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Lawrence K. Hellman

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It is often tempting to avoid confronting an uncomfortable situation by trying to convince yourself that you really don't know that the situation exists. For lawyers, however, such a strategy can be dangerous. On the one hand, as we saw last month, circumstantial evidence may be sufficient to support a fact-finder's conclusion that you really did know something even though you might not have admitted it to yourself. On the other hand, your failure to know something can sometimes be actionable. In other words, it rarely pays to put your head in the sand to avoid seeing what "was plainly to be seen."[i]

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Take the case of Peter Galasso,[ii] a partner in a small New York law firm. Over a three-year period, the firm's bookkeeper, who happened to be Mr. Galasso's brother, misappropriated for his own use around $5 million, writing checks to himself from a special escrow account and the firm's IOLTA account and covering his tracks with false bookkeeping entries. Apparently, Peter Galasso knew nothing about this; there were no allegations that he benefitted from the misappropriations in any way. Of course, if he *had known* about his brother's thefts of client funds, Peter likely would have joined his sibling for a 2.5 to 7.5 year paid vacation at a state-operated penal institution. He wouldn't have had to worry about neglecting his clients during those years, for he surely would have been disbarred if had been in cahoots with his brother.

Well, it turned out that *not* knowing about the misappropriation was found to have been disciplinable. His conduct wasn't as bad as having known about it and either participating in it, condoning it, or failing to stop and remediate it. But New York authorities thought it was still pretty bad. For not adopting reasonable and prudent controls over the handling of client funds and not discovering and stopping his brother's criminal conduct before it did so much damage to firm clients, Mr. Galasso was suspended from practice for two years.[iii]

This was not a case where the court drew upon circumstantial evidence to conclude that Peter Galasso really did know that client funds were being stolen. On the contrary, it was explicitly found that he did *not* have such knowledge. His professional misconduct consisted of "set[ting] in place the firm's lax procedures" and failing to discover his brother's criminal conduct.[iv] The rules that Mr. Galasso was found to have violated were the equivalent of Oklahoma's Rules 1.15, regarding safekeeping client funds and property, and 5.3, regarding lawyers' supervisory responsibility with respect to nonlawyer employees.

Rule 1.15 requires lawyers to safeguard client funds that have been entrusted to them. This requires a bookkeeping system with financial controls that are sufficient to reduce the likelihood of purposeful or even negligent mishandling of client funds to an acceptable level. It doesn't have to be an absolutely foolproof system.[v] But Mr. Galasso's didn't come close. As the New York Court of Appeals put it, he "[ceded an unacceptable level of control over the firm accounts to his brother, thereby creating the opportunity for the misuse of client funds."[vi] Client funds were not accounted for properly, disbursed when they should have been, or kept safely segregated from the firm's operating account. In addition, the firm failed to provide accurate reports to clients regarding the status of their funds. In each of these ways, Mr. Galasso was found to have violated Rule 1.15. Because the firm's financial controls were so lax, Mr. Galasso was found to have allowed literally millions of dollars of the firm's clients' money to be stolen.[vii]

Rule 5.3 requires every partner in a firm (and every lawyer with supervisory responsibility over specific nonlawyer employees of the firm) to "make reasonable efforts to ensure that the [nonlawyers'] conduct is compatible with the professional obligations of the lawyer." Once again, the efforts don't have to be 100 percent foolproof. This is a rule of reason. Here, the Grievance Committee and New York Court of Appeals found that there were ample "warning signs" that should have triggered an inquiry that might have cut short the bookkeepers' criminal conduct. When the firm's outside accountant brought a $5,000 discrepancy in a large escrow account to Peter Galasso's attention, he allowed his brother to resolve the problem. The brother did so by fabricating an account statement. When Peter Galasso asked his brother to prepare a $100,000 check on the firm's operating account, his brother wrote the check on the firm's IOLTA account, and Peter Galasso signed it unquestioningly. Such incidents led the New York court to say, "Had respondent been more careful in supervising the accounts and his employee, he would have been aware of the malfeasance at a much earlier time when he could have substantially mitigated the [clients'] losses."[viii]

Mr. Galasso was punished for *negligent* supervision of accounts and employees, but in a similar case, the Delaware Supreme Court treated another lawyer's failure to have been on top of his firm's bookkeeper to constitute *intentional* neglect.[ix] That may sound oxymoronic, but that's how the court treated it.

While the Galasso firm's bookkeeper was a crook, the bookkeeper in Mr. Bailey's firm was simply disorganized, seemingly to the point of incompetence. For example, the firm's books were rarely reconciled, its bank accounts were often overdrawn, and employment tax reports were routinely late and slow to be paid even after they were filed. When this disarray was brought to light through a routine compliance audit that all Delaware firms undergo periodically, the bar ordered some follow-up investigatory audits conducted. This led to the discovery that, on one occasion, $26,500 had been improperly transferred from the firm's clients' trust account to its operating account and then spent. The bookkeeper made this transfer in order to accommodate Mr. Bailey's request to pay some money out of the operating account to satisfy a personal debt that Mr. Bailey owed. It wasn't that unusual for one of the two lawyers in this small firm to use the operating account to pay personal bills; they just treated such payments as advance draws on their next profit distribution. But it *was* unusual to cover such draws by "borrowing" funds from the clients' trust account.

There was a dispute as to whether Mr. Bailey had expressly asked or authorized the bookkeeper to move the money from the trust account to the operating account. The Delaware Supreme Court resolved the conflicting testimony by concluding that Mr. Bailey *must have known* that client funds in the trust account was the only source of money the bookkeeper could have used to satisfy Mr. Bailey's personal debt. Note that "must have known" doesn't mean the same thing as "should have known." In this case, "must have known" meant that the court used circumstantial evidence to conclude that Bailey had actual knowledge that funds were being taken from the client trust account for the purpose of enabling his personal debt to be paid: "If the operating account were repeatedly in an overdraft condition anyway, Bailey had to know that money had to be moved from some other account to cover the [$26,500] draws. The only account... that could have provided the money was the trust account... Hence, Bailey knew (at least insofar as one is presumed to intend the natural consequences of his acts) that by this extraordinary expenditure of funds to satisfy [his] debt, client trust funds would have to be, and were, invaded."

As was Mr. Galassos, Mr. Bailey's discipline was based on Rules 1.15 (handling client funds) and 5.3 (reasonable supervision of nonlawyer employees). But, whereas Mr. Galasso's violations of these rules had not benefitted him personally, Mr. Bailey's violations did. Nevertheless, Mr. Bailey received a less severe sanction: a six-month suspension, versus the two-year hiatus imposed on Mr. Galasso.

Like Mr. Benjamin, the securities lawyer discussed in last month's column, Mr. Galasso and Mr. Bailey were damned if they knew about the mishandling of client funds and damned if they didn't know. Bottom line: keeping their heads in the sand regarding how their firm's books were being managed resulted in a pretty stern kick in the rear.

i *U.S. v. Benjamin*, 328, F.2d 854, 863 (2d Cir. 1964).

ii In the Matter of Peter J, Galasso, 978 N.E. 2d 1254 (N.Y.A.D. 2012).

iii The opinion of the New York Court of Appeals remanded to a state grievance committee for it to reconsider the severity of the sanction, but, on remand and appeal from that remand, the two-year suspension stuck. In re Galasso, 2013 W.L. 696355 (N.Y.A.D. 2 Dept. Feb 27, 2013).

iv Galasso, at 1257.

v Jim Calloway, the OBA's nationally prominent law practice management guru, can help any law firm, large or small, review the adequacy of its financial controls.

vi Glasso, at1258.

vii The state's client security fund is unlikely to be capable of making the clients whole. Consequently, the clients who lost money can be expected to pursue civil remedies against Mr. Galasso to help mitigate their losses.

viii Glasso, at 1258.

ix In re Bailey, 821 A.2d 851 (DE 2003).

x *Id.* at 861. Because he was considered to be the managing partner of the firm, the Court imputed to him knowledge of the condition of the firm's operating account. *Id.*