COMMENTS

Limited Practice Officers and Admission to Practice
Rule 12: Taking or Not?

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I. INTRODUCTION

Each year in the state of Washington thousands of real estate transactions involving billions of dollars are consummated. Almost without exception, these transactions involve an intermediary, namely an escrow holder. Following a single set of written instructions as agreed upon by the principals to the transaction—the client-depositors—the escrow holder, at different points in the transaction, takes possession of the purchaser’s earnest money deposit and the seller’s proceeds, and with them the opportunity to make beneficial use of such funds.

Under the Supreme Court of Washington’s Admission to Practice Rule 12, escrow holders certified as limited practice officers can prepare certain routine legal documents incidental to the closing of real estate transactions.1 The quid pro quo for this privilege, however, is that limited practice officers are subject to Admission to Practice Rule 12.1,2 a modified version of the Interest on Lawyers’ Trust Accounts, or IOLTA.3 Under the provisions of Admission to Practice Rule 12.1(c)(1), a limited practice officer:

who receives . . . funds . . . shall maintain a pooled interest-bearing trust account for deposit of funds that are nominal in amount or expected to be held for a short period of time. The interest accruing on this account, not [sic] of reasonable check and deposit processing charges . . . shall be paid to the Legal Foundation of Washington, as established by the Supreme Court of Washington.4

Limited practice officers can no longer make beneficial use of a client-depositor’s funds by pooling them into a noninterest bearing

1. WASH. ADMISSION TO PRACTICE RULE (APR) 12, Limited Practice Rule for Closing Officers (West 2000). In addition, APR 12 specifies exactly what documents a limited practice officer is permitted to prepare, including: promissory notes, guaranties, deeds of trust, reconveyances, mortgages, satisfactions, security agreements, releases, Uniform Commercial Code documents, assignments, contracts, real estate excise tax affidavits, and bills of sale. WASH. APR 12(d).

2. WASH. ADMISSION TO PRACTICE RULE 12.1, Preserving Identity of Funds and Property in Transactions Closed by Limited Practice Officers (West 2000).

3. See Phillips v. Washington Legal Found., 524 U.S. 156, 159 (1998) (explaining that “[u]nder these programs, certain client funds held by an attorney in connection with his practice of law are deposited in bank accounts. The interest income generated by the funds is paid to foundations that finance legal services for low-income individuals.”).

account to generate interest in the form of "earnings credits." Otherwise, these credits would find their way to an escrow holder's sister corporation, ostensibly as payment for bookkeeping services furnished by the sister corporation on behalf of the escrow holder.

Like IOLTA rules elsewhere in the country, Washington's Admission to Practice Rule 12.1(c)(1) has spawned its share of controversy, including a suit brought by limited practice officers challenging the rule's constitutionality. Although Legal Foundation of Washington was dismissed on a motion for summary judgment, a recent U.S Supreme Court decision in Phillips v. Washington Legal Foundation effectively undercut the court's rationale in Legal Foundation of Washington, prompting an appeal by the plaintiffs.

The Supreme Court's holding in Phillips suggests that the constitutionality of Admission to Practice Rule 12.1(c)(1) is ripe for reexamination. Upon such a reexamination, the broader issue would be whether Admission to Practice Rule 12.1(c)(1) operates as an unconstitutional taking of property. Implicit within this question is the narrower question of whose property interest is taken. A variation of this question is what property interest, if any, does an escrow holder have in the beneficial use of a client-depositor's funds.

As the recipient of funds generated by the operation of Admission to Practice Rule 12.1(c)(1), the stakes for the Legal Foundation of Washington are high: in 1998, nearly forty-three percent of the

5. See, e.g., Washington Legal Found. v. Massachusetts Bar Found., 993 F.2d 962 (1st Cir. 1993) (holding that IOLTA rules are not a taking of plaintiff's property); Cone v. State Bar of Florida, 819 F.2d 1002 (11th Cir. 1987) (holding that interest income on IOLTA accounts was not within the legitimate expectations of the owner of the principal amount); Petition by Massachusetts Bar Ass'n, 478 N.E.2d 715 (Mass. 1985) (concluding that interest income on nominal or short-term trust deposits is not property for constitutional purposes); In re Interest on Lawyers' Trust Accounts, 648 S.W.2d 480 (Ark. 1983) (holding that participation in IOLTA program must be conditional upon notice and approval from clients whose funds are so used); In re Interest on Trust Accounts, 402 So. 2d 389 (Fla. 1981) (holding that notification to clients whose funds are nominal in amount or to be held for a short period of time is unnecessary).


7. See id.

8. 524 U.S. 156 (1998) (holding that interest income generated by funds held in IOLTA accounts is private property of owner of principal for purposes of Takings Clause).


10. According to the Legal Foundation of Washington, approximately $3,041,000 of its total 1998 revenues of nearly $6,998,000 were attributable to Limited Practice Officers. Approximately $5,756,000 of the Foundation's total revenues were then awarded as grants, with nearly $4,200,000 awarded to a single public interest law organization (e-mail from Jack Dragovich, Fiscal Manager, Legal Foundation of Washington, to the author (Mar. 24, 1999) (on file with
Foundation's revenue came from the application of the IOLTA rules to limited practice officers.

This Comment arrives at the conclusion that Admission to Practice Rule 12.1(c)(1) does indeed give rise to an unconstitutional taking. Implicit within this conclusion is a determination (1) that earnings on funds deposited in escrow, whether in the form of interest or earnings credits, are property; (2) that Admission to Practice Rule 12.1(c)(1) takes such property; and (3) that such taking warrants just compensation. Moreover, it is the client-depositor—not the limited practice officer—who suffers the taking.

This determination comes on the heels of another equally important conclusion: the standard disclosures used by the escrow industry as the basis for making beneficial use of a client-depositor's funds fall short of those required in a fiduciary relationship. As such, the very provision that limited practice officers sought to restore by bringing suit in *Legal Foundation of Washington* arguably constitutes a breach of the escrow holder's fiduciary duty to the client-depositor.

Beginning with a definition of an escrow, Part II of this Comment provides an overview of a transaction in escrow and an analysis of the escrow holder's relationship with and duties to his client-depositor. Part III discusses the statutory and regulatory constraints imposed on escrow holders under Washington's Escrow Agent Registration Act. Part IV explores the evolution of the limited practice officer in Washington and the advent of Admission to Practice Rule 12. Part V analyzes the takings implicated by Admission to Practice Rule 12. Finally, Part VI offers both a conclusion and suggested alternatives to current practices.

II. COMMON LAW DUTIES OF AN ESCROW HOLDER

A. The Escrow Transaction

An analysis of the rights and responsibilities of escrow holders—commonly referred to as escrow agents—begins with a definition of escrow. Washington's Escrow Agent Registration Act offers a convenient starting point:

[A]ny transaction wherein any person or persons, for the purpose of effecting and closing the sale, purchase, exchange, transfer, encumbrance, or lease of real or personal property to another person or persons, delivers any written instrument, money, evi-
idence of title to real or personal property, or other thing of value to a third person to be held by such third person until the happen-
ing of a specified event or the performance of a prescribed condition or conditions, when it is then to be delivered by such third person, in compliance with instructions under which he is to act, to a grantee, grantor, promisee, promisor, obligee, oblig-
or, lessee, lessor, bailee, bailor, or any agent or employee there-
of. ¹¹

Most transactions involving escrow holders entail an underlying agreement between parties for the purchase and sale of real property. In a typical transaction, a purchaser and seller designate in the purchase and sale agreement an escrow holder to "close" the transaction. The escrow transaction usually begins with the purchaser depositing earnest money with the escrow holder. Shortly thereafter, both the purchaser and seller sign a single contract with the escrow holder, referred to as a "closing agreement and escrow instructions." These escrow instructions govern the relationship amongst the escrow holder and the purchaser and seller as client-depositors. ¹²

Often the escrow holder simply mails copies of the escrow instructions to the client-depositors, including instructions to "sign and return." Thus, not only do the client-depositors seldom negotiate the terms of the agreement, but they often never even meet the escrow holder until the time of closing. Given the stress, turmoil, and confusion that surround many real property transactions, client-depositors—-with perhaps the exception of seasoned professionals—likely never read, let alone understand, the escrow instructions.

On a later designated date, referred to as "closing," the purchase and sale agreement is consummated in accordance with the escrow instructions. A closing entails two distinct transactions: (1) the seller’s transfer of marketable title to the purchaser, and (2) the purchaser’s delivery of sufficient funds to satisfy his obligations and close the transaction.

Delivery of a deed by the seller to the purchaser via the escrow holder as an intermediary accomplishes the requisite transfer of title. Until the conditions specified in the escrow instructions are satisfied,


¹². Typically, escrow instructions instruct the escrow holder to prepare the documents necessary to close the transaction, order title insurance, prepare a settlement statement and proportions of income and expenses, verify encumbrances, collect and disburse funds, and record documents. The instructions also establish parameters for the close of the transaction and payment of a fee to the escrow holder, and specify certain tasks that are outside the scope of the escrow holder’s duties that must be performed by the purchaser and seller prior to closing. Finally, the instructions give notice to the parties that the escrow holder is neither an advocate nor a representative of either party.
the seller's delivery of the deed is conditional. Once these conditions are satisfied, the escrow holder records the deed before delivering it to the purchaser. It is the delivery of the deed to the purchaser that conveys title.

Simultaneously, the purchaser and his lender deliver to the escrow holder sufficient funds to close the transaction, with the escrow holder typically depositing them into a trust account. These funds are subsequently disbursed to the seller net of any closing costs—again after all the conditions in the escrow instructions have been followed. Once all the escrow conditions and instructions are satisfied and the transaction is closed, the escrow terminates.

Absent instructions to the contrary, escrow holders not practicing as limited practice officers must deposit a client-depositor's funds into a noninterest bearing account. In doing so, certain escrow holders engage in a complex transaction that allows them to indirectly make beneficial use of a client-depositor's funds.

The transaction goes something like this: the officers of a corporation acting as an escrow holder form a second, sister corporation that performs the accounting and reconciliation services vis-à-vis a client-depositor's funds as mandated under the Escrow-Trust Account Procedures. The sister corporation then enters into an agreement with the depository bank holding the client-depositor's funds to perform the accounting services for these funds. The escrow holder then deposits the client-depositor's funds into a noninterest bearing account with the same depository bank. Instead of paying the escrow holder interest on the client-depositor's funds, the bank awards the escrow holder something called earnings credits, which are calculated in the same manner as interest. Acting as nothing more than an intermediary, the bank uses the escrow holder's earnings credits to reimburse the sister corporation for the fee it charges the escrow holder for the necessary accounting and reconciliation services. The sister corporation—with the same corporate officers as the escrow holder—in turn pays out its profits as dividends to its corporate officers. If earnings credits are equated to interest and the fees earned by the sister corporation are imputed to the escrow holder, the regula-

tion that mandates the use of the noninterest bearing account effectively sanctions an escrow holder’s nonconsensual beneficial use of his client-depositor’s funds, a clear breach of the escrow holder’s fiduciary duty.16

Limited practice officers, on the other hand, are subject to a different set of constraints under Admission to Practice Rule 12.1, and are unable to make use of noninterest bearing accounts and the potentially lucrative arrangement described supra. Rather than forego this revenue stream, many limited practice officers have opted to turn in their licenses as limited practice officers, while others have elected to test the constitutionality of Admission to Practice Rule 12.1 by bringing suit in Legal Foundation of Washington.

Just as escrow instructions can be a blur to client-depositors, the characterization of the legal relationship between the escrow holder and the client-depositors can appear amorphous and indeterminate. The Florida Court of Appeals put it this way:

The law of escrow does not fall neatly within the established rules of either contract, agency, or trust. The law of escrow is complicated primarily by the fact that the escrow agent or depositary provides a service to at least two parties with potential or actual adverse interests. The law has struggled to place a reasonable and predictable duty upon the third party who elects to perform this difficult task with its inherent potential for conflict.17

In what capacity does an escrow holder serve his principals, the client-depositors? What are an escrow holder’s duties to the client-depositors? While there are no definitive answers, the following section of this paper will help establish the contours of this relationship.

B. Escrow Holder as an Agent

A useful starting point for defining an escrow holder’s relationship to his principal is the concept of agency. An agency relationship occurs when four elements are present: (1) A (as in agent) is a fiduciary for P (as in principal, here, either the purchaser or seller); (2) A’s actions are subject to P’s control; (3) P has manifested his consent to A for A to act on P’s behalf; and (4) A is subject to P’s control, and A


has consented to this relationship. An escrow holder is not subject to the direct control of either client-depositor, but instead must adhere to the terms of the escrow instructions signed by the client-depositors. Arguably, he does not meet the second condition of agency and would not be considered an agent in the pure sense of the word. Rather, as we will see in the next section, because the escrow holder is subject to duties within the escrow instructions to which both client-depositors are parties, he is arguably a dual agent owing duties to both principals.

C. Escrow Holder as a Trustee

An escrow holder's status as a dual agent is not entirely inconsistent with his also acting as a trustee on behalf of the client-depositor. His ability to serve in the latter capacity turns in part on the definition of a trust. For this definition we turn to Restatement (Second) of Trusts § 2:

A trust . . . is a fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it.

Comment h to the Restatement (Second) of Trusts § 2 sets forth the elements of a trust:

[A] trust involves three elements, namely, (1) a trustee, who holds the trust property and is subject to equitable duties to deal with it for the benefit of another; (2) a beneficiary, to whom the trustee owes equitable duties to deal with the trust property for his benefit; (3) trust property, which is held by the trustee for the beneficiary.

The escrow instructions and concomitant duties reflect the equitable duties required by the first element. The client-depositors, as parties to the escrow instructions, stand as beneficiaries, establishing the second element.

Satisfying the third element, that of trust property, or res, is a slightly more complicated matter. In this setting it is important to distinguish property from the actual subject matter of the trust. Property denotes interests in things. The things themselves, such as land and money, constitute the subject matter of the trust. Interests in

18. JOSEPH L. FRASONA, AGENCY, 3 (1964).
20. Id. at § 2 cmt. h.
21. Id. at § 2. cmt. c.
property are either equitable or legal in nature. In escrow, the equitable interests remain with the beneficiary, while the escrow holder assumes certain legal interests, usually interests in money and certain contractual rights.22 The client-depositor's delivery of these property interests to the escrow holder at the outset of the escrow nonetheless establishes the requisite trust property, giving rise to the trust.

Comment d to the Restatement (Second) of Trusts § 32 offers additional support for the premise that a trust is created in escrow with the escrow holder as its trustee:

d. Deposits in Escrow. Where the owner of property delivers in escrow the subject matter or an instrument of transfer, manifesting an intention that upon the happening of a certain event the depositee should deliver the subject matter or the instrument to a third person as trustee, and the owner does not reserve a power of revocation, a trust is created at the time of the delivery in escrow. Although the title to the property does not pass to the trustee before the happening of the event, in the meantime he holds in trust the rights created in him as a result of the deposit in escrow. At the time of the delivery in escrow there is a presently created trust and not merely a trust to arise in the future, although the trust property is at first the rights under the deposit in escrow, and, later, on the happening of the condition, the trust property is the property transferred.23

How, then, does one reconcile an escrow holder's status as a trustee with the holder's simultaneous status as a dual agent, discussed supra? The answer lies in the fluctuating role of the escrow holder vis-à-vis the property interests deposited with him in escrow. Essentially, this role is bifurcated depending on the stage—preclosing or postclosing—of the transaction in escrow. Prior to closing ("the happening of the condition"), the escrow holder acts as both trustee and dual agent. As a dual agent, he is "subject to duties to perform for each party which neither party alone can forbid."24 In this same preclosing stage, the escrow holder essentially functions as an intermediary; the property interests in his possession are "in statis . . . available to neither the grantor nor grantee, awaiting disposition by the agent in accordance

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22. Because one can never have title to real property absent a deed to that effect (outside of adverse possession), and the real property that is the subject matter of an escrow is typically never deeded to the escrow holder, the escrow holder never has legal or equitable title to the subject matter real property. Consequently, here we concern ourselves solely with property in the form of funds.

23. RESTATEMENT (SECOND) OF TRUSTS § 32 cmt. d (emphasis added).

24. 30 C.J.S. Escrows § 8 (1955) (cited with approval in Radach v. Prior, 48 Wash. 2d 901, 906, 297 P.2d 605, 608 (1956)).
with the terms of the agreement."25 However, once the escrow holder fulfills these duties and the transaction closes, he is no longer a dual agent but merely a trustee, holding property interests on behalf of his client-depositors.

On at least one occasion, a Washington court acknowledged the transformation of the relationship between the escrow holder and his client-depositors, and thus the capacity in which he holds property, upon the closing of a transaction. In *Radach v. Prior*, the Supreme Court of Washington observed:

> When the condition on which the instrument is to take effect is performed, the nature of the dual agency changes and the depository becomes a mere agent or trustee for each party with respect to the things in escrow to which each has thus become completely entitled, and his possession is equivalent to possession by such party.26

The *Radach* court acknowledges an escrow holder’s status as both a dual agent and a trustee. This approach suggests that the relationship between the escrow holder and the client-depositor at a given point in the transaction matters less than the escrow holder’s duties. The next section of this Comment offers a rough sketch of these duties.

**D. Escrow Holder as a Fiduciary**

While the exact nature of an escrow holder’s relationship with his client-depositors fluctuates, his duties do not. To the contrary, an escrow holder’s duty to his client-depositors is a distinct one. The basis for this is the notion of a fiduciary, a rugged concept frequently used to describe a series of legal relationships. A fiduciary is defined as one “holding the character of a trustee, or a character analogous to that of a trustee... and having a duty to act primarily for another’s *benefit* in matters connected with such undertaking.”27 A fiduciary’s duty includes utmost good faith, trust, confidence, and candor.28

Washington courts, like others, recognize the unique relationship between an escrow holder and his client-depositors. But, despite the unique nature of this relationship, the Supreme Court of Washington in *National Bank of Washington v. Equity Investors, Ltd.*, left no doubt about the escrow holder’s fiduciary duty to his client-depositors:

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28. Id. at 523.
Whether he be designated escrow agent or escrow holder, or both, makes little difference in law; the important thing is that as an agent, holder or trustee for the parties, he occupies a *fiduciary relationship* to all parties to the escrow... [he] owes a *fiduciary duty* to his principals in the same way that all agents are held to such standards.  

Thus, whether acting as an agent or a trustee, an escrow holder owes a fiduciary duty to his client-depositors. A comparison of the duty of loyalty owed by agents and trustees as fiduciaries as contained in the Restatement (Second) reveals the versatility of the concept of fiduciary duty. Under the Restatement (Second) of Agency, the duty of loyalty owed by an agent to his principal includes a duty to account for profits arising out of his employment. Under the Restatement (Second) on Trusts, the duty of loyalty owed by a trustee to a beneficiary includes "a duty not to profit at the expense of the beneficiary and not to enter into competition with him without his consent, unless authorized to do so by the terms of the trust or by a proper court." In either case, absent sufficient consent, a fiduciary is generally not at liberty to profit at the expense of those to whom he owes a fiduciary duty. 

As a fiduciary, it follows that an escrow holder holds a client-depositor's property—funds—in a capacity analogous to that of a trustee. As such, the title to the funds, just like the corresponding property interest, is bifurcated. Legal title to the property—one that carries no beneficial interest—rests with the fiduciary, in this case the escrow holder. Equitable title—and with it the beneficial interest in the funds—remains with the client-depositor as beneficiary. Thus, in his capacity as a fiduciary, an escrow holder has no property interest per se in the beneficial use of funds deposited in escrow by a client-depositor. 

In addition to his fiduciary duty, an escrow holder must strictly comply with the provisions of the escrow agreement, and is liable for damages proximately resulting from his breach of these provisions, or from exceeding the authority conferred on him by the instructions.

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30. *RESTATEMENT (SECOND) ON AGENCY* § 388 (1958). "Unless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profit to the principal."
Certain client-depositors may opt to assign or bargain away their beneficial interest to an escrow holder, perhaps in exchange for a reduction in escrow fees. To what extent can a client-depositor make such an assignment? Answering this question requires an examination of the definition of beneficial interest:

Profit, benefit, or advantage resulting from a contract, or the ownership of an estate as distinct from the legal ownership or control ... [I]n trust law, refers to interest of the beneficiary in right to income or principle of trust funds, in contrast to trustee who holds legal title.34

Yet another aspect of the definition of a fiduciary closes the loop:

A relation [in which] ... neither party may deal with the subject-matter of the trust in such a way as to benefit himself or prejudice the other except in the exercise of the utmost good faith and with the full knowledge and consent of that other.35

These definitions suggest that a client-depositor may assign his beneficial interest in funds placed in escrow provided he does so with full knowledge and consent. The escrow holder, in his capacity as a fiduciary, may in turn make good faith, beneficial use of the client-depositor's funds to generate the earnings credits, more commonly referred to as interest income discussed supra.

What exactly gives rise to "full knowledge and consent"? To state it more precisely, what establishes the consent necessary for an escrow holder in his capacity as a fiduciary to make beneficial use of a client-depositor's funds? For the answer to this query we turn to the next section of this Comment.

E. Basis for an Escrow Holder's Beneficial Use of a Client-Depositor's Funds

The law's insistence on full knowledge and consent as the basis for an escrow holder's beneficial use of his client-depositor's funds reflects its long-standing presumption against transactions between a trustee and his beneficiary.36 As such, courts regard with suspicion direct dealings between a trustee and beneficiary.37 Such dealing can, however, survive this scrutiny by a showing that the beneficiary

34. BLACK'S LAW DICTIONARY 156 (6th ed. 1990) (emphasis added).
35. Id. at 626 (emphasis added).
undertook it with full knowledge of the facts of the case and of his legal rights.\textsuperscript{38}

Although little is written about the precise meaning of consent in this context, one need not go far to find the meaning of consent for breaches of trust in general. Consent is actually one of a trinity of long-recognized exceptions to the liability of a trustee for breaches of trust, the others being affirmation and release.\textsuperscript{39} For purposes of this Comment, our concern is with consent, as it is the exception typically used by escrow holders as the basis for beneficial use of a client-depositor's funds. And although the consent exception generally contemplates breaches of trust arising subsequent to the formation of the trust, it appears sufficiently pliable to immunize dealings between a client-depositor and escrow holder contemplated at the outset of an escrow transaction.

The Restatement (Second) of Trusts § 216(1) sets forth the parameters for employing consent in a trust setting: "[A] beneficiary cannot hold the trustee liable for an act or omission of the trustee as a breach of trust if the beneficiary prior to or at the time of the act or omission consented to it."\textsuperscript{40}

But while the Restatement (Second) of Trusts § 216 is long on carving out the consent exception, it does not actually define "consent." Although Washington courts have yet to address this issue, a Colorado court provides a list of factors to consider in evaluating a beneficiary's consent to deviations from the trust:

1) the beneficiary's education and business experience; 2) the beneficiary's input in negotiating the terms of the allegedly improper investment; 3) the clarity of the consent language; 4) the amount of time the beneficiary had for deliberation before signing the consent; 5) whether the beneficiary read the consent and considered its terms before signing it; 6) whether the beneficiary knew his or her rights under the trust and the relevant facts when the consent was signed; 7) whether the beneficiary was given an opportunity to consult with advisors or an attorney before signing the consent; 8) whether the beneficiary's consent was induced by improper conduct on the trustee's part.\textsuperscript{41}

The concept of consent within Restatement (Second) of Trusts § 216 is qualified, however, by a beneficiary's right to have knowledge of material facts which the trustee knew or should have known. This

\textsuperscript{38} Id.

\textsuperscript{39} David B. Zoob, Exceptions to the Liability of Trustees, 83 U. PA. L. REV. 726 (1935).

\textsuperscript{40} RESTATEMENT (SECOND) OF TRUSTS § 216(1).

right seems analogous to the "full knowledge" component of the full knowledge and consent required before an escrow holder may make beneficial use of a client-depositor's funds. What are material facts? For that matter, what is full knowledge? While a trustee need not advise a beneficiary of all the details of a transaction, the beneficiary should be sufficiently informed of all facts which would aid him in protecting his interest, such that the beneficiary understands the character of the transaction and is on equal footing with the trustee as fiduciary. Going a step further, a beneficiary should also arguably be informed of any dealings by the trustee as a fiduciary with himself or his affiliates or subsidiaries.

Thus, in the context of establishing the basis for an escrow holder's beneficial use of a client-depositor's funds, full knowledge and consent requires that the escrow holder inform the client-depositor of all facts which would aid the client in either protecting his interest or understanding the transaction, such that the client-depositor stands on equal footing with the escrow holder. This must be done in a fashion that allows the client-depositor to have input as to the terms of the consent, including sufficient time to deliberate them, and, if necessary, seek independent counsel. Finally, the consent language must be sufficiently clear, so that the client-depositor understands that he is manifesting his consent.

As we will see in Part III of this Comment, the escrow industry's language for a client-depositor's consent to an escrow holder's beneficial use of his funds arguably falls well short of this standard.

III. THE REGULATION OF ESCROW HOLDERS UNDER WASHINGTON'S ESCROW AGENT REGISTRATION ACT

In addition to the common law duties that escrow holders, including those practicing as limited practice officers, owe client-depositors as both agents and trustees, holders also owe duties under the Washington Escrow Agent Registration Act and related provisions of the Washington Administrative Code. Enacted in 1965 to protect the public and the clients of the escrow agents and officers,

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43. RESTATEMENT (SECOND) OF TRUSTS § 216 cmt. k.
44. RESTATEMENT (SECOND) OF CONTRACTS § 173 cmt. a.
45. See WASH. REV. CODE § 11.100.090 (1998) (prohibiting certain transactions by a fiduciary with an affiliate or subsidiary company, except when expressly provided for in the trust).
48. Id. at 498, 844 P.2d at 409.
the Act regulates the activities of most escrow holders conducting business in the state of Washington. The Act is administered by the Department of Financial Institutions.49

The Act distinguishes between escrow agents and escrow officers: an escrow agent encompasses any sole proprietorship, firm, association, partnership, or corporation engaged in the business of performing the duties of an escrow,50 whereas an escrow officer is any natural person handling escrow transactions on behalf of an escrow agent.51 While an escrow agent must be registered,52 an escrow officer must be licensed.53

With limited exceptions, all escrow agents must possess a valid certificate of registration as issued by the Director of Financial Institutions.54 An application for registration as an escrow agent is filed with the Director, and it must include the applicant’s business form and place of organization, credit history, proof of "honesty, veracity, and good reputation," disclosure of certain criminal convictions and civil judgments, and designated supervising escrow officers.55 At the time of filing, the applicant must furnish proof of a fidelity bond and an errors and omissions policy providing coverage of $200,00056 and $50,000,57 respectively as evidence of financial responsibility.58 The Act also requires escrow agents to keep adequate records, and to keep all funds held by the agent pending closing of the transaction in a separate escrow fund account, segregated from the agent’s own funds.59 While nothing in the Act prevents an escrow holder from pooling the funds of client-depositors, he must maintain a separate ledger sheet for each escrow transaction.60 Proof of registration as an

49. Id. § 18.44.010(2) (1998).
50. Id. § 18.44.010(U)(7).
51. Id. § 18.44.010(7).
52. Id. § 18.44.020 (1977).
53. Id. § 18.44.290 (1995).
54. Id. § 18.44.020.
55. Id. § 18.44.040 (1977).
56. Id. § 18.44.050(1) (1979).
57. Id. § 18.44.050(2).
58. Arguably, the required coverage under both the fidelity bond and errors and omissions policy is woefully inadequate given the cost of residential real property—the sale of which is the most common transaction handled by escrow holders. As of January 1999, the median price of a single family residence offered for sale in King County, the most populous county in the State of Washington, was $279,000. Thus, damages arising from an escrow holder’s misappropriation of funds for a single transaction could conceivably exceed the combined limits of coverage under the fidelity bond and errors and omissions policy. Steven Wayne, Editorial, Easing the Urban Housing Crunch, SEATTLE TIMES, Jan. 10, 1999.
59. WASH. REV. CODE § 18.44.070 (1968).
escrow agent is required in order to bring an action in a Washington court to collect an escrow fee.61

Every escrow agent engaged in escrow transactions must be supervised by a licensed escrow officer.62 Licensure requirements for an escrow officer include passing the escrow officer examination—which tests language, arithmetic, principles and forms of real estate conveyancing, obligations between principals and agents, and real property encumbrances—and submitting an application, including proof of honesty, truthfulness, and good reputation.63

Enforcement of the Act is the responsibility of the attorney general and prosecuting attorneys,64 either of whom may seek a restraining order or injunction to enjoin any person conducting business as an escrow agent without the necessary certificate of registration, or any certificated escrow agent from conducting business in an inappropriate manner or in violation of the Act.65

The Director of Financial Institutions has the overall responsibility of issuing and enforcing rules and regulations pertaining to the registration of escrow agents and licensing of escrow officers. He may order the denial, suspension, or revocation of a certificate of registration or license of any escrow agent or escrow officer if he finds that the applicant or agent/officer was found guilty of any one of a series of acts or omissions, including the conversion of funds "... delivered to him in trust or on condition,"66 or "[a]ccepting, taking, or charging any undisclosed commission, rebate or direct profit on expenditures made for the principal."67

The Director also has broad investigatory powers: subject to the Washington Administrative Procedures Act,68 he may conduct investigations69 of reported violations of the Act, and may subpoena witnesses, take evidence, and require the production of any relevant matter.70 Upon a written finding of fact that the Act has been or is about to be violated, the Director may issue a cease and desist order.

In addition to being subject to the Act, these same escrow holders are also subject to certain rules and regulations promulgated in the

62. Id. § 18.44.200.
63. Id. § 18.44.290.
64. Id. § 18.44.150.
65. Id. § 18.44.160.
66. Id. § 18.44.260(5).
67. Id. § 18.44.260(8).
68. Id. § 18.44.270.
69. Id. § 18.44.260.
70. Id. § 18.44.280.
Washington Administrative Code. Chapter 208-680E, Escrow-Trust Account Procedures, is particularly relevant, as it governs the administration of funds held by escrow holders. As a general proposition, the regulations require escrow holders, other than limited practice officers, to deposit funds received from any client-depositor into a noninterest bearing demand trust account in a recognized Washington state depository.

A notable exception to this requirement is a provision whereby escrow holders other than limited practice officers may place funds in an interest-bearing account "if directed by written agreement signed by the principals to the transaction and specifying the manner of distribution of accumulated interest to the parties to the transaction."

To what extent does compliance with these provisions of the Washington Administrative Code comport with an escrow holder's common law duties to act as a fiduciary and to follow instructions? If an escrow holder places the funds in an interest-bearing account as prescribed by § 208-680E-011(1)(a), then as long as he distributes the interest in compliance with the client-depositors' written instructions, he will fulfill his fiduciary duty to refrain from profiting from the use of the client-depositors' property absent their consent, as well as his duty under Styrk to strictly comply with the escrow instructions.

The regulations also permit an escrow holder not practicing as a limited practice officer to make limited beneficial use of a client-depositors' funds. As allowed under § 208-680E-011(1), these escrow holders may deposit a client-depositor's funds into a noninterest bearing demand deposit account to generate earnings credits for the benefit of the escrow holder.

The regulation does not specifically require the escrow holder to obtain the client-depositor's full knowledge and consent before making beneficial use of his funds. Arguably, an escrow holder can make limited beneficial use of a client-depositor's funds in compliance with § 208-680E-011(1) yet fail to meet his fiduciary duty to obtain the client-depositor's full knowledge and consent.

Perhaps even more troubling is the manner in which an escrow holder typically obtains such consent. In those transactions where an escrow holder intends to use the client-depositor's funds to generate

71. Wash. Admin. Code §§ 208-680 A-F (1999). Under these rules and regulations, in order to be licensed as an escrow holder, an applicant must take an examination, submit to a credit and character check, and pay certain fees. Once licensed, an escrow holder must maintain accurate records, act expeditiously, disburse funds in a timely fashion, comply with a series of trust account procedures, and maintain a fidelity bond and errors and omissions policy.
72. Id. § 208-680E-011(1).
73. Id. §§ 208-680E-011(1)(a)-(b).
earnings credits, the escrow holder will generally include within the escrow instructions a generic disclosure to the following effect:

All money received by ESCROW AGENT in this escrow is to be deposited in escrow bank accounts controlled by ESCROW AGENT pending closing. ESCROW AGENT receives banking benefits from non-interest bearing trust account deposits. These benefits may be in the form of but not limited to miscellaneous banking, accounting and computer support services. If an interest bearing account is to be established, ESCROW AGENT must be so advised in writing, prior to the deposit of funds, and furnished with a Federal Tax Identification Number.74

The issue here is whether such a disclosure is sufficient to give rise to the "full knowledge and consent" necessary for an escrow holder in his capacity as a fiduciary to make beneficial use of a client-depositor’s funds.

A 1978 decision by the Supreme Court of Oregon suggests that it is. In Derenco v. Benj. Franklin Federal Savings and Loan Association,75 borrowers brought suit against a savings and loan association to obtain an accounting of profits on funds in reserve accounts established to pay taxes and insurance premiums on mortgaged residences. The court concluded that a provision in a conventional mortgage that the funds in the reserve account would be noninterest bearing was the equivalent of an agreement that the reserves would not be the source of any income to the borrower.76 Included within the court’s rationale was the notion that not only was the issue not raised by the borrowers, who agreed that they would not receive any income from the use of the funds, but that the issue was specifically raised by the lender.77

Following Derenco's reasoning, disclosure within an escrow agreement to the effect that the funds will be placed in a noninterest bearing account, let alone that they will be used by the escrow holder to earn banking privileges, is sufficient to establish the consent necessary for the escrow holder to make limited, beneficial use of the funds from the standpoint of one court.

But an important factual distinction in Derenco indicates that the court stopped short of endorsing it as the standard for full knowledge and consent. Derenco involved an arms length transaction between a

75. 577 P.2d 477 (Or. 1978).
76. Id. at 493.
77. See id.
bank as creditor and its customer, the mortgagor, as debtor. As such, the bank had no duty to act in the best interest of the customer. Compare this relationship with the fiduciary relationship between an escrow holder and a client-depositor, a relationship characterized by trust, confidence, candor, and not a whiff of hard bargaining. This distinction leads to the conclusion that Derenco-style disclosures are inadequate for the fiduciary relationship between an escrow holder and his client-depositor.

We must instead compare the escrow industry’s generic disclosure to that required for full knowledge and consent as set forth in Part II. As the reader may recall, this standard requires the escrow holder to use clear language to inform the client-depositor of all facts which would aid him in either protecting his interest or understanding the transaction, while allowing the client-depositor sufficient time to deliberate the terms of the consent, in order that the client-depositor be on equal footing with the escrow holder.  

The generic disclosure does mention the fact that the deposits will be noninterest bearing. But in a style reminiscent of a negative pregnant, the disclosure fails to mention that the deposits are noninterest bearing to the client-depositor. Nor does it mention that the deposits generate earnings credits, calculated in a fashion similar to that of interest, for the escrow holder. The disclosure also makes no mention of the intermediary role played by the escrow holder’s sister corporation as the provider of accounting and reconciliation services, for which it receives a fee. Finally, the disclosure makes no mention of the fact that the client-depositor is indeed consenting to a transaction that would otherwise give rise to a breach of trust. Given these omissions, the client-depositor is unaware of the nature of the transaction such that he is not on equal footing with the escrow holder. As such, this disclosure falls short of that necessary to establish full knowledge and consent.

What emerges from the overlay of the statutory and regulatory scheme of the Escrow Agent Registration Act on the escrow holder’s common law duties is that an escrow holder has no per se property interest in the beneficial use of a client-depositors’ funds; such property interests are retained by the client-depositor. What property interest the escrow holder does have—namely, to make beneficial use of a client-depositor’s funds deposited into a noninterest bearing

78. See supra Part II.

79. Often introduced in the first year of law school, this term is defined as “a denial implying its affirmative opposite by seeming to deny only a qualification of the allegation itself…” BLACK’S LAW DICTIONARY 1032 (6th ed. 1990).
account—requires, at least under the common law, full knowledge and consent on the part of the client-depositor. Without it, an escrow holder who makes beneficial use of a client-depositor's funds under the complex arrangement permitted under § 208-680E-011(1) has arguably breached both his common-law fiduciary duty to his client-depositor and a statutory duty to refrain from "[a]ccepting, taking, or charging any undisclosed commission, rebate, or direct profit on expenditures made for the principal."  

The administration of funds held in escrow by limited practice officers, however, is subject to an entirely different provision of the Washington Administrative Code, namely § 208-680E-011(1)(c). This provision in turn subjects limited practice officers to Admission to Practice Rule 12.1, a modified version of the Interest on Lawyer Trust Accounts (IOLTA). Beginning with the history of the development of the limited practice officer, the next section of this Comment discusses the impact of these regulations on the administration of funds held by limited practice officers.

IV. LIMITED PRACTICE OFFICERS AND ADMISSION TO PRACTICE RULE 12

The application of IOLTA rules to escrow accounts administered by limited practice officers is actually the culmination of a series of judicial, statutory, and regulatory developments that flow from the premise that only those admitted to the state bar may practice law. In Washington State Bar Association v. Great Western Union Federal Savings and Loan Association, the court held that a lender's selection and preparation of deeds, mortgages, deeds of trust, and promissory notes constituted the unauthorized practice of law. In response to Great Western and in order to provide for a more economical alternative for the preparation of routine legal documents required in real estate transactions, in 1979 the Washington legislature enacted section 19.62 of the Revised Code of Washington. This statute authorized banks, escrow holders, title insurance companies and others

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82. WASH. ADMISSION TO PRACTICE RULE 12.1 - Preserving Identity of Funds and Property in Transactions Closed by Limited Practice Officers (West 2000).
typically engaged in the closing of real estate transactions to select and prepare a series of legal documents commonly associated with real estate closings.

In 1981 the tide turned against escrow holders and other authorized laypersons engaged in the preparation of these routine legal documents when the constitutionality of section 19.62 of the Revised Code of Washington was challenged in *Bennion, Van Camp, Hagen & Ruhl v. Kassler Escrow, Inc.* In *Bennion*, a law firm attempted to enjoin an escrow holder from preparing legal documents pursuant to the closing of a real estate transaction. In deciding *Bennion* shortly after the passage of section 19.62 the court held that the legislature’s enactment of section 19.62 constituted an encroachment on the judiciary’s exclusive right to regulate the practice of law, and declared the statute unconstitutional.

To mitigate the demise of section 19.62, in 1981 the Washington State Bar Association recommended and the Supreme Court of Washington adopted Admission to Practice Rule 12, Limited Practice Rule for Closing Officers. Admission to Practice Rule 12 “authorize[s] certain lay persons to select, prepare and complete legal documents incident to the closing of real estate . . . transactions.”

The IOLTA provisions governing a limited practice officer’s administration of funds are relatively straightforward. All funds received by limited practice officers “shall be deposited into one or more identifiable interest-bearing trust accounts . . .” Funds “nominal in amount or expected to be held for a short period of time . . . must be deposited into a pooled interest-bearing checking account,” with the interest—net of reasonable bank charges—paid to the Legal Foundation of Washington. Otherwise, the funds must be deposited in a separate interest-bearing trust account, with the interest distributed to the parties to the transaction as provided for in the agreement.

Regrettably, Admission to Practice Rule 12(c) does not set forth a definition of either “nominal” or “short period of time.” Instead, the limited practice officer must determine the type of account into which

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88. Id. at 453 35 P.2d at 736.
89. William H. Reetz, Gretchen L. Valentine, *Duties and Responsibilities of the Escrow Agent*, 3 WASHINGTON REAL PROPERTY DESKBOOK, Sec. 3.1 at 3-1, Sec. 3.4(2) at 3-30 (Edward W. Kuhrau et al. eds., 3d ed. 1997).
90. WASH. ADMISSION TO PRACTICE RULE (APR) 12(a)—Limited Practice Rule for Closing Officers (West 2000).
91. WASH. APR 12.1(b).
92. WASH. APR 12.1(c)(1).
93. WASH. APR 12.1(c)(2).
the funds should be deposited. In making this determination, the limited practice officer "shall consider only whether the funds to be invested could be utilized to provide a positive net return to the client. . . ." 94

How does this regulation comport with the provisions governing administration of funds by escrow holders not practicing as limited practice officers? Under Admission to Practice Rule 12.1(c)(1), a client-depositor cannot contract to allow the limited practice officer to deposit the client-depositor’s funds into a noninterest bearing account to generate earning credits which make their way back to the officers of the corporate escrow holder via a sister corporation, ostensibly in exchange for lower escrow fees for the client-depositor. To this extent, the client-depositor cannot bargain away an element of his beneficial interest. Additionally, in those situations where the funds are either nominal in amount or will be held for only a short period of time, a client-depositor is prohibited from earning interest on the funds. Instead, to the extent the funds can be used to generate a beneficial interest, the Supreme Court of Washington requires that the interest be paid to the Legal Foundation of Washington.

To what extent does either of these provisions rise to the level of an unconstitutional taking of property? Although the United States District Court in Legal Foundation of Washington concluded that these same provisions were not unconstitutional, as discussed in the next section of this paper, the subsequent U.S. Supreme Court decision in Phillips suggests a different conclusion.

V. A "TAKINGS" ANALYSIS OF ADMISSION TO PRACTICE RULE 12

Before proceeding to the takings analysis, a more precise statement of the issue is in order: Whether the requirement under Admission to Practice Rule 12.1(c)(1) that a client-depositor’s funds that are either nominal in amount or will be held for only a short period of time be deposited into interest-bearing accounts, with the interest distributed to the Washington Legal Foundation, operates as an unconstitutional taking of the client-depositor’s beneficial interest, including

94. WASH. APR 12.1(c)(3). As real estate transactions typically involve substantial sums of money, seemingly the application of APR 12(c)(3) would always lead to the conclusion that funds held by a limited practice officer can yield a net positive return. Even an earnest money deposit of 5% of the purchase price is hardly nominal. Given the thirty to ninety days that it takes to typically close even the simplest real estate transaction, it is hard to imagine circumstances in which earnest money deposited with a limited practice officer could not earn a net positive return. The same is true for the balance of the purchase price. While the limited practice officer might hold these funds for only a brief period of time, a few hours or perhaps overnight, the magnitude of the sum, often hundreds of thousands of dollars, is seemingly sufficient to earn a net positive return for the client depositor.
his right to assign his beneficial interest to a limited practice officer, who uses such beneficial interest to generate earnings credits.

A very similar issue was litigated in Legal Foundation of Washington.95 In Legal Foundation of Washington, the court held that first, an escrow client-depositor had no property interest in the IOLTA program interest,96 and that second, limited practice officers had no ownership interest in the earnings credits created by the escrow client-depositors' funds.97 In reaching its first holding, the court relied on an Eleventh Circuit decision in Cone v. State Bar of Florida98 while rejecting a Fifth Circuit decision to the contrary in Washington Legal Foundation v. Texas Equal Access to Justice Foundation.99

However, in its recent five-to-four decision in Phillips affirming Texas Equal Access, the United States Supreme Court rejected the Eleventh Circuit's conclusion in Cone, instead holding that interest income in IOLTA accounts is the "private property of the owner of the principal."100 As such, the Supreme Court effectively undercut the District Court's first holding in Legal Foundation of Washington. Furthermore, the District Court's second holding is suspect in that it fails to take into account the ability of a principal to assign elements of his beneficial interest. As such, the District Court's conclusions in Legal Foundation of Washington as to the takings claims raised by the IOLTA provisions of Admission to Practice Rule 12.1(c)(1) are ripe for reexamination.

A second look at the takings claims under Admission to Practice Rule 12.1(c)(1) begins with the source of law. Under the federal constitution, the takings clause in the Fifth Amendment provides that "[n]o person shall . . . be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."101 The Fifth Amendment was made applicable to the states through the Fourteenth Amendment in 1897.102 The basic purpose of the Takings Clause is to "bar Govern-

96. Id.
97. Id.
98. 819 F.2d 1002 (11th Cir. 1987) (holding that client-depositors do not have a property interest in the IOLTA interest).
99. 94 F.3d 996 (5th Cir. 1996) (rejecting the premise that clients do not have a valid property interest in the interest proceeds earned in funds in IOLTA account), aff'd sub nom., Phillips v. Washington Legal Found., 524 U.S. 156 (1998).
101. U.S. CONST. amend. V.
ment from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole.\textsuperscript{103}

A takings claim entails three distinct questions; namely, "whether the interest asserted by the plaintiff is property, whether the government has taken that property, and whether the plaintiff has been denied just compensation for the taking."\textsuperscript{104}

A. Client-Depositor's Beneficial Interest as Property

In addressing the first element of a takings claim, the broader issue of an unconstitutional taking under Admission to Practice Rule 12.1(c)(1) can be stated more narrowly: Does a client-depositor's beneficial interest in funds nominal in amount or expected to be held for a short period of time—including the right to assign such interest to a limited practice officer for purposes of generating earnings credits—constitute property for purposes of a taking under the Fifth Amendment?

In \textit{Phillips}, the U.S. Supreme Court seems to have squarely answered this question in the affirmative, holding that "interest income generated by funds in IOLTA accounts is the 'private property' of the owner of the principal."\textsuperscript{105} \textit{Phillips} is somewhat distinguishable from the \textit{Legal Foundation of Washington} in that it was brought on behalf of the client-depositor of a Texas lawyer rather than a Washington limited practice officer. However, the distinction makes little difference, because the IOLTA rules litigated in \textit{Phillips} use language that is strikingly similar to that litigated in \textit{Legal Foundation of Washington} and embodied in Admission to Practice Rule 12.1(c)(1).\textsuperscript{106}

In reaching its decision, the \textit{Phillips} court first looked at Texas law to determine the ownership of the underlying principal. In doing so it determined that under the Texas IOLTA rules, the principal belonged to the client.\textsuperscript{107} Applying the general rule that the ownership

\begin{itemize}
\item \textsuperscript{103} Armstrong v. United States, 364 U.S. 40, 49 (1960).
\item \textsuperscript{104} \textit{Phillips}, 524 U.S. at 172 (Souter, J., dissenting).
\item \textsuperscript{105} \textit{Id.} at 197.
\item \textsuperscript{106} Washington's Admission to Practice Rule 12.1(c)(1) encompasses only those "funds that are nominal in amount or expected to be held for a short period of time." See WASH. APR 12.1(c)(1) (West 2000). Compare this to the similar scope of the Texas IOLTA program, which includes "client funds that are 'nominal in amount' or 'reasonably expected to be held for a short period of time'." Washington Legal Found. v. Texas Equal Access to Justice Found., 873 F. Supp. 1, 4 (W.D. Tex. 1995), rev'd, 94 F.3d 996 (5th Cir. 1996), aff'd sub nom. Phillips v. Washington Legal Found., 524 U.S. 156 (1998) (quoting Rule 6 of [Texas] State Bar Rules Governing Operation of Equal Access to Justice Program).
\item \textsuperscript{107} \textit{Phillips}, 524 U.S. at 164.
\end{itemize}
of "interest follows principal,"\textsuperscript{108} the court ruled in favor of the respondent, the Washington Legal Foundation, and concluded that the interest earned on a client's funds in an IOLTA account belongs to the client.

The majority in \textit{Phillips} rejected the petitioner's argument that a client's funds, absent the pooling of funds available through an IOLTA account, "cannot reasonably be expected to generate interest income on their own."\textsuperscript{109} The majority went even further and acknowledged its "recognition that property is more than economic value,"\textsuperscript{110} and that it consists of "the group of rights which the so-called owner exercises in his dominion of the physical thing [such] as the right to possess, use, and dispose of it."\textsuperscript{111}

While the majority opinion in \textit{Phillips} offers a simple, clear, and, in the case of this paper, useful rule, it is not without its detractors. In his dissent, Justice Souter chastised the majority for "addressing only the issue of the property interest" and "leaving the questions of taking and compensation for a later day."\textsuperscript{112} In a separate dissent, Justice Breyer pointed out that the principal in the case of IOLTA accounts "otherwise is barren,"\textsuperscript{113} and that the "value of what is taken is bounded by that which is 'lost' not that which the taker gained."\textsuperscript{114}

Following the rule of \textit{Phillips}, to the extent a client-depositor's funds are used to earn interest, such interest is clearly the property of the client-depositor. This result is consistent with both the definition of beneficial interest as retained by the client-depositor, including the "right to income or principle of trust funds,"\textsuperscript{115} and the duties imposed upon a limited practice officer in his capacity as a fiduciary.\textsuperscript{116}

Furthermore, although the \textit{Phillips} court did not directly address the issue, its broad definition of property—"the group of rights which the so-called owner exercises in his dominion of the physical thing as the right to possess, use, and dispose of it”—would seemingly encompass a client-depositor's assignment of his beneficial interest to

\begin{footnotesize}
\begin{enumerate}
\item[108.] \textit{Id.} at 167.
\item[109.] \textit{Id.}
\item[112.] \textit{Phillips}, 524 U.S. at 173 (Souter, J., dissenting).
\item[113.] \textit{Id.} at 182 (Breyer, J., dissenting).
\item[114.] Boston Chamber of Commerce v. Boston, 217 U.S. 189, 195 (1910) (quoted in \textit{Phillips}, 524 U.S. at 182 (Breyer, J., dissenting)).
\item[115.] \textit{See} discussion supra Part II.D.
\item[116.] \textit{See} discussion supra Part II.D.
\item[117.] \textit{Phillips}, 524 U.S. at 170 (quoting United States v. General Motors, 323 U.S. 373, 378 (1945)).
\end{enumerate}
\end{footnotesize}
a limited practice officer to earn banking privileges. Ironlly, such an assertion is not inconsistent with Justice Breyer’s dissent, in which he points out that the “value of what is taken is bounded by that which is ‘lost’ not that which the taker gained.” What is lost in this case is the client-depositor’s ability to assign his beneficial interest to a limited practice officer who in turn may convert it into earnings credits. Although the government does not directly take these earnings credits from either the limited practice officer or the client-depositor, the ability of either to realize this form of property is essentially lost. Thus, both the majority and Justice Breyer’s dissent seem to suggest that the beneficial interest assigned by the client-depositors to limited practice officers for purposes of generating earnings credits is indeed a form of property.

Assume for a moment that the petitioner’s argument in Phillips that the client-depositor’s funds held in an IOLTA account “cannot reasonably be expected to generate interest income on their own” were upheld, and the interest earned thereon was not property for purposes of a taking. Is it still valid to conclude that a client-depositor’s assignment of his “barren” beneficial interest in such funds to a limited practice officer is a form of property? Arguably it is, and with help from the logic implicit in the petitioner’s argument. The premise of the petitioner’s argument is that without the intervention of a third party, in this case the government in its requirement for a pooling of funds, the client-depositors’ funds are incapable of generating a return. As such, the party that makes possible the pooling and the attendant return should be able to direct the use of the return. Under the rationale of Phillips, such a party would be the government by virtue of its IOLTA regulations.

But the government is not alone in its ability to generate returns from pooled funds, funds that on their own would not generate a return. Escrow holders not licensed as limited practice officers do the same thing by pooling client-depositor funds in noninterest bearing accounts, which in turn generate earnings credits. Instead of distributing the return to a third party having nothing at stake in the underlying transaction, the escrow holders retain the earnings credits and arguably can offer their client-depositors lower escrow fees, resulting in increased economic efficiency.

In light of the holding in Phillips that interest income generated by funds in IOLTA accounts is the “private property” of the owner of the principal, it follows that a client-depositor’s beneficial interest in

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118. Phillips, 524 U.S. at 182 (Breyer, J., dissenting) (quoting Boston Chamber of Commerce v. Boston, 217 U.S. 189, 195 (1910)).
funds nominal in amount or expected to be held for a short period of
time, including the right to assign such interest to a limited practice
officer for purposes of generating earnings credits, constitutes property
for purposes of a taking under the Fifth Amendment. In light of this
holding, the holdings of the district court in Legal Foundation of
Washington are in need of reexamination.

B. Operation of Admission to Practice Rule 12 as a Taking of Client-
Depositor's Beneficial Interest

The second element of a takings claim requires a showing that
the government has taken the property of a private party. Regulatory
takings—those short of physical ouster or direct appropriation—were
first addressed by the U.S. Supreme Court in 1922 in Pennsylvania
Coal Co. v. Mahon.119 In Mahon, Justice Holmes laid down the gen-
eral rule that "while property may be regulated to a certain extent, if a
regulation goes too far it will be recognized as a taking."

Generally speaking, regulatory takings are of two types: categori-
gorical or per se regulatory takings, and those requiring an ad hoc
inquiry.

Per se regulatory takings require no specific inquiry into the
public interest. They are generally characterized by regulations
resulting in either the permanent physical "invasion" of private prop-
erty under the government's direction,121 or the denial of all econo-
mically beneficial use of private property.122

Alternatively, a regulatory taking can be established through an
ad hoc inquiry. Such an inquiry must result in a determination that
the regulation either shifts a public burden onto private property own-
ers123—after taking into account "the economic impact of interference
with investment backed expectations"124—or fails to substantially
advance a legitimate state interest.125

Given this doctrinal backdrop, to what extent does Admission to
Practice Rule 12.1(c)(1) operate as a regulatory taking of a client-
depositor's beneficial interest in funds deposited with a limited prac-
tice officer? The most convenient starting point for this analysis is

119. 260 U.S. 393 (1922).
120. Id. at 415.
that a law requiring landlords to allow television cable companies to emplace cable facilities in
their apartment buildings constituted a taking).
with per se regulatory takings. As the property interest at stake in this case, the beneficial use of money, is intangible, it is not subject to permanent, physical invasion as required under Loretto. On this basis, there is no per se regulatory taking.

An arguably different result emerges under the economically beneficial use rule of Lucas. The issue here is whether a client-depositor is denied the economically beneficial use of funds deposited in escrow. Because Admission to Practice Rule 12.1(c)(1) requires that such funds be placed in an interest-bearing trust account with the interest distributed to the Legal Foundation of Washington, the client-depositor is unable to direct the use of funds held in trust for him by a limited practice officer. He cannot use the funds to generate interest for his own account, nor can he consent to a limited practice officer’s use of the funds to generate earnings credits. Unable to control the beneficial use of his funds under the strictures of Admission to Practice Rule 12.1(c)(1), a client-depositor is unable to make any economically beneficial use of his property. It follows that under the rule of Lucas, Admission to Practice Rule 12.1(c)(1) acts as a per se regulatory taking.

Suppose instead that the regulatory takings analysis takes the route of an ad hoc inquiry. Further suppose that the eventual use of the funds by the Legal Foundation of Washington—the funding of legal services for the indigent—is indeed a public burden. After factoring in the investment expectations of client-depositors, namely that they can control the beneficial use of their funds as required under Penn Central, Admission to Practice Rule 12.1(c)(1) arguably shifts a public burden onto private parties and interferes with their investment expectations. Based on this ad hoc inquiry, Admission to Practice Rule 12.1(c)(1) again emerges as a regulatory taking.

A second way to establish a taking through an ad hoc inquiry is to show that a regulation or ordinance does not substantially advance a legitimate state interest.126 This standard of judicial review, referred to as minimal scrutiny, is the same standard used in the review of zoning ordinances, under which most takings claims originate. Substantially less rigorous than the standard of review for due process and equal protection claims, this standard reflects the judiciary’s deference to the legislature.

Analyzing Admission to Practice Rule 12.1(c)(1) under this standard is best done by breaking the standard into two components. First, what is a legitimate “government interest?” Second, what does it mean to “substantially advance” such an interest?

126. See id.
While the U.S. Supreme Court has not elaborated the standards for determining what constitutes a "legitimate state interest," a review of takings cases reveals a common theme. A zoning ordinance that did not promote "the health, safety, convenience, and general welfare of the inhabitants" led the Court to conclude that the ordinance lacked the necessary state interest. Alternatively, a zoning regulation imposing density restrictions in order to protect the community at large from the ill effects of urbanization was found to advance legitimate government goals. Thus, the protection or promotion of the health, safety, and general welfare of the community at large constitutes a legitimate state interest.

How far must this protection extend? Dicta in a case involving eminent domain suggests that at a minimum such protection must extend beyond a particular class of individuals. Thus, the protection afforded by the ordinance or regulation must reach those in the community at large, including those burdened by the regulation. A regulation that burdens one class and benefits another with no overlap will not pass muster.

How would Admission to Practice Rule 12.1(c)(1) fare under such scrutiny? This question conceivably turns on whether the funding of the Legal Foundation of Washington with funds generated by Admission to Practice Rule 12.1(c)(1) protects the health, safety, and general welfare of the community at large. To put it slightly differently, would the health, safety, and welfare of the community at large somehow suffer without Admission to Practice Rule 12.1(c)(1)? Arguably it would not. While a subset of the community at large—the beneficiaries of legal services funded by the Legal Foundation of Washington—would no longer enjoy the benefit of free or heavily subsidized legal services, the community at large would not be harmed. This subset of the community, like other members of the community, would have to pay for legal services. Furthermore, given that the benefits of Admission to Practice Rule 12.1(c)(1) extend to only a subset of the community without benefiting those burdened by the regulation—limited practice officers and their client-depositors—the overlap between these two constituencies as required under Agins does not exist. It follows that the protections afforded by Admission to Practice Rule 12.1(c)(1) do not benefit the community at large and therefore do not further a legitimate state interest.

129. Agins, 447 U.S. at 261.
131. Agins, 447 U.S. at 262.
What does “substantially advance” mean in the context of a “legitimate government interest”? Like “legitimate government interest,” “substantially advance” is a phrase in search of meaning. However, a 1987 U.S. Supreme Court decision provides some important guidance. In *Nollan v. California Coastal Commission*, the Court held that in order for a regulation to substantially advance a legitimate government interest, there must be a nexus or fit between a permit condition imposed on an applicant for a permit and the stated purposes of the regulation cited as the basis for the permit condition. Thus, a condition imposed pursuant to the issuance of a building permit requiring a property owner to provide public access across his property and parallel to the shoreline did not “fit” with the stated purpose of the regulation—to provide public access from the street to the shoreline—cited as the basis for the permit condition.

Admission to Practice Rule 12.1(c)(1) seems to lack this same nexus. While lawyers have struggled with the question of how to furnish legal services to those who cannot pay, who are providers of legal services, and who are in a position to help these individuals, neither escrow holders, including limited practice officers, nor their client-depositors were subject to such responsibility prior to the adoption of Admission to Practice Rule 12.1(c)(1). Furthermore, they are not in a position to directly provide any meaningful degree of legal aid. Thus, the connection or fit between funding of the Legal Foundation of Washington and the limits imposed on a client-depositors’ beneficial use of funds is attenuated at best. Under the Nollan standard, Admission to Practice Rule 12.1(c)(1) clearly does not “substantially advance” a legitimate state interest.

Lacking the necessary legitimate state interest and/or failing to substantially advance such an interest, Admission to Practice Rule 12.1(c)(1) fails to meet the standard set forth in *Agin* to avoid the finding of a taking after an ad hoc inquiry. Under this line of inquiry Admission to Practice Rule 12.1(c)(1) operates as a regulatory taking.

C. Client-Depositor’s Claim for Just Compensation for a Regulatory Taking of His Beneficial Interest

Having established that Admission to Practice Rule 12.1(c)(1) operates as a regulatory taking of a client-depositor’s property—namely, his beneficial interest in funds deposited in escrow with a limited practice officer—a successful takings claim turns on a deter-
mination that the client-depositor or his assignee is entitled to just compensation.

The source of law for just compensation is the Just Compensation Clause of the Fifth Amendment to the United States Constitution, which provides that “[n]o person shall . . . be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.”\(^{135}\) The Just Compensation Clause, like the larger Takings Clause, was “designed to bar government from forcing some people alone to bear public burdens which in all fairness and respect should be borne by the public as a whole.”\(^{136}\)

What exactly is just compensation? Although there is no single definition, it generally means the full monetary equivalent of the property taken,\(^ {137}\) the fair market value of property taken at the time of taking,\(^ {138}\) measured from the standpoint of what “the owner lost, not what the taker gained.”\(^ {139}\)

In most cases, just compensation is paid pursuant to an eminent domain proceeding brought by the government when it takes private property for a public purpose. Alternatively, when a private property owner alleges that the government has taken his property, either by regulatory action or impairment of value rather than by government agents physically taking possession of the property or judicial or legislative transfer of title of the property to the government,\(^ {140}\) he may receive just compensation pursuant to an action for inverse condemnation.

The type of just compensation pursuant to an inverse condemnation proceeding depends on how the government elects to proceed once a judicial determination has been made that a taking has occurred. If the government chooses to end its taking, whether it be by repealing the regulation or taking other action to restore the value of the private property, a court may order just compensation for only a temporary taking.\(^ {141}\)

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140. JOHN E. NOWAK & RONALD D. ROTUNDA, CONSTITUTIONAL LAW 468 (5th ed. 1995).
The right to just compensation extends to takings of intangible as well as tangible property, and to regulatory takings.

Would just compensation be due if Admission to Practice Rule 12.1(c)(1) is found to effect a taking? Under *Lucas*, the fact that Admission to Practice Rule 12.1(c)(1) operates as a regulatory taking certainly is not fatal to a claim for just compensation. Under *City of Cincinnati*, the taking of intangible property—a client-depositor's beneficial interest—does not stand in the way of just compensation. The fair market value of the client-depositor's beneficial interest, whether it is measured by the interest income foregone by the client-depositor or the earnings credits foregone by the limited practice officer, is readily ascertainable. There is no *de minimis* standard for just compensation to bar its payment; or as Justice Stevens so eloquently put it, "the Fifth Amendment draws no distinction between grand larceny and petty larceny." Given these factors, it seems that just compensation would be due if indeed Admission to Practice Rule 12.1(c)(1) is found to effect a taking.

Whether just compensation is awarded for a temporary or permanent taking turns on the actions of the Supreme Court of Washington subsequent to a determination that Admission to Practice Rule 12.1(c)(1) constitutes a taking and just compensation is due. If the supreme court chooses not to repeal Admission to Practice Rule 12.1(c)(1), then there would be a permanent taking, and just compensation must be paid accordingly. However, unless the Legal Foundation of Washington can successfully execute an arbitrage strategy by earning more interest on client-depositor funds subject to Admission to Practice Rule 12.1(c)(1) than it would have to pay in just compensation, the prudent course of action would be to repeal Admission to Practice Rule 12.1(c)(1) and pay just compensation for a temporary taking.

VI. CONCLUSION

A reexamination of the takings claim precipitated by Admission to Practice Rule 12.1(c)(1) in light of the U.S. Supreme Court's decision in *Phillips v. Washington Legal Foundation* suggests that such a claim would be successful. Interest earned on a client-depositor's funds "either nominal in amount or held for a short period of time" is

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142. See *City of Cincinnati v. Louisville & Nashville R.R. Co.*, 223 U.S. 390 (1912) (holding that power of eminent domain extends to tangibles and intangibles, including choses in action, contracts, and charters).


clearly a form of property; the client-depositor's inability to make beneficial use of his funds and the subsequent distribution of the interest earned thereon to the Legal Foundation of Washington constitutes a regulatory taking, both on a per se basis and after ad hoc inquiry. Finally, the taking of such property warrants just compensation.

As a limited practice officer has no per se property interest in the beneficial use of a client-depositor's funds, the establishment of a successful takings claim on his behalf turns on a showing of sufficient consent by the client-depositor to the limited practice officer's beneficial use of funds. While the basis for an escrow holder's assertion of consent—a simple disclosure in a contract that fails to reasonably advise the client-depositor of the choices available—has in the past done the trick, it is arguably too slender to support the level of informed consent required in a fiduciary relationship.

What now? Assuming a takings claim is successful, the IOLTA regulations as we know them under Admission to Practice Rule 12.1(c)(1) would be repealed. The new regulations, to the extent that they permit a limited practice officer to make beneficial use of a client-depositor's funds, must require meaningful informed consent on the part of the client-depositor. To the extent the regulations under section 208-680E-011(1) of the Washington Administrative Code governing the administration of funds by those escrow holders not practicing as limited practice officers similarly fail to establish sufficient informed consent, similar modifications are in order.

These regulations could take various forms. One possibility is that all escrow holders, including limited practice officers, would have to offer client-depositors a menu of choices as to how their funds will be administered. Such choices might include depositing funds into:

- a pooled, interest bearing account, with interest distributed to the client-depositor;
- a pooled, interest bearing account, with interest distributed to the Legal Foundation of Washington;
- a noninterest bearing account—from the standpoint of the client-depositor—upon which the escrow holder may earn banking privileges in the form of earnings credits, perhaps in exchange for a reduced escrow fee.

From this menu a client-depositor would then select the option that best suits his interests. Such a selection could be made after consultation with the escrow holder. No longer would client-depositors merely "sign and return" escrow instructions.
In that client-depositors would be required to make an election, they are more likely to consult with escrow holders at the front-end of the transaction. As such, some of the mystery surrounding the role of escrow holders would vanish. The client-depositor could make meaningful choices—and if he so chooses—can sufficiently manifest the informed consent necessary for an escrow holder to make beneficial use of funds in escrow. Finally, to the extent that the Legal Foundation of Washington can make a compelling case for its interests, it too will have a seat at the table.