FDIC Insurance & IOLTA Accounts - When is it Enough Protection?

Pennsylvania IOLTA Board Guidance | April 6, 2023

I. Executive Summary

Recent bank failures have raised questions about how attorneys can protect their IOLTA accounts above and beyond the Federal Deposit Insurance Corporation (FDIC) insurance limits. This guidance provides detailed information in response to attorneys' concerns and explains how IOLTA accounts benefit from "pass-through" coverage as fiduciary accounts so that the FDIC insurance coverage limit is applied separately to each client or third party with funds held in an IOLTA account. Thus, a single IOLTA account holding funds from multiple clients will potentially benefit from much more than $250,000 in FDIC coverage, and this guidance provides several examples to show how this pass-through coverage would apply in practice. In addition, potential proactive measures that attorneys with high IOLTA balances can consider to provide additional protection are also described in detail, and include: (a) maintaining multiple IOLTA accounts; (b) arranging for excess balance protection via certain types of overnight sweep services; and, (c) paying financial institutions to secure IOLTA accounts with collateral.

II. Background

The failures of Silicon Valley Bank and Signature Bank in March of 2023 have prompted some attorneys to think about how they can protect their IOLTA account above and beyond the FDIC insurance limits. In this guidance we will describe how FDIC insurance[1] works relative to IOLTA accounts in providing them with more potential coverage than standard deposit accounts, and for the small percentage of firms where it's possibly relevant, we will also describe some common banking services that law firms can evaluate to determine whether it is prudent for their firm to incur the cost to obtain additional protection for their IOLTA account.

Before embarking on this evaluation, it is fair to consider past actions by the federal banking regulators when faced with the possibility of enforcing FDIC insurance limits at failed financial institutions. During the financial crisis of 2008, the FDIC implemented the Transaction Account Guarantee Program (TAGP) which included a provision for unlimited FDIC insurance coverage for all IOLTA accounts (and which was extended several times through 2010).[2] In March 2023, the U.S. Treasury Department, Federal Reserve, and the FDIC issued a joint statement on the "systemic risk" posed by the collapse of Silicon Valley Bank and Signature Bank that allowed

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[1] While this guidance addresses FDIC insurance as the vast majority of IOLTA accounts are held at FDIC insured banks, it should be noted that deposit accounts at federally insured credit unions receive deposit insurance coverage through the National Credit Union Administration (NCUA)'s National Credit Union Share Insurance Fund; see https://mycreditunion.gov/knowledgebase/what-ncua (last accessed April 6, 2023).

[2] See https://www.fdic.gov/regulations/resources/tlgp/index.html (last accessed April 6, 2023).

them to fully insure all deposit accounts under their existing regulatory authority.[3] While past actions are no guarantee of future outcomes, the past actions of the federal banking regulators are helpful to consider in conjunction with the information presented below.

III. IOLTA Accounts & FDIC Insurance - Understanding the Basics

At the outset, it's important to note that IOLTA accounts have more FDIC insurance protection than typical bank accounts because they have "pass-through" coverage as fiduciary accounts which means that their FDIC insurance coverage is not limited to the $250,000 that would normally apply to the law firm as an account holder of a deposit account. Instead, the FDIC insurance limit applies to each client or third party that has funds held inside the IOLTA account waiting to be disbursed.[4] Thus, a single IOLTA account that holds the funds of multiple clients will potentially benefit from much more than $250,000 in FDIC coverage.

If a bank fails and FDIC insurance limits are enforced, separate coverage applies for each bank customer's combined balances in their deposit accounts at the failed bank in each of the "ownership" categories in which the customer is holding deposit accounts (such as $250,000 for individual accounts, $500,000 for joint accounts, etc.).[5] However, as mentioned above, the FDIC considers IOLTA accounts to be pass-through fiduciary accounts for FDIC insurance purposes which means that in the event of a bank failure, the FDIC would request records maintained in the ordinary course of business by the bank customer (the law firm using the IOLTA account) to see which clients or third parties are owed funds from the IOLTA account and are entitled to corresponding FDIC insurance protection.[6] The following examples illustrate how FDIC insurance would work in the context of an IOLTA account maintained at a failed bank:

> <u>Example 1.</u> The law firm of John Doe & Associates has $1,000,000 in its IOLTA account at Acme Bank which is owed to four different clients, each of whom are entitled to $250,000 (and none of the clients have their own accounts at Acme Bank). In this scenario all $1,000,000 in the IOLTA account would be fully covered by FDIC insurance.
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> <u>Example 2.</u> John Doe & Associates has $100,000 in its IOLTA account at Acme Bank that is owed to Client A, and Client A also has a personal checking account at Acme

[3] Joint Statement by the Department of the Treasury, Federal Reserve, and FDIC (PR-17-2023) (March 12, 2023), available at https://www.fdic.gov/news/press-releases/2023/pr23017.html (last accessed April 6, 2023).

[4] See 12 C.F.R.§ 330.7(a); 12 C.F.R. § 330.5(b); Federal Deposit Insurance Corporation, *Financial Institution Employee's Guide to Deposit Insurance* (2016) at 123, available at https://www.fdic.gov/resources/deposit-insurance/diguidebankers/documents/financial-institution-employees-guide-to-deposit-insurance.pdf (last accessed April 6, 2023).

[5] See Federal Deposit Insurance Corporation, *Your Insured Deposits* (2020), available at https://www.fdic.gov/resources/deposit-insurance/brochures/documents/your-insured-deposits-english.pdf (last accessed April 6, 2023).

[6] 12 C.F.R. § 330.5(b)(2).

Bank with a balance of $175,000. The FDIC will only pay Client A $250,000 for the combined $275,000 that they had at Acme Bank because the $100,000 owed to them from their attorney's IOLTA account plus the $175,000 in Client A's personal checking account are combined under the individual / single owner coverage category for Client A at the failed Acme Bank.

<u>Example 3.</u> John Doe & Associates received a legal settlement of $200,000 owed to Client B in their IOLTA account at Acme Bank. Client B also has $400,000 in a Certificate of Deposit held jointly with their spouse and is also the beneficiary of a $240,000 payable on death (POD) savings account opened by their uncle, both of which are also at Acme Bank. In this scenario, each ownership category's limit is separately applied, so all of Client B's funds will be covered by FDIC insurance and they will benefit from $840,000 in coverage as the $200,000 in their attorney's IOLTA account will fall under the $250,000 limit for their individual / single owner accounts, the $400,000 will be covered by the $500,000 limit for joint accounts, and the $240,000 in the POD account will count toward the $250,000 limit for revocable trust accounts.

IV. Providing Extra Protection for High Balance IOLTA Accounts

The majority of law firms will have no need to consider securing their IOLTA account beyond the existing advantageous designation already afforded to IOLTA accounts as pass-through fiduciary accounts for FDIC insurance coverage. However, those law firms that routinely receive large amounts of funds owed to one particular client or third party that are significantly in excess of FDIC insurance limits (which are also "Qualified Funds" under Pa. R.P.C. 1.15(a)(9) (i.e., IOLTA Funds)) may want to consider taking steps to add additional protection to their IOLTA account. These additional steps may include: (a) maintaining two or more IOLTA accounts at different banks; (b) arranging for custom overnight sweep protection, or; (c) paying a service fee to your financial institution to arrange for the "collateralization" of your firm's IOLTA account in the same manner that financial institutions holding deposit accounts for municipalities containing public funds secure these deposits in excess of FDIC limits. The value of the protection afforded by each approach as well as the cost and burden to implement it will vary by firm and will necessarily be an individual decision. Additionally, the availability of relevant sweep or collateralization service add-ons will vary by bank and will in most cases require the involvement of the bank's back office Treasury Management staff.

(a) Maintaining Multiple IOLTA Accounts

For those law firms that receive Qualified Funds from distinct practice areas that can easily be managed separately for IOLTA recordkeeping purposes (and where the combined amount of the Qualified Funds owed to a single client or third party is regularly in excess of FDIC insurance limits), it may make sense to maintain multiple IOLTA accounts at different banks where each IOLTA account is designated for a particular practice area of the firm. There is no limit on the number of IOLTA accounts that a particular lawyer or law firm may utilize, although doing has the potential to increase the effort spent on administrative recordkeeping. Additionally, while it may be feasible to maintain two or three IOLTA accounts grouped by the different primary practice areas of a firm, the protection in terms of FDIC insurance coverage is only effective if the use of multiple IOLTA accounts results in keeping the amount owed to a given client or third party in a particular bank below the FDIC insurance limits.

(b) Arranging for Excess Balance Protection via Overnight Sweep Services

An "overnight sweep" refers to a banking service that provides for the automatic transfer of funds from a bank account (typically when funds exceed a designated amount) overnight into an investment account where they earn interest before being swept back into the linked bank account. This service is often marketed by banks under the umbrella of commercial "Cash Management" or "Treasury Management" services. There are many different iterations of sweep products, some which have a sweep frequency that occurs less frequently than overnight as well as a range of possible investments into which funds can be swept. For attorneys looking to secure their IOLTA accounts, only those products that offer an overnight sweep (so that the funds are always available the next day) similar to the options described in greater detail below are suitable to use with IOLTA accounts. A law firm is free to pay the requisite service fee to their bank (from the firm's funds) to provide this service, just as firms pay for other commercial add-on services, such as positive pay check protection, ACH debit filtering, etc., which can be billed directly to the firm's operating account at the same bank or assessed to the IOLTA account and then immediately repaid by the attorney per Pa. R.P.C. 1.15(h).

(i) Requirements for Sweep Protection Services & IOLTA Accounts

Attorneys must ensure that any add-on sweep services intended to provide additional security for their IOLTA account do not inadvertently prevent them from complying with their obligations in Pa. R.P.C. 1.15. As commercial banking services often change and vary by financial institution, lawyers should keep the following general criteria in mind if they are considering working with their bank to add an overnight sweep to their IOLTA account to secure balances over the likely FDIC insurance limits. Specifically, attorneys should ensure that:

(1) the sweep service provides more protection to Qualified Funds than they would receive if they were held in a pooled IOLTA account without the sweep service;

(2) Qualified Funds are effectively under the control and direction of a financial institution approved to hold Pennsylvania IOLTA accounts;

(3) bank statements and related records for the IOLTA account allow for the attorney to perform the monthly reconciliations required by Pa. R.P.C. 1.15(c)(4) based on the total balance of all Qualified Funds;

(4) the sweep service adopted to protect the high balances in the IOLTA account against loss must do so in a way that ensures that the Qualified Funds are available for prompt disbursement (i.e., within one business day) to clients or third parties;

(5) the sweep service will not permit the routing of Qualified Funds anywhere but between the IOLTA account and the sweep service so that any disbursements to clients or third parties only occurs from the IOLTA account by the action of a Pennsylvania-licensed attorney or someone under their direct supervision per Pa. R.P.C. 1.15(g);

(6) the sweep service will not interfere with the obligation of the financial institution holding the IOLTA account to submit reports of overdrafts to the Pennsylvania Lawyers' Fund for Client Security per Pa. R.D.E. 221, and;

(7) the sweep service will not interfere with the financial institution's obligation to send IOLTA remittance reports to the IOLTA Board as required by Pa. R.P.C. 1.15(o) and 204 Pa. Code § 81.105(g).

(ii) FDIC Sweep Service

One type of sweep option that may work for lawyers to secure their IOLTA accounts is offered by banks that contract with IntraFi Network[7] (or a similar service provider) to offer their customers sweep products that have the purpose of providing FDIC protection for all their funds (sometimes referred to as an "FDIC sweep"). The architecture of the service offered by banks that utilize IntraFi and similar service providers extends FDIC coverage by essentially automating the same process that would occur if a customer were to open accounts at multiple banks while also keeping the customer relationship solely with the bank that holds the customer's '"real" account that will be utilizing the sweep for increased FDIC insurance coverage.

While there are many iterations of the sweep services offered by IntraFi and the banks that contract with them, the one that is relevant for attorneys looking to get a sweep service to protect a high balance IOLTA account is referred to as the "ICS" or "Insured Cash Sweep" in the overnight sweep configuration that utilizes demand deposit accounts. This sweep service functions whereby IntraFi, acting as the vendor of the bank holding an attorney's IOLTA account, sweeps a designated portion of the funds in the IOLTA account overnight in increments of less than $250,000 into other FDIC insured banks that also participate on IntraFi's ICS sweep network, and then sweeps the funds back into the IOLTA account so that they are available for outgoing

[7] See https://www.intrafi.com/ (last accessed April 6, 2023).

payments from the IOLTA account. IntraFi's ICS sweep service utilizes the IOLTA bank as the custodian for purposes of placing the swept deposits along with BNY Mellon as the sub custodian who is responsible for maintaining all the linked deposit accounts at the ICS network banks that receive the overnight sweeps. The IOLTA bank remains solely responsible for providing the monthly bank statements, account holder documents, interest remittances, etc. The ICS network banks that receive the overnight sweep deposits have no relationship with the law firm holding the IOLTA account, and only in the event of their failure would the linked IntraFi account used in the ICS sweep (maintained by BNY Mellon) be "opened" to see who the owner is for FDIC insurance purposes (and in this case it would be law firm who would be separately responsible for getting the funds to their client that would be reimbursed by the FDIC). Bank customers that wish to utilize the ICS sweep service also have the ability to "exclude" financial institutions from the universe of those at which IntraFi can place their funds in linked accounts to reduce the risk of exceeding FDIC insurance at a given bank, and this function can also ensure that only the banks on the approved list for Pennsylvania IOLTA accounts are utilized to provide overnight sweep protection.

It is important to stress that law firms that are interested in obtaining the ICS sweep service to protect high balance accounts will need to not only ensure that the general criteria to utilize a sweep service with an IOLTA account are met, but also confirm the funds availability and ICS configuration available at their particular financial institution, as there is variability by bank. Lastly, it should be noted that the IOLTA Board does not endorse or require the use of the IntraFi Network's ICS sweep service as the only means of utilizing an overnight sweep to achieve additional FDIC insurance.

(iii) Treasury Repurchase Agreement Sweep Service

An additional sweep option that may work for law firms to secure high balance IOLTA accounts is to arrange for an overnight sweep of a designated amount of funds from their IOLTA account into a "repo sweep" (repurchase agreement sweep) managed by a financial institution approved to hold Pennsylvania attorney trust accounts where the swept funds can only purchase U.S. Government Securities overnight before being repurchased by the financial institution, converted back into cash, and then swept back into the IOLTA account so that they are available each business day. In order to use a repurchase agreement sweep to add security to a high balance IOLTA account, the law firm must have a perfected security interest in the U.S. Government Securities being utilized with the sweep.[8] Additionally, the overnight repurchase agreement sweep should be established only with a financial institution that is deemed to be "well capitalized" or "adequately capitalized" as defined by applicable federal statutes and regulations.

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[8] See 12 C.F.R. § 360.8(d)(3)(iii); see also Federal Deposit Insurance Corporation, FIL-39-2009 (July 6, 2009), available at, https://www.fdic.gov/news/financial-institution-letters/2009/fil09039a.html (last accessed April 6, 2023).

(c) Paying Your Financial Institution to Secure Your IOLTA Account with Collateral

Banks at which municipalities and government entities maintain deposit accounts containing public funds must collateralize these accounts to the extent that their balances exceed FDIC insurance coverage so that if the bank fails, the public funds are secured. In Pennsylvania, 72 Pa. Stat. Ann. § 3836-4 describes what is acceptable collateral to secure public deposits which includes the options described in U.S. Treasury Circular No. 92 (such as US Treasuries, municipal bonds, etc.) or an irrevocable letter of credit issued by a Federal Home Loan Bank. While the collateralization of business deposit accounts like IOLTA accounts that are not used to hold public funds is not a service that is typically offered at banks, there is nothing in the IOLTA rules that prevent a law firm from contracting with their bank to obtain a similar collateral pledge to protect the balances in their IOLTA account above and beyond the FDIC insurance limits.[9] As with the option to pay a bank to add a custom sweep service to their IOLTA account, a law firm is free to pay the requisite service fee to their bank (from the firm's funds) to provide customized collateral protection which can be billed directly to the firm's operating account at the same bank or assessed to the IOLTA account and then immediately repaid by the attorney per Pa. R.P.C. 1.15(h).

The options to protect high balance IOLTA accounts that have been described above are intended to be illustrative and not exhaustive. Lawyers can contract with their banks for other services to secure high balance IOLTA accounts so long as those services allow the lawyer to comply with their obligations in the Rules of Professional Conduct. Additionally, attorneys should carefully weigh the pros and cons of each option before proceeding. Establishing multiple IOLTA accounts at different banks is simple on the front end, but if a firm's practice areas are not easily segregated, there is a greater chance of accidentally crediting a client's funds to the wrong account (or using the wrong checkbook when making distributions) and the FDIC insurance coverage is only effective if the use of multiple IOLTA accounts results in keeping the amount owed to a given client or third party in a particular bank below the FDIC insurance limits. With a repurchase agreement sweep or the ICS sweep, there is much more complexity on the front end in setting up the service to ensure that the sweep add-on does not inadvertently cause a violation of the Rules of Professional Conduct, but if established correctly, it can allow a firm receiving large amounts of Qualified Funds to consolidate their IOLTA recordkeeping by maintaining one single IOLTA account and can provide an additional hedge against possible bank failures. Lastly, as noted earlier, it is important to keep in mind that IOLTA accounts receive pass-through FDIC insurance coverage so that a single IOLTA account holding the funds of multiple clients has the potential to benefit from much more than $250,000 in FDIC insurance without the need for any additional action by the law firm account holder.

[9] Financial institutions that participate in Pennsylvania's IOLTA program also hold a small number of "MJ-IOTA" accounts which are similar to IOLTA accounts but which are used by Magisterial District Judges and Municipal Judges per 204 Pa. Code § 81.301 et seq., and these accounts are protected by collateralization as they hold public funds.