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Client Trust and IOLTA Accounts: Managing Money and Avoiding Risk

Introduction

Most lawyers will tell you that they prefer practicing law to managing the day-to-day operations of a law firm. Although many business-related tasks may be delegated to support staff and third-party vendors, lawyers must pay scrupulous attention to, as well as supervise both subordinates and outsourcing providers in a responsible manner in order to ensure that duties to clients are fulfilled and that the law firm may continue to function. One of the primary responsibilities that lawyers must consider when evaluating law firm operations concerns a lawyer's responsibility to protect client funds and property. Commingling law firm funds with client funds and conversion of client funds constitute two of the leading causes of lawyer discipline and may lead to liability issues as well.[1] Therefore, if lawyers seek to continue to practice law, they must devote time and resources to instituting sound banking and trust accounting procedures and supervising the parties entrusted with the authority to handle client funds.

Commingling is often a precursor to conversion, and both constitute a breach of the fiduciary duty that lawyers have to guard clients' property that they maintain.

1 "Annual Report of 2020" (Illinois) Attorney Registration & Disciplinary Commission, Chart 12, p. 48 (2021)

What types of bank accounts should law firms maintain?

Almost all jurisdictions require law firms to maintain three types of bank accounts: an operating account, a client trust account, and an Interest on Lawyer Trust Account ("IOLTA") account. State supreme courts and state bar associations will designate the financial institutions in the jurisdiction eligible for law firm establishment of client trust accounts and IOLTA accounts. These selected financial institutions are obligated to alert the relevant bar disciplinary authority when a law firm's client trust account or IOLTA account is overdrawn. Let's review the type of funds that should be deposited in each account.

- **Operating account:** Client funds that the law firm has earned and monies from others that are not being held in escrow should be placed in the law firm's operating account. Funds from clients that have not been earned must not be placed in this account.
- **Client trust account:** Client funds intended to pay the law firm's fee that have not yet been earned should be deposited in a client trust account. For example, if a client pays the law firm a $5,000 retainer to work on a legal matter on an hourly basis, and the law firm has only earned $1,000, the $4,000 balance should remain in the client trust account until earned or returned to the client.
- **IOLTA trust account:** Client funds or funds of third persons, which are either nominal in amount or expected to be held for a short period of time, should be placed in an IOLTA account in the vast majority of jurisdictions. The interest generated from these accounts is used to fund charitable institutions, typically legal aid entities that serve indigent clients. No jurisdiction has defined "nominal" or "short term" pertaining to IOLTA accounts with any specificity. Generally, the determination of whether a the funds of a client or third party are nominal or short term rests within the discretion of the lawyer. If the lawyer exercises sound judgment, no disciplinary action will be taken against the lawyer.

In deciding whether to deposit client funds in a trust account or IOLTA account, lawyers should consider the anticipated amount of net interest such funds are expected to generate. If the net interest is expected to be nominal, due to either the nominal amount of the principal or the limited amount of time the funds are anticipated to remain in the account, the funds should be placed in the IOLTA account.[2] If the net interest is expected to be more than nominal, the funds should be placed in the client trust account. Any interest earned in the client trust account should go to the client, rather than the law firm.[3]

What are some examples of how lawyers determine which funds go into which type of account?

Example A

If a lawyer receives a large retainer to work on a business transaction matter for a client that will take weeks or months to complete, the retainer should be placed in the client trust account. The law firm may only move part of such funds to their operating account when the law firm has earned that portion of the funds.

Example B

If a lawyer handling a residential real estate closing for a client charges a flat fee of $400, and the client gives the lawyer a $400 check at the closing, the lawyer may deposit the check into her law firm's operating account. She earned the $400 once the closing was completed.

Example C

If a lawyer settles a personal injury matter for a plaintiff/client and expects to pay the client his portion of the settlement proceeds once the settlement check clears, he should deposit the settlement proceeds into his IOLTA account, assuming the relevant jurisdiction has an IOLTA rule. The settlement funds are only expected to be held for a matter of days, which would meet the short-term time period referenced by the IOLTA rules in several jurisdictions.

Some jurisdictions permit nonrefundable or advance payment retainer fees, which are earned immediately by the law firm upon payment.[4] The premise for these fees is that in exchange for this nonrefundable fee, the lawyer will be available to the client to provide legal services or advice at an unspecified future time, depending upon the client's needs. Lawyers should review the rules and laws of the relevant jurisdiction to verify whether such a retainer is permitted. If a nonrefundable or advance payment retainer fee is permitted, and the law firm accepts such a nonrefundable retainer fee, it should be deposited in the law firm's operating account, rather than the client trust account. Lawyers should recognize that even in jurisdictions that permit such fees, they should be relied upon by law firms "sparingly", and "only when necessary to accomplish some purpose for the client that cannot be accomplished by a [regular] retainer."[5]

What records am I required to keep and for how long?

American Bar Association Model Rule of Professional Conduct ("ABA MRPC") *Rule 1.15* states that law firms must preserve "complete records" of client trust account funds for five years after termination of representation. Lawyers should review the rule of the relevant jurisdiction, as many states require that the records be maintained for more than five years. In order to ensure compliance with the rule, law firms should retain the records noted below for at least as long as the corollary rule to *ABA MRPC Rule 1.15* in the relevant jurisdictions. While most jurisdictional rules on protecting client property apply solely to client trust and IOLTA accounts, best practices dictate that the requirement apply to the law firm's operating account as well.

- **Banking transaction records:** All transaction records provided by the financial institution maintaining the trust account, which includes but is not limited to cancelled checks, monthly banking statements, records of deposits, etc.
- **Receipt and disbursement statements:** Any cash transactions should be documented by the law firm.
- **Engagement letters/fee agreements:** Any and all engagement agreements between the lawyer and client, including language concerning the legal fees and expenses to be paid by the client.
- **Bills/invoices:** Any bills or invoices issued to clients for legal services or expenses.
- **Third-party vendor payments/expenses:** Any payments made to vendors or others, such as expert witnesses, transcription services, filing fees, etc., that are directly related to a client's matter.
- **Law firm bookkeeping/accounting records:** Any ledgers or electronic records that track the activity in the law firm's operating and trust accounts.

2 *See*, e.g., Ill. Sup. Ct. Rule 1.15 (j)(2)
3 *See*, e.g., Ill. Sup. Ct. Rule 1.15 (f)
4 *See, e.g., Dowling v. Chicago Options Assocs., Inc.*, 875 N.E.2d 1012 (Ill. 2007)
5 *Id.*

What constitutes commingling and conversion and what should law firms do to prevent either from occurring?

Commingling occurs when a law firm mixes its own funds with client funds, often making it difficult to discern which funds belong to the client. *Section (b)* of *ABA MRPC Rule 1.15* states, however, that a "lawyer may deposit the lawyer's own funds in a client trust account for the sole purpose of paying bank service charges on that account, but only in an amount necessary for that purpose." A law firm engages in conversion when it makes unauthorized use of trust account funds that deprive the client or third person of the use of the funds, even if only temporarily and causes no lasting harm to the client.[6] Conversion may arise even if the lawyer had no dishonest motive in taking the funds.[7]

Commingling is often a precursor to conversion, and both constitute a breach of the fiduciary duty that lawyers have to guard clients' property that they maintain. This duty is codified in *ABA MRPC 1.15*. This Rule requires that lawyers and law firms do the following:

- Segregate client funds and property separate from the law firm's own property;
- Give notice of the receipt of any funds or other property;
- Maintain appropriate records of any property, particularly money, held on behalf of another;
- Render an accounting of any funds held in a fiduciary capacity upon request;
- Promptly deliver funds or other property to the person who is legally entitled to them; and
- When a representation involves the possession of property where two or more persons claim interests, the property must be kept separate by the lawyer until the dispute is resolved.

Many courts view the misappropriation of client funds as one of the most serious forms of professional misconduct.

6 *People v. Brown*, 461 P.3d 683 (Colo. O.P.D.J. 2019)
7 *In re Mulroe*, 956 N.E.2d 422 (Ill. 2011)

In addition to these basic requirements, law firms should institute the following procedures to minimize the risk of commingling and conversion due either to carelessness or malfeasance by a rogue lawyer or employee:

- Prohibit debit card or use of ATM to withdraw funds;
- Prohibit checks made payable to cash;
- Prohibit "cash out" on deposits;
- Reconcile monthly all law firm bank accounts, including a review of accounts payable/receivable;
- Do not write checks until all deposits have been cleared;
- Prohibit the use of signature stamps and signed blank checks;
- Require dual signatures on checks;
- Rotate job duties related to banking and accounting duties, when possible;
- Consider changing passwords to bank accounts whenever a lawyer or support staff member who knew the passwords leaves the law firm; and
- Separate job duties related to finances and accounting.

What disciplinary and professional liability consequences may result from commingling and conversion?

Many courts view the misappropriation of client funds as one of the most serious forms of professional misconduct.[8] In the *ABA Standards for Imposing Lawyer Sanctions, Standard 4.11* states that "[d]isbarment is generally appropriate when a lawyer knowingly converts client property and causes injury or potential injury to a client." In addition to violating the rule on safekeeping client property, some bar disciplinary authorities will charge lawyers with violating their jurisdiction's corollary to ABA MRPC Rule 8.4(c), which prohibits lawyers from engaging in "dishonesty, fraud, deceit or misrepresentation," when the conversion was intentional.

Discerning whether a conversion constitutes negligence or intentional misconduct requires an intensive review of the facts and circumstances. In some cases, the intent to convert client funds will be obvious. For example, when a lawyer accepts funds for a client's realty escrow and then deposits those funds in the law firm's operating account instead of the client fund account and immediately spends such funds for his own personal use, conversion will arise.[9] In other cases, such as where a lawyer's personal turmoil leads to carelessness and inattention with respect to monitoring the client trust fund, a court may conclude that the lawyer acted with no dishonest motive in converting the client funds.[10]

8 *The Fla. Bar v. Johnson*, 132 So.3d 32 (Fla. 2013)
9 *People v. Rasure*, 212 P.3d 973 (Col. O.P.D.J. 2009)
10 *Attorney Grievance Comm'n v. Mungin*, 96 A.3d 122 (Md. 2014)

Aggravating and mitigating factors, such as the amount of the funds converted, whether the lawyer demonstrates remorse, and whether or not the lawyer has a prior record of discipline, guide disciplinary hearing boards and courts in recommending and imposing an appropriate sanction, which can range from reprimand to disbarment. Lawyers contending that any instances of commingling and conversion were unintentional, and therefore worthy of a lesser sanction, should consider the relevant language in Comment 2 to ABA *MRPC 8.4*: "A pattern of repeated offenses, even ones of minor significance when considered separately, can indicate indifference to legal obligation."

Lawyers also must be wary of any rogue colleague who may be converting client trust account funds. Some courts have held that such so-called "innocent partners" are financially liable for a partner's conversion, even if the other partners were unaware of it.[11] Lawyers also may encounter disciplinary issues for a partner's conversion involving failure to adequately supervise the wrong-doing partner.[12] The same liability and disciplinary ramifications also may apply if a law firm staff member commits the conversion.[13] When conversion of client funds occurs, whether intentionally or inadvertently, lawyers have a duty to communicate that information to any affected clients.[14]

Conclusion

Protecting client funds represents one of the fundamental duties that lawyers owe clients. Law firms should adopt sound banking and accounting practices and exercise their supervisory responsibilities to ensure that client funds are protected. Lawyers who fail to educate themselves on governing client trust rules and laws and neglect their duty to oversee their colleagues and outsourcing providers that help manage such accounts increase their risk of disciplinary complaints and professional liability claims. For help in managing billing, collections, and compliance with trust and IOLTA account rules, please see CNA Lawyers Professional Liability Allied Vendor Program.

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11 *Husted v. Gwinn*, 446 N.E.2d 1361 (Ind. Ct. App. 1993)
12 *In re Wallman*, 696 N.Y.S.2d 164 (App. Div. 1999)
13 *Office of Disciplinary Counsel v. Krzton*, No. 86 DB 2020 (Pa. 2021)
14 See CNA's "To Err is Human: A Guide for Attorneys on How to Manage Errors" at www.cna.com.

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