

## Oregon State Bar Bulletin — MAY 2015

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Embezzlement — the theft of assets, including money or other property by a person in a position of trust or responsibility over those very same assets, usually in an employment setting — is an act of betrayal. The victim often feels like “How could this happen to me?” The good news is that you don’t have to become a victim of embezzlement. Fortunately, you can learn to spot the red flags and learn what steps to take to safeguard your law practice against lawyers or staff that may have the motive, means and opportunity.

The biggest and most common asset in most law firms is client money in the lawyer trust account. Who has oversight of that money? The lawyer may say, “I’m just not good with numbers” or “I’m too busy to handle the bookkeeping” and delegate complete oversight to a trusted staff member. Ultimately, the lawyer is responsible and therefore must oversee the staff member.

Many firms commonly do not have appropriate safeguards in place. Perhaps it’s because of a misplaced belief that the law firm auditor will catch any embezzlement attempts. Maybe there is no law firm auditor. But it’s just likely that lawyers prefer to believe this type of problem would never happen in their own firm.

Here are a handful of embezzlement examples:

1. At a sole practitioner's office, \$60,000 was embezzled from a trust bank account on which the lawyer was serving as trustee. Who embezzled? It was the trusted legal assistant. The lawyer only found out when the bank called about the irregularity of the large cash withdrawal.
2. In a small firm, a trusted staff person, relied upon by the firm for over 18 years, funded her growing addiction to Internet shopping by embezzling close to \$100,000, much of which belonged to clients. Checks that should have been properly credited and deposited to the lawyer trust account or to the firm's general business account were misappropriated. Many instances of the embezzlement were accomplished by the staff person depositing client checks directly into her personal account through the ATM.
3. A sole practitioner with a home office felt too busy to closely monitor receipts and disbursements in both the lawyer's trust account and lawyer's general business account. An experienced legal assistant did everything from answering the phone to handling the monthly billing and banking. While the lawyer was making court appearances, the legal assistant was embezzling over \$25,000 from the trust account and the general account. How was the situation brought to light? The attorney switched to a basic money management program that could download all banking transactions to help her reconcile accounts. When the transactions were sorted, the numerous bank service fees prompted her to ask the bank for an explanation.
4. An associate responsible for corporate real estate transactions diverted and shuffled money into funding holding companies. He devised elaborate and meticulous chains of moving money from company to company to company to lawyer. The trail was well disguised but eventually led back to the associate.
5. A partner at a smaller firm was the self-appointed manager of the firm's finances. Unfortunately, the partner had a gambling problem and "borrowed" a number of "interest-free loans" from the firm's bank accounts and the firm's client. Money borrowed from client A was repaid by client B, who was repaid by client C, and so on. It got too confusing and collapsed.

Motive, means and opportunity can result in that perfect storm of conditions leading to embezzlement. Spotting warning signs at any stage can go a long way toward identifying and thwarting an ongoing fraud.

### **Motive**

What motivates a partner, associate or staff member to commit an act of embezzlement? It can be a need for cash, real or imagined. There may be a financial reversal, some unaddressed addiction or mental illness, or some other catastrophic personal crisis. There may be a desire to finance an unrealistic and unsustainable lifestyle befitting a "successful attorney." It can even be an irrational desire on the part of the embezzler to make things "right" because the embezzler views himself or herself as someone who is underpaid and underappreciated.

Look for someone undergoing financial stress. Watch for potential red flags such as someone who persistently asks for advances on pay, or pay raises, or someone who complains about performance reviews. These behaviors don't necessarily but may indicate the person could be motivated to defraud your firm.

Beware of an employee who refuses to delegate anything, works extraordinarily long hours after everyone else has left the office and never takes sick leave or vacation. Perpetrating a scam requires vigilance and maintenance.

Pay attention to someone exhibiting an extreme change in personality or lifestyle. A drastic change in temperament could be a sign of the increasing pressure of maintaining a fraud. What about a dramatic improvement in lifestyle? Investigate further the sudden acquisition of a brand-new luxury home, luxury car and designer clothing or other outer trappings of newfound wealth.

Lawyers who are not meeting law firm performance targets may become distressed and motivated to commit embezzlement. Increased nonbillable activities may be concealing ongoing embezzlement. Partners who have launched on a career trajectory that is unsustainable may succumb to investing in the great business deal of the firm's client and need to fund the investment capital with embezzled funds — a short-term loan. The intention to pay it back before anyone finds out may become the payback time that may not come.

### **Be on the Lookout for Opportunity and Means**

Partners have the greatest opportunity to embezzle because their law practice is usually conducted with greater autonomy and privacy than that of associates. In addition, they may often be in the sole position to override internal controls in the firm.

However, both partners and associates who have direct client contact may have opportunities for embezzlement. For example, litigation lawyers may divert settlement funds; commercial and real estate lawyers may divert sales and mortgage proceeds; estate administration and probate lawyers may divert funds from liquidation of estate assets; or the attorney on a smaller scale diverts money earmarked for a litigation charge such as expert witness fees.

Staff members rarely use dummy corporations or divert payments through clients of the firm. Instead they usually take advantage of flaws in accounting and internal control systems to divert payments to spouses, other family members or family businesses, or they may invent fictitious clients or suppliers. Often the wrongdoing staff member simply deposits the check payable to the firm into his or her private bank account, taking advantage of ATMs to conduct the fraudulent transfers.

Watch out if your assistant can boast that he or she can copy your signature! Forged signatures may be so prevalent on law firm documents — think: emergency letters, pleadings that have to get out when the lawyer is out of the office — that these forged signatures no longer arouse suspicion when they're used for personal purposes. It is hard to believe that a lawyer would allow and even direct an assistant to sign the lawyer's name to a pleading in the lawyer's absence, but it happens. This very scenario enabled

one assistant to launch an embezzlement scheme that went on for 18 months. The lawyer knew nothing about the new client who paid a cash retainer pocketed by the assistant. The assistant diverted the follow up from the resulting bar complaint by destroying all letters of investigation from the bar discipline counsel and not relaying voicemail. Finally, the assistant tendered the lawyer's resignation when it became apparent that the lawyer was going to be subpoenaed for depositions.

Even if your firm has formal checks and balances in place, informal procedures often happen daily at law firms. It's these exceptions to the normal checks and balances that need to be eliminated because they allow an employee to circumvent the normal process for his or her embezzlement scheme. Watch for anyone with the ability to go into a lawyer's office from another part of the firm and asked for a rush approval signature for an urgent transaction. Partners who inattentively sign checks in this way are eliminating controls and opening an enormous window of opportunity. Best practices call for separate check issuance and separate check requisition and separate approvals. Be alert to any requests to deviate from safe divisions of duties because you are losing your opportunity to detect irregular transactions.

The embezzler is by definition a person in a position of trust. Typically this means a person who has been with the firm for a long time. This individual is usually given an inordinate amount of discretion so he or she can circumvent normal office procedures without raising suspicion. For example, you may require two signatures on any office check over \$5,000. Your bank will not want to be responsible for ensuring that your internal requirements are complied with. Thus it is easy for a single-signature check over the \$5,000 two-person limit to be negotiated. Your long-term coworker knows this. Be aware that a frequent window of opportunity for rushing checks through arises near an accounting deadline to close the books, especially if it's late on a Friday afternoon when the usual check signers have left for the weekend.

Realize that allowing normal procedures to be overridden by trusted employees can provide the means to carry out embezzlement. If there are no checks and balances in place such as having a two-person execution and verification of checks, then it becomes too easy for one person to pull off an active embezzlement. Don't enable embezzlement by allowing the same individual to open the mail, write the checks and reconcile the bank statements and client ledger accounts. You may want to insist that all employees take at least one vacation of two consecutive weeks yearly, because you can more readily identify irregularities over a two-week period.

### **Monitor Your Practice**

Here is where you might want to start an investigation. Look at areas where large amounts of cash are flowing through the firm's trust accounts: plaintiff personal injury work, large commercial practices, particularly commercial real estate, or wills and estates practices. Within these practice areas, files involving vulnerable or institutional clients where bills may be less likely to be scrutinized or even questioned are most exposed and vulnerable. Beware if the lawyer is the signing officer for corporate clients and refuses to bill the client for filing fees or work done. These may indeed be red flags that you should be heeding.

Make these practice areas the focus of "surprise audits," rotate your staff routinely or enforce separation of duties. Have your accounting department check that clients and suppliers are regularly receiving the payments issued by the firm. Review all firm checks for any handwritten amendments to the payee or look for double endorsements of the checks when they come back from the bank in electronic form. Insist on seeing the checks and the monthly bank statement. It is a wise practice to have the managing partner receive the bank statements at home so he or she can review them first or bring them into the firm opened and process them along with the staff person who is responsible for managing the law firm's bookkeeping. It is highly unlikely that the managing partner and the staff member will be co-conspirators.

Watch for any change in pattern, such as a sudden increase in payments to a particular person, which may indicate double billing, or checks payable to persons with the same last name as any employee. When employees embezzle, they generally alter, forge or even destroy checks, sales invoices, purchase orders, purchase requisitions or receiving reports. Red flags to watch for include missing documents, names of payees or customers that are similar to those of firm members, addresses that are similar to those of firm members or even post office box addresses.

Further investigation to see if the firm's payments are being redirected by staff is warranted in any of the following occurrences:

The firm is getting past-due account notices for bills that should have been paid on time.

The firm is seeing second endorsements appearing on firm checks when they come back from the bank.

The firm is coming across documents that appear to have been altered, or there are handwritten marks on documents that appear questionable.

The firm cannot find original documents.

The accounting department or staff person is in a position to find fraud at the concealment stage when it notices missing or altered documents, miscounts or other anomalies. Unfortunately, the accounting personnel often goes to the suspected party first for an explanation. Not suspecting fraud, the accounting staff may be readily satisfied with the explanation given by the respected member of the firm and may even allow the suspected party a second chance to "substantiate" the transaction which the fraudster does with forged documentation.

You will often find that those who work more closely with the fraud perpetrator will witness the fraudulent act and comment on the unusual way the transaction has been handled or explained. Coworkers are familiar with each other's personalities and lifestyles and are in a position to identify extreme changes in behavior or finances. Statistics show that most embezzlers and fraudsters are caught by coworkers who provide their employer with an anonymous tip, not by auditors. Capitalize on this by instituting an anonymous whistle-blowing procedure to facilitate the detection and investigation of fraud and embezzlement. Honest employees who are vigilant for fraud are your most important investigative tools.

## Dealing with a Suspected Fraud

If you suspect fraud, proceed with caution. Investigators usually state that acts of fraud and embezzlement often end up being more complex than they first appear to be. Respond with tact and care to ensure that you comply with your obligations under the rules of professional conduct, your professional liability coverage and employment law requirements.

Approach any investigation of embezzlement on the initial presumption that there is an innocent explanation for what has occurred. Record and investigate all exculpatory evidence. Don't hesitate to pursue the investigation because a trusted longtime employee appears to be involved.

If the fraud or embezzlement involves client trust funds or property, or if there is the possibility of a negligence claim, you should report the fraud to your professional liability carriers (primary and excess), fidelity insurers or bonding companies and any other potential insurer or carrier that might insure this type of loss. The goal is to not jeopardize any possible coverage. (The PLF does not automatically cover these losses, but it might, depending upon the facts and circumstances.)

Look into your ethical duties under the Oregon Rules of Professional Conduct, which require you to report another lawyer's professional misconduct. RPC 8.3 states, "A lawyer who knows that another lawyer has committed a violation of the Rules of Professional Conduct that raises a substantial question as to that lawyer's honesty, trustworthiness or fitness as a lawyer in other respects, shall inform the appropriate professional authority."

Confront the embezzlement suspect last. People can react unpredictably if they feel threatened or if they have been under pressure for a long time. Conduct interviews privately with at least two management personnel present to serve as witnesses. Ensure that other employees are not nearby. Meet before or after work hours. Do not invade the suspected embezzler's privacy at the office. Do not look into his or her briefcase, purse or other personal possessions without express permission. A technology use policy should give the firm the right to review email and data on any employee's computer.

## Departing Employees

Use a departure checklist during any confrontation meeting with a suspected embezzler. This situation requires a great deal of sensitivity and tact. Until there is a police investigation and criminal proceeding, there is only alleged embezzlement.

An ounce of prevention is worth far more than a pound of cure when it comes to embezzlement. Every law firm will be best served by taking proactive steps to prevent it. Not only will this help to keep your law firm safe, but it may also keep troubled employees safe from stepping over the line.

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