

The Bookkeeper Did It! Lawyer Responsibility for Staff Theft of Client Funds

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Introduction

One of the most searing problems a law firm can face is the theft of client funds by a staff member.¹ Although large firms are not immune from such thefts, they are more common in smaller firms where a single person manages the firm's trust account and related bookkeeping. "Smaller," however, is a relative term. The dollar amounts involved are often quite large. In fact, successful smaller firms are uniquely vulnerable because the lawyers are often busy practicing law and may delegate trust account management to a staff member with little or no supervision.

This article examines three facets of staff theft of client funds. First, the regulatory consequences to supervising lawyers are surveyed. Second, lawyer ratification of employee theft is discussed. Third, the practical impacts beyond lawyer discipline are outlined.

Regulatory Consequences of Failure to Supervise

When a theft of client funds by a law firm staff member is discovered, regulatory issues usually coalesce around state counterparts of two ABA Model Rules of

Professional Conduct: Rule 5.3(b) and Rule 1.15(a).² The former requires that “a lawyer having direct supervisory authority over the nonlawyer shall make reasonable efforts to ensure that the person’s conduct is compatible with the professional obligations of the lawyer[.]” The latter requires lawyers to safeguard client funds by “hold[ing] property of clients . . . that is in a lawyer’s possession in connection with a representation separate from the lawyer’s own property.”

A recurring profile is a small, successful firm where the firm’s partners are busy practicing law. Management of trust accounting is left to a single staff member with little, if any, oversight by the lawyers. The lack of oversight, ironically, is sometimes a product of the confidence the lawyers have in the staff member. *In re Galasso*, 978 N.E.2d 1254 (N.Y. 2012), for example, involved thefts totaling more than \$5 million by a law firm office manager who was the brother of a name partner. *In re Anonymous*, 876 N.E.2d 333 (Ind. 2007), in turn, involved thefts of \$22,000 by a law firm bookkeeper who was married to one of the firm’s two partners. Similarly, in *In re Zucker*, 60 N.Y.S.3d 199 (N.Y. App. Div. 2017), a bookkeeper who stole more than \$2 million in client and firm funds had come to the firm on the recommendation of a name partner’s sister, who was a retired lawyer.

Although some thefts are sophisticated, many are not and could have been prevented by relatively simple internal controls. In *In re Hawk*, No. 115-006, 2016 WL 7157977 (S.D. Ga. Dec. 6, 2016) (unpublished), for example, a lawyer provided his office manager with a rubber stamp of the lawyer’s signature for trust account checks and then failed to routinely monitor the trust account. The office manager eventually embezzled more than \$500,000. Similarly, in *In re PRB Docket No. 2016-042*, 154 A.3d 949 (Vt. 2016),

a lawyer routinely failed to compare bank statements with internal ledgers prepared by his office manager. Over a period of years, the office manager embezzled roughly \$2,000 in client funds and \$962,000 from the firm's operating account.

Courts typically stress that the basis for imposing discipline is not vicarious liability but the knowing failure to supervise. The Southern District of Georgia put it this way in *Hawk*:

To be clear, a lawyer's supervisory liability under Rule 5.3 is not vicarious or imposed upon a lawyer based simply upon the relationship between lawyer and nonlawyer . . . Rather, Rule 5.3 imposes an independent duty to supervise, and liability is imposed when that supervision fails.³

The Washington Supreme Court made a similar point in *In re Trejo*, 185 P.3d 1160, 1173 (Wash. 2008), where a solo practitioner's secretary had used the lawyer's trust account for a check-kiting scheme:

[A]lthough . . . [the lawyer] . . . 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.

It is important to stress that not all staff thefts should automatically lead to discipline. As the Southern District of Georgia in *Hawk* noted, lawyers are not vicariously liable as a matter of lawyer regulation if they otherwise had adequate internal controls in place, took reasonable steps to supervise firm staff and responded appropriately when the embezzlement was discovered. Nonetheless, and as discussed further later, the firm involved may still face civil liability for the loss of client funds entrusted.

Sanctions for failure to supervise in this context are very fact-dependent and range widely from private admonitions⁴ to substantial suspensions.⁵ Three factors, however,

stand out.⁶ First, being busy is not an excuse. It may explain how a bookkeeper was able to embezzle but it will not negate the lawyer's duty to supervise. The court in *Hawk* explained: "The problem . . . is that a lawyer's supervision may be so lax that he does not see the red flags."⁷ Second, the scope of the thefts and the corresponding lack of internal controls often affect the resulting discipline – with suspensions more likely the greater the number of clients impacted and the supervisory deficiencies more pronounced. *Zucker*, for example, resulted in a suspension where more than \$2 million was stolen from approximately 200 clients, the lawyer had provided the errant bookkeeper with signature authority over the firm's trust account and allowed the bookkeeper to work without supervision in a remote office. Third, prompt and cooperative reporting to regulatory authorities upon discovery of a theft and conscientious efforts to make restitution appear to temper the extent of discipline imposed even when the deficient supervision that enabled the theft. In *In re Ponder*, 654 S.E.2d 533 (S.C. 2007), for example, the lawyer received a public reprimand following his self-report⁸ and full restitution of more than \$200,000 embezzled by his bookkeeper from his firm's trust account. Accurate restitution, in turn, may often mean retaining a forensic accounting service to reconstruct the accounts involved.⁹ Similarly, firms usually need to demonstrate that they have instituted appropriate internal safeguards moving forward.¹⁰

In an anomaly that appears to be relatively uniform nationally, discipline does not typically result when a supervisory failure only results in a loss of firm – rather than client – funds. *In re PRB Docket No. 2016-042*, for example, involved a single theft of client funds totaling approximately \$2,000 and multiple thefts of nearly \$1 million in firm

funds. In issuing a private admonition, the Vermont Supreme Court pithily summarized this distinction by putting the emphasis on the duty to safeguard client property under state equivalents to ABA Model Rule 1.15: “Perhaps an attorney may blindly trust an employee with his own funds, but the attorney who undertakes to handle a client’s funds has the duty to take reasonable steps to safeguard the funds.”¹¹

Lawyer Ratification

If a lawyer discovers embezzlement and does nothing, the regulatory dimension changes sharply. Under state counterparts to ABA Model Rule 5.3(c)(1), a lawyer becomes responsible for staff misconduct if the lawyer “with the knowledge of the specific conduct, ratifies the conduct involved[.]”¹² *In re VanDerbeek*, 101 P.3d 88 (Wash. 2004), for example, involved a lawyer who was disbarred for, in relevant part, failing to supervise her office manager even after she learned he was systematically defrauding clients by overbilling them. Similarly, in *In re Moore*, 704 A.2d 1187 (D.C. 1997), a lawyer was disbarred when he had knowledge of a number of improper checks written by his office manager against the firm trust account but failed to take corrective action.

At the point a lawyer learns of a staff theft of client funds and does nothing, the lawyer effectively “owns it” and the disciplinary character can quickly ripen into a violation of state equivalents of ABA Model Rule 8.4(c). This is particularly the case if, as in *VanDerbeek*, the lawyer benefits from the theft directly or indirectly.¹³ In short, it is one thing to be negligent in supervising an employee – it is another to become complicit in a theft by doing nothing once it is discovered.

Beyond Lawyer Discipline

When embezzlement is discovered, a firm usually will face the prospect of civil litigation¹⁴ on at least two fronts.

First, the clients affected will understandably want their money back. Although the particular legal theories pursued will turn on state-specific principles ranging from conversion to bailment, litigation is frequently threatened and often follows unless the firm involved is able to pay the clients back quickly.¹⁵ In many instances, therefore, firms recovering from a significant theft retain both civil litigation and counsel to respond to bar regulators.

Second, litigation to assemble the funds necessary to make restitution may also occur. In the absence of specific employee theft coverage, law firms may face extended litigation over whether a staff member's theft is covered under the firm's malpractice policy. In *Stouffer & Knight v. Continental Casualty Company*, 982 P.2d 105 (Wash. App. 1999), for example, a law firm's malpractice carrier denied coverage for a secretary's embezzlement under the policy's "dishonest act" exclusion. The firm filed a coverage case against the carrier, arguing that its negligent supervision enabled the theft. The Washington Court of Appeals affirmed summary judgment for the carrier, observing: "While this may be true, nevertheless, the loss was [the] direct result of . . . [the secretary's] . . . embezzlement, a dishonest and criminal act."¹⁶ Firms may face equally lengthy litigation with their banks over the accounts used to perpetrate an embezzlement. In *Bank of America v. Hubert*, 101 P.3d 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 when the firm's negligence had contributed to those acts.

Conclusion

The New York Court of Appeals in *Galasso* aptly summarized what can—and cannot—be delegated by lawyers to law firm staff:

This is not to say that attorneys are prohibited from delegating certain tasks to firm employees, but any delegation must be made with an appropriate degree of oversight. We stress that it is the ethical responsibility of the attorney—not the bookkeeper, the office manager or the accountant—to safeguard client funds.¹⁷

Given that non-delegable duty, law firms need to ensure that they have adequate internal controls appropriate to firm size and practice for handling client funds. The failure to supervise can provide the opportunity for staff embezzlement that results in both regulatory discipline and a potentially catastrophic financial loss.

¹ Theft of client funds is not the exclusive province of law firm staff. Lawyers, too, have stolen client funds. From the regulatory perspective, those cases typically involve the straightforward application of state equivalents of ABA Model Rule of Professional Conduct 8.4(c) and usually result in disbarment. *See, e.g., In re Fossedal*, 399 P.3d 1169 (Wash. 2017) (lawyer disbarred for stealing client funds). Similarly, lawyers have also been disbarred for stealing law firm funds. *See, e.g., In re Renshaw*, 298 P.3d 1216 (Or. 2013) (lawyer disbarred for stealing from law firm's general business account).

² State counterparts of ABA Model Rule 5.3(a) may also be implicated, which addresses the responsibility of lawyers in firm management to "make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that the person's conduct is compatible with the professional obligations of the lawyer[.]" In many instances, however, the firms involved are small enough that the lawyers had direct supervisory roles over the staff members involved. Therefore, violations of local equivalents of ABA Model Rule 5.3(b) tend to be charged more frequently than ABA Model Rule 5.3(a). For a case specifically involving a managing partner's failure to institute and supervise appropriate accounting systems, *see In re Bailey*, 821 A.2d 851 (Del. 2003). Similarly, lawyers are also sometimes charged under state counterparts to ABA Model Rule 1.15(d) for the failure to properly account for funds.

³ 2016 WL 7157977 at *9. The court in *Hawk* was also critical of the law firm's failure to do a thorough background investigation as a part of its hiring process—which would have revealed that the office

manager had a criminal record that included convictions for forgery and theft by deception. Most reported disciplinary cases, however, focus primarily on the failure to supervise once the staff member involved is working at the firm rather than the failure to adequately investigate the staff member's background.

⁴ See, e.g., *In re* PRB Docket No. 2016-042, 154 A.3d 949 (Vt. 2016) (private admonition).

⁵ See, e.g., *In re* Galasso, 978 N.E.2d 1254 (N.Y. 2012) (two-year suspension).

⁶ In imposing discipline, courts usually weave these factors into the ABA Standards for Imposing Lawyer Sanctions (1992) in fashioning case-specific remedies. See, e.g., *In re* Hawk, 2016 WL 7157977 at *11 (S.D. Ga. Dec. 6, 2016).

⁷ 2016 WL 7157977 at *11.

⁸ Although self-reporting is not required under state professional rules patterned on ABA Model Rule 8.3, self-reporting is often a prudent strategy because the embezzlement involved may, by that point, have already triggered a trust account overdraft notification or have otherwise become known.

⁹ See, e.g., *In re* Zucker, 60 N.Y.S.3d 198, 121 (N.Y. App. Div. 2017) (describing efforts to reconstruct accounts).

¹⁰ See, e.g., *In re* Ponder, 654 S.E.2d 533, 535-36 (S.C. 2007) (describing new office management procedures).

¹¹ 154 A.3d at 957, quoting *Louisiana State Bar Ass'n v. Keys*, 567 So.2d 588, 592 (La. 1990).

¹² ABA Model Rule 5.3(c)(2) may also come into play in some instances. It provides that a lawyer with either management responsibility within a firm or direct supervisory responsibility for a staff member is responsible for staff misconduct if the lawyer "knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action." The theft of a client's funds would almost certainly trigger a reporting duty to the client under state equivalents of ABA Model Rule 1.4.

¹³ In *VanDerbeek*, the benefit to the lawyer was direct through the additional firm revenue generated by the billing fraud. In other instances, the benefit may be indirect. For example, the office manager in *Galasso* used \$360,000 of the client funds he stole to finance the purchase of an office condominium for the firm.

¹⁴ Even when there is no culpability by the law firm in the theft, the firm will usually need to interface with law enforcement in reporting the employee involved and cooperating with any subsequent criminal investigation. See, e.g., *In re* Galasso, 978 N.E.2d 1254, 1256 (N.Y. 2012) (noting the lawyer's cooperation with the criminal investigation involved); *In re* Hawk, 2016 WL 7157977 at *2 (S.D. Ga. Dec. 6, 2016) (same).

¹⁵ See, e.g., *In re* Strader, 27 D.B. Rptr. 219, 222 (Or. 2013) (noting that the client affected by an employee theft retained new counsel to pursue recovery of the loss from the firm).

¹⁶ 982 P.2d at 111.

¹⁷ 978 N.E.2d at 1258.