How Does FDIC Insurance Work for Lawyer Trust Accounts?

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In 2023, within days of each other, Signature Bank and Silicon Valley Bank closed and the Federal Deposit Insurance Corporation (FDIC) was appointed the receiver for both. This happened because the banks did not have enough liquid cash assets to cover customer demand for withdrawals. When a bank goes insolvent, the FDIC provides federally-funded insurance to help depositors recover funds that should have been protected by the bank.

While such events are rare, it's important to understand how a bank closure could impact your practice.

So, what happens to your law firm if your bank closes? Are your clients funds held in trust secure? Are you prepared to answer their questions about the security of their funds in your trust account? What is the procedure for recovering IOLTA funds stored in an insolvent bank?

Lawyers need to become familiar with how FDIC insurance works for trust accounts.

What is FDIC Insurance?

From the FDIC's website, the agency was created by Congress to "maintain stability and public confidence in the nation's financial system." Regulated banks and saving associations pay deposit insurance premiums to the FDIC. These premiums are used to fund the FDIC. The FDIC directly supervises and examines more than 5,000 banks and savings associations for operational safety and soundness. Premiums are also used to cover insurance claim payments to depositors.

How does FDIC Insurance work when a bank failure occurs?

Depositors are the banks' customers who deposit money with a bank. When a bank failure occurs, the FDIC insurance will reimburse deposits up to the standard insurance amount. Since the start of the FDIC insurance program in 1934, no depositor has lost a penny of insured funds as a result of a failure. Currently, the standard insurance amount is set at $250,000 per depositor, per insured bank, for each account ownership category.

In order to know if your clients' funds held in trust are covered by FDIC insurance, you will need to know who is considered a depositor in a trust account and further banking details about impacted clients.

How does FDIC Insurance work for trust accounts?

Trust accounts are treated as "fiduciary accounts," by the FDIC. Fiduciary accounts are deposit accounts established by a party for the benefit of other parties. These other parties are called the "principals."

Three requirements to be recognized as a fiduciary account

For a trust account to be recognized as a fiduciary account, three requirements must be met.

1. The funds must be owned in fact by the principal. The FDIC might review your engagement agreement with the client and the source of funds if there is a dispute about who's funds are in the trust account. Being able to document the source of the funds, like through a trust request, will help demonstrate a principal's ownership of the funds. (In Clio Manage, you can generate trust requests to accept trust funds for your clients.)
2. Your bank account must indicate that it is holding funds on behalf of others. Many states have a requirement that IOLTA or other trust accounts be labeled with the words "trust account" or similar terms. A failure to follow this guidance may result in your trust account being ineligible for fiduciary account insurance coverage.
3. The records of the fiduciary must indicate the identities of the principals as well as their ownership interest in the deposit. Your law firm will need to be able to show who has money in your trust account and how much money was there. Up to date client trust ledgers and trust account ledgers are a requirement for meeting the FDIC's requirements.

Funds covered

If your trust account meets all three requirements for a fiduciary account, the amount of funds FDIC insurance covers increases dramatically.

Instead of the standard insurance amount set at $250,000, a compliant IOLTA account will be eligible for up to $250,000 per client whose funds are in the trust account.

Making a claim

To obtain these amounts, a lawyer must file an insurance claim with the FDIC on behalf of their clients. The lawyer should be prepared with details about their account, attorney-client relationship, and clear documentation including their trust account and client ledgers.

Once the FDIC approves your insurance claim, they will send the clients' recovery amounts to the lawyer. Trust account recoveries are not sent directly to clients by the FDIC.

Recovered client funds should be deposited in a trust account (either with the insolvent bank's receiver) or a new banking institution. It is the lawyer's responsibility to disburse recovered funds to clients.

What is the FDIC insurance limit for trust accounts?

For a period following the 2008 Financial Crisis, lawyer trust accounts were covered for an unlimited amount of funds. This unlimited insurance coverage ended in 2014. Lawyers now need to understand the factors that may limit clients' ability to recover funds.

Limit per bank

Whether or not your trust account is an fiduciary account according to the FDIC is not the only factor impacting a recovery of client funds. The FDIC insurance standard amount is not just $250,000 per depositor. It is also per insured bank for each account ownership category. Other facts, like does your client have a personal account with the same bank, impacts the amount they may recover.

For example, assume your trust account and the client's personal savings account are deposited at the same insolvent bank. Between the two accounts, the client may only recover $250,000 total. Even if the two accounts collectively contain more than that amount of the client's funds, they can only recover the FDIC's standard insurance amount. Because the separate accounts are held by the same bank, the recovery is capped.

Limits per account ownership category

Recovery amounts are also impacted by the "account ownership category." These categories include single accounts, joint accounts, Individual Retirement Accounts (IRAs) and other select retirement accounts, revocable and irrevocable trusts, bank accounts

owned by registered business entities, and deposits from certain employee benefits plans. Depending on the interests of the depositors and participants in each account ownership category, a total recovery may exceed $250,000.

If the above hypothetical client had a joint account rather than the personal savings account (i.e. a single account), they might be able to recover up to $500,000 between the two account ownership categories. This amount is possible despite the fact that the lawyer and client both deposited funds at the same insolvent bank.

What law firms can do

When helping clients understand the impact of bank closure on their FDIC insurance recoveries, lawyers need to research the client's full banking details. Only once you know the client's total banking institutions, account types, and ownership categories can you help them maximize their recovery.

Ethics duties for lawyer trust accounts during a bank closure

Many lawyers hold sums greater than $250,000 in trust on behalf of clients. Real estate attorneys, personal injury and mass tort lawyers, wealth counsel, and more regularly hold large amounts of client funds in trust.

Given that lawyers regularly hold funds that exceed the FDIC standard insurance amount, are there additional ethical obligations to minimize a client's risk from insolvent banks?

No, there are not.

So long as the lawyer deposits funds in a manner compliant with their state's trust accounting rules and their client's instructions, there are little to no other ethical obligations.

IOLTA accounts

Most jurisdictions do restrict IOLTA accounts to pre-approved eligible institutions. Many of these eligible institutions are required to be FDIC-insured. Client funds deposited in an IOLTA account should be eligible for the standard amount of FDIC coverage.

Separate trust accounts for clients depositing significant amounts

Clients depositing significant amounts may request that their funds be held in separate trust accounts. The interest on these accounts is retained for the client's benefit. These are not IOLTA accounts, but may still be fiduciary accounts eligible for client recovery if held in an FDIC-insured bank. Most jurisdictions require lawyers to prudently select banks with these protections.

Outside of these actions, the few ethical opinions that address this topic impose no additional burdens on lawyers.

Ethics opinions on duties of lawyers for amounts above FDIC insurance

When it comes to weighing client risk above that of the FDIC standard insurance amount the Connecticut Bar Association Opinion 91-2 (12/27/91) states,

"In light of the foregoing, including our newfound knowledge of the relevant FDIC rules, it would seem that those rules do not, in and of themselves, pose any ethical obligations or limitations on a lawyer's handling of client funds."

The opinion goes on to state that it is the lawyers job to assess risk and consult with clients. But the details of those are legal questions outside the scope of the ethics committee.

Several ethics opinions have also addressed if there exists an ethical lawyers' responsibility to cover client trust funds in excess of the $250,000 covered amount.

In BAR ASSOCIATION OF NASSAU COUNTY Opinion 92-9 (4/22/92) (not currently available on the Nassau County Bar Association's website), the committee does not see any ethical obligation to replace funds lost in excess of FDIC-recovery.

"A lawyer who deposits in a bank escrow funds in excess of the amount covered by the Federal Deposit Insurance Corp. is not ethically bound to replace the funds when the bank fails. DRs 9-102(A)(B); EC 6-4."

South Carolina Ethics Advisory Opinion 08-10 even goes so far as to state there is no is no requirement in the ethical rules that the attorney maintain insurance on his trust account for amounts in excess of FDIC standard insurance coverage.

That being said, the oldest ethics opinion on the topic does advise lawyers to act prudently. The Florida Bar's Ethics Opinion 72-37 says,

“Although there is no ethical requirement that a lawyer divide trust funds in order to ensure complete FDIC coverage, he is nevertheless expected to act prudently and consider the deposits’ size in relation to the size and reputation of the financial institutions concerned.”

How to protect client trust account balances

Should a lawyer open multiple trust accounts once a client deposits exceed the $250,000 coverage cap? While there is no ethical duty to do so, lawyers should be open with their clients as to risks associated with holding large sums for long periods of time.

The best protection a lawyer can provide clients is helping them speedily resolve their issues so that funds do not linger unnecessarily in the law firm’s trust account.

Separating large trust deposits would only provide the client extra FDIC coverage if the lawyer used trust accounts in different banks. The chance for error or misplaced funds would only increase if lawyers attempted to do all their trust account banking with capped limits per client.

Final thoughts on FDIC insurance and trust accounting

No one was expects their bank to close suddenly. Knowing the FDIC deposit insurance rules and how they pertain to lawyer trust accounts helps lawyers and clients have faith in their financial dealings.

Lawyers’ best defense against a bank closure is following their state’s trust account rules and maintaining detailed trust and client ledgers. Learn more about how Clio helps automate trust account record keeping—watch our on-demand webinar on Best Practices for Trust Accounting.

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