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Clients Should Have No Interest in IOLTA Programs: An Analysis of the Supreme Court's Decision in Phillips v. Washington Legal Foundation

Emily Hood
University of Kentucky

Clients Should Have No Interest in IOLTA Programs: An Analysis of the Supreme Court's Decision in *Phillips v. Washington Legal Foundation*

BY EMILY HOOD*

I. INTRODUCTION

On June 15, 1998, the Supreme Court dealt Interest on Lawyer Trust Accounts ("IOLTA") a staggering blow In *Phillips v. Washington Legal Foundation*,[1] the Court was presented with the following issue: Do IOLTA programs "take" client property in violation of the Fifth Amendment? The Court held that "[i]nterest income generated by funds held in IOLTA accounts is the 'private property' of the owner of the principal."[2] In essence, the Court applied an "interest follows principal" analysis and determined that the interest generated by client funds held by lawyers in IOLTA accounts is a "property interest" of the client whose funds were used to generate the interest. However, the Court was not faced with, and declined to decide, the ultimate question—whether the interest had been "taken" by the state in violation of the Fifth Amendment.[3]

This Note analyzes both IOLTA precedent and the Supreme Court's decision in *Phillips v. Washington Legal Foundation*. Part II of the Note explains the history and mechanics of IOLTA programs.[4] A brief overview of the requirements of a Takings Clause claim and the Supreme Court's previous interpretations of the Clause is presented in Part III.[5] Part IV summarizes the First, Eleventh, and Fifth Circuits' holdings in previous

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* J.D. expected 2000, University of Kentucky

[1] Phillips v. Washington Legal Found., 118 S. Ct. 1925 (1998).

[2] *Id.* at 1934.

[3] *See id.*

[4] *See infra* notes 10-29 and accompanying text.

[5] *See infra* notes 30-58 and accompanying text.

IOLTA challenges.[6] An analysis of the Supreme Court's decision in *Phillips v. Washington Legal Foundation*, including the rationales of both the majority and dissenting Justices, is set forth in Part V.[7] Part VI of the Note further analyzes the *Phillips* decision and concludes that the interest generated by IOLTA programs is neither a "property interest" of the client nor a "taking" of the client's property.[8] The Note closes by assessing the impact of the Court's decision in *Phillips* upon the future of American IOLTA programs.[9] It concludes the Court incorrectly held that IOLTA funds are a "property interest" of the client for purposes of a Fifth Amendment takings claim and that IOLTA programs do not represent a violation of the Takings Clause of the Fifth Amendment.

II. HISTORY AND MECHANICS OF IOLTA PROGRAMS

A. History of IOLTA Programs

Attorneys must hold client funds in trust accounts under many different circumstances. Filing fees, real estate closing costs, and personal injury settlement drafts, for example, all require the attorney to hold funds in trust for the client. Before 1980, the treatment of interest on such lawyer trust accounts was a simple business practice. Funds placed in a trust account with an attorney were required to be available to the client on demand.[10] Therefore, the lawyer routinely deposited the funds in a non-interest bearing demand account. This practice changed, however, with the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980,[11] which created Negotiable Order of Withdrawal ("NOW") accounts. NOW accounts allowed select client funds to be both available on demand and interest bearing. A separate NOW account was justified for clients whose money was left in trust for a long period of time or whose account

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[6] *See infra* notes 59-118 and accompanying text.

[7] *See infra* notes 119-77 and accompanying text.

[8] *See infra* notes 178-93 and accompanying text.

[9] *See infra* notes 194-204 and accompanying text.

[10] *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.15 (1998); MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 9-102 (1969) (cited in Betsy B. Johnson, Comment, *'With Liberty and Justice for All' IOLTA in Texas—The Texas Equal Access to Justice System*, 37 BAYLOR L. REV 725, 726 (1985)).

[11] Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 303, 94 Stat. 132, 146 (1980) (codified as amended at 12 U.S.C. § 1832 (1994)).

balance was large. However, for clients whose deposits were small or short term, NOW accounts were not justified because the bank's service charges would exceed the interest earned.[12]

The inspiration for IOLTA accounts arose from the fact that lawyers continued to put client funds that did not justify an individual NOW account into pooled, non-interest bearing demand deposit accounts.[13] The developers of IOLTA programs sought to create pooled accounts of client funds that would earn net interest for pro bono legal programs (in those situations where client trust fund accounts could not earn net interest for the client whose funds generated the interest). IOLTA founders "wanted to shift the benefit of the implicit interest generated from such pooled accounts from depository institutions to legal aid organizations."[14]

IOLTA programs were not a completely novel idea. Prior to their appearance in the United States, similar programs had already been used in other countries to support legal aid for the poor.[15] When NOW accounts were authorized in 1980, it appeared as if the United States could benefit from the advantages of IOLTA programs. However, there remained one obstacle since "federal banking regulations prohibit[ed] the holding of interest-bearing checking accounts by for-profit businesses such as law firms."[16] The barrier was removed when, in a private letter ruling, the Federal Reserve Board's General Counsel concluded that IOLTA funds could be deposited in NOW accounts if the funds were held in trust and a charitable organization had the exclusive right to the interest.[17]

Thereafter, Florida became the first state to implement an IOLTA program.[18] By the time of the *Phillips* decision, a total of forty-nine states

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[12] *See* W Frank Newton & James W Paulsen, *Constitutional Challenges to IOLTA Revisited*, 101 DICK. L. REV 549, 555 (1997).

[13] *See* Kevin H. Douglas, Note, *IOLTAS Unmasked: Legal Aid Programs' Funding Results in Taking of Clients' Property*, 50 VAND. L. REV 1297, 1301 (1997).

[14] *Id.*

[15] *See* Brennan J. Torregrossa, Note, Washington Legal Foundation v Texas Equal Access to Justice Foundation*: Is There an Iota of Property Interest in IOLTA?*, 42 VILL. L. REV 189, 196 (1997).

[16] *Id.* at 197

[17] *See* Letter from Michael Bradfield, General Counsel, Federal Reserve System, to Donald M. Middlebrooks (Oct. 15, 1981), *reprinted in* Donald M. Middlebrooks, *The Interest on Trust Accounts Program: Mechanics of its Operation*, 56 FLA. B.J. 115, 117 (1982).

[18] *See* Kenneth P Kreider, Note, *Florida's IOLTA Program Does Not "Take" Client Property for Public Use:* Cone v. State Bar of Florida, 57 U. CIN. L. REV

and the District of Columbia had adopted IOLTA programs.[19] Since their implementation, the programs have provided extensive funding to legal services for the poor. It has been observed that:

> IOLTA programs have become an integral component of state bar strategies to improve the availability of basic legal services to low-income citizens. Nationwide, the programs currently generate about $100 million a year, second only to federal Legal Services Corporation ("LSC") grants as a source of funding for legal services to low-income Americans. IOLTA funds help provide basic legal services to some 1,700,000 Americans in a given year.[20]

B. Mechanics of IOLTA Programs

With the advent of the NOW account, attorneys found that the funds they held in trust for their clients fell into two distinct categories. First, there were those client trust fund accounts that were large enough or were held for a sufficiently long period of time to justify the cost of the NOW account charges. Funds falling into this category should be placed in an individual interest bearing NOW account for the client.

Alternatively, there were client trust fund accounts that were too small in amount or so short-term that the administrative charges of the financial institution would exceed the possible interest to be earned.[21] Attorneys involved in IOLTA programs must make a "good faith judgment"[22] as to the proper category into which each of their client's trust funds fall. If the attorney decides that the client funds could "productively earn interest for the client,"[23] they are unsuitable for an IOLTA account. Funds falling into this category should be placed in an individual interest bearing NOW account for the client. On the other hand, if the attorney concludes that the client's funds are "nominal in amount or held only for a short period of time,"[24] such that the funds would be incapable of earning interest profitably for the client in an individual NOW account, the attorney may place the client's funds in a pooled IOLTA account.

369, 372 (1988).

[19] *See* Phillips v. Washington Legal Found., 118 S. Ct. 1925, 1927-28 (1998).

[20] Newton & Paulsen, *supra* note 12, at 550 (footnotes omitted).

[21] *See supra* note 12 and accompanying text.

[22] Douglas, *supra* note 13, at 1302.

[23] Newton & Paulsen, *supra* note 12, at 555.

[24] *Id.* at 555-56.

IOLTA programs apply the principle of "economies of scale" in that they "permit[ ] the combination of client deposits that could not individually earn interest because the costs of administration would exceed the interest generated. This larger fund can be administered profitably as a unit, although administrative or service costs would render the account unprofitable if subdivided."[25] The only funds that can be validly deposited into an IOLTA account are those funds that, if deposited in an individual interest bearing NOW account, "could not be reasonably be expected to earn interest for the client."[26] Furthermore, "[i]n making this determination, the attorney is directed to consider the practicalities of the situation, including the 'cost of establishing and maintaining the account, service charges, accounting costs and tax reporting costs.' "[27] The IOLTA account is able to accumulate net interest whereas individual accounts for each client, saddled with the necessary expenses of their creation, could not.[28] By pooling client funds that would individually be incapable of earning interest, IOLTA "creates" aggregate interest that would not have existed were it not for the special protections of the IOLTA program.

The newly created interest is entirely a product of the IOLTA provisions. Under no circumstances could the individual client have earned net interest on his trust account for, by definition, if he could have earned such interest his attorney would never have placed the trust funds in an IOLTA account. The IOLTA program thus allows for consolidation of the unprofitable funds to generate net interest. The interest generated is allowable under federal banking laws because *charitable organizations have the exclusive right to the interest.*[29] Thus, the regulations that allow IOLTA to create net interest effectively shift the benefit from financial institutions to IOLTA programs.

III. ELEMENTS OF A TAKINGS CLAUSE CLAIM

A. Constitutional Requirements Under the Takings Clause

The Fifth Amendment to the Constitution of the United States promises "nor shall private property be taken for public use, without just compensa-

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[25] *Id.* at 553.

[26] *Id.* at 555-56.

[27] *Id.* at 556 (quoting TEXAS RULES OF COURT Rule 6 (West 1997)).

[28] *See* Douglas, *supra* note 13, at 1302.

[29] *See supra* note 12 and accompanying text.

tion."[30] Generally, to prove that a taking has occurred four elements must be shown.

First, the object must be a "property interest."[31] Second, the court must determine whether a "taking" of the property interest has occurred.[32] Third, the court must ask whether the taking was for a "public use."[33] The Supreme Court has defined "public use" broadly, so that this element is almost always satisfied.[34] All that is required to find that a taking is for public use is to find that it is "rationally related to a conceivable public purpose."[35] Because the Court generally defers to state or congressional action, it usually finds the test to be met. Finally, the court must inquire whether "just compensation" has been paid.[36] The determination of this issue is gauged by the loss to the owner of the property interest.[37] The Takings Clause, therefore, is invoked only when all four elements of the claim are satisfied.

B. The Supreme Court's Analysis of the Takings Clause

In *Connolly v. Pension Benefit Guaranty Corp.*,[38] the Supreme Court upheld federal legislation that required an employer to pay a portion of a pension plan's unfunded vested benefits when an employee withdrew from the plan. The Court held that the laws were simply economic regulations in the public interest and recognized that many types of economic regulations cause one group of people or businesses to benefit at the expense of another.[39] In holding that reasonable economic regulation was not a taking of property, the Court thus commanded the takings analysis "to assess both the nature and importance of the governmental interest and the

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[30] U.S. CONST. amend. V

[31] The Supreme Court has looked to state law to determine whether the object is a "property interest." *See* ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES 505 (1997).

[32] *See id.* at 504.

[33] *Id.* at 505.

[34] *See id.*

[35] *See id.* (citing Hawaii Housing Auth. v. Midkiff, 465 U.S. 1097 (1984)).

[36] *See id.*

[37] *Id.*

[38] Connolly v. Pension Benefit Guar. Corp., 475 U.S. 211 (1986).

[39] *See id.* at 225.

nature and extent of the economic loss of the individual property owner or class of property owners."[40]

In determining whether a taking had occurred in violation of the Fifth Amendment, the *Connolly* Court relied upon *Penn Central Transportation Co. v. City of New York*.[41] Generally, *Penn Central* is acknowledged as a good summary of the legal analysis for a claim brought under the Takings Clause.[42] In that case, a zoning law designed to protect the historical landmarks of New York City prevented Penn Central from building an office tower above its existing terminal. The owner of the terminal brought suit against the City for designating the terminal as a historic landmark and thereby prohibiting construction. He claimed a taking of the property had occurred in violation of the Fifth Amendment.[43]

The Supreme Court ruled that the restriction on building over the site of the terminal was not a taking.[44] The Court's opinion established several important elements of the modern Takings Clause analysis. First, the Court noted that to recover under a takings claim, the plaintiff must establish the presence of a recognized property interest before any further consideration of the claim may be addressed.[45] Additionally, the Court established a three-factor test for analyzing the takings claim: (1) the economic impact of the regulation on the plaintiff; (2) the extent to which the regulation hampers distinct investment-backed expectations; and (3) the character of the government action.[46] The Court went on the say that "[a] 'taking' may more readily be found when the interference with property can be characterized as a physical invasion by government than when the interference arises from some public program adjusting the benefits and burdens of economic life to promote the common good."[47]

More pertinent to the claims that IOLTA programs take client property is *Webb's Fabulous Pharmacies, Inc. v. Beckwith*.[48] In *Webb's*, the

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[40] JOHN E. NOWAK & RONALD D. ROTUNDA, CONSTITUTIONAL LAW 440 n.9 (5th ed. 1995).

[41] Penn Cent. Trans. Co. v. City of New York, 438 U.S. 104 (1978).

[42] *See* Washington Legal Found. v. Massachusetts Bar Found., 993 F.2d 962, 973-74 (1st Cir. 1993) (looking to *Penn Central* as a summary of "takings" law and listing its factors); Cone v. State Bar of Florida, 819 F.2d 1002, 1005 (11th Cir.) (citing *Penn Central* in the IOLTA context), *cert. denied*, 484 U.S. 917 (1987).

[43] *See Penn Cent.*, 438 U.S. at 104.

[44] *See id.* at 138.

[45] *See id.* at 124-25.

[46] *See id.* at 124.

[47] *Id.* (citing United States v Causby, 328 U.S. 256 (1946)).

[48] Webb's Fabulous Pharmacies, Inc. v. Beckwith, 449 U.S. 155 (1980).

Supreme Court utilized the *Penn Central* factors to analyze the plaintiff's IOLTA claim. In that case, a Florida statute provided that all interest earned on public or private money deposited with a county circuit court registry became the property of the clerk. Moreover, the statute went on to provide that "[a]ll interest accruing from moneys deposited shall be deemed income of the office of the clerk. "[49] The plaintiffs interpleaded $1,812,145.77 into the Florida court registry for a dispute over the purchase of Eckerd's pharmacy [50] At the time the conflict was resolved between the two pharmacies, the receiver for Webb's requested the principal and interest from the court clerk.[51] The clerk remitted the principal but refused to give the receiver the accumulated interest.[52] The interest earned on the interpleaded amount exceeded $100,000.[53]

The Supreme Court of Florida held that the statute requiring retention of the interest was constitutional.[54] The court reasoned that the fund was public money and therefore the interest earned was not private property It said the "statute [took] only what it create[d]."[55]

The United States Supreme Court reversed,[56] and held that the failure to transmit the interest amounted to a taking under the Fifth Amendment. The Court applied an "interest follows principal" rationale and held that the interest belonged to the plaintiffs.[57] Although the Court recognized that the denial of a beneficial use of property to individual owners may be allowed when the government can justify the denial as promoting the general welfare, the Court declined to so hold in this case.[58]

IV PRIOR CIRCUIT COURT CHALLENGES TO IOLTA PROGRAMS

A. The Eleventh Circuit's Decision in Cone v State Bar of Florida

In *Cone v. State Bar of Florida*,[59] the plaintiff challenged the constitutionality of Florida's IOLTA program. In 1969, the plaintiff retained a law

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[49] *Id.* at 160 (citing FLA. STAT. ANN. § 28.33 (West 1973)).

[50] *See id.* at 156.

[51] *See id.* at 157-58.

[52] *See id.* at 158.

[53] *See id.*

[54] *See* Beckwith v. Webb's Fabulous Pharmacies, Inc., 374 So. 2d 951 (Fla. 1979), *rev'd*, 449 U.S. 155 (1980).

[55] *Id.* at 953.

[56] *See Webb's*, 449 U.S. at 155.

[57] *See id.* at 162-63.

[58] *See id.* at 163.

[59] Cone v State Bar of Florida, 819 F.2d 1002 (11th Cir. 1987).

firm to probate the estate of her deceased husband.[60] She paid the firm a deposit of $100, which was subsequently deposited in a non-interest bearing trust account.[61] At the end of the firm's representation of the plaintiff, the firm neglected to return to her the $13.75 remaining in her account.[62] The money stayed in the account until 1981, when Florida enacted its IOLTA program. At that time the firm transferred all of its nominal or short term trust accounts into an IOLTA account, including the funds inadvertently retained from Cone.[63] In 1984, the firm discovered the error and returned the principal to the plaintiff. However, the firm forwarded the $2.25 in interest to the Florida Bar Association under the terms of the state's IOLTA program.[64]

In a class action lawsuit, the plaintiffs claimed that the Florida IOLTA program had "taken" the interest generated by the nominal and short-term deposits from the owners of the respective principals.[65] The district court found that the plaintiffs did not have a legitimate property claim to the interest.[66] The court relied on the "interest follows principal" rationale and stated that "interest goes with the principal, as the fruit with the tree."[67] The court noted that this necessarily assumes a fruit-bearing tree and were it not for the IOLTA "tree" the plaintiffs' principals would never have borne fruit.[68]

The Eleventh Circuit affirmed the lower court and agreed with its application of the "fruit-bearing tree" analysis, stating that for a recognizable property interest to attach to the interest earned on the principal, there must actually be enough principal to produce interest.[69] The court distinguished *Webb's* by saying that the interest earned on the interpleader fund in *Webb's* was much larger in amount and held for a much longer period of time so as to give rise to a legitimate expectation of entitlement to the $100,000.[70] In *Cone*, however, the Court considered the $2.25 in interest to be such a minimal amount that there could be no legitimate expectation of receiving the money after making accommodations for

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[60] *See id.* at 1003.
[61] *See id.*
[62] *See id.* at 1004.
[63] *See id.*
[64] *See id.*
[65] *See id.*
[66] *See id.*
[67] *See id.* (quoting Himely v. Rose, 9 U.S. (5 Cranch) 313, 319 (1809)).
[68] *See id.*
[69] *See id.* at 1002.
[70] *See id.* at 1007

administrative costs.[71] The court reiterated the statement of the lower court that " 'the crucial distinction is not the amount of interest earned, but that the circumstances led to a legitimate expectation of interest exclusive of administrative costs and expenses.' "[72] Here, the court said the plaintiff did not meet its burden of showing a legitimate claim of entitlement to the $2.25.[73] Since the plaintiff's trust fund, standing alone and without the pooling benefits of the IOLTA program, could earn no net interest, she had no legitimate property interest that Florida could "take" through the IOLTA program.[74] The court emphasized that it was not "establishing a de minimis standard for Fifth Amendment takings, or due process violations,"[75] but instead it was relying upon the fact that the interest income generated by the IOLTA account pooling process was not within the legitimate expectations of the principal owners.[76] The Eleventh Circuit, therefore, held that the Florida IOLTA program withstood constitutional scrutiny and did not "take" client property under the Fifth Amendment.[77]

B. *The First Circuit's Decision in* Washington Legal Foundation v Massachusetts Bar Foundation

The First Circuit's decision in *Washington Legal Foundation v. Massachusetts Bar Foundation*[78] relied upon the Eleventh Circuit's decision in *Cone* to hold that clients do not have a constitutionally protected interest under the Fifth Amendment in the interest generated from IOLTA accounts.

In *Massachusetts Bar Foundation*, the plaintiffs alleged that the Massachusetts IOLTA program violated both their Fifth Amendment rights to due process of law and to be justly compensated for government takings, and their First Amendment rights to freedom of speech and association.[79] The district court had dismissed the plaintiffs' takings claim, saying the plaintiffs did not have a property interest in the interest generated through

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[71] *See id.*

[72] *Id.*

[73] *See id.*

[74] *See id.*

[75] *Id.*

[76] *See id.*

[77] *See id.*

[78] Washington Legal Found. v. Massachusetts Bar Found., 993 F.2d 962 (1st Cir. 1993).

[79] *See id.* at 970.

the IOLTA program.[80] The court also dismissed the First Amendment claim on the grounds that the Massachusetts IOLTA program did not force the plaintiffs to associate.[81]

The First Circuit affirmed the dismissal of the district court.[82] The circuit court noted that other courts had refused to recognize a property right attaching to interest earned through IOLTA programs.[83] In this case, however, the court noted that the plaintiffs sought not to prove a right to their IOLTA interest, but rather "claim[ed] a property right to the beneficial use of their deposited funds, and more specifically, the right to control and to exclude others from the beneficial use of those funds."[84] The plaintiffs argued that their claim to the beneficial use of their funds arose from trust law The court dismissed this argument by reasoning that although a lawyer owes a fiduciary duty to his clients, the mere deposit of the clients' funds into an IOLTA account will not change the lawyer's fiduciary duty into one of a trustee whereby the client would be able to retain his right to control the beneficial uses of the fund.[85] The court also rejected the plaintiffs' claim that they had a right to exclude others from the beneficial use of their IOLTA funds.[86] The plaintiffs based this "right to exclude" on real property principles granting such a right, but the court refused to extend this proposition to the realm of intangible property [87] The First Circuit went on to say that even if the plaintiffs had established a property interest in the IOLTA interest, the Massachusetts program still would not effect an unconstitutional taking of their property under the *Penn Central* factors.[88]

The court examined whether the taking claimed by the plaintiffs amounted to either a physical invasion of the property or a regulation which denied the plaintiffs of all economic use of their property [89] The court determined that the IOLTA property in question was not a taking by physical invasion because the IOLTA interest was intangible, not real, property [90] The court also concluded that the IOLTA program did not amount to an economic regulation that denied plaintiffs their property

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[80] *See id.* at 971.
[81] *See id.*
[82] *See id.* at 962.
[83] *See id.* (citing Cone v. State Bar of Florida, 819 F.2d 1002 (11th Cir. 1987)).
[84] *Id.* at 973.
[85] *See id.* at 974.
[86] *See id.*
[87] *See id.*
[88] *See id.*
[89] *See id.* at 974-76.
[90] *See id.* at 975.

rights. The court stated that since "clients would not otherwise be entitled to the interest earned on pooled accounts,"[91] because the funds could not earn net interest individually, the IOLTA program did not hinder "investment-backed expectations."[92] Using the "bundle of property rights" idea, the court characterized the plaintiffs' claim as "at best, a thin strand in the commonly recognized bundle of property rights."[93] Furthermore, "where an owner possesses a full 'bundle' of property rights, the destruction of one 'strand' of the bundle is not a taking, because the aggregate must be viewed in its entirety."[94] Since the IOLTA program did not interfere with the plaintiffs' ability to "possess, use, and dispose of the principal sum deposited in IOLTA accounts,"[95] the court held the Massachusetts program did not constitute a taking.

Finally, the court rejected the plaintiffs' reliance on *Webb's* and distinguished the case based on the same rationale as the *Cone v. State Bar of Florida* court. The court stated the difference as being "[t]he *Webb's* claimants had property rights to accrued interest which is tangible personal property, while plaintiffs in this case have claimed only intangible property interests"[96]—the right to control and to exclude others. Additionally, the court stated that in *Webb's* the plaintiffs had a legitimate expectation of ownership to the interest earned, whereas in the present case the plaintiffs have no such legitimate investment-backed expectations.[97] For the foregoing reasons, the First Circuit held that the Massachusetts IOLTA program withstood constitutional scrutiny and that the IOLTA program did not take the clients' property in violation of the Fifth Amendment.

C. *Progeny of the Supreme Court's IOLTA Holding: The Fifth Circuit's Decision in* Washington Legal Foundation v Texas Equal Access to Justice Foundation

With the precedent of the Eleventh Circuit's decision in *Cone v. State Bar of Florida*,[98] and the First Circuit's decision in *Washington Legal Foundation v. Massachusetts Bar Foundation*,[99] the Washington Legal

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[91] *Id.* at 976.

[92] *Id.*

[93] *Id.*

[94] *Id.*

[95] *Id.*

[96] *Id.*

[97] *See id.* at 975.

[98] Cone v State Bar of Florida, 819 F.2d 1002 (11th Cir. 1987).

[99] Washington Legal Found. v Massachusetts Bar Found., 993 F.2d 962 (1st Cir. 1993).

Foundation instigated an IOLTA suit in the Fifth Circuit.[100] The plaintiff in *Washington Legal Foundation v. Texas Equal Access to Justice Foundation*, like the plaintiffs in the previous two circuit court IOLTA challenges, alleged that the Texas IOLTA program infringed upon their constitutional rights under the Fifth Amendment.[101] Specifically, their two challenges to the program were as follows: (1) that the interest generated by IOLTA accounts constituted client property such that the state "takes" the property when it distributes the interest from the IOLTA program, and (2) that the IOLTA program impairs the clients' "beneficial use"[102] of their property by requiring them to contribute the interest to the IOLTA program.[103]

The district court, in accord with the holdings of the Eleventh and First Circuits, granted summary judgment for the defendants.[104] The court stated its rationale as being that the plaintiffs had no " 'reasonable expectation' of a property interest"[105] in the IOLTA interest income since such interest would never have existed but for the IOLTA program.[106] The court also determined that the plaintiffs did not have a protected right to exclude others from the beneficial use of IOLTA funds because the program did not intrude or interfere with a real or tangible property interest.[107] The district court concluded that because the plaintiffs had no legitimate property interest in real or tangible property, the Texas IOLTA program did not "take" client property [108]

The Fifth Circuit reversed the district court, and held that the clients who owned the principal funds of the IOLTA accounts were respectively entitled to the "property interest" of the accrued interest.[109] Citing to Texas' "interest follows principal" rule,[110] the court rejected the district court's reliance on the decisions of the First and Eleventh Circuits and found the IOLTA interest to be the property of the clients.[111]

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[100] *See* Washington Legal Found. v. Texas Equal Access to Justice Found., 873 F Supp. 1 (W.D. Tex. 1995).

[101] *See id.*

[102] *Id.* at 5.

[103] *See id.*

[104] *See id.* at 8.

[105] *Id.* at 7

[106] *See id.*

[107] *See id.* at 8.

[108] *See id.*

[109] *See* Washington Legal Found. v Texas Equal Access to Justice Found., 94 F.3d 996 (5th Cir. 1996).

[110] *See id.* at 1000.

[111] *See id.* at 1005.

The Fifth Circuit relied heavily on the United States Supreme Court's decision in *Webb's*, reasoning that *Webb's* created a rule that a property interest exists simply because "'[t]he earnings of a fund are incidents of ownership of the fund itself and are property just as the fund itself is property'"[112] The court felt that this rule should apply regardless of the value of the claimed amount. It criticized the *Cone* court's rationale that a property interest attaches only to net interest (the interest remaining after the bank deducts its surcharges) which would never exist for an IOLTA claimant.[113] Instead, the Fifth Circuit took the position that a property interest attaches the moment the interest is credited to the account and therefore exists before the bank deducts its charges, making the IOLTA interest a "property interest."[114]

The defendants argued that for these reasons, the interest could not accrue to the clients. The court rejected this argument based on IRS regulations. The court stated that the IRS regulations which made IOLTA feasible provide that clients will not be taxed on IOLTA interest only so long as they do not have any control over their participation in the program or assignment of that interest.[115] Under the IRS regulations, if the client has any control over the interest, it is taxable.[116] In light of the IRS regulations, the court reasoned that it would be illogical to conclude that the interest generated from IOLTA principals is not the property of the principal owners.[117] Therefore, the Fifth Circuit held that clients do have a property interest in the interest income produced through IOLTA accounts.[118]

V THE UNITED STATES SUPREME COURT'S DECISION IN *PHILLIPS V WASHINGTON LEGAL FOUNDATION*

A. Overview of the Supreme Court's Decision

The Fifth Circuit's decision in *Washington Legal Foundation v. Texas Equal Access to Justice Foundation* broke with the precedent of the First and Eleventh Circuits.[119] Although the Washington Legal Foundation lost

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[112] *Id.* at 1002 (quoting Webb's Fabulous Pharmacies, Inc. v Beckwith, 449 U.S. 155, 164 (1980)).

[113] *See id.* at 1003.

[114] *See id.*

[115] *See id.* at 1003-04.

[116] *See id.* at 1003.

[117] *See id.*

[118] *See id.* at 1004.

[119] *See* Washington Legal Found. v. Massachusetts Bar Found., 993 F.2d 962 (1st Cir. 1993); Cone v State Bar of Florida, 819 F.2d 1002 (11th Cir. 1987).

on its claim in the First Circuit, it declined to appeal that decision to the Supreme Court. Instead, the Foundation instigated another suit in which it successfully rallied to victory in Texas to achieve its desired result—a circuit split for IOLTA jurisprudence. Against this background, the United States Supreme Court granted certiorari to hear *Phillips v. Washington Legal Foundation*.[120]

On June 15, 1998, the Supreme Court dealt IOLTA a devastating setback with its decision in *Phillips*. The Court held, in a five to four decision, that the "interest income generated by funds held in IOLTA accounts is the 'private property' of the owner of the principal."[121] Although the respondents claimed that the Texas IOLTA program amounted to a "taking" of their property under the Fifth Amendment, the Court declined to give any opinion as to whether the IOLTA funds had been "taken" by the state or as to the amount of "just compensation" that might be due the principal owners.[122] The case was remanded for adjudication of those issues.[123]

There were two dissents in *Phillips*.[124] The first, authored by Justice Souter, argued that the case should be remanded to the district court on the grounds that it was error for the Court to limit its inquiry to the abstract "property interest" issue without addressing the totality of the takings claim.[125] Justice Breyer's dissent, while agreeing with Justice Souter and "believ[ing] it wrong to separate Takings Clause analysis of the property rights at stake from analysis of the alleged deprivation,"[126] considered the issue of whether IOLTA interest constituted a "property interest" and concluded that it did not.[127]

B. Rationale of Chief Justice Rehnquist's Majority Opinion

The majority in *Phillips* narrowly defined the issue as "whether the interest on an IOLTA account is 'private property' of the client for whom the principal is being held."[128] In a footnote the Chief Justice stated that,

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[120] Phillips v. Washington Legal Found., 118 S. Ct. 1925 (1998).

[121] *Id.* at 1934.

[122] *See id.*

[123] *See id.*

[124] *See id.* at 1934-37 (Souter, J., dissenting); *see id.* at 1937-39 (Breyer, J., dissenting).

[125] *See id.* at 1934-37 (Souter, J., dissenting).

[126] *Id.* at 1938 (Breyer, J., dissenting).

[127] *See id.* at 1939 (Breyer, J., dissenting).

[128] *Id.* at 1930.

because the petitioners did not argue in their petition for certiorari that it was error for the circuit court to address only the property interest question, it would thus be improper for the Court to reach the "taking" or "just compensation" elements of the claim which were not set forth in the petition.[129] As a result, the Court limited its inquiry solely to the "property interest" issue.[130]

Pointing out that "the Constitution protects rather than creates property interests,"[131] the Court stated that "the existence of a property interest is determined by reference to 'existing rules or understandings that stem from an independent source such as state law' "[132] Therefore, the Court relied upon the "interest follows principal" rule,[133] citing to an English common law case[134] and to the Texas decision of *Sellers v. Harris County* [135] The Court also relied heavily on *Webb's* and stated the following:

> We held [in *Webb's*] that the statute authorizing the clerk to confiscate the earned interest violated the Takings Clause. As we explained, "a State by *ipse dixit*, may not transform private property into public property without compensation" simply by legislatively abrogating the traditional rule that "earnings of a fund are incidents of ownership of the fund itself and are property just as the fund itself is property." In other words, at least as to confiscatory regulations (as opposed to those regulating the use of property), a State may not sidestep the Takings Clause by disavowing traditional property interests long recognized under state law.[136]

The Court consequently refused to accept petitioners' arguments that Texas' exceptions to the "interest follows principal" rule, which included income-only trusts and marital community property rules, could be extended in principle to embrace the IOLTA situation.[137] "Petitioners'

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[129] *See id.* at 1930 n.4.

[130] *See id.* at 1930.

[131] *Id.*

[132] *Id.* (quoting Board of Regents of State Colleges v. Roth, 408 U.S. 564, 577 (1972)).

[133] *See id.*

[134] *See id.* (quoting Beckford v. Tobin, 27 Eng. Rep. 1049, 1051 (Ch. 1749), which states that "[I]nterest shall follow the principal, as the shadow the body ").

[135] *See id.* at 1931 (quoting Sellers v. Harris County, 483 S.W.2d 242, 243 (Tex. 1972) (arguing that "[t]he interest earned by deposit of money owned by the parties to the lawsuit is an increment that accrues to that money and to its owners.")).

[136] *Id.* (citations omitted).

[137] *See id.* at 1931-32.

examples miss the point of our decision in *Webb's*,"[138] the Court asserted, because in the Court's opinion the Texas exceptions noted by the petitioners were well-established in traditional property law, while an owner's distribution of income generated by the principal is also a fundamental principal of property law [139] Therefore, under the guise of respecting "traditional"[140] property law concepts, the Court relied upon *Webb's* strictly as an "interest follows principal" decision, and disregarded the widespread factual differences between the interest income generated by the principal in the interpleader account in *Webb's* and the IOLTA program in the Texas case.[141]

The petitioners in *Phillips* also argued that since the client funds deposited in the IOLTA program could not generate net interest, the principal owners could not assert a property interest in the interest income.[142] The Court rejected this claim, stating "[w]e have never held that a physical item is not 'property' simply because it lacks a positive economic or market value."[143] The Court accepted the position that "property" is more than an economic interest, but rather a "group of rights which the so-called owner exercises in his dominion of the physical thing,"[144] and encompasses "the right to possess, use and dispose of it."[145]

Most importantly, the Court rejected the United States' amicus curiae position that "private property" is not jeopardized by IOLTA programs because the interest income generated is "government-created value."[146] The Court wholly discarded this contention as being "factually erroneous."[147] Contrary to the First and Eleventh Circuits, the Supreme Court stated that:

> The interest income transferred to the [Texas IOLTA program] is not the product of increased efficiency, economies of scale, or pooling of funds

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[138] *Id.* at 1931.

[139] *See id.* at 1932.

[140] *Id.*

[141] *See id.* at 1931-32 (citing and comparing the facts in *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155 (1980)).

[142] *See id.* at 1933.

[143] *Id.*

[144] *Id.*

[145] *Id.* (quoting United States v General Motors Corp., 323 U.S. 373, 378 (1945)).

[146] *Id.* (quoting Brief for United States as *Amicus Curiae*, No. 96-1578, 1997 WL 528612, at *20 (Aug. 25, 1997)).

[147] *Id.*

> by the government. [T]he State does nothing to create value; the value is created by the respondents' funds. The Federal Government, through the structuring of its banking and taxation regulations, imposes costs on this value if private citizens attempt to exercise control over it. Waiver of these costs if the property is remitted to the State hardly constitutes "government-created value."[148]

The Court maintained that it had similarly rejected the above argument in *Webb's*.[149]

Based on the above conclusions, the Supreme Court affirmed the decision of the Fifth Circuit and held that "interest income generated by funds held in IOLTA accounts is the 'private property' of the owner of the principal."[150]

B. Rationale of Justice Souter's Dissenting Opinion

Dissenting from the Court's ruling in *Phillips*, Justice Souter, joined by Justices Breyer, Stevens, and Ginsburg, maintained that by trisecting the takings analysis and thereafter ruling as to only one portion of the claim, the Court presented an abstract holding.[151] Justice Souter stated:

> I do not join in today's ruling because the Court's limited enquiry has led it to announce an essentially abstract proposition; even on the assumption that the abstract proposition is a correct statement of law, it may ultimately turn out to have no significance in resolving the real issue raised in this case, which is *whether the Interest on Lawyers Trust Account (IOLTA) scheme violates the Takings Clause of the Fifth Amendment.* Since the sounder course would be to vacate the similarly limited judgment of the Court of Appeals for the Fifth Circuit and remand for the broader enquiry outlined below, I respectfully dissent.[152]

Justice Souter argued that the Court, by ruling only as to the "property interest" component of the Takings Clause analysis, failed to recognize the integrated nature of the elements of the claim. In fact, the petitioners'

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[148] *Id.*

[149] *See id.* (citing Webb's Fabulous Pharmacies, Inc. v. Beckwith, 449 U.S. 155 (1980)).

[150] *Id.* at 1934.

[151] *See id.* at 1934-37 (Souter, J., dissenting).

[152] *Id.* at 1934 (Souter, J., dissenting) (emphasis added).

fundamental argument rested on the totality of the takings claim. The Petitioners claimed that there was no Fifth Amendment taking of the respondents' property because the "respondent client would effectively be barred from receiving any net interest on his funds subject to the state IOLTA rule."[153] The respondents would be barred from earning any net interest from their funds placed in IOLTA accounts because of the combined effects of an *unchallenged* federal banking statute authorizing IOLTA accounts, an *unchallenged* Texas rule of attorney conduct, and an *unchallenged* Internal Revenue Service construction of the Tax Code.[154] Therefore, argued Justice Souter, the division of the respondents claim into "abstract" categories and the ruling of the Court only as to one of the categories erroneously ignored the totality of the petitioners' claim—that the Texas IOLTA program does not "take" the clients' property.[155]

In support of his position that the Court's analysis should be an integrated rather than segregated approach, Justice Souter reached the crux of his argument, pointing out that "the way we may ultimately resolve the taking and compensation issues bears on the way we ought to resolve the property issue."[156] He asserted:

> If it should turn out that within the meaning of the Fifth Amendment, the IOLTA scheme had not taken the property recognized today, or if it should turn out that the "just compensation" for any taking was zero, then there would be no practical consequence for purposes of the Fifth Amendment in recognizing a client's property right in the interest in the first place; any such recognition would be an inconsequential abstraction.
>
> Approaching the property issue in conjunction with the two others would, in fact, be entirely faithful to the Fifth Amendment, for as we have repeatedly said its Takings Clause does nothing to bar the government from taking property, but only from taking it without just compensation.[157]

Accordingly, because the Fifth Circuit did not address either the taking or compensation elements, Justice Souter's proposition is that the Court

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[153] *Id.* (Souter, J., dissenting).

[154] *See id.* (citing 12 U.S.C. § 1832(a); 12 C.F.R. § 204.130 (1997); Texas Bar Rules, art. 10, § 9, Rule 1.14(b); Rev. Rul. 81-209, 1981-2 C.B. 16; Rev. Rul. 87-2, 1987-1 C.B. 18).

[155] *See id.* at 1934-37 (Souter, J., dissenting).

[156] *Id.* at 1935.

[157] *Id.* (citations omitted).

should have examined whether either of those claims might have been resolved against the respondents, and if so, then the case should have been remanded to the Court of Appeals for adjudication of all the issues.[158]

As to the "taking" issue, Justice Souter relied on *Penn Central* and cited the "nature of the government's action, its economic impact, and the degree of any interference with reasonable, investment-backed expectations"[159] as the appropriate considerations for a Takings Clause claim. Noting that there had been no physical invasion of property, no net economic impact, nor any reasonable expectation of an investment or gain of net interest, Justice Souter concluded that aside from a departure from the *Penn Central* rationale, the respondents would be unlikely to succeed in proving that a "taking" had occurred.[160]

With respect to the "just compensation" element of the Takings Clause claim, Justice Souter stated that "'[j]ust compensation' generally means 'the full monetary equivalent of the property taken.'"[161] Furthermore, "[i]n determining the amount of just compensation for a taking, a court seeks to place a claimant 'in as good a position pecuniarily as if his property had not been taken.'"[162] Therefore, to determine what would constitute just compensation for the respondents' IOLTA claim, a court should examine what property interest the client could have procured in the absence of the IOLTA program. This analysis at best would produce a discouraging result for the respondents since by definition no client funds will ever be placed in an IOLTA account if the attorney concludes that the funds may independently earn interest for the client in an individual NOW account.

Given the above consideration of the taking and just compensation elements of the respondents' IOLTA claim, Justice Souter concluded that the judgment of the Fifth Circuit should be vacated and the case remanded for adjudication of all elements of the Takings Clause claim.[163]

C. Rationale of Justice Breyer's Dissenting Opinion

Justice Breyer, joined by Justices Stevens, Souter, and Ginsburg, dissented from the majority in *Phillips* on the ground that the interest

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[158] *See id.* at 1935-36 (Souter, J., dissenting).

[159] *Id.* at 1936 (Souter, J., dissenting) (citing Penn Cent. Transp. Co. v City of New York, 438 U.S. 104, 124 (1978)).

[160] *See id.* (Souter, J., dissenting).

[161] *Id.* (Souter, J., dissenting) (quoting United States v. Reynolds, 397 U.S. 14, 16 (1970)).

[162] *Id.* (Souter, J., dissenting) (quoting United States v. 564.54 Acres Land, 441 U.S. 506 (1979)).

[163] *See id.* at 1937 (Souter, J., dissenting).

earned on client trust funds deposited in IOLTA accounts does not amount to a "property interest" for purposes of the Fifth Amendment.[164] Although in agreement with Justice Souter that the proper result would be for the case to be remanded for review of each of the three prongs of the takings analysis, Justice Breyer nevertheless considered the "property interest" question independently [165]

Referring to the Court's reliance on *Webb's*, Justice Breyer rejected the majority's deference to the "interest follows principal" rationale. He did not consider the case or its rationale to be applicable to the IOLTA suit.[166]

Justice Breyer refused to embrace the "interest follows principal" rationale because the circumstances under which IOLTA interest is generated differ dramatically from the traditional situation in which the rationale applies. In the case of IOLTA-generated interest, by definition the owner's principal would never have generated any net interest were it not for the unique benefits of the IOLTA program.[167] Justice Breyer posed the question, "[u]nder these circumstances, what is the property right of the client that IOLTA could have 'confiscat[ed]'?"[168] In answering, he reasoned:

> The most that Texas law here could have taken from the client is not a right to use his principal to create a benefit (for he had no such right), but the client's right to keep the client's principal sterile, a right to prevent the principal from being put to productive use by others And whatever this Court's cases may have said about the constitutional status of such a right, they have *not* said that the Constitution forces a State to confer, upon the owner of property that cannot produce anything of value for him, ownership of the fruits of that property should that property be rendered fertile through the government's lawful intervention Thus the question is whether "interest," *earned only as a result of IOLTA rules* and earned upon otherwise *barren* client principal "follows principal."[169]

Justice Breyer likewise rejected the Court's reliance on *Webb's* because of the factual differences that separate the two cases.[170] In *Webb's*, the funds deposited in the court's interpleader account could have generated the

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[164] *See id.* (Breyer, J., dissenting).
[165] *See id.* at 1938 (Breyer, J., dissenting).
[166] *See id.* (Breyer, J., dissenting).
[167] *See id.* (Breyer, J., dissenting).
[168] *Id.* (Breyer, J., dissenting).
[169] *Id.* (Breyer, J., dissenting) (citations omitted) (emphasis added).
[170] *See id.* (Breyer, J., dissenting).

$100,000 of net interest in the absence of state intervention.[171] In the case of IOLTA programs, no net interest on a client's principal would ever be generated but for the state's action. The *Webb's* holding, that interest produced from a principal which could generate net interest *on its own* takes private property without just compensation,[172] sheds little light on who owns interest generated by a barren principal through the use of governmental IOLTA programs.[173]

Concluding that justification for the majority's holding (that interest generated by IOLTA accounts is a "property interest" of the owner of the principal) could be found neither in *Webb's* nor in the "interest follows principal" precept, Justice Breyer turned to an analogy to justify his position.[174] Looking to land valuation cases as an example, Justice Breyer stated that "the value of what is taken is bounded by that which is 'lost,' not that which the 'taker gained.' "[175] Therefore, it would be impossible to claim that the owners of the IOLTA principal funds incurred a government "taking" when absent the governmental intrusion there would have been no property to take.[176] Consequently, Justice Breyer concluded that the interest earned on the funds deposited in the Texas IOLTA account was not "private property" for purposes of a Takings Clause claim.[177]

VI. ANALYSIS

A. IOLTA Interest is Not a "Property Interest"

The majority in *Phillips* narrowly defined the issue as being "whether the interest on an IOLTA account is 'private property' of the client for whom the principal is being held."[178] In forming its answer to this question, the Court was obligated to determine the existence or nonexistence of such a property interest by looking to Texas state law. The majority opinion, like the opinion of the Fifth Circuit, relied solely upon the Texas case of *Sellers*

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[171] *See* Webb's Fabulous Pharmacies, Inc. v. Beckwith, 449 U.S. 155, 158 (1980).

[172] *See id.* at 155.

[173] *See Phillips*, 118 S. Ct. at 1939 (Breyer, J., dissenting).

[174] *See id.* (Breyer, J., dissenting).

[175] *Id.* (Breyer, J., dissenting) (citing Boston Chamber of Commerce v. Boston, 217 U.S. 189, 195 (1910)).

[176] *See id.* (Breyer, J., dissenting).

[177] *See id.* (Breyer, J., dissenting).

[178] *Id.* at 1930.

v. Harris County[179] to ascertain the appropriate Texas state law to apply to the Takings Clause claim.[180] However, it can be argued that the Fifth Circuit's, and therefore the Court's, reliance on the *Sellers* opinion and its "interest follows principal" rationale was erroneous:[181]

> The touchstone of the Fifth Circuit's opinion, and the only point at which the court explicitly refers to Texas authority, is the statement that "Texas observes the traditional rule that 'interest follows principal' " In support of this supposed general rule, the panel cited a 1972 Texas Supreme Court decision, *Sellers v. Harris County*.
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> [C]ontrary to the Fifth Circuit's statement, the Texas Supreme Court in *Sellers* never once used the phrase "interest follows principal," whether stated as a "traditional rule" or otherwise. Moreover, while the Fifth Circuit introduced its citation to *Sellers* with an "e.g." signal, implying that other Texas cases also have espoused the "interest follows principal" rule, that implication is questionable. Judging from Texas cases in the Westlaw and LEXIS databases, which include Texas appellate opinions from the late 1880s on, one can say with some confidence that *no* Texas court in the modern era seems *ever* to have used the phrase, "interest follows principal," whether in a holding, as dicta, or otherwise.[182]

Even if for the purpose of argument one accepts the "interest follows principal" rationale, the Court misapplied the rationale when it adopted the reasoning of *Webb's*. The *Webb's* decision was based upon a fact situation that was entirely different from the IOLTA case presented by *Phillips*.[183] Of prime importance is the distinction between the amount of money deposited in the interpleader account in *Webb's*[184] and the amount of money deposited by the IOLTA claimants.[185] In the case of the *Webb's* funds, the

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[179] Sellers v. Harris County, 483 S.W.2d 242 (Tex. 1972).

[180] *See Phillips*, 118 S. Ct. at 1931.

[181] *See* Newton & Paulsen, *supra* note 12, at 567-72.

[182] *Id.* at 568 (footnotes omitted).

[183] *See supra* notes 164-77 (discussing Justice Breyer's dissent in *Phillips v. Washington Legal Found.*, 118 S. Ct. 1925, 1937-39 (1998)).

[184] *See* Webb's Fabulous Pharmacies, Inc. v. Beckwith, 449 U.S. 155, 156-58 (1980). The lawsuit in *Webb's* involved another pharmacy company's purchase of the Webb's chain for $1,812,145.77 This amount was tendered to the court during the dispute, where it earned over $90,000.00 in interest while held by the clerk; thereafter, the interest on this amount reached more than $100,000.00.

[185] In contrast, the sums deposited by IOLTA claimants were minimal amounts. *See Phillips*, 118 S. Ct. at 1929.

total amount of the deposit was sufficient to *independently earn net interest in its individual capacity* This is radically different from the situation of the *Phillips* property holders, whose money would never even have been placed in an attorney's IOLTA account if the funds had the capability to independently earn net interest for the client. In the second situation it is the aggregation of individual clients' funds in the IOLTA program, not the principals of the individual owners, that operates to earn net interest.

Webb's was a limited decision, in which the Court expressly stated that its holding was narrow [186] By relying on the *Webb's* decision, the Court inaccurately transposed an absolute "interest follows principal" analysis that was neither present in the limited decision in *Webb's* nor applicable to the unique facts of the IOLTA program.

Therefore, it was erroneous for the Supreme Court to hold that the interest income generated by the Texas IOLTA program was a "property interest" of the principal owners for purposes of a Takings Clause claim.[187] The Court's reliance on the Fifth Circuit's faulty analysis of Texas property law,[188] coupled with its misplaced dependence on the *Webb's* decision, produced an "interest follows principal" rationale that was both inaccurate and inappropriate. It is impossible to claim that the owners of the IOLTA principal funds incurred a government "taking" of a "property interest" when absent the governmental intrusion there would have been no "property" to take.[189]

B. *IOLTA Programs Do Not Cause a Fifth Amendment Taking of Client Property*

By trisecting the Takings Clause analysis and thereafter ruling only on one portion of the claim, the Court presented an abstract holding and left the future of IOLTA programs in a state of uncertainty The ultimate question is whether the IOLTA scheme constitutes a "taking" under the Fifth Amendment. In ruling only as to the "property interest" prong of the claim, the Court did not resolve the question, but instead created even more perplexity in this unsettled area of the law Those concerned with the constitutional status of IOLTA programs have been presented with an isolated holding by the country's highest Court that the interest income generated by the programs is a "property interest."

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[186] *See Webb's*, 449 U.S. at 164.

[187] *See Phillips*, 118 S. Ct. at 1934.

[188] *See* Washington Legal Found. v. Texas Equal Access to Justice Found., 94 F.3d 996 (5th Cir. 1996).

[189] *See Phillips*, 118 S. Ct. at 1939 (Breyer, J., dissenting).

Unquestionably, the Supreme Court will be forced to rule on the chief issue, whether IOLTA programs "take" the property of the principal owners, before the question is resolved. Although the Court held in *Phillips* that the interest generated through the Texas IOLTA program was a "property interest" of the client who owned the principal, this holding may have little or no effect on the eventual resolution of the IOLTA debate.

As stated by Justice Souter in his dissenting opinion in *Phillips*, the Takings Clause analysis should be an integrated analysis resting on the totality of the "takings" claim.[190] He asserted that "[a]pproaching the property issue in conjunction with the two others would, in fact, be entirely faithful to the Fifth Amendment, for as we have repeatedly said its Takings Clause does nothing to bar the government from taking property, but only from taking it without just compensation."[191] In the case of IOLTA programs, it is unlikely that claimants will be able to prove that a "taking" has occurred without "just compensation" because of the nature of the IOLTA scheme.[192]

Since in the unique IOLTA context there has been no physical invasion of property, no net economic impact, nor any interference with reasonable expectations of an investment or gain of net interest, it is rationally impossible for the principal owners to claim a "taking" has occurred.[193]

Additionally, the IOLTA claimants will not be able to prove the absence of "just compensation." Because a client's funds will never be placed in an IOLTA account if the attorney concludes that the funds have the capacity to independently earn net interest for the client, the client whose funds generated interest through the program cannot claim a lack of "just compensation." This is because the principal would never have generated interest, and the client could have expected no compensation in the absence of the IOLTA program. Based on the integrated analysis of all elements of a Takings Clause claim it is apparent that IOLTA programs do not "take" client property under the Fifth Amendment.

VII. CONCLUSION

When the Supreme Court handed down its opinion in *Phillips*, it rejected the precedent established by the First and Eleventh Circuits. More

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[190] *See id.* at 1935 (Souter, J., dissenting).

[191] *Id.* (Souter, J., dissenting).

[192] *See supra* notes 21-29 (discussing the minimal sums deposited in IOLTA accounts).

[193] *See Phillips*, 118 S. Ct. at 1936 (Souter, J., dissenting) (citing Penn Cent. Transp. Co. v. City of New York, 438 U.S. 104, 124 (1978)).

importantly, it stamped a giant question mark on the future of IOLTA programs in the United States. By ruling that the interest income generated by funds held in IOLTA accounts is the "private property" of the principal owners, the Court attacked the validity of IOLTA programs, while simultaneously leaving the ultimate disposition of the IOLTA debate—whether IOLTA programs constitute a Fifth Amendment takings claim—undecided.

As asserted by the dissenting opinions of Justices Souter and Breyer, it was error for the majority of the Court to abstractly decide this very important issue.[194] As this Note has outlined, the adjudication of constitutional attacks on IOLTA programs has been ongoing and presumably will continue until the Supreme Court makes an affirmative ruling as to the programs' constitutionality. Although, arguably, the Court could not reach the "taking" or "just compensation" components of the Takings Clause analysis because of the failure of the Fifth Circuit to rule on those issues,[195] perhaps *Phillips* was not the correct IOLTA case for the Court to hear.[196] Regardless, after the *Phillips* decision the states are left with only a partial judgment as to the constitutionality of their respective IOLTA programs.[197]

The question that must be asked is—"What is next for IOLTA?" To answer that inquiry one must step back from the limited holding in *Phillips* and attempt to ascertain the state of American IOLTA jurisprudence.[198] Based on the previous Takings Clause decisions of the Supreme Court and the decisions of the First and Eleventh Circuits in their respective IOLTA cases, the dissenting justices in *Phillips* were correct.[199] Justice Souter was correct in his assertion that it was error for the majority to "abstractly" consider only the "property interest" prong of the Takings Clause analysis. Because the takings inquiry is not discreetly confined to its respective elements, but rather is a determination to be made after considering the integrated components of the claim, the Court should have remanded *Phillips* for adjudication of the entire case. In doing so, the Court would not have placed IOLTA programs in the difficult position in which they stand as a result of the incomplete *Phillips* decision. Furthermore, Justice Breyer was correct in his assertion that based on the issue as it was currently

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[194] *See* discussion *supra* Parts V.B. and V.C.

[195] *See Phillips*, 118 S. Ct. at 1934.

[196] *See id.*

[197] *See id.*

[198] *See id.*

[199] *See id.* at 1934-37 (Souter, J., dissenting); *see id.* at 1937-39 (Breyer, J., dissenting).

before the Court, the interest income generated by IOLTA programs is not a "property interest" of the principal owners.[200]

The *Phillips* majority erroneously relied on the limited decision of *Webb's Fabulous Pharmacies, Inc. v. Beckwith*[201] and the Fifth Circuit's incorrect interpretation of Texas property law to utilize the "interest follows principal" rationale. Using this faulty rationale, the Court concluded that the interest generated through the Texas IOLTA program was a "property interest" of the client.[202]

Interest generated through IOLTA programs is not a "property interest" of the client. By definition of the IOLTA scheme, client funds placed in IOLTA accounts could never generate net interest for the principal owner. It is only through the combination of federal banking statutes authorizing IOLTA accounts, state IOLTA programs, and Internal Revenue Service permission that the barren funds of IOLTA claimants produce net interest.[203] Because the client funds deposited in IOLTA programs could never generate net interest in their individual capacities, the owners may not claim a "taking." There has been no physical invasion of property, no net economic impact, nor any interference with reasonable expectations of investment or gain of net interest. Since the IOLTA claimants could never have earned net interest in the absence of IOLTA programs, they have lost no property interest without "just compensation." No compensation is due when there has been no taking of a property interest. Net interest generated through IOLTA programs is not a "property interest" of the individual client that can be "taken" only with "just compensation." Rather, American IOLTA programs are a benefit generated through IOLTA's unique measures for the pro bono and legal aid programs which IOLTA funds support.[204] IOLTA programs, therefore, do not represent a violation of the Takings Clause of the Fifth Amendment.

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[200] *See id.* at 1937-39 (Breyer, J., dissenting).

[201] Webb's Fabulous Pharmacies, Inc. v. Beckwith, 449 U.S. 155 (1980).

[202] *See Phillips*, 118 S. Ct. at 1934.

[203] *See* discussion *supra* Part II.

[204] *See supra* note 14 and accompanying text.