



# STATE BAR OF CALIFORNIA

## INTER-OFFICE COMMUNICATION

**DATE:** February 20, 2014

**TO:** Regulation, Admissions and Discipline Oversight Committee

**FROM:** Doug Hull

**SUBJECT:** Discussion re Proposal to Audit Client Trust Accounts

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As an aid to discussion on this topic, attached is print out of the web page from the New Jersey courts. This pages discusses the Random Audit Project (RAP) which encompasses client trust accounts and general business accounts. Other documents relating to the project will be handed out at the meeting.

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## Random Audits

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## INTRODUCTION

The information on this webpage highlights the general operation of the **Random Audit Program (RAP)**, as well as some of the more important **accounting requirements** imposed on all attorneys who engage in the private practice of law in this state.

It is not a substitute for reading [New Jersey Court Rule 1:21-6](#) and [Rule of Professional Conduct 1.15](#). Every attorney is obligated to read these rules and comply with them in accordance with case law and advisory opinions interpreting them, and in accordance with generally accepted accounting practice.

The [Institute for Continuing Legal Education](#) [(908)249-5100] publishes a book entitled [Trust and Business Accounting For Attorneys](#) that contains more substantial detail together with samples of all required journals, ledgers, and reconciliation formats.

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## WHAT IS THE RANDOM AUDIT PROGRAM?

Since 1981, the New Jersey Supreme Court has operated a program for random audits of attorney trust and business account records to determine compliance with the Supreme Court of New Jersey's mandatory recordkeeping rule, [R.1:21-6](#), and ethics rule [RPC 1.15](#) ("Safekeeping Property"). The **Random Audit Program** is administered through the Supreme Court's **Office of Attorney Ethics**.

The central purpose of the New Jersey Random Audit Program is the **education** of New Jersey attorneys on the proper method of compliance with their recordkeeping and ethical responsibilities under [R.1:21-6](#) and [RPC 1.15](#).

A secondary purpose underlying random audits is **deterrence**. Just knowing that there is an active auditing program is an incentive, not only to keep good records, but also to avoid temptations to misuse trust funds.

Finally, there is the purpose of **detection** of misappropriation. Since the random selection process results, by definition, in selecting a representative cross-section of the Bar, a few audits inevitably uncover some lawyer theft. In those few instances the deterrent effect is heightened by the strong discipline imposed by our Supreme Court, namely the mandate of virtually automatic disbarment for the knowing misappropriation of client's funds as set forth in the case of *In re Wilson, 81 N.J. 451 (1979)*.

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## HOW ARE RANDOM AUDITS CONDUCTED?

### HOW ARE ATTORNEYS SELECTED TO BE AUDITED?

An annual random selection of audit candidates is made from the statewide list of licensed attorneys using the law firm as the entity subject to audit, rather than individual attorneys. Every attorney in private practice is regarded as a member of a law firm. A law firm may consist of one or more attorneys, and the law firm identifier is the 10 digit "main" office telephone number. That number is captured for all private practice attorneys annually as part of the **Attorney Registration Program**.

### IS THE SELECTION REALLY RANDOM?

The selection process is accomplished by a computer program that annually selects approximately 500 audit candidates using a tested random selection methods with is documented in its ability to produce truly random results. As a result, every law firm, regardless of size, has an equal chance of being selected for an audit.

### HOW DOES THE AUDIT PROCEED?

How much notice of the audit is given?

Once an attorney or law firm is selected, the attorney or firm is provided with written notice 10 days to two weeks in advance of the scheduled

date.

#### How many auditors are assigned to a matter?

Generally, only one auditor is assigned to a matter. Occasionally, two or more auditors are assigned if a large firm or other complicating feature is involved.

#### Does the attorney have to be present for the audit?

It is preferable for the attorney to be present at the audit. If the attorney cannot be present, a responsible person knowledgeable about the books and records must be available.

#### Exactly what does the auditor do at the audit?

On arriving at the law office, the auditor conducts an initial interview with the attorney or responsible person left in charge. Detailed information about the firm's recordkeeping procedures is secured and recorded on a **Random Audit Questionnaire** form. The auditor also conducts a review of the firm's trust and business account books and records in order to determine compliance with the rule requirements. The review culminates in a reconciliation of the attorney's trust account (or accounts) as of the date of the most recent bank statement.

#### What immediate feedback does the auditor provide?

Any recordkeeping deficiencies are noted by the auditor on a **Recordkeeping Deficiencies Checklist** which contains a brief description of the most commonly found recordkeeping deficiencies. The auditor provides a copy of the checklist to the attorney or person left in charge, and, in an exit conference, discusses with that individual the corrective actions that should be taken to remedy any deficiencies which have been found.

#### Are any informational handouts provided?

All law firms randomly audited are provided at the audit with a booklet, Outline of Record Keeping Requirements Under RPC 1.15 and R.1:21-6, developed by the Random Audit Staff. This outline includes a summary of the substantive requirements, and also contains samples of all required receipts and disbursement journals, client trust ledgers and reconciliation formats.

#### What happens after the audit?

Shortly after the audit, the attorney is formally advised by correspondence of the results. If the audit revealed no problems, a closing letter is forwarded that acts as the final disposition of the matter. If minor deficiencies were discovered, a deficiency letter is sent to the attorney describing the shortcomings that require corrective action. The source of information for the deficiencies is the aforementioned **Recordkeeping Deficiencies Checklist**.

#### What happens if there are minor deficiencies?

Within 45 days after the date of the deficiency letter, the attorney is required to submit a response addressing the corrective action taken for the cited recordkeeping deficiencies. On receipt of an acceptable response from the attorney, the matter is closed. If the attorney does not respond, the matter may be referred to the Office of Attorney Ethics for disciplinary action.

#### What happens if there are major deficiencies?

If, at any point during the audit process, major deficiencies are discovered, such as misappropriation of client's trust funds, the matter is referred immediately to the Office of Attorney Ethics for disciplinary action. Historically, such referrals are made in less than 1% of the audits conducted.

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### WHAT ETHICAL REQUIREMENTS DOES RPC 1.15 PLACE UPON AN ATTORNEY?

**RPC 1.15** ("Safekeeping Property") imposes upon all New Jersey attorneys the duty to safeguard the funds and property of clients coming into their possession in the practice of law. These assets must be kept separate from the attorney's personal and business assets, and not be used for any purpose whatsoever, other than as directed by the client.

The attorney is specifically obligated to notify a client promptly when client funds and property is received; to provide the client with appropriate accountings; and to disburse promptly to the client all funds and property to which the client is entitled. Non-cash property, such as bonds and securities, should be clearly identified as client property and secured in the attorney's safe or safe deposit box.

Finally, **RPC 1.15** imposes upon the attorney the duty to comply with the recordkeeping provisions of **R.1:21-6**.

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### WHAT RECORDKEEPING REQUIREMENTS DOES R.1:21-6 IMPOSE UPON AN ATTORNEY?

All attorneys who engage in the private practice of law in New Jersey are required to maintain at least two bank accounts: an attorney trust account and an attorney business account. In addition, **R.1:21-6** clearly defines the type of accounting records attorneys are required to keep, and imposes the requirement that these records must be fully reconciled with one another at least monthly.

- **Attorney Trust Accounts**
- **IOLTA Fund**
- **Attorney Business Accounts**
- **Deposit of Fees and Costs**
- **Basic Records and Maintenance**

## ATTORNEY TRUST ACCOUNTS

What is an Attorney Trust Account?

It is a special bank account, usually a checking account, into which must be placed all funds which are entrusted to the attorney's care while the attorney is acting in a legal representative capacity on behalf of a client.

An attorney trust account should **not** be used for funds which an attorney receives while acting in any special fiduciary capacity, such as executor, guardian, receiver or trustee; these funds are to be placed into separate fiduciary accounts.

Funds that are entrusted to the attorney's care that belong partly to a client and partly to an attorney, presently or potentially, must also be deposited into the attorney trust account. The attorney's portion may be withdrawn when due, unless the client disputes the withdrawal after receiving proper notice of the attorney's bill. In that event, the disputed portion must remain in the trust account until the dispute with the client is resolved.

**How many attorney trust accounts may an attorney maintain?**

An attorney may have one account, or several, depending on need.

**Where are attorney trust accounts to be maintained?**

They must be maintained in a financial institution located in New Jersey and approved by the Supreme Court of New Jersey, which annually publishes a list of such approved institutions. In order to be approved, a financial institution must agree to notify the Office of Attorney Ethics whenever an attorney's trust account check is presented against insufficient funds. A financial institution is defined as being a national or state chartered bank; a savings bank; savings and loan association; or a credit union.

**How are these accounts to be designated?**

The account must include the prominent designation, "**Attorney Trust Account**", and the checks and deposit slips for the account must be imprinted with that title.

**Are there restrictions on withdrawals and signatories?**

Withdrawals from an attorney trust account must be made to named payees, and not to cash. Only attorneys admitted to practice in New Jersey are permitted to sign attorney trust account checks.

**May personal funds be deposited for bank service charges?**

An attorney may deposit a minimal amount of personal funds into the attorney trust account to pay service charges and other fees incurred in connection with the account. The limit suggested by the Random Audit Program is \$250. These funds must be recorded on a ledger and all service charges properly reflected there.

**May any other personal funds be kept in the trust account?**

No other personal funds of the attorney may be deposited into the trust account because it would constitute active commingling of personal funds with trust funds. Moreover, earned legal fees must be withdrawn promptly from the trust account when due. Aggregating large sums of earned legal fees for extended periods of time constitutes passive commingling. Both active and passive commingling are unethical practices.

**May attorney trust accounts be interest-bearing?**

Attorney trust accounts may be interest-bearing, but the attorney may **never** be the recipient of interest earned on the portion of funds belonging to clients or other persons being held in the trust account. All interest or other income earned on an attorney trust account belongs to the clients or persons whose money generated the interest, or to the IOLTA Fund.

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## IOLTA FUND

**What is the IOLTA Fund?**

"IOLTA" is an acronym for "Interest on Lawyer Trust Accounts", and is a fund managed by trustees appointed by the Supreme Court of New Jersey. Pursuant to **R.1:28A**, all attorneys who practice in New Jersey must register with the IOLTA Fund, and if the circumstances outlined in that rule apply to them, they must establish an IOLTA attorney trust account. The IOLTA Fund collects the interest on these accounts statewide, and the revenue is used to fund civil legal services for the poor, and legal programs to improve the administration of justice. Further information may be obtained from: IOLTA Fund of the Bar of New Jersey, New Jersey Law Center, One Constitution Square, New Brunswick, NJ 08901-1500, (732) 247-8222.

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## ATTORNEY BUSINESS ACCOUNTS

What is an attorney business account used for?

All legal fees received by an attorney for professional services that have been rendered must be placed into an attorney business account. The business account is also traditionally used to pay the operating expenses of a law office. Attorneys may maintain more than one business account. The checks and deposit slips on these accounts must include the designation of either "**Attorney Business Account**", or "**Attorney Professional Account**", or "**Attorney Office Account**". In contrast to a trust account, a non-attorney (for example, a secretary) may be a signatory for a business account.

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## DEPOSIT OF FEES AND COSTS

Where are fee retainers and advanced costs deposited?

If an explicit understanding has been reached with a client that a fee retainer for legal services, or advanced costs for court fees and litigation expenses, are to be placed into an attorney trust account until such time as the fee is earned or the cost is incurred, then that is where these funds must be deposited. Otherwise, these funds may be maintained in either a trust account or a business account.

An attorney has an ethical obligation to refund unearned legal fees or unspent advanced costs to a client whenever the attorney completes or withdraws from representation, or the attorney is discharged by the client.

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## BASIC RECORDS AND MAINTENANCE

What basic trust accounting records are required by **R.1:21-6**?

A basic trust accounting system consists of a trust receipts journal, a trust disbursements journal, and a trust ledger book containing the individual ledger accounts for recording each financial transaction affecting that client's funds.

Each individual client ledger account should be maintained as a separate page in the attorney's trust ledger book. At a minimum, each ledger account should reflect the date, source, and a description of each item of deposit, as well as the date, payee, and purpose of each withdrawal.

### Is any specific accounting system required?

No specific accounting system is mandated, but **R.1:21-6** requires that all financial records be kept in accordance with generally accepted accounting practice. Many practitioners use a manual system consisting of handwritten journals and ledgers. Others use the so-called "one-write" or "pegboard" systems. There are also computer software packages available for law office trust accounting.

### In what manner must the accounts be maintained?

Whether it be a trust account or a business account, each should be maintained daily and accurately. All source documents such as duplicate deposit slips, bank statements, canceled checks, and check stubs must be preserved for seven years. An attorney should also preserve copies of records from client files that are necessary for a full understanding of the lawyer's financial transactions with a client.

### What reconciliations and accounting controls are required?

A running balance must be maintained at all times for all ledgers and checkbooks. The balances in the trust ledger book must be reconciled, at least monthly, with the balances in the trust receipts and disbursement journals, the trust account checkbook, and the bank statements. Records of these monthly reconciliations must be maintained for seven years.

### What other records must be maintained?

Every attorney, or law firm, must maintain, for seven years, certain additional records, including copies of all:

- client retainer and fee agreements;
- statements to clients showing disbursements of funds;
- bills rendered to clients; and
- records showing payments to other attorneys or non-employees for services rendered.

In the event of a dissolution of a law firm, appropriate arrangements must be made for the maintenance of the firm's records, whether by a former partner or the successor law firm.

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## WHAT ARE THE CONSEQUENCES OF NON-COMPLIANCE WITH RPC 1.15 AND R.1:21-6?

They are very serious. The knowing misuse of trust funds by an attorney will almost invariably result in disbarment. Major recordkeeping deficiencies, or negligent misuse of trust funds resulting from the failure of an attorney to properly maintain trust account books and records, will result in the imposition of discipline ranging from an admonition to a reprimand or a period of suspension.

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