By Donald R. Lundberg

Trust accounts in a time of bank failures

These are scary times. With the stock market's fluctuations many of us find ourselves recalibrating the date when we can afford to retire on a weekly basis. Of late, that date seems to keep getting farther and farther away. *But enough about us ...*

Bank failures

There's more to be worried about. On July 11, federal regulators seized IndyMac, a California bank. It has been described as the second largest bank failure in U.S. history. Reports are that there were almost $1 billion in uninsured deposits at IndyMac. There have been eight bank failures this year. Stresses in the financial services industry cause us to wonder whether other bank failures are in the offing. What if your trust account is at a bank that fails? I don't mean to be unnecessarily alarmist. Most banks are on sound financial footing, but that doesn't mean we can ignore a worst-case scenario.

Many lawyers hold substantial client funds in trust – usually in a pooled trust account. Rule of Professional Conduct 1.15 charges us with safekeeping our clients' property, including their money, when it is in our possession. Pooled trust accounts are generally IOLTA accounts. Rule 1.15(f)(4) states: "An IOLTA account may be established with any financial institution insured by the Federal Deposit Insurance Corporation or its equivalent." Our obligation to protect client property would seem to require us to also hold non-IOLTA trust funds in an FDIC or equivalent account.

Insurability of trust funds

How will our client trust funds be protected in an insured account, if the financial institution fails? The Federal Deposit Insurance Corporation insures accounts up to $100,000 in any one financial institution. Funds in a trust account will generally be fully insured if the overall balance is less than $100,000. But what if the balance exceeds $100,000? It depends.

According to the FDIC, fiduciary accounts, including IOLTA accounts, are insured as though the beneficial owner of the funds had directly deposited them so long as two requirements are met. The standards are at 12 CFR 330.5(b).

First, the fiduciary nature of the account must be disclosed in the account title. This should be nothing new to lawyers. Admis. Disc. R. 23(29)(a)(1) requires that trust funds be held in an account clearly identified as a "trust" or "escrow" account and that the financial institution be informed of the purpose and identity of the account.

Keeping good trust account records

Second, the identities and interests of the principals must be ascertainable from deposit account records of the bank or records maintained in good faith and in the regular course of business by the fiduciary or someone acting for the fiduciary. This, too, is a requirement that any lawyer with a properly managed trust account should be able to meet. Admis. Disc. R. 23(29)(a)(2) through (4) describe the records lawyers must keep about their trust accounts, including the ledgers link deposits, disbursements and balances to particular clients.

If these requirements are not met, the deposits will be treated as though they belong to the agent and will be insured only up to a total of $100,000 when combined with any other balances in accounts owned by the agent in the same bank.

Different standards apply to multi-tiered fiduciary relationships – when a lawyer holds funds in trust for a client who is, in turn, holding funds for others as a fiduciary. If you find yourself in this situation, you should consult the regulation. 30 CFR 330.5(b)(3).

A general discussion of this topic is on the FDIC Web site at: *http://www.fdic.gov/deposit/deposits/financial/fiduciary.html*. That Web site is full of other helpful information about insurability of funds.

Each client's funds will be insured

With a properly managed trust account, FDIC will insure funds for each client who has funds in trust at the time of any bank failure up to a total of $100,000 per client. If no client has funds in trust greater than $100,000, there will be full coverage, with one exception. If the client has other funds in the failed bank, those other funds will be aggregated with the trust funds for that client to determine insurability. Thus, if a lawyer is holding $75,000 in trust for a client who also owns another account at the same bank with a balance of $50,000 and the bank fails, $25,000 of that client's funds will not be FDIC insured.

If a lawyer holds funds in trust for any one client who would have more than $100,000 on deposit in that bank, in order to benefit from full insurability of the funds, the funds would need to be spread out over two or more banks so that there is no more than $100,000 for any one client in any one bank. The cost-benefit analysis of doing so is beyond the scope of this

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article. But if you find yourself holding client funds in either a single-client or pooled trust account that exceed FDIC insurance limits, it would be prudent to discuss the situation with the client and determine whether an alternative method of holding the funds is warranted – especially if the funds will be held for a significant period of time or if there is any basis for doubting the bank's solvency.

A non-starter solution to the problem

One enterprising solution to the problem of holding funds in excess of $100,000 in any one bank is a service called CDARS, an acronym for Certificate of Deposit Account Registry Service (*http://www.cdars.com*). Under this program, a participating bank will transfer balances in excess of $100,000 to a sufficient number of other participating banks so that no single bank holds more than $100,000. This is done by agreement with the depositor, but without the depositor's active participation in deciding where the excess funds will be deposited. *Voila!* All of the funds will be FDIC insured because they are spread out among several banks in increments of less than $100,000.

While a clever solution for business or individual depositors, this will not work for trust accounts. Under Rule 1.15(f)(4)(iii), a trust account depository must be approved under Admission & Discipline Rule 23(29)(a)(1). The reason for this is to obtain bank or other financial institution agreement to report overdrafts on lawyer trust accounts to the Disciplinary Commission. An unapproved institution has no such obligation. Because funds in excess of FDIC limits are placed through CDARS in other banks, even out-of-state banks, without regard to whether they have been approved by the Commission, chances are some of the funds will end up in unapproved financial institutions.

Moreover, IOLTA account deposits must be available for "withdrawal upon request and without delay and without risk to principal by reason of said withdrawal." Rule 1.15(a)(4). Because CDARS places funds in other banks in the form of certificates of deposit, the requirement of immediate availability of funds cannot be satisfied.

If a lawyer decides to keep funds of more than $100,000 per client in a single trust account, I have one observation and one question.

The importance of due diligence

The observation: Knowing that some of the funds on deposit for at least one client will not be insured, the lawyer should take great pains to investigate the financial solvency of the bank where the funds are held. The FDIC does not, itself, issue public ratings of bank solvency. But there are many bank rating services that will provide reliable information. The FDIC has collected an excellent list of bank rating services on its Web site at: *http://www.fdic.gov/bank/individual/bank/*

Malpractice liability

The question: If the bank where a lawyer has a trust account fails and there are uninsured losses to a client, is the lawyer liable for the loss? This is an untested question in Indiana and most other jurisdictions. One case addressing the issue is *Bazinet v. Kluge*, 14 A.D.3d 324, 788 N.Y.S.2d 77 (2003). In that case, the lawyer acted as an escrow for funds involved in a real estate transaction. He deposited $2.73 million in his IOLTA account. While the funds were still on deposit, the bank closed, and FDIC became the receiver. Imagine waking up to read that newspaper headline!

One of the parties to the real estate transaction sued the lawyer for the uninsured loss of most of his down payment. The claim was that it was legal malpractice for the lawyer to fail to assure FDIC insurability of all funds or otherwise protect the funds against loss by bank failure. The appellate court held: "There is no allegation that [the lawyer] violated any statute or regulation, much less that he breached the escrow provisions in 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 not 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." *Id*. at 325, 788 N.Y.S.2d at 78.

Without predicting how an Indiana court would answer the same question, a similar analysis would likely hold true in Indiana, at least to the extent that Rule 1.15(f)(4)(ii) requires only that the institution be insured by the FDIC or its equivalent, not that all funds in the account be so insured. But at a minimum, this case stands as a powerful incentive for every lawyer to exercise due diligence to ensure that the bank where they have their trust account is financially sound.

The special case of credit unions

A footnote on credit unions: The definition of "financial institution" at Admis. Disc. R. 23(29)(g)(1) includes credit unions. It seems from this that the Supreme Court did not consider credit unions to be off limits for trust accounts. That said, lawyers should be acutely aware that there are insurability concerns about funds in credit union trust accounts. Credit unions are membership organizations, and the lawyer who has a trust account in a credit union will need to be a member to open the account. So far so good. One problem is that under National Credit Union Administration rules, a member should be eligible to open an agency account only if all of the beneficial owners of the funds in the account are also members of that credit union. NCUA Opinion Letter 96-0841. That's only the eligibility side, something some credit unions apparently disregard.

But what about insurability of funds? Much like with the FDIC, when funds are held in a credit union by an agent, they are insurable as though they were deposited in the name of the principal. Here's the rub, though: If the beneficial owner of funds in trust is not also a credit union member, those funds will not be insured.

It is difficult to imagine that a lawyer will wish to restrict taking trust funds only from those clients who happen to be members of the same credit union. This means that the funds in trust of any client who is not, as is likely, a member of the credit union will be entirely uninsured. This is certainly something lawyers will want to keep in mind as they consider having their trust account at a credit union.

Conclusion

Things are scary and could get scarier. As Sgt. Esterhaus used to tell his cops at the end of roll call in *Hill Street Blues*, "Hey, let's be careful out there." ⚖

The views expressed in this column do not necessarily represent the positions of the Indiana Supreme Court or the Disciplinary Commission.