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## Accounting for Lawsuit Settlement Payments: Tips for Handling Client Funds

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If you're like most people, managing your clients' funds is unfamiliar territory. Most of us don't have an accounting background, and [accounting](#) isn't a subject that's included in law school curriculums.

You can't just tuck your clients' settlement funds in with the rest of your law firm's general funds, and you certainly can't stuff those crisp dollar bills in a pillowcase for safekeeping. To establish trust with your clients and ensure your law firm upholds its ethical responsibilities, you need to learn some accounting principles.

In this guide, we'll give you a quick overview of the basics of attorney trust accounts and describe how you should manage settlement proceeds and other funds on behalf of a client.

(Note: your state will have its own rules governing how you handle client funds. We encourage you to read those too.)

### A basic overview of general law firm accounting

Simply put, you need to know about your firm's financial performance. But, you also need to be able to meet your legal, regulatory, and ethical obligations, such as preparing your federal and state income tax returns and managing your clients' money. Accounting practices enable you to prepare financial statements, capture expenses, and create budgets and forecasts. The better you understand your [law firm's finances](#), the easier it will be to make smart decisions for your business and to avoid legal and ethical headaches.

Let's start by reviewing some common accounting terms that you should know.

- **Generally accepted accounting principles (GAAP):** These are the general guidelines for accounting, including the standards and rules that accountants follow.
- **Accounting method:** There are three general methods that your firm can follow: *cash basis*, where you recognize revenue when you collect cash and recognize expenses when you disburse cash; *accrual basis*, where you recognize revenue and expenses when you send or receive a bill; and *modified cash*, where you recognize revenue when it's collected but recognize expenses when you record them as payable.
- **General ledger accounts:** These accounts are used to sort, store, and summarize a firm's transactions. Types of general ledger accounts include assets, liabilities, equity (assets minus liabilities), income, and expenses.
- **Chart of accounts:** This list includes all of your firm's general ledger accounts. In addition to the accounts listed above under general ledger accounts, you'll also need to add trust accounts to this list.
- **Double-entry accounting:** The system of entering corresponding yet opposite financial transactions—debits and credits—into two (or more) accounts (hence double-entry). The result of double-entry accounting is a balance sheet.
- **Balance sheet:** A document that reflects your firm's business health. It includes assets, liabilities, and equity. Your total assets must always equal your liabilities plus your equity.
- **Income statement:** Also called a profit and loss statement or P&L, this document shows changes to your income and expenses.
- **Cash flow statement:** A document that helps firms plan for growth by showing them their current financial state and expected revenue and expenses.
- **Client trust ledger:** A statement that shows all fund activity, including balances, deposits, and payments, for each client.
- **Trust account:** A trust account is a bank account where a lawyer receives and holds money on behalf of a beneficiary, such as a client or third party. Lawyers must keep their clients' funds separate from their business, or operating, accounts. Funds in trust accounts may include settlement funds, court fees, retainer fees, or advanced costs.
- **Operating account:** A bank account that holds all money not held in trust on behalf of a beneficiary.
- **Interest on lawyers' trust accounts (IOLTA):** This type of bank account earns interest on client funds held in trust. The interest is often collected by the state bar on behalf of a charitable cause, such as legal services for indigent people. (Lawyers cannot collect interest on money they hold in trust for clients.) (In New York, these accounts are called IOLAs, which stands for interest on lawyer accounts.)

## Which client funds go where, and why should they be separate?

There are two main reasons that lawyers should keep their clients' funds separate from their personal or business operating accounts and from other fiduciary accounts. First, lawyers have a fiduciary responsibility to their clients. Second, it's essential that the public have confidence in the trustworthiness of the legal profession.

That's where trust accounts come in. Trust accounts are designed to safeguard client and third-party funds from loss. These separate accounts protect clients' funds from being used to satisfy the firm's financial obligations and from being seized by the firm's creditors.

Not all client funds need to go into a trust account. A general rule of thumb is that if funds are for tasks that aren't yet completed, they should go into the trust account. But if the funds have already been earned, they should go into the firm's operating account.

Here is a list of common client funds that you should place in a trust account:

- **Advanced costs:** Clients' advance fees and costs to pay for future obligations. These are fees that you haven't yet earned and costs that you haven't yet been required to pay. You must deposit these funds into a trust account because the client expects you to take care of them until they are earned or needed. Note that an advanced fee is not the same thing as a retainer.
- **Settlement payments:** These client funds must live in your trust account until they are disbursed to your client. If the settlement resolves a matter you handled on a contingent fee basis, you'll need to provide the client a statement showing the settlement amount, any fees and costs, and the portion that the client is entitled to.
- **Bill overpayments:** Overpayments are partly earned (the part covering the outstanding balance) and partly unearned (the part that was overpaid). The earned part must be withdrawn from the trust account, while you may either refund the overpayment to the client or, with the client's permission, hold the overpayment in the trust account and apply it to future services or fees.
- **Escrow funds:** Funds relating to closing a real estate or personal property transaction must be deposited in your trust account.
- **Fiduciary funds:** If you receive funds in connection with a representation in which you are acting as a trustee, guardian, personal representative, executor, agent, or escrow agent, you must deposit these funds in a trust account. Note that this rule does not apply if you are not serving as a lawyer and are simply acting as the executor of an estate or the like.

It's equally important to know what funds shouldn't go into a trust account. By depositing the wrong funds into a trust account, you change the nature of the account, opening it to the risk that it could be raided by firm creditors.

Here is a list of funds to avoid depositing in a client trust account:

- **Earned fees:** If your client pays a bill in full (without overpaying), that payment should go to your operating account, not your trust account.
- **Reimbursements for advanced litigation expenses:** Lawyers should pay advances of expenses out of their operating account. An advance usually occurs when no client funds have been deposited in a trust account. If the client reimburses you for these expenses, the funds should go into your operating account. But note that this rule will change if the advanced costs are paid from a settlement. The settlement belongs to the client, so you must first deposit the settlement in the trust account. You can withdraw the portion to cover your attorney fees and costs after the settlement check clears and you've provided a settlement statement to your client.
- **Retainers:** The key here is to clarify whether the fee is for future work (trust account) or simply to engage the lawyer's services (to ensure their availability), separate from any legal services to be performed. Retainers are generally not deposits for future work. Ensure that your retainer agreement specifies the time period for the retainer, that the lawyer will treat the retainer payment as the lawyer's property immediately, and that the lawyer will bill the client separately for services provided.
- **Flat fees:** Flat fees are payments that do not vary depending on the amount of time or effort that a lawyer spends completing the services. Flat fees can be paid in advance and in whole or in part. If they are paid in advance, they ordinarily will need to be deposited in a trust account, unless (in

some states) the flat fee agreement says that the fee is the lawyer's property upon receipt.

- **Personal or business transactions:** Deposits related to a lawyer's personal or business transactions cannot be placed in a trust account. All funds in a trust account must be for your clients and connected to a representation.

## What is IOLTA and what are the requirements for an IOLTA account?

IOLTA, which stands for interest on lawyers' trust accounts, is a type of trust account that raises money for charitable purposes, primarily for providing legal services to indigent people. IOLTA programs came to be in 1981 after Congress passed laws allowing checking accounts to earn interest and after the Supreme Court and state court rules created IOLTA programs.

All 50 states, plus the District of Columbia, Puerto Rico, and the U.S. Virgin Islands, operate IOLTA programs. The majority of states require lawyers to participate, though two programs are voluntary and four others allow lawyers to opt-out.

### How does an IOLTA work?

When lawyers receive a large sum of money that belongs to a client, such as a settlement payment or advanced fees, they should deposit the money into a trust account, where the funds can earn interest for the client. However, if the amount of money is small or if the lawyer only holds the money for a short time, the costs of collecting interest might outweigh the amount of interest the funds can earn.

However, an IOLTA account allows lawyers to deposit smaller funds from one client into a pooled, or combined, trust account with other short-term client funds. IOLTA trust accounts are typically checking accounts to facilitate fund access.

Because it is unethical for lawyers to benefit financially from funds that belong to their clients, lawyers can't earn interest on these accounts. With IOLTA, the interest that the funds accumulate is passed on to each state's IOLTA program to fund charitable causes.

### What happens to IOLTA account interest?

The goal of an IOLTA is to offer access to justice for individuals living in poverty without taxing the public or charging lawyers and their clients. The interest generated in IOLTA accounts supports civil legal aid and improvements in the justice system.

More specifically, IOLTA programs use the interest generated to fund free, non-criminal legal assistance for low- and middle-income people. The assistance includes helping provide access to health care, housing, government benefits, employment, and educational services. These services are provided by lawyer volunteers on a pro bono basis and by legal aid attorneys.

IOLTA funding also supports self-help and other educational resources, such as legal information websites and legal assistance hotlines. Other programs supported include alternative dispute resolution programs, public service projects, victim services programs, court-appointed special advocate programs, pro se assistance resources, minority lawyer recruitment initiatives, and law school scholarship programs.

IOLTA programs work with financial institutions to maximize their revenue, requiring banks to pay interest rates comparable to non-IOLTA accounts and negotiating to increase interest rates and lower service charges.

To find the IOLTA program in your jurisdiction, visit the [National Association of IOLTA Programs directory](#).

## What are the rules governing trust accounts?

Trust accounts are governed by state rules of professional conduct. Most of these rules are based on the American Bar Association's Model Rules of Professional Conduct. [Model Rule 1.15](#), titled "Safekeeping Property," sets forth lawyers' obligations with respect to client and third-party property:

- (a) A lawyer shall hold property of clients or third persons that is in a lawyer's possession in connection with a representation separate from the lawyer's own property. Funds shall be kept in a separate account maintained in the state where the lawyer's office is situated, or elsewhere with the consent of the client or third person. Other property shall be identified as such and appropriately safeguarded. Complete records of such account funds and other property shall be kept by the lawyer and shall be preserved for a period of [five years] after termination of the representation.
- (b) A lawyer may deposit the lawyer's own funds in a client trust account for the sole purpose of paying bank service charges on that account, but only in an amount necessary for that purpose.
- (c) A lawyer shall deposit into a client trust account legal fees and expenses that have been paid in advance, to be withdrawn by the lawyer only as fees are earned or expenses incurred.
- (d) Upon receiving funds or other property in which a client or third person has an interest, a lawyer shall promptly notify the client or third person. Except as stated in this rule or otherwise permitted by law or by agreement with the client, a lawyer shall promptly deliver to the client or third person any funds or other property that the client or third person is entitled to receive and, upon request by the client or third person, shall promptly render a full accounting regarding such property.
- (e) When in the course of representation a lawyer is in possession of property in which two or more persons (one of whom may be the lawyer) claim interests, the property shall be kept separate by the lawyer until the dispute is resolved. The lawyer shall promptly distribute all portions of the property as to which the interests are not in dispute.

You should always review their state's rules, which may include additional requirements for managing funds and setting up trust accounts.

If lawyers don't adhere to the rules in their jurisdiction for trust accounts, they're likely to be subject to disciplinary action. Depending on the severity of their transgression, they may face anything from a reprimand up to suspension and even disbarment.

So, let's take a closer look at how law firms can meet their ethical responsibilities for trust accounts.

## Best practices for client trust accounts

When you receive funds from a client or on behalf of a client, and this money is an advance payment for services, costs, or fees or is a settlement payment, you must take great care to handle this money in accordance with your ethical and fiduciary duties. What follows is a brief summary of some of these duties:

### Duty to keep client funds safe

To satisfy this duty, a lawyer must deposit client funds into a trust account that is clearly identified and labeled with the client's name or as an IOLTA account.

Be especially careful when setting up an IOLTA account. It's very likely that you'll need to choose a financial institution that your state bar has approved before you can set up an IOLTA account. The bar may have specific registration requirements that you must follow. You may need to register the account with your state's nonprofit that administers civil legal services. You'll also need to obtain the nonprofit's taxpayer identification number.

Here are some suggestions that may help you avoid depositing funds into the wrong account.

- Label your deposit slips with the account title, such as "[Law Firm] Trust Account Funds."
- Print checks for different accounts in different colors.
- Maintain your operating account and trust accounts with different banks.

### Duty to segregate client funds

You must avoid commingling your firm's operating funds with client funds. Depending on the number of funds that you are holding for your clients, you will need to proceed in one of two ways with the allocation of funds:

1. You can set up a separate trust account for a client if you are holding client funds for more than a brief period and the amount is sufficient to earn interest and is worth the expense of establishing and maintaining the separate account.
2. You can pool the money of multiple clients in a single IOLTA account if you are only holding the individual client funds briefly or if the amounts are too small to support a separate interest-bearing account.

When you include client funds in an IOLTA account, you have an ethical responsibility to manage each client's funds separately. To do so, you will need to set up a ledger for each client. You can set up a ledger in a [legal practice management platform](#), or you can use Excel or accounting software like QuickBooks.

For each client, you must maintain a separate ledger of all funds received and deposited and all funds paid or distributed out of the account. You must also show the balance of funds in the trust account.

Note that there is one exception to the rule against commingling client and firm funds: you are permitted to keep a reserve of firm funds in your trust account to cover bank and credit card fees, so long as you maintain proper records.

## Duty to notify your client of receipts and disbursements

Every time you receive or disburse funds from a client's trust account, you must notify your client. That means you must contact your client whenever you deposit money or withdraw money to cover incurred expenses or pay for fees that you've earned. You must give the client a statement of the services you rendered or the expenses you paid on their behalf. This statement must also show the amount you are withdrawing from the account to cover these costs.

In some states, you may be required to notify your clients of the amount they owe before you take the money out of the trust account. This advance notice is required to allow the client to dispute the fee or expense. If you don't comply with this rule, you might face a claim that you engaged in the misappropriation of client funds.

Here are some tips that will help you avoid fee disputes:

- Review how the trust account works in a fee agreement letter that you send to each client. Give an overview of your standard billing procedures and how the funds in the client's trust account will cover fees and expenses. Explain that if your client has a concern about the amount due, they must file a dispute within a certain time or else you will proceed to pay the amount due.
- Remind clients of your billing process, including your dispute procedure, every time you send an invoice. Your cover letter can include this information. It's also a good idea to share the current balance in the trust account, the amount of the invoice, and the balance that will remain after the invoice is paid. You must keep these records anyway, and transparency goes a long way toward strengthening the client relationship.
- If the balance of the client trust is approaching zero, you may want to request an additional deposit of funds if necessary to cover any additional legal work, fees, or costs.

## Duty to provide your client a full report of their funds

Clients have the right to ask for details about their funds. When this occurs, you must provide a report that shows how you have used their money in a timely manner. This is why it's so important to maintain accurate records of client funds at all times, so you have an accurate audit trail showing all client-related fund activity.

This report, called a client trust ledger, shows all deposits and withdrawals from each client's trust account in chronological order. Note that no account should ever have a negative balance, which would indicate that you're disbursing money that you have not received.

Additionally, every month, you should reconcile your transaction records against your client trust accounts. Most jurisdictions require lawyers to reconcile their accounts on a set schedule, whether monthly, bimonthly, or at the time of audit.

Law firms have a unique way of reconciling their accounts: three-way reconciliation. This process checks your law firm's books against the trust account balance and all individual client ledger balances. The sum of all of the individual client ledgers must match the balance in your books and the account balance.

To perform a three-way reconciliation, take these steps:

- Identify the beginning cash balance in the account.

- Add the total receipts for the applicable period.
- Deduct any disbursements and service charges to arrive at the cash balance.
- Check for any outstanding deposits and checks. You may need to adjust for these to ensure the account matches the bank statement balance.
- Total all of the individual client ledger balances and compare them to the overall trust account's ledger balance.

Three-way reconciliation offers yet another safeguard to protect client funds. It ensures that all money entrusted to your firm is correctly kept and isn't being paid to cover another client's charges, firm expenses, or bank fees. It's important to conduct this activity frequently because if the bank has made an error, then you only have a short period to request a correction. It also ensures that if you have made an error, you correct it quickly to minimize the risk of harm to your client.

Here are some tips to reduce the risks in the account reconciliation process:

- Ask someone who is not normally involved in handling the books to perform the three-way reconciliation.
- Close your books as soon as you reconcile your accounts to prevent any accidental edits and to ensure the integrity of your reports.
- Save a copy of your reconciled statements.
- If you discover a mistake, correct it immediately. Then document the error and the steps you took to fix it. You'll need these records later in the event of an audit.

## Common trust account mistakes

Handling trust accounts is challenging, especially when you have so many other responsibilities. But, lawyers are ultimately held accountable for all of their client funds in trust accounts. That's why it's so important to regularly review your accounts for compliance and take steps to avoid the most common trust account mistakes:

### Commingling firm funds with client funds

Lawyers should not mix their operating funds and client funds in any account. But while this principle sounds simple, it's hard to implement.

Say, for example, that your client sends a check to cover both legal fees and costs. You're being paid a flat fee for services, and the costs will cover the court fees when you file the client's personal injury lawsuit. It may be tempting to deposit all of the fees in your operating account, because the bulk of the check is covering your fees, and write a check from one account to the other. However, that would be impermissibly commingling fees.

Because the check covers costs that have not yet been incurred, you should deposit the check into the trust account to hold those fees for your client. Then you should write a check payable to your operating account for the fees. It's important to take all earned fees out of the trust account to pay for client invoices to avoid commingling.

### Writing checks against a trust account before checks have cleared

It always takes some time for checks to clear. That's why it's important to get notice that a deposit



has cleared before you write a check against funds in your trust account; otherwise, you'll have a negative balance, which will show up when you reconcile your accounts and be a red flag that you aren't following appropriate accounting procedures.

Don't be pressured into sending clients settlement proceeds immediately. Wait for a notice from the bank that the deposit has cleared. To avoid upset clients, explain your bank's policy on holding funds and your procedures for disbursements in advance.

## **Borrowing funds from a trust account**

If your firm isn't tracking funds properly, or if you are short on cash one month, it can be tempting to dip into a trust account to pay for business-related expenses. After all, you'll earn the money soon enough, so it doesn't matter whether you wait until you're actually ready to invoice the client, right? Or you might plan to put the money back into the trust account as soon as more money comes in.

Either way, this is wrong. It's unethical to transfer unearned money from the trust account to your operating account to cover expenses for your firm or another client. You'd also be violating a number of other ethical duties, including failing to account for your client's funds, commingling business and client funds, and failing to maintain accurate records.

## **Failing to safeguard the trust account**

If you don't limit who has access to your trust accounts, you're putting client funds at risk and breaching your ethical responsibility to safeguard them. And if you aren't following good accounting practices and regularly reconciling your accounts, you may not notice if a check goes missing or if someone writes a check to themselves until it's too late.

Law practice management software and online banking systems can alert you in case of problems like these. You can also ask the bank to send you an email whenever a check clears. Additionally, consider implementing physical safeguards, such as keeping trust account checkbooks locked in a cabinet.

## **Failing to track client funds**

Memories fade, so recordkeeping is important. It's especially important when you have a fiduciary duty to track your clients' funds and to be able to give clients account statements on demand.

To make sure you don't lose track of checks, make sure you write the client's name and matter number on each check that you issue. This will also help you reconstruct records in the event your records are lost, hacked, or destroyed. If you have to rebuild your client ledgers using bank statements and old checks, you'll be able to more quickly get back up to speed.

## **Recording a trust deposit as income**

When you receive funds for a client trust account, don't record it as income in your accounting software. These funds are your client's property, not your own. If you record them as firm income, not only are you breaching your fiduciary duty to your client, but you are also creating a potential mess with taxing authorities and regulators, including the IRS.

## **Failing to maintain trust account records**

ABA Model Rule of Professional Conduct 1.15 recommends that lawyers should maintain trust account records for at least five years after the termination of the representation. Some states require longer periods and start the retention period with the last disbursement of funds.

Best practices suggest that you should keep online records as well as hard copies of every important document. Print and securely store all client ledgers, monthly reconciliation reports, and trial balances for receipts and disbursements. And, make sure to back up your electronic records frequently.

## **What is the best way to handle client retainers?**

The best approach to managing retainers is one that complies with your jurisdiction's requirements, meets your clients' expectations, and is the easiest for you to manage.

In many cases, that will mean that you should keep client retainers in your trust account. A few jurisdictions will allow you to keep a retainer in your operating account. Check your state's rules if you're not sure of the requirements.

No matter which account you choose, the key is to keep good records of your client trust funds. You must make sure you know which client and matter to associate the retainer with. You must also keep each client's retainer funds separate, and, if you're keeping the retainer in your operating account, keep it separate from other firm funds. This is why client ledgers are so important: you must be able to segregate each transaction for each client and keep up to date with each client's balance.

It's also prudent to keep your clients apprised of the status of their retainer balance. That way, when the retainer fee is running low, you won't ever have work in progress that exceeds your retainer balance. Legal practice management software can alert you when a client's retainer dips below a certain level.

## **How do I properly track, record, and pay settlement transactions?**

Settlement checks can pose another accounting quandary for lawyers—especially if settlement checks are jointly payable to the lawyer for fees and expenses with the balance going to the client.

Settlement checks are the client's property and should be deposited in a client's trust account or an IOLTA account—never in the firm's operating account. Before depositing the check, make sure the client and the firm both sign the check if the check is made out to both parties. Record the client number, matter number, and matter description on the check. Copy or scan the check, saving the copy in the client's file.

The lawyers should present information to the client that explains how they propose to disburse the funds. This statement should spell out what funds will be payable to the client, what portion will cover fees and expenses, and what if any, portion will be paid to a third party. You should be able to get a copy of the expenses paid from your practice management system.

Sending a report for the client to review also allows time for the settlement check to clear. Lawyers

cannot advance funds from a trust account to pay the client while they wait for the bank to process the check.

After the check has cleared and the client has approved the disposition of funds, the lawyer should transfer the funds from the trust account to the client. Before doing so, prepare an invoice detailing your fees and expenses, then write a check from the trust account payable to your firm. The check should include the client's name and matter number. Be sure to record the transaction in your client's account ledger, then deposit the payment in your firm's operating account. Write any other checks to your client and third parties as required by the settlement statement.

Finally, check for a zero balance. Run a client ledger report that shows all deposits and checks written. When you're satisfied that you've reconciled all of the transactions, send the settlement statement, settlement check paid invoice, ledger report, and signed settlement agreement to the client, saving a copy of everything you send in the client's file.

## **What do you do if you mismanage your IOLTA account or client trust account?**

With so many moving parts in trust accounts, it's easy to see how a lawyer might make a mistake. That's especially true if you're using manual bookkeeping methods or Excel spreadsheets to keep track of your accounts. It's always prudent to run your accounting methods by a professional accountant who has experience with trust accounts and IOLTA accounts.

If you're worried that you've made a mistake, a smart first step is to check with a practice management advisor in your state. Many of these advisors work confidentially, so they can advise you without reporting any ethics violations to the bar. Visit your state bar website to learn whether you have access to a free advisor.

In most cases, the safest bet is to self-report a mistake and take good faith steps to correct it immediately. The failure to report can be as bad as, if not worse than, the initial accounting mistake.

## **How to use technology to simplify the trust accounting process**

As you can see from this guide, trust accounting can be challenging. But it doesn't have to be another headache on top of the stresses of your law practice.

The first step is to put down the pencil and paper—or even the Excel spreadsheet. And if you want to really get serious about your accounting and recordkeeping, you need to ditch small business accounting platforms that weren't designed specifically to meet lawyers' needs.

You need a [legal practice management platform](#) that includes full billing and accounting capabilities, making sure that you're able to track every last penny and satisfy your ethical obligations to your clients.

To find a tool that's able to resolve your biggest trust accounting challenges and meet your firm's needs, look for a platform equipped with the following capabilities:

- Linking each trust transaction to client and matter details, including the source or payee, amount,

date, matter, and its purpose

- Building comprehensive client trust ledgers that track all transactions from the first deposit to the last disbursement
- Preventing the entry of a trust transaction unless an associated client matter is specified
- Filtering data by client, matter, date range, and transaction type
- Identifying and maintaining all funds in a single trust account (IOLTA) for individual client matters
- Moving funds easily from trust accounts to operating accounts
- Preventing errors such as overdrafts and duplicate check numbers
- Closing reconciled books to prevent inadvertent editing of transactions
- Tracking voided transactions to maintain an accurate audit trail
- Archiving monthly reconciliation statements for audit
- Sequentially numbering cleared and outstanding transactions
- Handling three-way reconciliation
- Preparing a three-way reconciliation statement linking bank balance, book balance, and individual ledger balances
- Reporting monthly on receipts, disbursements, and running balances
- Running ledger balance reports that show portions of each client trust account that have and haven't cleared
- Printing disbursement checks

Features like these can make the difference between an inefficient trust account management process that's prone to errors and bookkeeping and accounting systems that run like clockwork, enabling you to meet your ethical obligations and client trust account reporting requirements.

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