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IOLA After *Phillips*: Clearing Up Some Misconceptions

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In this article, I examine the Supreme Court's decision in *Phillips v. Washington Legal Foundation,* 118 S.Ct. 1925; 1998 U.S. LEXIS 4003 (1998), which has been widely but incorrectly described as the beginning of the end of Interest On Lawyers' Trust Accounts ("IOLTA") programs. Phillips was a constitutional challenge to the IOLTA program in Texas. In Phillips, the Supreme Court considered "whether interest earned on client funds held in IOLTA accounts is 'private property' of either the client or attorney for purposes of the Takings Clause of the Fifth Amendment." A 5-4 majority held that the interest was the property of the client under Texas common law, but it did not reach the constitutional question. Instead, it remanded the case to resolve two further issues: whether the Texas IOLTA program amounts to an unconstitutional "taking" of private property for a public purpose; and most importantly, if the IOLTA programs do constitute a "taking", does that property have economic value to the client, for which the client must be compensated?

In this Part I, I review the basic purpose, structure and mechanics of IOLTA programs and the ethics opinions which have endorsed lawyers' participation. In Part II, which will appear in NYPRR next month, I will examine the implications of *Phillips* and the basic response to it.

PART I — What Is IOLTA

IOLTA programs are non-profit organizations that raise money for law-related charitable purposes by collecting interest on lawyer-held client deposits that can not be collected by the client. They use the interest to make grants to providers of civil legal services to the poor, for the administration of justice and for law-related education. In 1997, IOLTA programs generated and distributed approximately $123 million nationally. The New York program, called the "lOLA Fund" is the second largest source of funding for civil legal services in New York, currently providing about $10 million a year to more than 80 legal services providers. Many attorneys mistakenly believe that lOLA is somehow related to the Fund For Client Protection. There is absolutely no relationship between the two agencies.

Instead, the New York Lawyers Fund For Client Protection is a government trust fund financed by assigning to the Fund $100 of the $300 bi-annual registration fee paid by every New York lawyer to the Office of Court Administration. The Fund reimburses eligible client losses which result from a lawyer's dishonest conduct in the practice of law.

[For a description of the Fund for Client Protection; see The New York Professional Responsibility Report, September, 1998.]

IOLTA programs exist in all 50 states and the District of Columbia. In five states, including New York, they are statutory. In all other states, they were created by court rule. The IOLTA concept is based on the

fact that lawyers often hold money, on behalf of their clients, for such things as expenses, retainers, real estate down-payments, and settlements (generically called "client funds"). If the client funds are so small or will be held for such a short period of time that they cannot be expected to earn interest net of banking charges and administrative costs, the funds may be put in an IOLTA account. In New York, client funds that cannot earn net interest for the client are called "qualifying funds" and those that can earn net interest for the client are called "non-qualifying funds." 22 NYCRR §1300.1.

Participation Mandatory

Participation in New York's lOLA program is mandatory in two senses. First, every New York lawyer who handles client funds must maintain an lOLA account. Second, the lawyer must use an lOLA account for qualifying funds, unless he or she uses an account which will generate, compute and pay net interest to the client. A New York lawyer may not place qualifying funds in a non-interest-bearing account. Lawyer participation in IOLTA is also mandatory in approximately 27 other jurisdictions. In the remainder, a lawyer (but not the client) may choose to deposit the funds either in an IOLTA account or in a pooled non-interest-bearing account. In every jurisdiction, if a client's deposit is large enough or will be held long enough to earn interest for the client net of banking charges and administrative costs, IOLTA does not govern the handling of the funds. Instead, fiduciary rules apply and, in most jurisdictions, the funds must be deposited in an individual trust account for the benefit of the client.

In determining whether or not the client's funds are likely to earn interest net of the bank's fees and the cost of the lawyer or law firm's related services, we must first ask what those costs and fees will be. Rates and fees vary from bank to bank and at the same bank over time and depending on many circumstances, such as the size of deposit and other aspects of the relationship between the lawyer and the bank. The determination also involves predicting several things: how long will the funds, in fact, be held; how many transactions will there be; will interest rates stay the same, rise or fall? The New York lOLA statute and regulations specifically direct a lawyer to consider "the capability of the banking institution, through subaccounting, to calculate and pay interest earned by each client's fund, net of any transaction costs, to the particular client."

Safe Harbors For Lawyers

Determining whether particular client funds are or are not "qualifying" is thus more of an art than a science. In recognition of that fact, some IOLTA programs have "safe harbors" upon which an attorney can rely in making this determination. Most IOLTA programs hold a lawyer harmless for the good-faith exercise of judgment whether given client funds are qualifying funds. In New York, for example, the statute requires the lOLA board to promulgate a regulation setting "a specific dollar amount equivalent to the cost of administering a segregated interest bearing account for a client." The regulation provides the test that client funds are presumptively qualified funds if they "cannot reasonably be expected to generate at least $150 of interest or such larger amount as the attorney or law firm in the exercise of his professional judgment deems may be equivalent to the costs of administering a separate account." Moreover, New York attorneys are not liable in damages or held to answer for a charge of professional misconduct if they deposit money into an IOLTA account in their good faith judgment that they are qualified funds. The hold harmless provision has been upheld by at least one court.

Correcting Errors

If a lawyer errs by placing non-qualified client funds in an IOLTA account, or if the initial decision requires change under subsequent events, the lawyer can remove the funds at any time simply by writing a check from the IOLTA account to the appropriate account. In addition, most IOLTA programs have specific mechanisms by which the attorney can recover for the client the interest paid by the bank on non-qualifying funds while deposited in an IOLTA account. New York's statute and regulations specifically provide for "the refund [of anyl such moneys upon application by any aggrieved party." The statute and regulations provide further that lOLA shall neither pay interest on the proceeds (the interest earned while in an lOLA account) nor make any deduction for service charges.

Behind each lawyer's participation in an IOLTA program is the uncontroversial proposition that a lawyer holding client funds is a fiduciary. The lawyer may charge the client the reasonable costs of handling those funds, but may not profit by virtue of holding the funds, either directly or indirectly. For example, a lawyer who has placed funds with a bank may not enjoy any accommodation provided by that bank by virtue of that placement. If it is clear that the lawyer can cause the client to earn interest on the client's funds consistently with other obligations to the client (protection of the principal, maintaining availability, etc.) the lawyer has a fiduciary obligation to secure that interest, as directed by the client. However, a lawyer is not an investment manager, and is under no obligation to maximize the client's return. The lawyer is not required to shop around for the best deal, or to move client accounts every time a new entrant in the escrow banking business offers a higher rate or lower fees.

Ethical Underpinnings

The ethical underpinnings of IOLTA programs must be examined in the light of the lawyer's fiduciary duty. Since the principal duty of the lawyer-fiduciary in these circumstances is to safeguard the client's funds, and not to invest them, the lawyer is under no obligation, subject to the foregoing limits, to assure that the client obtains the maximum amount potentially available. The ABA and many state and county ethics committees have issued opinions on the appropriateness of lawyers' participation in JOLTA programs. All have approved, and none have held participation to be unethical, either before Phillips or since. How did the ABA and the relevant NY ethics opinions reach the conclusion that participation in IOLTA was ethical, and what concerns are engendered by Phillips?

ABA Opinion And Our Dilemma

ABA Formal Opinion 348 (1982), entitled "Placing Client Funds at Interest", is the principal ethics opinion on IOLTA. The ABA Committee stated:

> The viability of these programs depends on the answer to a question of law: whether the client has a constitutionally protected property right in the interest earned on these client funds. ... In the opinion of the Committee, [the client does not have such a property right if t]he interest is not client funds ... . Therefore, assuming that either a court or a legislature ..., either implicitly or explicitly, has made a determination that the interest earned is not the clients' property, participation in the program by lawyers is ethical.

Therein lies our dilemma. The ABA ethics opinion, like other opinions that have followed it (including New York State Opinion 554 (1983)) says that IOLTA is ethically accept~~ for the same reason that it is constitutionally acceptable: the interest earned is not the client's property. Now that the Supreme Court

has said that, at least under Texas law, the interest earned is the client's property, does it follow that the ethics opinions must be incorrect or inapplicable? In my opinion, the answer is: No. The ethics opinions in fact said more, and the Supreme Court said less, than is apparent from superficial reading. Upon closer examination, which will be the subject of Part II of this article, it becomes clear that the conflict is semantic, not substantive, and that the conclusions of the ethics opinions remain valid.

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