

# PENN ATTORNEYS

## TITLE ALERT

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**DATE: 9/11/08**

**RE: Title Alert 2008-10**

**Cautionary Measures to Protect Trust Accounts**

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**For your information, here is a special title alert from First American's Home Office Underwriting Group.**

The downturn in the economy has created the need to look closely at the security of trust account deposits in banks. As attorneys and title agents, you should be concerned about the choice of banks in which you deposit trust funds and your responsibilities to your clients and customers.

The Federal Deposit Insurance Corporation ("FDIC") protects depositors/owners against the loss of their insured deposits if an FDIC-insured bank or savings association fails. While there is comfort in knowing that deposits maintained in an FDIC-insured bank are protected as individually-owned funds up to \$100,000 (or \$250,000 for self-directed retirement accounts), you may possibly be liable to your customers if you don't make an informed decision to choose the proper bank, and the bank where you deposit escrow funds fails.

This memo suggests three (3) business practices that may help reduce your exposure as a fiduciary. While these preventative measures are good suggestions, there is no guarantee that by following these procedures you will be protected from claims due to bank failure. These practices are:

- I. Move your trust accounts to a "safe" bank**
- II. Comply with the disclosure requirements for FDIC coverage**
- III. Expressly limit your liability for matters beyond your control**

Please understand that the information you obtain from this memo is not legal advice and is not intended to be legal advice. We recommend that you consult an attorney for individualized advice regarding your situation.

### **I. Move to a "safe" bank.**

Obviously, it makes good business sense to have your trust accounts in banks with strong capitalization, profitability, liquidity and marginal to zero sub-prime exposure. Few of us have the expertise to meaningfully evaluate and compare the "riskiness" of various banks. Size of a bank is not necessarily indicative of the safety of that bank. Fortunately, there are several services that have evaluated the filings made by each bank and offer their "opinion" of the risk of holding deposits in those banks. While we do not guarantee the accuracy of the information on these services, we offer them as a possible source of information.

The FDIC website includes a link to several rating services:

**<http://www.fdic.gov/bank/individual/bank/index.html>**. Another useful website that reviews and rates the financial conditions of various banks is

**[http://www.bankrate.com/brm/safesound/ss\\_home.asp](http://www.bankrate.com/brm/safesound/ss_home.asp)**. Please keep in mind that while these reports and services are only the opinions of the various providers, they may be useful in evaluating the riskiness of your bank.

If a depository bank is not highly rated or exhibits some other cause for concern, it may be prudent to move your trust account(s) to a higher-rated banking institution insured by the FDIC. Protection of your clients should be your primary goal. After all, this type of preventive measure could help your

office avoid having to deal with a bank failure.

## II. Comply with the disclosure requirements for FDIC coverage.

Regardless of the rating of the bank, increasing the probability that each of your customers has the maximum amount of FDIC insurance protection is a good idea. This memo suggests steps you can take in an effort to comply with the FDIC's requirements for recognizing the individual nature of interests in fiduciary/trust accounts. Attached to this article is an excerpt from an FDIC manual that explains the FDIC's disclosure requirements for fiduciary accounts. We strongly suggest that you contact knowledgeable counsel to ensure compliance.

The excerpt states that funds deposited by a fiduciary on behalf of one or more persons or entities (the owners) will be insured as the deposits of the owners if the fiduciary meets the disclosure requirements for fiduciary accounts, which are:

1. **The fiduciary nature of the account must be disclosed in the bank's deposit account records** (for example, "[Law Firm Name] Trust Account" or "XYZ Title Agency, Escrow Account"); and
2. **The name and ownership interest of each depositor/owner must be readily ascertainable from the deposit account records of the bank or the deposit account records maintained by the escrow agent.**

Please see 12 C.F.R.330.1 et. seq.

The FDIC provides an exception to the first disclosure requirement for fiduciary accounts in instances where the FDIC determines, in its sole discretion, that the titling of the deposit account and the underlying deposit account records sufficiently indicate the existence of a fiduciary relationship. This exception may apply, for example, where the deposit account title or records indicate that the account is held by an escrow agent, title company or a company whose business is to hold deposits and securities for others. However, it is a suggested practice to title the deposit account with the specific fiduciary nature regardless of this exception.

The second disclosure requirement appears to be quite challenging since the applicable rules defining "deposit account records" provide the FDIC with significant latitude in deciding what is deemed sufficient as a "deposit account record." Under 12 C.F.R. § 330.1(e), "deposit account records" are defined to include:

- **account ledgers, signature cards, certificates of deposit, passbooks, corporate resolutions authorizing accounts in the possession of the insured depository institution and other books and records of the insured depository institution, including records maintained by computer, which relate to the insured depository institution's deposit taking function, but does not mean account statements, deposit slips, items deposited or cancelled checks.**

Given the FDIC's wide discretion in interpreting its own rules and regulations, it is advisable for you to build a paper trail that fully and clearly discloses the fiduciary nature of the account in the bank's "deposit account records." You might also consider providing a written statement to the bank as follows:

- **"This is a [title agency/law firm] escrow account under [insert citations to escrow agent statute and Bar rules, as applicable] containing funds belonging to others received by [title agent/law firm] in a fiduciary capacity. The relationship and the interests of other parties in this account are ascertainable from the bank's deposit records, which include and are supplemented by records maintained in the regular course of business by the**

**[title agency/law firm]. [name of bank] has been advised of the policy of [title agency/law firm] to obtain escrow agreements from parties to transactions in which deposits are made to this account either as part of a contract appointing [title agency/law firm] as escrow agent or pursuant to a separate agreement. These escrow agreements are intended by [title agency/law firm] to be considered part of the bank's deposit records as defined by the FDIC regulations."**

Another area of potential concern related to the recognition of the individual nature of deposits in a trust account arises if the trust account is "swept" into other investments periodically in order to increase the interest earned on the trust account where lawful and according to local custom. You should talk to your bank and consult with an attorney about the nature in which the sweep accounts are invested. Please be aware that some sweep vehicles may not have the protection of FDIC insurance. You should ask if the sweep transactions will affect the criteria by which the FDIC determines whether it will recognize the individuality of depositors in the trust account.

The steps set forth in this memo do not ensure that the FDIC insurance will be available for each client or customer. As stated earlier, the FDIC has discretion in determining how the FDIC insurance coverage will apply. The steps suggested herein are for the purpose of attempting to make it more likely that the FDIC will recognize the fiduciary nature and the individual interests within a single trust account. Since the entire purchase price for each transaction is usually in a trust account at the moment of closing, almost every customer's sub-account, if recognized by the FDIC, will probably exceed the \$100,000 insurance level at some point during the life of the transaction. Therefore, maximizing the FDIC coverage does not alleviate the potential for loss, and is merely a supplement to picking a "safe" bank.

### **III. Expressly limit your liability for matters beyond your control.**

The "best practices" in our industry have long dictated that funds should be held with an express written escrow agreement. Given today's market and economy, we suggest that you go a step further and expressly disclaim liability in your escrow agreement for:

1. The financial status or insolvency of any other party, or any misrepresentation made by any other party.
2. The legal effect, insufficiency, or undesirability of any instrument deposited with or delivered by or to the escrow agent or exchanged by the parties hereunder, whether or not the escrow agent prepared such instrument.
3. The default, error, action or omission of any other party to the escrow.
4. Any loss or impairment of funds that have been deposited in escrow while those funds are in the course of collection or while those funds are on deposit in a financial institution if such loss or impairment results from the failure, insolvency or suspension of a financial institution, or any loss or impairment of funds due to the invalidity of any draft, check, document or other negotiable instrument delivered to the escrow agent.
5. The expiration of any time limit or other consequence of delay, unless a properly executed settlement instruction accepted by the escrow agent has instructed the escrow agent to comply with said time limit.
6. The escrow agent's compliance with any legal process, subpoena, writ, order, judgment or decree of any court, whether issued with or without jurisdiction and whether or not subsequently vacated, modified, set aside or reversed.
7. Any shortfall in the sufficiency of the amount held in escrow to accomplish the purpose of the escrow.
8. Any obligation to collect additional funds, unless such obligation is in writing and signed by the escrow agent.

We also suggest that you disclose the identity of the bank where the escrow account will be held and have escrow instructions approving that arrangement from the parties to the transaction.

Understandably, this can be problematic in the title industry because the “standard” real estate contracts often do not include this level of protective language. Since the attorney/title agent is usually not a party to the initial contract and is not obligated to accept an escrow simply because a contract has been signed, you might consider a separate confirmatory escrow letter or agreement “accepting” the escrow subject to the terms and conditions as set forth above.

By keeping your trust accounts in “safe” banks, building a paper trail for maximum FDIC coverage and contractually limiting your liability, you are taking steps that should help reduce your exposure and that of your clients and customers in the event of a bank failure.

Title Alerts from 1997 to present are available on our website at: <http://www.pennattorneys.com>

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