

Handling Clients' Funds –A Lesson From The Lone-Star State

BY JOSEPH S. GENOVA

[Editor's Note: This is Part I of a two-part article. Part II will appear in the May issue of NYPRR.]

A recent decision in a closely watched case, on remand from the United States Supreme Court, provides some useful if unexpected instruction regarding the ethical pitfalls of trying to handle client funds that belong in IOLTA accounts in some other way. In a nutshell — New York lawyers who fail to place qualifying funds in an IOLA account may risk fiduciary and ethical violations.

Background

Just over a year ago, in these pages, I wrote about the ethical implications of a pending constitutional challenge to the IOLTA concept. ("IOLA after Phillips; Clearing Up Some Misconceptions", NYPRR November and December, 1998.) IOLTA, called IOLA in New York, is an arrangement in which a lawyer pools client funds that cannot earn net interest for individual clients, and the interest on the pooled account is used to fund legal services for the poor. At that time, in *Phillips v. Washington Legal Foundation*, 524 U.S. 156, 118 Sup. Ct. 1925 (1998), the Supreme Court had concluded that the interest earned on client funds held in IOLTA accounts maintained by Texas lawyers was "private property" for purposes of the takings clause of the Fifth Amendment, and remanded to the district court to answer two more questions. First, do IOLTA programs constitute unconstitutional "taking" of private property for a public purpose? Second, if they do, what is the economic value of what they take?

On remand, the case went back to federal district court Judge James R. Nowlin. Nowlin is a conservative Reagan appointee with no particular affection for the "liberal" concept of using IOLTA to fund lawyers for poor people. He is, however, a solid, straight-shooting judge who had granted IOLTA's original summary judgment motion on the strength of an unbroken line of cases finding no constitutional violation. Vowing to decide all the issues in this case once and for all, he instructed the parties to complete discovery, after which he held a two-day bench trial in September of 1999, with eight witnesses and multitudinous exhibits, followed by complete post-trial briefing.

No Constitutional Violation

Judge Nowlin's decision on January 28, 2000 found no violation of the federal constitution and dismissed the plaintiffs' case with prejudice. The lynchpin of his Fifth

Amendment decision, as predicted in these pages ("[n]either IOLTA nor the lawyers who follow the applicable rules take anything of economic value from their clients"), was the fact that the Fifth Amendment forbids not "taking", but "taking without just compensation."

For purposes of analysis, Judge Nowlin assumed there was a taking (even though, in a separate analysis, he found that there was not a taking), and asked, what was just compensation? His conclusion was that, = “based upon the evidence ... regarding in-firm pooling, sub-accounting [and the net benefit theory] ... Mr. Summers’ loss is zero.” Thus, IOLTA does not violate the takings clause. In other words, IOLTA does not violate the takings clause because, even if there is a taking, the value of the taking is \$0, and, hence, the just compensation is also \$0.

The Washington Legal Foundation — a conservative action group which had attacked IOLTA repeatedly and unsuccessfully before, and which is the real interested party in this case — has announced its intention to appeal. In the meantime, IOLTA is safe and sound. In particular, New York’s “IOLA” fund is going about the important business of funding legal services for the indigent, having awarded \$11 million to nearly 80 providers last December. That means that thousands of low-income citizens will get the legal help they need: e.g., victims of domestic violence; people facing homelessness or the loss of their children; the physically and developmentally disabled, etc.

Plaintiffs Offer Three Theories

In order to reach the conclusion that the loss suffered by Mr. Summers, the client plaintiff, was \$0, and hence that “just compensation” was also \$0, the court had first to consider three factual arguments pressed by the Washington Legal Foundation. The heart of the trial was the evidence regarding these three factual arguments, and the key to the court’s conclusion about the Fifth Amendment was its analysis and rejection of them. Along the way, the court offered some important ethical warnings to lawyers who might be considering these supposed alternatives to IOLTA.

The plaintiffs claimed that even small funds could generate net interest for (or otherwise benefit) the client if lawyers employed one or more methods other than using an IOLTA account. Those methods were “sub-accounting” (a commercial banking product that involves separate but linked accounts), “in firm pooling” (basically a do-it-yourself plan in which lawyers do the accounting that banks usually do), and the “net benefit theory” (an amorphous concept that amounts to the lawyer saying “trust me, I’ll take the interest, but you will be better off.”)

The IOLTA concept rests on the fact that lawyers often hold clients’ money for such things as expenses, retainers, real estate down-payments, and settlements, generically called “client funds”. IOLTA applies only to those client funds that are so small or will be held for so short a period of time that clients cannot earn net interest because the costs of segregating, accounting and reporting the client’s interest income to the IRS would be greater than the interest earned. The lawyer pools these funds with other, similar client funds in an IOLTA account, which is burdened by none of those costs and therefore generates net interest for legal services. In New York, these funds are called “qualifying funds.”

The Texas IOLTA program argued (and the court ultimately agreed) that the plaintiffs’ claim simply begged the issue because, by definition, client funds are only placed in an IOLTA account if they cannot be made to render net interest for the client through an alternative method of treatment. The court went further, however, to examine and reject each of the alternatives proffered by the plaintiffs — the “net benefit theory”; “in-firm pooling”; and “sub-accounting”. The court’s reasoning provides some useful instruction.

“Net Benefit Theory”

This was plaintiffs’ most audacious argument, and somewhat ironic in a case in which plaintiffs claimed that IOLTA is unconstitutional because it takes money from clients.

Plaintiffs argued that clients would be better off if funds that would otherwise go into IOLTA accounts (because they could not generate net interest for the client) were maintained by lawyers in pooled accounts which paid the clients no interest! A somewhat incredulous Judge Nowlin said: “This theory is difficult to fathom, but in a nutshell [it] is that by decreasing the lawyer ’s costs through the use of the client’s money, the client will benefit.”

Even in the frontier days before IOLTA, lawyers did not go so far as to treat their clients’ funds as interest-free loans (although their banks did!). Before IOLTA, lawyers pooled client funds that could not generate net interest for the client in a non-interest bearing checking account. The bank got free use of the money. While the lawyers did not benefit directly, many did so indirectly, enjoying banking perquisites and favors commensurate with the size of the non-interest bearing account from which the bank profited.

That was unseemly (and in my view, unethical) enough. Apparently, though, the plaintiffs were urging something much more directly and clearly unethical — that the lawyers actually be able to use the client’s money, for their own benefit. They argued that, by decreasing the lawyer ’s costs, the clients would benefit in some unspecified way (lower hourly rates, perhaps?). The precise outlines of the argument are not clear, but no matter. Judge Nowlin quickly consigned the “net benefit” theory to the dung heap in which it belongs: “[T]his option is generally foreclosed by Canon 11 of the Canons of Professional Ethics,The court finds that allowing attorneys to benefit from their clients’ trust accounts, even if they pass this benefit on to clients, would qualify as an ethical violation.”

New York Applies The Same Rules

In New York, of course, we have our own Code of Professional Responsibility instead of the “Canons of Professional Ethics” adopted in Texas, but the result would be the same. The rules governing client funds are part of our Canon 9, which says, “A Lawyer Should Avoid Even the Appearance of Professional Impropriety.” Disciplinary Rule 9-102 provides detailed and specific rules for the handling of client funds, which equally prohibit the scheme proposed by the Washington Legal Foundation. Rule 9-102(A) begins: “A lawyer in possession of any funds or other property belonging to another person, where such possession is incident to his or her practice of law, is a fiduciary and must not misappropriate such funds or property or commingle such funds or property with his or her own.”

In the Empire State, as in the Lone Star State, a lawyer may not benefit from his or her role as a fiduciary of client funds. For a lawyer to follow the suggestion of the Washington Legal Foundation in this regard, and to employ the “net benefit theory” would risk disbarment. So said Judge Nowlin, and so say we.

Joseph Genova is a former member of the ABA Commission on IOLTA, a litigation partner at Milbank, Tweed, Hadley & McCloy, LLP, where he supervises the pro bono program, and a frequent contributor to NYPRR.