

DO IOLTA ACCOUNTS PUT YOUR FIRM AT RISK?

IOLTA accounts will not put your firm at risk, but the improper use of them may. Let me explain why. The current credit crunch has caused over 110 banks to be placed on the watch list of the FDIC and they seem to be adding banks every month. The names of these banks are not public information. This does not mean that these banks are going to fail. It only means the FDIC is concerned about them, although more banks have failed in the last 12 months (10) than failed in the previous five years (7). Even if your IOLTA account is in one of these banks, you will be safe if each client's portion of your IOLTA is less than \$100,000. If your firm has over the FDIC limit in any one bank your firm's money over \$100,000 is at risk should the bank fail.

Rule 4¹ of The Texas Access to Justice Foundation (TAJF) requires client money to be placed in an IOLTA account, but only if the amount is nominal or for a short period of time. The ultimate test is whether the client would realize any interest on their money. If not, it should go in an IOLTA. If the client would earn interest net of fees in their account, then their money should be in an individual account.

The Texas Supreme Court created the TAJF to administer IOLTA accounts and collect funds. The funds collected are then used to provide attorneys for the poor. The justification for the creation of TAJF is that setting up individual accounts could actually cost clients money because of their nominal amounts or short durations but when you comingle accounts together the size and duration is sufficient for a bank to pay interest. Since it would be an administrative nightmare to try and distribute the interest among the clients, it made sense to use the money for charitable purposes. Please note that this justification does not address the risk associated with funds not being FDIC insured.

The constitutionality of IOLTA accounts was raised in *PHILLIPS v. WASHINGTON LEGAL FOUNDATION*². This case established that the interest on money earned in client accounts was the property of the client. The constitutionality of these accounts was established by *BROWN v. LEGAL FOUNDATION OF WASH*³. This case is important to lawyers, because it establishes that if a mistake is made by placing funds which could have earned interest into an IOLTA the loss falls on the lawyer. The case states:

If petitioners' money could have generated net income, the Limited Practice Officers (LPO's) violated the court's Rules, and any net loss was the consequence of the LPOs' incorrect private decisions rather than state action. Such mistakes may give petitioners a valid claim against the LPOs, but would provide no support for a compensation claim against the State or respondents.

State Bar Rules seem to free an attorney from any liability if unqualified funds are placed in an IOLTA account Art. XI, Sec. 7⁴. This is not a safe harbor. It is qualified by the words "in good faith". Since a loss could occur on balances greater than \$100,000, it would be a stretch to say that a deposit greater than \$100,000 was "in good faith" a nominal amount. It is doubtful that

the court can, by rule, change the legal liability of an attorney to his client for misplacement of the client's funds for the qualified IOLTA deposit. It does not attempt to change the duties as to funds that are not IOLTA qualified. Since IOLTA are FDIC insured up to \$100,000 per client against bank failure, the distinction may not make much difference. For amounts over \$100,000 per client, it can make all the difference in the world. At a minimum the attorney would be required to show that an effort was made to assure that the qualifications were met. The TAJF website has some rule of thumb calculations to help determine if the IOLTA deposit is a qualified one. (www.teajf.org/attorneys/financial_considerations.aspx). Pay close attention to the rate of interest used in the calculation, .80% on the site. Inspect the annual report of Fidelity U.S. Treasury MMF (symbol FDLXX) as a part of your due diligence. For a general discussion of money market funds take a look at www.kiplinger.com/columns/balance/archive/2008/balance0319.html . Think this is too much trouble? Imagine you are cross examined in a suit when you IOLTA account containing funds above the insured amount as lost because the bank holding the account failed and you are asked, "What steps did you take to protect the funds that were not IOLTA eligible?" A good alternative would be to consult a financial advisor who knows the requirements for securing clients funds to select an appropriate place for you client's money. Ignorance is not likely to satisfy the requirements of Section 7. The first sentence of the rule states that it does not change the attorney's obligations for amounts that are not IOLTA qualified.

The Texas Disciplinary Rules of Professional Conduct, Rule 1.14 (a)⁵ set out the requirements for selecting a depository for client funds. Client funds must be separate from the lawyer's; held in an account called a "trust" or "escrow" account, maintained in an account in the state of residence of the lawyer or elsewhere with the client's consent; complete records must be maintained and retained for five years.

It is possible to FDIC insure deposits against loss for amounts in excess of \$100,000 by requesting your bank to put your or your client money into a Certificate of Deposit Account Registry System (CDARS) account. These accounts allow your bank to spread a deposit in excess of \$100,000 among several other FDIC insured banks, resulting in the entire amount being FDIC insured. Not all banks are signed up for the CDARS program, so don't be surprised if they unfamiliar with it. CDARS are not eligible to be used in conjunction with an IOLTA account as they are not demand deposits.

It should be noted that Rule 1.14 requires that the account must be in the state of residence of the attorney or in a state consented to by the client. Rule 1.14 does not require that the funds be placed in a demand account, but it does require the institution to be on their approved list of financial institutions. It does not specify the type of account that should be used. Since Rule 4¹ permits the use of a money market account invested solely in United States Government Securities, it would seem to be an alternative to CDARS. The rules of CDARS accounts require the funds be left on deposit for 28 days, so money markets may be an attractive alternative for deposits of durations less than 28 days. If the use of the CDARS account or

money market account is spelled out in the contract with the attorney, then the element of consent will not be overlooked when the account is used.

Assume that your bank does not fail, the amount is less than \$100,000 and is IOLTA eligible, your firm is still at risk. The funds are still subject to theft by illegal withdrawals from the account. The rules for reporting such theft to the bank must be strictly followed. In *Okonkwo v. Wa. Mut. Bank*, 14-05-009-CV (Texas App. [14th District] 3-15-2007), one hapless lawyer notified his bank of the theft more than 30 days after he received his bank statement and then failed to complete the fraudulent activity affidavits properly. His suit to recover his funds failed on summary judgment. For those of you who believe that banks have an obligation to check signatures on your checks, think again. It is your duty to review bank statements. Don't rely on the clerk who writes the checks to review the statements. Most thefts from law firms are accomplished by the person who writes the checks. Properly notify the bank of the questioned transaction and if necessary file your fraudulent claim affidavit. File suit within one year.

There are risks in handling other people's money. I hope this little article either reduces your firm's risk or at least makes you aware of the risks you are taking.

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¹ Rules Governing the Operation of the Texas Equal Access to Justice Foundation

RULE 4. DEPOSIT OF CERTAIN CLIENT FUNDS

An attorney licensed by the Supreme Court of Texas, receiving in the course of the practice of law in this state, client funds that are nominal in amount or are reasonably anticipated to be held for a short period of time, must establish and maintain a separate interest or dividend-bearing insured depository trust account at an eligible institution and deposit such funds in the account. "Interest or dividend-bearing insured depository trust account" means a federally insured checking account or investment product, including a daily financial institution repurchase agreement or a money market fund at an eligible institution as defined in Rule (7). A daily financial institution repurchase agreement must be fully collateralized by, and an open-end money market fund must consist solely of United States Government Securities. A daily financial institution repurchase agreement may be established only with an eligible institution that is deemed to be "well capitalized" or "adequately capitalized" as defined by applicable federal statutes and regulations. An open-end money market fund must hold itself out as a money market fund as defined by applicable federal statutes and regulations under the Investment Company Act of 1940 and have total assets of at least \$250,000,000.

² 524 U.S. 156 (1998) This case arose out of an action brought to determine if IOLTA accounts amounted to a "taking" under the Fifth Amendment of the Constitution. WASHINGTON LEGAL FOUND. v. TEXAS EQUAL ACCESS, 94 F.3d 996 (5th Cir. 1996). The Fifth had overturned a summary judgment in favor of TEA. The U. S. Supreme court affirmed. The Fifth Circuit remanded the case to determine if there had been a "taking" and if the petitioners were entitled to just compensation. The trial court found there was no "taking" and the petitioners were not entitled to compensation essentially because the client's money would have earned no net interest. Again the Fifth circuit reversed finding there had been a "taking" and that the petitioners were entitled to just compensation. WA. LEGAL FOUND. v. TX. EQ. ACCESS TO JUSTICE, 270 F.3d 180 (5th Cir. 2001).

³ 538 U.S. 216 (2003) Although the petitioners were not fully licensed attorneys, the same rationale would seem applicable to attorneys. This case effectively overruled Wa. Legal Foundation.

⁴ STATE BAR RULES, ARTICLE XI. INTEREST EARNED ON CLIENT FUNDS HELD BY ATTORNEYS, SECTION 7. ATTORNEY LIABILITY:

Nothing in this Article affects the obligations of attorneys, law firms, or professional corporations engaged in the practice of law with respect to client funds other than client funds reasonably determined to be "nominal in amount" or reasonably anticipated to be held for a "short period of time," as those terms are defined by the rules adopted by this Court. An attorney, law firm, or professional corporation is not liable in determining which funds are nominal in amount or on deposit for a short period of time if the determination is made in good faith in accordance with the rules.

⁵ TEXAS DISCIPLINARY RULES OF PROFESSIONAL CONDUCT,

I. CLIENT-LAWYER RELATIONSHIP,

RULE 1.14 SAFEKEEPING PROPERTY

(a) A lawyer shall hold funds and other property belonging in whole or in part to clients or third persons that are in a lawyer's possession in connection with a representation separate from the lawyer's own property. Such funds shall be kept in a separate account, designated as a "trust" or "escrow" account, maintained in the state where the lawyer's office is situated, or elsewhere with the consent of the client or third person. Other client property shall be identified as such and appropriately safeguarded. Complete records of such account funds and other property shall be kept by the lawyer and shall be preserved for a period of five years after termination of the representation.

(b) Upon receiving funds or other property in which a client or third person has an interest, a lawyer shall promptly notify the client or third person. Except as stated in this rule or otherwise permitted by law or by agreement with the client, a lawyer shall promptly deliver to the client or third person any funds or other property that the client or third person is entitled to receive and, upon request by the client or third person, shall promptly render a full accounting regarding such property.