

Do States' IOLTA Programs Violate The Fifth Amendment?

BY LAZAR EMANUEL

Over the last 20 years, virtually all fifty states have adopted programs creating Interest-on Lawyer-Trust- Accounts. In most states these are called IOLTA accounts. In New York, they are called IOLA accounts.

Under New York's IOLA program, lawyers deposit "Qualified" funds received "in a fiduciary capacity from a client or beneficial owner" into "unsegregated" interest bearing bank accounts. The funds which are deposited into these accounts are those "Qualified" client funds which are "too small in amount or are reasonably expected to be held for too short a time to generate sufficient income to justify the expense of administering a segregated fund for the benefit of a client or beneficial owner." "Funds received in a fiduciary capacity" are funds received by a lawyer from a client or beneficial owner in the course of his practice, including but not limited to escrow funds, "but not including funds received as trustee, guardian or receiver in bankruptcy."

New York's IOLA program was created under § 497 of the Judiciary Law. The purpose of the program was to accumulate and devote the interest earned on all IOLA accounts to help finance legal services for the poor and indigent. Under § 497(c), New York banks are required to remit interest on all IOLA accounts quarterly to the State's IOLA fund, after deducting service charges and fees, if any. The importance of the New York program is measured by the fact that in the year ending December 1999, the State's IOLA Fund awarded \$11 million dollars to 80 providers of legal assistance to low-income citizens.

In New York, the determination whether funds are "qualified funds" requiring deposit into an IOLA account is left to the discretion of the lawyer. In making his decision, the lawyer is expected to consider:

- (i) the amount of interest the funds are likely to earn during the period of deposit;
- (ii) the cost of establishing and administering the account, including the cost of the lawyer's services;
- (iii) the ability of the bank to apply subaccounting to calculate and pay interest to each client on his individual funds, net of any transaction costs.

Under § 497(5), a lawyer is absolved of liability for damages and is not "held to answer" for a charge of professional misconduct "because of a deposit of moneys to an IOLA account pursuant to a judgment in good faith that such moneys were qualified funds."

Supreme Court Considers Constitutional Issues

In 1998, the United States Supreme Court considered whether a Texas IOLTA program similar to New York's violated the Takings Clause of the Fifth Amendment to the Constitution ("...nor shall private property be taken for public use without just compensation"). *Phillips v. Washington Legal Foundation*, 524 U.S. 156 (1998). The Court concluded that interest earned on a client's funds was the client's property under Texas common law.

The Court remanded the case to the district court to determine (a) whether the IOLTA program constituted a "taking" as contemplated by the Fifth Amendment, and (b) if so, whether the client's "property" (i.e., the interest on his funds) constituted economic value which required compensation.

After a two-day trial in which expert testimony was offered on both issues, the lower court decided that the Texas IOLTA program did not constitute a "taking" as anticipated by the Fifth Amendment. Having reached that decision, the court did not need to decide the "if so" issue of economic value and compensation. *Washington Legal Foundation v. Texas Equal Access to Justice Foundation*, 86 F. Supp.2d 624 (W.D. Tex. 2000).

The district court assumed for purposes of analysis that the accumulation of interest on IOLTA accounts constituted a "taking." It concluded, however, that as to any one client whose funds were placed in a lawyer's IOLTA account, there was no loss because the value of the client's income interest was \$0. It reasoned that a client's segregated IOLTA funds cannot earn "net interest" — i.e., interest in excess of the costs involved in setting up and maintaining an individual account. Consequently, just compensation was also \$0. [Editor's note: For a full discussion of the reasoning behind the court's decision, see, Joseph S. Genova, *Handling Clients' Funds — A Lesson From The Lone Star State*, NYPRR, April 2000.]

Circuit Court of Appeals Enjoins Texas Program

On October 15, 2001, the Court of Appeals for the Fifth Circuit reversed the decision of the district court and remanded the case for the entry of declaratory and injunctive relief. The appellate court did not specify the remedial steps to be taken by the district judge, but the decision has the potential to block the entire Texas IOLTA program. *Washington Legal Foundation et al. v. Texas Equal Access to Justice Foundation et al.*, (No. 00-50139, 5th Cir. 2001). In recent years, the Texas program has earned more than \$5 million dollars annually. In declaring the Texas program unconstitutional, the court has set in motion a chain of events which threatens IOLTA programs everywhere.

The appellate court concluded that as to any one client, the mandatory deposit of his funds into a lawyer's IOLTA account constituted a *per se* taking by the state. The court cited a series of Supreme Court decisions which had applied the *per se* principles. In *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982), the Court determined that a New York law requiring landlords to allow cable companies to install cable facilities in their apartment buildings constituted a taking, even though the facilities occupied only 1-1/2 cubic feet in each building. In the *Phillips* case, *supra*, the Court said, "The government may not seize rents received by the owner of a building simply because it can prove that the costs in collecting the rents exceed the amount collected."

Citing *Philips* again, the appellate court reasoned that the Supreme Court had already decided that the interest income earned by the client's individual funds in the lawyer's IOLTA account were the "private property" of the client. Therefore, because the State of Texas "has permanently appropriated Appellant[s] ...income against his will, instead of merely regulating its use, there is a *per se* taking."

Having determined that the Texas IOLTA program constituted a taking under the Fifth Amendment, the appellate court proceeded to a discussion of the remedies available to the successful appellants. In an earlier decision involving the same parties, the same court had held that the immunity granted to state officials under the Eleventh Amendment to the Constitution precluded the award of monetary compensation.

However, the appellants had also sought declaratory and injunctive relief. Among the remedies sought by the appellants were injunctions against the discipline of lawyers who refused to comply with the IOLTA program and against the enforcement of the program by the Justices of the Texas Supreme Court.

The appellate court considered and rejected an argument by the appellees that an unconstitutional taking can be remedied only by the payment of just compensation, not by injunctive relief. First of all, the court reminded the appellees that they had previously conceded the court's power to grant injunctive relief and could not change their minds now.

Analyzing a line of Supreme Court cases, the appellate court decided that declaratory and injunctive relief was proper under all the circumstances.

...because the purpose of IOLTA is to take the interest generated from client funds and use it to fund legal services for the indigent, it is obvious that the program makes no provision for the payment of just compensation. If the interest earned on client-funds were available as just compensation to the clients, the very purpose of the program would be thwarted; therefore, it would defy logic, to say the least, to presume the availability of a just compensation remedy...

The appellate court rejected the claim of the Texas Supreme Court Justices that they were immune from suit for injunctive relief. The court held that the Justices were not entitled to immunity because they had the power to suspend and discipline Texas lawyers who do not comply with the IOLTA rules. The court reminded the Justices that they had created the program and its underlying rules and that the rules required them to be notified whenever a lawyer failed to follow the program.

The appellate court relied on the Supreme Court decision in *Supreme Court of Virginia v. Consumers Union of the United States, Inc.*, 445 U.S. 719 (1980). In that case, Consumers Union sought a declaration that the Virginia Supreme Court had violated the First and Fourteenth Amendments by adopting and enforcing rules prohibiting lawyer advertising. The Supreme Court held that the Virginia Supreme Court was not immune from suit. Although it was true that the Court had legislative immunity as to its adoption of the rules, it could not assert immunity as to its role as enforcer of the rules.

Accordingly, the appellate court ordered the district court to proceed with declaratory and injunctive relief against the Justices of the Texas Supreme Court and the Foundation administering the State's IOLTA program.

Conclusion

The decision of the Fifth Circuit Court of Appeals will undoubtedly be appealed to the Supreme Court. The issues involved are critical to the support of public funding for legal assistance to the poor. The ultimate threat is to the IOLTA program in every state, especially in those states, like New York, in which participation in the program is mandatory.

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