

# Attorneys Need to Take Extra Care in Watching Client Trust Accounts

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With the precarious economy and the number of financial institutions either failing (such as IndyMac Bank) or being taken over by other institutions (such as Washington Mutual), lawyers who have client trust accounts should be thinking about the safety of those accounts.

Actually, lawyers with client trust accounts should be thinking about the safety of the accounts – property that belongs to clients and others -- *all the time*, not just in a financial crisis and not just to comply with the specific requirements of Rules 43 and 44, Ariz.R.Sup.Ct.

But the financial crisis provides a good reason to explore exactly what lawyers should be concerned about, ethical obligations to safeguard money in their trust accounts and ethical obligations to communicate with their clients. According to the Arizona Foundation for Legal Services & Education (which receives the interest on lawyers' pooled client-trust accounts), about 470 client trust accounts contain more than \$100,000.

Let's look at the situation using a hypothetical involving a bank we'll call My Bank. My Bank has multiple branches. You have your client trust account at My Bank. Your client trust account contains \$100,000, of which \$75,000 belongs to Client A and \$25,000 belongs to Client B.

Q. How do I figure out how safe my trust account is?

A. All client trust accounts must be held at a "regulated financial institution." [Rule 44(c), Ariz.R.Sup.Ct.] The accounts at My Bank – assuming it is a regulated financial institution -- would be insured by the Federal Deposit Insurance Corp. Effective October 3, 2008, FDIC insurance was raised to \$250,000 (from \$100,000) *per depositor per insured bank*. The increase is in effect through December 31, 2009. ["FDIC Insurance Basics," [www.fdic.gov/deposit/deposits/insured/basics.html](http://www.fdic.gov/deposit/deposits/insured/basics.html); "Summary of Deposit Insurance Coverage," [www.fdic.gov/news/news/financial/2008/fil08102a.html](http://www.fdic.gov/news/news/financial/2008/fil08102a.html)]

A client trust account by definition does not belong to you; it contains money owned by clients. Therefore, each client would be a depositor under the FDIC regulations. Because it is a fiduciary account, the funds on deposit "would be added to any other deposits of the owners at the same insured bank and the total would be subject to the insurance limit for the applicable ownership category." ["FAQs About FDIC Insurance," [www.fdic.gov/deposit/deposits/insured/faq3.html](http://www.fdic.gov/deposit/deposits/insured/faq3.html). See also 12 C.F.R. § 330.7; FDIC Advisory Op. 98-2, available at [www.fdic.gov/regulations/laws/rules/4000-9940.html](http://www.fdic.gov/regulations/laws/rules/4000-9940.html)]

For example, if Client A, for whom you hold \$75,000 in your trust account, also has

accounts at My Bank that contain \$200,000, Client A has \$275,000 on deposit in My Bank. Now that the insurance has been increased to \$250,000, Client A would not be insured for \$25,000.

The increase in FDIC insurance reduces the risk for many clients.

Q. Do I have to do anything special to make sure my client trust account is treated as a fiduciary account for FDIC insurance purposes, or does it automatically qualify?

A. The short answer is that you must meet two requirements to qualify. According to the FDIC,

[t]he fiduciary nature of the account must be disclosed in the bank's deposit account records (e.g., "Jane Doe as Custodian for Susie Doe" or "First Real Estate Title Company, Client Escrow Account"). 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).

[“FAQs About FDIC Insurance,” *supra*. See also 12 C.F.R. § 330.5]

You meet the FDIC requirements if you are complying with Rules 43 and 44, Ariz.R.Sup.Ct., which set out trust-account requirements.

The first requirement is that your client trust account must specifically indicate that it is your client trust account, thus showing the fiduciary relationship. It already is supposed to be designated as such, but now is a good time to make sure it is. Your trust account should be titled the following way:

Lawyer Name

Client Trust Account

Your trust-account checks should include this same designation. Check with your bank to make sure it has your account titled properly internally, as well.

The second requirement is that you must maintain records showing “the interests of the parties in the account.” You already must be maintaining such records to comply with Rules 43 and 44, Ariz.R.Sup.Ct. As a result, if you are keeping appropriate trust account records, you should have the appropriate information.

Q. Should I warn Client A that he may not be fully insured? I know he’s got lots of money, and at least \$200,000 in his personal accounts at My Bank. And even though I don’t know anything about how much Client B may have, should I warn her as well?

A. Yes. The best practice would be to identify the risk in your engagement letter or fee agreement. You could consider saying something like “Our client trust account is with My Bank. Your funds, up to \$250,000, deposited into our trust account are insured by the FDIC. If, however,

you have additional funds on deposit with My Bank and those funds plus your funds in our client trust account total more than \$250,000, the amount over \$250,000 is not insured by the FDIC.” You also could convey the information on a case-by-case basis as needed.

Q. Can I spread the risk by creating multiple client trust accounts?

A. FDIC insurance applies *per depositor per insured bank*. Your multiple client trust accounts, if all held at My Bank – even at different branches -- would not spread the risk.

Q. What if I establish client trust accounts at *different* financial institutions? In this case, I could establish a second trust account at Competitor Bank.

A. That could theoretically spread the risk for the clients, assuming, of course, you put Client A’s \$75,000 in Competitor Bank and Client A does not have more than \$175,000 otherwise on deposit in Competitor Bank (for a total of \$250,000).

Q. I just received a \$1.5 million PI settlement for Client C. We’ve got some liens to deal with, so I’ll be holding \$500,000 for a while. In light of the FDIC insurance limitations, what do I do about that much money?

A. Because of the size of the settlement and depending on how long you’ll need to hold the money, you should consider opening a trust account just for Client C under Rule 44(b)(4). But opening a trust account just for Client C’s money still poses the same risks as putting it in your pooled client trust account. Even if Client C doesn’t have any other money on deposit at My Bank, \$500,000 obviously exceeds the insured limit of \$250,000.

One possibility is to exercise the option under Rule 44(c)(1)(B) to invest in U.S. Treasury obligations, although this has limitations. Another possibility is to explore purchasing insurance for the amount above the FDIC-insured amount.

Q. I’ve heard about this thing called CDARS. Wouldn’t participating in that protect the \$500,000?

A. No, because participating in CDARS does not comply with our trust account rules. CDARS stands for Certificate of Deposit Account Registry Service. The CDARS website, [www.cdars.com](http://www.cdars.com), explains how it works:

Financial institutions can offer CDARS because they are members of a special network.

When you place a large deposit with a network member, that institution uses CDARS to place your funds into certificates of deposit issued by banks in the

network. This occurs in increments of less than \$100,000 to ensure that both principal and interest are eligible for full FDIC insurance.

The problem is that the funds can be placed in banks that are not authorized institutions under Rule 44(d), Ariz.R.Sup.Ct., and may not be available to be withdrawn on demand as required by Rule 44(c)(1), Ariz.R.Sup.Ct., because CDARS places funds in banks in the form of certificates of deposit. *See* Lundberg, *Trust Accounts in a Time of Bank Failures*, Vol. 52, No. 2 Res Gestae 33 (2008).

Q. Doesn't this all boil down to how safe My Bank is? It's a bank that has agreed to abide by the conditions for being an approved institution for trust account purposes, so isn't it safe?

A. The fact that a bank is an authorized institution to handle client trust accounts under Rule 44(d), Ariz.R.Sup.Ct., does not mean it is financially sound. "Authorized" means it has agreed to comply with certain reporting obligations, not that it has demonstrated to the State Bar or the Arizona Foundation for Legal Services & Education that it won't go under. You have a duty to safeguard client funds, so you should investigate the financial soundness of any bank where you establish your client trust account. Websites like bankrate.com may help you collect information. You also should consult with your malpractice carrier about the issue.

Q. With all the economic problems with banks, can I establish my trust account at a credit union?

A. Theoretically yes – a credit union is a "financial institution" under Rule 44(c)(1), Ariz.R.Sup.Ct. -- but you have an intrinsic problem if you use a credit union. To be insured, all the owners of the money in your trust account – the clients -- must be members of the federally insured credit union. [National Credit Union Administration Opinion Letter 96-0841, available at [www.ncua.gov](http://www.ncua.gov)] Placing non-members' funds in a credit union trust account would not be considered as appropriately safeguarding them if the non-members' funds are not insured. One credit union *is* on the "authorized institutions" list. But because credit unions have to change their rules and regulations to accomplish this, it is not the norm. For more information, visit [www.azflse.org/azflse/IOLTA](http://www.azflse.org/azflse/IOLTA).

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