Trial®

Client trust accounts in the age of bank failure

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Client trust accounts always require careful handling. That's even more important in these days of financial crisis and economic insecurity. Take extra care to keep those funds secure—and protect yourself from liability.

The troubling state of the economy presents new challenges for lawyers who handle bank accounts set up to hold client funds, also known as Interest on Lawyers Trust Accounts (IOLTA). While we must always be mindful of our fiduciary responsibilities when handling client funds in trust and at disbursal, this is especially important now, when more bank failures are a distinct possibility.

How do we protect our clients in the face of financial meltdown? The first—and essential—step is gaining a solid understanding of deposit insurance, IOLTA accounts, and our fiduciary duties regarding client funds that are held in trust.

The Federal Deposit Insurance Corp. (FDIC) is an independent corporate entity established by the federal government. It protects financial customers against the loss of deposits, including funds in IOLTA accounts. According to its Web site, "the FDIC insures more than $5 trillion of deposits in U.S. banks and thrifts—deposits in virtually every bank and thrift in the country." The FDIC is funded by premiums charged to financial institutions—not taxpayers—and is backed by the full faith and credit of the U.S. government.

Until recently, the FDIC insured accounts up to $100,000, but in October 2008 the FDIC raised that limit to $250,000. The change was part of the Temporary Liquidity Guarantee Program (TLGP), adopted by the FDIC's board of directors to ensure stability and confidence in our struggling financial system. A month later, the FDIC went even further and announced that IOLTA accounts would be fully insured regardless of the amount in the accounts, provided certain conditions are met.[1]

Two important facts regarding these developments are relevant to the status of IOLTA accounts: The protections are not universal, and they are not permanent. Financial institutions had an opportunity to opt out of this expanded coverage (a subset of the TLGP called the Transaction Account Guarantee Program), and some did.[2] IOLTA accounts at those institutions that have opted out will continue to be insured through December 31, 2009, for up to $250,000 under the FDIC's general deposit insurance rules. For those institutions that opted for the expanded

coverage, the protections expire at the end of this year, when the FDIC limit will revert to $100,000 absent further congressional action.[3]

FDIC regulations and state bar association rules (many are patterned after Rule 1.15 of the Model Rules of Professional Conduct) require that lawyers maintain accurate records about their IOLTA accounts and be able to identify and separate the different client funds pooled into each account. This seems like basic common sense, but some attorneys fail to do it.

Many state bar associations go further than the model rules, mandating that IOLTA accounts be held in financial institutions that meet certain requirements, including pre-approval by the bar. In reality, it may not be enough to rely on these criteria—after all, the fiduciary responsibility to your client and his or her funds and property lies with you, not the bar association or another third party.

The FDIC specifically requires that trust account records reveal the existence of a fiduciary relationship as a precondition of insurance coverage. The fiduciary nature of the account must be disclosed in the bank's deposit account records. The name and ownership interest of each owner must be ascertainable from the deposit account records of the insured bank or from records maintained by the agent (or by some person or entity that has agreed to maintain records for the agent). Once these conditions are satisfied, funds in participating institutions attributable to each client will be insured in whatever right and capacity that client owns the funds.[4]

If an IOLTA account in a participating institution contains funds that belong to one person, the money will be insured up to the limit, whatever it happens to be at the time. Currently, there is no limit, but the original $100,000 limit is expected to return in 2010. Put another way, before the original FDIC limits were temporarily removed, if a lawyer had $500,000 deposited in his or her trust account on behalf of five clients, the FDIC insurance coverage would apply for up to $100,000 for each client.

Potential pitfalls

So if the FDIC has waived the coverage limit on IOLTA accounts, does this mean you needn't care about ensuring that your clients' deposits don't exceed the FDIC's original $100,000 limit? Absolutely not.

First, there is no guarantee that the waiver will extend beyond the December 31 deadline. And absent congressional action there's every reason to believe that when it expires, the original $100,000 limit will be back in force on January 1.

Given that, you should manage your client's IOLTA accounts as if no waiver exists to avoid this worst-case scenario: Your client's deposits exceed $100,000. The waiver expires on December 31, 2009. The client's bank goes under on January 3, 2010. The client loses all her money and tells you she's thinking about suing you for legal malpractice for not ensuring that her deposits were protected.

There have been few reported claims for legal malpractice against attorneys based on liability for loss of uninsured client funds in a bank failure.[5] Those cases turned on whether the bank's failure was foreseeable; a quick check of the headlines today suggests that this defense will be difficult to maintain in future litigation.

One trap for the unwary is the possibility that your client may have other accounts at the same financial institution where you have set up your IOLTA account. This is more plausible than you might think in the age of mergers—especially in smaller communities that have fewer banks.

Lawyers, like most people, tend to combine all their banking at the same place, for convenience and security. But this can lead to trouble. For example, say you hold $100,000 in your trust account for a particular client and that client also has a $100,000 certificate of deposit and $75,000 in a savings account, all at the same bank.

Typically, in this scenario, your client's funds would be underinsured. (Of course, that's not the case this year because the IOLTA limits have been lifted for those institutions that opted for the expanded coverage.) Given your fiduciary duty, your failure to know of your client's other accounts can translate into exposure for malpractice and disciplinary action if there is a bank failure.

Your client's business accounts are another concern. Although the FDIC typically considers corporations and partnerships separate "owners" for the purpose of FDIC coverage, many small businesses are unincorporated and typically operate under a trade name without any formal corporate or partnership status. These so-called business accounts would be subject to the same FDIC limits as personal accounts.

Be equally careful with decedent estate accounts—that is, funds deposited by an executor or administrator of a deceased person's estate. These accounts are insured (up to the FDIC limit) as the deceased person's single account funds, and the coverage limit includes any other funds maintained in that person's name.

Coverage is not provided on a per-beneficiary basis: Even if there are several beneficiaries of an estate, the account would be insured only up to the FDIC limit. These funds are insured separately from the personal funds of the executor or administrator.

As far as disciplinary action is concerned, any failure on your part to recognize the FDIC's rules and regulations could be considered a breach of your fiduciary responsibility. As laid out in the rules of professional conduct, this responsibility compels you to be prudent when making decisions about IOLTA funds, including selecting depository institutions and the manner in which accounts are maintained.

Historically, you could reasonably expect to rely on the government's and other sources' assurances that an institution was viable and sound. But these days, as the latest headlines make clear, no one—and certainly no bank— appears safe.

Protective steps

Disciplinary actions and malpractice claims are prospects no lawyer wants to face—especially when there are concrete steps you can take to prevent them. The following suggestions will help you protect your clients' funds—and yourself.

- Be sure that the bank or financial institution where you place your pooled IOLTA account is FDIC insured (check online sources of this information like http://www.fdic.gov/ or http://www.veribanc.com/). Make sure you know whether the bank has opted out of the recently expanded FDIC limits.
- Investigate the bank's financial stability. Have your accountant or financial adviser give you brief, periodic evaluations of the bank's viability and help you develop a plan to protect your clients' funds.
- Let the bank know that the account you are using as a trust account is a fiduciary account; you can simply label it an "IOLTA" or "client trust account" to satisfy this requirement.
- Make sure that the name and ownership interest of each owner (client) is ascertainable from the deposit account records of the insured bank or from records maintained by you as fiduciary in the regular course of business.
- Put the onus on the bank's local executive to alert you to any major changes in its viability or ratings.
- Find out if your clients hold other accounts at the same bank.
- Depending on the applicable FDIC limits, split large trust fund deposits into different banks, spreading the risk and extending FDIC coverage. This is particularly important when you expect a significant delay in disbursal (for instance, you may be waiting for probate disbursals requiring a court's approval or for resolution of Medicare liens).
- Consider holding onto a settlement check instead of immediately depositing the funds when a long wait time for disbursal is likely, as long as this does not violate your state's IOLTA requirements. (Caveat: Given the present uncertain financial status of some insurance companies, holding onto settlement checks may lead to other problems if the payer suddenly becomes insolvent).
- Set up a reminder to revisit your trust fund account practices at the end of 2009, when the waiver of limits on IOLTA accounts is set to expire.
- When dealing with a structured settlement or establishment of a trust, make sure that the consultant you hire to do this exercises due diligence given the current financial climate. Make sure your client is specifically advised of the risks and benefits of various investments.
- Promptly resolve any lien issues well before settlement, so that funds are not tied up because of your failure to act. Any unreasonable delay in disbursal that results in client funds being lost in a bank failure may lead to claims of malpractice or disciplinary action against you.
- Always recommend that your clients meet with tax and finance specialists before they receive funds from an IOLTA account.

The financial world is changing rapidly, and some of those changes can have profound effects on how you protect your clients' money. Make sure you keep up to date on these changes and continue to monitor these funds with care, diligence, and a heightened awareness of potential problems. Doing this will keep you and your clients safer.

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Notes:

1. Press Release, Fed. Deposit Ins. Corp., *FDIC Board of Directors Approves TLGP Final Rule*, www.fdic.gov/news/news/press/2008/pr08122.html (Nov. 21, 2008). For additional information on the TLGP, see Fed. Deposit Ins. Corp., *Temporary Liquidity Guarantee Program Frequently Asked Questions*, www.fdic.gov/regulations/resources/TLGP/faq.html.
2. A list of all institutions that opted out is at Fed. Deposit Ins. Corp., Temporary Liquidity Guarantee Program Opt-Out Lists, www.fdic.gov/regulations/resources/TLGP/optout.html (as of Feb. 12, 2009).
3. The 2008 Emergency Economic Stabilization Act, also known as the financial "bailout" bill, temporarily increased the FDIC limit to $250,000 through the end of 2009, whereupon the depository insurance limit will revert back to $100,000 (unless Congress acts to extend the program or permanently change the limits). Pub. L. No. 110-343, §136, 122 Stat. 3765, 3799 (2008). At press time, Congress was considering H.R. 384, which would make permanent the increase in the standard maximum deposit insurance amount from $100,000 to $250,000. H.R. 384, 111th Cong. (Jan. 9, 2009) (as introduced).
4. The FDIC has a very useful Web site that details the prerequisites for depository insurance coverage, at www.fdic.gov/deposit/index.html.
5. As one court ruled, "There is no allegation that [the lawyer] violated any statute or regulation, much less that he breached the escrow provisions of the contracts. There is no requirement imposed by law that an attorney-escrow agent place escrow funds in an account fully insured by the FDIC, and there are no allegations that [the lawyer] knew that [the bank] was in danger of closing. The proximate cause of [the depositor's] injury, if any, was [the bank's] unforeseen demise." *Bazinet v. Kluge*, 788 N.Y.S.2d 77 (App. Div. 2003) (citation omitted).