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California's new trust accounting rules: A critical update for attorneys

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The practice of law requires a high level of professionalism, especially when it comes to managing client funds. In California, the Rules of Professional Conduct have long served as a critical framework guiding attorneys in their fiduciary duties. The first major revisions in over 25 years brought substantial changes, particularly to trust accounting rules, with the updated Rule 1.15 effective Nov. 1, 2018. In the wake of the Girardi scandal, Rule of Professional Conduct 1.15 was further revised, limiting the time for attorneys to notify claimants of receipt of funds to 14 days, and creating a rebuttable presumption that an attorney has not promptly distributed entrusted funds if the funds have not been disbursed within 45 days. In the post-Girardi landscape, it is imperative for attorneys to recognize their non-delegable duty to maintain absolute accuracy in their client trust accounts (CTA), to keep appropriate records, to promptly distribute funds and disburse earned fees from the CTA, and to conduct monthly trust account reconciliations.

The evolution of trust accounting rules in California

Prior to the 2018 revisions, the rules governing trust accounts were outlined in former Rule 4-100, adopted in 1992. However, the growing complexities of legal practice necessitated a more robust and clearer framework, leading to the development of the current Rule 1.15. This updated rule emphasizes the critical importance of maintaining accurate and up-to-date records of all funds held on behalf of clients or third parties, recognizing that any mismanagement could lead to severe ethical violations. Trust accounting violations are serious since they pose a significant risk of financial harm to clients and other third parties for whom an attorney may hold funds.

The non-delegable duty of trust accounting

One of the cornerstones of Rule 1.15 is the recognition that the responsibility for keeping trust accounts in order is non-delegable. While attorneys may rely on staff, such as bookkeepers or accountants, to manage the day-to-day aspects of trust accounting, the ultimate responsibility lies with the attorney. This means that any errors or discrepancies in the trust account cannot be blamed on staff; the attorney is ethically required to ensure that the account is accurate and reconciled regularly.

To maintain the integrity of trust accounts, it is crucial that attorneys reconcile their accounts at the time monthly bills are prepared and sent to clients. This regular oversight helps prevent errors from going unnoticed and ensures that the attorney can promptly address any issues that arise.

Even if the law firm doesn't routinely send out invoices, as is often

the case with personal injury firms dealing with large settlement funds, it is still necessary to reconcile the CTA on a daily basis.

Who needs a trust account?

In California, any attorney who holds money on behalf of clients or third parties is required to have a client trust account. This account must be registered with the State Bar of California and be clearly labeled as a trust account. The purpose of this requirement is to ensure that client funds are kept separate from the attorney's own funds, preventing the commingling of personal and client money.

The State Bar's Client Trust Account Handbook is an essential resource for attorneys, providing detailed guidance on the "how-to's" of trust accounting. It is recommended that attorneys print out the entire handbook and keep it in a three-ring binder for easy reference, ensuring they are well-versed in the requirements and best practices.

California's approach to trust accounting

Under Rule 1.15, California attorneys are required to maintain sufficient records to track how much money is held for each client at all times. This means that attorneys must be able to prove, if necessary, that they knew the exact amount of money in their trust account for each client.

Rule of Professional Conduct 1.15(a) mandates that all funds received or held by a lawyer or law firm for the benefit of a client, or any other person to whom the lawyer owes a legal duty, must be deposited in one or more identifiable bank accounts labeled "Trust Account." These accounts must be maintained in California, unless the client provides written consent for the funds to be deposited in a jurisdiction where there is a substantial relationship to the client or the client's business.

The duty owed to third persons

A significant aspect of Rule 1.15 is the codification of the duty owed to third persons when an attorney is holding entrusted funds. The rule makes it clear that attorneys owe the same fiduciary duties to any person to whom they have a contractual, statutory, or other legal duty as they do to their clients. This means that attorneys must exercise the same level of care and diligence in managing funds held for third parties as they do for their clients.

Managing flat fees and operating accounts

One notable provision in Rule 1.15 is the allowance for flat fees to be deposited into an operating account under specific conditions. According to Rule 1.15(b), a flat fee paid in advance for legal services may be deposited in an attorney's operating account if the attorney discloses in writing that the client has the right to require the fee to be deposited in a trust account until earned. If the flat fee exceeds $1,000, the client's agreement to this arrangement must be in writing and signed by the client.

Avoiding commingling and promptly withdrawing earned fees

Commingling, or the mixing of an attorney's personal funds with client funds is strictly prohibited under Rule 1.15(c). Attorneys are only allowed to deposit funds into a trust account that are necessary to cover bank charges or that belong in part to the client and in part to the attorney. As soon as the attorney's interest in a portion of the funds becomes fixed and is not in dispute, the attorney is ethically obligated to withdraw those funds promptly.

Failure to promptly withdraw earned fees can lead to ethical violations, as it could be seen as an attempt to keep personal funds in the client trust account. Attorneys are encouraged to withdraw their fees regularly, such as during monthly reconciliations, to avoid unwarranted attention from the State Bar.

The importance of maintaining an audit trail

Maintaining a comprehensive audit trail is another critical aspect of trust accounting under Rule 1.15. An audit trail includes records such as canceled checks, bank statements, and deposit slips, which provide a clear history of what happened to the money handled by the attorney. This documentation is essential not only for compliance with ethical rules but also for protecting the attorney in the event of an audit by the State Bar.

With these documents, the attorney needs to maintain a comprehensive account journal, detailing every transaction in the account by date tied to each client or matter. A filtered report in the account journal will serve as the client ledger card, identifying each transaction for a client in any particular time period in the account journal.

The monthly reconciliations of the account to the bank statements, identifying the explainable differences in the balances between the account statement and the accounting records (usually the result of checks issued but still outstanding) also needs to be maintained for at least five years from the last disbursement.

Conclusion

Rule 1.15 represents a significant evolution in trust accounting rules for California attorneys. By adhering to these guidelines, attorneys can ensure they fulfill their fiduciary duties, maintain the integrity of their practice, and protect themselves from potential ethical violations. Trust accounting is not just about managing funds; it is about upholding the trust that clients place in their attorneys to handle their money with the utmost care and accuracy.

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