Trust Accounting and Financial Recordkeeping in South Carolina

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When lawyers are entrusted with money or property from, on behalf of, or for clients or third parties, they must preserve the integrity and safety of it. There are two rules that set out the requirements regarding how that money is to be maintained, accounted for, and distributed. The first is Rule 1.15 of the Rules of Professional Conduct (RPC), Rule 407, SCACR. This safekeeping of property rule has six basic requirements for receipt and maintenance of client funds:

- Client funds must be kept separate from your own funds
- Client funds must be maintained in the state where your office is located, unless the client consents to other arrangements
- Client funds must be specifically identified and safeguarded
- Complete records regarding the funds must be created and preserved for six years
- You must promptly notify the client or third party 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
- You must promptly and fully account for all funds received and disbursed

The second set of requirements for handling client funds is found in Rule 417, SCACR. Rule 417 contains a list of financial records that you are required to maintain regarding your law practice. It also sets forth limitations on the use of trust accounts and procedures for monthly reconciliation. A violation of Rule 417 subjects a lawyer to disciplinary action.[2] The Supreme Court adopted this rule in January 1997. Since that time, the Court has issued dozens of disciplinary opinions imposing sanctions on lawyers who did not comply with it. A significant number of those have been 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.[3] 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.

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[2] See RPC Rule 1.15(a), which states that a lawyer "shall comply with Rule 417, SCACR."

[3] In re Myers, 321 S.C. 93, 467 S.E.2d 446 (1996); In re Miles, 335 S.C. 242, 516 S.E.2d 661 (1999).

A. Disbursement & Commingling

A lawyer who receives funds on behalf of a client has to keep those funds in a trust account until distribution. 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 RPC Rule 1.15. Subsection (c) requires that you deposit into your client trust account all unearned legal fees and expenses that have been paid in advance. You may only withdraw those funds as fees are earned or expenses are incurred. Once a fee is earned, it must be withdrawn from the trust account. To leave it in the trust account is commingling.

Advance Fees

Only fees that the client agrees are earned when paid may be placed directly into the general (or 'operating') account. Advance fees (sometimes referred to as 'flat fees' or 'nonrefundable fees') may be treated as immediately earned if the client agrees in advance in a written fee agreement.[4] 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 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.

The best practice is to avoid using the term 'nonrefundable' in reference to advance fees so as to avoid misleading the client. Even if you call your fee 'nonrefundable'" a fee is always subject to refund, whether you hold an advance fee in trust or not.

Trust Account Cushions

A lawyer might be tempted to keep a cushion in the trust accounts to avoid bouncing checks. This practice is prohibited because it is commingling. While a nominal amount sufficient to cover incidental bank charges (such as check orders or chargeback fees) is permitted by RPC Rule 1.15(b), any amount over that is commingling.[5] You may deposit your own funds in your client trust account for the sole purpose of paying bank 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

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[4] RPC Rule 1.5 was revised by the Supreme Court of South Carolina by order dated April 10, 2014, to permit deposit of fees paid in advance into the firm account in limited circumstances.

[5] Matter of Rogol, 355 S.C. 627, 586 S.E.2d 593 (2003).

funds have been received and collected by your bank. 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.

Deposit and Collect Prior to Disbursement

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 RPC 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. A significant number of trust account overdrafts reported to the Commission on Lawyer Conduct result from intentional violations of this rule.

In addition to the requirement that you deposit funds prior to disbursement, RPC Rule 1.15 requires that you wait until funds are actually collected by your bank before issuing checks in most circumstances. RPC does provide a 'good funds' exception that allows you to disburse some items upon deposit without waiting for actual collection.6 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, subsection (f)(2) permits you to treat cash, verified and documented electronic fund transfers, or other deposits treated by the depository bank as equivalent to cash as collected funds. Certain negotiable instruments, once deposited, can be disbursed without verification that the accounted has been credited. Those instruments include properly endorsed government checks, certified checks, cashier's checks, insurance company checks (not exceeding $50,000.00). The good funds provision also includes "any other instrument payable at or through a bank, if the amount of such instrument does not exceed $5,000.00 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 business days after notice 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.

Client Funds for Personal Gain

RPC Rule 1.15(g) prohibits a lawyer from using the balance in a trust account to obtain credit. Client or third-party funds may not be used as collateral and may not be reported to a lender or creditor as assets for purposes of obtaining a loan or credit. Additionally, a lawyer may not use funds in a trust account for the lawyer's personal benefit or for the benefit of someone other than the client or third party to whom the funds belong.

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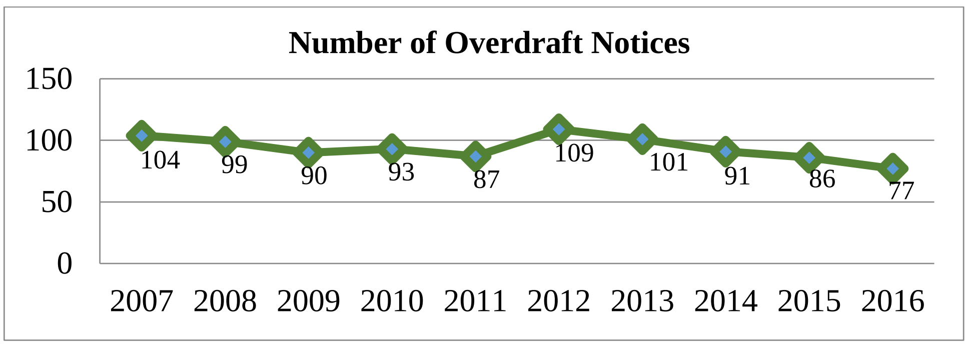
[6]See RPC Rule 1.15(f)(2).

Mandatory Overdraft Reporting

RPC Rule 1.15(h) contains a mandatory overdraft or insufficient funds reporting requirement. Under this provision, you are required to file written instructions with your bank directing that it report to the Commission on Lawyer Conduct when any instrument drawn on your trust account is presented for payment against insufficient funds or when the trust account is overdrawn. There is no particular form required. If your banker does not have a prepared form for your use, a simple letter including the language from RPC Rule 1.15(h) will suffice. It is important that you keep a copy of your bank directive with your financial records as evidence of your compliance with this provision of the rule. If your bank refuses to accept the directive or fails to comply with it, 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 about100 bank notices each year. The Commission refers these matters to the Office of Disciplinary Counsel, which investigates all reports. The reporting requirement is not limited to returned checks. It includes any incident in which a check is presented on insufficient funds. This includes circumstances when a lawyer's trust account check bounces or the trust account balance falls below zero. Your bank may elect to honor a check even if there are not sufficient funds in the account to cover it, but a report to the Commission is still required.



The overdraft notification process helps disciplinary authorities identify financial mismanagement and misappropriation before significant client, law firm, and bank losses occur. While many overdrafts and NSF items result from inadvertence or accounting errors, a significant percentage are caused by a failure to comply with the Rules of Professional Conduct either by the lawyer or by a member of the law firm staff.

Wrong Account - Lawyer	24%	Disbursed Before Collection - Not Good Funds	3%
Disbursed Before Deposit	19%	Theft/Misappropriation	3%
Transcription/Math Error	13%	Unanticipated Bank Charge	3%
Wrong Account - Bank	8%	Improper Indorsement/Remote Deposit Error	2%
Forgot Deposit	7%	Returned Deposit/Improper Stop Payment	2%
Bank Error	6%	Credit Card Processing Error	<1%
Disbursed Before Collection - Good Funds	6%	Fraud on Account	<1%
Failed to Reconcile	4%		

B. Recordkeeping

The recordkeeping rule (Rule 417) clearly sets forth 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 is likely at some point to create, receive, or process financial records. Therefore, everyone must be familiar with the recordkeeping requirements. It is your obligation under RPC Rule 5.3 (Supervision of Nonlawyers) to educate your staff about the recordkeeping requirements and to adequately supervise the process to ensure strict compliance.

There are two primary reasons why strict financial recordkeeping is important. First, if there is ever a question about the integrity of client funds or about financial mismanagement, disciplinary authorities will subpoena your 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 or other ethical violation. Second, the only way to detect fraud or misappropriation of client funds or law firm funds is diligent and comprehensive recordkeeping and financial review.

Required Records

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 representation. This means that you cannot necessarily destroy financial records by record date. This is particularly true of documents that contain information about more than one client, such as bank statements and accounting journals. You must retain any given document for six years beyond the end of your representation of any client referenced in that document.

The rule allows a lawyer to maintain financial records in a form other than paper, such as electronic or digital media; however, 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.

The Reconciliation Process

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 records 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-part 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 else reconcile your account every month, such as a staff person or outside accountant, you must ensure that they understand the fiduciary aspects of trust accounting. For example, even an experienced accountant might not be familiar with the concept of deriving a trial balance from the individual client ledgers then reconciling it with the journal balance and bank statement balance.

In addition, you should provide your accounting and bookkeeping professionals with a list of warning signs that might indicate an innocent error or deliberate misappropriation. 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 deposited by the firm for that purpose

Safeguarding Trust Accounts

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. Although not prohibited by the rules, 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 between the trust and operating accounts. If you receive a client check that includes both payment on a fee invoice and 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 out promptly upon collection.

Third, records of deposit into the trust account must be "sufficiently detailed to identify each item," including the client name, matter number, or other identifier (or some combination thereof if the client has more than one matter with the firm). Lawyers often 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, even 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 separately with an adequate client/case identifier for bookkeeping purposes. The client reference, whether a name or number, must match the client reference in your books. Also, 'records of deposit' include deposit receipts in addition to copies of deposit slips. The deposit slip is not sufficient documentation that a deposit was actually made. 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. If you make deposits electronically using a scanner and the Internet, you must reduce the proof of deposit to a record (electronic or paper) and include it with your other Rule 417 records. You should not rely on online records available from your bank, as those records may only be accessible for a limited period of time.

Fourth, withdrawals may be made only by check to a named payee or by authorized electronic funds 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 in blank or payable to 'cash' or 'bearer'. 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.

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.

As Internet banking becomes a common bookkeeping tool for busy lawyers, opportunities to run afoul of this restriction increase. The advent of remote deposit, electronic transfer of funds between accounts, and mobile electronic access to funds 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 that way, you must keep meticulous records and maintain in writing all of the information that you would have if you had made the transfer by check.

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. 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.

Incidents involving paralegals, office managers, and other nonlawyer assistants who steal client or law firm funds are not uncommon. Lawyers should carefully check the background of each potential employee before making a hiring decision. Once a nonlawyer is hired, reasonable supervision is necessary. 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.[7] A lawyer who does not will be held financially and ethically accountable for the wrongful conduct of the nonlawyer employee. Further, all lawyers should provide formal, documented ethics and trust accounting training to staff to both lessen the risk and defend against an allegation of inadequate supervision.

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, defensiveness
- Lack of monthly reconciliations of bank accounts
- Unopened bank statements or unopened bills
- Frequent trips to the bank
- Vendors/third parties not timely paid or not receiving 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 means
- Signs of depression or substance 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. Conclusion.

Preservation of the safety and integrity of client funds and other property must be a priority for lawyers. Even those who are not adept at accounting and delegate responsibility for financial recordkeeping to others must study the rules that govern trust account management. A thorough understanding of, and strict compliance with, RPC Rule 1.15 and Rule 417 can help ensure that client funds are kept safe from errors and misappropriation. Lawyers interested in learning more about trust accounting should consider attending the Legal Ethics and Practice Program Trust Account School, a program available through the South Carolina Bar Continuing Legal Education

[7] Se RPC Rule 5.3, Rule 407, SCACR.

Division. LEAPP Trust Account School is a half-day session (4 hours) addressing mandatory accounting and recordkeeping requirements for client trust accounts. Participants also explore hypotheticals based on actual disciplinary cases and discuss tools, techniques, and law office policies that can help the practitioner effectively avoid mistakes, misappropriation, and discipline. Participants work in small groups and conduct a monthly trust account reconciliation with the assistance of the faculty. Registration for LEAPP Trust Account School is offered two times each year and is open to lawyers and nonlawyers. Registration is available online at https://www.scbar.org/shop-cle/#/tab/live-courses-tab/ or by calling the CLE Division at (800) 768-7787.