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How to Ethically Oversee Trust Accounts

This CE Course will provide an overview of what your firm needs to know about the trust accounting process.

COURSE DESCRIPTION
This course is intended to acquaint legal management professionals and staff with the proper use of trust accounts.

COURSE OBJECTIVES
- Identify governing authorities for law firm trust accounts.
- Examine the type and function of trust accounts.
- Outline the trust account processes.
- Explain trust account records and retention.
- Summarize monthly trial balances and quarterly reconciliations.
- Discuss internal controls and separation of duties.
- Identify warning signs of improper trust account activities.
- Review procedure for handling disputed funds.
- Review procedures upon sale or dissolution of firm.

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Guided by the American Bar Association (ABA) Model Rules, this overview outlines proper processes, recordkeeping and internal controls that involve law office personnel and trust accounts. Since lawyers are licensed by the individual states, they are required to follow the rules of the state in which they are licensed, including those rules that apply to the use of trust accounts.

When looking for guidance on how to handle a particular situation, review the applicable state law, but since many states use the ABA Model Rules as guidance in creating their state rules, in many cases, the rules will be the same. Where state law is unclear, the ABA Model Rules may help in choosing a course of action. However, it is state law and the courts in the particular state that will make the ultimate determination in the handling of trust account issues.

THE FUNCTIONING OF TRUST ACCOUNTS

Lawyers have a fiduciary responsibility to safeguard the property of their clients, and trust accounts are a means to accomplish this. Law firm managers and staff are important elements to ensure that this responsibility is not breached.

Trust accounts must be kept separate from the operating accounts of the firm to ensure against the accidental use or intentional misuse of client funds. To use a single account for client funds and the general operation of the law firm requires tracking each individual client’s funds — revenue, and expenses of the firm, loans, payroll and equity distributions. To attempt to account for those numerous activities with a single account adds several layers of complexity, and invites the misuse of client funds. At the very least, this creates the appearance of impropriety and subjects the lawyer to disciplinary proceedings and possible disbarment. The lawyer, the legal management professional and/or staff member may also be subject to civil and/or criminal liability. Client funds are never to be treated as if they are the funds of the law firm.

There are ordinary trust accounts and what are known as Interest on Lawyers Trust Accounts (IOLTA) trust accounts. An ordinary trust account is a separate bank account with its own separate set of accounting records and identified as a client trust account. An IOLTA account is like an ordinary trust account except that — at no cost to lawyers or their clients — interest from trust accounts is pooled to provide civil legal aid and to support improvements to the justice system. If there is a large amount of interest, then such interest is paid to the client. What is considered “large” is a matter of professional judgment.

CLM® App Credit for Functional Specialists: 1 hour in the subject area of Financial Management (FM) towards the additional hours required of some Functional Specialists to fulfill the CLM application.

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All 50 states, the District of Columbia and the U.S. Virgin Islands have an IOLTA program. Forty-four jurisdictions have mandatory IOLTA programs (requiring attorneys to participate), while six jurisdictions maintain opt out IOLTA programs; participation is voluntary in two other jurisdictions. If an IOLTA account is overdrawn, in some jurisdictions, the bank must report this situation to the appropriate state lawyer licensing authority. It is critical to maintain adequate account oversight to ensure proper recordkeeping and to avoid against overdraying the account in an ordinary trust account. But with an IOLTA account, the consequences are relatively immediate and unforgiving.

TRUST ACCOUNT PROCESSES

Upon the creation of a trust account, the lawyer or a person under the direct supervision of the lawyer shall be an authorized signatory or authorize transfers from a client trust account. The best situation is to have only the lawyer as the signatory because it is ultimately the lawyer’s responsibility, but depending on the size of the firm, there may be a non-lawyer signatory. Law firm managers and staff who take on the role of a signatory face significant responsibility and potential liability, which should not be taken lightly.

The use of and accounting for a trust account requires that certain procedures be rigidly followed. There should be no split deposits where one portion of the check goes into the trust account and the remainder into the law office operating account or another account. The reason for this prohibition is that split deposits cloud the accounting for funds and makes it difficult to trace such funds. The complete check must be deposited in the trust account and then distributed. With credit card payments, ABA-approved software solutions that manage split payments are available.
Advanced fees paid by the client or flat fees paid in advance are deposited in the trust account since — until they are earned — they are the client’s property and not the lawyer/firm property. Such funds are withdrawn from the account when they are earned by the lawyer. If such services are never rendered by the lawyer, then the funds must be paid back to the client. There should be no excess funds in the trust account except that which is necessary to pay any bank service expense. The trust account is for the purpose of holding the client’s funds only and not as an account for the lawyer to hold excess operating or client funds.

Checks deposited in the client’s trust account must clear before the funds are distributed to that client. Otherwise, the funding of such distributions is from another client’s funds, and there is no right to use a client’s funds except on activities of that particular client. Funds held in the trust account and then earned by the lawyer, payments to a client such as settlement proceeds, or refund of expenses incurred on behalf of the client can be paid out of the trust account. General firm operating expenses are paid out of the operating account and not paid out of the trust account.

It is critical to maintain distance between the trust account funds and all other funds. It is important to keep in mind that the purpose of the trust account is to safeguard client funds and not for use of the firm and/or personal expenses of the lawyers of the firm. For convenience, it may make sense to pay firm expenses using the trust account when a lawyer has earned some of the funds, but do not do it!

Keeping clients advised of all the activities is always prudent. Plus, it’s required to report to clients the deposits of their funds into the account; the payment or transfer of funds is required. The failure to keep the client informed of such activities can be an ethical violation and also invites client suspicion of your other activities in the case.

TRUST ACCOUNT RECORDS AND RETENTION

It is critical to strictly account for the inflow and outflow of funds in the trust account. In your accounting system, you must create cash as an asset account and payables as liability account. A liability account is assigned to each client. There should be journal entries where each individual transaction is recorded regarding the receipt of funds and withdrawal of funds from the trust account and any other activities that pertain to the client accounts.

For example, the receipt of cash in connection with the settlement of a lawsuit involves the recording of an increase in cash with a corresponding increase in a liability for the particular client. Using the language of accountants: you debit cash and credit a payable — double-entry accounting. The journal entries record the individual transactions that impact the trust account. Also, for every receipt into and payment from the trust account the following should be recorded where applicable:

A. Identity of the client
B. Identity of the payer of the funds
C. Reason for the payment
D. Reason for holding funds
E. Date of the transaction
F. Deposit receipt
G. Copy of the check or electronic record of the transfer
H. Settlement sheet
I. Relevant correspondence

The payee must be identified and checks for “cash” or payable to “bearer” are never acceptable because it makes it difficult to trace.

Journal entries are recorded in the ledger identifying each separate trust client or beneficiary. They should show the source of all funds deposited, the names of all persons for whom the funds are or were held, the amount of such funds, the descriptions of deposits or withdrawals, and the name of all persons or entities to which such funds were disbursed. The fund balance is also maintained here.

It is critical to maintain a paper trail so a proper accounting can be made to the client or beneficiary. Though the use of the terms journal and ledger may sound like an old manual accounting system, most law firms, if not all, would use
software to record such transactions; however, the concept is the same. When starting a new law firm, it is advisable to consult with an external accounting professional when setting up your trust account system.

Whether electronic or paper, the trust account records must be retained for a period of time. The ABA recommends a period of five years after the termination of representation of the client. However, the state where the office is located determines the period of time for retaining the records.

MONTHLY TRIAL BALANCES AND QUARTERLY RECONCILIATIONS
For a proper accounting of all the funds, a monthly trial balance should be constructed and at least quarterly three-way reconciliations of the trust account should be performed, with the recommendation that the three-way reconciliation is also monthly. A trial balance requires that the total of all assets recorded in the ledger equal the total of all the liabilities recorded in the ledger. In a three-way reconciliation of the trust account, all the individual client ledger accounts — plus any excess funds in the account that are earmarked for bank service charges — are totaled and compared with the total cash balance on your books. You then compare the book cash balance total with the bank cash statement. All three totals should equal. If they do not, you should examine the following:

A. Bank statement balance with ledger balances
B. Relevant checks and deposit documentation
C. Transactions in the journals
D. Transactions in ledgers
E. Explanations of transactions noted in such documents as correspondence and settlement sheets

This three-way reconciliation ensures that the law firm or the bank did not make any mistakes with respect to the transactions recorded in the trust account.

INTERNAL CONTROLS
In order to protect against improper entries, improper deposits, or distributions and possible misappropriation of the funds in the trust account, a set of internal controls is required. The nature and extent of the internal controls is based on the size of the law firm and the nature of the use of the trust account. Consulting with an external accounting professional for setting up appropriate internal controls is advisable. For example, some effective internal controls include the following elements:

A. Segregation of duties
B. Mandatory vacations
C. Bonding of employees
D. Written policies
E. Staff training

As further explanation of internal controls, segregation of duties requires that the various processes involved in the receipt and the distribution of funds in the trust account are handled and recorded by different individuals. For example, the person who receives the check should not be the one who records it in the account or the one who disburses the funds — it is harder to misappropriate funds when several people are involved in the process.

Many conspiracies tend to break down over time due to greed, over-confidence and jealousy. In smaller firms, the segregation of duties may be difficult or perhaps impossible to achieve. In such firms, the lawyer must more closely supervise the activities in order to compensate for the inability to separate the duties.

There are some other internal controls you can take. For example, mandatory vacations for an extended period is another element of such controls. A staff member on vacation will be unable to conceal any misdeeds.

Another internal control is to require the staff to be bonded. Bonding can protect the firm against losses incurred due to the improper activities of the staff.

Written policies to guide the operations and training of staff concerning such policies serve to enforce the controls. The greatest set of controls are ineffective if they are disregarded by the law firm staff.

WARNING SIGNS OF IMPROPER TRUST ACCOUNTING
Despite the controls in place and an ethical law firm staff, no system is perfect. Therefore, here are warning signs that may indicate problems with the trust account:

- Checks and deposit slips that are incomplete
- Incomplete accounting records
- Missing checks or checks that are out of sequence
- Numerous voided checks
- Checks returned due to insufficient funds
- Employees who are defensive about disclosure of the financial records
• Failure to perform the basic accounting functions, such as creating trial balances and doing reconciliations of the trust account
• Lawyers or employees with personal or financial problems, or who seem to be living outside their means

There may be a legitimate reason for some of these discrepancies, but they certainly merit investigation. At the very least, they warn of lax accounting procedures, which signals a cause for concern. Whether any indications of problems or not, an annual review of the trust accounting procedures and practices is advisable.

PROCEDURES FOR HANDLING DISPUTED FUNDS
In cases where there is a dispute about the ownership and disposition of certain funds in the trust account, the funds must remain separate until the dispute is resolved. If the law firm is involved in the dispute, such funds may be transferred to a disinterested third party. The resolution of the dispute may involve the agreement of all parties or it may require a judicial determination.

PROCEDURES UPON THE SALE OR DISSOLUTION OF THE FIRM
Upon the dissolution of the firm or sale of law practice, reasonable arrangements must be made for the maintenance of client trust account records in accordance with the trust account rules in the appropriate jurisdiction. Client permission is necessary and a responsible lawyer must be secured to take control of the funds.

In all cases, it is the lawyer’s duty to ensure fiduciary responsibilities are carried out.

ABOUT THE AUTHOR
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