

## THE THREAT FROM WITHIN: THEFT AND FRAUD INSIDE LAW FIRMS

### Introduction:

Many media stories detail instances of theft and fraud occurring within law firms. In Virginia, a former account manager and bookkeeper forged law firm checks totaling more than \$500,000 to fund investment accounts, purchase a BMW, and pay her mortgage.<sup>1</sup> In Minnesota, a long-time partner embezzled close to \$2 million from his law firm and clients over a sixteen-year period by submitting false expense reports from dummy entities in order to pay for extensive renovations to a historic mansion that he owned.<sup>2</sup>

In Georgia, an associate lawyer at a national law firm stole more than \$500,000 by performing investigative services for clients and then submitting false invoices under the name of an investigator who worked at the firm but did not work on the billed matters. He also performed title examinations himself and then billed his employer under a fictitious vendor name and social security number that he obtained from documents in a bankruptcy proceeding.<sup>3</sup> In Pennsylvania, a paralegal handling estate matters for her law firm forged the signature of the executors of the estates to steal more than \$100,000. She had stolen the money to pay restitution to her former employer, a New York law firm from which she had stolen \$285,000.<sup>4</sup>

Theft and fraud at law firms is not limited to the theft of funds from the law firm. Theft of client trust funds is also a problem. Additionally, attorneys may commit many different types of fraud: securities fraud; expense fraud; title fraud; and fraud involving collusion with other attorneys, clients, real estate agents, and other third parties. While these frauds are often committed for self enrichment or to cover up an ongoing theft, they are also committed by an attorney overbilling to enhance the attorney's stature in the firm or to cover up performance deficiencies.

In New York, for example, a respected partner at a large law firm reaped approximately \$17 million in illicit profits by illegally trading shares in a number of companies where he helped structure private investment in public equity (hereinafter "PIPE") transactions. Shares in PIPE transactions must be registered with the United States Securities and Exchange Commission before they can be publicly traded. The partner defrauded other investors by buying his clients' unregistered and restricted PIPE shares and selling them to others as registered and freely tradable.<sup>5</sup> In Massachusetts, a partner at a law firm defrauded almost \$2 million from banks and title insurance companies by submitting false mortgage loan applications and issuing false title insurance policies that stated the lender was in first lien position when in fact the lawyer caused multiple "first" mortgages to be placed on a single property.<sup>6</sup>

As the above stories illustrate, theft and fraud can be committed by anyone in a law firm, regardless of stature or title. In fact, it is usually the long-term, trusted employee who is in the best position to execute

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<sup>1</sup> Alan Cooper, "Law Firm Bookkeeper Pleads Guilty in \$567,075 Theft," The VLW Blog, July 8, 2011, <http://valawyersweekly.com/vlwblog/2011/07/08/law-firm-bookkeeper-pleads-guilty-in-567075-theft/>.

<sup>2</sup> Rochelle Olson, "St. Paul Lawyer Michael Margulies Leaves Trail of Missing Money," The Star Tribune, April 15, 2010, <http://www.startribune.com/local/stpaul/90898154.html>.

<sup>3</sup> Mike Morris, "Attorney Pleads Guilty to Stealing \$500,000 from Law Firm, The Atlanta Journal Constitution, October 20, 2010, <http://www.ajc.com/news/attorney-pleads-guilty-to-686306.html>.

<sup>4</sup> Zack Needles, "Paralegal Charged with Stealing Funds from One Law Firm to Pay Restitution to Another," Law.com, May 19, 2009, <http://www.law.com/jsp/law/LawArticleFriendly.jsp?id=1202430809517>.

<sup>5</sup> Patricia Hutardo and Joel Rosenblatt, "Ex-McGuire Woods Lawyer Gets Three-Year Term in PIPEs Case," Bloomberg News, February 28, 2011.

<sup>6</sup> "Former Boston Attorney Sentenced to 4 Yrs in Prison for Mortgage Fraud," The Mortgage Fraud Reporter, May 19, 2011.

a continuing and damaging illegal scheme.<sup>7</sup> After learning that a well-liked paralegal had stolen more than \$100,000 from her law firm, one of the partners described the situation as heartbreaking and added: “She was a valued member of the firm. She was treated like family. We attended her wedding.”<sup>8</sup>

### **Recent Increases in Workplace Fraud:**

There has been a 17% increase in major embezzlement cases from 2009 to 2010.<sup>9</sup> According to the Association of Certified Fraud Examiners, the average workplace fraud costs employers \$160,000.<sup>10</sup> In tough economic times and a poor job market, the temptation to steal from an employer can be heightened. Additionally, some employees who feel that their work is not appreciated or compensated appropriately may feel entitled to steal from an employer, regardless of the state of the economy or the employee’s financial situation.

### **Risk Control Techniques to Prevent Fraud:**

Law firms need to guard against becoming the victim of their own employees’ avarice. By recognizing this growing problem, screening potential employees carefully, watching for warning signs, and implementing antitheft and antifraud policies and procedures, law firms can protect their clients and themselves from the economic loss and reputational damage associated with this type of malfeasance.

#### Screen Potential Employees Carefully

Law firms that do not perform complete background checks on job candidates run the risk of employing someone with a history of job changes, relocations, civil litigation or criminal prosecution that could be warning signs of past embezzlements or frauds. Employment history, application information and references should always be verified.

Past employers can be a fruitful source of information about a candidate’s prior misdeeds, though, in some instances, legal requirements may limit what they may disclose. Law firms that fail to follow these basic hiring protocols may also be liable for any harm that its employee later causes to third parties.<sup>11</sup> A law firm should consult with an experienced employment law attorney to ensure that its screening procedures are in compliance with applicable state and federal law.

#### Watch for Warning Signs

While there is no foolproof way for law firms to screen out future embezzlers, there are certain warning signs that employees may send out that should warrant careful attention. One organization that monitors embezzlement cases concluded that there are five major motivating factors that cause employees to steal from their employers. They are:

- Financial problems
- Gambling problem/addiction
- Desire to live lavishly

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<sup>7</sup> Patricia Schaefer, “Employee Theft a Big Problem for Small Business,” [www.businessknowhow.com](http://www.businessknowhow.com), 2006.

<sup>8</sup> David Ovalle, “South Florida Paralegal Charged with Embezzling from Law Firm,” The Miami Herald, July 19, 2011, <http://www.miamiherald.com/2011/07/19/2321513/south-florida-paralegal-charged.html>.

<sup>9</sup> The 2010 Marquet Report on Embezzlement, p.4, [www.marquetinternational.com](http://www.marquetinternational.com)

<sup>10</sup> 2010 Report to the Nations on Occupational Fraud and Abuse, Association of Certified Fraud Examiners, p. 4, <http://www.acfe.com/rtnn/2010-rtnn.asp>.

<sup>11</sup> *Selechnik v. Law Office of Howard R. Birnbach*, 920 N.Y.S.2d 128 (App.Div. 2011).

- Substance abuse
- Support of a personal business<sup>12</sup>

In the vast majority of cases, greed or the desire to live a relatively more lavish lifestyle appears to be the key motivating factor—not to alleviate personal financial problems, as some might expect.<sup>13</sup> Accordingly, law firms should closely monitor employees that appear to be living beyond their means or are known to be experiencing financial difficulties.

### Pay Attention to the Business Aspects of Running a Law Firm

A number of frauds that involve the embezzlement of firm or client funds in the custody of the law firm can be detected or prevented through the institution of appropriate oversight and supervision. While every practice may be different, no lawyer should be immune from oversight, including senior and managing partners.

Many embezzlement schemes and other financial frauds are facilitated because law firms do not have strict internal controls. Lawyers may be more concerned with practicing law than with managing the routine day-to-day operations of their law firm's business practices. Attorneys are sometimes reluctant to spend time on tasks that do not generate revenue for the law firm (i.e., non-billable work). As a result, lawyers who should be managing the day-to-day operations instead entrust their employees with these tasks, as well as access to the firm's financial data and instruments which makes the firm vulnerable to fraud. Some unscrupulous employees will take advantage of a lawyer's lack of interest and attention to the business aspects of running a law firm. Studies show, however, that a person's willingness to steal is inversely proportional to the perceived risk of being discovered. In other words, those who believe that they will be caught engaging in fraud are less likely to commit it.<sup>14</sup> Law firms can often prevent these crimes of opportunity by establishing clear policies against fraud and theft, instituting effective internal accounting and financial controls, and exercising oversight for such procedures.

### Implement Antitheft and Antifraud Policies and Procedures

- **Emphasize the Importance of Ethical Behavior**

In addition to having a written policy that prohibits theft, fraud, and other misconduct, firms should conduct periodic training sessions to educate attorneys and support staff on the significance of maintaining an ethical workplace. This message should be delivered in both regular in-person meetings with all employees and periodic written communications.

- **Reconcile Bank Account Statements**

Fraud is frequently accomplished through the use of the law firm's bank accounts. Bank statements should be reconciled regularly, with the electronic check copies provided.

The proliferation of online banking means no waiting for monthly paper statements. Lawyers should periodically check their law firm's transactions online to ensure no irregularities in its financial transactions. Additionally, law firms should consider establishing individual trust

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<sup>12</sup> The 2010 Marquet Report on Embezzlement, p.12.

<sup>13</sup> *Id.*

<sup>14</sup> Joseph T. Wells, "Let Them Know Someone's Watching: From the Boardroom to the Mailroom, All Fraudsters Think Alike," Assn. of Certified Fraud Examiners, May 2002, <http://www.acfe.com/resources/view-content.asp?ArticleID=23>.

accounts for their clients and allowing them to review their account activity online in order to quickly address any discrepancies.

Any potential improprieties in a law firm's or client's account must be timely reported to the bank. The Uniform Commercial Code severely restricts a depositor's right to sue the bank if it is not notified promptly of any discrepancies, and some banks have contractually shortened the reporting time period to within 60 days of the depositor receiving the bank statement.<sup>15</sup>

- **Review Accounts Payable/Receivable**

Lawyers should review transactions in the deposit and disbursement reports on a monthly basis so that any discrepancies can be addressed immediately and small thefts can be stopped from growing into large thefts. Since lawyers are ultimately responsible for the financial statements of the law firm as well as any client funds that they hold, lawyers should exercise proper oversight into this review process. There are many software programs available to assist lawyers in monitoring a law firm's accounts payable and receivable.

- **Require Dual Signatures on Checks**

Many embezzlement schemes in law firms thrive because wrongdoers have access to checks from the firm's operating or trust fund accounts. One way to guard against this threat is to require that all outgoing checks require dual signatures. Prohibiting the use of signature stamps to endorse checks improves a law firm's risk profile as well. Law firms should prohibit the signing of blank checks, even if this method has been used in the past successfully. Additionally, a law firm may want to mandate that the managing partner or other senior partner personally sign all checks that are at or more than an established threshold amount.

- **Rotate Job Duties When Possible**

The vast majority of major embezzlers in law firms are acting alone.<sup>16</sup> Law firms should be especially wary of an employee who handles multiple duties; who is the only employee that knows certain job duties, computer software systems, or financial systems; and who is "too busy" to respond to reasonable requests for information.

Such "lone wolf" employees sometimes foster such isolation in order to perpetrate a fraud that others may not be able to detect. These employees can often easily destroy or alter signs of their illicit scheme when no one else at the law firm is privy to such information. Cross-training employees to handle different tasks, especially those related to finances and accounting, can reduce a law firm's risk of being victimized by the lone wolf employee.

- **Separate Job Functions Related to Finances and Accounting**

Fraud prevention should be a component of a law firm's structure. For example, the law firm employee who writes checks should not be responsible for reconciling bank statements. If the office manager receives equipment and inventory, someone else should be responsible for initiating the purchase order. Similarly, the person who issues payroll checks should not be

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<sup>15</sup> U.C.C. §4-406(2001); *see also National Title Ins. Corp. Agency v. First Union Nat'l Bank*, 559 S.E.2d 668 (Va. 2002).

<sup>16</sup> The 2010 Marquet Report on Embezzlement, p.5.

allowed to maintain the law firm's personnel database. Keeping these job functions separate renders it difficult for a law firm employee to defraud the law firm alone.

- **Enforce a Mandatory Vacation Policy**

Related to rotating job duties and separating job functions is ensuring employee time off and vacations. Law firms can uncover financial improprieties when a wrongdoer is away from the office.

In one recent case from Illinois, an office manager who had been with the law firm for more than 20 years embezzled close to \$900,000 by writing checks to herself and to an upscale lunch club where she and her mother dined. The law firm uncovered the theft after a \$40 reimbursement check bounced while she was on vacation in Hawaii.<sup>17</sup>

- **Protect Against Fraud by Law Partners or by Managers Overriding Internal Controls**

Perhaps the most difficult type of fraudulent conduct for law firms to detect is the illicit scheme committed by partners or managers of the law firm. To help guard against such frauds, law firms should institute some level of supervision over these high-ranking firm members. Law firms should establish an ethical culture by protecting employees who make good faith inquiries or allegations concerning the activities of all firm employees, including partners and managers. Forming a committee comprised of lawyers and non-lawyer staff to investigate complaints of reported irregularities within the law firm may reduce a law firm's risk of loss due to fraud. Lawyers should be mindful that if they discover another attorney at their law firm engaged in fraud or criminal conduct, they may have a duty to report such misconduct to the appropriate lawyer disciplinary authority.<sup>18</sup>

- **Conduct Surprise Independent Inspections of Your Books**

Law firms should carry out unscheduled inspections of financial records to help better prevent misfeasors from altering or destroying incriminating records than if the inspection was announced in advance or part of a regularly scheduled examination. Publicizing the fact that the law firm conducts independent surprise inspections may also deter employees from attempting to steal funds.

- **Establish a Reporting Program**

A written policy that prohibits theft, fraud, and other misconduct should include direction to employees on how to report suspected or actual misconduct. In an effort to encourage reporting, the law firm should consider allowing employees to make reports anonymously. Employees should be assured that their anonymity will be protected whenever possible and that no retaliation will be tolerated against those who report allegations of misconduct in good faith.

### Responding to the Discovery of a Theft or Fraud

In the event a fraud or theft is discovered, the law firm should consult with external attorneys specializing in employment, criminal, or securities law, as applicable, prior to taking further

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<sup>17</sup> Martha Neil, "Former Law Firm Manager Gets 8 Years for Stealing \$884K; \$47K Spent on Lunch Club Meals with Mom," ABA Journal Mobile, April 13, 2011.

<sup>18</sup> See ABA Model Rule 8.3.

action. Insurance carriers, police, and possibly regulatory authorities will need to be notified. The lawyers should also consider the firm's obligations to notify potentially affected clients or third parties, as well as the need to manage public relations in the event the fraud or theft becomes public.

Insurance coverage applicable to theft and fraud losses and third party claims varies widely depending on the facts and circumstances, so it makes sense for the firm to consult with the firm's insurance agent regarding applicable coverage and reporting obligations.

## **Conclusion:**

Law firms should take a proactive approach to protect themselves from the risk of theft and fraud by their own attorneys, managers or support staff members. In addition to following the guidelines and employing the risk control techniques discussed above, it is important for law firm leaders to consistently reiterate the importance of ethical behavior within the workplace and to conduct themselves accordingly. Employees who know that their law firm employers take ethics seriously and have appropriate risk control measures in place may be less likely to attempt to steal or commit fraud.

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