Originally printed in Law Practice (November/December 2017)

Avoiding Common Mistakes When Handing Client Funds

Mishandling client or third-party funds can result in very serious lawyer discipline. Commingling funds – that is, holding a lawyer funds improperly in the same account with other people's money – or misappropriating others' money may result in serious discipline, including suspension and disbarment.

The rules governing how lawyers must handle other people's money (including in their trust accounts) are often complex and unforgiving. Lawyer trust accounts also receive scrutiny from disciplinary counsel, including through trust account audits and overdrafts, because now most states require banks holding funds to give prompt notice to disciplinary counsel when an overdraft occurs.

I cannot in one column address all the possible variations and mistakes. This column therefore sets out to address nineteen common mistakes lawyers make when handling other people's money. When reviewing this list, please be mindful that the law in your jurisdiction may alter these guidelines. If nothing else, hopefully this column will encourage you to familiarize yourself with your home state's regulations governing lawyer trust accounts and handling of other peoples' money.

1. Trusting someone else's management. Despite the obvious and significant dangers of trust account mistakes, too often lawyers take care of the trust account, with very little oversight. You are ultimately responsible for management of your trust accounts, including how funds are handled and how records are kept. Very likely, the person you might entrust is not really trained on the proper handling of trust account management, including that bookkeepers and accountants almost never understand lawyer trust accounting. Take a serious interest in your trust account and its operations. Also, take the remaining eighteen warnings to heart when trying to manage client and third-party funds.

2. Putting the lawyers' money – including earned fees – into the trust account. Lawyers often place too much of their own money into their trust account. Regulations severely restrict when lawyers may place their own funds into the account. Normally deposit of the lawyer's funds are permitted only when necessary to cover bank charges or other fees. Lawyers generally should not put their own money into their trust account in other circumstances. Further, when a client or third-party payment consists only of fees the lawyer has already earned, those funds should not be deposited into the trust account.

3. Maintaining a "cushion" of lawyer funds in trust account. Lawyers should avoid maintaining a large cushion of the lawyers' funds in the trust account. The presence of such a cushion commingles the

lawyers' funds with other funds in the account, and may result in discipline.

4. Mishandling fixed fees. Fixed fees paid in advance may create peril for unwary lawyers. Some jurisdictions (like Missouri) require all fixed fees paid in advance to be held in trust until earned. Other jurisdictions (like Illinois) require all fixed fees to be treated as the lawyers' own funds, even when paid in advance. If fixed fees are mishandled, the lawyer may be failing to properly protect client funds or commingling earned fees with unearned client funds. While fixed fees paid after work is completed are always earned fees, you should check how your jurisdiction wants fixed fees paid in advance handled.

5. Disbursing before funds become "good funds." Lawyers depositing checks into their trust account should not disburse funds from those checks until the funds are received by the bank and become "good funds." Banks regularly make funds "available" after a few days, before the funds are received. You need to wait for the funds to be "received" or "good," not merely "available." This may take a week or two. If you do not wait, the check may bounce or be refused, resulting in an overdraft or improper disbursement of other funds in the account.

6. Withdrawing unearned funds. Lawyers are often tempted to withdraw or "borrow" funds too early. Perhaps you are sure a check will clear, or need funds and anticipates earning fees on an engagement. Avoid the temptation to make early withdrawals. An early withdrawal may be deemed a misappropriation, creating a risk for serious discipline.

7. Not "sweeping" out earned funds. When you have earned a fee from funds held in trust, and the funds are "good," you should sweep all the earned fees from that transaction in a single transfer or withdrawal. Often lawyers will withdraw only a portion of earned fees, and leave the remainder in the account. This constitutes commingling, and may result in discipline.

8. Paying firm expenses from the trust account. Avoid paying law firm expenses from your trust account. You may pay client expenses from a client's funds held in trust, but you cannot and should not use your trust account to pay your own expenses, such as rent, salary, insurance, or other operating expenses. Instead, transfer all earned funds into your business or operating account, and then make payments for your own expenses from that account.

9. Treating advance payments as "non-refundable." Most states prohibit lawyers from charging "non-refundable" fees. ABA Model Rules 1.5(a) and 1.16(d) are interpreted as requiring lawyers to refund any fees they have not earned, particularly when a client representation is terminated prematurely. Therefore, avoid calling advance charges "non-refundable," and refund any funds you receive but do not earn.

10. Disbursing trust account funds to non-named payees. Ethics rules generally prohibit lawyers from making disbursements to "cash" or using counter checks with no pre-specified payee are not permitted. Each disbursement (by check or electronic transfer) should be to a named payee.

11. Allowing improperly authorizations for disbursements. States often restrict who can sign trust account checks or authorize disbursements. Many jurisdictions allow only a licensed attorney to be an authorized signer. You should be careful about who authorizes disbursements. Also, avoid using a signature stamp for trust account disbursements. Even if allowed, such stamps often result in improper disbursements, jeopardizing your law license.

12. Mishandling advance payments by credit card. I encourage lawyers to accept credit card payments from clients, because anything that makes it easier for clients to pay increases the chances a lawyer will get paid. If you are going to receive credit card payments for future legal services, however, you should be very careful. Many credit card vendors require that all payments enter and all fees and chargebacks (or canceled payments) go into and out of a single account. Such restrictions create dangers for lawyers, who may miscalculate or fail to address credit card charges, or forget to make a necessary transfer between accounts.

To avoid such problems, I recommend that lawyers seriously consider using a credit card processor tailored to law firms. These lawyer-specific credit card payment processors will often allow a lawyer to receive payments into both a trust and an operating account, but will then deduct fees and chargebacks – even for payments made into the trust account – from the lawyer's business or operating account. This removes the need to calculate and account for all credit card charges, and protects the lawyer from overdrafts or other problems when a client cancels a charge or the lawyer fails to properly deduct fees or transfer funds. Lawyer-specific credit card processors may charge slightly higher fees, but the reduced risk make them a real bargain.

13. Mishandling funds subject – and not subject – to dispute. Lawyers are generally required to hold funds subject to a dispute in trust until the dispute can be resolved, or interplead the funds so a court can resolve the dispute. You should carefully comply with such requirements. You should also make sure that, if only a portion of the funds are subject to dispute, all remaining funds not subject to dispute should be disbursed promptly after they become "good funds."

Suppose, for example, that you recover $20,000 for a client. You are entitled to a $8,000 fee, but the client asserts you should only receive $6,000. Also, a third party has a lien on the funds, but the client orders you not to honor the lien, which is $500. You should disburse the $11,500 to the client, and you should disburse the $6,000 in fees to yourself. You need to hold the remaining $2,5000 – the $2,000 in fees in dispute and the $500 for the third-party lien – until those disputes can be resolved.

14. Not considering a "non-IOLTA" account. Most states require lawyers to set up and use an "IOLTA" account. IOLTA stands for "interest on lawyers' trust accounts," and indicates any interest the account generates will be used to help fund legal services for the indigent.

Where funds held in trust will generate significant interest, *Phillips v. Washington*

Legal Foundation, 524 U.S. 156 (1998), held the client has a constitutionally protected right to receive that significant interest. Therefore, if you expect to hold a large amount of money for a significant period, you may need to use a non-IOLTA trust account where the client – and not legal aid – will receive the interest. Fortunately, most states provide some protection for a lawyer exercising good faith in choosing an IOLTA or non-IOLTA account.

15. Not keeping client ledgers. Lawyers are required to track and use funds held in trust on a client-by-client basis. A law firm may not, for example, use funds held for Client A to pay legal fees or third-party expenses of Client B. This requires a firm to maintain ledgers for each client as well as for the trust account itself.

16. Not reconciling regularly. Lawyers are generally required to reconcile trust accounts on a regular basis, preferably soon after receiving the trust account statement. When lawyers do not regularly reconcile their trust account, mistakes may persist for a long period and result in bigger headaches (such as overdrafts) or become difficult to unravel and fix.

17. Not performing "three-way" reconciliation. Reconciling a trust account normally requires "three-way" reconciliation. You should reconcile the account statement with trust account ledger, and also with all client ledgers. This insures that all deposits and disbursements are properly recorded in the account, and are also attributed to the proper client.

18. Failing to keep adequate records. States often impose significant record-keeping requirements on lawyers. This may include keeping engagement agreements and settlement statements as well as copies of all account statements and ledgers, client statements, and checks deposited in or written to the account. Failure to do so may result in discipline.

19. Failing to keep records long enough. State rules also often specify how long lawyers must keep trust account records. Often all records must be kept for a significant period – perhaps five or six years – after a client representation ends or the final disbursement has been made. You should know and comply with this document retention period. Fortunately, most states now permit lawyers to keep such records only in electronic form.

As a final note, if you are looking to improve how you handle your trust account operations, I suggest you check what your practice management software can do. Most practice management software programs today are designed to help lawyers track all funds entering and leaving the lawyer's trust account. I have automated my trust account record-keeping through my practice management software, and have found it saves a lot of headaches.

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