the lawyer respond to a third party's lien claim by affirmatively stating that (1) the issue is one between the third party and the client, and (2) the lawyer will not assume responsibility for payment of the client's obligations.

This Committee agrees that a lawyer may not stand mute in response to a third party's claim to client funds. The lawyer should discuss the third party's claim with the client and decide what response should be made. The third party should then be informed of the client's decision with regard to the claim. Regardless of the client's decision, unless the lawyer intends to be personally responsible, the third party should be informed that the lawyer will not assume responsibility for payment of the client's obligations.

A situation such as this may also arise where the client has entered into a contract with a third party, and the client then instructs the lawyer to disregard the contract when the property or funds are received by the lawyer. If the lawyer has either explicitly or implicitly led the third party to believe that the property will be distributed pursuant to the contract between the client and the third party, the lawyer should advise the client and the third party to resolve the dispute. The lawyer should distribute the undisputed portions. Where the client and the third party consent, the disputed property may be retained in the lawyer's trust account pending resolution of the dispute between the client and third party. If the client and third party do not agree to place the property in a trust account or are unable to resolve their dispute, the lawyer should file an interpleader action with regard to the portion in dispute.

5. *Distribution where the client demands that the lawyer not disclose the existence of the funds to the third party.*

a. Where a third party has an interest in the property a result of a statutory lien or court order, and the client demands that the lawyer not disclose to the third party that the lawyer is holding the property, Rule 1.15(b) requires the lawyer to distribute the funds to the third party notwithstanding the client's instructions. Because the third party is legally entitled to receive the property, Rule 1.15(b) requires the lawyer promptly to distribute the property to the third party, and to render an accounting, if requested. The lawyer's duties under Rule 1.15(b) may conflict with the lawyer's duty of confidentiality under Rule 1.6. Under the circumstances discussed in this subsection, however, the Committee believes that the objectives of Rule 1.15(b) take precedence; thus the lawyer should distribute the property notwithstanding the client's request for confidentiality.⁹

b. Where the third party holds an interest pursuant to a contract with the client, but the client disputes the validity of the contract or amount of the third party's claim under the contract, and the third party has not been induced by the lawyer's conduct to believe that the third party will be paid from the property held by the lawyer, the lawyer should maintain the confidentiality of the existence of the property and distribute the property to the client, pursuant to Rules 1.2(a) and 1.6(a).¹⁰ Even though the lawyer may be aware of potential liability which may be incurred by the client with regard to the third party, this Committee does not believe this vitiates the client's entitlement to the property under normal circumstances. However, the lawyer may not distribute the property to the client if to do so would be to engage in or assist the client in conduct that the lawyer knows is criminal or fraudulent in violation of Rule 1.2(d) or is otherwise not permitted by the Rules of Professional Conduct in violation of Rule 1.2(e). Under the latter circumstances, the lawyer should move to interplead the property. *See* Section 5(c) below and Rule 4.1(b).

c. Where there is a contract and the third party has been induced by the lawyer to believe the contract will be honored and the client disputes the validity of the contract or the amount of the third party's claim and demands that the lawyer not disclose that the lawyer is holding the property, the lawyer should attempt to have the client permit disclosure regarding the property's existence. The lawyer should also advise the client to attempt to resolve the dispute. If the client refuses to allow disclosure of the property, the lawyer must interplead the property, naming both the client and the third party as necessary parties.

The interpleader action will disclose the existence of the property. However, this Committee believes that where the lawyer's duties under Rules 1.15(b) and 1.2(d) or (e) conflict with the duties under Rule 1.6, the confidentiality provision must be read in the context of the overall purpose of the Rules.

The ABA Committee on Ethics and Professional Responsibility noted that Rule 1.6(a)'s confidentiality provision can give way to Rules 1.16 and 1.2(d):

While it is also true that neither Rule [1.16 or 1.2(d)] contains language explicitly overriding the confidentiality requirement of Rule 1.6 (as do Rules 3.3 and, of course, Rule 1.6 itself), the absence from their text of a preemption clause does not seem to us necessarily determinative of the proper course of conduct in a situation where compliance with Rules 1.16(a)(1) and 1.2(d) appears to require conduct that may have the collateral consequence of disclosing client confidences. In the absence of a clear textual indication of how such a conflict should be resolved, the Committee believes that the confidentiality requirement of Rule 1.6 should not be interpreted so rigidly as to prevent the lawyer from undertaking to the limited extent necessary that which is required to avoid a violation of Rules 1.2(d) and 1.16(a)(1).

The exception here (if 'exception' is an appropriate term to describe the inevitable consequences of one rule's operation upon another) simply results from a recognition that fulfillment of the lawyer's obligations . . . may have the collateral effect of inferentially revealing a confidence. ABA Formal Opinion 92-366 at pp. 10-11 (*but see* Dissent to the Formal Opinion).

By analogy, the Committee believes that, although an interpleader action may have the collateral effect of revealing a client confidence (here, the existence of the property), Rule 1.15(b) does not permit a

lawyer who has induced reliance to either retain the property or to ignore the interests of third parties who are relying on a contract which, unbeknownst to them, has been challenged or disputed by the client.

Conclusion

Distribution of property should be addressed with the client when the lawyer first learns of the statutory lien, contract or court order to prevent disputes from arising upon receipt of the funds by the lawyer. Early recognition of the potential for disputes between the client and the third party can avoid many of the complications discussed above.

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A question may arise as to whether the lawyer may distribute the disputed property to the client where the statute of limitations has run. The Committee believes that it is proper for the lawyer to distribute the property if it is clear that the statute has run. However, if there is a question as to whether the statute of limitations has run, then the lawyer has an obligation to notify the third party and ask the third party whether he or she is making a claim to the property, giving the third party a reasonable time to state his or her position. If the third party makes a claim, then the lawyer should proceed in accordance with Section 3 above, which deals with distribution where there is a dispute as to the validity of the claim. If the lawyer does not receive a meaningful response from the third party, and the lawyer believes the statute of limitations has run, the lawyer may distribute the property to the client. In accordance with Section 4 above, the lawyer should be aware that if the lawyer has induced a third party to believe that he or she will be paid or that his or her interest will be protected whether or not a statute of limitations has run, and the lawyer fails to act in accordance therewith, the lawyer may be subject to discipline.

NOTES

1. For example, Colorado statutes provide for a lien in favor of a hospital. C.R.S. § 38-27-101. Statutory liens also include those liens created by C.R.S. § 26-4-403 which provides for recovery for certain payments made by the Medicaid Program and liens created by § 1862 of the Social Security Act, codified at 42 U.S.C. § 1395, which provides for recovery of certain payments made by the Medicare program. In some cases, a lawyer can be held personally liable for a distribution which is contrary to a statute. *See* C.R.S. § 26-4-403.

2. An oral or written agreement between the client and a third party, granting the third party a right to receive funds which are expected to come under the control of the lawyer on behalf of the client as a result of that agreement, including by way of example: an assignment by the client, an agreement between a health care provider and the client for health care services, agreements between the client and an employer, a landlord, or an insurer.

3. Recent amendments to the Supreme Court Rule regarding contingency fees (Chapter 23.3, effective January 31, 1992) provide that the effect of third party liens shall be disclosed to the client in writing. It is advisable that this be discussed with the client whether or not a contingent fee agreement is in place.

4. The term “interest” is used to denote a right, claim or legal share in property, such as the right a third party has to property by virtue of a statutory lien, contract or court order.

5. Cleveland Bar Association Professional Ethics Committee Opinion 87-3 (3/29/88).

6. Alaska Bar Association Ethics Committee Opinion 92-3 (6/1/92).

7. California State Bar Standing Committee on Professional Responsibility and Conduct Opinion 1988-101.

8. Where the attorney personally executes the “lien,” the attorney subjects himself or herself to personal liability (*Conyers v. Lee*, 511 P.2d 506 (Colo. App. 1973)) and potentially violates the Rules of Professional Conduct (*see* first tab, this book) by failing to honor the lien.

9. This section assumes that the client has taken no court action to challenge the validity or amount of the statutory lien or court order. If such action has been taken, resolution of the dispute should be accomplished in a fashion similar to that set forth in Section 3 above.

10. Rule 1.2(a) provides:

A lawyer shall abide by a client's decision concerning the objectives of representation, subject to paragraphs c, d, and e, and shall consult with the client as to the means by which they are to be pursued.

Rule 1.6(a) provides that:

A lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation and except as stated in paragraphs (b) and (c).

The fact that client property is being held by the lawyer constitutes "information relating to representation of a client," as described in Rule 1.6(a). While the fact that such property exists may not rise to the level of information protected by the attorney-client privilege, the confidentiality requirement of Rule 1.6(a) is not limited to only privileged information. Rather, the Rule prohibits disclosure of any information relating to the lawyer's representation of that client.