

OPEN SESSION AGENDA ITEM

54-122 JULY 2018 RAD AGENDA ITEM III.B

DATE: July 19, 2018

TO: **Members, Regulation and Discipline Committee**
Members, Board of Trustees

FROM: Randall Difuntorum, Program Manager, Professional Competence

SUBJECT: Rule 1.15(e) of the Rules of Professional Conduct - Adoption of Client Trust Account Recordkeeping Standards

EXECUTIVE SUMMARY

New rule 1.15 of the Rules of Professional Conduct governs the safekeeping of funds and property of clients and other persons. It will become operative on November 1, 2018. Paragraph (e) of the rule continues the existing authorization for the Board of Trustees to adopt recordkeeping standards. This agenda item requests Board adoption of proposed standards developed by the Rules Revision Commission.

BACKGROUND

On May 10, 2018, the California Supreme Court issued an order approving comprehensive amendments to the Rules of Professional Conduct, which will go into effect November 1, 2018. New rule 1.15 (titled "Safekeeping Funds and Property of Clients and Other Persons") replaces current rule 4-100. Paragraph (d)(3) of the new rule requires a lawyer to maintain complete records of all funds, securities, and other property of a client or other person coming into the possession of the lawyer.

Like current rule 4-100, to facilitate lawyer compliance with the recordkeeping duty, paragraph (e) of the new rule provides that: "The Board of Trustees of the State Bar shall have the authority to formulate and adopt standards as to what 'records' shall be maintained by lawyers and law firms in accordance with paragraph (d)(3). The standards formulated and adopted by the Board, as from time to time amended, shall be effective and binding on all lawyers." In anticipation of the operative date of the new rules, the standards pursuant to rule 1.15(e) are recommended for Board adoption. (A clean version of the proposed standards is provided as Attachment A.)

DISCUSSION

The current recordkeeping standards were adopted by the Board on July 11, 1992, effective January 1, 1993. This followed comprehensive amendments to the rules operative in 1989 and 1992. The current standards generally require that a lawyer maintain the following for all funds received: (1) a written ledger for each client; (2) a written journal for each bank account; (3) all bank statements and cancelled checks for each bank account; and (4) a monthly reconciliation balancing the foregoing records. Regarding securities or other properties held for the benefit of a client, a journal must be maintained.¹

As part of the work by the Rules Revision Commission to prepare the comprehensive amendments that have been approved by the Supreme Court effective November 1, 2018, the Commission also studied the current standards and drafted revisions that could be adopted by the Board if the Supreme Court's action on the new rules continued the Board's authority to adopt standards. Aside from general revisions made throughout the rules, such as changing "member" to "lawyer" and "Board of Governors" to "Board of Trustees," the Commission made only two changes to the current standards. (A redline/strikeout version of the proposed standards showing changes to the current standards is provided as Attachment B.) First, in the introductory language preceding the standards, the Commission substituted "this rule" for "rule 4-100." Second, the Commission substituted "client or other person" for "client" in relevant instances in the standards. This change conforms the standards to the recordkeeping duty in new rule 1.15. Rule 1.15 extends duties owed to clients to certain non-clients and this includes a lawyer's recordkeeping duty.² However, there is one instance in the standards where the substitution was inadvertently omitted. In paragraph (1)(b)(ii), staff recommends changing "client" to "client or other person" to correct this omission.³

As an integral part of rule 1.15, the proposed recordkeeping standards were circulated for an initial 90-day public comment period (that ended on September 27, 2016) and a subsequent 45-day public comment period (that ended on January 9, 2017). No public comments were received that directly addressed the changes to the proposed standards. However, one public comment addressed the new rule's requirement to hold in a trust account any flat fees paid in advance and this commenter expressed concerns that there would be increased administrative burdens for lawyers, including increased recordkeeping.⁴ The Commission did not modify the standards in response to this public comment.⁵

¹ The Supreme Court has emphasized that "the purpose of keeping proper books of account, vouchers, receipts, and checks is to be prepared to make proof of the honesty and fair dealing of attorneys when their actions are called into question, whether in litigation with their client or in disciplinary proceedings and it is part of their duty which accompanies the relation of attorney and client." (*Dixon v. State Bar* (1985) 39 Cal.3d 335, 344.)

² The extension of duties to other persons is explained in Comment [1] to rule 1.15. It is a concept that is consistent with longstanding Supreme Court case law including *Crooks v. State Bar* (1970) 3 Cal.3d 346, 358 [90 Cal.Rptr. 600] [lawyer who agrees to act as escrow or stakeholder for a client and a third-party owes a duty to the non-client with regard to held funds]. For convenient reference, an executive summary of rule 1.15 is provided as Attachment C.

³ One additional staff recommended "clean-up" amendment is the substitution of "paragraph" for "subparagraph" in the introductory language to the Standards. This change conforms to the style used throughout the new rules.

⁴ A copy of this written comment (file no. Y-2016-2-[1.15]-FS) is on file with the Office of Professional Competence and is available upon request. Contact Lauren McCurdy at lauren.mccurdy@calbar.ca.gov.

⁵ The State Bar Court Review Department has held that the duty to account and maintain records is not limited to funds required to be held in a client trust account. (*In the Matter of Fonte* (Rev. Dept. 1994)

Consistent with past practice when comprehensive rule revisions have been recommended to the Court, the standards under consideration by the State Bar were included in the Court submission of the proposed rules but with a statement clarifying that the Board's final consideration of recordkeeping standards would occur only after Court approval of a new rule 1.15. As a result, in the May 10, 2018 order the Court made minor nonsubstantive copyediting corrections to the punctuation used in Standard (1) and the version of the standards recommended for Board adoption is the Court's version.

To be ready for the implementation of the new rules, including rule 1.15, adoption of the revised standards is recommended with an operative date of November 1, 2018.

FISCAL/PERSONNEL IMPACT

None

RULE AMENDMENTS

The text of the rules and the duties imposed are not changed by this recommended action. However, Board adoption of revised recordkeeping standards under new rule 1.15 would replace the existing Board adopted standards under current rule 4-100.

BOARD BOOK AMENDMENTS

None

STRATEGIC PLAN GOALS & OBJECTIVES

Goal: 2. Ensure a timely, fair, and appropriately resourced admissions, discipline, and regulatory system for the more than 250,000 lawyers licensed in California.

RECOMMENDATION

It is recommended that the Regulation and Discipline Committee and Board of Trustees approve the following resolution:

RESOLVED, that following public comment and consideration of the comments received, the Board of Trustees adopt the recordkeeping standards, as set forth in Attachment A; and it is

FURTHER RESOLVED, that the operative date of the standards will be November 1, 2018.

2 Cal. State Bar Ct. Rptr. 752, 758). Accordingly, a duty to account and maintain records is not avoided by simply refraining from depositing funds into a client trust account.

ATTACHMENT(S) LIST

- A.** Clean Version of the Proposed Recordkeeping Standards
- B.** Redline/strikeout Version of the Proposed Recordkeeping Standards Showing Changes to the Current Standards
- C.** Executive Summary of Rule 1.15

ATTACHMENT A

PROPOSED RECORDKEEPING STANDARDS PURSUANT TO RULE 1.15(d)(3) *(Clean Version)*

Standards:

Pursuant to this rule, the Board of Trustees of the State Bar adopted the following standards, effective November 1, 2018, as to what “records” shall be maintained by lawyers and law firms* in accordance with paragraph (d)(3).

- (1) A lawyer shall, from the date of receipt of funds of the client or other person* through the period ending five years from the date of appropriate disbursement of such funds, maintain:
 - (a) a written* ledger for each client or other person* on whose behalf funds are held that sets forth:
 - (i) the name of such client or other person*;
 - (ii) the date, amount and source of all funds received on behalf of such client or other person*;
 - (iii) the date, amount, payee and purpose of each disbursement made on behalf of such client or other person* and
 - (iv) the current balance for such client or other person*;
 - (b) a written* journal for each bank account that sets forth:
 - (i) the name of such account;
 - (ii) the date, amount and client or other person* affected by each debit and credit; and
 - (iii) the current balance in such account;
 - (c) all bank statements and cancelled checks for each bank account; and
 - (d) each monthly reconciliation (balancing) of (a), (b), and (c).
- (2) A lawyer shall, from the date of receipt of all securities and other properties held for the benefit of client or other person* through the period ending five years from the date of appropriate disbursement of such securities and other properties, maintain a written* journal that specifies:
 - (a) each item of security and property held;
 - (b) the person* on whose behalf the security or property is held;
 - (c) the date of receipt of the security or property;
 - (d) the date of distribution of the security or property; and
 - (e) person* to whom the security or property was distributed.

ATTACHMENT B

PROPOSED RECORDKEEPING STANDARDS PURSUANT TO RULE 1.15(d)(3) (Redline/Strikeout Version Showing Changes to the Current Standards)

Standards:

Pursuant to this rule ~~4-100(C)~~, the Board of Trustees of the State Bar adopted the following standards, effective ~~January~~ November 1, ~~1993~~ 2018, as to what “records” shall be maintained by ~~members~~ lawyers and law firms* in accordance with ~~subparagraph~~ paragraph (Bd)(3).

- (1) A ~~member~~ lawyer shall, from the date of receipt of ~~client~~ funds of the client or other person* through the period ending five years from the date of appropriate disbursement of such funds, maintain:
 - (a) a written* ledger for each client or other person* on whose behalf funds are held that sets forth:
 - (i) the name of such client; or other person;*
 - (ii) the date, amount and source of all funds received on behalf of such client; or other person;*
 - (iii) the date, amount, payee and purpose of each disbursement made on behalf of such client; or other person;* and
 - (iv) the current balance for such client or other person;*
 - (b) a written* journal for each bank account that sets forth:
 - (i) the name of such account; i
 - (ii) the date, amount and client or other person* affected by each debit and credit; i and
 - (iii) the current balance in such account;
 - (c) all bank statements and ~~canceled~~ cancelled checks for each bank account; and
 - (d) each monthly reconciliation (balancing) of (a), (b), and (c).
- (2) A ~~member~~ lawyer shall, from the date of receipt of all securities and other properties held for the benefit of client or other person* through the period ending five years from the date of appropriate disbursement of such securities and other properties, maintain a written* journal that specifies:
 - (a) each item of security and property held;
 - (b) the person* on whose behalf the security or property is held;
 - (c) the date of receipt of the security or property;
 - (d) the date of distribution of the security or property; and
 - (e) person* to whom the security or property was distributed.

ATTACHMENT C

NEW RULE OF PROFESSIONAL CONDUCT 1.15 (Former Rule 4-100) Safekeeping Funds and Property of Clients and Other Persons

EXECUTIVE SUMMARY

The Commission for the Revision of the Rules of Professional Conduct (“Commission”) has evaluated current rule 4-100 (Preserving Identity of Funds and Property of a Client) and considered ABA counterpart, Model Rule 1.15 (Safekeeping Property). The Commission also reviewed relevant California statutes, rules, and case law relating to the issues addressed by the proposed rules. The result of the Commission’s evaluation is proposed rule 1.15 (Safekeeping Property).

Rule As Issued For 90-day Public Comment

Proposed rule 1.15 amends current rule 4-100. In substance, it continues the various requirements of the current rule concerning the holding of client funds and property, including the duty to properly account for such funds and property. Proposed rule 1.15 also continues the existing authorization for the Board to adopt recordkeeping standards (proposed paragraph (e)).

The two main issues considered by the Commission in studying this rule were whether to require that: (i) fees paid in advance, including a flat fee, be held in trust until the fees have been earned; and (ii) the duties owed to a client be extended to other persons, such a statutory lienholder with a claim against funds held by the lawyer. The Commission is recommending that both changes be implemented in the proposed rule.

Fees Paid in Advance. Proposed paragraph (a) requires that fees paid in advance be held in trust similar to the current rule’s requirement on advances for costs and expenses.¹ The Commission also recommends a new paragraph (b) to address the specific issue of a lawyer’s handling of *flat* fees paid in advance, including a protocol that would permit a lawyer to hold such fees in a firm’s operating account rather than a trust account.

As originally circulated for public comment, proposed paragraph (b) provided:

- (b) Notwithstanding paragraph (a), a flat fee paid in advance for legal services may be deposited in a lawyer’s or law firm’s operating account, provided:
 - (1) The lawyer or law firm discloses to the client in writing (i) that the client has a right under paragraph (a) to require that the flat fee be deposited in an identified trust account until the fee is earned, and (ii) that the client is entitled to a refund of any amount of the fee that has not been earned in the event the representation is terminated or the services for which the fee has been paid are not completed, and
 - (2) The client’s agreement to deposit the flat fee in the lawyer’s operating account and the disclosures required by paragraph (b)(1) are set forth in a writing signed by the client.

¹ Proposed paragraph (a), in relevant part, revises the current rule as follows: “All funds received. . . , including advances for **fees**, costs and expenses, shall be deposited in one or more identifiable [trust accounts].”

Paragraph (b) is intended to balance competing interests: (i) the public protection afforded by a rule intended to assure that unearned fees are available for a refund to a client; and, (ii) the freedom of a lawyer and client by agreement to set the terms of a fee arrangement. The initial public draft provided no exceptions to the requirement that disclosures and client's agreement to placing funds in the lawyer's operating account be in a writing signed by the client.

Reports of insufficient funds in a client trust account are a significant concern in attorney discipline.² At the same time, comments by stakeholders to the first Commission have asserted that a requirement to hold certain fees in a client trust account would be contrary to a client's best interest and would impair a lawyer's ability to focus on a client's representation. In particular, comments from criminal defense lawyers and lawyers who represent clients against the Internal Revenue Service or Franchise Tax Board have expressed concerns that holding advance fees in a trust account creates unnecessary risks of the loss of those funds through government seizure or forfeiture.³

Paragraph (b) seeks to accommodate both of these interests by permitting a flat fee paid in advance to be held in a law firm operating account so long as the lawyer provides a mandatory disclosure to the client and obtains the client's agreement in a writing signed by the client. This permissive option is intended to be limited to a *flat* fee paid in advance rather than all fees paid in advance, in part, because commenters have expressed the view that this particular fee arrangement represents a situation where the fees are earned upon receipt and holding such fees in a client trust account would be inconsistent with the basic fiduciary obligation to segregate funds that belong to a lawyer or law firm. Similarly, paragraph (b) would not apply to a true retainer fee as defined in proposed rule 1.5(d) and (e) [current rule 3-700(D)(2)].

Although proposed paragraph (b) permits a flat fee to be held in a law firm operating account, it does not diminish a lawyer's obligation to account for the funds or to refund any amount owing to a client due to a subsequent unexpected failure of consideration. For example, a situation could arise where a lawyer is unable to complete the contemplated legal services due to accident or illness and a refund would be required in this instance despite the fact that the funds might not have been held in a trust account.

The approach proposed in paragraph (b) builds on the State Bar's prior attempts to implement rule changes in the area of advance fees. This includes a 1992 rule filing that would have amended rule 4-100 to provide that: "Unless a written fee agreement expressly provides that a fee paid in advance is earned when paid or is a true retainer (as set forth in current rule 3-700(D)(2)), all advance fees received shall be deposited in one or more [client trust accounts]." (See October 1992 State Bar rule filing, Supreme Court Case No. S029270.) It also includes an

² The [2015 State Bar Annual Discipline Report](#) indicates that: "The most common action reported by others, accounting for approximately eighty percent of all reports each year, was actions falling under [Bus. & Prof. Code] section 6091.1, which requires financial institutions to report overdrafts from attorney trust accounts." (2015 State Bar Annual Discipline Report at p. 19.)

³ For example, in 2010 the first Commission received a comment from attorney Paul L. Gabbert stating: In criminal securities litigation involving federal prosecutors and the Securities and Exchange Commission ("SEC") payment of attorney's fees and the relationship of that payment to restraining orders and preliminary injunctions can not only distract the attorney from the case she was hired to defend, it can eclipse the underlying case and result in the attorney having to defend herself in contempt proceedings based on how her fee was paid. Even when the attorney prevails in the litigation, this can result in the functional equivalent of a fee forfeiture because the cost of successfully defending the civil contempt action can greatly reduce or eradicate the fee paid to defend the client in the underlying criminal action. . . .¶ True retainers and other fixed fees are the only way for practitioners to avoid these pitfalls.

effort in 1997 by the Committee on Professional Responsibility and Conduct (“COPRAC”) that would have required advance fees to be held in trust unless the lawyer obtained a client’s informed written authorization to deposit those funds in another account. These attempts created issues that precipitated questions and substantial adverse public comment. With respect to the 1992 proposal, the Supreme Court raised a question about an ambiguity as to the use of the term “earned when paid” and the duty to refund “unearned” fees. The 1997 proposal also engendered claims of ambiguity. The proposal was criticized, in part, for creating a new concept of “informed written authorization” that was perceived as more than written disclosure but less than informed consent. The Commission believes that proposed paragraph (b) is responsive to the concerns raised with respect to these prior, unsuccessful attempts at reform.

The Commission also considered whether proposed paragraph (b) would work together with the Commission’s non-refundable and flat fee provisions in proposed rule 1.5 (“Fees for Legal Services”) (see the executive summary of proposed rule 1.5) that include a definition of a “flat fee,” and concluded that it would. In relevant part, proposed rule 1.5 states that:

(d) A lawyer may make an agreement for, charge, or collect a fee that is denominated as “earned on receipt” or “non-refundable,” or in similar terms, only if the fee is a true retainer and the client agrees in writing after disclosure that the client will not be entitled to a refund of all or part of the fee charged. A true retainer is a fee that a client pays to a lawyer to ensure the lawyer’s availability to the client during a specified period or on a specified matter, but not to any extent as compensation for legal services performed or to be performed.

(e) A lawyer may make an agreement for, charge, or collect a flat fee for specified legal services. A flat fee is a fixed amount that constitutes complete payment for performance of described services regardless of the amount of work ultimately involved and which may be paid in whole or in part in advance of the lawyer providing those services.

Taken together, proposed rules 1.5 and 1.15 would implement enhanced public protection by: (1) prohibiting a “nonrefundable fee” except for a true retainer; (2) generally requiring that advanced fees be held in trust; and (3) providing a limited permissive option for flat fee arrangements.

Extending the Rule to Cover Other Persons. The Commission recommends adding the concept that under certain circumstances a lawyer owes duties to protect funds and property of a third person. This change is comparable to the standard in Model Rule 1.15 and to the rules adopted in some jurisdictions. Most significantly, California case law has held that a lawyer owes such duties to third persons. The Commission is concerned that current rule 4-100 is deficient to the extent that it fails to address the issue of funds and property entrusted by non-clients. By clarifying the rule, lawyer compliance would be facilitated. To explain this new addition to the rule, the Commission drafted proposed Comment [1], which provides:

[1] Whether a lawyer owes a contractual, statutory or other legal duty under paragraph (a) to hold funds on behalf of a person other than a client in situations where client funds are subject to a third-party lien will depend on the relationship between the lawyer and the third party, whether the lawyer has assumed a contractual obligation to the third person and whether the lawyer has an independent obligation to honor the lien under a statute or other law. In certain circumstances, a lawyer may be civilly liable when the lawyer has notice of a lien and disburses funds in contravention of the lien. See *Kaiser Foundation Health Plan, Inc. v. Aguiluz* (1996) 47 Cal.App.4th 302. However, civil liability by itself does not establish a violation of this rule. Compare *Johnstone v. State Bar of*

California (1966) 64 Cal.2d 153, 155-156 (“When an attorney assumes a fiduciary relationship and violates his duty in a manner that would justify disciplinary action if the relationship had been that of attorney and client, he may properly be disciplined for his misconduct.”) and *Crooks v. State Bar* (1970) 3 Cal.3d 346, 358 (lawyer who agrees to act as escrow or stakeholder for a client and a third party owes a duty to the nonclient with regard to held funds).

This explanatory Comment is important because it alerts lawyers to the fact that case law research may be needed to ascertain the nature and extent of a duty owed to a third person.⁴ Other proposed Comments explain what is meant by the term “advances for fees” (see proposed Comment [2]) and caution that paragraph (b)’s protocol for holding a flat fee in a firm operating account does not diminish a lawyer’s duty to account for the fee or the lawyer’s burden to establish that the fee has been earned.

Revisions Following 90-Day Public Comment Period

After consideration of comments received in response to the initial 90-day public comment period, the Commission substituted the preferred spelling “labeled” for “labelled.” The Commission also added the phrase “If the flat fee exceeds \$1,000.00” in paragraph (b)(2) to limit paragraph (b)’s requirement that the disclosures and client agreement to deposit the funds in a lawyer’s operating account be in a writing signed by the client to those matters for which a flat fee exceeds \$1,000.00.

With these changes, the Board authorized an additional 45-day public comment period on the revised proposed rule.

Final Commission Action on the Proposed Rule Following 45-Day Public Comment Period

After consideration of comments received in response to the additional 45-day public comment period, the Commission made only non-substantive grammatical and punctuation revisions.

With these changes, the rule Commission voted to recommend that the Board adopt the proposed rule.

The Board adopted proposed rule 1.15 at its March 9, 2017 meeting. Board consideration of recordkeeping standards is anticipated to occur following approval of the rule by the Supreme Court.

Supreme Court Action (May 10, 2018)

The Supreme Court approved the rule as modified by the Court to be effective November 1, 2018. In Standard (1)(a)(i) through (iii) and Standard (1)(b)(i) through (ii), copyediting errors were corrected. In Comment [1], citation style was revised to conform to the California Style Manual. Lastly, an omitted asterisk for a defined term was added.

⁴ In some circumstances, the duty imposed by the proposed rule may be a requirement to communicate and inform a third person concerning that person’s claim to client trust funds (see *In the Matter of Nunez* (Review Dept. 1992) 2 Cal. State Bar Ct. Rptr. 196 [lawyer believed that client’s bankruptcy would nullify a lien and failed to communicate with the lienholder concerning the lien claim), while in other situations a lawyer might be required to withhold disbursement of funds to the lawyer’s client to protect the rights of a third person (see *In the Matter of Respondent P* (Review Dept. 1993) 2 Cal. State Bar Ct. Rptr. 622 [lawyer’s failure to honor a statutory Medi-Cal lien]).