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RECORD TIME: Countdown to the New Rule on Trust Accounting

by
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The long-anticipated revisions to the record keeping rule, Mass. R. Prof. C. 1.15, finally take effect on July 1, 2004. With that deadline in mind (and although most of you have no doubt already conformed your records to the new requirements), this article will attempt to review some of the issues and questions likely to arise.

What's New

First, a preliminary matter: as of the date that this article will be published, there is one more scheduled training program upcoming on Rule 1.15, on June 17, 2004 from 4:00 7:00 p.m. at MCLE in Boston. Five other programs were given in April and May, with even more last fall and winter.

Second, the revisions to Rule 1.15 were examined in an earlier article in this space, "Records for Other People's Money" (Lawyers Weekly, 10/20/03)), available—along with a comprehensive booklet from the IOLTA Committee, "Managing Clients' Funds and Avoiding Ethical Problems"— on the BBO website, www.mass.gov/obcbbo. The information provided in the article and booklet, including forms and samples, will not be repeated here. In very brief summary, however, here are some of the important changes:

- Records that lawyers are required to make and keep of the receipt and disposition of trust funds— including a check register, individual client ledgers and an additional individual ledger for the small amount of the lawyer's own funds on deposit to pay bank charges— are described in detail. Rule 1.15(f).
- Lawyers must perform a "three-way" reconciliation (of the sum of the individual ledgers including the bank charges ledger, the check register, and the bank statements) of the account at least every sixty days. Rule 1.15(f)(1)(E).
- Lawyers are required to mail or deliver written itemized bills to clients at or before the time that the lawyer withdraws funds from a trust account to pay herself for services, showing the services provided and the amount of funds the lawyer continues to hold for the client after withdrawal of the fee. Rule 1.15(d).
- Lawyers are prohibited from making withdrawals from trust accounts by ATM or checks payable to "Cash" and are required to use only prenumbered checks. Rule 1.15(e)(3).

The remainder of this article will attempt to address some of the confusion over what has not changed, as well two questions asked most frequently since the revisions to the rule were approved.

What's Not New

The basic IOLTA account model remains the same. You must deposit all trust funds that are either nominal in amount or to be held for a short period of time to a pooled IOLTA account, with interest payable to the IOLTA Committee. There is one narrow exception for a conveyancing account that is maintained in the lending bank and used exclusively for loan transactions for that bank only; accounts meeting these conditions are permitted, but not

required, to be IOLTA accounts. If these types of conveyancing accounts are not IOLTA accounts, however, they must be noninterest-bearing.

All other trust funds must be maintained in separate individual trust accounts, with interest payable as directed by the client or third party for whom the funds are held. Rule 1.15(e)(5). The check register for an individual trust account is in fact the client ledger, so that for individual accounts, only a two-way reconciliation of the check register to the bank statement is required.

The concept of what constitutes trust property also remains essentially the same. It includes both tangible property—for example, securities, jewelry, original documents such as marriage certificates or wills—and funds. The definition of trust funds has always included, and continues to include, funds of clients or third persons in a lawyer's possession in connection with a representation. The obvious examples are items such as settlement funds from a claim or lawsuit, mortgage proceeds, deposits on sales of real estate, and other traditional receipts. Also included are trust funds held in any fiduciary capacity, such as executor, guardian, or escrow agent. As to these latter, and unless for some reason the funds received are a one-time, short-term deposit, funds held for these purposes must be maintained in an individual trust account with interest payable to the estate or beneficiary, rather than in an IOLTA account.

The definition of trust funds also continues to include retainers, that is advance fees paid by clients to be earned in the future on an hourly or other basis. Retainers and other trust funds belonging in part to a lawyer and in part to a client must be deposited to a trust account. Rule 1.15(b)(2)(ii). On the other hand, earned fees—that is fees paid only after services have already been rendered—cannot be deposited to a trust account and must be deposited to a business or personal account.

Subject to the strict new notification and billing requirements in Rule 1.15(d) and to other requirements concerning disputed fees in Rule 1.15(b)(ii), lawyers must withdraw fees from the trust account in full when earned. This rule requiring that fees be withdrawn at the earliest reasonable time after the lawyer's interest becomes fixed is again not new; a lawyer who leaves earned fees in a trust account is commingling. Thus, if the lawyer is due a one-third contingent fee on a settlement of $10,000, then the entire $3333 must be withdrawn promptly. You cannot withdraw $500 this week, $1000 next week, and so on until the full amount is paid.

You also cannot withdraw fees by paying your bills, or writing checks to your spouse, directly from your trust account. This practice has long been deemed commingling and the new rule now is explicit that funds withdrawn from a trust account to pay fees must be payable to the lawyer or law firm. Combined with the new requirement that no withdrawals can be made in cash or by ATM (again, a course of action that was always improper, but has now been spelled out), the bottom line is that fees must be paid only to the lawyer or law firm and only by check or electronic funds transfer.

Even the requirement of individual client ledgers is not really new. Lawyers have routinely been disciplined for errors, particularly negligent misuse of funds, caused by inadequate record keeping including the absence of an individual ledger. The rule states expressly that the individual ledger can never be negative. It is unstated, but obvious, that the ledger must also zero out at the conclusion of a case. A ledger for a long-settled personal injury case, for example, should not show $350 undisbursed month after month. Either a bill hasn't been settled or compromised, fees haven't been withdrawn in full, or the client is due a small balance. Whatever the reason, the matter needs to be addressed and the funds paid out in full.

And, of course, the dishonored check provisions of Rule 1.15 remain. Financial institutions offering IOLTA and other trust accounts are still required to notify Bar Counsel when a check

drawn on a trust account is returned unpaid. Bear in mind that Bar Counsel's examination of a lawyer's trust account records in conjunction with receipt of a notice of dishonored check will now by necessity trigger an examination of the lawyer's compliance with the new record keeping requirements.

FAQs

In the course of the many CLE programs on the new rule over the last year, a few questions have been raised that deserve repeating in a wider forum. One is the issue of how flat fees should be handled. Flat fees occupy a gray area between retainers and earned fees. Bar Counsel's position is that flat fees can be deposited to a business or personal account (and thus that the notification requirements of Rule 1.15(d) would not apply). That said, flat fees are still subject to the requirements of Rule 1.16(d) that unearned fees must be refunded. If the client pays $5,000 for an OUI defense today, and tomorrow decides to terminate your services and hire the latest hotshot, you must promptly refund the unearned portion, in this instance probably most of what was paid.

Another FAQ concerns investment accounts, that is, to what extent do the record-keeping requirements of Rule 1.15 apply to trust accounts held at brokerage firms or other similar institutions. Lawyers of course have the same general fiduciary obligations for these accounts that they would have for any trust property. For example, every account statement must be examined when received for obvious errors and to insure that the transactions recorded comport with the lawyer's directions. However, the detailed record keeping requirements of Rule 1.15 need only apply to the so-called cash portion of the account against which the attorney has checkwriting privileges. As to such funds, the attorney must comply with all requirements of Rule 1.15, including maintaining a separate check register, reconciling the check register to the cash portion of the account statement, and complying with the notification requirements when withdrawing fees.

The Transition

Most of you have probably already implemented the necessary changes to your accounts and record keeping. For those few of you who put it off to the last minute, here are a few helpful tips.

First and foremost, you must be able to identify who the clients or third parties are whose funds comprise the current balance in your IOLTA account and exactly what amounts you are holding for each. Your check register should identify an opening balance split among those persons, noting the amounts held for each both in the check register and then in the clients' individual ledgers.

If you cannot identify precisely whose funds you are currently holding and in what amounts, you may need to retain an accountant to assist you. While the problem is being addressed, however, you should not be depositing new funds to this account. Open a new IOLTA account for new trust funds received going forward (and as to which records will be maintained in compliance with the revised rule). You should transfer to this new account funds held in the old IOLTA account the source of which you can ascertain. For example, if you know that you received a retainer of $2000 from Joe Jones and that you have paid yourself $500 from this retainer, you should transfer $1500 to the new trust account, identifying the deposit as the Joe Jones retainer both in the check register and on an individual Joe Jones ledger.

If you have funds being held for missing clients, you may be obligated to commence an escheat of the property to the Commonwealth, in compliance with the Abandoned Property Act, G.L.c.200A, and the regulations of the state treasurer. See "Lost and Found—What to do with missing client's funds" at the BBO website.

If these steps are followed, the only funds that will remain in the old IOLTA account are those

that cannot be pegged to a particular client in either name or dollar amount. If the old account does not wind down in a few months as outstanding checks clear, you will have to retain an accountant.

Finally, if you have questions about any of these issues, please feel free to call Bar Counsel's helpline on Monday, Wednesday and Friday afternoons.

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