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It's Not Your Money: Tips for Ethical Handling of Client Trust Accounts

Lawyers don't go to law school to learn principles of accounting and banking. However, once armed with a law license, lawyers - - especially solo practitioners and those that run small firms - - need to understand that their ethical and fiduciary duties to clients extend to proper handling of client trust accounts (CTAs). Indeed, mishandling of client trust funds is one of the primary targets of state bar regulators because violations can be relatively easy to detect through an audit and there is little subjectivity involved like other rule violations, such as the failure to communicate, lack of diligence or competence. Harm to the client is not a prerequisite to discipline, and discipline has been imposed even for mishandling nominal sums.

Overview of ABA Model Rule 1.15

All states have enacted a version of ABA Model Rule 1.15: Safekeeping Property, which sets forth the primary duties in handling CTAs. Essentially, lawyers must:

- Keep client and third party funds separate from the lawyer's own property, meaning that the lawyer cannot commingle the lawyer's money with the entrusted funds. There are two general exceptions to this rule: (1) the lawyer may keep a sum in the CTA necessary to cover bank fees; and (2) fees and costs advanced by the client (or third party payor) may be kept in the account until earned or incurred, at which time the funds must be promptly withdrawn.
- Provide *prompt notice* to the client or third party of the receipt of funds belonging to them. Prompt notice means that it must be given within a reasonable time (within a few days) after receipt and it must include the exact amount of the funds.
- Provide *prompt delivery* of funds belong to the client or third party either upon request or receipt, depending on the state's version of Rule 1.15. In the event of a dispute over distribution between clients, the client and the lawyer, or between the client and a third party with a legitimate interest in the funds, the funds may be kept in the trust account until the matter is resolved informally or through court proceedings. This issue is discussed further below. The critical point is that when faced with a dispute the lawyer must act promptly to attempt to resolve it.
- Provide a *prompt accounting* of funds contained in the CTA, typically upon request.
- Maintain proper accounting records and keep records for at least five years (some state rules provide for longer periods), measured from the date of termination of the representation.

Funds that Must Be Placed in the CTA

So what exactly must be placed in the CTA? Rule 1.15 requires that any funds in which the client or a third party has an interest must be placed in the CTA. The typical example is settlement funds,

including settlement checks made payable to the lawyer and client jointly. However, it also includes other types funds such as spousal support payments and community property assets held during marital dissolution proceedings; client funds for the payment of investments, property, or real estate; and funds from third parties to pay for rentals, leases, real property or other investments.

Advance payment of fees to be earned upon the performance of future legal services must also be deposited into the CTA and withdrawn or transferred to an operating account immediately after the fees are earned. Some lawyers refer to advance deposits as a "retainer," but true retainers, which is a fee paid by the client to ensure the lawyer's availability for a specified period or on a specified matter, are earned when paid and should not be deposited into the CTA.

Duties to Third Parties and Handling Disputes

Comment [3] to Model Rule 1.15 advises:

> Paragraph (e) also recognizes that third parties may have lawful claims against specific funds or other property in a lawyer's custody, such as a client's creditor who has a lien on funds recovered in a personal injury action. A lawyer may have a duty under applicable law to protect such third-party claims against wrongful interference by the client. In such cases, when the third-party claim is not frivolous under applicable law, the lawyer must refuse to surrender the property to the client until the claims are resolved. A lawyer should not unilaterally assume to arbitrate a dispute between the client and the third party, but, when there are substantial grounds for dispute as to the person entitled to the funds, the lawyer may file an action to have a court resolve the dispute.

In other words, the lawyer may owe fiduciary duties to *nonclients* such as lienholders and other claimants to entrusted funds. It is sometimes difficult to determine whether a third party has a legitimate right or lien to a portion of the funds, especially when the lien does not arise directly from client's matter, such as statutory liens, medical liens in a personal injury lawsuit, or a predecessor lawyer's lien for fees in a contingency case. For example, there may be situations where the client enters into an agreement with a creditor to pay the debt out of a recovery in the matter handled by the lawyer. The lawyer may not know about this arrangement or unsure whether the creditor has a nonfrivolous claim. *See e.g., Farmers Ins. Exch. v. Zerin* (1997) 53 Cal.App.4th 445. If the client objects to the distribution of funds claimed by the third party, then the lawyer should (1) obtain consent from the client and third party to hold the funds in the CTA until they can resolve the dispute, and recommend that each retain independent counsel to represent them in the dispute, or (2) commence an interpleader action for a court to determine the existence and extent of the lienholder's rights. *See,* Cal. State Bar Form.Opn. 1988-101.

Of course, the lawyer is not obligated to satisfy the debts claimed by the client's general creditors. The creditor must have a specific contractual or statutory lien or right to the funds in the CTA.

Recordkeeping Best Practices

Most states promulgate minimum standards of recordkeeping under Rule 1.15, which may include the maintenance of a client ledger, which details every monetary transaction for each client and an account journal, which details the transactions in the CTA (generally covering multiple clients). Lawyers are also required to keep bank statements and canceled checks, which then should be used to conduct a monthly reconciliation between the client ledger, account journal, and the bank records. Of course, lawyers may rely on accountants and bookkeepers to perform these tasks. However, lawyers remain ethically responsible for training and supervising their staff and independent contractors; general accounting practices may not satisfy legal and ethical standards.

Lawyers should not permit nonlawyers to be signatories to CTA checks, and for law firms, a policy requiring two lawyer signatures should be implemented.

Most state bar associations have published handbooks on proper accounting and recordkeeping practices for CTAs. For more information on this topic, please visit your state bar website.

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