NOTES

IOWA'S IOLTA PROGRAM: A NEW WAY TO FINANCE PUBLIC SERVICE ACTIVITIES IN IOWA

I. INTRODUCTION

Trust accounts are not new to attorneys in Iowa. The Iowa Code of Professional Responsibility dictates that all client funds paid to a lawyer be held in an interest-bearing trust account.[1] Some attorneys utilize individual trust accounts for clients when large amounts of funds are retained by the attorney. In addition, practically every attorney retains a pooled trust account in which he places client funds of nominal amounts or funds that are to be held for a short period of time.[2]

Although trust accounts are not new to the Iowa practitioner, a new program has been implemented to collect and disburse interest earned on these accounts. Iowa, along with thirty-six other American jurisdictions, has recently enacted an Interest on Lawyers' Trust Accounts (IOLTA) program.[3] IOLTA programs collect interest earned on lawyers' trust accounts and use it for public purposes, such as providing legal services for the poor in civil cases.[4] These programs have enjoyed recent popularity for three reasons: (1) the recent advent of interest-bearing demand accounts;[5] (2) high interest rates; and (3) the need for funds to supply legal services to the

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1. IOWA CODE OF PROFESSIONAL RESPONSIBILITY DR 9-102(A) (1985).

2. Both pooled trust accounts and trust accounts for individual clients are allowed in Iowa. *See* IOWA CODE OF PROFESSIONAL RESPONSIBILITY DR 9-102(C).

3. Iowa adopted a mandatory IOLTA program by judicial order on December 28, 1984. *In re* Petition of The Iowa State Bar Association, No. 84-1641, slip op. at 5 (Iowa 1984). The program became effective on July 1, 1985. *Id.* at 4. The other thirty-six jurisdictions that have enacted IOLTA programs are the following: Arizona, Arkansas, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois, Kansas, Louisiana, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New Hampshire, New Mexico, New York, North Carolina, Ohio, Oklahoma, Oregon, Rhode Island, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, and Washington. LAWYERS' MANUAL ON PROFESSIONAL CONDUCT (ABA/BNA) at 45:201-205.

4. *See, e.g., In re* Petition of The Iowa State Bar Association, No. 84-1641, slip op. at 1 (Iowa 1984).

5. A recent federal enactment established Negotiable on Withdrawal Accounts (more commonly known as NOW Accounts), which allow interest to be earned on demand accounts. 12 U.S.C. § 1832 (1982).

poor.[6]

The basic concept of IOLTA—the collection of interst earned from lawyers' trust accounts—is universal to IOLTA programs. There are differences, however, among states in their implementation of IOLTA programs. For example, some state legislatures have created IOLTA programs by statute, while many state supreme courts have enacted programs by judicial order.[7] Additionally, an IOLTA program may require either mandatory or voluntary participation by attorneys.[8] Moreover, guidelines for investing a client's funds in a separate trust account, as opposed to the pooled IOLTA account, range from broad, general language to specific provisions.[9]

Although the implementation of various IOLTA programs differs, the issues raised concerning the programs are similar. IOLTA programs have been attacked on constitutional,[10] taxation,[11] and ethical grounds.[12] Critics of IOLTA programs claim that the use of clients' funds for public purposes is an unconstitutional taking of private property.[13] Further, the question has been raised whether the interst earned on IOLTA accounts should be considered gross income to the client under the "assignment of income" doctrine of *Lucas v. Earl*.[14] A third problem concerning IOLTA programs is whether it is an ethical violation for an attorney to participate in an IOLTA program.[15] Other than these three issues, there is another issue especially applicable to Iowa's IOLTA program which has not previously been discussed—whether a state supreme court possesses the power to implement and maintain an IOLTA program.[16] This Note will review the treatment of IOLTA programs nationwide and the way in which such treatment relates to Iowa's IOLTA program.

II. Background

Although IOLTA programs are relatively new to the United States, foreign jurisdictions have been operating similar programs for quite some time. In 1964, the Australian state of Victoria became the first jurisdiction to adopt an IOLTA-type system.[17] Under the Australian program, the funds

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6. In approving the IOLTA program, the Iowa Supreme Court recognized that "[a] critical need exists in Iowa for legal services to the poor in civil cases." *In re* Petition of The Iowa State Bar Association, No. 84-1641, slip op. at 1 (Iowa 1984).

7. *See infra* notes 109-17 and accompanying text.

8. *See infra* notes 24-28 and accompanying text.

9. *See infra* notes 29-33 and accompanying text.

10. *See infra* notes 41-75 and accompanying text.

11. *See infra* notes 76-96 and accompanying text.

12. *See infra* notes 97-108 and accompanying text.

13. *See infra* note 41 and accompanying text.

14. *See infra* notes 76-81 and accompanying text.

15. *See infra* note 97 and accompanying text.

16. *See infra* note 109 and accompanying text.

17. Comment, *A Source of Revenue for the Improvement of Legal Services, Part I: An*

are invested in a law foundation or law society and used for a client security fund as well as for providing legal aid.[18] Florida became the first jurisdiction in the United States to enact an IOLTA program when the Florida Supreme Court approved a voluntary program in 1978.[19] The idea has since spread quickly to other states.[20]

III. Mechanics of IOLTA Programs

Although the concept of the IOLTA program is similar nationwide, state programs vary in implementation. Some state legislatures have created IOLTA programs by statute, while many state supreme courts have enacted IOLTA programs by judicial order.[21] An IOLTA program may be voluntary or may require mandatory participation.[22] Guidelines for investing a client's funds in a separate trust account, versus the pooled IOLTA account, vary from broad, general language to specific considerations.[23] Finally, the use of IOLTA funds varies from state to state.[24]

A. *Mandatory versus Voluntary Participation*

While a majority of IOLTA programs in the United States are voluntary, it does not appear that lawyer participation in those states is extensive.[25] For example, in Florida only 18 percent of attorneys have partici-

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Analysis of the Plans in Foreign Countries and Florida Allowing the Use of Clients' Funds Held by Attorneys in Non-Interest-Bearing Trust Accounts to Support Programs of the Organized Bar, 10 St. Mary's L.J. 539, 543 (1979). Soon after Victoria enacted its IOLTA program, the other Australian states followed suit. *Id.* The concept spread to Canada in 1969, with British Columbia being the first Canadian province to authorize an IOLTA program. Report to the Board of Governors, ABA Task Force and Advisory Board on Interest on Lawyer Trust Accounts [hereinafter cited as ABA IOLTA Report] (July 26, 1982) at 4. Nine other provinces enacted similar programs in the 1970's. *Id.* The countries of Republic of South Africa, South West Africa and Zimbabwe have also enacted similar programs. *Id.*

18. ABA IOLTA Report, *supra* note 17, at 4.

19. *In re* Interest on Trust Accounts, 356 So. 2d 799 (Fla. 1978). By October 1983, $2.3 million in interest had been generated from Florida's IOLTA program. Lawyers' Manual on Professional Conduct (ABA/BNA) at 45:202.

20. *See supra* note 3.

21. *See infra* notes 109-17 and accompanying text.

22. *See infra* notes 24-28 and accompanying text.

Although Iowa's IOLTA plan is technically a "mandatory" plan, a lawyer may also maintain another pooled, interest-bearing trust account if he is able, by subaccounting, to calculate and pay to each client interest earned on that client's funds. Iowa Code of Professional Responsibility DR 9-102(C)(2)(b) (1985). The attorney, however, must still determine whether there will be a "significant positive return" to his clients. *Id.* at DR 9-102(C)(3). *See infra* notes 29-33 and accompanying text.

23. *See infra* notes 29-33 and accompanying text.

24. *See infra* notes 25-27 and accompanying text.

25. Of the thirty-seven American jurisdictions that have adopted IOLTA programs, thirty-one are voluntary and six are mandatory. Lawyers' Manual on Professional Conduct (ABA/BNA) at 45:201-05. The six mandatory jurisdictions are: Arizona, California, Iowa, Min-

pated in the program.[26] Similarly, in Maryland only ten percent of the state's attorneys are involved in the IOLTA program.[27] In order to fully reap the benefits of an IOLTA program, states with voluntary programs will either have to encourage more members of the bar to participate, or make their IOLTA programs mandatory. The Iowa Supreme Court, in enacting a mandatory IOLTA program, noted that it believed a mandatory program would be more cost-effective and also "holds greater promise of meeting the public need involved."[28]

B. *Investment Guidelines*

Although IOLTA programs require participating attorneys to hold nominal funds (or funds held for a short time) in a common, interest-bearing account, lawyers still have an ethical duty to open a separate interest-bearing account for the benefit of the client if the funds are substantial, or if they are to be held for a period of time where considerable interest may be gained.[29] IOLTA programs vary in the guidelines given to attorneys for determining when a separate trust account should be utilized for a separate client.

In Iowa, for example, very broad and general language is used.[30] Attorneys are to use "ordinary prudence" in determining whether a client's funds could provide a "significant positive return" to the client.[31] In adopting this standard, the Iowa Supreme Court reasoned that it was the same standard which guides attorneys in making other ethical decisions.[32]

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nesota, Ohio, and Washington. *Id.*

26. *Id.* at 45:202. Out of 17,500 attorneys in Florida, 3,100 have participated. *Id.* Between its inception in 1978 and October 1983, the Florida IOLTA has collected $2.3 million in revenues. *Id.*

27. *Id.* at 45:203. In six months of operation, the Maryland IOLTA program has generated $65,000 in income. *Id.*

28. *In re* Petition of The Iowa State Bar Association, No. 84-1641, slip op. at 3 (Iowa 1984). The court also resolved that, just like the Client Security Fund and the Continuing Legal Education program, "the IOLTA program should involve all members of the Iowa bar in their role as officers of the judicial department and court." *Id.*

29. ABA Comm. on Ethics and Professional Responsibility, Formal Op. 348 (1982).

30. IOWA CODE OF PROFESSIONAL RESPONSIBILITY DR 9-102(C)(3) (1985).

31. *Id.* The provision enumerates three factors for attorneys to consider in deciding whether a client's funds will generate a "significant positive return":

> (a) The amount of interest which the funds would earn during the period they reasonably are expected to be deposited;
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> (b) The cost of establishing and administering the account, including the cost of the lawyer's services and the cost of preparing any tax reports required for interest accruing to a client's benefit; and
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> (c) The capability of financial institutions . . . to calculate and pay interest to individual clients.

Id.

32. *In re* Petition of The Iowa State Bar Association, No. 84-1641, slip op. at 3 (Iowa 1984). The court reasoned:

In contrast, the Maryland provisions provide participating attorneys with more specific guidelines. Under the Maryland program, an attorney may place a client's funds into the attorney's pooled trust account if he "reasonably expects" the funds to earn fifty dollars or less of interest.[33] Any such guidelines should be specific enough so as to avoid possible conflicts with clients and the organization established to receive IOLTA funds.

C. *Proceeds*

The way in which proceeds generated by IOLTA programs are spent varies from state to state. Although no funds collected under the Iowa IOLTA program have yet been disbursed,[34] the Iowa Supreme Court has sated that funds "will be expended primarily to assist in providing legal services to the poor in civil cases."[35] Other states, however, have indicated that

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> The determination by the lawyer in his or her professional judgment in applying the standard to determining what funds should be placed in an IOLTA account is the same standard of ordinary prudence that governs lawyer conduct in making other ethical judgments. We do not believe it is necessary or desirable to adopt a different standard.

Id.

33. Md. Ann. Code art. 10, § 44 (Michie 1985 Supp.). The Maryland provision reads as follows:

> If in the judgment of the attorney any trust moneys received from any client or beneficial owner are too small in amount or are reasonably expected to be held for too short a period of time to generate at least $50 of interest or such larger amount of interest as in the judgment of the attorney may be equivalent to the cost of administering an account for the benefit of the client or beneficial owner, such moneys may be pooled and commingled by the attorney with other such moneys held for other clients or beneficial owners, and the aggregate interest earned on such commingled account shall be paid . . . to the Maryland Legal Services Corporation . . . .

Id. The table below shows the amount of funds held and the length of time necessary to generate interest in excess of the Maryland $50 "safe harbor" amount:

Principal Deposit	Number of Days Required to Generate $50 Interest at 5¼ % Interest Compounded Daily
$ 500	654
1,000	335
2,000	169
5,000	69
10,000	34
20,000	17
30,000	12

ABA IOLTA REPORT, *supra* note 17, at 24.

34. Telephone interview with John Courtney, Administrator of the Iowa IOLTA Fund (Jan. 23, 1986).

35. *In re* Petition of The Iowa State Bar Association, No. 84-1641, slip op. at 3-4 (Iowa 1984). Other states have also expressed that providing funds for legal services to the poor is a primary goal of their IOLTA programs. *See In re* Interest on Lawyers' Trust Accounts, 283 Ark. 252, _, 675 S.W.2d 355, 358 (1984), *modified*, 286 Ark. 64, 689 S.W.2d 352 (1985); Petition

IOLTA funds would also be used for student loans and improving the judicial system.[36] In any event, the use of funds must be limited to public purposes in order to avoid any adverse tax consequences to clients.[37]

IV. Challenges to IOLTA Programs

Although several American jurisdictions have enacted IOLTA programs recently, they have not done so without controversy. IOLTA programs have been attacked on constitutional,[38] taxation,[39] and ethical grounds.[40]

A. *Constitutional*

Opponents of IOLTA programs claim that the use of clients' funds for public purposes is an unconstitutional taking of private property.[41] In order for there to be a "taking" under the fifth amendment, there must be "property," and it must be "taken" by the government. The critics claim that, by virtue of the recent Supreme Court opinion in *Webb's Fabulous Pharmacies, Inc. v. Beckwith*,[42] these two factors are met.

Beckwith dealt with a Florida statute which permitted counties to retain the interest that accrued on interpleader funds kept in their registries.[43] The Supreme Court held that the statute amounted to an unconstitutional "taking,"[44] and that the interest belonged to the ultimate owners of the interpleaded amount.[45] In reaching its conclusion, the *Beckwith* Court noted, "[t]he earnings of a fund are incidents of ownership of the fund itself and are property just as the fund itself is property."[46]

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of New Hampshire Bar Association, 122 N.H. 971, _, 453 A.2d 1258, 1262 (1982); *In re* Interest on Lawyers' Trust Accounts, 672 P.2d 406, 406 (Utah 1983).

36. *See, e.g., In re* Interest on Lawyers' Trust Accounts, 283 Ark. 252, _, 675 S.W.2d 355, 358 (1984), *modified*, 286 Ark. 64, 689 S.W.2d 352 (1985).

37. *See infra* notes 90-96 and accompanying text.

38. *See infra* notes 41-75 and accompanying text.

39. *See infra* notes 76-96 and accompanying text.

40. *See infra* notes 97-108 and accompanying text.

41. The fifth amendment provides, in part, "[N]or shall private property be taken for public use, without just compensation." U.S. Const. amend. V. This provision applies to states through the fourteenth amendment. Chicago, B. & Q.R.R. v. City of Chicago, 166 U.S. 226, 239 (1897); Penn Central Transportation Co. v. City of New York, 438 U.S. 104, 122 (1978).

42. 449 U.S. 155 (1980).

43. *Id.* at 156.

44. *Id.* at 164-65.

45. *Id.* at 162.

46. *Id.* at 164. The Court said further, in more direct fashion, that:

> [A] State, by *ipse dixit*, may not transform private property into public property without compensation, even for the limited duration of the deposit in court. This is the very kind of thing that the Taking Clause of the Fifth Amendment was meant to prevent. That Clause stands as a shield against the arbitrary use of governmental power.

Id.

In the first case since *Beckwith* to decide the constitutionality of an IOLTA program, the Florida Supreme Court found that there was no unconstitutional "taking."[47] The court distinguished the IOLTA program from the situation in *Beckwith*, stating that with the IOLTA program, "no client is compelled to part with 'property' by reason of a state directive, since 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."[48] The Florida court reasoned that since only clients' funds of nominal amounts (or funds to be held for a short time period) will be placed in the IOLTA accounts, clients could not benefit from having separate accounts, and the IOLTA accounts are merely creating interest where none existed before by pooling these funds.[49]

A number of jurisdictions which have enacted IOLTA programs after the Florida decision have cited to its rationale in refusing to find an unconstitutional "taking."[50] The Iowa Supreme Court, in dealing with the "taking" issue, summarily adopted the reasoning of the Minnesota Supreme Court.[51] The "taking" issue appears to be the most prevalent issue raised concerning IOLTA programs. The various courts' summary treatment of this issue, however, leads one to believe that it does not represent a looming concern over IOLTA programs.[52]

Indeed, the Supreme Court recently declined to review, among other

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47. *In re* Interest on Trust Accounts, 402 So. 2d 389, 395 (Fla. 1981).

48. *Id*

49. *Id.* at 396.

50. *See, e.g.*, Petition of New Hampshire Bar Association, 122 N.H. 971, _, 453 A.2d 1258, 1261 (1982). The New Hampshire court, after a brief analysis of the Florida court's findings, simply noted that "[w]e agree with the Florida court's analysis and find no constitutional impediment to the interest-bearing-account proposal." *Id.*

51. *In re* Petition of The Iowa State Bar Association, No. 84-1641, slip op. at 2 (Iowa 1984). In addition to adopting the rationale of the Minnesota Supreme Court, the Iowa Supreme Court concluded:

> [A]n IOLTA program of the kind involved here does not take client property because the fund is derived only from interest on pooled accounts where individual client principal is so small or held for such a short period of time that transaction and maintenance cost preclude an individual property right in the principal from arising. Because no property right exists, no taking occurs within the meaning of the fifth amendment of the United States Constitution and Iowa Constitution article I, section 9.

Id. The Minnesota Supreme Court itself only briefly dealt with the subject. It simply stated that "[w]e do not find that under the circumstances here the client has any 'property' that is being taken without compensation or without due process of law . . . . " *In re* Petition of The Minnesota State Bar Association, 332 N.W.2d 151, 158 (Minn. 1982).

52. Despite the summary treatment given to the "taking" issue by most state courts, at least one state supreme court has refused to implement an IOLTA program because it was deemed to be an unconstitutional taking. ABA IOLTA REPORT, *supra* note 17, at 8-9. The North Carolina Bar had proposed an IOLTA program, but Chief Justice Branch of the North Carolina Supreme Court concluded that the plan was violative of the fifth amendment and of the United States Supreme Court's holding in *Beckwith*. *Id.*

constitutional issues, the "taking" question raised concerning the California IOLTA program.[53] In *Carroll v. State Bar of California*, California's mandatory IOLTA program was challenged, *inter alia*, as a "taking of property" violative of the fifth amendment.[54] The California Supreme Court, without discussing the findings of any other state supreme court concerning the "taking" issue as it applies to IOLTA programs, concluded that the plaintiffs "mistakenly rel[ied]" upon the holding in *Beckwith*.[55] The court determined that, unlike *Beckwith*, where the rightful owners of the interpleaded amount were entitled to a substantial amount of interest, the plaintiffs here would not gain any "economic advantage" by preventing retention of their funds in an IOLTA account.[56]

The California court also rejected several other constitutional challenges made by the plaintiffs in *Carroll*. First, the plaintiffs alleged that the IOLTA statute was unconstitutionally vague in its reference to funds "nominal in amount or . . . on deposit for a short period of time."[57] The *Carroll* court dismissed this argument, saying that this phrase requires attorneys to make a good faith effort to determine if funds will generate sufficient interest for the client.[58]

Second, the plaintiffs asserted that, because some clients have no trust funds on account with their lawyers, and some have trust funds held in separate trust accounts, this denies equal protection to clients whose funds are required to be maintained in IOLTA accounts.[59] The *Carroll* court also summarily dismissed this argument, citing as support the lack of evidence proving a denial of equal protection.[60]

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53. Carroll v. State Bar of California, 166 Cal. App. 3d 1193, 213 Cal. Rptr. 305, *cert. denied Sub nom., Chapman v. State Bar of California, 106 S. Ct. 142 (1985)*.

54. Carroll v. State Bar of California, 166 Cal. App. 3d at _, 213 Cal. Rptr. at 311-12.

55. *Id.* at _, 213 Cal. Rptr. at 312. The court reasoned that, "[t]o have a property interest subject to protection under the Fifth Amendment, one must have more than an abstract need or desire, more than unilateral expectation." *Id.*

56. *Id.* The court opined:

> We accept respondent's generalized claims that clients have property rights in their money. However, the client relinquishes control of the money once it is place in trust with the lawyer. So long as the principal is secure, not diminished, and is not economically capable of generating net income through deposits or investments legally available for lawyers' trust funds, the client retains no meaningful right of control except to recover the principal upon a request made before it is properly expended.

Id.

57. *Id.* at 310.

58. *Id.* at 311. The *Carroll* court further stated that "[t]he statutory language does not, as respondents suggest, require a crystal ball to determine whether it is practical to segregate client trust deposits to earn income for a client's benefit in light of the costs involved in earning and accounting." *Id.*

59. *Id.* at 312.

60. *Id.* at 313. The court stated:

> We find no suspect classifications here: clients who have no funds held by their lawyers subject to deposit, receive no windfall, and clients whose trust funds are suffi-

Finally, the plaintiffs argued that the IOLTA program violated the sixth amendment right to counsel because it discriminates against persons who need legal services.[61] The *Carroll* court disposed of this challenge by simply stating that no such discrimination was shown.[62]

While the Supreme Court's denial of certiorari to review the constitutional questions raised by *Carroll* (especially the "taking" question) certainly cannot be considered a decision on the merits, it does indicate that the "taking" issue is certainly not a pressing question to the Justices. Because of the number of constitutional questions raised in *Carroll*, it was considered the strongest candidate for review by the Supreme Court.[63]

Nearly all courts that have dealt with the "taking" issue in regard to IOLTA programs have summarily dismissed that question on the ground that there is no property to take.[64] As a result, there has been no analysis as to whether, even if there was property to take, the IOLTA program would be an *unconstitutional* "taking" by state government.[65]

The Supreme Court has not provided a definitive standard for determining when a "taking" has occurred. In *Pennsylvania Coal Co. v. Mahon*,[66] the Court nebulously declared that "[t]he general rule . . . is, that while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking."[67] Two later decisions by the Court also failed to provide a conclusive test.[68] The Court conceded only recently that it was not able to develop an exact standard for determining when a "taking" has occurred; rather, it decided that the determiniation should be made on a case-by-case basis.[69] Although the Court has failed to formulate a definitive

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cient to generate net income after costs of administration and accounting pay their own way in generating individual income. Where it is economically impossible for nominal and short-term trust deposits to generate net income, even in a pooled account, the impact, if any, on the client-depositor is so minimal, and the public interest is so compelling, that the presumption of constitutionality is not rebutted.

Id.

61. *Id.*

62. *Id.*

63. Nat'l L.J., Oct. 21, 1985, at 5, col. 3.

64. *See, e.g.*, Petition by the Massachusetts Bar Association, 395 Mass. 1, 478 N.E.2d 715 (1985); Petition of New Hampshire Bar Association, 122 N.H. 971, 453 A.2d 1258 (1982); *see also supra* note 51 and accompanying text.

65. The court in *Carroll*, while not addressing the issue directly, implied that, even if there were property to take, it is not an unconstitutional taking. Carroll v. State Bar of California, 166 Cal. App. 3d at __, 213 Cal. Rptr. at 312. The court noted that "[w]here the public good is great, and 'taking' is minimal, it is permissible. Even a substantial property interest may be taken through zoning laws, etc." *Id.*

66. 260 U.S. 393 (1922).

67. *Id.* at 415.

68. United States v. Caltex, 344 U.S. 149 (1952) ("no rigid rules" exist to find an unconsitutional taking); Goldblatt v. Town of Hempstead, 369 U.S. 590 (1962) (there is no "set formula" for determining when an unconstitutional taking has occurred).

69. Penn Central Transportation Co. v. City of New York, 438 U.S. 104, 124 (1978).

test to determine when a taking has occurred, it did identify two relevant factors that should be examined.[70] The Court first stated that the character of the government action should be reviewed.[71] An unconstitutional "taking" occurs more often when the government action is a "physical invasion" than when the action is for some public good.[72] The second factor the Court expressed as a characteristic of a taking is the "economic impact" of the government action.[73]

Applying these two factors to IOLTA programs, it would appear that there are no indications of an unconstitutional taking. First, because they provide funds for, *inter alia*, legal services to the poor, IOLTA programs are established for the public good.[74] Second, because interest is being created where there was none before, there is no real adverse impact on clients whose funds are deposited in IOLTA accounts.[75]

B. *Taxation*

A second issue raised concerning IOLTA programs is whether the interest should be considered gross income to the client under the "assignment of income" doctrine of *Lucas v. Earl*.[76] In *Lucas*, the taxpayer had entered into a contract with his wife whereby he and his wife would be considered joint tenants to his salary.[77] The taxpayer and his wife filed separate returns in which each included half of the husband's total salary as gross income.[78] The Commissioner asserted that the full amount should be charged to the taxpayer,[79] and the Supreme Court agreed.[80] In so holding, the Court found that "the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it."[81]

Under the original IOLTA program adopted by the Florida Supreme Court, a client could take affirmative steps to inform his attorney that the

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70. *Id.*
71. *Id.*
72. *Id.* The Court stated 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 common good." *Id.*
73. *Id.* The Court stated that "[t]he economic impact of the regulation on the claimant and, particularly the extent to which the regulation has interefered with distinct investment-backed considerations are, of course, relevant considerations." *Id.*
74. *See supra* note 6 and accompanying text.
75. *See supra* note 51 and accompanying text.
76. 281 U.S. 111 (1930).
77. *Id.* at 113-14.
78. *Id.* at 114.
79. *Id.* at 113.
80. *Id.* at 114-15.
81. *Id.* at 115.

client did not want interest gained from his funds going into the IOLTA program.[82] The attorney, in addition to any individual trust accounts and his interst-bearing IOLTA account, was to maintain a traditional, non-interest-bearing trust account.[83]

Because of this feature of client discretion to participate in the IOLTA program, the Internal Revenue Service did not immediately rule that Florida's IOLTA program would not result in adverse tax consequences to clients.[84] The Service feared that, even though the IOLTA program was not designed for tax avoidance, it might somehow be used as precedent to establish tax avoidance schemes.[85] Therefore, any plan that seeks to shift income from one party to another is examined very closely by the IRS.[86]

The IRS eventually conceded that interest earned in FLorida's IOLTA program would not be classified as income to the client under the assignment of income doctrine if, *inter alia*, all client control was removed from the program.[87] Florida then amended its IOLTA program in 1981 to remove all client control from the destiny of earnings gained on funds.[88] In response, the IRS issued a Revenue Ruling which pronounced that interest earned from a client's funds held in trust by his attorney would not be included in the client's gross income if, *inter alia*, the interest was paid to a tax-exempt bar foundation, and the client had no election whether to participate in the program.[89]

Another important and related tax issue which could affect the tax status of IOLTA programs is the way in which the proceeds are collected and

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82. *In re* Interest on Trust Accounts, 356 So. 2d 799, 811 (Fla. 1978). Attorneys who participated in the original Florida IOLTA program were required to send a notice to each client for whom they held trust funds. *Id.* at 810-11. The notice read, in part:

> We have sent you this explanation, at the direction of the Florida Supreme Court, to advise you that we are participating in the Court's new program and that the funds you have entrusted to us for your affairs . . . will be deposited in an interest-bearing trust savings account unless you specifically give us written instructions to the contrary. A directive not to allow such use of your funds will not produce income for you. Your funds will simply be placed in a non-interest-bearing trust checking account until needed.

Id. at 811.

83. *Id.* at 805.

84. *In re* Interest on Trust Accounts, 402 So. 2d 389, 391 (Fla. 1981).

85. *Id.*

86. *Id.* at 390.

87. *Id.* at 391. The Florida Supreme Court, in reviewing this tax issue, noted:

> The linchpin of approval [by the IRS] was removal of all client control over the placement or non-placement of funds at interest — that is, elimination of the client's veto over the investment of funds from which he could never benefit because the amounts on deposit were either too small in amount or to be held for only a short duration.

Id.

88. *Id.*

89. Rev. Rul. 209, 1981-2 C.B. 16.

disbursed. The IRS issued its Revenue Ruling on the assignment of interest question based upon the assumption that the funds would be paid to a tax-exempt organization defined under section 501(c)(3) of the Internal Revenue Code.[90] Additionally, the funds must be disbursed by a tax-exempt organization in a manner that is not inconsistent with its tax-exempt status.[91] If the funds are not collected and disbursed in accordance with these measures, the collecting organization may lose its tax-exempt status, or the IRS might find that there has been an assignment of income.[92] In either case, the IRS would tax clients on the interest earned on their funds.[93] So long as the specific measures set out in Revenue Ruling 81-209[94] are followed, it appears that a state's IOLTA program will not be in jeopardy of being classified as an "assignment of income" scheme. The Iowa Supreme Court, in approving its IOLTA program, charged the Lawyer Trust Account Commission with the duty to ensure that the Iowa program would receive tax-exempt status.[95] Additionally, the court ordered that funds would be limited to use for tax-exempt purposes only.[96]

C. *Ethical*

A third problem raised concerning IOLTA programs is whether it is an

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90. *See id.*

91. If a bar foundation disburses funds inconsistent with its tax-exempt status, this may jeopardize its classification as a tax-exempt organization, causing adverse tax consequences to the foundation or to the clients. ABA IOLTA REPORT, *supra* note 17, at 16. In amending its IOLTA program to receive a favorable revenue ruling from the IRS, the Florida Supreme Court recognized this potential problem. *In re* Interest on Trust Accounts, 372 So. 2d 67, 67-68 (Fla. 1979). Originally, the Florida Supreme Court proprosed seven uses for funds collected by the IOLTA program:

(a) to provide legal aid to the poor;
(b) to provide for the adequate delivery of legal services to all members of the public;
(c) to augment the clients' security funds with a view toward full reimbursement;
(d) to fund a more expeditious and efficient grievance mechanism;
(e) to provide student loans;
(f) to improve the administration of justice; and
(g) for such other programs for the benefit of the public as are specifically approved by the Court from time to time.

In re Interest on Trust Accounts, 356 So. 2d 799, 811 (Fla. 1978). The IRS asserted that, (1) providing legal services to the general public (instead of just to the poor); (2) augmenting the client security fund; and (3) funding for a more efficient and expeditious grievance system were inconsistent with tax-exempt organizations. *In re* Interest on Trust Accounts, 372 So. 2d 67, 67-68 n.4 (Fla. 1979). In order to avoid the risk of losing tax-exempt status, the court dropped the three disapproved uses for the funds. *Id.* at 67-68.

92. ABA IOLTA REPORT, *supra* note 17, at 16-17.

93. *See id.* at 16.

94. 1981-2 C.B. 16.

95. *In re* Petition of The Iowa State Bar Association, No. 84-1641, slip op. at 4 (Iowa 1984).

96. *Id.*

ethical violation for an attorney to participate in the program. A lawyer holding a client's funds in trust has a fiduciary duty to properly handle those funds.[97] The Iowa Code of Professional Responsibility requires an attorney to: (1) promptly notify a client when the attorney has received client funds or other property; (2) maintain complete records of any client funds held by the attorney and give appropriate accounts to the client regarding those funds; and (3) promptly pay to the client funds held by the attorney which the client is entitled to receive.[98]

Despite the significant ethical duties that an attorney must comply with regarding a client's funds, an attorney is under no duty to inform a client that his funds are being used to generate interest which is used for public purposes.[99] Although arguably this could be considered unethical, according to the ABA Committee on Ethics and Professional Responsibility, this lack of a duty presents no ethical problems.[100] The Committee concluded in a formal opinion that, since a client has no property interest in the interest earned on the funds, there is no ethical duty for the attorney to notify the client concerning the use of the interest earned on his funds.[101]

The Committee did note that, even if a client has no property interest in the interest earned on his funds, it would be an ethical violation for an attorney to use the interest earned on client funds to defray the attorney's own operating expenses unless the client consents after full disclosure.[102] The Committee, however, distinguished this retention of interest from participation in the IOLTA program on three grounds.

First, the attorney who retains interest to defray his own expenses places his own interests in conflict with his clients, because he would then have an incentive to hold client funds beyond a reasonable period of time.[103] In contrast, an attorney who participates in an IOLTA program does not select who will receive the interest; therefore, there is no personal interest to delay disbursement of funds.[104] Second, unlike the attorney who retains interest on his clients' funds, a state-authorized IOLTA program must withstand public accountability and scrutiny.[105] Attorneys who use interest on

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97. *See* ABA Comm. on Ethics and Professional Responsibility, Formal Op. 348 (1982).

98. IOWA CODE OF PROFESSIONAL RESPONSIBILITY DR 9-102(B) (1985).

99. *In re* Petition of The Iowa State Bar Association, No. 84-1641, slip op. at 2-3 (Iowa 1984). The court stated that, "because the IOLTA fund does not take client property, no ethical duty issues to obtain client consent to establishing an IOLTA account of the nature proposed." *Id.*

100. *See* ABA Comm. on Ethics and Professional Responsibility, Formal Op. 348 (1982).

101. *Id.* This is also the rationale of the Iowa Supreme Court. *See supra* note 99. In addition, if an attorney were required to notify a client concerning the use of the client's funds in an IOLTA program, this could bring the program back into an "assignment of income" problem. *See supra* notes 76-89 and accompanying text.

102. ABA Comm. on Ethics and Professional Responsibility, Formal Op. 348 (1982).

103. *Id.*

104. *Id.*

105. *Id.*

their clients' funds may be reviewed only on the complaint of a client.[106] Third, since an attorney who participates in an IOLTA program retains no interest earned on his clients' funds, there is no commingling of funds belonging to the attorney and his clients.[107] Despite the lack of an ethical duty for attorneys to notify clients that their funds are being used to generate interest for IOLTA, the Iowa Supreme Court "urged" attorneys to notify their clients of the program.[108]

V. Judicial Power

A potential problem which has received little attention from opponents and commentators of IOLTA programs is whether state supreme courts possess the requisite power to implement and maintain these programs.[109] Of the thirty-seven American jurisdictions that have implemented IOLTA programs, thirty-three have come about by judicial order of the various states' supreme courts.[110] Florida's supreme court, the first state supreme court to adopt an IOLTA program by judicial order, did not discuss its power to create such a program, and no other supreme court that has implemented an IOLTA program has been found to discuss this issue.[111]

The Iowa Supreme Court, in creating an IOLTA program by judicial order, has certainly exercised its power in a broader fashion than ever before. The Iowa Supreme Court's powers originate from the constitutional provision that reads, in part, "[t]he supreme court . . . shall exercise a supervisory and administrative control over all inferior judicial tribunals

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106. *Id.*

107. *Id.*

108. *In re* Petition of The Iowa State Bar Association, No. 84-1641, slip op. at 3 (Iowa 1984). Additionally, an attorney has a duty to invest a client's funds into a separate interest-bearing account with interest accruing to the benefit of the client if a "significant positive return" can be generated for the client. *See* Iowa Code of Professional Responsibility DR 9-102(C)(3) (1985). *See also supra* notes 29-33 and accompanying text.

109. Another potential problem with Iowa's IOLTA program, which will not be discussed here, is a provision which requires attorneys to place trust accounts in a financial institution that is authorized to do business in Iowa. Iowa Code of Professional Responsibility DR 9-102(C) (1985). This could potentially be violative of the Commerce Clause of the U.S. Constitution, which vests in Congress the duty to regulate commerce among the states. U.S. Const. art. I, § 8, cl. 3.

110. Lawyers' Manual on Professional Conduct (ABA/BNA) at 45:201. The District of Columbia's IOLTA program, which is included as one of the thirty-three mentioned above, was approved by the D.C. Court of Appeals. *Id.* The four jurisdictions which have created IOLTA programs legislatively are: California, Maryland, New York, and Ohio. *Id.*

111. In a 1981 proceeding to amend its IOLTA program, the Florida Supreme Court did note that, "[i]t has been suggested that the [Florida Bar] Foundation's proposal is not only outside our constitutional authority, being a legislative function (taxation), but is unconstitutional (taxation without representation, among other reasons)." *In re* Interest on Trust Accounts, 402 So. 2d 389, 392 (Fla. 1981). After noting this, however, the court failed to discuss its authority. *Id.*

throughout the state."[112] Moreover, the supreme court's strained interpretation of its constitutional powers seems to fly in the face of the legislature's recent overhaul of the judiciary. A recently enacted provision of the Iowa Code directs that most funds collected by the judicial system be paid into the state's general fund.[113]

IOLTA programs are capable of producing vast amounts of income.[114] The state legislature, faced with the problem of meeting government budget allocations, may soon question the constitutionality of the supreme court collecting and disbursing funds created by the IOLTA program. The situation has the potential of creating deep rifts between the governmental branches. If the legislature questions the situation in the form of a lawsuit, they will ultimately have to argue their point before the same tribunal which maintains the IOLTA program, the Iowa Supreme Court. The court has declared that it is the function of the judicial department to ascertain whether any department has overstepped its constitutional authority.[115] While the supreme court is undoubtedly the most qualified state department to determine state constitutional law, the issue becomes sticky when the court is addressing the extent of its own powers. If such a scenario should arise re-

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112. IOWA CONST. art. V, § 4 (codified 1985). Although the court has not specifically enumerated where its supervisory and administrative power lies, it has declared that:

> The superintending control is hampered by no specific rules or means for its exercise. It is so general and comprehensive that its complete and full extent and use have practically hitherto not been fully and completely known and exemplified. It is unlimited, being bounded only by the exigencies which call for its exercise. As new instances of these occur it will be found able to cope with them.

Warren County v. Judges of the Fifth Judicial District, 243 N.W.2d 894, 897 (Iowa 1976) (citations omitted). Perhaps the court is implicitly treating the IOLTA program as a new exigency for its supervisory power.

113. "Except [generally, for fees collected by court clerks], all fees and *other revenues* collected by judicial officers and court employees *shall be paid into the general fund of the state.*" IOWA CODE § 602.1304 (1985) (emphasis added). The term "judicial officers" includes supreme court justices. *Id.* at 602.1101(8). "Court employees" is defined as, "an officer or employee of the judicial department . . . . " *Id.* at 602.1101(5). This includes employees of the Lawyer Trust Account Commission, who would be collecting funds from IOLTA accounts. The Lawyer Trust Account Commission was established by the Iowa Supreme Court as a commission of the court. *In re* Petition of The Iowa State Bar Association, No. 84-1641, slip op. at 4 (Iowa 1984).

114. It has been reported that the California IOLTA program, which is mandatory, has generated $17.5 million in revenues in 2 ½ years of operation. NAT'L L.J., Oct. 21, 1985, at 5, col. 2. The Iowa IOLTA program collected approximately $250,000 in revenues during the first six months of operation from July 1, 1985 to December 31, 1985. Telephone interview with John Courtney, Administrator of the Iowa IOLTA Fund (Jan. 23, 1986).

115. Luse v. Wray, 254 N.W.2d 324, 327 (Iowa 1977). The court reasoned that its power to decide state constitutional questions was derived from section 1 of article V of the Iowa Constitution that states, "[t]he Judicial power shall be vested in a Supreme Court, District Courts, and such other Courts, inferior to the supreme court, as the General Assembly may, from time to time, establish." *Id.* (quoting IOWA CONST. art. V, § 1). The court determined that "judicial power . . . include[s] the gamut of *the determination of constitutional questions.*" *Id.*

garding Iowa's IOLTA program, the court, in order to avoid an appearance of impropriety, will have to examine the exercise of its own powers as objectively as possible.[116]

Before such a situation develops, perhaps the legislature should concede that the IOLTA program is a good program that should continue to be maintained by the Iowa Supreme Court. The best way to do this would be to enact legislation similar to that enacted for the Client Security Fund.[117] Like the Client Security Fund, such a statute would exempt the IOLTA program from the general rule that all funds collected by the judiciary, except court costs, must be paid to the general fund of the state. This would allow the supreme court to properly continue an innovative program that is sorely needed in Iowa.

VI. Conclusion

Like many other states have done in recent years, the Iowa Supreme Court's implementation of a mandatory IOLTA program is an innovative way to fund public service activities in the state, especially legal services for the poor.[118] Of course, the basic concept of IOLTA—the collection of interest earned from lawyers' trust accounts—is universal to IOLTA programs. IOLTA programs, however, vary in regard to implementation. For instance, some state legislatures have enacted IOLTA programs, while in other states the courts have created IOLTA programs by judicial order.[119] Participation in some IOLTA programs is mandatory, while in others it is voluntary.[120] Lastly, the investment guidelines given to participating attorneys vary among states.[121]

The issues presented to date concerning IOLTA programs have not hampered their effectiveness. IOLTA programs have withstood attacks from

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116. The Iowa Supreme Court has not addressed the issue of a possible breach of its own constitutional powers. The Minnesota Supreme Court, however, when deciding on whether a judicial action was within its judicial powers stated very plainly that:

> [T]he courts, being the final interpretive body as to constitutional matters, must exercise extreme care and caution when declaring its own powers under the [state] constitution. However, as long as there remains the basic constitutional commitment to separate, co-equal, branches of government, the courts are singularly best equipped to define the constitutional powers of each branch. Thus, the courts must not only resist improper challenges to its constitutional powers, but must also diligently preserve the powers of the other branches of government.

State v. Osterloh, 275 N.W.2d 578, 579-80 (Minn. 1978).

117. This provision reads: "Any moneys received from those persons admitted to practice law and which are designated for a client security fund or similar fund created by the Supreme Court shall be separately retained and administered by said court in accordance with rules promulgated by it." Iowa Code § 610.45 (1983).

118. *See supra* note 6.

119. *See supra* notes 109-17 and accompanying text.

120. *See supra* notes 25-28 and accompanying text.

121. *See supra* notes 29-33 and accompanying text.

constitutional,[122] taxation,[123] and ethical grounds.[124] The constitutional "taking" issue appears to be dormant given the Supreme Court's recent refusal to review such a challenge to California's IOLTA program.[125] Further, in light of the revenue ruling issued by the IRS, interest earned on IOLTA accounts will not be taxed as gross income to the client so long as the state IOLTA program follows the enumerated guidelines.[126] In addition, the ethical issue does not appear to present a serious problem.[127]

Despite the apparent resolution of the problems raised to date concerning IOLTA programs, this does not end the discussion of their validity, especially for Iowa's IOLTA program. The question that remains is whether the Iowa Supreme Court (and other state supreme courts, for that matter) in implementing and maintaining an IOLTA program is overstepping its constitutional mandate to "supervise and administrate the judiciary."[128] This question seems especially ripe in light of the recent statute passed by the Iowa Legislature.[129] Instead of creating a conflict among state branches, the best course of action is for the legislature to statutorily adopt the IOLTA program as a proper function of the Iowa Supreme Court.[130] In this manner, the court will be able to properly maintain a program whose time has come.

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122. *See supra* notes 41-75 and accompanying text.
123. *See supra* notes 76-96 and accompanying text.
124. *See supra* notes 97-108 and accompanying text.
125. *See supra* note 53 and accompanying text.
126. *See* Rev. Rul. 209, 1981-2 C.B. 16.
127. *See supra* notes 97-108 and accompanying text.
128. *See* IOWA CONST. art. V, § 4 (codified 1985).
129. *See* IOWA CODE § 602.1304 (1985).
130. *See supra* note 117 and accompanying text.