SBM STATE BAR OF MICHIGAN

MEMORANDUM

p 517-346-6300
p 800-968-1442
f 517-482-6248
www.michbar.org

306 Townsend Street
Michael Franck Building
Lansing, MI
48933-2083

TO: Members of the Representative Assembly

FROM: The Client Protection Fund Standing Committee

RE: Proposed Rule for Trust Account Overdraft Notification

DATE: March 14, 2006

The Client Protection Fund Standing Committee voted to submit a proposed rule implementing Trust Account Overdraft Notification to the Assembly at its September 2006 meeting. You may be asking why such a rule is needed. You correctly recognize that you would never inappropriately take client funds. You may wonder why you should care.

Why Is a Trust Account Overdraft Notification Rule Needed?

In the past four years the State Bar of Michigan Client Protection Fund has paid $1,028,418 in claims. Sixty-nine percent of these claims, or $705,000 is attributable to the actions of nine attorneys from nine different counties throughout the Lower Peninsula.

Approximately thirty-five jurisdictions have implemented trust account overdraft notification programs [Exhibit A] and all jurisdictions report that the programs have been very successful. New Jersey reports that since the program began in 1985, it has averaged three hundred and twenty-five (325) attorney overdrafts per year. The New Jersey Supreme Court has disciplined eighty-five (85) attorneys for financial misconduct that was discovered solely through overdraft notification. Fifty of the eighty-five attorneys were disbarred, approximately 59%. The balance were suspended, reprimanded or admonished.

The New York Fund reports that from 1993 to February 28, 2006, the Fund has processed over 6,465 bounced check reports with a total face amount in excess of $174.2 million. The reports have identified upwards of 145 lawyers who had misused escrow funds.

As reported by the New Jersey Law Journal, a New Jersey lawyer was suspended from practice in the face of evidence provided by the bank indicating that the lawyer had been using client trust funds to fuel a gambling addiction. [Exhibit B]

Pennsylvania reports that it received 225 overdraft notices during the 2004-2005 fiscal year, which resulted in 26 overdraft notices being referred to the Office of Disciplinary Counsel for further inquiry. The remaining 190 overdraft notices were reviewed, dismissed with a satisfactory explanation, and scheduled for destruction 6 months thereafter.

For fiscal year 2005, Maryland received 109 overdraft notifications. Twenty four were bank error; fifty-eight were resolved because there was a proper deposit to the wrong account, a late deposit, internal fraud, a check drawn for an incorrect amount, a deposit which had not yet cleared, an error on an endorsement or death of the attorney-maker. Twenty-four overdrafts warranted disciplinary action. Three were still pending at this time.

Pennsylvania reports an incident where $100 overdraft led to the discovery that a lawyer had been steadily misappropriating from estates, for a total loss in excess of 1.5 million, and was ultimately suspended from the practice of law.

From 1991-2006, Minnesota's trust account overdraft notification program has resulted in 85 private disciplines (admonitions or private probations), two transfers to disability status, 17 public reprimands and probation, 35 suspensions and 14 disbarments.

As shown by the Michigan Client Protection Fund statistics and the statistics from other states, members of the public are suffering substantial harm at the hands of our fellow attorneys who, for whatever reason, have violated their fiduciary responsibilities.

Why You Should Care

The legal profession is one of the few remaining professions enjoying the privilege of self-regulation. If the profession fails to deal with our "bad apples" and give the public a reason to be confident in the legal profession, we run the risk that, like other professions, a taxpayer sponsored, state agency will be constructed to regulate the profession. Dealing with the bad apples of the profession is a responsibility that comes with having the privilege to practice law.

We as Michigan lawyers cannot tell Michigan citizens that we oppose a program that would identify lawyers who may be stealing client funds, when thirty-five other states have instituted these programs that have successfully prevented the public from being victimized.

Addressing Your Concerns

The Committee recognizes concerns that you may have with such a program, chief among them having innocent attorneys drawn into the discipline system and increased expense. Overdraft notification programs are not intended to result in the discipline of every lawyer who overdraws a trust account. Lawyers and financial institutions may make innocent errors and a mechanism will be created to identify these situations without adverse impact on the lawyers. The program is structured to create a mechanism whereby the disciplinary agencies can receive an early warning of improprieties so that harm to the public can be avoided.

The Committee has gathered rules from other jurisdictions and will be studying them thoroughly. Over the late spring and summer the Committee will be working with representatives from the Attorney Grievance Commission, the Attorney Discipline Board, the State Bar of Michigan Foundation and others to create a procedure and draft a rule addressing these concerns and striking the right balance between the competing policy issues.

Attached are copies of the ABA Model Rule [Exhibit C] and rules from other states as an example of how these programs work. The better-structured programs maintain a list of "approved" banks and financial institutions from which attorneys must choose to set up their trust accounts. In order to be on the "approved" list the institution must enter into a written contract, agreeing to notify the designated agency of an overdraft on an attorneys' trust account. The terms of these contracts are fairly standard from state to state.

The Committee welcomes your comments and suggestions as we move through the process and look forward to bringing you a final proposed order in September.

L Fallasha Erwin uc

L. Fallasha Erwin
Chairperson, Client Protection Fund Standing Committee

August 10, 2005

AMERICAN BAR ASSOCIATION
STANDING COMMITTEE ON CLIENT PROTECTION

State by State Adoption of ABA Client Protection Programs

	Trust[1] Account Overdraft Notification (35)	Random[2] Audit of Trust Accounts[7] (11)	Payee[3] Notification (10)	Disclosure[4] of Insurance (14)	Mandatory[5] Fee Arbitration (12)	Mediation[6] Non-Fee Disputes (23)
AL	Yes	No	No	No	No	No
AK	No	No	No	Yes	Yes	Yes
AZ	Yes	No	No	No	No	Yes
AR	Yes	No	No	No	No	No
CA	Yes	No	Yes	No	Yes	Yes
CO	Yes	No	No	No	No	No
CT	Yes	No	Yes	No	No	Yes
DE	Yes	Yes	Yes	Yes	No	Yes
DC	Yes	No	No	No	Yes	No
FL	Yes	No	No	No	No	Yes
GA	Yes	No	Yes	No	Yes	Yes
HI	Yes	Yes	No	No	No	No
ID	Yes	No	No	No	No	No
IL	No	No	No	Yes	No	No
IN	Yes	No	No	No	No	Yes
IA	Yes	Yes	No	No	No	No
KS	Yes	Yes	Yes	Yes	No	No
KY	Yes	No	No	No	No	Yes

Exhibit A

	Trust Account Overdraft Notification	Random Audit of Trust Accounts	Payee Notification	Disclosure of Insurance	Fee Arbitration	Mediation Non-Fee Disputes
LA	No	No	No	No	No	Yes
ME	No	No	No	No	Yes	No
MD	Yes	No	No	No	No	Yes
MA	Yes	No	No	No	No	No
MI	No	No	No	Yes	No	No
MN	Yes	No	No	No	No	No
MS	No	No	No	No	No	Yes
MO	No	No	No	No	No	Yes
MT	Yes	No	No	No	Yes	No
NE	No	Yes	No	Yes	No	No
NV	Yes	No	Yes	No	No	No
NH	No	Yes	No	Yes	No	No
NJ	Yes	Yes	Yes	No	Yes	No
NM	No	No	No	Yes	No	Yes
NY	Yes	No	Yes	No	Yes	Yes
NC	Yes	Yes	No	Yes	Yes	Yes
ND	No	No	No	No	No	No
OH	Yes	No	No	Yes	Yes	No
OK	No	No	No	No	No	No
OR	Yes	No	No	Mandatory Ins. Req.	No	Yes

	Trust Account Overdraft Notification	Random Audit of Trust Accounts	Payee Notification	Disclosure of Insurance	Fee Arbitration	Mediation Non-Fee Disputes
PA	Yes	No	Yes	No	No	Yes
RI	Yes	No	Yes	No	No	No
SC	Yes	No	No	No	Yes	No
SD	No	No	No	Yes	No	No
TN	Yes	No	No	No	No	No
TX	No	No	No	No	No	Yes
UT	Yes	No	No	No	No	Yes
VT	Yes	Yes	No	No	No	Yes
VA	Yes	No	No	Yes	No	No
WA	Yes	Yes	No	No	No	Yes
WV	No	No	No	Yes	No	No
WI	Yes	No	No	No	No	No
WY	No	No	No	No	Yes	Yes

[1] ABA *Model Rules for Trust Account Overdraft Notification*:: http://www.abanet.org/cpr/clientpro/opreface.html

[2] ABA *Model Rules for Random Audit of Lawyer Trust Accounts*: http://www.abanet.org/cpr/clientpro/apreface.html

[3] ABA *Model Rule for Payee Notification*: http://www.abanet.org/cpr/clientpro/ppreface.html

[4] ABA *Model Court Rule on Insurance Disclosure*:
http://www.abanet.org/cpr/clientpro/Model_Rule_InsuranceDisclosure.pdf

[5] ABA *Model Rules for Fee Arbitration*:: http://www.abanet.org/cpr/clientpro/fapreface.html

[6] ABA *Model Rules for Mediation of Client-Lawyer Disputes*: http://www.abanet.org/cpr/clientpro/medpreface.html

From: "Holtaway, John" <JHoltaway@staff.abanet.org>
To: <CPR_LAWYERSFUND@MAIL.ABANET.ORG>
Date: 1/12/06 12:40PM
Subject: Lawyer Suspended Amid Probe of Gambling-Related Client Fund Withdrawals

Lawyer Suspended Amid Probe of Gambling-Related Client Fund Withdrawals

New Jersey Law Journal
January 12, 2006

A Voorhees, N.J., lawyer was suspended from practice Jan. 4 in the face of evidence she has been using client trust funds to fuel a gambling addiction.

The state Supreme Court's action came a day after oral argument in the case of Jaffa Stein and just three weeks after the justices ordered the solo practitioner to stop taking on new clients.

The ethics case began in November, after Wachovia Corp. informed the Office of Attorney Ethics of unusual transfers between Stein's trust and business accounts. Once the funds were moved, business account checks were being cashed at banks in the Atlantic City area.

When questioned by the OAE, Stein admitted her actions but blamed them on a gambling addiction, OAE counsel Michael Sweeney told the Court Jan. 3.

Sweeney said that during interviews with investigators, Stein said she had been seeing an addictions counselor but had discontinued the sessions and had started gambling again. Although she said she had placed her name on a list that casinos use to keep out problem gamblers, she continued to stay at casinos. When pressed, she said she was merely cashing in "comps," free room and meal offers.

"[S]he's beyond the pale at this point," said Sweeney, telling the justices that he would request disbarment.

On Dec. 14, the court ordered that a supervisor be appointed to oversee Stein's financial affairs and also barred Stein from taking on new clients, a mandate that Sweeney said had been ignored.

Stein's lawyer, Cherry Hill, N.J., solo Mark Kancher, asked the court to stop short of a suspension, pointing out that Stein, a plaintiffs personal injury lawyer, has a number of breast-implant cases due to be tried soon, for which another lawyer could not become prepared in time.

Kancher asked the court for more time to appoint a fiscal overseer, saying the OAE had rejected one of the attorneys he recommended and that it had been hard to contact others during the holidays.

"She recognizes she is in need of help," Kancher said. "She is in need of strong supervision of the financial aspect of her law practice."

But the court said that its Dec. 14 order had proved "not sufficient to protect the public and the respondent's clients."

Exhibit B

Kancher declined to comment after the court issued its suspension, and Stein did not return messages left at her office.

This is not the first brush with the ethics system for Stein, formerly a partner at Cherry Hill's Tomar, O'Brien, Kaplan, Jacoby & Graziano. The OAE is presently investigating whether Stein and four other lawyers -- Ronald Graziano, David Jacoby, Michael Kaplan and Robert O'Brien -- used that firm's employees as runners, paying them substantial bonuses for bringing in personal injury clients.

Model Rules for Trust Account Overdraft Notification

PREFACE

The rules of professional conduct mandate and the lawyer disciplinary systems enforce the standard of safekeeping of client property as a fundamental fiduciary obligation of lawyers. The dishonor of drafts for insufficient funds drawn from client trust accounts is an "early warning" that a lawyer is engaging in conduct likely to injure clients. An overdraft notification program has the potential to reduce significantly the level of lawyer defalcations across the country. By requiring financial institutions which maintain lawyer trust accounts to notify the highest court or lawyer disciplinary agency of overdrafts the appropriate disciplinary authorities are able to intervene before major losses occur and significant numbers of clients are harmed. The rule also enables authorities to counsel errant lawyers to take corrective action before the lawyer's misconduct becomes so egregious as to mandate serious sanction. Participation by financial institutions is a prerequisite to their continued eligibility to hold lawyer trust accounts. The costs of providing notification can be assessed against the lawyer who caused the overdraft. An effective overdraft notification program should conserve substantial resources for both clients and lawyers' funds for client protection.

Exhibit C

Model Rules for Trust Account Overdraft Notification

Rule 1 CLEARLY IDENTIFIED TRUST ACCOUNTS REQUIRED

Lawyers who practice law in this jurisdiction shall deposit all funds held in trust in this jurisdiction in accordance with [Rule 1.15(a) of the Model Rules of Professional Conduct] in accounts clearly identified as "trust" or "escrow" accounts, referred to herein as "trust accounts," and shall take all steps necessary to inform the depository institution of the purpose and identity of such accounts. Funds held in trust include funds held in any fiduciary capacity in connection with a representation, whether as trustee, agent, guardian, executor or otherwise. Lawyer trust accounts shall be maintained only in financial institutions approved by the highest court of the jurisdiction or the state lawyer discipline agency.

Comment

Under Rule 1.15(a) of the ABA Model Rules of Professional Conduct or its equivalent, a lawyer must maintain client funds in an account separate from the lawyer's own property. Trust funds for a lawyer's own spouse or minor child and a lawyer's own funds properly held in a non-fiduciary capacity, such as funds in a business or personal account, do not fall under this rule.

It should be noted that although Model Rule of Professional Conduct 1.15 generally requires that trust accounts be maintained in the state where the lawyer's office is situated, trust property may be held outside the lawyer's home jurisdiction upon consent of the client. The overdraft notification rule governs funds held within the adopting state. A lawyer's obligation to deposit trust funds in an approved institution will arise upon adoption of the overdraft notification rule in a state where the lawyer deposits trust funds, whether that state is the state wherein the lawyer's office is situated or some other state.

Model Rules for Trust Account Overdraft Notification

Rule 2 OVERDRAFT NOTIFICATION AGREEMENT REQUIRED

A financial institution shall be approved as a depository for lawyer trust accounts if it shall file with the highest court of the jurisdiction or the state lawyer disciplinary agency an agreement, in a form provided by the court or disciplinary agency, to report to the disciplinary agency in the event any properly payable instrument is presented against a lawyer trust account containing insufficient funds, irrespective of whether or not the instrument is honored. The court or disciplinary agency shall establish rules governing approval and termination of approved status for financial institutions, and shall annually publish a list of approved financial institutions. No trust account shall be maintained in any financial institution which does not agree to make such reports. Any such agreement shall apply to all branches of the financial institution and shall not be canceled except upon [30] days notice in writing to the court or disciplinary agency.

Comment

For purposes of this rule, each financial institution wishing to be approved as a depository of client trust funds must file an overdraft notification agreement with the highest court of the jurisdiction. In some jurisdictions, the court may wish to delegate to the state bar or some other agency the duty to enter into overdraft notification agreements with financial institutions and to publish a list of approved institutions.

The overdraft notification agreement requires that all overdrafts be reported to the state lawyer disciplinary agency, irrespective of whether or not the instrument is honored. In light of the purposes of this rule, and the ethical proscriptions concerning the preservation of client funds and commingling of client and lawyer funds, it would be improper for a lawyer to accept "overdraft privileges" or any other arrangement for a personal loan on a lawyer trust account.

Denial of discretion to financial institutions serves two important purposes. First, it makes notification by a financial institution an administratively simple matter. An institution which receives an instrument for payment against insufficient funds need not evaluate whether circumstances require that notification be given; it merely provides notice. It then becomes the responsibility of the lawyer disciplinary agency to determine whether further action is warranted.

Second, mandatory notification shields the financial institution from potential tort claims by the lawyer's clients for failure to report overdrafts. Liability for negligence in reporting overdrafts could be alleged by a person, injured by such failure to report, who falls within the zone of forseeability and for whose benefit the duty to report was instituted. Arguably, a financial institution could owe a duty to the lawyer's clients who supplied the funds, and to the lawyers' fund for client protection if a pay-out is made in the event of theft of those funds. If an institution reports all overdrafts, its potential liability for negligent failure to report is minimized. In cases where a bounced check or overdraft is a result of an accounting error (caused by either the lawyer or the financial

institution), but notification has already been sent to the state agency, the institution should provide the lawyer with a written explanation (preferably, an affidavit from an officer of the institution) which the lawyer can then submit to the agency to verify the error. In the event of financial institution error no record need be kept by the agency.

The rule calls for the highest court of the jurisdiction (or lawyer disciplinary agency, where the court has so delegated) to establish rules governing approval of financial institutions' holding of client trust funds, and termination of such approved status. These rules should specify under what circumstances approved status will be withdrawn. For instance, the court's rules might state that approved status may be revoked where the institution demonstrates "a pattern of neglect or a showing of bad faith" rather than an occasional or negligent failure to report an overdraft. *See Overdraft Implementation Guidelines*, 115 N.J.L.J. (Feb. 14, 1985), at 1.

Model Rules for Trust Account Overdraft Notification

Rule 3 OVERDRAFT REPORTS

The overdraft notification agreement shall provide that all reports made by the financial institution shall be in the following format:

> (1) In the case of a dishonored instrument, the report shall be identical to the overdraft notice customarily forwarded to the depositor, and should include a copy of the dishonored instrument, if such a copy is normally provided to depositors; and
> (2) In the case of instruments that are presented against insufficient funds but which instruments are honored, the report shall identify the financial institution, the lawyer or law firm, the account number, the date of presentation for payment and the date paid, as well as the amount of overdraft created thereby.

Such reports shall be made simultaneously with, and within the time provided by law for, notice of dishonor, if any. If an instrument presented against insufficient funds is honored, then the report shall be made within [5] banking days of the date of presentation for payment against insufficient funds.

Comment
The rule provides the proper format for overdraft reports, distinguishing between dishonored instruments and instruments that are presented against insufficient funds but honored. Where instruments are dishonored, a copy of the notice of dishonor is sufficient. Where instruments are presented against insufficient funds but paid, the rule specifies the information that the institution should provide.

Ordinarily, a financial institution gives notice of an overdraft to a depositor before midnight of the next banking day following receipt of the item or notice. *See* Uniform Commercial Code (U.L.A.) ° 3-503(c) (Revised Article 3, 1990) or Uniform Commercial Code (U.L.A.) ° 3-508(2) (Prior Article 3, pre-1990). This is the same time period in which overdraft notification is to be given to the state lawyer disciplinary agency. Where an instrument presented against insufficient funds is honored, the rule recommends that the financial institution send overdraft notification to the agency within 5 days of the date of presentation.

The rule contemplates that the lawyer disciplinary agency, upon receipt of the overdraft notification, will contact the lawyer or law firm by telephone and request an explanation for the overdraft. A letter, requesting a documented explanation, may also be sent. If the overdraft is an accounting error, the lawyer or law firm will submit a written, documented explanation to substantiate the error.

Where the lawyer or law firm cannot supply an adequate or complete explanation for the overdraft, other action may be taken, including an audit or a demand for production of the lawyer's books and records.

Model Rules for Trust Account Overdraft Notification

Rule 4 CONSENT BY LAWYERS

Every lawyer practicing or admitted to practice in this jurisdiction shall, as a condition thereof, be conclusively deemed to have consented to the reporting and production requirements mandated by this rule.

Comment

The rule establishes that consent to the reporting and production requirements mandated by the rule is a condition of the privilege to practice law in the jurisdiction which has adopted the rule. As a consequence, financial institutions are protected from claims by lawyer-depositors based on disclosures made in accordance with the rule, although the only parties to an overdraft notification agreement are the court and the financial institution.

Model Rules for Trust Account Overdraft Notification

Rule 5 COSTS

Nothing herein shall preclude a financial institution from charging a particular lawyer or law firm for the reasonable cost of producing the reports and records required by this rule.

Comment

In addition to normal monthly maintenance fees on each account, the lawyer or law firm can anticipate that financial institutions will charge additional fees for reporting overdrafts in accordance with this rule. *See* Johnson, Lawyer, *Thou Shall Not Steal*, 36 Rutgers L. Rev. 454, 555 (1985) (institutions could reasonably raise their existing charges for the notification service).

Financial institutions, however, already flag overdrafts and returned checks, and, thus, it is only slightly more burdensome for the institution to forward a copy to the state lawyer disciplinary agency. The additional cost to the lawyer should be insignificant.

Rule 5 should not be interpreted to allow a lawyer to permit trust account funds to be reduced through deductions made by a financial institution to cover costs of overdraft notification. Notification costs, if charged, should not be borne by clients.

Model Rules for Trust Account Overdraft Notification

Rule 6 DEFINITIONS

"Financial institution" includes banks, savings and loan associations, credit unions, savings banks and any other business or person which accepts for deposit funds held in trust by lawyers. "Properly payable" refers to an instrument which, if presented in the normal course of business, is in a form requiring payment under the laws of this jurisdiction.

"Notice of dishonor" refers to the notice which a financial institution is required to give, under the laws of this jurisdiction, upon presentation of an instrument which the institution dishonors.

Comment

Under the laws of most jurisdictions, the definition of "properly payable" will be contained in Uniform Commercial Code (U.L.A.) ° 4-401(a) (Amended Article 4, 1990) ("An item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and bank.") or its predecessor, Uniform Commercial Code (U.L.A.) ° 4-104(i) (Prior Article 4, pre-1990) ("'Properly payable' includes the availability of funds for payment at the time of decision to pay or dishonor").

Under the laws of most jurisdictions, the definition of "notice of dishonor" will be determined by reference to Uniform Commercial Code (U.L.A.) ° 3-503(c) (Revised Article 3, 1990), under which notice must be given by a collecting bank before midnight of the next banking day following the banking day on which the bank receives notice of dishonor or by any other person within 30 days following the day on which the person receives notice of dishonor, or its predecessor, Uniform Commercial Code (U.L.A.) ° 3-508(2) (Prior Article 3, pre-1990), which states any necessary notice must be given by a bank before its midnight deadline and by any other person before midnight of the third business day after dishonor or receipt of notice of dishonor.