

Ethically Speaking



By Charles Slanina, Esquire

The Banking Mess: The FDIC and Attorney Liability for Escrow Funds Deposited in Banks that Fail

You thought your handling of escrow funds was beyond reproach. You safeguarded funds of clients or third parties “in a separate account maintained in the state where the lawyer’s office is situated, or elsewhere with the consent of the client or third person.” Rule 1.15. That account was designated as an “Attorney Trust Account” or “Attorney Escrow Account” in a financial institution “approved as a depository by the Lawyers’ Fund for Client Protection.” Rule 1.15A. You followed all of the reconciliation, subsidiary ledger, monthly listing of balances and stale check provisions contained in both the Rules and the Lawyers’ Fund for Client Protection Audit Program. Rule 1.15(d)(1) through (9) (A) through (G). You maintained a copy of those records for a period of at least five years and, if maintained on a computer, each month printed out hard copies of all monthly journals, ledgers, reports and reconciliations as well as reviewed same. Rule 1.15(d) and Rule 1.15(d)(10). But what is your liability if, despite all of these safeguards, the bank where these funds are deposited fails?

On July 11, 2008, IndyMac Bank was closed by the Office of Thrift Supervision and the Federal Deposit Insurance Corporation was named Conservator when it became the second largest bank failure in U.S. history. Last year, three other U.S. banks failed and, at the end of 2007, there were 76 institutions on the problem bank list of the Federal Deposit Insurance Corporation. The near collapse of the housing market has caused some of the largest U.S.

banks, including Citigroup and Bank of America, to report huge loan losses as consumers fall behind on home equity, credit card and other consumer loans. More than a third of smaller, community banks have made property loans that exceed 300% of their capital, according to the Office of the Comptroller of the Currency. In comparison, hundreds of banks failed in 1987 amid a commercial property collapse when such loans were equal to only 175% of their capital.

However, most readers will, by now, have raised the protest that such funds are FDIC protected up to \$100,000 and be tempted to dismiss this as another attempt by “Ethically Speaking” to create something new for you to worry about. To such readers, I award only partial credit. According to the FDIC, the \$100,000 coverage is per customer per bank. For purposes of computing coverage, the attorney is the “customer.” (www.fdic.gov/deposit/faqs). Even if the attorney or firm opened multiple accounts at the same bank, they are still viewed as falling within the \$100,000 limit of coverage. As a result, the attorney escrow account is insured to a maximum of \$100,000 regardless of the balance or the number of clients with funds on deposit. (Attorneys may also want to consider having their personal accounts at a separate institution from where they bank their client funds so that such funds aren’t counted toward the maximum.)

There is an open question as to what liability, if any, an attorney or firm may have should they deposit client funds in excess of the \$100,000 FDIC coverage

should those funds be lost due to the depository’s failure. In 2005, a New York attorney successfully defended a malpractice claim for depositing escrow funds in a bank that failed. Defendant Riser acted as escrow agent in two real estate transactions involving co-op apartments on Central Park West in New York City. He deposited down payments of \$1.45M and \$1.28M in the firm’s escrow account maintained at a New York branch of a Connecticut bank. That bank failed and the FDIC was named as receiver. The attorney was alleged to have committed legal malpractice by not depositing the escrowed funds in a manner which would have been covered by FDIC insurance or by taking other, unspecified steps to ensure protection of those funds. The court, on appeal, granted a motion to dismiss the claim finding that there was no allegation that Riser violated any statute or regulation or breached the escrow provisions of the contract. Moreover, there was no notice available to the attorney or the parties that the bank was in danger of failing. *Bazinet v. Kluge*, 788 N.Y.S.2d 77 (N.Y.A.D. 1 Dept., 2005).

Stewart Title recently sent out a letter to its agent attorneys regarding FDIC claims and the \$100,000 maximum coverage for each depositor. It noted that FDIC will permit the insurance to “pass-through” the escrow agent to the true owner of the funds if certain requirements are met. The requirements closely track the same requirements found in Rule 1.15. Attorneys with real estate practices may routinely exceed the \$100,000 limit and

may want to discuss this issue with their underwriters.


There have not been any disciplinary cases to date brought against attorneys for loss of client funds in excess of the FDIC coverage at failed institutions. However, Rule 1.3 requires that "a lawyer shall act with reasonable diligence and promptness in representing a client," and Rule 1.15 requires that an attorney safeguard client property. It is certainly not unforeseeable that an attorney who deposits client funds in excess of the \$100,000 FDIC coverage at an institution that fails could face both tort and disciplinary liability. This begs the question as to whether or not reliance on the Lawyers' Fund would provide any sort of defense. The Professional Conduct Rules require an attorney to deposit escrow funds only in institutions "approved" by the LFCP, limiting such choices. The LFCP Trust Fund, funded by from assessments pursuant to Supreme Court Rule 66(e) paid by active members of the Bar, was created to protect the

public from loss. However, LFCP Rule 4 provides that the fund will only receive and consider claims for losses due to the defalcation or dishonesty of a member of the Bar.

What, if anything, can an attorney or firm do to both ensure client escrow funds and avoid potential liability arising from the deposit of such funds in an institution that fails? Security in excess of \$100,000 could be obtained by purchasing treasury bills backed by the U.S. government in excess of the \$100,000 FDIC limit. However, Rule 1.15 does not appear to permit such arrangements since it requires deposits of escrow funds with "approved" depositories. One option is to establish escrow accounts in multiple institutions selected after due diligence as to their solvency maintaining less than \$100,000 in each institution. Another option is an arrangement such as the Certificate of Deposit Account Registry Service (CDARS) whereby a large deposit with a bank participating in the network

is placed into Certificates of Deposit issued by other banks in the network in increments of less than \$100,000 to ensure that both principal and interest are eligible for full FDIC insurance. Of course, the initial bank would have to be "approved" by the LFCP and the IOLTA issue would need to be considered.

Short of such an elaborate arrangement, attorneys may be well advised to keep an eye on their escrow account balances and the bottom line of the bank or banks where those deposits are held. Aside from the theoretical liability that the attorney might incur, this may be the last line of defense that your clients have against an uninsured loss.

**"Ethically Speaking" is intended to stimulate awareness of ethical issues. It is not intended as legal advice nor does it necessarily represent the opinion of the Delaware State Bar Association. Additional information about the author is available at www.delawgroup.com. *

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WEDNESDAY, OCTOBER 22, 2008

12:00 NOON

THE DU BARRY ROOM

HOTEL DU PONT

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Outstanding Service to the Courts and Bar Award

Distinguished Mentoring Award

Service to Children Award

Women's Leadership Award

New Lawyers Distinguished Service Award

Invitation to follow

