Bank Failures:  If your bank goes under, are your clients’ trust account deposits fully insured?

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Here is a question that makes lawyers very nervous as the list of failed banks and banks on the “watch list” grows: Could a lawyer be liable if the bank that held a client’s trust funds went under? After reading news articles about the recent collapse of Pasadena-based mortgage lender IndyMac Bank, lawyers are making inquiries on state bar ethics hotlines. With financial institutions recognizing losses on their sub prime loan portfolios, increasing mortgage foreclosures and steeply declining bank stock prices, concerned lawyers are making inquiries about the security of IOLTA/trust accounts in federal and state chartered banks.

“Lawyers should not take too much comfort in this decision.”

On July 11, 2008, federal regulators seized IndyMac, marking the second largest bank failure since the demise of Continental Illinois Bank in 1984. One of the nation’s largest independent mortgage lenders, IndyMac, ran into trouble after too many of its subprime loans defaulted. While the crash of IndyMac and other smaller banks recently came as a bit of surprise, the failure of a bank presents a problem attorneys should not ignore. Lawyers need to be thinking about ways to protect their clients’ funds. A lawyer’s failure to safeguard and protect client funds and property can be grounds for malpractice and discipline. But does this mean that a lawyer can be held accountable if the bank fails and client funds are not adequately insured? Not necessarily.

An Internet listserv for members of the Association of Professional Responsibility Lawyers has been buzzing with attorneys discussing whether a lawyer could be disciplined or found liable of malpractice as a result of future bank failures. At least 25 attorneys from across the nation had weighed in on this issue during the listserv discussion. No consensus was reached.

The ABA Model Rules of Professional Conduct, specifically Rule 1.15(a), requires lawyers to maintain client funds in “a separate trust account in the state where the lawyer’s office is situated.” with “complete records” identifying those funds. Additionally, many states in their individual Rules of Professional Conduct have added further specificity to this language by requiring that trust account funds be “clearly identified” and on deposit with a “financial institution recognized and approved.”

MLM Launches Practice Assets™ Web Site For Policyholders

A new online practice tool has been developed to help MLM policyholders better manage the risk associated with specific practice issues and gain a greater understanding of their claims exposure. The extranet web site, Practice Assets™ at www.practiceassets.com, was launched exclusively for policyholders this month, and it incorporates over 25 years of MLM’s archived materials, practice management tools, and forms expanded for online use.

The idea for Practice Assets™ grew out of a market evaluation study aiming to expand MLM’s services to sole practitioners and small law firms. The survey provided overwhelming evidence that online practice tools were a preferred choice for policyholders. MLM is now unique among lawyer professional liability companies in the United States by providing a closed web site with practice management advice and information for policyholders, along with its longstanding consultative services and risk management seminars.

(continued on page 2)
Bank Failures: If your bank goes under, are your clients’ trust account deposits fully insured? (continued from page 1)

by” the State’s bar or supreme court. To be approved, these financial institutions must be regulated state or federally chartered banks, savings institutions or credit unions in which the deposits are insured by an agency of the federal government. Thus, the safety of bank deposits and the soundness of these financial institutions are the subject of federal and state regulation. In addition, private entities provide rankings and information about the financial safety of individual financial institutions.3

Generally, a depositor’s account at a bank is insured by the Federal Deposit Insurance Corp. (FDIC) for up to $100,000.4 According to the FDIC, deposit account records of the banking institution must disclose the existence of a fiduciary relationship before insurance coverage based on fiduciary relationships will be recognized.5 Lawyers should make sure that the fiduciary nature of any account holding fiduciary funds is clearly reflected in the title of the account used by the financial institution. If the deposit account records of the banking institution do disclose the existence of a fiduciary relationship, then FDIC insurance (up to applicable limits) will be available for each client or third person whose funds are held in the account. Under Rule 1.15(a) a lawyer is required to “clearly identify” his or her trust account. Designation of the account as an IOLTA/trust account satisfies this requirement and discloses the existence of a fiduciary relationship for purposes of FDIC coverage. This designation means, for example, that if a lawyer’s IOLTA is holding $100,000 for Client A, Client A’s funds are insured up to $100,000 unless Client A has funds deposited in another account in the same financial institution as the lawyer’s IOLTA account. A lawyer holding $1 million in his or her clearly identified trust account on behalf of 10 clients would have FDIC insurance coverage up to $100,000 for each of these 10 clients provided the lawyer’s and/or bank’s record-keeping documents the identities and deposits of the client’s on whose behalf the deposits were made.

In other words, for the purpose of FDIC insurance, IOLTA accounts are fiduciary accounts. As such, each client is insured as if the funds were deposited directly by the principal (the client), provided certain requirements are met. Generally, each client will be insured up to $100,000 if they have no other deposits held in the same name at that institution. Obviously, the vast majority of IOLTA accounts are sufficiently insured by the FDIC. However, there are still many IOLTA accounts that hold more than $100,000 for an individual client and, therefore, those accounts are underinsured. In these circumstances, legal ethics experts and bar officials recommend that such large accounts be spread over multiple FDIC-insured banks in order to increase FDIC insurance coverage.

To date, there are no reported disciplinary or malpractice cases in which a lawyer was held accountable to a client for lost trust funds caused by a bank failure. A 2005 New York appellate case may provide some reassurance from a civil liability standpoint. In Bazinet v. Kluge,6 a lawyer was not held liable for malpractice for putting a prospective purchaser’s trust fund of more than $1 million into a bank that went under. The prospective purchaser accused the attorney, who was acting as an escrow agent in real estate transactions involving two co-op apartments in New York City, of malpractice for not depositing the funds in a manner that was FDIC-insured. The appellate court, however, found in favor of the attorney, noting there was no way he could have foreseen the bank’s demise and that there was no rule, statute or regulation that an attorney-escrow agent must place funds in an account fully insured by the FDIC.

Lawyers should not take too much comfort in this decision. With the depth of current banking crisis, the failure of a major bank, and the improvements and availability of financial information on financial institutions, a malpractice claimant may convince a judge or jury that a particular bank failure was foreseeable. Moreover, regardless of possible malpractice or disciplinary exposure, good lawyers take reasonable measures to prevent or mitigate financial loss to clients.

In addition to opening multiple trust accounts at different banks, there are some other things to consider. Lawyers must also ensure that the trust account recordkeeping, as required by Rule 1.15, is properly maintained and accurate so that the amount of every deposit designated to the client can be readily documented and proven to the FDIC. Lawyers should also identify for the client, at the outset of the engagement, the particular bank at which the client’s trust funds will be deposited and ask the client if he or she holds any accounts at that same bank. These questions can be readily incorporated into the intake process and noted on the intake form. There may even be circumstances where it would be appropriate from the outset of the
representation to document the discussion of this issue in the engagement letter or in a separate escrow agreement. If the client holds accounts with significant balances in his or her name at the same bank where the lawyer has the trust account, the lawyer and client should consider opening a trust account at a different financial institution. Finally, lawyers should periodically seek information or ratings regarding the stability of the financial institution where the trust account is maintained. Typically, state bars do not audit or certify the strength or stability of financial institutions. That work is performed by other governmental and private organizations. Lawyers should not assume that just because their state bar or other licensing authority maintains a list of approved depository banks for lawyers trust accounts that this is an approval of the institution’s financial health and stability.

(Footnotes)

1 For the list of failed banks maintained by the FDIC, point your Internet web browser to: http://www.fdic.gov/deposit/deposits/financial/fiduciary.html. Seven banks have been closed in 2008.
2 This bank was closed on July 11, 2008 by the Office of Thrift Supervision and the FDIC was named Conservator. All non-brokered insured deposit accounts and substantially all of the assets of IndyMac Bank, F.S.B. have been transferred to IndyMac Federal Bank, F.S.B. (IndyMac Federal Bank), Pasadena, CA a newly chartered full-service FDIC-insured institution. FDIC Press Release 56-2008 (7/11/08) found at: http://www.fdic.gov/news/news/press/2008/pr08056.html
3 For example, Veribanc rates every institution in the US on a quarterly basis using proven metrics with a solid track record over 25 years. For more information and to obtain a report on your bank, point your Internet web browser to: http://www.veribanc.com/Business%20Reports.html.
4 The FDIC oversees an industry-funded reserve of about $53 billion used to insure up to $100,000 per deposit and $250,000 per individual retirement account at insured banks. “Only 13 Percent of Banks on Watch List Fail,” Reuters, July 28, 2008, last checked on July 30 at http://www.reuters.com/article/ousiv/idUSN2825428920080728. The so-called “Watch List” of 90 banks maintained by the FDIC is not published on the agency’s website. One way to find out about the financial health of a particular bank is to read that bank’s call report on the FDIC’s web site. In most states information about state chartered banks can be obtained by calling the appropriate State Corporation Commission’s Bureau of Financial Institutions.

MLM Launches Practice Assets℠ Web Site For Policyholders (continued from page 1)

MLM policyholders attempting to access Practice Assets℠ can do so by logging on with an assigned user name and password that was e-mailed to them on August 28, 2008 in MLM’s e-newsletter Wh@t’s up? The user name and password are unique to each firm MLM insures and are the same login credentials lawyers use to access the MLM web site when applying for professional liability insurance or renewing their policy. Lawyers who may have forgotten or misplaced their login credentials can contact any MLM account manager at 800-422-1370 and request their access information over the phone.

Lawyers visiting Practice Assets℠ now have access to the following unique features:

- **Understanding Professional Liability** – Policyholders have access to information regarding professional liability insurance coverage, risk assessment surveys, and examples from the claim files.
- **Risk Management Library** – The resource Library is a repository for MLM’s CLE content, articles, and an array of other materials giving policyholders full access to MLM’s resources through a quick search tool.
- **ePublications** – Over 700 MLM policyholders have already downloaded “Avoiding Conflicts of Interest,” the first in MLM’s new Law Practice Management Booklet Series available only to policyholders free of charge at Practice Assets℠.
- **Practice Management Tools** – The source for client intake forms, engagement letters, retainer agreements and other essential practice forms.
- **Technology Tips** – A compilation of MLM’s exclusive articles on all areas of law office technology including practice recommendations for lawyers.
- **Consultative Services** – Policyholders have direct access to MLM’s experts to discuss their unique issues involving legal ethics, potential claims, practice management, and legal technology.
- **RU@RISK?** – MLM’s new blog is just one more way MLM keeps lawyers up-to-date on timely information to help attorneys improve their practice management skills and reduce their risk of malpractice claims.

The extranet website is still under construction, and new content and features are being added to Practice Assets℠ every day, so policyholders are encouraged to visit the site often. As lawyers’ needs increase and technology continues to change the legal environment in which they operate, Practice Assets℠ will deliver information to them in a cost effective and efficient manner, giving them access to risk management resources 24 hours a day.
What If the Bank is Your Client...?

The banking crisis presents unique situations for lawyers, especially those who represent a bank facing financial difficulty. Suppose a lawyer represents Bank X. While the bank has not engaged in any fraudulent misrepresentations, the lawyer learns from discussions with Bank X’s management that Bank X’s solvency is doubtful and that its failure is a distinct possibility. May a lawyer alert their clients to this problem and move trust or fiduciary accounts to another bank?

It does not appear that the lawyer can do this without breaching the duty of confidentiality to Bank X under Rule 1.6. More to the point is Rule 1.8(b):

“A lawyer shall not use information relating to the representation of a client for advantage of the lawyer or of a third person or to the disadvantage of the client unless the client consents after consultation, except as permitted or required by Rule 1.6 or Rule 3.3.”

Neither Rule 1.6 nor Rule 3.3 permit disclosure unless the client, Bank X, intends to commit a future crime or has, in the course of the representation, perpetrated a fraud on a tribunal or third party.

Assuming that the bank will not consent, it appears that there is a Hobson’s choice for the lawyer: either the lawyer breaches their Rule 1.8(b) duties and possibly the 1.6 duties to their client, Bank X; or takes no action and remains silent; thereby, breaching the lawyer’s fiduciary duties under Rule 1.15 to clients who are trusting the lawyer to safeguard and protect their funds. Another issue that may come to mind is whether pursuant to Rule 1.7 the lawyer has a conflict of interest that requires withdrawal from the representation? Probably not, while the issue is one of economic advantage under Rule 1.8(b); there is no direct adversity of legal interest arising from the information. Thus, no withdrawal under the conflicts rules is required. However, this ethical dilemma still presents a difficult choice under Rule 1.8(b) of weighing one’s duties to refrain from using information gained during the representation of the bank; against one’s fiduciary duties to protect and safeguard client’s funds under Rule 1.15. The Lawyer should assess the consequences and risks likely associated with either course of action, on the one hand, failing to take action to protect trust account funds, or on the other hand, moving trust account funds and thereby violating Rule 1.8(b) and possibly Rule 1.6. While a difficult choice is at hand; the most prudent course of action would likely be to protect the client’s funds by moving the lawyer’s fiduciary accounts to another financial institution while disclosing as little as possible regarding Bank X’s financial condition.

by Jim McCauley, Ethics Counsel, Virginia State Bar and Wendy Inge, Director, Risk Management Programming

(Footnotes)

5 FDIC Advisory Opinions 92-30 and 98-2. Federal regulations regarding insured deposits can be found at 12 C.F.R. Part 330. For more information about FDIC insurance on fiduciary accounts, point your Internet web browser to http://www.fdic.gov/deposit/deposits/financial/fiduciary.html


About the Author:

James M. McCauley is the Ethics Counsel for the Virginia State Bar, and manages the staff counsel serving the Standing Committees on Legal Ethics, Unauthorized Practice of Law, and the Standing Committee on Lawyer Advertising and Solicitation. Mr. McCauley and his staff write the draft advisory opinions for the Standing Committees and provide informal advice over the telephone to members of the bar, bench and general public on matters involving legal ethics, lawyer advertising and the unauthorized practice of law. Mr. McCauley frequently lectures and publishes articles on matters relating to legal ethics and the unauthorized practice of law. He teaches Professional Responsibility at the T.C. Williams School of Law in Richmond, Virginia. In 2008, he was appointed to serve on the American Bar Association’s Standing Committee on Legal Ethics and Professionalism. He received his law degree from the T.C. Williams School of Law, University of Richmond, in 1982. Mr. McCauley serves as a member on the Virginia State Bar’s Mandatory Professionalism Course faculty. He is also a Fellow of the Virginia Law Foundation and the American Bar Foundation.