

A Discussion of Trust Accounts

For Michigan Attorneys

The following two trust account articles appeared in the Ingham County Bar Association publication “Briefs” in the March 2009 (Part One) and April 2009 (Part Two) issues.

Trust Accounts Part One: **Establishing IOLTA and Non-IOLTA Trust Accounts**

By: Linda Rexer, Esq., Executive Director, Michigan State Bar Foundation

Trust Accounts Part Two: **Financial Management of Client or Third Party Funds**

By: Danon D. Goodrum-Garland, Esq., Professional Standards Investigative Counsel and Nkrumah Johnson-Wynn, Esq., Professional Standards Service Counsel, State Bar of Michigan

Trust Accounts Part One: Establishing IOLTA and Non-IOLTA Trust Accounts

By: Linda Rexer, Esq., Executive Director, Michigan State Bar Foundation.

This is the first article in a two-part series. It examines basic trust account requirements set forth in MRPC 1.15 and IOLTA Account Guidelines approved by the Michigan Supreme Court (see www.msbf.org/iolta for the rule and guidelines). The second article, Trust Accounts Part Two: Using IOLTA and Non-IOLTA Trust Accounts, discusses the types of funds that must be placed into trust accounts and how lawyers should account for those funds. It was written by Danon D. Goodrum-Garland, Esq. and Nkrumah Johnson-Wynn, Esq. of the State Bar of Michigan's Professional Standards Division.

1. Safeguarding Client Funds

The Michigan Supreme Court requires lawyers to certify their client trust account compliance each year on their bar dues form. SBR 2. This underscores the importance of long-standing mandates that lawyers safeguard client funds which come into their possession.

A lawyer shall hold property of clients or third persons in connection with a representation separate from the lawyer's own property. All client or third person funds shall be deposited in an IOLTA or non-IOLTA account. Other property shall be identified as such and appropriately safeguarded. MRPC 1.15(d).

In addition to separating the funds, MRPC 1.15(b) reflects the lawyer's other core obligations to notify the client or third person when funds or property are received, preserve records of those funds for five years after the representation, deliver property clients are entitled to receive and render an accounting of the funds (trust account record keeping will be covered in Part Two of this series). These fiduciary duties apply to third party funds as well as client funds, which cannot be comingled with the lawyer's funds (except for an amount to cover bank fees) and which must be deposited in a financial institution authorized to do business in Michigan and which carries government deposit insurance. Because these are lawyer's duties, only lawyers (and not other law firm employees) should be signatories on client trust accounts (see ethics opinion R-7 at www.michbar.org/opinions/ethics/search.cfm).

2. Two Types of Trust Accounts: IOLTA and Non-IOLTA Accounts

An "IOLTA account" (Interest on Lawyers Trust Account) refers to a pooled interest- or dividend-bearing account at an eligible institution that includes only client or third person funds that cannot earn income for the client or third person in excess of the costs incurred to secure such income. MRPC 1.15(a)(3). A "Non-IOLTA account" refers to an interest- or dividend-bearing account in banks, savings and loan associations, and credit unions which contain larger or longer term funds that can net income for the client. MRPC 1.15(a)(4). Because the above definitions of IOLTA and non-IOLTA accounts require that both types of accounts bear interest (or dividends), and because MRPC 1.15(d) requires ALL client or third party funds be placed in either an IOLTA or non-IOLTA account, MRPC 1.15 does not permit lawyers to place client funds in non-interest bearing accounts.

IOLTA accounts only contain funds which are too small or held too briefly to be invested for the client, but the net interest or dividends on the aggregate are captured for public purposes. Banks (not attorneys) must forward net IOLTA account earnings to the Michigan State Bar Foundation, an IRS tax-exempt charity, which employs the income to support civil legal services for the poor and for improvements in the administration of justice. All fifty states have IOLTA programs.

While an IOLTA account is a pooled account containing multiple client deposits, a non-IOLTA account can either be a separate account for a particular client or a pooled account with subaccounting by the bank or by the lawyer which will provide for computation of earnings for each client's or third person's funds and the payment thereof to the client or third person. MRPC 1.15(a)(4)(A-B).

Based on the expected duration of the deposit and its amount, financial institutions can assist lawyers in selecting the appropriate interest-bearing product for non-IOLTA accounts. Banks can also do the tax reporting for earnings on a single client non-IOLTA account if the account carries the client's tax identification number. Even then, the lawyer is still the "account holder" who manages the account and receives monthly statements like any other account holder. Some law firms choose to set up one interest-bearing account in which they pool all non-IOLTA deposits and then do the subaccounting and tax reporting in-house. In that case, the bank uses the law firm's tax identification for the bank account, and the law firm provides the 1099 forms annually to the client for earnings on client funds.

MRPC 1.15(g) requires legal fees and expenses that have been paid in advance be placed in a trust account. MRPC 1.15(c) also requires that when two or more persons (one of whom may be the lawyer) claim an interest in the trust account funds, the disputed funds shall be kept separate by the lawyer until the dispute is resolved. Part Two of this series will cover in greater depth the types of funds (e.g., retainers, settlements, etc.) that must be placed in trust accounts.

3. Determining Which Funds Go into Which Trust Accounts

In many types of law practice, it is rare to need a non-IOLTA account. Even large sums can properly be placed in an IOLTA account if net earnings over costs are not expected for the time the funds will be held (e.g., a settlement check deposited into an IOLTA account just long enough for the check to clear and funds to be disbursed). Lawyers must do the math to figure out whether a fund can earn net income and therefore cannot go into an IOLTA account. Factors to use in making this determination are set forth at MRPC 1.15(e). Fundamentally, lawyers can call their bank or visit its website to ascertain the interest rate that would be used if a non-IOLTA account were established; predict how long the funds will be held; and estimate the costs of administering the account (including bank fees and law firm time/costs). A simple example would be a \$12,000 deposit which would earn ½ percent in a savings account for the 60 days it will be held, but that \$10 of earnings would not be enough to offset bank fees of, say, \$5 per month plus law firm costs to set up and manage the account and do any tax reporting required. Because the funds cannot earn net income for the client, it is a proper IOLTA deposit.

A lawyer's good-faith decision regarding the deposit or holding of such funds is not reviewable by a disciplinary body. MRPC 1.15(j). However, a lawyer must review the IOLTA account at reasonable intervals to determine whether changed circumstances require the funds to be deposited prospectively in a non-IOLTA account. MRPC 1.15(j). Whether to place funds into an IOLTA account is a lawyer's decision; a client waiver to put otherwise non-IOLTA funds into the IOLTA account is not permissible. That IOLTA accounts may only contain client funds that could not earn net income for the client was made clear in a United State Supreme Court Case, *Brown v Legal Foundation of Washington*, 538.U.S. 216 (2003), which upheld the constitutionality of IOLTA.

4. 2005 Amendments to MRPC 1.15

The 2005 amendments to MRPC 1.15, and separate attorney IOLTA guidelines (also approved by the Michigan Supreme Court – see www.msbf.org/iolta) did not change the fundamental trust account requirements noted above. They did, however, reflect updated banking practices that had

evolved since IOLTA was first established in Michigan in 1990. Now, lawyers may only place their accounts at financial institutions which pay the highest interest rate generally available to that bank's similarly-situated non-IOLTA customers (labeled "eligible institutions" at MRPC 1.15(a)(2)). This change has been adopted by two dozen other states and is called "rate comparability."

Another change lists which bank fees may be billed to the lawyer because they cannot be deducted from interest on IOLTA accounts. Many banks waive all fees on ordinary IOLTA accounts, for which they are listed on the "IOLTA Honor Roll" because their generosity makes more funds available for charitable grants. Lawyers can help sustain this practice by thanking their bank for being on the "IOLTA Honor Roll" or, if their bank is not yet on the Honor Roll, asking them to join.

As noted in the Michigan Supreme Court approved "Attorney IOLTA Guidelines," the rule does not require lawyers to contact their banks to assure that "comparable rates" are being paid: "The Foundation attends to implementation by financial institutions. If there is an issue, the Foundation will contact the lawyers affected and provide assistance and information to them." In fact, to date, no Michigan lawyer has had to change an IOLTA account as a result of the new "comparable rate" requirements.

Participation in IOLTA is and has always been voluntary for banks. But, if a bank participates, it must comply with the comparable rate requirement by either setting up IOLTA accounts as the higher rate products when warranted by the IOLTA account balance, or banks can choose to just pay the rate that product would have yielded on the existing IOLTA account. To date, all banks in Michigan have chosen the latter. Should any bank require a new product be established, lawyers would only need to sign the bank's standard form, but even then, the Foundation would notify and assist lawyers as needed. Permissible products are listed in the attorney guidelines; they include a checking account with an automated sweep feature to allow daily balances to be swept to government money market funds or repurchase agreements. The main IOLTA account would remain what it is now, an interest-bearing checking account which operates the same for lawyers as before these changes.

It is worth noting that FDIC insurance has always applied to trust accounts in banks. The amount of the coverage per owner of the funds (each client, not the total pooled account balance) was previously \$100,000 but was increased to \$250,000 through December 31, 2009. If a client has other funds at the same bank as the lawyer uses for a trust account, those amounts are combined in determining the limits of coverage for any particular client. For IOLTA accounts, however, the FDIC recently approved unlimited coverage regardless of amount, under the Temporary Liquidity Guarantee Program. This unlimited insurance protection is in effect through December 31, 2009. A list of banks not electing this unlimited coverage is available on the FDIC website at www.fdic.gov.

5. Getting Help or More Information

Information about IOLTA accounts can be obtained by contacting the Michigan State Bar Foundation at 800-968-6723 or visiting www.msbf.org/iolta. The Foundation was assigned by the Michigan Supreme Court to administer IOLTA. Part of this duty includes distributing IOLTA receipts through a grants process to support civil legal aid for the poor or for improvements in the administration of justice. IOLTA funds helped nonprofit legal aid agencies receiving IOLTA grants to close more than 53,000 cases throughout Michigan in 2007, by helping low-income families whose annual income is below 200% of poverty (which is \$28,000 for a family of 2) stay safe from family violence, avoid homelessness, access medical care, obtain child support, and

resolve other critical civil legal needs. See www.msbf.org for more information about the charitable programs assisted with IOLTA funds.

Questions about trust accounting can always be directed to the State Bar of Michigan's Ethics Helpline at (877) 558-4760. In addition, ethics opinions relating to trust accounting have been assembled in one collection on the State Bar's web site at www.michbar.org/opinions/ethics/trust.cfm.

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Trust Accounts Part Two: Financial Management of Client or Third Party Funds

By: Danon D. Goodrum-Garland, Esq., Professional Standards Investigative Counsel and Nkrumah Johnson-Wynn, Esq., Professional Standards Service Counsel, both of whom serve as staff counsel in the Professional Standards Division of the State Bar of Michigan.

This article, the second in a two-part series, reviews the fundamentals of trust account management as required by the Michigan Rules of Professional Conduct (MRPC). Part One examined the basic trust account requirements set forth in MRPC 1.15 and IOLTA Account Guidelines approved by the Michigan Supreme Court. This article will discuss the types of funds that must be deposited into client trust accounts and how lawyers should account for those funds.¹

I. Financial Management Requirements

MRPC 1.15 requires lawyers to ethically manage client and third party funds received by them. This caretaker obligation consists of five essential elements – a duty to notify, safeguard, segregate, deliver, and account for funds belonging to the client or third party.² Mismanagement of any one of these areas of responsibility could result in discipline of the lawyer for misconduct, even if the client or third party is not harmed by the lawyer’s ethical violation. Current media attention to Ponzi schemes and other abuse of investment duties creates a heightened awareness of the need for proper financial management by all fiduciaries. However, lawyers entrusted with client or third party funds need not read about high profile cases to know that they must understand and always follow ethical requirements when handling client and third party funds.

A. Characterizing Trust Funds

The requirements pertaining to the handling of funds apply upon the lawyer’s receipt of them; therefore, careful attention should be given to ordinary and common financial transactions between the lawyer and both clients and third parties. A clear understanding of which funds are properly characterized as trust funds is an absolute necessity to ensure proper performance of the lawyer’s required caretaker duties.

The commingling of client or third party funds with funds belonging to the law firm or lawyer violates MRPC 1.15(a). If a lawyer deposits funds received from a client that should have been held in trust into the law firm’s operating account, that ethical duty is breached. Accordingly, a lawyer must be prepared to determine how funds should be handled upon their initial receipt.

MRPC 1.15(d) requires that “[a]ll client and third person funds shall be deposited in an IOLTA or non-IOLTA account.” The question is how to determine whether funds coming into a lawyer’s possession in connection with a representation are “client or third person funds.” MRPC 1.15(g) includes the criteria for trust funds.

Legal fees and expenses that have been paid in advance shall be deposited in a client trust account and may be withdrawn only as fees are earned or expenses incurred.

Lawyers typically understand the basic concept that an “advance” or a “retainer”³ paid by a client for work not yet performed *must* be deposited into a client trust account.⁴ However, lawyers do not always fully understand the breadth of the funds that are characterized as a fee paid in advance. For example, when a client pays a fixed or flat fee at the beginning of the representation but there

is no agreement between the client and lawyer regarding when the fees are earned or whether any portion is refundable, the entire fee must be deposited into a client trust account. The reasoning behind this provision is that the fee has not yet been earned because the services are to be performed in the future.⁵ This is true even if the legal services are expected to be completed in a short period of time or do not require substantial attorney time to complete due to the nature of the case (*e.g.*, an eviction proceeding, a misdemeanor, an uncontested divorce with no children or marital assets, or a driver's license restoration hearing).

The total dollar amount of the fixed or flat fee paid in advance is not indicative of whether it should be deposited into a client trust account. A flat fee charged in advance could be as little as \$500 or as much as \$50,000 for two different matters. If there is no agreement about refundability or when the amount is earned, both amounts must be deposited into a client trust account until the lawyer has performed the legal services to which the client is entitled.⁶

Similarly, if a lawyer is paid fees in advance for a matter to be performed on an hourly basis, the advance fee must be deposited into a client trust account and withdrawn by the lawyer only as services are performed and billed.⁷ If the advance fee paid to the lawyer is a mixture of unearned fees and, for example, filing fees, a check that contains both amounts must be deposited into a client trust account. Thereafter, the amount of the filing fees may be removed from the trust account and deposited into the firm's operating account to reimburse the firm for expenses previously paid or remitted directly to the court for payment.⁸

Certain funds remitted to a lawyer are earned upon receipt and **must not** be deposited into a client trust account. Funds paid for legal services already performed have been earned when paid and must not be deposited into a trust account.⁹ A fee meeting all of the requisites of a "nonrefundable retainer"¹⁰ is considered earned upon receipt and therefore should not be commingled with client funds.¹¹ However, "[i]f any portion of the retainer is unearned because it is paid in advance for legal services to be performed in the future on an hourly, flat or percentage basis, the retainer has not been earned and is not a nonrefundable retainer."¹²

A lawyer must also be mindful of ethical considerations when handling settlement proceeds. Without exception, a lawyer is required to handle the financial management of a settlement distribution for a client and may not engage in conduct to avoid this responsibility.¹³ This means the lawyer is required to accept payment of the settlement funds on behalf of the client, deposit the settlement funds into a client trust account, and promptly disburse the settlement proceeds to the client and/or third parties.¹⁴ A lawyer runs afoul of MRPC 1.15 by permitting payment of a settlement check directly to the client because third parties are permitted to assert an interest in the funds.

When two or more persons (one of whom may be the lawyer) claim interest in the property, it shall be kept separate by the lawyer until the dispute is resolved. The lawyer shall promptly distribute all portions of the property as to which the interests are not in dispute.¹⁵

Additionally, a lawyer violates MRPC 1.15 and MRPC 1.8(e), by paying a client a settlement amount from funds in the law firm's operating account or the lawyer's personal account and then depositing the proceeds of a settlement check into either the law firm's operating account or the lawyer's personal account.¹⁶ MRPC 1.15(d) proscribes this conduct.

A lawyer shall hold property of clients or third persons in connection with a representation separate from the lawyer's own property. All client or third person funds shall be deposited in an IOLTA or non-IOLTA account. Other property shall be identified as such and appropriately safeguarded.

Such conduct impermissibly provides financial assistance to a client and commingles funds because *all* client or third party funds must be deposited into a client trust account.¹⁷ In fact, an ethical problem arises whenever a lawyer receives a check made payable to both the client and law firm and the lawyer fails to deposit these funds into a client trust account.¹⁸ The assertion that the funds will be immediately disbursed to the client and/or third party (in whole or in part) when the check clears is irrelevant in the analysis of whether an ethical violation has occurred.

There is only one limited circumstance when a lawyer is permitted to commingle the funds of the law firm or the lawyer's personal funds with client or third party funds. A lawyer may do so to defray or waive the service charges associated with maintaining a client trust account.

A lawyer may deposit the lawyer's own funds in a client trust account only in an amount reasonably necessary to pay financial institution service charges or fees or to obtain a waiver of service charges or fees.¹⁹

Simply put, lawyers must be meticulous in managing client and third party funds and must avoid prematurely paying themselves from these funds. Failure to do so constitutes unethical conduct and may result in disciplinary action by the Attorney Grievance Commission for misconduct related to commingling, misappropriating, and/or converting client and third party funds.²⁰

B. Accounting For Trust Funds

The lawyer's financial management of client or third party funds necessarily requires the lawyer to account for these funds. This entails prompt notification to the client or third party upon the lawyer's receipt of such funds, prompt delivery of the funds to the client or third party, and preservation of bank statements and other financial records accounting for these funds for five years after they have been disbursed to the owner.

A lawyer shall:

- (1) promptly notify the client or third person when funds or property in which a client or third person has an interest is received;
- (2) preserve complete records of such account funds and other property for a period of five years after termination of the representation; and
- (3) promptly pay or deliver any funds or other property that the client or third person is entitled to receive, except as stated in this rule or otherwise permitted by law or by agreement with the client or third person, and, upon request by the client or third person, promptly render a full accounting regarding such property.²¹

The lawyer may rely on the assistance of others (*e.g.*, a financial institution, a CPA, and law firm personnel) to carry out this accounting duty. However, the lawyer should properly supervise persons so entrusted because the lawyer remains ultimately responsible for trust accounting errors and omissions.²²

II. Getting Help or More Information

Questions about trust accounting may be directed to the State Bar of Michigan's Ethics Helpline at (877) 558-4760. In addition, ethics opinions relating to trust accounting have been assembled in one collection on the State Bar's web site at www.michbar.org/opinions/ethics/trust.cfm.

Information about IOLTA accounts may also be obtained by contacting the Michigan State Bar Foundation at 800-968-6723 or visiting www.msbf.org/iolta. The Foundation was assigned by the Michigan Supreme Court to administer IOLTA. Part of this duty includes distributing IOLTA receipts through a grants process to support civil legal aid for the poor or for improvements in the administration of justice. IOLTA funds helped nonprofit legal aid agencies receiving IOLTA grants to close more than 53,000 cases throughout Michigan in 2007, by helping low-income families whose annual income is below 200% of poverty (which is \$28,000 for a family of 2) stay safe from family violence, avoid homelessness, access medical care, obtain child support, and resolve other critical civil legal needs. See www.msbf.org for more information about the charitable programs assisted with IOLTA funds.

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¹ See Linda Rexer, Trust Accounts Part One: Establishing IOLTA and Non-IOLTA Trust Accounts, BRIEFS, March, 2009.

² MRPC 1.15(b), (c), (d), (h), and (g).

³ The term “retainer,” as used in this article, refers to a fee paid in advance for legal services. A “true retainer” is for the lawyer’s availability only and not for legal services. ABA/BNA Lawyers’ Manual on Professional Conduct, 41:202-203. A fee paid for legal services to be performed in the future is technically an “advance” and not a “retainer,” even though the terms are frequently used interchangeably.

⁴ MRPC 1.15(g); Formal Ethics Op R-7.

⁵ Informal Ethics Op RI-69.

⁶ *Id.*

⁷ *Id.*

⁸ Formal Ethics Op R-7.

⁹ *Id.*; Informal Ethics Op RI-69. See also, MRPC 1.15(d).

¹⁰ See Informal Ethics Op RI-10 for a discussion of the circumstances under which nonrefundable retainers can ethically be charged and retained.

¹¹ *Id.*; Formal Ethics Op R-7; Informal Ethics Op RI-69.

¹² Formal Ethics Op R-7, p 8; see also MRPC 1.15(g).

¹³ Informal Ethics Ops RI-189 and RI-93.

¹⁴ *Id.*

¹⁵ MRPC 1.15(c). See also Informal Ethics Ops RI-189 and RI-93.

¹⁶ Informal Ethics Ops RI-189.

¹⁷ MRPC 1.15(d).

¹⁸ *Id.*

¹⁹ MRPC 1.15(f).

²⁰ Formal Ethics Op R-7.

²¹ MRPC 1.15(b).

²² Formal Ethics Op R-7.

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