

# Legal Trust Accounting

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## 1) Trust Accounting Fundamentals

### 1.1 Purpose of trust accounting

- Protect client/third-party funds
- Prevent commingling and misappropriation
- Create a verifiable audit trail

### 1.2 Key definitions

- **Client trust account (CTA):** bank account holding client/third-party funds
- **IOLTA** (pooled interest account): interest goes to an approved legal aid foundation (typical)
- **Separate interest-bearing trust:** for large/long-term client funds where interest belongs to client (jurisdiction-specific)
- **Operating account:** firm funds (fees earned, firm expenses)
- **Retainer types**
  - **Advance fee deposit / security retainer** (usually unearned until work performed → trust)
  - **Evergreen retainer** (kept at a minimum level in trust, replenished)
  - **True/general retainer** (may be earned on receipt in some places—must follow local rules and agreement language)
- **Client costs/advanced costs:** filing fees, records, experts—often handled via trust depending on arrangement
- **Third-party funds:** medical liens, co-counsel splits, settlement proceeds

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## 2) Ethical Rules That Drive the Bookkeeping (Tested Heavily)

### 2.1 Core prohibitions

- **Commingling:** mixing client funds with firm funds (except limited permitted items like bank fees cushion where allowed)
- **Conversion/misappropriation:** using client funds for firm purposes, even temporarily
- **Negligent trust handling:** poor records, late reconciliations, missing documentation

## 2.2 Required behaviors

- Deposit client funds promptly and correctly
- Disburse only when allowed (collected/cleared funds and proper authorization)
- Keep complete records and perform periodic reconciliations
- Provide client accountings upon request and at matter conclusion

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# 3) Bank Account Structure & Setup

## 3.1 Typical accounts for a small law office

- Client Trust (IOLTA) – pooled
- Operating (general business checking)
- Payroll (optional)
- Tax/withholding (optional)
- Credit card clearing (optional)
- Separate client trust accounts (only when required)

## 3.2 Bank requirements (common themes)

- Approved financial institution list (some jurisdictions)
- Overdraft notification agreement between bank and bar (common in many states)
- Checks/online access controls: dual authorization, no ATM cards (preferred), positive pay (best practice)

## 3.3 Fee handling

- Bank fees should generally be paid by the firm (operating), not deducted from pooled client funds unless your rules allow a minimal cushion and it's tracked

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# 4) The Accounting Model: How Trust Books Should Be Organized

## 4.1 Minimum record set (the “trust accounting triangle”)

1. **Trust bank statement** (what the bank says)
2. **Trust checkbook register / general trust ledger** (all trust activity)
3. **Client matter ledgers** (sub-ledgers for each client/matter)

## 4.2 The non-negotiable principle

- The **sum of all client ledger balances** must equal the **adjusted trust bank balance** at all times.

## 4.3 Chart of accounts (common approach)

- Trust is often tracked as:
  - **Trust Bank Account (Asset)**
  - **Client Trust Liability (Liability)** with sub-ledgers by client/matter or using a dedicated trust module that mirrors this logic.

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# 5) Deposits Into Trust (Intake to Deposit Workflow)

## 5.1 What goes into trust

- Unearned retainers/advance fees (most common)
- Settlement proceeds (until disbursed properly)
- Funds held for third parties (liens, co-counsel, experts) if received with settlement
- Filing fees/cost advances depending on fee agreement and local rules

## 5.2 Deposit workflow checklist

- Identify matter and payer
- Issue receipt/acknowledgment (internal and sometimes to client)
- Deposit promptly
- Post to:
  - Trust register (date, deposit #, payor, matter, amount)
  - Client matter ledger (same detail)
- Keep supporting docs:
  - Copy of check, deposit slip, confirmation, correspondence

## 5.3 Special deposit situations

- **Mixed funds check** (client pays retainer + earned fee in one check): many jurisdictions require splitting correctly (often deposit all to trust, then transfer earned portion after proper billing/authorization—follow local rules)
- **Electronic payments** (ACH/credit card): watch processing fees and timing; often best practice is to route fees to operating and gross client funds to trust, or reimburse trust from operating immediately—depends on local guidance

## 6) Withdrawals and Transfers (When Money Can Leave Trust)

### 6.1 Allowed disbursements (typical)

- Refund to client (unused retainer)
- Payments to third parties (filing fees, liens, experts) with authorization
- Transfer of earned fees to operating (only after earned + documented)

### 6.2 Earned fee transfers (the “billing-to-transfer” chain)

- Perform work → generate invoice → determine amount earned from retainer → client notice per agreement/rules → transfer from trust to operating
- Post entries:
  - Trust register: “Transfer to Operating – fees earned”
  - Client ledger: decrease trust balance
  - Operating books: income entry (and AR logic if used)

### 6.3 Cleared funds rule (critical)

- Don’t disburse against uncollected deposits (bad checks, pending ACH). Many trust violations happen here.

### 6.4 Prohibited behaviors (common exam traps)

- Paying firm rent/payroll from trust
- Using Client A’s funds for Client B’s expenses (even temporarily)
- Creating/ignoring negative client ledger balances

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## 7) Settlement Accounting (Big Topic)

### 7.1 Settlement deposit and hold

- Deposit settlement check into trust
- Wait for cleared funds per policy/rules

## 7.2 Settlement statement / disbursement sheet

Include:

- Total settlement amount
- Attorney fees (how calculated)
- Case costs advanced (itemized)
- Medical liens/third-party claims (itemized)
- Client net proceeds
- Signatures/approvals as required

## 7.3 Disbursement sequence (common best practice)

- Pay liens/third parties per agreement
- Transfer earned fees to operating
- Pay client net proceeds
- Document every payment with check/EFT confirmation and ledger postings

## 7.4 Disputed funds

- If there's a bona fide dispute (client vs lienholder, co-counsel split): hold the disputed portion in trust until resolved; disburse undisputed portions where allowed.

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# 8) Three-Way Reconciliation (Must Know Cold)

## 8.1 The three numbers

1. **Bank statement ending balance**
2. **Trust register balance**
3. **Sum of client ledgers**

## 8.2 Steps (monthly is standard; some require more frequent)

1. Start with bank statement ending balance
2. Adjust for outstanding checks and deposits in transit → **Adjusted bank balance**
3. Compare adjusted bank balance to trust register balance
4. Compare trust register balance to sum of client ledger balances
5. Investigate and correct discrepancies immediately
6. Print/sign/date reconciliation package and retain

### **8.3 Common reconciliation problems**

- Data entry errors (wrong matter, transposed numbers)
- Outstanding items not tracked
- Bank fees/interest not posted
- Duplicate postings
- Using the wrong date (posting by invoice date vs transaction date)
- Negative client balances hidden by pooled total

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## **9) Recordkeeping, Controls, and Audit Readiness**

### **9.1 Documents to retain (typical categories)**

- Bank statements, canceled checks/check images
- Deposit records (slips, copies of checks)
- Trust register reports
- Client ledger reports
- Reconciliation reports
- Invoices, settlement statements, authorizations
- Wire/EFT confirmations
- Fee agreements and amendments

### **9.2 Internal controls (best practice)**

- Separation of duties (receive funds ≠ reconcile bank)
- Numbered checks; restrict signing authority
- Dual approval for wires/transfers
- Positive pay / payee verification
- Monthly management review of reconciliations and exceptions
- Written trust accounting procedures manual

### **9.3 Error correction protocol**

- Never “plug” numbers to force reconciliation
- Correct with clear adjusting entries + memo + documentation
- If funds are missing/overdraft risk: escalate immediately to attorney/firm owner

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## 10) Common Scenarios You Should Be Able to Work Through

1. Client pays \$5,000 retainer → bill \$1,250 → transfer earned fees
2. Settlement \$100,000 with 33⅓% fee, \$4,200 costs, \$18,000 liens → calculate net and post all entries
3. Credit card retainer with processing fee → keep client principal whole in trust (method depends on local rules)
4. Disputed lien amount → hold disputed funds; disburse rest
5. Refund unused retainer at case close
6. Trust bank fee hits account → how to handle properly
7. Check bounces after partial disbursement → how to correct and prevent recurrence

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## 11) Study Aids and “What to Memorize”

### 11.1 Memorize the core rules

- No commingling, no borrowing, no negative ledgers
- Cleared funds before disbursement
- Three-way reconciliation process and why it matters
- Settlement statement components

### 11.2 Build quick templates

- Client ledger template
- Trust register template
- Monthly reconciliation checklist
- Settlement statement template
- Retainer draw authorization language (non-legal wording for internal forms)