

Trust Accounting and Financial Recordkeeping in South Carolina

Barbara M. Seymour

When lawyers are entrusted with money or property from, on behalf of, or for clients, they must preserve the integrity and safety of it. There are two sources for guidelines in how that money is to be maintained, accounted for, and distributed. The first is Rule 1.15 of the Rules of Professional Conduct. This safekeeping of property rule has six basic requirements for receipt and maintenance of client funds. They are:

- Client funds must be kept separate from your own funds;
- Client funds must be maintained in the state where your office is, unless the client consents to other arrangements;
- Client funds must be specifically identified and safeguarded;
- Complete records regarding the funds must be kept and you must preserve those records for six years;
- You must promptly notify the client of the receipt of the funds and promptly deliver the funds to the client or a third party with a legitimate interest in the funds; and,
- You must promptly and fully account for all client funds received and disbursed.

The second set of guidelines for handling client funds is found in Rule 417, SCACR. Rule 417 is essentially a list of financial records that you are required to maintain regarding your law practice. This rule is a court order, the violation of which subjects the lawyer to disciplinary action. The Supreme Court adopted this rule in January 1997. Since that time, the Court has issued dozens of disciplinary opinions imposing sanctions on lawyers based on findings of violations of it. A significant number of those were disbarments.

The Court has held that when there is clear and convincing evidence of trust account violations or other inadequate recordkeeping, the lawyer must produce records sufficiently detailed to overcome that evidence.¹ In other words, a lack of adequate records creates a presumption of trust account mismanagement. You and all staff members handling funds or preparing financial records should be well versed in the requirements of Rule 417. If you have not met with your accountant or bookkeeper to review and explain the requirements of Rule 417, you should do so immediately to confirm that you are in compliance.

A. Disbursement & Commingling

A lawyer who receives funds on behalf of a client has to keep those funds in a trust account until distribution. A trust account is a fiduciary account. Money held in trust on behalf of clients must be kept separate and apart from the operating funds of the law firm and your personal funds. Combining client trust money with your own money is called commingling and is prohibited by Rule 1.15. Once a fee is earned, it must be withdrawn from the trust account. To leave it in the trust account is commingling. Rule 1.15(c) requires that you deposit into your client trust account all unearned legal fees and expenses been paid in advance. You may only withdraw those funds as fees are earned or expenses are incurred.

Only fees that the client agrees are earned when paid may be placed directly into the general (or “operating”) account. Advance fees (also known as ‘flat fees’ or ‘nonrefundable retainers’) may be treated as immediately earned if the client agrees in advance in a written fee

¹ *In re Miles*, 516 S.E.2d 661, 335 S.C. 242 (1999).

agreement.² That written fee agreement must include notice to the client:

- (1) of the nature of the fee arrangement and the scope of the services to be provided;
- (2) of the total amount of the fee and the terms of payment;
- (3) that the fee will not be held in a trust account until earned;
- (4) that the client has the right to terminate the lawyer-client relationship and discharge the lawyer; and
- (5) that the client may be entitled to a refund of all or a portion of the fee if the agreed-upon legal services are not provided.

Some lawyers attempt to keep a cushion in their trust accounts to avoid bouncing checks. While a nominal amount sufficient to cover incidental bank charges (such as checkbook orders) is acceptable, any amount over that is commingling.³ You may deposit your own funds in your client trust account for the sole purpose of paying service charges on that account, but only in an amount necessary for that purpose. The better practice is to make arrangements with your bank to have any service charges on the trust account drafted from your operating or general account.

Except in limited circumstances, you are not supposed to issue a trust account check until funds have been received and credited to the account. Additionally, lawyers and their bookkeepers should be meticulous in their record keeping and calculating so that mathematical errors resulting in insufficient funds are avoided. Therefore, there should never be a circumstance in which you must rely on a cushion of your own money in your client trust account.

One frequent rule violation that results in overdrafts (and discipline) is disbursement of funds prior to deposit. You must deposit funds before disbursing them. Delivering checks to payees prior to deposit of funds received for that purpose is a violation of Rule 1.15(f)(1). For example, funds received in connection with a real estate closing or personal injury settlement must be physically deposited with your bank before you can hand out checks to the client or other payees. Nearly twenty percent of trust account overdrafts reported to the Commission on Lawyer Conduct result from intentional violations of this rule.

The "good funds" rule allows a lawyer to treat certain negotiable instruments as cash that can be disbursed after deposit, but before actual collection by the bank. Ordinarily you may not disburse funds from your trust account unless the funds are actually collected funds, meaning the check has cleared and your account has been credited for the deposit. However, a lawyer may treat cash, verified and documented electronic fund transfers, or other deposits treated by the depository bank as equivalent to cash as equivalent to collected funds. Certain negotiable instruments including properly endorsed government checks, certified checks, cashier's checks, insurance company checks (not exceeding \$50,000.00) once deposited, can be disbursed without verification that the accounted has been credited. The good funds

² Rule 1.5 was revised by the Supreme Court of South Carolina by order dated July 30, 2012.

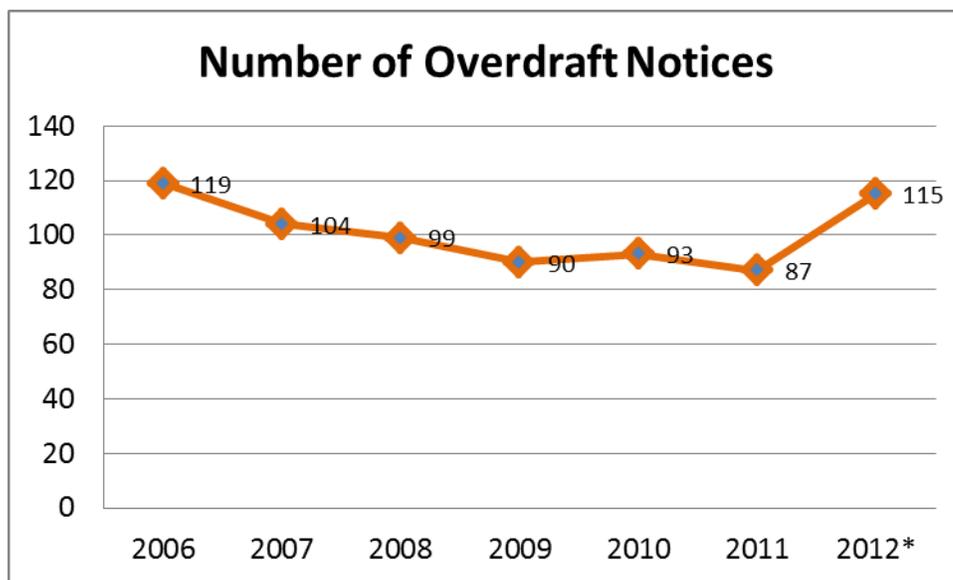
³ *Matter of Rogol*, 355 SC 627, 586 SE2d 593 (2003).

provision also includes “any other instrument payable at or through a bank, if the amount of such instrument does not exceed \$5,000 and the lawyer has reasonable and prudent belief that the deposit of the instrument will be collected promptly.” If it turns out that the funds are not collected, the lawyer is required to deposit replacement funds in the account as soon as practical but no later than five working days after notice of that the funds have not been collected. A failure to collect even good funds will result in an investigation if the bank pays the trust checks on insufficient funds.

Rule 1.15(g) prohibits a lawyer from using the balance in the trust account to get credit or for other personal benefit or for the benefit of someone other than the client.

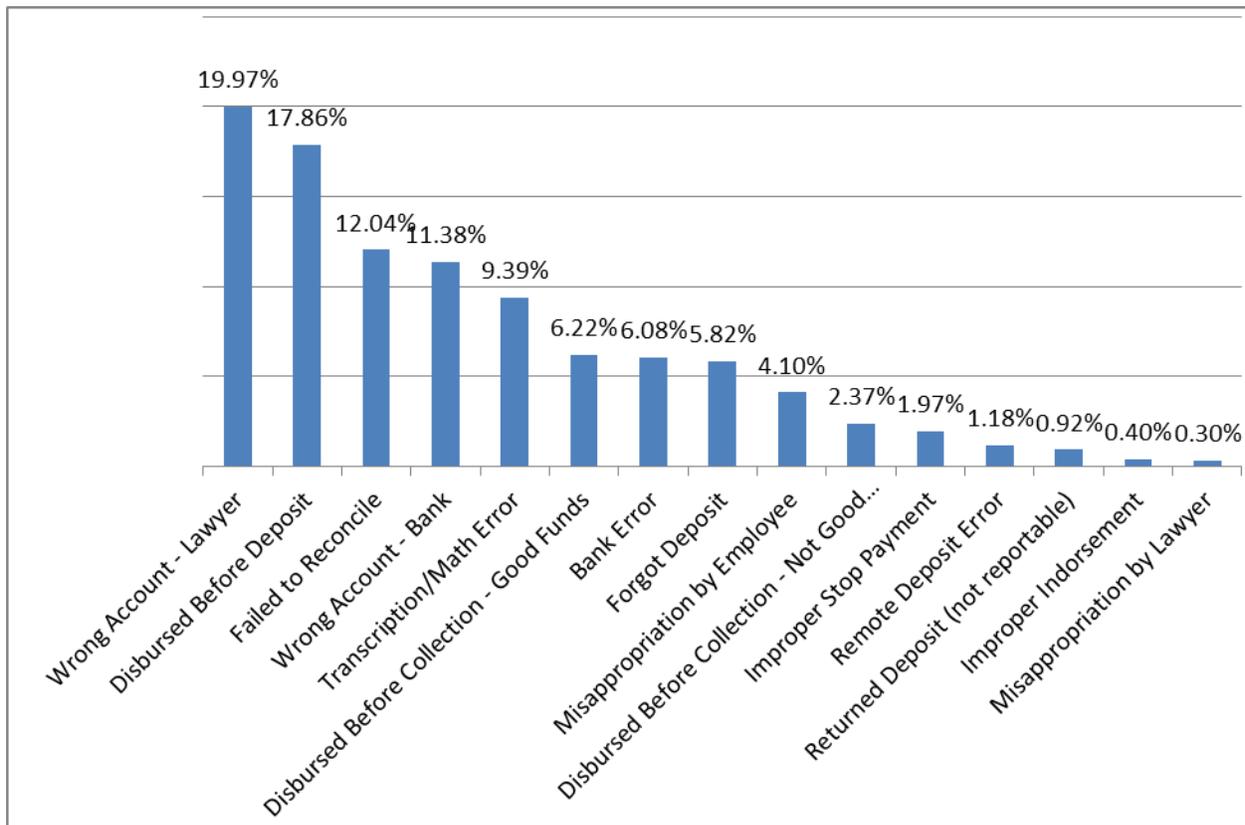
Rule 1.15 contains a mandatory overdraft or insufficient funds reporting requirement found in section (h). Under this provision, you are required to file a written directive with your bank that it report to the Commission on Lawyer Conduct when any instrument drawn on your account is presented for payment against insufficient funds. If your bank refuses, you have to find another bank.

The overdraft reporting rule has been in effect since October 2005. The Commission on Lawyer Conduct receives an average of 110 bank notices each year. The Commission refers these matters to the Office of Disciplinary Counsel, which investigates any incident where a lawyer’s trust account balance falls below zero or when a lawyer’s trust account check bounces.



*projected

This process helps identify instances of financial mismanagement and misappropriation before significant client and bank losses. More than half of the overdrafts result from a failure to comply with the Rules of Professional Conduct either by the lawyer or by a staff person.



*Statistics collected October 2005 through July 2012

B. Recordkeeping

The recordkeeping rule (Rule 417⁴) sets out clearly the minimum required financial records that you must prepare and maintain. Oftentimes, bookkeeping and banking responsibilities are delegated to paralegals or other nonlawyers in the office. Each member of the legal team at some point is likely to create, receive, or process financial records. Therefore, everyone must be familiar with the recordkeeping requirements. It is your obligation under Rule 5.3 (Supervision of Nonlawyers) to educate your staff about the recordkeeping requirements.

There are two primary reasons this is important. First, if there is ever a question about the integrity of client funds or about financial mismanagement, disciplinary authorities will subpoena the financial records. If you are unable to produce complete records in full compliance with Rule 417, you will be subject to sanction even if ultimately there is no mismanagement. Second, the only way to detect misappropriation of client funds or law firm funds is diligent and comprehensive recordkeeping and financial review.

Pursuant to Rule 417-1, financial records relating to client transactions must be maintained by the lawyer for a period of six years from the date of termination of the

⁴ Rule 417 was revised by the Supreme Court of South Carolina by order dated September 9, 2011.

representation. The rule allows a lawyer to maintain financial records a form other than paper, such as electronic or digital media, but they must be readily accessible to the lawyer and the lawyer must be able to produce printed copies.

Rule 417-1 provides a list of trust account records that must be prepared and maintained. Those records include:

- (a) receipt and disbursement journals containing a record of deposits to and withdrawals from client trust accounts, specifically identifying the date, source, and description of each item deposited, as well as the date, payee, and purpose of each disbursement;
- (b) ledger records for all client trust accounts showing, for each separate trust client or beneficiary, 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 and amounts of charges or withdrawals, and the names of all persons or entities to whom such funds were disbursed;
- (c) copies of retainer and compensation agreements with clients as required by Rule 1.5 of the South Carolina Rules of Professional Conduct;
- (d) copies of accountings to clients or third persons showing the disbursement of funds to them or on their behalf;
- (e) copies of bills for legal fees and expenses rendered to clients;
- (f) copies of records showing disbursements on behalf of clients;
- (g) the physical or electronic equivalents of all checkbook registers, bank statements, records of deposit, pre-numbered canceled checks, and substitute checks provided by a financial institution;
- (h) records of all electronic transfers from client trust accounts, including the name of the person authorizing transfer, the date of transfer, the name of the recipient and confirmation from the financial institution of the trust account number from which money was withdrawn, and the date and the time the transfer was completed;
- (i) copies of monthly trial balances and monthly reconciliations of the client trust accounts maintained by the lawyer; and
- (j) copies of those portions of client files that are reasonably related to client trust account transactions.

Rule 417 requires that you reconcile your trust account every month. This is a relatively simple process of comparing your records to the bank's as reflected on your monthly statement. Most banks provide a form with the monthly statement that you can use to balance your account by hand. Bookkeeping software can do this for you; however, someone has to enter the data when the monthly statement arrives. Proper reconciliation of a trust account is a three step process.

The comment to Rule 417-1(i) explains the reconciliation requirement as follows:

The trial balance is the sum of balances of each client's ledger card (or the electronic equivalent). Its value lies in comparing it on a monthly basis to a control balance. The control balance starts with the previous month's balance, then adds receipts from the Trust Receipts Journal and subtracts disbursements from the Trust Disbursements Journal. Once the total matches the trial balance, the reconciliation readily follows by adding amounts of any outstanding checks and subtracting any deposits not credited by the bank at month's end. This balance should agree with the bank statement.

If you have someone other than yourself reconcile your account every month, such as a staff person or outside accountant, you should ensure that they understand the fiduciary aspects of the trust account. You should provide them with a list of warning signs that might indicate an innocent or deliberate error. When an error is discovered, you should prepare a written memorandum of what occurred and how the problem was resolved. Some of those warning signs include:

- Deposits in your records not reflected on the statement or not credited within one business day of the date in your records
- Checks written on the trust account that have not cleared the bank within a month
- Deposits or checks with amounts that differ from your records
- Checks written significantly out of sequence
- Skips in check sequence without documentation of a voided check
- Unexplained debits or credits to the account through funds transfers
- NSF or overdraft charges
- Unexpected bank charges not covered by funds maintained in the account for that purpose

Rule 417-2 also contains several provisions specifically designed to safeguard client funds. First, only a lawyer admitted in South Carolina or someone under the direct supervision of a lawyer admitted in South Carolina may disburse funds from a trust account. Giving signatory authority or electronic access to your trust account to a nonlawyer is not advisable. Most of the misappropriation cases in recent years involve trusted, longtime staff members stealing client money using access granted by the responsible lawyer, either by check or electronic transfer. While Rule 417 does permit nonlawyers to be authorized on a trust account, if you choose to do so, you must proceed with caution.

Second, you must deposit all funds received intact. In other words, you cannot split a deposit. If you receive a retainer check that includes an advance payment of costs, you cannot split the deposit by placing the fee portion in the operating account and the costs portion in the trust account. The entire amount must be deposited into the trust account and then a check payable to the operating account for the amount of the earned fees paid should be written from the trust account. This makes it easier to track incoming funds.

Third, records of deposit into the trust account must be "sufficiently detailed to identify each item," including the client name or case number (or both if the client has multiple cases with the firm). Frequently lawyers produce carbon deposit slip books in response to financial mismanagement allegations that do not contain the required information. The source of cash, money orders, cashier's checks, and even regular checks is not noted. Many times when the

lawyer does include a client reference, it is not sufficiently identifiable (“Smith” for example). You can deposit more than one check or multiple cash receipts with the same deposit slip, but when you do, you should list each item singly with a full name and case number for identification purposes. Records of deposit include deposit receipts in addition to copies of deposit slips. Don’t forget to attach the original deposit receipt to the carbon of the deposit slip and make a copy to attach to each client ledger.

Fourth, withdrawals may be made only by check to a named payee or by authorized electronic transfer. A lawyer may not withdraw cash at the counter or use an automated teller machine or debit card. A lawyer may not write a check from the trust account payable to cash. If the client does not have an account or other means to negotiate a check, the lawyer should assist the client in getting the trust account check cashed at the lawyer’s bank. That check must be written payable to the client or other named payee. The lawyer cannot disburse funds to a client or a third party in cash. As internet banking becomes a common bookkeeping tool for busy lawyers, opportunities to run afoul of this restriction increase. The advent of remote deposit and electronic transfer of funds between accounts makes the necessity of accurate and detailed records even more important. While it might not be the most efficient method of banking, the best practice is to physically deliver deposits to the bank and obtain a paper receipt and to disburse all funds from the trust account by check, even if you are moving earned fees from your trust account to your operating account. It might be easier to transfer your earned fees from the trust account to the operating account or a personal account electronically, but it is risky. If you do it this way, you should keep meticulous records and you should maintain in writing all of the information that you would have if you had made the transfer by check.

Rule 417-5 provides a limited set of circumstances in which funds can be disbursed electronically. If authorized by the client, a lawyer may transfer funds from the trust account without the use of a paper check under the following circumstances:

- (a) money required for payment to a client or third person on behalf of a client;
- (b) expenses properly incurred on behalf of a client, such as filing fees or payment to third persons for services rendered in connection with the representation;
- (c) money transferred to the lawyer for fees that are earned in connection with the representation and are not in dispute; and,
- (d) money transferred from one client trust account to another client trust account.

C. Misappropriation

It should be self-evident that a lawyer must never convert client funds to his own use. Unfortunately, each year the Court must address this situation in disciplinary cases. Misappropriation also subjects the lawyer to civil and criminal liability. Partners of a lawyer disbarred for misappropriation might spend years recouping their losses and might even be held ethically accountable. Associates who work for a lawyer disbarred for misappropriation lose their jobs. What’s worse is their employment reference is a disbarred lawyer known for dishonest and criminal conduct. All lawyers, whether partners or associates, must be conscious of the financial situations in their law offices. Getting innocently caught up with a lawyer who steals client money can significantly hamper your career.

On the other hand, we are reading more and more in the newspapers and in the advance sheets about paralegals who steal from clients or from their law firms. Lawyers should carefully check the background of each potential employee. A lawyer who gives diligent attention to the processing of client and firm funds and to financial recordkeeping will be alerted to financial misconduct of nonlawyer employees. A lawyer who doesn't could be held financially and ethically accountable for the wrongful conduct of the nonlawyer employee.

There are several warning signs that a member of the legal team might be misappropriating money:

- Blank or incomplete check stubs or deposit slips;
- Missing checks;
- Accounts that do not balance;
- Checks returned for insufficient funds;
- Unidentified counter withdrawals or electronic transfers;
- Checks clearing out of sequence;
- Records of excessive voided checks;
- Checks made payable to an unfamiliar vendor;
- Excessive checks to a particular vendor;
- Possessiveness, secretiveness, or defensiveness of the lawyer or employee responsible for bookkeeping;
- Lack of monthly reconciliations of bank accounts;
- Unopened bank statements or unopened bills;
- Frequent trips to the bank;
- Complaints from vendors or third parties that they are not being timely paid or that they did not receive a check that had been issued;
- Past due law office bills such as phone or other utility bills;
- Operating account or personal account checks written to the trust account;
- Monthly checks for the same amount (such as a car or mortgage payment);
- Unusual urgency about resolving a case (settlement, closing, etc.);
- Signs of a lifestyle beyond the means of the lawyer or employee;
- Signs of depression or alcohol or drug abuse.

While there may be a logical explanation for each of these circumstances, many cases of misappropriation of large sums of client or firm funds could have been avoided if these warning signs had been heeded.

D. Checklist of Recommendations to Ensure Security of Client Funds

- _____ **Written policies** for handling funds and recordkeeping
- _____ Staff training on handling funds and recordkeeping
- _____ Personal meeting with bank officer regarding attorney's obligations, including overdraft reporting requirement
- _____ Written fee agreements or letters of confirmation in all cases
- _____ Include scope of representation, fee calculation & explanation of costs
- _____ **Monthly** reconciliation of all law office accounts
- _____ Notification to attorney of uncleared checks & check/deposit errors
- _____ Annual review by outside accounting professional
- _____ All receipts from or on behalf of clients deposited into trust account
- _____ All firm funds withdrawn from trust account when earned
- _____ Checks or check writing software are secured
- _____ Maintain accounting journal for each account
- _____ Check stubs/check register with date, payee, amount, & case ID
- _____ Client identification on memo line of all checks
- _____ All receipts deposited intact
- _____ Note client identification on all deposit slips and deposit receipts
- _____ **No signature stamps**
- _____ **Only attorneys sign checks**
- _____ No cash disbursements or checks payable to cash
- _____ Electronic transfers only when absolutely necessary & maintain good records
- _____ Receipts given to clients & duplicates retained
- _____ Copies of front & back of all checks & money orders received
- _____ No disbursements until deposit clears
- _____ **Two sets of eyes** on all transactions
- _____ Adopt uniform coding for Memo/Description fields
- _____ Written directive on file with bank to report to CLC all NSF checks & overdrafts
- _____ Maintain copies of all financial records for six years:
 - _____ Account journals
 - _____ Client trust account ledgers
 - _____ Copies of deposit slips
 - _____ Original deposit receipts
 - _____ Check duplicates or check stubs
 - _____ Original or copies of canceled checks
 - _____ Records of wires & electronic transfers
 - _____ Records of counter withdrawals (other than from trust account)
 - _____ Disbursement statements (settlement ledgers, HUDs, etc.)
 - _____ Retainer and compensation agreements or letters
 - _____ Billing statements
 - _____ Invoices from vendors
 - _____ Accountings to third parties (including courts)
 - _____ Bank statements for all accounts
 - _____ Reconciliation reports for all accounts
 - _____ Memos regarding bank errors, math errors, account correction, etc.