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FIGHTING FRAUD

AS FIRMS' FIRST LINES OF DEFENSE FOR FINANCIAL INTEGRITY, ADMINISTRATORS NEED TO TAKE STEPS TO AVOID EMBEZZLEMENT.

BY ED POLL

Funds can come up missing in any law firm, and the cause typically involves one of two scenarios: either there has been an honest mistake, or there has been intentional theft that qualifies as fraud or embezzlement. In either scenario the strategy to prevent money from coming up missing is the same. Those in charge of the firm, and of firm administration, must be consistent in their policies of handling cash, persistent in applying those policies and insistent that there be no shortcuts and no exceptions in the proper handling of funds.

Tom Collins, former Chairman of Juris, Inc. is a CPA who has worked with businesses of all types. He noted that he never encountered a single case of embezzlement outside of the legal community and found it relatively commonplace among law firms. Collins cited a KPMG survey reporting that the average embezzlement incident goes on for 18 months before detection. The need to be consistent, persistent and insistent in working for financial integrity could not be more obvious.

RULES VERSUS MOTIVATION

Ethical considerations should be uppermost in the law firm environment. Why should financial fraud even be a concern? After all, ABA Model Rule of Professional Conduct 8.4 states clearly that "It is professional misconduct for a lawyer to... commit a criminal act that reflects adversely on the lawyer's honesty, trustworthiness or fitness as a lawyer… [or to] engage in conduct involving dishonesty, fraud, deceit or misrepresentation." That seems to cover the financial fraud waterfront pretty thoroughly. The fact that such a statement/rule even exists in the rules that govern lawyer conduct is remarkable. However, the fact that even people who know the "straight and narrow" can deviate from it is one of the biggest reasons why lawyers exist.

The motivations for funds to go missing can be as varied as the people who take the money. In today's tough economic conditions, it is all too easy for someone who has real or imagined financial hardship to lose his or her moral compass when money is readily available and not readily monitored – the temptation can simply be too strong. More often, however, the real problem is that the opportunity is there. Lawyers in charge of the firm can be so focused on their practice matters that they lose sight of the business side and never realize what's occurring. Often this is aided and abetted by the fact that a trusted employee who has been with the firm for years is given free rein and little scrutiny. When the practice of law is so demanding, it is very easy for the lawyer to turn over authority to such people and assume that they are doing what is right. That is too often when bad things happen.

HOW THINGS GO WRONG

Missing funds can, of course, be the direct result of conscious malfeasance by a lawyer or lawyers in a firm, and this is a constant theme in state bar regulatory matters. Typically the matter comes to light at the state bar level as the result of a client complaint. This kind of issue can involve one of several attempts to deceive, or to cover up deception.

- The lawyer can pad a bill. Certainly the degree of "perfection" in being able to pull off this unethical action depends in part on how inattentive the client is to the lawyer's bill, and how lacking in detail that bill is. A bill that only says, "For legal services rendered," or that is inaccurate or confusing, potentially opens the door to concerns, or actual allegations, that the bill is padded. A client who so believes, correctly or not, can take the matter right to the state bar disciplinary board.
- The lawyer can siphon off funds. Several years ago, for example, news stories focused on a St. Louis law firm that sued one of its former associates, alleging that the attorney secretly signed up and hid clients from the firm and prevented it from collecting possibly millions in attorneys' fees.
- The lawyer can mismanage, carelessly or deliberately, client trust accounts. This can happen with accounts that grow so large that the record keeping becomes flawed and develops errors. This can happen in very active personal injury or debt collection law practices, family law practices, and in large firm real estate practices, among others. This is big trouble, because every state imposes a fiduciary duty to properly account for clients' trust funds to prevent misappropriation or negligence.
- The lawyer can "dip" into the client trust account for his/her own benefit or for the benefit of another client. For example, the lawyer might:
  - o Need money now to pay for staff payroll or rent intending to repay the trust account within a matter of a few days when an outstanding account receivable is collected as promised; but often the client doesn't honor his promise and the lawyer is stuck with a shortfall; or
  - o A second client receives a settlement or judgment draft, the law firm processes it but the funds have yet to hit the lawyer's bank; the second client needs the money now; and the lawyer writes a check from the trust funds held for the benefit of the first client. This is a "loan" from one client to another arranged by the lawyer without the permission or consent of either. It violates the rules of professional conduct per se!

Administrators **who understand** the firm's financial situation can make their firms stronger **(and their own jobs more valuable)** by being the lawyer's guide and **guard for the integrity of funds**.

Often, however, if lawyers themselves are not directly responsible for the problem, they know nothing about a client complaint lodged against them with the state bar. They may not even know that the matter is being investigated until disbarment proceedings are begun against them, sometimes not until such proceedings have been completed and the final notice of disbarment has been mailed. This is more than likely because a key administrative assistant is the person who controlled both the missing funds and the inflow of official correspondence to the lawyer.

HOW THINGS GO RIGHT

A five-step process can greatly reduce the chances of financial fraud occurring in any firm, provided that each step is followed consistently. They all embody the same principle: The more people who are involved in handling funds and financial records, the less likelihood there is that any one person can cause problems. It is seldom, if ever, that a "conspiracy to commit fraud" occurs.

1) The person who opens the mail that contains client checks in payment for invoices should not have any responsibility for handling the firm's financial records.
2) The person who is given incoming funds when they are received should not be the same person who deposits those funds. This person can track the accounts receivable.
3) A third person not responsible for handling either the profit-and-loss financial records or the deposit of funds should reconcile the firm's bank accounts at least monthly, and ideally more frequently if the firm uses online banking.
4) Yet another person, preferably an accountant from an outside CPA firm, should review and "audit" all financial records quarterly.
5) Create a "safety valve" by having more than one person trained and capable of doing each of the first four steps, and switching off occasionally between those people so that different sets of hands and eyes come to bear on the financial process.
6) The one iron-clad rule for every person involved in this entire process is to make sure every single person takes a vacation at least once a year. That is the ideal time for a different person trained at the same function to look at what has been done. Often the "diligent workers" who never take vacations are the ones who are afraid to do so for fear that their misconduct will come to light if they are not there to deflect scrutiny.
7) In a small law firm, or sole practice, the same steps can be performed. The lawyer might be more involved doing such things as opening the mail; an outside bookkeeper or accountant might be retained to review the records, etc.

CHECKS AND BALANCES

The net effect of this process is to create a system of checks and balances that no one person, or even several in collusion, can circumvent. The checks and balances process can and should be extended to the firm's entire operations, and is fundamental to best practices. A law firm run as a business will approach business operations with the kind of checks and balances that eliminate financial irregularities.

For example, every firm should maintain separate payroll and general accounts, placing in the payroll account the full amount of gross payroll (including employee portion of taxes) on the day that payroll is due. This eliminates the temptation to "borrow" payroll and payroll tax funds in the expectation that enough accounts receivable will be collected to cover them. If the money (accounts receivable) does not come in before payroll and taxes are due and payable, and the "borrower" is ultimately exposed for the transgression, the result will be civil and potential criminal penalties for the individual and the firm.

Lawyers are the owners of the firm and have ultimate financial stewardship for it. However, capable and honest administrators are the lawyers' first line of defense when it comes to financial integrity. Lawyers need help in understanding financial issues because the dearth of their business competency is built into their education, from the typical undergraduate degree in the liberal arts to law school curricula that have little business focus. Administrators who understand the firm's financial situation can make their firms stronger (and their own jobs more valuable) by being the lawyer's guide and guard for the integrity of funds. And from first-rate software accounting programs to outside accountants, administrators should use the full range of tools available to help them with that responsibility. Not doing so is to invite misconduct, state bar inquiry and trouble. When it comes to financial integrity, every document, check and ledger entry is important; and the firm administrator is the person best positioned to make sure that importance is understood. ❊

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