BEST PRACTICES FOR TRUST ACCOUNTING

Ellen Freedman, CLM

It's rare that a week goes by without receiving at least one hot line call which has been referred to me by someone at the IOLTA Board. It's hard to believe that lawyers still struggle with how to handle a trust account properly, but they do. And it's not just small or solo lawyers who get in trouble. A distinction exists. Usually the solo or small firm gets in trouble as a result of a lack of understanding of how to do things properly. On the other hand, mid and large-size firms mostly get in trouble due to a purposeful ignorance of established procedures, or fraud.

Just to illustrate how easy it is to get into trouble, I will describe the ordeal of someone I recently assisted. The solo attorney was the subject of a complaint filed with the Disciplinary Board by an unhappy client. It had absolutely nothing whatsoever to do with handling of trust funds. Mostly it was a case of a poorly written engagement agreement, and poor communications with the client during the matter. The attorney had an otherwise unblemished career of several decades.

The problem arose when the Disciplinary Board ("D-Board") started its investigation. Similar to government agencies which occasionally intrude upon law firm life to investigate specific allegations, when they arrive at the door they don't ask to see just what is related to the particular matter. When they investigate a particular complaint made against a firm, they look at all sorts of things at the same time. In fact, the D-Board spent *a full year* investigating the operation of the practice. Imagine how difficult it is to keep practicing at full speed while that is going on.

It's a rare law practice which can withstand the bright light of continued scrutiny into all its dark crevices, without providing something ugly to view. Such was the case with this attorney. The trust account was inadequately documented; not all funds which should have been run through the trust account had been; and in a few instances funds were disbursed before they should have been.

In the short space of one article I can't cover everything you need to know about trust accounting best practices. But I'll attempt to cover the most important ones. Keep in mind that Rule 1.15 [Safekeeping Property], the Booklet provided by the IOLTA Board, numerous Opinions issued over the years, and solid accounting and fraud prevention strategies are the guiding principles which apply.

1. **No Commingling**. It is permitted to keep a small amount of the firm's money — $100 or so — in the trust account as a precaution to cover bank charges, such as incurred when a deposited check bounces for insufficient funds, in order to prevent an overdraft, or inappropriately using another client's money. Trust funds should never be deposited into a firm's operating account, and then transferred into the trust account. It is permitted, according to Informal Opinion 90-8, to have a separate account solely for the purposes of receiving payments from clients which may include both payment for services billed and retainer fees, provided that the retainer fees are immediately transferred to a trust account. This situation may arise when clients pay by credit card, wire transfer, PayPal, or other methods.

2. **Keep clear documentation**. I.O. 90-8 reiterates a point where many attorneys falls short. It is important to keep clear documentation reflecting all transactions regarding trust funds, and to keep such records for at least five years following termination of the representation of the client. It is particularly important when trust funds are "swept" from an intermediary account into trust, as mentioned above, to document that the transfer was done immediately.

3. **Keep individual client trust ledgers**. Whether your accounting system handles this, or you do it manually with Excel, or even paper, there must be a ledger set up for each client for whom you deposit funds in your trust account. You must track all incoming money to show date of receipt, date of deposit, a description which delineates the source (who sent the money and by what method), and any identification number such as check number or wire transfer confirmation number. And finally, you need to show the amount. Every payment made from the trust account on behalf of the client should be similarly recorded with all the relevant data, such as check date, to whom payable, for what, and amount. A running balance of remaining funds is the last piece of necessary information.

4. **Reconcile monthly**. Another area where many firms fall short is in monthly reconciliation. It is not sufficient just to reconcile the amount you have on your books with the amount the bank shows on the statement. You must

additionally reconcile each individual client trust account balance, and verify that the total of all of those balances exactly equals the amount in the bank and on your books. The only exception would be any small amount which the firm may maintain as a cushion in the account. Any discrepancy, even if just a penny, should be tracked down and corrected. Never let a discrepancy go unexplained to the following month

5. **Understand the difference between "available" and "cleared" funds**. Banks routinely make money deposited available within a short time period, meaning you can draw against it. But that doesn't mean that the deposit has actually cleared. It is not cleared until it makes it through the clearing house to the issuing institution, and is honored. Law firm trust accounts across the nation and in many Canadian provinces have fallen victim to phony certified bank check scams, and lost literally millions from their trust accounts. Smart lawyers, at firms of all sizes, have fallen prey. Remember, if you disburse funds from trust before the money is truly cleared — which can take a week to a month, depending on the instrument used to pay — you will need to explain subsequent bounced checks if it doesn't clear, and make up the shortage out of your pocket. Don't look to the bank to accept responsibility, even if an officer personally looked at the certified check and said it was legitimate. One big NYC law firm already lost that legal battle. The agreement you have in place with the bank covers their lack of responsibility clearly in the fine print. There will no doubt be attorneys who insist on overriding the firm's normal "holding" period in drawing against a deposited check, because he or she is certain the deposit is "good." And it may well be. However, should your firm be audited, this unacceptable practice will be quickly spotted. Allow it at your own risk. Select a reasonable "holding" period, based on the type of deposit, and stick to it.

6. **Take your fees when earned**. This is a thorny issue, and a place where firms of all sizes transgress. First, many attorneys believe that because the purpose of the retainer is to cover fees and costs as incurred, that they can just write themselves a check, and send the client a paid bill when they get around to it. Wrong! You may never take the client's trust funds if there is a dispute regarding how they will be used. So the proper method is to first send the bill to the client. Give the client a reasonable length of time to review the bill and raise any objections. Just 48 hours can be reasonable, and I would recommend that you specify whatever length of time you choose right in your engagement agreement. After this brief period of time has elapsed, assuming the client has raised no

objections to the bill, you can take your fees and costs. But not before. (I am not addressing non-refundable fees here.)

7. **Don't delay taking your earned fees**. This is yet another even more thorny issue. Many attorneys like to leave earned fees in the trust account as a "cushion" for leaner times. There are two serious issues created by this action. One, there is a distinct likelihood that you may defer declaring the income until a different accounting period. The IRS has a real problem with that. In fact, should your firm undergo an audit for any reason, they will most certainly examine your trust account to determine whether you take your fees when earned, because this is such a common problem at law firms. Two, a more frequent problem arises when a firm, particularly solo and small firms, actually forget to take the money. Years later, I am contacted when the retiring attorney is trying to close the firm, but the bank won't let him or her withdraw the remaining balance in the trust account. Lacking absolutely clear documentation to show that what remains is untaken fees and/or costs, the attorney will be required to turn the funds over to the state under the Unclaimed Property Act, sometimes referred to as Escheat Rules. And then only after maintaining the account for a lengthy period of years first. Oh, and if you do manage to clearly show that they are fees and costs which should have been taken years before, you are now potentially back in the soup with the IRS.

8. **Control who can sign**. Only an attorney is permitted to sign checks on a trust account. That should not be accomplished by use of a signature stamp, which would create irresponsible exposure to theft. Sometimes attorneys set up separate interest-bearing trust accounts for clients, such as when handling large real estate deals, or estates. A misstep is often made by forgetting to include at least one other partner of the firm as a signatory. Solo attorneys should also always plan on having an outside attorney with a Power of Attorney as a pre-designated signatory on file with the bank, in case the solo is suddenly disabled or dies. Yes, sadly I get those calls all too often. It can create malpractice exposure for the firm, and negatively impact the value of the deceased attorney's estate, or the recovered attorney's practice viability.

I could go on and on, but my editor keeps reminding me that I must keep my articles under a certain length, and I struggle each month to do so. Suffice it to say that these are some of the more frequent and thorny issues which arise, but this article is not all-inclusive. All PBA members are encouraged to contact me for additional discussion, to ensure you don't face issues which may inadvertently land you in ethical hot water.

A version of this article originally appeared in the May 6, 2013 issue of the Pennsylvania Bar News.

Freedman Consulting, Inc.
(215) 628-9422