Pennies from Heaven—Why *Washington Legal Foundation v. Legal Foundation of Washington* Violates the U.S. Constitution

Kristi L. Darnell
PENNIES FROM HEAVEN—WHY WASHINGTON LEGAL FOUNDATION V. LEGAL FOUNDATION OF WASHINGTON VIOLATES THE U.S. CONSTITUTION

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Abstract: In Washington Legal Foundation v. Legal Foundation of Washington, the Ninth Circuit Court of Appeals held that Washington’s Interest on Lawyers’ Trust Account (IOLTA) program did not perpetuate a “taking without just compensation” in violation of the Fifth Amendment. Even though the court acknowledged that IOLTA-generated interest was client property, the first element necessary to establish a taking, it reasoned that the appropriate subsequent analysis for this problem was the ad hoc test. Applying the ad hoc test to the IOLTA program, the court concluded that the requisite unconstitutional elements were absent. This Note argues that the Ninth Circuit incorrectly analyzed the IOLTA issue and instead should have applied the more appropriate per se takings analysis, resulting in an automatic finding of an unconstitutional taking. Finally, this Note suggests constitutionally valid alternatives to the IOLTA program that would continue to fund Washington’s important legal aid organizations.

For more than fifteen years, Washington’s public legal aid organizations have enjoyed approximately three million dollars annually in “free money” generated by this state’s Interest on Lawyers’ Trust Accounts program (IOLTA). This free money is earmarked to provide free or low cost legal assistance to those who would otherwise have no access to the justice system. At first glance, the idea appears to be genius. Client owned monies that are presumed to be incapable of earning interest alone because they are either too small or held for too short a period of time are pooled through governmental regulation and together do in fact generate income. This money is then automatically donated to the Legal Foundation of Washington (LFW), a charitable organization created by the Supreme Court of Washington to distribute the IOLTA-generated interest to various legal aid groups throughout the state. While the goals of this program are worthy, the mechanism is unconstitutional.

2. Id. at 869.
3. Id.

A lawyer who receives client funds shall maintain a pooled interest-bearing trust account for deposit of client funds that are nominal in amount or expected to be held for a short period of
The plain language of the Fifth Amendment is simple, but the jurisprudence surrounding the interpretation of the takings phrase "nor shall private property be taken for public use, without just compensation" is complex. The crux of the IOLTA issue lies in the choice of takings analyses—either per se or ad hoc. Courts apply the per se takings approach when the government mandates a permanent physical occupation of the property or when it denies all economically viable uses of the property. Both of these government actions automatically result in a taking, regardless of the minimal economic impact or the charitable intention of the government regulation. On the other hand, the ad hoc takings analysis employs a multi-factor balancing test to determine whether a regulation has gone too far. Courts apply the ad hoc analysis to situations where a portion of something, but neither the entire property nor all of its economic value, has been appropriated.

In Washington Legal Foundation v. Legal Foundation of Washington. [hereinafter Legal Foundation of Washington II], the Ninth Circuit, en banc, failed to apply the correct test. While acknowledging that IOLTA-generated interest is the private property of the client, the court nevertheless stated that the per se analysis was inappropriate outside of the real property context. Furthermore, the court stated that the ad hoc balancing test was created for this very situation, where the government

time. The interest accruing on this account, net of reasonable check and deposit processing charges which shall only include items deposited charge, monthly maintenance fee, per item check charge, and per deposit charge, shall be paid to The Legal Foundation of Washington, as established by the Supreme Court of Washington. All other fees and transaction costs shall be paid by the lawyer. A lawyer may, but shall not be required to, notify the client of the intended use of such funds.

6. U.S. Const., amend. V.
8. See, e.g., Legal Found. of Wash. II, 271 F.3d 835, 854 (9th Cir. 2001), cert. granted 70 U.S.L.W. 3580 (U.S. June 10, 2002) (No. 01-1325).
11. Id.
13. Id.
14. 271 F.3d 835 (9th Cir. 2001).
15. Id. at 854.
adjusts the benefits and burdens for the common good. However, the Ninth Circuit should have applied the per se analysis as suggested by precedent, instead of the ad hoc balancing test. If the court had employed the correct test, it would have been compelled to rule that the IOLTA program in its present form was unconstitutional.

Although the Ninth Circuit held Washington State's IOLTA program was not unconstitutional, this issue is by no means resolved nationwide. Because the Texas IOLTA program was declared unconstitutional by the Fifth Circuit Court of Appeals only weeks earlier, the Ninth Circuit decision created a split among the circuits, and the United States Supreme Court has granted certiorari to decide the issue. When the Court hears this case, it should find that, contrary to the Ninth Circuit's decision, the forced donation of IOLTA-generated interest earned on client monies is a "taking without just compensation" under the Fifth Amendment, and is therefore unconstitutional.

Because the goals of the IOLTA program are both worthy and commendable, advocates for publicly supported indigent legal services should look to a constitutionally acceptable reform of this program, thereby continuing to fulfill a crucial societal need without compromising important constitutional values. There are a number of other avenues that the Washington State Supreme Court, the Washington State Bar Association, and the state's attorneys themselves can and should pursue to meet these funding needs, including making the program voluntary or levying a fee.

This Note shows that the Ninth Circuit's analysis in Legal Found. of Wash. II is fatally flawed. Part I explores the general history and development of IOLTA programs throughout the country and specifically in Washington State. Part II examines the development of

16. Legal Found. of Wash. II, 271 F.3d at 852-53.
22. Id.
24. See infra Part V.D.
the initial takings question—whether interest income is property. Part III provides a brief overview of the jurisprudence surrounding the takings analysis and addresses the post-Phillips IOLTA circuit decisions. Part IV details the Ninth Circuit's en banc decision in Legal Found. of Wash. II. Finally, Part V analyzes the proper application of the takings test, argues that the IOLTA program works an unconstitutional taking of clients' private property, and suggests constitutionally valid alternatives.

I. INTEREST ON LAWYER TRUST ACCOUNT PROGRAMS

Washington's IOLTA program, like the IOLTA programs currently present in all fifty states, was created with charitable and ethical goals in mind. The program evolved out of the strict ethical rules that have always surrounded the handling of client funds by attorneys. It has long been absolutely forbidden to commingle client funds with law firm or lawyer monies. This prohibition includes all client owned monies that come within the lawyer's possession, including, for example, settlement funds and retainer fees.

To obey these ethical rules, lawyers generally maintained separate trust accounts for client funds. Client funds commonly had to be available at any time on the client's demand, so attorneys placed these funds in demand checking accounts (as opposed to interest-bearing savings accounts). Therefore, lawyers only deposited sums of money expected to generate substantial amounts of interest in interest-bearing savings accounts on the rationale that the convenience of a checking account was only outweighed by a substantial amount of interest. Because pre-1980 banking laws did not allow for the payment of interest

26. See Legal Found. of Wash. II, 271 F.3d at 843, ("An ethical tradition of the legal profession is the provision of legal services to those who cannot afford to pay them.").
27. See, e.g., CANONS OF PROF'L ETHICS, C. 11 (as amended 1933).
A lawyer shall hold property of clients or third party persons that is in a lawyer's possession in connection with a representation separate from the lawyer's own property. Funds shall be kept in a separate account maintained in the state where the lawyer's office is situated, or elsewhere with the consent of the client or third person.
29. Legal Found. of Wash. II, 271 F.3d at 867-68.
30. Id.
32. Legal Found. of Wash. II, 271 F.3d at 842. (emphasis added).
on demand checking accounts, client trust accounts essentially functioned as interest-free loans to banks.

As interest rates rose to all-time highs in the late 1970s, many banking regulations were altered. In 1980, Congress authorized the use of Negotiable Order of Withdrawal (NOW) accounts, and the transformation of the banking industry began. NOW accounts are interest-bearing checking accounts subject to one major caveat—all interest earned on these accounts must be donated to charitable organizations. While clients were still unable to access the interest, the interest could be used to support legal services, so long as a charitable organization had the “exclusive right to the interest.” Even so, short-term and small funds remained incapable of earning interest beyond the administrative costs of establishing separate NOW accounts. Therefore, lawyers generally continued to place client funds in non-interest bearing checking accounts.

The advent of NOW accounts set the stage for the IOLTA program. In 1981, Florida became the first state to establish an IOLTA system. Today, IOLTA programs are present in some form in all fifty states and the District of Columbia. Generally, IOLTA programs were introduced through a state’s supreme court, and made applicable to all licensed attorneys through a state’s Bar Association. These programs typically dictate that upon receipt of client monies, an attorney then determines whether the funds will presumably be incapable of generating interest on their own. Those funds that are incapable of generating interest must be

34. Legal Found. of Wash. II, 271 F.3d at 842.
35. Id. at 842–43.
37. Id. (quoting 12 U.S.C. § 1832(a)(2) (1980)).
38. Id.
39. Legal Found. of Wash. II, 271 F.3d at 842–43. The costs include bank charges, as well as lawyer and accountant fees for setting up the accounts. Id. at 844.
43. See Goldstein, supra note 25, at 1277 (stating program names vary slightly from state to state).
44. See Legal Found. of Wash. II, 271 F.3d 835 app. at 869 (9th Cir. 2001).
placed in a designated IOLTA account, where the bank will pool client monies and generate interest on the collective funds.\textsuperscript{46} That interest is then donated directly to a charitable organization designated by the state bar association or the state supreme court.\textsuperscript{47} While clients may be aware of the IOLTA program,\textsuperscript{48} their authorization of the use of their principal and interest is not required so long as the attorney has determined that the principal will be incapable of generating interest on its own.\textsuperscript{49}

Washington State's IOLTA program was created in 1984 by the Supreme Court of Washington\textsuperscript{50} and subsequently codified in the Washington Rules of Professional Conduct.\textsuperscript{51} Interest generated from IOLTA accounts must be donated directly to the Legal Foundation of Washington, a non-profit organization established to grant funds to various non-profit legal aid programs throughout the state.\textsuperscript{52} Only when the interest generated on client funds is expected to exceed the administrative costs, including bank charges and attorney fees to establish separate interest bearing accounts, should the money be deposited in a separate, non-IOLTA, interest-bearing account where interest is payable to the client.\textsuperscript{53} In other words, a client will receive interest income only when an attorney can predict that a net profit will result.\textsuperscript{54} However, if the client funds alone are presumed incapable of generating a net interest for the client, the administrative pooling of money in the IOLTA account creates interest that is donated to the Legal Foundation of Washington.\textsuperscript{55}

II. EARLY CHALLENGES TO THE IOLTA PROGRAM UNDER THE FIFTH AMENDMENT

Despite what at first glance seems to be an ingenious idea to derive interest from otherwise barren funds, there have been numerous Fifth

\begin{itemize}
\item \textsuperscript{46} Legal Found. of Wash. II, 271 F.3d at 869.
\item \textsuperscript{47} Id.
\item \textsuperscript{48} See WASH. RULES OF PROF'L CONDUCT, 1.14(c)(1) (2001).
\item \textsuperscript{49} Id.
\item \textsuperscript{50} Legal Found. of Wash. II, 271 F.3d at 869.
\item \textsuperscript{51} Id.
\item \textsuperscript{52} Id.
\item \textsuperscript{53} Id.
\item \textsuperscript{54} Id.
\item \textsuperscript{55} Id.
\end{itemize}
Amendment takings challenges to IOLTA programs across the country.\textsuperscript{56} The Fifth Amendment of the Constitution states that no "private property be taken for public use, without just compensation."\textsuperscript{57} The plain language of the Amendment has been interpreted to mean that a court must find three elements in order to conclude that a regulation constitutes a taking: 1) the regulation must take private property, 2) the property must be taken for public use, and 3) the taking must lack the payment of just compensation.\textsuperscript{58} It is important to note that the Fifth Amendment does not prohibit the taking of private property for public use—instead, it only requires that just compensation be paid.\textsuperscript{59}

Initially, these IOLTA challenges failed because courts systematically ruled that IOLTA-generated interest was not the personal property of clients. Therefore, there was no need to engage in further Fifth Amendment takings analysis.\textsuperscript{60} However, the U.S. Supreme Court has recently held that IOLTA-generated interest is to be considered personal property of clients.\textsuperscript{61}

A. Webb's Fabulous Pharmacies v. Beckwith

Although not an IOLTA case, \textit{Webb's Fabulous Pharmacies v. Beckwith}\textsuperscript{62} has been used by analogy to address the question of whether interest income is private property under the Fifth Amendment.\textsuperscript{63} In \textit{Webb's}, the trial court required one of the parties to deposit almost $2,000,000 with the clerk of the court in an interpleader action.\textsuperscript{64} Because a Florida statute required that interest be accrued on interpleader funds, the money was deposited into an interest-bearing account.\textsuperscript{65} After one year, the funds generated $100,000 in interest.\textsuperscript{66} The trial court

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\item \textsuperscript{56} \textit{See generally} Phillips v. Wash. Legal Found., 524 U.S. 156 (1998); Wash. Legal Found. v. Mass. State Bar Found., 993 F.2d 962 (1st Cir. 1993); Cone v. State Bar of Fla., 819 F.2d 1002 (11th Cir. 1987).
\item \textsuperscript{57} U.S. Const. amend. V.
\item \textsuperscript{58} \textit{See id.}
\item \textsuperscript{59} \textit{See Legal Found. of Wash. II,} 271 F.3d at 851–52.
\item \textsuperscript{60} \textit{See, e.g.,} Cone, 819 F.2d at 1004–05; Mass. State Bar Found., 993 F.2d at 973–74.
\item \textsuperscript{61} Phillips, 524 U.S. 156, 172 (1998).
\item \textsuperscript{62} 449 U.S. 155 (1980).
\item \textsuperscript{63} \textit{See generally} Phillips, 524 U.S. 156; Mass. State Bar Found., 993 F.2d at 973–74; Cone, 819 F.2d 1002.
\item \textsuperscript{64} Webb's, 449 U.S. at 156–57.
\item \textsuperscript{65} \textit{Id.}
\item \textsuperscript{66} \textit{Id.} at 158.
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retained the interest and returned the principal to the victorious party. Not surprisingly, the retention of such a large amount of interest raised alarm among the owners of the principal, and the case was eventually heard before the U.S. Supreme Court. Following the rule that "[t]he earnings of a fund are incidents of ownership of the fund itself and are property just as the fund itself is property," the Court held that the interest earned on the interpleader account was the private property of the owner of that principal.

While the Webb's court clearly set the standard of takings law as it applied to interest income in general, many subsequent courts considering the IOLTA issue have noted that there are two important distinguishing factors. First, Webb's was not about IOLTA issues, but instead addressed the interest earned on interpleader accounts. While there are clearly some analogies between the two, the largest difference is the fact that the interpleader amount generated interest on its own, while IOLTA principals would not. Second, the size of the principal involved in Webb's was considerably larger than the IOLTA amounts at issue, and while the interest earned on IOLTA accounts individually is virtually non-existent, in Webb's it amounted to more than $100,000. The way courts have addressed these potential differences has greatly affected the outcome of the subsequent IOLTA takings challenges.

B. Pre-Phillips Application of Webb's to IOLTA.

The first IOLTA constitutional challenge took place in Cone v. State Bar of Florida. As would be repeated in the many subsequent IOLTA challenges, the plaintiff in Cone asserted that the appropriation of interest...
Washington's IOLTA Program

generated on her principal was unconstitutional because she had not been justly compensated.77 Similarly, in 1993, the First Circuit addressed the IOLTA takings issue in *Washington Legal Foundation v. Massachusetts Bar Foundation*.78 In both cases, the circuit courts, in distinguishing the Webb's analysis, found that the respective IOLTA programs did not constitute a taking under the Fifth Amendment.79 The *Cone* court found that the interest at issue was far too small to come under the Webb's analysis—$13.75 at issue in *Cone*, compared with approximately $100,000 at issue in Webb's.80 Similarly, the *Massachusetts Bar Foundation* court distinguished Webb's on the basis that it was not an IOLTA case and that the plaintiffs involved in Webb's had a recognized property right in the interest income, while the principal holders of IOLTA funds did not.81

At the base of both the First and Eleventh Circuit cases was the idea that IOLTA-generated interest was not the private property of the client.82 Both courts essentially stopped the takings analysis at this point because all three elements of a taking must be present in order to find a constitutional violation.83 However, these early federal challenges to the IOLTA program would no longer be valid once the U.S. Supreme Court took up the IOLTA issue in *Phillips*.84

C. Phillips v. Washington Legal Foundation

Undeterred by its defeat in the First Circuit, the Washington Legal Foundation85 again attacked the IOLTA program, this time taking up the battle in Texas.86 Again, plaintiffs claimed relief under the Fifth

77. *Id.* at 1004.
78. 993 F.2d 962 (1st Cir. 1993).
80. *Cone*, 819 F.2d at 1006–07.
82. *Id.*; *Cone*, 819 F.2d at 1007.
85. The "Washington Legal Foundation" organization is a self-proclaimed advocate for "freedom and justice,... [working to] maintain balance in the Courts and [to] help our government strengthen America's free enterprise system." See http://www.wlf.org (last visited July 31, 2002).
The District Court followed the rationale developed in the First and the Eleventh Circuits, holding that IOLTA-generated interest was not the private property of the client. However, when the Fifth Circuit addressed the issue, it interpreted Webb’s to mandate a holding that IOLTA interest was the personal property of the client. Further, the “Webb’s decision . . . creates a rule that is independent of the amount or value of [the] interest at issue.”

The U.S. Supreme Court took up the IOLTA issue in Phillips v. Washington Legal Foundation to resolve the resulting circuit split. Because the Fifth Circuit had ruled that IOLTA-generated interest was the private property of the client, the Supreme Court only considered this narrow issue, and did not reach the broader issue of whether the IOLTA program was a taking. Still, the Court was sharply divided on this issue and a 5-4 decision resulted. The case generated two dissenting opinions, each of which was joined by all dissenters.

The Phillips majority affirmed the Fifth Circuit, holding that the interest generated by the IOLTA program was the private property of the client. While the Court recognized that a State is generally at liberty to establish property rights, it found that “at least as to confiscatory regulations . . . a State may not sidestep the Takings Clause by disavowing traditional property interest long recognized under state law.” Because Texas common law had long recognized the maxim that “interest follows principal,” the Court concluded that under Texas law, the IOLTA-generated interest was the private property of the owner of the principal.

The majority also rejected the defendants’ argument that there could be no property rights in IOLTA-generated interest because the client

88. Id. at 7.
89. Tex. Equal Access to Justice Found., 94 F.3d at 1002.
90. Id.
92. Id. at 157.
93. Id. at 172.
94. Id. at 164, n.4.
95. Id. at 158.
96. Id.
97. Id. at 160.
98. Id. at 166–67.
99. Id. at 164, 166–67.
deposits alone could not independently earn interest. The Court noted that it had “never held that a physical item is not ‘property’ simply because it lack[ed] a positive economic or market value.” In fact, the Court noted that there are many non-economic property rights including the ability to possess, control, and dispose of property. According to the Court, these property rights belong to the owner of the principal.

Finally, after deciding that IOLTA interest was indeed private property, the Court discussed in a cursory manner the remaining takings analysis. In dicta, the majority noted that a “property right [can be] taken even when infringement of that right arguably increased the market value of the property at issue.” Therefore, the argument that the IOLTA program itself actually added value to the principal should be irrelevant in determining whether a taking is present. In addition, the Court indirectly analogized the Loretto per se test to the IOLTA context.

Thus, the Supreme Court has resolved the first issue in the IOLTA takings analysis. The interest earned in IOLTA accounts is indeed the private property of the client. After Phillips, the circuit courts were faced with the challenge of determining whether this private property was actually taken, and if so, whether just compensation for such a taking was possible.

III. AD HOC V. PER SE ANALYSIS—CIRCUITS CONSIDER POST-PHILLIPS FIFTH AMENDMENT CHALLENGES TO IOLTA PROGRAMS

In Phillips, the U.S. Supreme Court established that IOLTA-generated interest was indeed the private property of the client. Going no further, the Court left the analysis of the remaining two takings factors, whether the property was taken and whether just compensation was due, for the
circuit courts to interpret. The circuit courts have split on these issues and the cases turn on the particular analysis that each employs. The Fifth Circuit has adopted the per se analysis, automatically finding that the Texas IOLTA program was unconstitutional. In contrast, the Ninth Circuit opted to use the ad hoc balancing test and ruled that Washington's program was constitutional.

A. Ad Hoc and Per Se Analyses of Fifth Amendment Takings Claims

Generally, Fifth Amendment takings issues are resolved on a case-by-case basis. However, recent case law has created a number of broad propositions, and two forms of takings analysis have been recognized. To determine whether a taking is present, the questionable action at issue will be subjected to either an ad hoc analysis or a per se analysis. Generally, an ad hoc takings analysis applies when the subject regulation denies the property owner of less than the total value of the property. In cases applying the ad hoc test, a number of factors are balanced to determine whether the regulation has gone too far. In contrast, the per se takings analysis applies when it appears that the property owner has been denied all economically viable use of the property or where there is a permanent physical occupation of the property. If the per se analysis is applicable, an automatic taking will be found, regardless of any other factors a court might ordinarily consider under the ad hoc test, including the legitimacy of the state interest or the economic impact of the regulation.

108. Id. at 172.
111. Legal Found. of Wash. II, 271 F.3d at 857-61.
112. See id.
114. Legal Found. of Wash. II, 271 F.3d at 854.
115. Id.
117. Id.
119. See, e.g., Loretto, 458 U.S. at 434-35.
1. Ad Hoc Takings

The evolutionary development of ad hoc takings jurisprudence began with *Pennsylvania Coal Co. v. Mahon*,120 when Justice Oliver Wendell Holmes stated for the majority that "while property may be regulated to a certain extent, if [the] regulation goes too far it will be recognized as a taking."121 In this case, a group of homeowners sued to prevent the Pennsylvania Coal Company from mining under their property and removing the subjacent support of their homes and surrounding land.122 Although the homeowners had previously contracted with the coal company to allow this mining operation, the state subsequently enacted a regulation preventing mining companies from undermining the subjacent support of existing surface structures.123 As a result, a conflict developed between the state's police power to regulate and the private property rights of the Pennsylvania Coal Company.124 Balancing these competing interests, the U.S. Supreme Court held that the regulation went too far and infringed on the mining company's constitutionally protected property rights.125

With the holding in *Pennsylvania Coal* as its starting point, the U.S. Supreme Court further refined the ad hoc takings analysis in *Penn Central Transportation Co. v. New York City*.126 *Penn Central* involved the New York City's regulation of the Grand Central Terminal as a historic landmark, requiring city authorization for any fundamental alteration to the building.127 When the owner sought authorization for plans to build a multistory office building over the terminal, the city denied this use as contrary to the building's historic character.128 In response, the owner requested compensation for his lost profit arguing that the city's regulation worked as an unconstitutional taking.129

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120. 260 U.S. 393 (1922).
121. *Id.* at 416. ("We are in danger of forgetting that a strong public desire to improve the public condition is not enough to warrant achieving the desire by a shorter cut than the constitutional way of paying for the change.").
122. *Id.* at 412.
123. *Id.* at 412-13.
124. *Id.* at 413.
125. *Id.* at 413-14.
127. *Id.* at 115.
128. *Id.* at 117.
129. *Id.* at 119.
The Supreme Court first stated generally that when the regulation goes so far as to "forc[e] some people alone to bear public burdens which, in all fairness, and justice, should be borne by the public as a whole," a taking occurs. The Court in *Penn Central* set forth the modern ad hoc balancing test for analyzing whether a regulatory taking has occurred: 1) the economic impact of the regulation on the claimant, 2) the extent to which the regulation has interfered with investment-backed expectations, and 3) the character of the government action in establishing the regulation. In applying these factors to the facts of the *Penn Central* case, the Court held that the regulation did not work as an unconstitutional taking. Because the regulation allowed the owners to continue their present use of the property, it did not go too far and was therefore permissible.

2. *Per Se Takings*

In contrast, the per se takings analysis has traditionally been applied in situations where there is a permanent physical invasion or a complete denial of economically viable use of the subject property. The U.S. Supreme Court first established the parameters of the per se takings analysis in *Loretto v. Teleprompter Manhattan CATV Corp.*, and later expanded the analysis in *Lucas v. South Carolina Coastal Council*.

In *Loretto*, the Court determined that a permanent physical invasion occurred when a plaintiff landlord was required to allow the installation of cable television lines in her building. While the cable wires were small and occupied only a minute area of the roof, these lines nevertheless constituted a per se violation of the takings clause, regardless of the "public interest [the wires] might serve" or the "minimal economic impact on the owner." Because the permanent

130. Id. at 123 (quoting Armstrong v. United States, 364 U.S. 40, 49 (1960)).
131. Id. at 124.
132. Id. at 128–34.
133. Id.
139. Id. at 422.
140. See id. at 426.
141. Id. at 435, 438.
physical occupation resulted in an automatic taking, there was no need to engage in any balancing of various factors.\textsuperscript{142} In addition, the Court noted that to the extent the regulation caused a permanent occupation of the property, it effectively destroyed the rights “to possess, use and dispose” that are compensable property rights.\textsuperscript{143} \textit{Loretto} is now considered the appropriate analysis to determine whether per se takings violations are present.\textsuperscript{144}

The Supreme Court, building on the holding in \textit{Loretto}, held in \textit{Lucas} that a per se taking was also present when an owner was denied all “economically viable use” of his or her property.\textsuperscript{145} The plaintiff had purchased two residential lots on a South Carolina barrier island with the intention of building single-family homes similar to those located on adjacent plots.\textsuperscript{146} However, prior to the commencement of construction, the State legislature enacted a statute designed to protect the beach.\textsuperscript{147} The legislation prohibited the erection of permanent habitable buildings on these two plots.\textsuperscript{148} The Court reasoned that from the property owner’s point of view, “the total deprivation of beneficial use...[is the] equivalent of a physical appropriation.”\textsuperscript{149} Because the Plaintiff was completely denied any economically viable use of the land, the Court held that there had been a per se taking for which just compensation was due.\textsuperscript{150} Therefore, the per se analysis must result in an automatic holding that a taking occurred where there has been a permanent physical invasion or a regulation that denies all economically viable use.

\textbf{B. Circuit Application of the Takings Analysis to IOLTA Challenges}

The Fifth and Ninth Circuits both applied the established takings jurisprudence to determine the constitutionality of the IOLTA program, but arrived at very different conclusions. The Fifth Circuit found that the per se approach was most appropriate, and held the IOLTA program

\begin{itemize}
\item \textsuperscript{142} Id. at 434–35.
\item \textsuperscript{143} Id. at 435 (citing United States v. General Motors Corp., 323 U.S. 373, 378 (1945)).
\item \textsuperscript{144} Legal Found. of Wash. II, 271 F.3d 835, 854 (9th Cir. 2001).
\item \textsuperscript{145} Lucas v. S.C. Coastal Council, 505 U.S. 1003, 1019 (1992).
\item \textsuperscript{146} Id. at 1006–07.
\item \textsuperscript{147} Id. at 1007–09.
\item \textsuperscript{148} Id. at 1007.
\item \textsuperscript{149} Id. at 1017.
\item \textsuperscript{150} Id. at 1019, 1028.
\end{itemize}
unconstitutional. The Ninth Circuit, on the other hand, applied the ad hoc approach, and held the IOLTA program to be legal.


After the Phillips decision, the U.S. Supreme Court remanded the case to the trial court to determine and apply the appropriate takings analysis.\(^{151}\) A federal district court held in Washington Legal Foundation v. Texas Equal Access to Justice Foundation\(^{152}\) that the Texas IOLTA program was constitutional, despite the fact that the interest generated was the private property of the client.\(^{153}\) The district court applied the ad hoc takings analysis, finding that no taking had occurred and no compensation was due.\(^{154}\) The district court reasoned that the “economic impact of the regulation on Plaintiffs is nill.”\(^{155}\)

The case was appealed to the Fifth Circuit Court of Appeals.\(^{156}\) The Fifth Circuit reversed on the grounds that the client’s ability to possess, control, and dispose of the IOLTA-generated interests were valuable property rights for which compensation was due.\(^{157}\) On this basis, the Fifth Circuit declared the Texas IOLTA program to be unconstitutional.\(^{158}\)

The Fifth Circuit rejected the district court’s application of the ad hoc test, reasoning instead that the U.S. Supreme Court had suggested that the per se test was the appropriate analysis in Phillips.\(^{159}\) The Fifth Circuit recognized that when applying the takings clause to interest income, the Webb’s Court had cited the Penn Central ad hoc test, but had not itself engaged in an ad hoc analysis.\(^{160}\) Instead, the Webb’s Court

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153. Id. at 636, 646–47.
154. Id. at 647.
155. Id. at 646.
157. Id. at 187–88, 195.
158. See id.
159. Id. at 186 (“We conclude... Webbs Fabulous Pharmacies Inc. v. Beckwith, and Loretto v. Teleprompter Manhattan CATV Corp., cases the Phillips Court relied upon in reaching its property interest holding, compel applying the per se analysis.”) (internal citations omitted).
160. Id.
Washington's IOLTA Program

actually utilized the early form of the per se approach. In doing so, the Webb's Court also dispelled the notion that the per se test can only apply to real property. Therefore, the Fifth Circuit was free to decide that the forced contribution of interest income does more than simply adjust the "benefits and burdens of economic life to promote the common good.

Furthermore, the Fifth Circuit was compelled by the language in the Lucas case, which suggested that the Loretto per se analysis applied to permanent invasions "no matter how minute the intrusion, and no matter how weighty the public purpose behind it." Because the Loretto Court refused to allow a "permanent invasion" without just compensation, the Fifth Circuit by analogy held that the refusal of the Webb's Court to allow confiscation of interest income was applicable to the IOLTA program. Therefore, the per se test was appropriate for analyzing the status of IOLTA-generated interest.

The defendants in Texas Equal Access to Justice Foundation also attempted to preclude the finding of an automatic taking by arguing that United States v. Sperry Corp. applied. Sperry, a takings case, involved the United States government collecting a "user fee" on a portion of the money recovered by American claimants before the Iran-United States claims tribunal. The U.S. Supreme Court found there was no taking and rejected governmental appropriations of money being subjected to the per se analysis. However, the Phillips Court also foreclosed any argument on this basis by clearly distinguishing Sperry from the IOLTA cases:

This would be a different case if the interest income generated by IOLTA accounts was transferred to the State as payment "for services rendered" by the State [as was the case with Sperry]. Our holding does not prohibit a State from imposing reasonable fees it incurs in generating and allocating interest income. But here the

161. Id. at 186–87 (citing United States v. Causby, 328 U.S. 256 (1946)).
162. Id. at 187.
163. Id. at 186 (citing Webb's Fabulous Pharmacies v. Beckwith, 449 U.S. 155, 163 (1980)).
164. Id. at 186–87 (citing Lucas v. S.C. Coastal Council, 505 U.S. 1003, 1015 (1992)).
165. Id. at 186–88.
166. Id. at 188.
170. Id. at 62, n.9.
State does not, indeed cannot, argue that its confiscation of [a client's] interest income amounts to a fee for services performed. 171

In addition, the Fifth Circuit noted that the Webb's Court had concisely dispelled the notion that the per se test can apply only to real property. 172 Therefore, any argument that the appropriation of money is subject only to the ad hoc analysis was incorrect. In its discussion of the final element of the takings analysis, whether or not just compensation was due, the court addressed the variety of possible compensable property rights. 173 While the Fifth Circuit remanded the case for a determination of the appropriate compensation, 174 it did recognize that even if the interest income itself was not economically beneficial, there was nonetheless value in the rights to possess, control, and dispose of interest income. 175 In sum, because the Texas IOLTA program satisfied all of the Fifth Amendment elements, the Fifth Circuit held that it was unconstitutional.

2. The Ninth Circuit Panel Decision in Washington Legal Foundation v. Legal Foundation of Washington

Amidst its pursuit to bring down the IOLTA programs, the Washington Legal Foundation also launched an attack in Washington State. 176 A federal district court, lacking the benefit of the U.S. Supreme Court's ruling in Phillips, dismissed the claim reasoning that IOLTA-generated interest was not private property. 177 However, a Ninth Circuit panel in Washington Legal Foundation v. Legal Foundation of

173. Id. at 188–89.
174. Id. at 195.
175. Id. at 187–88.
176. See Legal Found. of Wash. II, 271 F.3d 835, 841 (9th Cir. 2001). The facts of Washington Legal Foundation v. Legal Foundation of Washington I & II are somewhat unusual in that the Washington Legal Foundation joined a number of plaintiffs who were either Limited Practice Officers (LPOs) or their clients-and were not associated with attorneys or law firms in any way. LPOs are generally real estate closing officers who are allowed to perform limited legal practices. Id. at 1102–03. Through a relatively recent amendment to the state's IOLTA program, LPOs are also required to abide by the IOLTA rules. Id. However, the Ninth Circuit noted that while the case was factually different from most IOLTA challenges, it made no difference in the analysis of whether IOLTA is constitutional. Id. at 869–70.
177. Id. at 873.
Washington's IOLTA Program

Washington [hereinafter Legal Foundation of Washington I],\(^\text{178}\) acknowledged a property right to interest income under Phillips.\(^\text{179}\) The Legal Foundation of Washington I court applied a per se takings analysis, finding that Washington's IOLTA program was unconstitutional.\(^\text{180}\)

Having first established the fact that IOLTA-generated interest was private property of the client, as compelled by Phillips, the Ninth Circuit panel next addressed the takings issue.\(^\text{181}\) Again, the defendants argued that there was no "physical invasion of tangible property,"\(^\text{182}\) and therefore the Penn Central ad hoc analysis should apply.\(^\text{183}\) However, the court found that the Penn Central case would be inapplicable to the IOLTA question because it would result in the "nonsensical proposition that a taking would less readily be found if a state entirely confiscated people's money from their bank accounts or IRAs than if it installed a sign on their land."\(^\text{184}\) Instead, the court found the per se Loretto approach to be the more appropriate test.\(^\text{185}\) The Ninth Circuit panel recognized that the Phillips Court had interpreted Loretto to mean that property was taken "even when infringement of that right arguably increased the market value of the property at issue."\(^\text{186}\)

In addition, the Ninth Circuit panel noted that the rights to possess, control, and dispose are valuable property rights,\(^\text{187}\) foreclosing the argument that no property right of independent value had been infringed. The court noted, for example, that the holder of the principal's right to control what group will receive the interest generated from their particular principal is valuable, and may be compensable in relation to the property owner's political, religious, or social beliefs.\(^\text{188}\) Furthermore, the loss of the ability to further invest the interest income might be the primary concern for other property holders.\(^\text{189}\) Finally, the court found

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\(^{178}\) Wash. Legal Found. v. Legal Found. of Wash. 236 F.3d 1097, 1102–03 (9th Cir. 2001) [hereinafter Legal Found. of Wash. I].

\(^{179}\) Legal Found. of Wash. I, 236 F.3d at 1108–09.

\(^{180}\) Id. at 1110–12.

\(^{181}\) Legal Found of Wash. II, 271 F.3d at 877–80.

\(^{182}\) Id. at 878.

\(^{183}\) Id.

\(^{184}\) Id. (emphasis in original).

\(^{185}\) Id. at 879.


\(^{187}\) Wash. Legal Found. II, 271 F.3d at 874 (citing Phillips, 524 U.S. at 170).

\(^{188}\) Id. at 877–78.

\(^{189}\) See, e.g., id.
that a per se taking had occurred because all of the interest of the IOLTA fund had been appropriated, just as it is a per se taking to permanently commandeer property by physical invasion.\textsuperscript{190} On this basis, the Ninth Circuit panel held Washington’s IOLTA program to be unconstitutional without just compensation.\textsuperscript{191}

IV. LEGAL FOUNDATION OF WASHINGTON II CREATES A CIRCUIT SPLIT

Because of the highly contested nature of this issue, the Ninth Circuit agreed to an en banc rehearing. In its decision, \textit{Legal Foundation of Washington II}, the Ninth Circuit vacated most of the panel decision and instead held that although IOLTA-generated interest is clearly the private property of the client, the IOLTA program is nonetheless constitutional.\textsuperscript{192} The court utilized the \textit{Penn Central} ad hoc analysis.\textsuperscript{193} After balancing the factors, the Ninth Circuit held that Washington’s IOLTA program did not impose an unconstitutional taking.\textsuperscript{194} Furthermore, the court held that no just compensation would be due, even if it could be proved that property was taken.\textsuperscript{195} However, the decision was not unanimous and a scathing dissent, authored by Judge Kozinski, furthers the debate over what constitutes a proper analysis of this issue.\textsuperscript{196}

A. Majority Opinion

1. IOLTA Interest is Client Property Under Washington Law

The Ninth Circuit first acknowledged its required adherence to the \textit{Phillips} holding, reiterating that IOLTA-generated interest is the private property of the client.\textsuperscript{197} The defendants argued that Washington law did

\begin{footnotesize}

\footnotesize{190. \textit{id.} at 879, 884.}

\footnotesize{191. \textit{id}.}

\footnotesize{192. \textit{Legal Found. of Wash. II}, 271 F.3d 836, 864 (9th Cir. 2001).}

\footnotesize{193. \textit{id.} at 857-61.}

\footnotesize{194. \textit{id}.}

\footnotesize{195. \textit{id.} at 861-64.}

\footnotesize{196. See \textit{id.} at 864-67 (Kozinski, J., dissenting). The dissent was joined by Judges Trott, Kleinfeld and Silverman. \textit{id.} at 864.}

\footnotesize{197. See \textit{id.} at 852-53. While the court stated that it rejected the "trifurcated" approach to the Fifth Amendment takings issue (i.e., breaking the Fifth Amendment down into its component parts,}

\end{footnotesize}
not create a property right in interest income because Washington’s property law did not include the “interest follows principal” mandate and the IOLTA statute itself abrogated any property right to IOLTA interest.\textsuperscript{198} However, the court held that Washington’s common law did include the “interest follows principal” doctrine, and this principle had been adopted by Washington’s reception statute.\textsuperscript{199} Additionally, the Ninth Circuit held that because there could be no interest without the principal, the property interest at issue in the IOLTA context included both the interest and the principal together.\textsuperscript{200}

Furthermore, the IOLTA statute could not abrogate this property right under the Ninth Circuit’s holding in \textit{Schneider v. California Department of Corrections}.\textsuperscript{201} In \textit{Schneider}, a California statute provided that interest earned on prison inmate trust accounts would go to an “inmate welfare fund” instead of the owner of the principal.\textsuperscript{202} The Ninth Circuit, following the \textit{Phillips} rule that interest income is the property of the principal holder, held that “constitutionally protected property rights can—and often do—exist \textit{despite} statutes . . . that appear to deny their existence.”\textsuperscript{203} The \textit{Schneider} court recognized that the rule that interest follows principal is at the core of constitutionally protected values.\textsuperscript{204} Therefore, while the statute enacting the IOLTA program attempted to deny that IOLTA-generated interest was the property of the client, it could not deny this constitutionally protected property right.\textsuperscript{205}

2. \textit{Per Se v. Ad Hoc Analysis}

Having set the stage for a true takings analysis, the Ninth Circuit next addressed the issue of whether it should apply the per se or ad hoc test.\textsuperscript{206}

\textsuperscript{198} \textit{Id.} at 852.
\textsuperscript{199} \textit{Id.} at 853; \textit{WASH. REV. CODE} § 4.04.010 (2001) “[T]he common law, so far as it is not inconsistent with the Constitution and laws of the United States, or of the state of Washington, nor incompatible with the institutions and condition of society in this state, shall be the rule of decision in all the courts of this state”). \textit{See also} City of Seattle v. King County, 762 P.2d 1152, 1155 (Wash. Ct. App. 1988) (holding Washington does adhere to common law “interest follows principal” rule).
\textsuperscript{200} \textit{Legal Found. of Wash. II}, 271 F.3d at 853.
\textsuperscript{201} 151 F.3d 1194 (9th Cir. 1998).
\textsuperscript{202} \textit{Id.} at 1195.
\textsuperscript{203} \textit{Id.} at 1199 (emphasis in original).
\textsuperscript{204} \textit{Id.} at 1201.
\textsuperscript{205} \textit{See id.} at 853.
\textsuperscript{206} \textit{Id.} at 854–57.
The court reasoned that a per se analysis has rarely been applied outside the realm of real property and is not relevant to the questions of fungible property, including cash and accounts.\footnote{207} Therefore, use of the ad hoc approach was compelled.\footnote{208} The Ninth Circuit noted that the \textit{Webb’s} Court used the \textit{Penn Central} ad hoc test in its analysis of the Fifth Amendment rights of fungible interest income.\footnote{209} In addition, the Ninth Circuit noted that the \textit{Penn Central} test was created for just such a situation—where the government’s “interference arises from some public program adjusting the benefits and burdens of economic life to promote the common good.”\footnote{210}

According to the \textit{Penn Central} ad hoc analysis, a taking can only be found if the regulation goes so far as to “force some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole.”\footnote{211} \textit{Penn Central} created three standards to be considered and balanced in determining whether or not a regulation has gone too far: 1) the regulation’s economic impact on the claimant, 2) the extent of the regulation’s interference with the claimant’s investment-backed expectations, and 3) the character of the government’s actions in enacting the regulations.\footnote{212}

In applying these standards to the Washington IOLTA program, the Ninth Circuit determined that the regulation did not go too far and therefore did not violate the takings clause.\footnote{213} First, the court stated that the regulation did not economically impact the claimant because the client funds would not earn interest without the IOLTA program.\footnote{214} In addition, the court noted that no other non-pecuniary loss had been adequately proven.\footnote{215} Similarly, in addressing the second factor involving investment-backed expectations, the Ninth Circuit again determined that the funds were incapable of earning interest without IOLTA intervention and thus the claimants had no investment-backed expectation.\footnote{216} With regard to the third factor, which concerns the character of the

\begin{footnotes}
\footnote{207} Id. at 854 (relying on one footnote in the \textit{Sperry} case, 493 U.S. at 62, n.9). \textit{See supra} note 15.
\footnote{208} See id. at 857.
\footnote{209} Id. at 855.
\footnote{210} Id. (citing Penn Cent. Transp. Co. v. New York City, 438 U.S. 104, 124 (1978)).
\footnote{211} \textit{Penn Cent.}, 438 U.S. at 123.
\footnote{212} Id. at 124.
\footnote{213} Legal Found. of Wash. II, 271 F.3d at 857–61.
\footnote{214} Id. at 857–60.
\footnote{215} Id. at 858.
\footnote{216} Id. at 860.
\end{footnotes}
government action, the court found that the IOLTA program was not out of character for the commercial industry or the professions they affect industry. Finally, the court recognized that the government is merely limited to keeping regulations "just and fair." The court noted that the appellants were not being singled out to bear the burden of greater society, but instead were essentially paying their dues as participants in the legal system. Thus, under an ad hoc analysis, the Ninth Circuit held that Washington’s IOLTA program was constitutional.

3. Just Compensation

Having found that Washington’s IOLTA program did not constitute a regulatory taking, the Ninth Circuit still addressed the "just compensation" issue in dicta. Even if property was being taken by the regulation, the court stated that the IOLTA program would nonetheless be constitutional because no just compensation would be due. Just compensation must put the "owner of the condemned property in as good a position pecuniarily as if the property had not been taken. Furthermore, incidental losses often do not require just compensation. Because the real question was whether the owner has lost and not whether has the taker gained, the Ninth Circuit decided that it was appropriate to address what advantages the plaintiffs would have enjoyed had their funds not been subject to the IOLTA program. At most, the plaintiffs lost the right to keep their principal from earning interest, which the court found was a right without economic value. Therefore, according to the Ninth Circuit, no just compensation would be due and

217. Id. at 861.
218. Id. (citing Andrus v. Allard, 444 U.S. 51, 66–67 (1979)).
219. Id.
220. See id. at 861–64. Even if the per se or ad hoc elements are present, the taking of personal property by the government is constitutional if just compensation has been paid to the property owner. Id. at 861.
221. Id.
222. Id. at 862 (citing United States v. 564.54 Acres of Land, 441 U.S. 506, 510 (1979)).
223. Id. (citing Winn v. United States, 272 F.2d 282, 286 (9th Cir. 1959)).
224. Id. (citing Boston Chamber of Commerce v. City of Boston, 217 U.S. 189, 195 (1910)).
225. Id.
226. Id. In response to the defendants’ contention that clients have the right to prevent the accrual of interest on their principal, the court clarified that the property to be addressed included the combination of the interest plus the principal, following the reasoning in Phillips and Webb’s. Id. at 854.
no constitutional violation had occurred even if the regulations somehow constituted a taking. 227

B. Dissent

A four-judge dissent took the majority to task on all aspects of its analysis except the concession that IOLTA-generated interest is client property. 228 The dissent accused the majority of following the reasoning of the dissenting opinions in Phillips, while ignoring the analysis of the majority opinion. 229 The dissent attacked the reasoning that money, because it is fungible, is different from other forms of property. 220 The dissent concluded that this was a nonsensical basis for applying the ad hoc test. 221 Using an illustration involving a Renoir painting, the dissent argued that a property owner will suffer the same pecuniary loss when the government takes a Renoir painting, so called "real property," as when the government takes an equal value in cash. 222 "For the purposes of the takings clause," the dissent stated, "real and personal property are reduced to their cash equivalents." 223 Therefore, according to the dissent, it would be "peculiar and quite dangerous to say that the government has greater latitude when it takes money than when it takes other kinds of property." 224

The dissent also attacked the majority’s utilization of the Penn Central ad hoc test as opposed to the more appropriate Loretto per se test, 235 stating that "contrary to the majority’s assertion, it is not true that a court is free to choose whether it prefers the ad hoc approach or the per se approach in taking cases. Rather, the two approaches reflect different solutions to different problems." 236 The dissent reasoned that the Penn

227. Id. at 864.
228. Id. (Kozinski, J., dissenting).
229. Id.
230. Id.
231. Id.
232. Id. at 866 (Kozinski, J., dissenting).
233. Id.
234. Id. (“This portion of the majority’s opinion will doubtless be greeted with a rousing cheer by government officials who will eagerly look to bank accounts and other places where money is kept, with an eye to snatching a few dollars here and there, and justifying it with some sort of ‘ad hoc’ analysis.”). But note that it has long been settled that taxes do not constitute a Fifth Amendment taking. See, e.g., Commercial Builders of N. Cal. v. City of Sacramento, 941 F.2d 872, 877–78. (Beezer, J., dissenting) (9th Cir. 1991).
236. Id.
Central's ad hoc balancing test is only applicable when the court is dealing with a regulatory taking, "where the government does not take property outright, but rather, limits the owner's use of the property for a regulatory purpose."237 For the dissent, it is only in the rare case when a regulation goes too far that compensation is due under the ad hoc test.238 The dissent noted that the ad hoc analysis "has never been applied to a case where the government actually takes and uses the property in question."239 Instead, the dissent argued that the U.S. Supreme Court in Loretto held "the physical taking of any property by the government or its agents is a compensable taking, even if the property owner gets an offsetting—or even a net—benefit."240

The dissent also disputed the majority's contention that there are certain types of property that may be taken without just compensation, stating that no case law exists to support this alarming proposition.241 The dissent argued that the majority appeared to adopt the Phillips dissent by holding that "if the property owner would not have realized the value of the property but for the government's actions, then the government can take it and pay the owner nothing."242 The dissent argued that this holding ignored the Phillips majority, which clearly recognized that there are other property interests, aside from economic value, that warrant just compensation.243 "While the interest income at issue here may have no economically realizable value to its owner, possession, control, and disposition are nonetheless valuable rights that inhere in the property."244 The Phillips majority stated, "[t]he government may not seize rents received by the owner of a building simply because it can prove that the costs incurred in collecting the rents exceed the amount collected."245 Similarly, the dissent argued that it is insufficient to justify the compulsory IOLTA program on the basis that the costs incurred in setting up a separate interest bearing account for client monies exceed the amount of interest that they would generate on their own.246 This

237. Id.
238. Id. (citing Dolan v. City of Tigard, 512 U.S. 374 (1994); Nollan v. Cal. Coastal Comm'n, 483 U.S. 825 (1987)).
239. Id. at 865–66. (Kozinski, J., dissenting).
240. Id. at 866 (Kozinski, J., dissenting) (emphasis in original).
241. Id. at 864. (Kozinski, J., dissenting).
242. Id. at 865 (Kozinski, J., dissenting).
243. Id.
244. Id. (quoting Phillips v. Wash. Legal Found., 524 U.S. 156, 170 (1998)).
245. Id.
246. Id.
basis ignores the valuable property rights of possession, control and disposal.247

Through its nearly fifteen years in existence, Washington’s IOLTA program has generated a substantial amount of funding for public service groups throughout the state.248 However, because IOLTA programs across the country have come under significant fire in recent years for alleged constitutional violations,249 Washington’s program should be inspected very closely. While the Ninth Circuit has held Washington state’s program to not be unconstitutional, Phillips, Texas Equal Access to Justice Foundation, and previous takings jurisprudence seem to compel a different analysis.250 A more appropriate application of the Fifth Amendment cases to Washington’s IOLTA program is discussed below.

V. WASHINGTON’S IOLTA PROGRAM IS UNCONSTITUTIONAL.

The Ninth Circuit’s en banc analysis of the IOLTA takings issue is fatally flawed for a number of reasons.251 While the majority correctly concluded that IOLTA interest is the private property of the client as required by Phillips, the court failed to adopt the more appropriate per se takings analysis.252 In addition, while the Ninth Circuit correctly asserted that Phillips only found that interest income is private property,253 it ignored the Phillips suggestion in dicta that the Loretto per se approach is the more appropriate analysis for the IOLTA issue.254 Applying the correct analysis to the facts at issue in Washington Legal Foundation v. Legal Foundation of Washington leads to the conclusion that Washington’s IOLTA program works an unconstitutional taking of client property without just compensation.255 However, there are constitutional

247. Id.
248. Legal Found. of Wash. I, 236 F.3d 1097, 1102–03 (9th Cir. 2001).
249. See supra notes 20–23.
251. See supra Part IV.B.2.
252. Legal Found. of Wash. II, 271 F.3d 835, 854–57 (9th Cir 2001)
253. See id. at 845.
255. See supra Part III.C. (discussing the correct analysis of this issue in the Ninth Circuit’s initial panel decision).
alternatives for maintaining the important legal work IOLTA currently funds.  

A. Characterization of IOLTA-Generated Interest.

The Ninth Circuit correctly applied the Phillips holding, which required that IOLTA-generated interest be regarded as the private property of the client. 257 However, in further characterizing the type of property at issue, the majority attempted to distinguish interest income from real and personal property on the basis that money is "fungible." 258 The court did so in an attempt to preempt the application of the per se test to the IOLTA facts. 259 However, this argument is inappropriate and unnecessary in the IOLTA context. Fungible property should be considered legally indistinguishable from real property for the purposes of this analysis 260 because the U.S. Supreme Court has been clear that a per se taking occurs anytime there is a "permanent physical occupation." 261 This principal should apply regardless of the type of property interest at stake.

The Ninth Circuit's argument that fungible property is distinguishable from real property for the purposes of a takings analysis is based on one footnote appearing in United States v. Sperry Corp. 262 While the Sperry Court rejected the application of the Loretto per se takings analysis on the basis that money is fungible, Sperry contemplates a factual scenario very different from IOLTA takings issue. 263 The takings issue in Sperry surrounded the appropriation of a "user fee" by the United States government from money recovered by American citizens from the Iran-United States Claims Tribunal. 264 But as Phillips stated, interest income is not analogous to a "fee." 265 Phillips distinguished Sperry from the IOLTA context by noting that there had never been any dispute that the IOLTA program would be constitutional if couched in terms of a

256. See infra Part V.D.
257. See supra Part IV.A.1.
259. Id.
260. See id. at 866 (Kozinski, J., dissenting).
263. See id.
264. Id. at 54.
"fee." On this basis, Phillips foreclosed the argument that Sperry disallowed the application of the per se analysis to fungible property.

While the Ninth Circuit held that the property at issue in this case included both the interest income and the underlying principal, this characterization is incorrect. Although the court correctly noted that "without the principal, there would be... no property right in that interest," it overlooked a very important fact. In both Phillips and Webb's, the U.S. Supreme Court recognized that interest income constitutes a property interest above and beyond the principal. The Court considered and discussed the rights surrounding interest income independent from the rights surrounding the principal. Therefore, the Ninth Circuit contradicted prior U.S. Supreme Court precedent when it refused to consider interest income apart from the principal.

B. Ad Hoc vs. Per Se Analysis

Having established that interest is indeed property, the inquiry shifts to selecting the appropriate takings test: either the per se takings analysis or the ad hoc takings analysis. The Ninth Circuit incorrectly applied the ad hoc takings analysis. Because the per se analysis must be applied when there is a permanent physical occupation and the entire subject property has been confiscated, it is the correct approach for the purposes of the IOLTA issue.

The Ninth Circuit was incorrect when it applied the Penn Central ad hoc analysis. Application of the ad hoc test to the facts of the IOLTA program relies on the absurd proposition that the confiscation of money would be less likely to amount to a taking than the placement of a sign
on someone's real property.\textsuperscript{275} The ad hoc approach is intended for situations where a regulation has taken away some, but not all, of the property's economically viable use,\textsuperscript{276} as was the case in Penn Central, where the historic building was not allowed to be further developed, but could continue its current use.\textsuperscript{277} This is immediately distinguishable from the facts presented by the IOLTA program. Here, the regulation takes away all economically viable use of the interest, and results in a permanent physical occupation of that interest—the client is unable to regain the interest income, or authorize how it is to be controlled, possessed or disposed, all of which are recognized as valuable property rights.\textsuperscript{278}

Instead, the Ninth Circuit should have applied a per se takings approach to this issue, as the forced donation of IOLTA-generated interest amounts to a permanent physical occupation.\textsuperscript{279} First, because the IOLTA-generated interest at issue is not simply regulated by the government, but is confiscated completely, there is a permanent physical occupation and denial of all economically viable uses.\textsuperscript{280} Even if the property at issue is characterized to include the underlying principal, the property would still be subject to the Loretto per se test, because a permanent physical occupation of the interest income has occurred.\textsuperscript{281} Loretto applies regardless of how minute the property intrusion is, as long as it constitutes a permanent physical occupation.\textsuperscript{282} Therefore, Loretto and Lucas compel the application of the per se analysis to this particular scenario.\textsuperscript{283}

The per se analysis has been endorsed by the U.S. Supreme Court in Phillips and Webb's.\textsuperscript{284} Returning again to the cornerstone of the IOLTA takings analysis, Webb's established that a physical occupation of

\textsuperscript{275} Legal Found. of Wash. I, 236 F.3d 1097, 1109 (9th Cir. 2001).
\textsuperscript{276} Id. at 865–66. The application of the Penn Central ad hoc test to situations where there has been a partial regulatory taking was recently affirmed by the U.S. Supreme Court in Tahoe–Sierra Preservation Council, Inc. v. Tahoe Reg'l Planning Agency, No. 00–1168, 2002 WL 654431, at *12 (U.S. April 23, 2002).
\textsuperscript{277} Supra note 119–25 and accompanying text.
\textsuperscript{279} Legal Found. of Wash. I, 236 F.3d 1110–11.
\textsuperscript{280} See supra note 4.
\textsuperscript{282} Id. at 435.
\textsuperscript{283} See supra Part III.A.2.
\textsuperscript{284} See Wash. Legal Found. v. Tex. Equal Access to Justice Found., 270 F.3d 180, 186 (5th Cir. 2001).
interest income can occur for purposes of a takings analysis. While Webb's was decided before Loretto and therefore does not employ the traditional per se takings analysis set forth in that case, in Webb's the Court nonetheless engaged in similar arguments, rejecting the balancing test of the ad hoc approach set forth in Penn Central. The Court instead followed United States v. Causby, a traditional physical property occupation case. Therefore, the Webb's Court also rejected the application of the ad hoc analysis and would, by implication, compel the per se analysis. In addition, the Court in dicta in Phillips suggested that Webb's and Loretto constitute the appropriate per se analysis to address the IOLTA issue.

Consequently, regardless of the characterization of interest income as an independent property right or as an inseparable part of the principal, its confiscation results in a permanent physical invasion. Loretto demands application of the per se analysis in this situation. This result is consistent with prior U.S. Supreme Court analyses of takings of interest income. Therefore, the Ninth Circuit should have held that a takings had automatically occurred under the per se framework.

C. Because There Is a Taking, Just Compensation is Due

While most cases addressing the "just compensation" portion of the IOLTA takings issue have done so only in dicta or have remanded the question to lower courts, it is nonetheless logical that just compensation is due if the takings analysis is followed to its rational conclusion. The Ninth Circuit's argument that no just compensation is due when a program "creates" the interest income is unconvincing. To

286. Webb's, 449 U.S. at 163–64.
287. 328 U.S. 256 (1946).
288. See Webb's, 449 U.S. at 163–64.
289. Id.
291. See, e.g., Legal Found. of Wash. II, 271 F.3d 835, 861–64 (9th Cir. 2001).
293. See Legal Found. of Wash. II, 271 F.3d at 861–63 (stating “In seeking compensation for the interest their principal earned when deposited in the IOLTA account, [appellants] are in actuality seeking compensation for the value added to their property by Washington’s IOLTA program.” Id. at 862)
the contrary, in *Phillips* the Supreme Court simply stated that "the State does nothing to create [IOLTA] value; the value is created by [the clients’] funds."294

In addition, the Ninth Circuit failed to acknowledge the important property rights of control, possession, and disposal—all of which may be compensable.295 As the Ninth Circuit correctly noted, the determination of whether just compensation is due requires returning the owner of the property to "as good a position pecuniarily as if the property had not been taken."296 While the court may have been correct in determining that there would be little, if any, just compensation due for confiscation of the interest income in tangible form, it ignored other important property rights.297 The rights to possess, control, and dispose of the interest are rights for which compensation will vary from client to client, but are compensable nonetheless.298 For some, the right to control what group will receive the interest generated from their particular principal is extremely valuable, and may be compensable in relation to their political, religious, or social beliefs.299 For others, the loss of the ability to further invest the interest income as they choose may be of prime concern.300 While the possibilities of these intangible rights seem endless, it is clear that they are all compensable in some form or another, even if the compensation is small.301

In addition, intangible property rights are impacted even where the regulation actually increases the economic value of the property, as is the case with the IOLTA program.302 In *Phillips* the Supreme Court noted that a taking may be found even when the subject regulation increases the market value of the property.303 The Court stated that "[t]he government may not seize rents received by the owner of a building

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294. *Phillips*, 524 U.S. at 170–71 ("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.'").

295. *See id.* at 170.

296. *Legal Found. of Wash. II*, 271 F.3d at 862 (citing U.S. v. 564.54 Acres of Land, 441 U.S. 506, 510 (1979)).

297. *See supra* note 102.


299. *See id.*

300. *See id.*

301. *See id.*

302. *Id.*

303. *Id.*
simply because it can prove that the costs incurred in collecting the rents exceed the amount collected.\textsuperscript{304} Because funds that are expected to generate more fees than interest are automatically subject to the IOLTA program, they are clearly analogous to the seizure of rents whose collection costs exceed their proceeds—both of which are prohibited by the takings clause.\textsuperscript{305} Therefore, the Ninth Circuit was also incorrect in holding that just compensation was due for confiscated IOLTA interest.

D. Constitutional Alternatives to the IOLTA System

In sum, because the IOLTA program meets the three elements of a taking under the Fifth Amendment, the program is unconstitutional in its current form.\textsuperscript{306} To allow it to continue will disturb the values surrounding the Fifth Amendment, a price to steep to be paid, regardless of the value of the particular program. Because IOLTA serves a valid public need, the debate should now focus on constitutionally acceptable alternatives.\textsuperscript{307}

Because the idea behind the IOLTA program is quite ingenious, and the vast majority of clients subjected to its regulation neither feel its effects, nor are concerned by them, the best alternative is one that will allow the program to continue substantially unchanged.\textsuperscript{308} To accomplish this, the Supreme Court of Washington need only make the program consensual.\textsuperscript{309} An amendment to the current statute could easily cure the problem. While the program could remain mandatory for attorneys of the state, requiring them to place short term or small client funds in IOLTA accounts, the scope could be constitutionally limited to only those clients who have consented to the program. The administration of this change could be as straightforward as an additional consent form included for client signature when a retainer agreement is signed. Once the client has been notified of the IOLTA program and informed that the interest that would otherwise accrue on their funds would not outweigh the administrative cost to receive it, there will no longer be a constitutional issue. Perhaps the form could include an explanation that if a client

\textsuperscript{304} Id.
\textsuperscript{305} See id.
\textsuperscript{306} See supra notes 57–58 and accompanying text.
\textsuperscript{308} See, e.g., Breemer, supra note 113, at 243–45.
\textsuperscript{309} See Legal Found of Wash. II, 271 F.3d at 867 (Kozinski, J., dissenting); See also Breemer, supra note 113, at 244–46; supra note 4 and accompanying text.
refuses, he or she will by default agree to pay the administrative costs of having the fund maintained in a separate account. In this instance, it seems plausible that the Legal Foundation of Washington would continue to receive its much needed funding but would have cured the important constitutional violation through simple consent.

In the alternative, the Supreme Court of Washington could generate funds equal to the IOLTA interest by adding an additional fee to the annual bar dues of the state’s licensed attorneys. As noted in Phillips, fees have never been alleged as unconstitutional takings—but are instead considered payment “for services rendered.” Here, the service performed by the additional fee would be the fulfillment of an ethical obligation on the part of the state’s attorneys to render pro bono assistance to the state’s indigent population. Through the payment of these fees, such services can be vicariously accomplished. The fees would then fund the worthwhile legal aid organizations, such as Columbia Legal Services, who perform this service for the public.

VI. CONCLUSION

In conclusion, Washington State’s IOLTA program in its current form violates the Fifth Amendment of the U.S. Constitution. The U.S. Supreme Court’s decision in Phillips compels that the interest income generated from the program be considered the private property of the client, the principal owner. Because the interest income is confiscated in its entirety by the government, the necessary per se analysis results in an automatic Fifth Amendment taking. Furthermore, just compensation is due for tangible interest itself, as well as intangible rights to possess, dispose of, and control the interest. Therefore, the IOLTA program is unconstitutional.

310. Washington State currently has over 22,000 licensed attorneys, each paying between $100 and $350 per year to maintain their license to practice law. See http://www.wsba.org/ (last visited July 31, 2002)


A lawyer should render public interest legal service. A lawyer may discharge this responsibility by providing professional services at no fee or a reduced fee to persons of limited means or to public service or charitable groups or organizations, by service in activities for improving the law, the legal system or the legal profession, and by financial support for organizations that provide legal services to persons of limited means.

313. Id.
Because the IOLTA program cleverly generates money for public legal aid organizations with admittedly little harm to the average client, it is vital that the debate now focus on constitutionally valid alternatives to or remedies for this program. At the very heart of the issue are the ethical obligations on all lawyers of the state (as well as the nation) to serve the public through pro bono or low cost legal service at some point in their career. Because of these obligations, it is imperative that lawyers now either discuss the IOLTA program with their clients, and obtain their consent to participate in the program, or accept an additional fee from the bar association to meet this valuable need.