

**NATIONAL LEGAL PROFESSIONAL REFORM**  
**RESPONSE TO TASKFORCE DISCUSSION PAPER ON FIDELITY COVER**

1. This response to the Taskforce's 11 December 2009 paper on Fidelity Cover has been approved by the following members of the Consultative Group:-

Tony Abbott – Lawyer, Law Society of South Australia

Barbara Bradshaw – CEO, Law Society, Northern Territory

Joe Catanzariti – President, Law Society of NSW

Harold Cottee – General Manager, Professional Standards, LIV

Noela L'Estrange – CEO, Queensland Law Society

Martyn Hagan – CEO, Law Society of Tasmania

Philip Selth – Executive Officer, NSW Bar Association

Dudley Stow – Immediate Past President, Law Society of Western Australia

**Context**

2. The Model Bill proposes that the purpose of fidelity cover is to establish and maintain a fund to provide a source of compensation for defaults by law practices arising from, or constituted by, the acts or omissions of associates.<sup>1</sup>
3. Most Australian jurisdictions have adopted the Model Bill provisions concerning fidelity cover.
4. Under the Model Bill a default requires dishonesty and may involve either trust money or trust property.<sup>2</sup> Trust property is defined<sup>3</sup> as property entrusted to a law practice in the course of or in connection with the provision of legal services by the practice but does not include trust money or money that involves financial services or investments.<sup>4</sup> It is important to note that the latter categories are specifically excluded from compensation and such exclusion should be maintained.
5. The Model Bill also provides an additional protection to clients and persons who entrust trust property to law practices – the external intervention process. A principal purpose of external intervention is the protection of the interests of clients, which includes trust money and their trust property. There is consequently a significant overlap between the fidelity fund claim process and the external intervention process, in particular, the operation of receiverships of law practices.

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<sup>1</sup> Section 3.6.1

<sup>2</sup> Section 3.6.2

<sup>3</sup> Section 1.2.1

<sup>4</sup> Section 3.3.3

6. The majority of claims on fidelity funds arise from defaults committed by associates of law practices to which a receiver or external intervener is subsequently appointed.
7. In Victoria for example, since the introduction of the Model Bill based legislation on 12 December 2005, records indicate that 89 claims have been submitted in respect of 43 law practices. Of these 89 claims, 65 arose from 18 law practices to which a receiver had been appointed. Notably, the incidence of non receivership related claims is very low and usually relates to law practices where non legal associates may have misappropriated trust money.
8. The administration of fidelity fund schemes is also closely related to the conduct of trust account investigations of law practices. It is not uncommon for such investigations to discover defaults by associates of law practices which then leads to external intervention.
9. Generally it is the receiver who is in a position to review the available documentation and ascertain the circumstances of particular defaults. In these instances, the receiver or external intervener frequently takes action to recover trust money or trust property on behalf of clients and is in a position to assist and provide evidence to the fidelity fund claim investigation.
10. Where these various functions are provided by the same entity, a natural synergy and efficiency results.
11. It should be acknowledged that the external intervention process under the Model Bill not only assists the recovery of misappropriated trust property but can also act as a powerful general deterrent. If Australian legal practitioners understand that any assets accumulated as a consequence of an act of default on their part would be the subject of recovery action they will be clearly be less likely to participate in that activity.

## **Taskforce Proposals**

### **Fidelity Cover: Where a claim could be made**

The Taskforce proposes to reduce compliance costs for multi-jurisdictional law practices by allowing each multi-jurisdictional practice to have a single trust account held in one of the jurisdictions in which the law practices operates.

12. There is general agreement that multi jurisdictional practices should be able to operate a single trust account and this proposal is addressed in the Taskforce discussion paper dealing with "Trust Money and Trust Accounting".
13. We agree with the Taskforce proposal that a fidelity fund claim should always be made against the home jurisdiction of the associate who defaulted.<sup>5</sup> However we note for the Taskforce's information

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<sup>5</sup> Paragraph 3 of page 3

that, if by "home jurisdiction" it is meant the principal place of practice of the relevant defaulting associate, then this is a separate issue to the operation of a single trust account by multi jurisdictional practices.

14. Clearly the possibility will arise and should be recognised that a default could take place in a jurisdiction that is not the "home jurisdiction" of the defaulting associate.

#### **Fidelity Cover: Administration of Funds**

15. Fidelity fund administration and claim investigation is proposed to be based upon the "home jurisdiction" of the defaulting associate regardless of the State or Territory that the law practice may have its trust account domiciled. This being so the existing Fidelity Fund levy and payment arrangements should continue in each State or Territory as is presently the case.
16. To ensure that no additional expense is incurred it is recommended to the Taskforce that the existing States and Territories fidelity fund administration arrangements be maintained.

#### **Fidelity Cover: Determination of Claims**

17. The discussion paper proposes that any actual or perceived conflict of interest be addressed by ensuring that claims against fidelity funds be determined at "*arms length from the profession and professional associations*".
18. It is important to distinguish between the process of **investigating** claims on the fund and the process of **determining** whether compensation should be paid.
19. The legislation provides that it is a pre-condition for any claim on the Fidelity fund for money or trust property to have been received **in the course of legal practice**.<sup>6</sup> It follows in our view that any fidelity claim investigation would be more efficiently undertaken and completed by organisations that are closely familiar and understand the actual practice of law and the day to day operation of law practices, in particular the handling of trust money and trust property. Certainly the professional associations satisfy that criteria.
20. As regards the process of **determining** whether compensation should be paid the discussion paper does not articulate the nature of the actual or perceived conflict of interest nor is any evidence provided in support of this contention.
21. More particularly the paper fails to recognise that in some jurisdictions lay persons do sit on fidelity fund claims committees and are actively involved in the determination of claims. It also fails to recognize the voluntarily given and very significant time and input of

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<sup>6</sup> Section 3.6.2

the legal profession in the administration of funds and in particular the determination of claims.

22. Regardless, the Taskforce suggest that possible mechanisms to address the conflict issue is:
- Have a majority of people governing the administration of the fund as being independents;
  - By having an "independent person" assess claims against the funds; or,
  - By having the National Legal Services Ombudsman (through its delegates) consider and determine a claim against the fidelity fund.
23. None of these options would of themselves make the claims process more efficient or cost effective. To the contrary, each option would be considerably more expensive and inefficient in terms of time, resourcing and quality of outcome.
24. Further, there is a fundamental failing to recognise that the fidelity fund claim investigation and determination process is essentially a fact finding exercise conducted by reference to the relevant law. It requires investigative and legal skills. To ask, for example, a majority of lay persons to determine whether a "default" has occurred requires them to conduct themselves as both judge and jury and to make a finding of dishonesty or otherwise on the part of a law practice associate. They are not equipped to do this and it is unacceptable at any level.
25. In our view, given the specificity of the Model Bill legislation dealing with the determination of claims and the appeals process it provides for disallowed claims, that the chance of any real conflict of interest occurring is minimal, and certainly does not justify the need for claims to be determined at "arms length from the profession and professional associations".

### **Proposed Regulatory Objectives**

26. The Taskforce proposes the following "overarching objective":

To ensure that consumers of legal services have a source of compensation for defaults by law practices arising from or constituted by acts or omissions of associates.
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27. It is our submission that as the definition of "default" in the Model Bill includes the words "arising from or constituted by acts or omissions of associates" that their repetition in the objective is unnecessary.

## Proposed Regulatory Principles

Principle 1: A person who suffers loss as a result of a default by a law practice is entitled to make a claim against the relevant fidelity fund<sup>7</sup> in accordance with the National Rules.

28. If by a "person" it is intended to cover consumers of legal services, namely clients of law practices, we agree.

Principle 2: A default<sup>8</sup> by a law practice is a failure of the practice to deliver trust money or trust property received in the course of legal practice, where the failure is due to a dishonest act or omission.

29. We agree. However there is a need to ensure consistency and that any reference to "practice" should be amended to read "law practice".

30. The time of default should be clarified. Is it when there is a "failure to deliver the trust money or trust property" or is it at the time of the "dishonest act or omission"?

Principle 3: Unless otherwise exempted, an Australian legal practitioner is to contribute to the fidelity fund in accordance with the National Rules.

31. There is support for the principle that all Australian legal practitioners should, unless exempted, contribute to the fidelity fund. However, the current State/Territory arrangements concerning the administration of the various Funds should remain. There is no justifiable reason to interfere with current arrangements

32. As disclosed in Attachment "A" to the Taskforce paper there is considerable disparity amongst the States and Territories in respect to the contributions made by Australian legal practitioners to the fidelity funds in their respective jurisdictions.

33. The underlying issue is the need to ensure there is real rigour built into the process of determining appropriate contribution rates. This process should be entirely transparent to the legal profession and broader community. It requires careful consideration of the incidence of claims; the different nature of practice in the various States and Territories; the extent to which those claims are excluded by the Model Bill provisions concerning investments, mortgages and financial services; and the actual number, nature and amount of claims paid out of the various fidelity funds over time.

34. Victoria<sup>9</sup>, where no compensation limit presently applies, provides valuable data concerning the management of fidelity funds as set out in the Table 1 below.

<sup>7</sup> The relevant fidelity fund would be defined in as outlined above.

<sup>8</sup> The Taskforce proposes to adopt the Model Bill definition of 'default' (s 3.6.2).

Year Ending	Claims received	\$ Total Contrib.	\$ Amount paid <sup>10 11</sup>	\$ Admin. Expenses	\$ Provision for claims	\$ FF Net Assets	Contrib. Rate
30/06/06	34	800,000 <sup>12</sup>	2,145,685	477,814	7,800,000	29,631,000	\$60-240
30/06/07	12	969,000	2,367,227	358,000	9,300,000	30,002,000	\$60-240
30/06/08	12	1,147,000	674,343	302,000	8,900,000	30,572,000	\$65-265
30/06/09	33	1,298,000	127,000	203,000	8,114,000	33,604,000	\$72-300 <sup>13</sup>
Totals	91 <sup>14</sup>	4,214,000	5,314,255	1,340,814			

35. Table 1 suggests that:

- Compensation amounts paid for claims in the years 2008 and 2009 reflect the Model Bill provisions introduced in Victoria on 12 December 2009 which refined the range of claims that were excluded from compensation.<sup>15</sup>
- Fidelity fund contributions received in 2008 and 2009 were 63% greater than that required to meet compensation payments in those years.
- Fidelity Fund net assets have increased almost \$4 million in 4 years;
- The actuarial derived provision for claims has been unrealistically high. Notably the data relied on for its determination has never been supplied;
- Administration expenses, which do **not** include claim investigation costs are very high;
- In Victoria, the professional indemnity insurer provides "fraud or dishonesty" cover under Clause 20.6 of its policy.

*"Arising, in whole or in part, directly or indirectly from, or brought about by –*

- (a) the dishonesty or fraudulent act or omission of any Insured on or before 31 December 1997; or*
- (b) a defalcation or default as defined in the Act or as defined in applicable, corresponding legislation in another State or*

9 Legal Service Board Annual Reports for the periods indicated.

10 Compensation and interest components

11 The majority of payments in years 2006 and 2007 relate to claims made under pre-existing legislation

12 Estimate as figure not available

13 Interstate principal legal practitioners who have established law practices in Victoria that receive trust money are required to contribute at the same rate as local legal practitioners.

14 Financial years figure

15 Under the pre-existing legislation [(Legal Practice Act 1996 section 208(3)] defalcations in connection with nominee mortgages or given for the purpose of investment or re-investment that was not merely incidental to legal practice or made in the course of or in connection with the administration of an estate

*Territory of Australia, irrespective of whether a claim lies against any Fidelity Fund"*

The availability of the "fraud or dishonesty" cover to the benefit of clients does not appear to be acknowledged or taken into account in the determining the contribution levels paid by legal practitioners.

36. In summary there is no disagreement that fidelity cover should be afforded to persons who suffer loss as a result of the default by a law practice.
37. However, in drafting legislation for an effective compensation scheme and in fixing appropriate contribution rates greater recognition should be given to:
  - The actual incidence and nature of claims and the actual compensation paid;
  - the deterrent effect of the external intervention and recovery process;
  - the availability of fraud and dishonesty professional indemnity insurance cover; and,
  - the exclusion under the Model Bill from compensation of claims relating to trust money or money that involve financial services or investments which has reduced the incidence of claims but which has not been adequately recognised in claim provision amounts by actuaries.

Principle 4: The relevant regulatory authority is responsible for administering the fidelity fund. Administering the fidelity fund may include arranging insurance for the fund.
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38. We agree.

Principle 5: Claims against the fidelity fund must be determined independently, at arm's length from the profession.
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39. We refer to paragraphs 17 to 21 above.

Principle 6: The relevant regulatory authority may investigate a claim made to it in any manner it considers appropriate.
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40. We refer to paragraphs 17 to 21 above.

Principle 7: The Board may issue National Rules<sup>16</sup> on fidelity cover, the maintenance of fidelity funds and claims against a fidelity fund, including:

- the minimum terms and conditions of fidelity cover;
- the requirements and processes for making a claim, including time limits, etc; and
- the procedure by which a claim is to be processed, including notifications, advertisements, etc.

41. We agree.

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<sup>16</sup> The Taskforce proposes that the National Rules be based on a simplified and streamlined version of Part 3.6 of the Model Bill.