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Every Lawyer's Nightmare: Theft of Client Funds

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On the scale of "bad things" that can happen to a law firm, few are as uncomfortable for all concerned as the theft of client funds. Thefts involving a firm's general business account are no less pleasant, but they do not invoke the significant duty all lawyers and their firms have to safeguard client property. Historically, many such thefts were often the work of trusted staff members who had the confidence of their lawyer-supervisors. In today's "electronic" environment, it would not be hard to imagine a theft by outsiders who had penetrated the firm's computer network.

In this column, we'll look at three primary considerations that arise when a theft of client funds occurs. First, we'll examine the potential regulatory consequences. Second, we'll discuss insurance coverage issues. Finally, we'll touch on the relationship to the firm's deposit agreement with its bank on the question of who may bear financial responsibility. With each, we'll use a trio of Washington cases as examples. In doing so, it is important to note that our neighbors to the north don't necessarily run into these problems more often. But, Washington has provided telling examples on each point in the form of published appellate opinions.

We will approach all of these issues from the perspective of a lawyer-supervisor who is not complicit in the theft concerned. Needless to say, direct lawyer involvement in a theft is one of the quickest routes to a new line of work (*see, e.g., In re Renshaw*, 353 Or 411, 298 P3d 1216 (2013)).

Regulatory Consequences

RPC 1.15-1 charges us with "safekeeping" clients' property generally and RPC 1.15-2 applies that principle to the most common form of trust account—"IOLTA" accounts. Thefts of client funds from trust accounts by law firm staff can expose the lawyer-supervisor to discipline under these provisions. In most circumstances, however, regulatory discipline is only imposed on lawyers whose negligent supervision effectively allowed an errant staff member to exploit that negligence to steal. When that occurs, the lawyers involved are usually also charged with failure to supervise under RPC 5.3(a)—which imposes a duty on lawyers' supervising law firm staff to "make reasonable efforts to ensure that the [staff] person's conduct is compatible with the professional obligations of the lawyer[.]"

In re Trejo, 185 P3d 1160 (Wash 2008), for example, involved a solo practitioner who effectively ceded control over his trust account to his secretary. Unfortunately, she used the trust account in a check-kiting scheme to pay her personal debts. The lawyer was disciplined under Washington's analogous rules governing trust accounts and lawyer supervision of firm staff. In doing so, the

Washington Supreme Court emphasized (at 1173) the lawyer's knowing failure to supervise: "[A]lthough he did not know about or participate in . . . [the secretary's] . . . check floating and misappropriation, he knew that he had completely abdicated all responsibility for complying with the ethical requirements of trust accounting to a nonlawyer assistant."

Coverage Issues

Many lawyers assume that because we are required to deposit client funds into a trust account that a theft from that account will be covered by malpractice insurance. They should look carefully at their policy. The Oregon State Bar Professional Liability Fund Plan, for example, makes plain in the comments to Section III ("What is a Covered Activity") that it does not cover "conduct in carrying out the commercial or administrative aspects of law practice" and uses as an illustration of that exclusion "depositing or withdrawing monies or instruments into or from trust accounts[.]"

The Oregon PLF is not unique. In *Stouffer & Knight v. Continental Cas. Co.*, 982 P2d 105 (Wash App 1999), for example, the Washington Court of Appeals agreed that a "dishonest act" exclusion in a malpractice policy precluded coverage when a law firm secretary stole money from the firm's trust account—even when the firm admitted that its supervision of the secretary was negligent. For firms that typically have substantial balances in trust, this suggests purchasing an employee theft rider on a general commercial policy. The clients affected are going to want their money back. In the absence of insurance, the firm will be forced to rely on its own resources to make the clients whole.

Banking Agreement

The agreement with the bank that the law firm signed when it opened its trust account may also allocate financial responsibility for any loss relating to the account to the law firm when the loss is the result of a dishonest act by a law firm employee. In *Bank of America v. Hubert*, 101 P3d 409 (Wash 2004), for example, the Washington Supreme Court found that the bank hosting a law firm's trust account was not liable for losses stemming from a paralegal's use of the trust account in a check-kiting scheme because the deposit agreement expressly excluded liability on the bank's part for dishonest acts by authorized signers or where the firm's negligence had contributed to those acts. This again suggests adding an employee theft rider to the firm's general commercial policy.

ABOUT THE AUTHOR

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