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9th Circuit In Conflict With 5th Circuit Over IOLTA

BY LAZAR EMANUEL

In an *en banc* decision on rehearing, the Court of Appeals for the Ninth Circuit has reached a decision affecting the IOLTA program of the State of Washington which is directly contra to the Fifth Circuit's decision in October involving a similar IOLTA program in the State of Texas. *Washington Legal Foundation et al. v. Legal Foundation of Washington, et al.* (No. 98-35154, 9th Cir., November 14, 2001). As this article was being written, a petition for rehearing had been filed with the 5th Circuit by the Justices of the Supreme Court of Texas.

In *Washington Legal Foundation et al. v. Texas Equal Access to Justice Foundation et al.* (No. 00-50139, 5th Cir. 2001), the Court of Appeals for the Fifth Circuit had previously held that the Texas IOLTA program constituted a *per se* taking of property without just compensation and, therefore, violated the Fifth and Fourteenth Amendments. (*See*, NYPRR, December 2001, p. 1.) The 5th Circuit Court had enjoined the Texas Supreme Court Justices from taking any disciplinary action against lawyers who failed to deposit client funds in an IOLTA account. The property which the 5th Circuit regarded as "taken" was the interest generated by the mandatory deposit of qualified client funds by Texas lawyers into IOLTA bank accounts. Qualified funds are client escrow funds which are so small in amount or which will be held for so short a time that they are not likely to generate enough income to cover the expense of setting up and administering individual client accounts. The interest generated from IOLTA accounts is then distributed among organizations providing legal services to low-income or indigent citizens.

All fifty states now have some version of the IOLTA program. In New York, the accounts are referred to as IOLA accounts. The New York IOLA accounts generate more than ten million dollars each year and are distributed among eighty providers of legal services.

Three Essential Issues

Both the Texas case and the Washington case, as well as several similar cases brought against the authorities administering the IOLTA program in other states, turn on three essential questions:

1. To whom does the interest generated by IOLTA accounts belong?
2. If the interest is deemed to belong to the individual client whose funds are pooled with the funds of other clients, does the payment of the interest to the state's IOLTA fund constitute a "taking?"
3. If a "taking" has occurred, what is the value of the property taken?

The first question was answered by the Supreme Court in *Philips v. Washington Legal Foundation*, 524 U.S. 156 (1998), a case which originated in an attack on the Texas IOLTA program brought by the Washington Legal Foundation (a public-interest law center), a Texas lawyer and a Texas businessman whose funds had been deposited into an IOLTA account by his attorney. The Supreme Court said:

> In sum, we hold that the interest income generated by funds held in IOLTA accounts is the "private property" of the owners of the principal...

The Court reasoned that the controlling principle was the common law rule that "interest follows principal."

However, the Court refused to consider Questions 2. and 3., above:

> ...We express no view as to whether these funds have been "taken" by the State; nor do we express an opinion as to the amount of "just compensation," if any, due respondents. We leave these issues to be addressed on remand.

The decisions by the two Federal Circuits now provide diver- gent answers to these questions.

The Washington Court decided first of all that the Washington Legal Foundation had no standing to pursue a Fifth Amendment takings claim as representative of individuals whose funds were deposited in IOLTA accounts. The court reasoned that a representative action was not available when the appropriate remedy was not injunctive relief but just compensation (i.e., compensation, if any, would belong to the individual members of the Foundation; therefore, only the individuals would have standing to sue).

In this reasoning, the Washington Court differed radically from the Texas Court, which had not only permitted the Foundation to remain as an essential party to the proceeding, but had granted injunctive relief because, under its view, just compensation was not possible at the time of taking.

The Washington Court recognized standing to challenge the Washington IOLTA program in two real estate investors whose escrow funds had been deposited into IOLTA accounts not by lawyers but by LPO's (i.e., nonlawyers licensed by Washington to prepare legal documents in connection with transactions in real and personal property). Following the *Philips decision*, the Court stated: "There can be no doubt that the interest earned on IOLTA account deposits is the private property of the owners of the principal."

***Per Se* Analysis v. *Ad Hoc* Analysis**

The Court proceeded to determine whether a taking had occurred. The Court examined two methods of analysis in takings cases: the *per se* method (i.e., any deprivation of a property right is by definition a "taking") and the *ad hoc* method (i.e., all the facts and circumstances surrounding the deprivation of property must be considered, including the social benefits to be derived). Departing again from the reasoning of the Texas Court, the Washington Court rejected the *per se* method.

> The *per se* analysis has not typically been employed outside the context of real property. It is a particularly inapt analysis when the property in question is money...
>
> ...Although we note that the Fifth Circuit recently has decided in a two to one decision to adopt the *per se* method in similar (but not identical) circumstances...given the monetary nature of the property in question, the public nature of the IOLTA program, and the highly regulated nature of the banking industry, we believe that the better approach is that of *Penn Central*. [Editor's note: In

Penn Central Transportation Co. v. New York, 438 U.S. 104 (1978), the Supreme Court applied the *ad hoc* method to determine whether building restrictions placed upon real property designated as a landmark under New York City's Landmark Preservation Law constituted a taking under the Fifth and Fourteenth Amendments.]

Applying the *ad hoc* method of analysis, the Court emphasized that although its analysis was limited by the facts of the case to IOLTA deposits by LPO's rather than lawyers, its analysis would apply "with the same force of logic to lawyer-deposited client funds."

In conducting the fact-based *ad hoc* analysis, the Washington Court was guided by the principle that a taking has occurred only if a particular regulation goes so far that it "forces 'some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole.'" In carrying out this principle, a court must look at:

1. "[t]he economic impact of the regulation on the claimant;"
2. "the extent to which the regulation has interfered with distinct investment-backed expectations;" and
3. "the character of the governmental action." (quoting *Penn Central, supra*, 438 U.S. at 124).

The Court proceeded to judge the Washington IOLTA program under each of these standards.

The economic impact. The Court's analysis was influenced by the fact that the case involved escrow deposits of LPO's employed by title companies. The plaintiffs argued that the title companies had lost the economic benefit of earning credits from the banks maintaining the accounts by being required to deposit the funds in IOLTA accounts. The Court rejected these arguments on the theory that these benefits would not have accrued to the individual plaintiffs but to the title companies.

The Court concluded that there was no economic impact upon the individual plaintiffs because, "...the IOLTA regulations themselves provide that only those funds that would not earn a net interest-either on their own or when pooled with sub accounting-are to be deposited in IOLTA accounts."

Interest with investment-backed expectations. Because there was no reasonable expectation by the individual plaintiffs that their funds would ever generate net income while in the hands of the title companies with which they were placed, the deposit of the funds into the IOLTA program by the title companies could not be said to interfere with their investment-backed expectations.

Character of Government Action. The Washington Court reasoned that the Takings Clause does not prevent the government from regulating how people use their property but limits the regulation to what is just and fair. Neither plaintiff was singled out to bear a burden that should be borne by the public as a whole. Instead, they were participants in a legal system who were required to place their money, at no cost to them, in a legal program which benefits them as well as others. The IOLTA program should be viewed as a reasonable extension of the state's regulation of both the banking industry and the practice of law.

Having analyzed all three standards, the Court concluded that Washington's IOLTA program had not taken the property of either individual plaintiff.

Further, even if a taking had occurred, the Fifth Amendment protects only those takings which are without just compensation. Here, no compensation was due the plaintiffs because the value of the property taken was nil. If anything, value was added to their funds by the very existence of the IOLTA program. Under the cases, the state is not obligated to compensate property owners for value added by the state to their property.

In their complaint, the plaintiffs had alleged that the Washington IOLTA program violated their rights under the First Amendment. The Court of Appeals remanded the case to the district court to resolve the First Amendment question.

The conflict presented by the decisions in the Fifth and Ninth Districts will bear close watch over the next few months as other cases move through the federal courts in other states and as we wait for developments in the Supreme Court.

Lazar Emanuel is the publisher of The New York Professional Responsibility Report (NYPRR).

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