

Test Your Client Trust Account IQ

What You Don't Know Really Can Hurt You

Testing your client trust account IQ may be the last thing you have an interest in doing. Client trust account management is pretty boring stuff, besides somebody else in the office takes care of all the nitty-gritty work anyway – why worry? If that is your attitude, it could well be that you are not keeping up with recent Supreme Court lawyer disciplinary cases. A breathtaking number of them involve lawyers who were found in violation of their professional responsibility for safekeeping client funds. Suspension and disbarment are typical sanctions and usually mean the end of a legal career. While people who write about risk management for lawyers too frequently resort to cheap scare tactics to get your attention, that is not what is going on in this article. One of the most frequent causes of lawyer discipline is client trust account misfeasance, malfeasance, and nonfeasance. So check it out – just how much do you really know about taking care of client money?

What follows are 20 true/false statements. A statement that is false in part or incomplete is “false.”

True False

1. A client trust account is identical for all practical purposes to a fiduciary account such as an escrow account used for real estate closings.

True False

2. A Kentucky lawyer may maintain client trust accounts in Kentucky banks and in banks in other states.

True False

3. A firm may open dedicated client trust accounts for individual clients and may open any number of pooled client trust accounts for safekeeping multiple clients' funds.

True False

4. All client trust accounts must be in a bank that is FDIC insured.

True False

5. A lawyer has satisfied the requirement that client trust accounts be maintained in a bank that agrees to notify the Kentucky Bar Association of any overdraft by confirming with bank officials that they will promptly report an overdraft to the KBA.

True False

6. The lawyer in a firm managing client trust accounts is solely responsible for all firm violations of Professional Conduct Rule 1.15, Safekeeping Property (SCR 3.130).

True False

 7. When there is a quick turn-around requirement to disburse funds to a client a lawyer may hold the funds in the office temporarily for direct payment to the client rather than depositing them in a client trust account.

True False

 8. Minor errors in managing client trust accounts that are quickly found, corrected, and cause no harm do not violate Rule 1.15, Safekeeping Property.

True False

 9. Conversion of client funds occurs when a lawyer fails to segregate client and third party funds from funds of the firm or personal funds of the lawyer.

True False

 10. When a lawyer receives a check that includes client funds and earned fees the correct procedure is to deposit the funds in a firm account and immediately transfer the client's funds to a client trust account. To do otherwise results in improper commingling of firm funds with client funds.

True False

 11. Lawyers may deposit firm or personal funds in a client trust account to minimize bank charges on an account.

True False

 12. Any disbursement from a client trust account on a client's behalf including settlement and transaction proceeds, fees, costs, expenses, earned legal fees, and return of unearned fees is permissible.

True False

 13. If a client disputes some of a lawyer's fee, the entire fee must remain in the client trust account until the dispute is resolved.

True False

 14. If a third party claims funds held in a client trust account, a lawyer may disperse the funds only in compliance with the client's latest instructions to pay or not to pay the third party.

True False

 15. Lawyers do not have implied authority to sign a client's signature on a check in furtherance of a representation.

True False

16. An overdraft occurs when a check written on a client trust account is dishonored and triggers a bank report to the KBA Bar Counsel.

True False

17. A permissible way to avoid an overdraft in a client trust account is to arrange with the bank a line of credit or other overdraft protections that prevent the dishonor (bouncing) of a client trust account check.

True False

18. Records of funds held in client trust accounts must be retained for five years after termination of the representation.

True False

19. It is permissible in Kentucky to maintain client trust account records as electronic records in a computer database instead of in a paper file.

True False

20. It is permissible for Kentucky lawyers to accept credit card payment of earned fees.

ANSWERS

1. False: A client trust account is an account established in a bank by a lawyer to safekeep funds entrusted to the lawyer by clients and third parties when rendering legal services in a client-attorney relationship. A fiduciary account is an account established by a lawyer for safekeeping funds entrusted to the lawyer when rendering professional fiduciary services such as trustee, guardian, personal representative of an estate, attorney-in-fact, and escrow agent. It has been traditional in Kentucky to refer to client trust accounts as escrow accounts, but that became a misleading label with the Supreme Court's adoption in 1990 of Rule of Professional Conduct 1.15, Safekeeping Property (SCR 3.130). The rule and comments are couched in terms of trust accounts. The duties of a lawyer acting purely as a fiduciary, *e.g.*, as escrow agent, and those of a lawyer holding funds relating to a client representation are not the same. It is permissible for a lawyer to deposit funds held as a fiduciary in a client trust account, but it may not be advisable to do so. Lawyers providing only fiduciary services who deposits fiduciary funds in a client trust account may be exposing themselves to a malpractice claim as well as a fiduciary breach claim if something goes wrong even if no legal services were rendered. One court saw this practice as indicating the lawyer served as both lawyer and escrow agent (*Bazinet v. Kluge*, 764 N.Y.S.2d 320(2003)).

2. True: Rule 1.15 provides that "Funds shall be kept in a separate account maintained in the state where the lawyer's office is situated, or elsewhere with the consent of the client or third person. The separate account referred to in the preceding sentence shall be maintained in a bank which has agreed to notify the Kentucky Bar Association in the event that any overdraft occurs in the account."

3. True: There is no limit on how many dedicated or pooled client trust accounts a firm may open. When the funds held for an individual client will be held long enough to earn an appreciable amount of interest for the client, a dedicated client trust account should be opened for that client. There is no hard and fast rule on how much interest must be earned before a dedicated client trust account is appropriate. Some states use earned interest of \$50 as the threshold amount required for opening a dedicated client trust account.

4. False: Rule 1.15 does not require that client trust accounts be maintained only in banks that are FDIC insured. SCR 3.830 does require that IOLTA client trust accounts be maintained in FDIC insured banks. As a practical matter it is only good practice to use FDIC insured banks for all client trust accounts. If the funds in an account exceed the \$100,000 FDIC coverage, be sure the bank has adequate other insurance. Confirm this in writing. In some cases it may be necessary for the lawyer to purchase firm insurance for the account or to open additional accounts in other banks to adequately protect client funds. It is good practice to get client instructions on how large amounts are to be deposited and with what security.

5. False: To comply with this requirement a lawyer must submit to the KBA Office of Bar Counsel a letter from the depository bank confirming the bank's agreement to notify the KBA when an overdraft occurs in any client trust account. The letter should identify each account by name and number and include a bank contact person. A bank overdraft notification must be in writing and addressed to: Kentucky Bar Association, Office of Bar Counsel, 514 West Main Street, Frankfort, Kentucky 40601. It should include sufficient information about the overdraft to initiate an inquiry to include:

- a. Name of the lawyer (or firm).
- b. Account name and number.
- c. Date and amount of the overdraft.
- d. A duplicate copy of the overdraft (or NSF) notice sent to the payee.

6. False: The lawyer in a firm in charge of representing a client is directly responsible for all funds and property received by the firm in connection with that representation. The internal management of funds and property may be delegated to other lawyers in the firm, usually a managing partner, or office staff. If things go wrong, however, the lawyer in charge no matter how junior in the firm, along with the lawyer managing client trust accounts and any partner, bears ultimate responsibility for a breach of fiduciary duties. You can delegate authority, but you can't delegate responsibility.

7. False: The first step in safekeeping client funds is to meet the requirement to segregate them from firm funds and a lawyer's personal funds. This means depositing them in a bank account completely separate from firm operating accounts and lawyer personal accounts. There is no exception to this requirement. Practical difficulties such as a quick turn-around for disbursement do not excuse failure to deposit funds in a client trust account. Nor can the requirement be avoided by a lawyer personally holding the funds

until dispersal. The value of this strict requirement for lawyers is that it creates an audit trail that affirmatively shows exactly how funds were dispersed.

8. False: Lawyers have strict liability for any irregularity in a client trust account or mishandling of non-monetary property even though no client or third party suffers a loss. These irregularities range from theft to minor bookkeeping errors that are quickly corrected and harm no one. “No harm – still a foul” is the rule. Poor supervision of nonlawyer staff, sloppy records, and dishonored client trust account checks are just a few of the mistakes that can occur that may result in bar discipline. While it is true that minor mistakes often do not result in discipline, a pattern of minor mistakes can result in serious sanctions. Any significant problem with a client trust account carries a high risk of suspension or disbarment.

9. False: Examples of conversion are stealing, unauthorized temporary use of client funds regardless of purpose, check kiting, misapplying funds earmarked for a special purpose, failure to return unearned fees or unused client funds, improperly withholding fees from client funds, and using one client’s funds to pay another’s charges. Commingling occurs when a lawyer fails to segregate client and third party funds from funds of the firm or personal funds of the lawyer. This results in the client funds losing their separate identity. The fact that no funds are misapplied or are lost by a client does not excuse commingling.

10. False: When a lawyer receives a check that includes client funds and earned fees the lawyer must deposit the entire amount in a client trust account and then immediately withdraw the earned fee portion of the amount deposited. This is an exception to the commingling prohibition.

11. True: Funds may be deposited in a client trust account to cover bank charges (Rule 1.15 (d)).

12. False: Any disbursement not in dispute on a client’s behalf including settlement and transaction proceeds, fees, costs, expenses, earned legal fees, and return of unearned fees is permissible.

13. False: If a client disputes some of a lawyer’s fee, only the disputed portion of the fees must be left in the client trust account until the dispute is resolved. *See KBA Ethics Opinion 293 (1985).*

14. False: The latest client disbursement instructions are controlling if no funds are in dispute. Rule 1.15 requires that disputed funds claimed by third parties be held in the client trust account until the dispute is resolved. If the client changes his mind after previously agreeing to pay a third party, a lawyer cannot unilaterally decide to honor the prior instructions by disbursing client funds. The rule appears to require that any third party disputed claim be kept in the client trust account until resolved. It does not address frivolous or unsubstantiated claims for payment by third parties. States that have considered this issue (Kentucky has not) have concluded that a bare assertion of a claim

against client funds is not enough to preclude disbursement to the client. Further, the lawyer has no obligation to investigate the merits of the third party's claim. If the claim is not based on a contract obligation, statutory lien, court order, or other law the lawyer may disburse the funds to the client. In these circumstances the client should be advised of the risks of not paying a valid claim.

15. True: There is no implied authority for a lawyer to sign a client's signature on a check. Doing so without authority is conversion of client funds.
16. False: An overdraw occurs when funds of one client are expended for the benefit of another client from a pooled client trust account. This does not trigger a bank report to the KBA, but is conversion and a clear violation of Rule 1.15. An overdraft occurs when a check is dishonored for lack of sufficient funds in the account and does trigger a bank report to the KBA.
17. False: Establishing a line of credit or other overdraft protection arrangements with a bank that prevent the dishonor (bouncing) of a client trust account check do not excuse the bank from notifying the KBA of an overdraft. The reason for this position is explained in the *ABA Model Rules for Trust Account Overdraft Notification*, Rule 2, which provides:

In light of the purposes of this rule, and the ethical proscriptions concerning the preservation of client funds and commingling of client and lawyer funds, it would be improper for a lawyer to accept "overdraft privileges" or any other arrangement for a personal loan on a lawyer trust account.
18. True: Rule 1.15(a) requires that: "Complete records of ... [client trust] account funds and other property shall be kept by the lawyer and shall be preserved for a period of five years after termination of the representation." Lawyers Mutual, however, recommends a 10-year retention period and longer if the statute of limitations has not run on the matter during the 10-year period. Some files could require even longer retention to include permanent retention. For more information on file retention read *The Secret Life Of Client Files*, KBA *Bench & Bar*, Vol. 67, No.1, Jan. 2003, available at www.lmick.com in the Risk Management *Bench & Bar* articles section.
19. False: There is no prohibition against using computers to manage client trust account records. Numerous affordable computer software programs are available that offer all the functions needed to do so. Given the efficiency and accuracy of these programs they are an improvement over a manual system. Care must be taken, however, to backup the system and produce paper records for the file. In time electronic records alone may be acceptable for compliance with professional responsibility requirements, but there is no current authority to maintain client trust account records exclusively in electronic format.
20. True: Payment by credit card for legal services performed by law firms was approved in KBA Ethics Opinion 172 (Nov. 1977). This opinion is one of first impression concerning the basic question of whether credit card payments may be

accepted at all by law firms in Kentucky. It did not consider many ethical issues concerning credit card fee collection. Specifically:

- May all billing to a client be paid by credit card or only earned fees? What about retainers (unearned fees) and advance expense payments?
- In what kind of firm bank account should credit card payments be deposited when received by the bank – a business account or a client trust account?
- Is it permissible to arrange for automatic charges against a client's credit card?
- How are bank credit card service charges applied? Does the full amount charged apply to the client's bill or only an amount net of bank service charges?
- If a client disputes a charge and directs the credit card issuer to "charge back" the payment against the firm's trust account, is the firm at risk of using other client funds to cover firm obligations?

These questions are discussed in the article *Credit Cards, Firm Trust Accounts, and Thou*, KBA *Bench & Bar*, Vol. 67, No.6, Nov. 2003, which is available on Lawyers Mutual's website at www.lmick.com in the Risk Management *Bench & Bar* articles section.

How Did You Do?

If you got all the answers right you either just took the bar exam or ought to be writing this article. If you missed only a couple, that's good work and shows you are keeping up. If you missed more than two or three, what you don't know could hurt you. For those of you who would like a quick refresher on client trust account professional responsibility you will be interested to know that Lawyers Mutual and the IOLTA Fund recently joined in publishing "*Client Trust Account Principles & Management for Kentucky Lawyers*." This guidebook is divided into seven sections covering:

- Rule 1.15 Safekeeping Property and Related Rules
- A Description of Rule 1.15's Fiduciary Requirements
- Strict Liability Is the Standard for Breach of Trust
- The Basics of Client Trust Account Transactions
- Client Trust Account Management Special Considerations

Should the Account be a Client Trust Account or Fiduciary Account?

Bank Interest

Bank Charges

Insuring Client Trust Accounts – FDIC

Check Signature Authority

Overdraws and Overdrafts

KBA Overdraft Notification Requirement

Outstanding Checks

Unclaimed Funds and Non-Monetary Property

Credit Card Deposits

File Retention Requirements

Use of Computers for Client Trust Account Management and Recordkeeping

- Client Trust Account Recordkeeping
 - What Constitutes an Adequate System of Account?*
 - Supporting Documentation*
 - Chart of Accounts*
 - Dedicated Client Trust Account Ledger*
 - Pooled Client Trust Account Journal*
 - Monthly Client Trust Account Reconciliation Report*
- Interest on Lawyers' Trust Accounts Fund (IOLTA)

This 56 page guidebook also includes the complete text of key KBA Ethics Committee Opinions on client trust accounts. It is yours for the asking by contacting the IOLTA Fund (502.564-3795 or 800.874-6582) or Lawyers Mutual (502-568-6100 or 800-800-6101). Don't let what you don't know hurt you.
