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Robert C. Hughes III

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Casenote

Nothing Lost, Nothing Owed: Supreme Court Upholds State IOLTA Program in *Brown v. Legal Foundation of Washington*

In a 5-4 decision in *Brown v. Legal Foundation of Washington*,¹ the United States Supreme Court held that a state law that (1) requires lawyers and limited practitioner officers (“LPOs”) to deposit client funds that cannot otherwise generate net-earning for their clients into an interest on lawyer’s trust account (“IOLTA account”) and (2) mandates that the interest produced on those funds be transferred to a different owner for a legitimate public use *could* constitute a per se taking of the clients’ right to that interest, but no compensation is owed to such clients when they suffer no net loss.² The Court reasoned that any compensation must be measured by the owner’s net pecuniary loss rather than by the value of the taker’s gain.³ Conversely, the dissent argued that the appropriate measure of just compensation is the fair market value of the property at issue rather than the owner’s net

1. 538 U.S. 216 (2003).

2. *Id.* at 239.

3. *Id.* at 240.

pecuniary loss, emphasizing that such fair market value should not be reduced by any administrative or transactional costs to the owner.⁴

I. FACTUAL BACKGROUND

In 1980 Congress passed legislation allowing federally insured banks to pay interest on negotiable-order-of-withdrawal accounts ("NOW accounts"). The federal law provides that interest can be paid on deposits made by individuals and charitable organizations, but not on deposits made by for-profit corporations or partnerships unless such deposits are made pursuant to a program under which charitable organizations are the sole recipients of the interest earned. This legislation prompted Florida to establish the first statewide IOLTA program in 1981, permitting the use of NOW accounts for the deposit of client funds when accumulated interest is used for charitable purposes. Other states quickly followed Florida's example, and now every state in the country uses an IOLTA program to help finance legal services for indigent clients.⁵

Like many states, Washington instituted its IOLTA program through the state supreme court.⁶ According to the Washington Supreme Court, Washington's IOLTA program imposes four basic requirements.⁷ First, all client funds that can earn net interest for the client—i.e., an amount greater than the costs associated with establishing and administering the account and disbursing the interest—must be deposited in interest-bearing trust accounts.⁸ Second, funds that cannot otherwise earn net interest for the client must be deposited in an IOLTA account.⁹ Third, lawyers must instruct the banks to pay the interest on the IOLTA accounts to the Legal Foundation of Washington ("Foundation").¹⁰

4. *Id.* at 250 (Scalia, J., dissenting).

5. *Id.* at 221. Before the federal law was modified in 1980, banks retained the value of the use of client funds held in non-interest-bearing client-trust accounts. However, due to the implementation of IOLTA programs, that value is now conveyed to charitable organizations that provide legal services for the disadvantaged. Reportedly, the aggregate value of those contributions in 2001 exceeded \$200 million. *Id.* at 222-23.

6. Washington's IOLTA program was established in 1984 when the Washington Supreme Court amended its Rules of Professional Conduct. *Id.* at 223 (citing IOLTA Adoption Order, 102 Wash. 2d 1101 (1984)).

7. *Id.* at 224.

8. *Id.* The Washington Supreme Court stated that in determining whether client funds should be deposited in an IOLTA account, the lawyer should consider the following factors: "the amount of interest the funds would earn during the period they are expected to be deposited, the cost of establishing and administering the account, and the capability of financial institutions to calculate and pay interest to individual clients." *Id.* at 225.

9. *Id.* at 224.

10. *Id.*

Fourth, the Foundation must use all funds received from IOLTA accounts for “tax-exempt law-related charitable and educational purposes.”¹¹

In 1995 the Washington Supreme Court extended its IOLTA rules to reach LPOs¹² as well as attorneys.¹³ Thus, LPOs are bound by the aforementioned requirements with respect to their clients’ funds. Soon after this 1995 amendment, plaintiffs Allen Brown and Greg Hayes sued the Foundation and other defendants to enjoin Washington state officials from continuing to require LPOs to deposit client funds into IOLTA accounts. Brown and Hayes were real estate investors who regularly purchased and sold real estate, and in the course of those transactions transferred funds to LPOs who were required to place them in IOLTA accounts. To establish standing, each plaintiff identified a specific transaction in which his money was held in an IOLTA account and interest earned on it was paid to the Foundation.¹⁴ Plaintiffs alleged that the state’s requirement that the interest earned on their funds in IOLTA accounts be transferred to the Foundation effected a taking of

11. *Id.* Upon adopting its IOLTA program, the Washington Supreme Court issued an order responding to the program’s critics. *Id.* at 225. Opponents of the program claimed that the program would induce unconstitutional takings of property without just compensation. *Id.* at 225-26. The court dismissed this argument, emphasizing that the program “creates income where there had been none before, and the income thus created would never benefit the client under any set of circumstances.” *Id.* at 226 (quoting IOLTA Adoption Order, 102 Wash. 2d at 1108). Others asserted the program would result in ethical violations by attorneys because attorneys are forced to consider factors other than their client’s best interest when deciding whether to deposit client funds in an IOLTA account. *Id.* The court rejected this contention as well, reasoning that the rule “makes it absolutely clear that the enumerated factors are merely facets of the ultimate question of whether client funds could be invested profitably for the benefit of clients. If they can, then investment for the client is mandatory.” *Id.* at 226-27 (quoting Reply Brief of Proponents at 14, IOLTA Adoption Order, 102 Wash. 2d at 1113-14).

12. LPOs are licensed to serve as escrowees in real estate closings. Though LPOs are not attorneys, they frequently control the funds of their clients for brief periods of time. *Id.* at 227.

13. *Id.*

14. Hayes and a third party made an earnest money deposit of \$2000 on August 14, 1996, and a second deposit of \$12,372.32 two weeks later with respect to a real estate purchase that was closed on August 30, 1996. This money was placed in an IOLTA account. The parties agreed that the money contained in the IOLTA account generated some interest that was in part owned by Hayes. In a separate real estate transaction, Brown made a payment of \$90,521.29 on May 1, 1997, which remained in an IOLTA account for two days. Brown estimated that the interest earned on that deposit amounted to \$4.96. *Id.* at 229. The Court stated that although the facts were somewhat unclear, the record suggested that “funds deposited by each of the petitioners generated some interest that was ultimately paid to the Foundation,” and “without IOLTA those funds would not have produced any net interest for either [Brown or Hayes].” *Id.* at 230.

that interest in violation of the Fifth Amendment. Plaintiffs asserted that the requirement that client funds be deposited in IOLTA accounts constituted a taking as well.¹⁵

The United States District Court for the Western District of Washington granted summary judgment in favor of defendants. The court observed that under the state's IOLTA rules, clients were not permitted to make any net returns on the interest earned in the IOLTA accounts; if the funds could earn net interest, they should not have been placed in IOLTA accounts in the first place.¹⁶ With that in mind, the court held that "the constitutional issue focused on what an owner has lost, not what the [government] has gained."¹⁷ The court concluded that Hayes and Brown suffered no loss as a result of the IOLTA program and accordingly found no constitutional violation.¹⁸

Reversing the lower court, a three-judge panel of the United States Court of Appeals for the Ninth Circuit held that the IOLTA program effected a taking. Significantly, the panel's holding came after the United States Supreme Court decided in *Phillips v. Washington Legal Foundation*¹⁹ that the interest earned in IOLTA accounts is the private property of the clients because the clients own the principal that produced that interest.²⁰ The panel took the *Phillips* holding into consideration and held that "the interest generated by IOLTA pooled trust accounts is property of the clients and customers whose money is deposited into trust, and . . . a government appropriation of that interest for public purposes is a taking entitling them to just compensation."²¹ The panel explained that "just compensation for the takings may be less than the amount of interest taken, or nothing, depending on the circumstances," and therefore remanded the case for determination of a remedy.²²

Subsequently, the Ninth Circuit reconsidered the case en banc. The en banc majority employed the factor-based approach set out in *Penn*

15. *Id.* at 228-29 (citing App. 25). Plaintiffs also alleged that being compelled by the state to associate with the recipient organizations constituted a violation of their First Amendment rights. *Id.* However, neither the Ninth Circuit nor the Supreme Court's majority addressed that particular claim. *Id.* at 229.

16. *Id.* (citing App. to Pet. for Cert. at 94a, *Wash. Legal Found. v. Legal Found. of Wash.*, No. C97-0146C (W.D. Wash. 1998)).

17. *Id.* (quoting App. to Pet. for Cert. at 94a, *Wash. Legal Found.*, No. C97-0146C).

18. *Id.* (citing App. to Pet. for Cert. at 94a, *Wash. Legal Found.*, No. C97-0146C).

19. 524 U.S. 156 (1998).

20. *Id.* at 172.

21. 538 U.S. at 230 (quoting *Wash. Legal Found. v. Legal Found. of Wash.*, 236 F.3d 1097, 1115 (2001)).

22. *Id.* at 230-31 (quoting *Wash. Legal Found.*, 236 F.3d at 1115).

*Central Transportation Co. v. City of New York*²³ and affirmed the judgment of the district court.²⁴ In applying the *Penn Central* analysis, the majority concluded that plaintiffs suffered no actual loss because they would not have “earned net interest on their principal deposits” without the IOLTA program,²⁵ and plaintiffs failed to “show that the cost of their individual real estate transactions increased as a result of the IOLTA rules.”²⁶ Moreover, the majority reasoned that the program could not have “interfered with [plaintiffs’] investment-backed expectations” because neither plaintiff “could have expected his principal to earn a net interest.”²⁷ The majority also emphasized that “the IOLTA regulations are not out of character for either the commercial industry or the professions they affect.”²⁸ Thus, the majority held that no taking occurred.²⁹ However, it observed that even if there was a taking, “there would be no Fifth Amendment violation because the value of their just compensation is nil.”³⁰ The en banc dissent contended that it was improper for the majority to rely on the *Penn Central* factor-based approach because the IOLTA program involved a per se taking rather than a regulatory taking. Like the three-judge panel that heard the original appeal, the en banc dissent would have remanded the case for a determination of whether any compensation was owed.³¹

The United States Supreme Court granted Brown’s and Hayes’s petition for certiorari regarding the takings issue.³² A divided Court narrowly affirmed the Ninth Circuit’s en banc holding by a margin of 5-4.³³

II. LEGAL BACKGROUND

The Fifth Amendment to the United States Constitution states, “nor shall property be taken for public use, without just compensation.”³⁴ In analyzing a takings claim, courts must consider: (1) whether the claimant owned the property at issue; (2) whether the government “took”

23. 438 U.S. 104 (1978).

24. *Wash. Legal Found. v. Legal Found. of Wash.*, 271 F.3d 835, 857-61 (2001).

25. *Id.* at 858.

26. *Id.* at 860.

27. *Id.*

28. *Id.* at 861.

29. *Id.*

30. *Id.* at 864.

31. *Id.* (Kozinski, C.J., dissenting).

32. *Brown*, 538 U.S. at 231.

33. *Id.* at 240.

34. U.S. CONST. amend. V.

that property; and (3) the amount of compensation owed to the claimant, if any.³⁵

A. *Determining Ownership*

The Supreme Court has addressed the ownership issue with respect to interest earned on principal. In *Webb's Fabulous Pharmacies, Inc. v. Beckwith*,³⁶ decided in 1980, the Supreme Court determined that interest follows the principal that produced it, and therefore interest belongs to the owner of the principal.³⁷ In that case, the plaintiff, Eckerd's of College Park, Inc. ("Eckerd's") filed an interpleader action in a Florida state court and tendered approximately \$2 million into the court.³⁸ A Florida statute provided that interest earned on an interpleader fund deposited in the registry of the court "shall be deemed income of the office of the clerk of the circuit court."³⁹ Pursuant to that statute, the clerk of the circuit court retained over \$100,000 in interest accumulated by the deposited interpleader funds.⁴⁰ Eckerd's objected to the clerk's retention of that interest.⁴¹ Upon a constitutional challenge to the Florida statute, the Court applied the *Penn Central Transportation Co. v. City of New York*⁴² factor-based approach and held that the statute effected a taking, emphasizing that "the earnings of a fund are incidents of ownership of the fund itself and are property just as the fund itself is property."⁴³

More pertinent here, the Supreme Court in 1998 held in *Phillips v. Washington Legal Foundation*⁴⁴ that interest earned on client funds held in an IOLTA account was the private property of the client for purposes of the Fifth Amendment Takings Clause.⁴⁵ The Court pointed out that "[w]hile the interest income at issue . . . may have no economically realizable value to its owner, possession, control, and disposition are nonetheless valuable rights that inhere in the property."⁴⁶ In reaching its conclusion, the Court dismissed the argument that the

35. See *Brown v. Legal Found. of Wash.*, 538 U.S. 216, 232-40 (2003).

36. 449 U.S. 155 (1980).

37. *Id.* at 162.

38. *Id.* at 156-57.

39. *Id.* at 156 n.1 (quoting FLA. STAT. § 28.33 (1977) (emphasis omitted)).

40. *Id.* at 161.

41. *Id.* at 158-59.

42. 438 U.S. 104 (1978).

43. *Id.* at 164.

44. 524 U.S. 156 (1998).

45. *Id.* at 172.

46. *Id.* at 170 (citing *Hodel v. Irving*, 481 U.S. 704 (1987)).

interest income constitutes “government created value.”⁴⁷ The Court explained that the state does not create value; rather, the client’s principal creates value.⁴⁸ The Court further noted that “the [s]tate’s having mandated the accrual of interest does not mean the [s]tate or its designate is entitled to assume ownership of the interest.”⁴⁹ Thus, under the Court’s holdings in *Webb’s* and *Phillips*, it is clear that clients whose funds are deposited in IOLTA accounts own the interest accumulated on those funds.

B. Determining Whether a Taking Occurred

In addition to establishing that he owned the property at issue, a plaintiff in a takings case must also establish that a taking occurred.⁵⁰ The drafters of the Constitution made no attempt to define a “taking” of property. Consequently, over the years, a wide body of case law has developed in connection with this issue.

Significantly, the Supreme Court distinguishes between “physical” takings and “regulatory” takings.⁵¹ With respect to physical takings, the Court generally applies straightforward, per se rules.⁵² However, the Court’s regulatory takings jurisprudence is generally characterized by factor-based inquiries.⁵³ The following decisions demonstrate the development of the Supreme Court’s regulatory takings and physical takings jurisprudence and provide insight into when a property owner is entitled to recover compensation for his loss.

1. Regulatory Takings Jurisprudence. In 1922 the Supreme Court in *Pennsylvania Coal Co. v. Mahon*⁵⁴ recognized that while the government may regulate private property to a certain degree, if regulation “goes too far,” it will be considered a taking.⁵⁵ The Court

47. *Id.* at 171.

48. *Id.*

49. *Id.* (quoting *Webb’s Fabulous Pharmacies*, 449 U.S. at 162).

50. See *Brown*, 583 U.S. at 233-35.

51. *Id.* at 233. Physical takings occur “whenever the government acquires private property for a public purpose, [regardless of] whether the acquisition is the result of a condemnation proceeding or a physical appropriation.” *Id.* In contrast, regulatory takings can occur under particular circumstances when the government promulgates “regulations that prohibit a property owner from making certain uses of her private property.” *Id.*

52. *Id.* In other words, when the government physically confiscates private property for a public use, it is deemed a “physical” taking as a matter of law, and the Court does not engage in any fact-based inquiry regarding whether such government action constitutes a taking. *Id.*

53. *Id.*

54. 260 U.S. 393 (1922).

55. *Id.* at 415.

reasoned that "the 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 a change."⁵⁶ The Court held that the particular facts of each case must be analyzed to determine whether the boundaries of that implied limitation have been crossed.⁵⁷ Noting that one factor to be considered in this analysis is the decrease in property value resulting from the government regulation, the Court held that when the diminution of value reaches a certain point, just compensation is required.⁵⁸

Expounding on its holding in *Pennsylvania Coal Co.*,⁵⁹ the Supreme Court announced in its 1978 *Penn Central*⁶⁰ decision that an ad hoc factual inquiry was the appropriate method for determining whether a government regulation resulted in a taking.⁶¹ The Court observed that "a 'taking' may more readily be found when the interference with property can be characterized as a physical invasion by government . . . than when interference arises from some public program adjusting the benefits and burdens of economic life to promote the public interest."⁶² The Court stated that the question of whether a regulatory taking occurred depends largely on the particular circumstances of the case and explained that it had been unable to devise a categorical rule with respect to the issue.⁶³ The Court identified several factors to consider in the analysis, including: (1) "the economic impact of the regulation on the claimant;" (2) "the extent to which the regulation interfered with distinct investment-backed expectations;" and (3) "the character of the governmental action."⁶⁴

In *Penn Central*, the Court considered those factors in holding that a building owner who was prohibited from constructing office space above his building due to a city landmark law need not be compensated.⁶⁵ The Court pointed out that in weighing the factors, it must focus on the whole parcel and should not limit its analysis to only the affected portion of the property.⁶⁶ The Court explained that takings jurisprudence "does not divide a single parcel into discrete segments and attempt to

56. *Id.* at 416.

57. *Id.* at 413.

58. *Id.*

59. *Id.* at 393.

60. 438 U.S. at 104.

61. *Id.* at 124.

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.* at 136-38.

66. *Id.* at 130-31.

determine whether rights in a particular segment have been entirely abrogated.⁶⁷ Because the property owner was still permitted to use the rest of his parcel in a productive fashion, and could therefore profit from the property and obtain a reasonable return on his investment, there was no taking.⁶⁸

2. Physical Takings Jurisprudence. In 1951 the Supreme Court held in *United States v. Pewee Coal Co.*⁶⁹ that the federal government's seizure and operation of a private coal mine constituted a physical taking.⁷⁰ President Franklin D. Roosevelt had issued an executive order during World War II authorizing the federal government to seize and operate coal mines to avert a national strike by coal miners. Pursuant to that order, the federal government took control of plaintiff's mine for approximately five months.⁷¹ Because the government took physical possession of the property for a public purpose, the Court held that a taking occurred, which required the government to compensate the private owner.⁷²

Similarly, in *Loretto v. Teleprompter Manhattan CATV Corp.*,⁷³ decided in 1982, the Supreme Court held that a state law requiring an apartment landlord to permit a cable company to install its cable facilities upon the landlord's property effected a taking.⁷⁴ Plaintiff was a landlord who had purchased an apartment building and subsequently discovered that Teleprompter, a cable provider, had placed cable components on her building. The landlord sued Teleprompter, alleging that to the extent Teleprompter relied on the state law at issue in installing its cable facilities on her apartment, the installation constituted a taking.⁷⁵ The Court agreed, holding that "a permanent physical occupation authorized by government is a taking without regard to the public interests that it may serve."⁷⁶ The Court explained that "permanent occupations of land by such installations . . . are takings, even if they occupy only relatively insubstantial amounts of space and

67. *Id.* at 130.

68. *Id.* at 136.

69. 341 U.S. 114 (1951).

70. *Id.* at 115.

71. *Id.* at 115-16.

72. *Id.* at 115-17.

73. 458 U.S. 419 (1982).

74. *Id.* at 421.

75. *Id.* at 421-24.

76. *Id.* at 426.

do not seriously interfere with the landowner's use of the rest of [her] land."⁷⁷

C. *Just Compensation*

After a court determines that a taking has occurred, it must consider how much compensation is owed to the property owner, if any.⁷⁸ The following decisions provide guidance for determining the amount that a property owner should be compensated.

In *Boston Chamber of Commerce v. City of Boston*,⁷⁹ decided in 1910, the Court considered how much compensation was owed to landowners in connection with the government's taking of land to build a public street.⁸⁰ The Court explained that the Constitution "merely requires that an owner of property taken should be paid for what is taken from him."⁸¹ The Court concluded that in determining the proper amount of compensation, the question hinges on what the owner has lost, not what the "taker" has gained.⁸²

In 1926 the Court held in *Marion & Rye Valley Railway Co. v. United States*⁸³ that when there was merely a technical taking of a railroad under the Federal Control Act, no compensation was owed if the property owner did not suffer a loss.⁸⁴ President Woodrow Wilson had been authorized to take possession and assume control of any railroad as a result of war emergency. Pursuant to that power, President Wilson issued a general proclamation to the effect that he took possession and control of each and every railroad system in the country. However, at no point did he take over the actual possession or operation of plaintiff's railroad, or interfere with plaintiff's operation of it in any way.⁸⁵ The Court held that "even if there was a technical taking, . . . [n]othing was recoverable as just compensation, because nothing of value was taken from the [property owner]; and [the property owner] was not subjected by the [g]overnment to pecuniary loss."⁸⁶

77. *Id.* at 430 (citing *Lovett v. W. Va. Cent. Gas. Co.*, 65 S.E. 196 (W. Va. 1909); *S.W. Bell Tel. Co. v. Webb*, 393 S.W.2d 117, 121 (Mo. App. 1965)).

78. *See Brown*, 538 U.S. at 235-40.

79. 217 U.S. 189 (1910).

80. *Id.* at 193-94.

81. *Id.* at 195.

82. *Id.*

83. 270 U.S. 280 (1926).

84. *Id.* at 282.

85. *Id.* at 282-83.

86. *Id.* at 282.

In *Kimball Laundry Co. v. United States*,⁸⁷ decided in 1949, the Court provided insight regarding whether nonpecuniary loss should be compensated.⁸⁸ The Court considered the amount of compensation owed to a private laundry company after the U.S. government had taken over the company's plant for use by the Army during World War II. The laundry company sought compensation not only for the occupation of its plant and for damage to the plant's equipment, but also for the destruction of its "trade routes," i.e., its ability to maintain a business relationship with the customer base it had acquired through solicitation prior to the condemnation.⁸⁹ In determining whether the company should be compensated for the loss of its trade routes, the Court noted that "the value compensable . . . is only that value which is capable of transfer from owner to owner and thus of exchange for some equivalent. Its measure is the amount of that equivalent."⁹⁰ The Court limited the laundry's recovery in connection with the trade routes to the amount that was transferable.⁹¹ Thus, under the Court's rationale in *Kimball*, an owner's nonpecuniary loss that stems from "his unique need for property or idiosyncratic attachment to it . . . is properly treated as part of the burden of common citizenship," and the owner should not be compensated for such losses.⁹²

III. RATIONALE OF THE COURT

A. *The Majority Opinion*

Against this background, the Supreme Court in *Brown v. Legal Foundation of Washington*⁹³ addressed Brown's and Hayes's argument that Washington's IOLTA program effected a taking of their property.⁹⁴ The Court held that even if a taking occurred, no compensation was owed.⁹⁵ The Court's conclusion rested on two subsidiary issues: (1) whether the per se approach to takings analysis applied with respect to

87. 338 U.S. 1 (1949).

88. *Id.* at 3-16.

89. *Id.* at 3-4, 8.

90. *Id.* at 5.

91. *Id.* at 16.

92. *Id.* (citing *Omnia Commercial Co. v. United States*, 261 U.S. 502, 508-09 (1923)); see *Brown*, 538 U.S. at 236-67.

93. 538 U.S. 216 (2003).

94. *Id.* at 220-41.

95. *Id.* at 240.

the IOLTA program rather than the factor-based approach, and (2) whether Brown or Hayes suffered actual pecuniary loss.⁹⁶

First, the Court considered whether the per se approach or the factor-based approach applied in determining whether a taking occurred.⁹⁷ The Court noted that Brown and Hayes challenged both the requirement that their funds be deposited in an IOLTA account (the "deposit requirement") and the requirement that interest gained on their funds be transferred to the Foundation (the "transfer requirement").⁹⁸ With respect to the deposit requirement, the Court explained that it did not result in the direct confiscation of interest because it was "merely a transfer of principal."⁹⁹ Therefore, the Court reasoned that the deposit requirement "could be viewed as the first-step in a 'regulatory taking,' which should be analyzed under the [*Penn Central Transportation Co. v. City of New York*¹⁰⁰] factor-based approach."¹⁰¹ However, the Court concluded that under the factor-based analysis, there was no regulatory taking because neither Brown nor Hayes suffered any adverse economic impact, and the deposit requirement did not interfere with their investment-backed expectations.¹⁰²

The Court then stated that the transfer requirement should be analyzed under the per se approach.¹⁰³ The Court reasoned that the per se approach was proper based on its decision in *Phillips v. Washington Legal Foundation*,¹⁰⁴ where it determined that interest earned on client funds held in IOLTA accounts is the property of the client.¹⁰⁵ In light of *Phillips*, the Court noted that "the transfer of the interest to the Foundation . . . seems more akin to the occupation of a small amount of rooftop space in *Loretto*[¹⁰⁶]" than anything else.¹⁰⁷ Accordingly, the Court assumed, arguendo, that: (1) Brown and Hayes retained ownership of some of the funds that were deposited in the IOLTA accounts, (2) those funds generated some interest, and (3) their interest was taken for a public use when it was transferred to the Foundation.¹⁰⁸

96. *Id.* at 233-39.

97. *Id.* at 233-35.

98. *Id.* at 234.

99. *Id.*

100. 438 U.S. 104 (1978).

101. *Id.* (citing *Penn Central*, 438 U.S. at 124).

102. *Id.* (citing *Penn Central*, 438 U.S. at 124).

103. *Id.* at 235.

104. 524 U.S. 156 (1998).

105. *Brown*, 538 U.S. at 235 (citing *Phillips*, 524 U.S. at 172).

106. 458 U.S. 419 (1982).

107. *Brown*, 538 U.S. at 235 (citing *Loretto*, 458 U.S. 419).

108. *Id.*

Second, the Court considered whether there was any loss for which Brown and Hayes should be compensated.¹⁰⁹ The Court reasoned that Brown's and Hayes's loss should be measured by their net pecuniary loss rather than the value of the government's gain.¹¹⁰ Consequently, if Brown's and Hayes's net pecuniary loss was zero, then no compensation was owed to them.¹¹¹ In addressing the loss issue, the Court confronted the hypotheticals posed by the Ninth Circuit dissenters which demonstrated that lawyers and LPOs sometimes mistakenly place client funds into IOLTA accounts even though they could have produced net income.¹¹² While the hypothetical examples convinced a minority of the Ninth Circuit that a remand was necessary to determine whether Brown and Hayes were owed compensation, the Supreme Court was not persuaded.¹¹³ The Court explained that Washington's IOLTA rules "unambiguously require lawyers and LPOs to deposit client funds in non-IOLTA accounts whenever those funds could generate net earnings for the client."¹¹⁴ Therefore, if Brown's and Hayes's funds were placed into IOLTA accounts when they could have produced net income, the LPOs who deposited their funds violated Washington's IOLTA rules.¹¹⁵ Thus, any loss to Brown and Hayes resulted from the LPOs' errors and not any "state action."¹¹⁶ The Court observed that while such errors may have given Brown and Hayes a valid claim against the LPOs, they

109. *Id.* at 235-37.

110. *Id.* at 237.

111. *Id.*

112. *Id.* at 237-38. The Court cited two of the Ninth Circuit dissenters' hypothetical situations. *Id.* Under the first hypothetical, one is to assume that \$2000 is deposited into an IOLTA account that pays five percent. After sitting in the account for two days, the \$2000 principal earns approximately \$0.55, which is worth less than the cost of the stamp, envelope, and administrative expenses necessary to deliver the interest to the owner of the principal. *Id.* at 237. The Ninth Circuit dissenters concluded that in that case, the client's financial loss from the taking would be nothing—"[t]he fair market value of a right to receive [\$0.55] by spending [an amount greater than \$0.55] to receive it would be nothing." *Id.* at 238 (quoting *Wash. Legal Found.*, 271 F.3d at 883). Thus, according to the dissenters, no compensation would be owed in that situation. *Id.* Under the second hypothetical, one is to assume that \$30,000 is deposited into an IOLTA account that pays five percent. After sitting in the account for six days, the \$30,000 principal earns approximately \$29.59, which exceeds the cost of the stamp, envelope, and administrative expenses necessary to deliver the interest to the owner of the principal. According to the Ninth Circuit dissenters, the client would be owed compensation under the second hypothetical. *Id.* at 238.

113. *Id.* at 239.

114. *Id.*

115. *Id.*

116. *Id.*

did not give rise to an action against the state of Washington for compensation.¹¹⁷

In conclusion, the majority held that a law that compels lawyers and LPOs to place client funds that could not otherwise produce net earnings into IOLTA accounts does not constitute a regulatory taking.¹¹⁸ Though the majority held that the requirement that interest earned on those funds in IOLTA accounts be transferred to a new owner for a "legitimate public use" could effect a per se taking, it determined that no compensation was owed to Brown or Hayes.¹¹⁹ The majority explained: "Because [just] compensation is measured by the owner's pecuniary loss—which is zero whenever the Washington law is obeyed—there has been no violation of the Just Compensation Clause of the Fifth Amendment in this case."¹²⁰ Affirming the Ninth Circuit Court of Appeals en banc holding, the Supreme Court held that there was no constitutional violation.¹²¹

B. *The Dissenting Opinion*

Justice Scalia, joined by Chief Justice Rehnquist and Justices Kennedy and Thomas, authored a dissenting opinion contending that the Court's prior holdings obligated the Court to hold that Brown and Hayes were entitled to the fair market value of the interest produced by their funds held in IOLTA accounts.¹²² The dissent rejected the majority's defini-

117. *Id.*

118. *Id.* at 240.

119. *Id.*

120. *Id.*

121. *Id.* at 240-41.

122. *Id.* at 241 (Scalia, J., dissenting). Justice Kennedy also authored a separate dissent in which he opined that the IOLTA rules could potentially lead to First Amendment free-speech violations in addition to Fifth Amendment takings violations. *Id.* at 253 (Kennedy, J., dissenting). Justice Kennedy explained that "[b]y mandating that the interest from [IOLTA] accounts serve causes the justices of the Washington Supreme Court prefer, the State . . . grants to itself a monopoly which might then be used for the forced support of certain viewpoints." *Id.* (Kennedy, J., dissenting). In other words, the Washington IOLTA rules require that the interest earned on clients' funds in IOLTA accounts be transferred to the Legal Foundation of Washington, who may in turn use that money to finance legal actions that may conflict with the clients' interests or philosophical beliefs. *Id.* (Kennedy, J., dissenting). Justice Kennedy noted that the IOLTA rules do not allow clients to opt out of this particular transfer of interest; thus, the clients are in effect compelled to support a cause they may not agree with, arguably in violation of the First Amendment. *Id.* (Kennedy, J., dissenting). Because neither the lower courts nor the majority addressed the First Amendment issue, this Article does not otherwise discuss Justice Kennedy's dissent.

tion of “just compensation,” which the majority concluded should be measured by the property owner’s net loss.¹²³

Specifically, the dissent criticized the majority for “endors[ing] simultaneously two competing and irreconcilable theories of how that loss should be measured.”¹²⁴ According to Justice Scalia, the majority claimed to agree with the Ninth Circuit en banc majority’s approach, i.e., that net loss is measured by the amount of interest Brown and Hayes would have received had their money been placed in non-IOLTA accounts.¹²⁵ At the same time, observed Scalia, the majority accepted the Ninth Circuit en banc dissent’s approach, i.e., that net loss is measured by determining the amount of interest actually accumulated in Brown’s and Hayes’s IOLTA accounts and subtracting from that figure the transaction costs that would be incurred in keeping the interest themselves.¹²⁶ Justice Scalia argued that the majority “cannot have it both ways . . . but even if it could, neither of the two options from which lower courts may now choose is consistent with *Phillips* [or other cases] that equate just compensation with the fair market value of the property taken.”¹²⁷

Justice Scalia noted that under the majority’s first theory (which was consistent with the Ninth Circuit en banc majority’s approach), Brown and Hayes were owed no compensation because pursuant to Washington’s IOLTA rules, the only funds that should have been deposited into IOLTA accounts were those that could not have otherwise generated net interest.¹²⁸ Brown’s and Hayes’s funds could not have produced net interest had they been placed in non-IOLTA accounts; therefore, this approach mandated a finding of no net loss.¹²⁹ Justice Scalia concluded that this approach to determining just compensation was unsound.¹³⁰ Citing *Phillips*, Justice Scalia pointed out that as soon as interest was generated on Brown’s and Hayes’s funds held in IOLTA accounts, that interest was their property.¹³¹ Thus, when the state transferred the interest to the Foundation, the state should have compensated Brown and Hayes for the fair market value of that interest.¹³² Though it may be true that Brown and Hayes could not

123. *Id.* at 245 (Scalia, J., dissenting).

124. *Id.* at 244 (Scalia, J., dissenting).

125. *Id.* (Scalia, J., dissenting).

126. *Id.* (Scalia, J., dissenting).

127. *Id.* (Scalia, J., dissenting).

128. *Id.* at 244-45 (Scalia, J., dissenting).

129. *Id.* (Scalia, J., dissenting).

130. *Id.* at 245 (Scalia, J., dissenting).

131. *Id.* (Scalia, J., dissenting) (citing *Phillips*, 524 U.S. at 168).

132. *Id.* (Scalia, J., dissenting).

have earned interest on their funds but for the IOLTA program's deposit requirement, "just compensation is not to be measured by what would have happened in a hypothetical world in which . . . [Washington's] IOLTA program did not exist."¹³³

Justice Scalia explained that when Washington took possession of Brown's and Hayes's property—the interest earned on their funds in IOLTA accounts—and turned it over to the Foundation, that property had value.¹³⁴ According to Justice Scalia, "[t]he conclusion that it is devoid of value because of the circumstances giving rise to its creation is indefensible."¹³⁵ Moreover, he asserted that the majority, in arriving at that conclusion, endorsed an argument that was expressly dismissed in *Webb's Fabulous Pharmacies, Inc. v. Beckwith*¹³⁶—that the interest income should not be compensated because it constituted government created value.¹³⁷ Therefore, the significance of the Court's prior holding in *Webb's* with respect to this issue is now uncertain.¹³⁸ Indeed, Justice Scalia warned: "[The majority's] endorsement of the proposition that there is no taking 'when the [s]tate giveth, and the [s]tate taketh away,' has potentially far-reaching consequences. May the government now seize welfare benefits, without paying compensation, on the ground that there was no 'net loss' to the recipient?"¹³⁹

Next, Justice Scalia examined the majority's second theory for explaining why no compensation was owed to Brown or Hayes. Not surprisingly, he determined that it was flawed as well.¹⁴⁰ The majority reasoned that just compensation should be measured by the amount of interest Brown and Hayes actually earned on their funds in IOLTA accounts minus the transactional costs associated with keeping it.¹⁴¹ Justice Scalia pointed out that the Court's holdings in prior takings cases do not support the use of "net value" to measure just compensa-

133. *Id.* (Scalia, J., dissenting).

134. *Id.* (Scalia, J., dissenting).

135. *Id.* (Scalia, J., dissenting).

136. 449 U.S. 155 (1980).

137. *Brown*, 538 U.S. at 245 (Scalia, J., dissenting) (citing *Webb's*, 449 U.S. at 155). Interestingly, Justice Scalia opted not to directly discuss the Court's recent rejection of this "government-created value" argument in *Phillips*, even though he referred to the *Phillips* holding extensively throughout his dissent. See *Phillips*, 524 U.S. at 169-70. This Author submits that Justice Scalia's dissent would have been stronger had he noted and explained the *Phillips* holding in connection with this issue in addition to citing the Court's holding in *Webb's*.

138. *Id.* at 247 (Scalia, J., dissenting).

139. *Id.* (Scalia, J., dissenting).

140. *Id.* (Scalia, J., dissenting).

141. *Id.* (Scalia, J., dissenting).

tion, as this approach requires.¹⁴² In fact, he noted that “*Phillips* flatly rejected the notion that just compensation may be reduced by transaction costs the former owner would have sustained in retaining his property.”¹⁴³

Justice Scalia emphasized that the appropriate measure of just compensation is the fair market value of the property at issue rather than the owner’s “net loss,” and fair market value should not be reduced by any transactional costs to the owner.¹⁴⁴ Moreover, he posited that even if net value were the proper measure of just compensation, the majority was wrong to conclude that the net value of Brown’s and Hayes’s interest was zero.¹⁴⁵ Though the majority correctly determined that under Washington’s IOLTA rules, Brown and Hayes could not have earned interest in non-IOLTA accounts, that fact did not affect the transactional costs that Brown and Hayes would have incurred in extracting their interest from the IOLTA accounts.¹⁴⁶ Thus, the majority “arbitrarily foreclose[d] clients from recovering the ‘net interest’ to which (even under the [majority’s] definition of just compensation) they are entitled.”¹⁴⁷

In a display of his distinctive wit, Justice Scalia labeled the takings that result from IOLTA programs “Robin Hood Takings.”¹⁴⁸ He characterized this as a new concept in takings jurisprudence “in which the government’s extraction of wealth from [its owners] is so cleverly achieved, and the object of the government’s . . . beneficence is so highly favored by the courts (taking from the rich to give to indigent defendants) that the normal rules of the Constitution protecting private property are suspended.”¹⁴⁹ In concluding his dissent, Justice Scalia expressed his desire that the majority’s ruling be limited to the unique situation at hand.¹⁵⁰ Indeed, he cautioned that if the rationale that was embraced by the majority—“what the government hath given, the government may freely take away”—is extended any further than this, the result will be devastating.¹⁵¹

142. *Id.* at 249 (Scalia, J., dissenting).

143. *Id.* (Scalia, J., dissenting) (citing *Phillips*, 524 U.S. at 170).

144. *Id.* at 250 (Scalia, J., dissenting).

145. *Id.* (Scalia, J., dissenting).

146. *Id.* (Scalia, J., dissenting).

147. *Id.* at 250-51 (Scalia, J., dissenting).

148. *Id.* at 252 (Scalia, J., dissenting).

149. *Id.* (Scalia, J., dissenting).

150. *Id.* (Scalia, J., dissenting).

151. *Id.* (Scalia, J., dissenting).

IV. IMPLICATIONS

In a practical sense, the most important implication of *Brown v. Legal Foundation of Washington*¹⁵² is that it safeguards state IOLTA programs that provide millions of dollars per year in funding for legal services to the poor. Significantly, every state in the nation utilizes these programs for this purpose.¹⁵³ If the Court had struck down the IOLTA program as unconstitutional, it is not immediately apparent how states could have redressed such a blow to the funding of indigent legal services on their own.¹⁵⁴ The Court's holding in *Brown* was a major triumph for supporters of the IOLTA programs.¹⁵⁵ However, in the majority's rush to rescue IOLTA programs from the jaws of conservative opponents, its holding may have created some unintended consequences as well.

As Justice Scalia observed in his dissent, one negative implication of the majority's holding is that it may allow the government to avoid compensating property owners when the government is responsible for creating the owners' property interests in the first place.¹⁵⁶ Consider, for instance, Justice Scalia's rather extreme welfare example.¹⁵⁷ Justice Scalia suggested that the government may now be able to confiscate an individual's welfare benefits without compensating that individual on the basis that the individual suffered no net loss because the state created that property interest.¹⁵⁸ Furthermore, while welfare benefits are a form of personal property, the Court's holding could similarly affect takings law in the context of real property. To the extent the government can demonstrate that it created the value that a landowner asserts has been taken, the government can argue under *Brown* that it need not compensate the landowner because the landowner suffered no net loss.¹⁵⁹ If the government can circumvent the compensation requirement in such instances, then the government has free reign with respect to a large category of property.

152. 538 U.S. 216 (2003).

153. *Id.* at 221.

154. John D. Echeverria, ELR News & Analysis: Regulatory Takings after *Brown*, 33 ENVTL. L. REP. 10626, 10627 (2003).

155. *Id.*

156. 538 U.S. at 247 (Scalia, J., dissenting).

157. *Id.* (Scalia, J., dissenting).

158. *Id.* (Scalia, J., dissenting).

159. RICHARD R. POWELL, POWELL ON REAL PROPERTY, 2003 SUPREME COURT UPDATE (Michael Allan Wolf ed., Matthew Bender 2003).

Thus, the majority's holding arguably carves out a large exception to nearly a century's worth of takings jurisprudence. Whether it in fact does so—as Justice Scalia posited—or does not effect any actual substantive change—as the majority opined—without a doubt, *Brown* will lead to a great deal of litigation over government-created property interests. This litigation will continue until the new boundaries, if any, of such takings jurisprudence are sufficiently marked.

Moreover, the majority's holding calls into question the use of fair market value as the proper standard for measuring the amount of compensation owed to a takings claimant.¹⁶⁰ This too could have important ramifications. Under the majority's definition of just compensation as net loss, transaction costs are taken into account in determining whether compensation is owed. If the transaction costs outweigh the actual value of the property taken by the government, then no compensation is owed. Therefore, it appears, for example, that if the government took an individual's right to receive payment from debtors, the government would not have to compensate that individual if it could prove that the costs the individual would incur in collecting those debts would outweigh the amount the debtors actually owed to him. This rather subjective standard seems blatantly inconsistent with basic notions of fairness, and more importantly, it contradicts the Court's prior holdings in *Phillips v. Washington Legal Foundation*¹⁶¹ and other similar cases.¹⁶² This aspect of the majority's holding will likely be the focus of much litigation in the future as well.

The Court could have averted the confusion that will be caused by its holding in *Brown* by following the precedent set in *Webb's Fabulous Pharmacies v. Beckwith*¹⁶³ and applying the *Penn Central Transportation Co. v. City of New York*¹⁶⁴ factor-based approach instead of the per se approach to determine whether a taking was effected by the requirement that interest earned on funds in IOLTA accounts be transferred to the Foundation.¹⁶⁵ Had it done so, the Court could have

160. *Brown*, 538 U.S. at 249-50 (Scalia, J., dissenting).

161. 524 U.S. 156 (1998).

162. See *id.* at 170 (noting that “the 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”); see also *Olson v. United States*, 292 U.S. 246, 255 (1934) (explaining that “it is the property and not the cost of it that is safeguarded by [the] Constitution”).

163. 449 U.S. 155 (1980).

164. 438 U.S. 104 (1978).

165. See *The Supreme Court, 2002 Term: Leading Cases*, 117 HARV. L. REV. 369, 376 (2003). That article's author asserts that based on *Loretto* and *Webb's*, the *Penn Central* factor-based approach should have been applied in *Brown*. The author observes that as a

held simply that no taking occurred, and thus would have completely avoided the compensation issue.¹⁶⁶ However, the majority did not choose this route, and as a result, future litigants and courts must deal with the consequences that follow. Though the positive implication of the Court's holding in *Brown*, i.e., the preservation of IOLTA accounts as a source of financial support for indigent legal services, is certainly significant in maintaining the flow of the modern legal system, the Court in retrospect may wish it had taken a different path to save it. The Court's decision in *Brown* has opened the door to a new array of litigation, and it is likely that many years will pass before the dust finally settles with regard to this aspect of takings law.

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result of utilizing the per se approach, the Court's holding in *Brown* suggests that the appropriation of money constitutes a per se taking. *Id.* Consequently, the author states that "the Court must now find a coherent way to avoid applying [the rule that the appropriation of money constitutes a taking] to taxes and to other government-created financial obligations generally recognized as permissible." *Id.* at 376-77.

166. *Id.* Arguably, had the majority employed the factor-based analysis, it would have found no taking. *Id.* at 378. With respect to the first factor—economic impact—the Court probably would have determined that the IOLTA program had only a minimal economic impact on the petitioners, especially in view of the small amounts at issue in this case. *Id.* In connection with the second factor—interference with the property owner's investment-backed expectations—the Court most likely would have concluded that the petitioners' investment-backed expectations were not affected because, under Washington's IOLTA provisions, petitioners could not have reasonably expected to earn interest on their principal. *Id.* As for the third factor—the character of the government action—the majority already determined that the IOLTA program at issue was overwhelmingly beneficial to the public. *Brown*, 538 U.S. at 232. Such findings would mandate the conclusion that neither *Brown* nor *Hayes* suffered a taking. See *Penn Central*, 438 U.S. at 124.