NSW Law Reform Commission

REPORT 44 OUTLINE (1984) - FOURTH REPORT ON THE LEGAL PROFESSION: SOLICITORS' TRUST ACCOUNTS

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New South Wales Law Reform Commission

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Preface

The Commission received a reference from the then Attorney General and Minister for justice, the Honourable Frank Walker, Q.C., M.P., to inquire into and review the law and practice relating to the legal profession.

Pursuant to this reference we have published *a Fourth Report on the Legal Profession*. The Report contains our final recommendations in relation to Solicitors' Trust Accounts.

The Report, and a Discussion Paper which preceded it, were prepared by a Division of the Commission By virtue of the Law Reform Commission Act, a Division is deemed, for the purposes of the reference in respect of which it is constituted, to be the Commission At the time of publication of the Discussion Paper, the Division consisted of the following Commissioners:

Mr. R-D. Conacher (then Deputy Chairman of the Commission)

Mr. Julian Disney

Mr. Denis Gressier

His Honour Judge Trevor Martin Q.C.

The Chairman of the Commission, Professor Ronald Sackville, presided over meetings of the Division but was not a member of it.

Mr. Conacher and Judge Martin ceased to be members of the Commission prior to commencement of work on the Fourth Report Mr. Gressier was closely involved in the early stages of its preparation but retired from the Commission upon his appointment as Master in Equity of the Supreme Court of New South Wales. Mr. Disney then took over principal responsibility for the preparation of the Report, with the assistance of Professor Sackville.

Not everyone will have the time or inclination to read the full Report. Accordingly we publish this Outline of the Report, for the benefit of those who seek a brief statement of the Commissions views and recommendations. Any person who would like a copy of the full Report should contact the Secretary of the Commission, GPO Box 6, Sydney 2001

(Telephone: 238 7213).

OUTLINE

I. INTRODUCTION

The Report and this Outline

1. This Outline is divided into seven Parts, namely

I. INTRODUCTION

II. PRINCIPAL CAUSES FOR CONCERN

III. HANDLING TRUST MONEY

IV. RECORDING AND ACCOUNTING FOR TRUST MONEY

V. INDEPENDENT SCRUTINY OF TRUST ACCOUNTS: GENERAL ISSUES

VI. INDEPENDENT SCRUTINY OF TRUST ACCOUNTS: OTHER ISSUES

VII. INVESTMENT OF CLIENTS' MONEY

The Outline concentrates on summarising the principal recommendations made in the Report, but it includes very brief outlines of the present position and of the reasons for our recommendations. The summaries of recommendations are printed here in bold type, and a cross reference is given (eg. R.3) to the relevant recommendation in the Report itself. It is important to note that the Report is the authoritative statement of the Commissions views and, in the event of inconsistency, the Report prevails over this Outline.

Our Methods of Inquiry (see chapter 1 of the Report)

2. In chapter 1 of the Report we describe the principal methods which we adopted in order to inform ourselves, and to canvass opinions, about the topics dealt with in the Report and about other topics falling within the scope of the Legal Profession Inquiry. Adoption of these methods resulted in the receipt of more than four hundred submissions, interviews with hundreds of clients and with a wide range of lawyers in New South Wales and elsewhere, examination of a large number of Law Society and Bar Association files, and extensive empirical and bibliographical research.

3. Our work on solicitors' trust accounts was greatly assisted by reports which we commissioned from the University of Sydney’s Accounting Research Centre and two leading firms of accountants (Coopers and Lybrand, and Yarwood, Vane & Co.). We also had the great assistance of advice from two honorary consultants, namely Mr. John Dorter (Solicitor) and Mr. Jack O'Donnell (Auditor General for New South Wales).

4. With the benefit of the information and ideas obtained by these means, we prepared and published a series of six Discussion Papers and five Background Papers on various topics falling within the ambit of the Legal Profession Inquiry. The Papers are listed at the back of the Outline. One of the Discussion Papers, *Solicitors' Trust Accounts and the Solicitors' Fidelity* Fund, made tentative suggestions on matters about which we make final recommendations in the Report on Solicitors' Trust Accounts. The responses which were received to this Paper were taken into account in the preparation of our final recommendations.

II. PRINCIPAL CAUSES FOR CONCERN (chapter 2)

5. In chapter 2 of the Report we outline the principal causes for concern In relation to mishandling of solicitors trust accounts. There are compelling reasons for grave public and professional concern about the prevalence and cost of mishandling of solicitors trust accounts in this State. Each year, hundreds, and probably even thousands, of millions of dollars are entrusted to solicitors. The great bulk of this money is handled satisfactorily but, at least in recent years, very substantial amounts have not been accounted for satisfactorily by the solicitors to whom they were entrusted, and their clients have had to seek compensation from other sources.

Evidence from the Fidelity Fund

6. Some idea of the magnitude of the problems which arise can be obtained from the records of the Solicitors' Fidelity Fund for the five-year period to 30th June, 1984.

> During that period, the Fund paid a total of $16.5 million to compensate clients for loss of money entrusted to their solicitors.
>
> In addition the Fund spent a total of $9.6 million investigating and handling clients' claims, administering the affairs of aberrant solicitors, paying the Law Society for its attempts to reduce the incidence of mishandled trust funds, and in other ways funding the regulation of solicitors activities in this area.

In order to finance this expenditure, the Fund received a total of $14.4 million generated by money belonging to members of the public (ie. interest earned on money entrusted to solicitors) and $4.8 million dollars of the profession is money (ie. Compulsory contributions). A further $1.4 million was derived from interest on moneys held in the Fund.

7. During the same five-year period, there were four instances of the Fidelity Fund re-paying more than $1 million in relation to a particular solicitors' practice. The largest of these repayments was $2.6 million. There were 14 instances of a re-payment to a particular client in excess of $100,000 and the largest re-payment to a single client was $540,000.

During the six-year period to 1st April 1984, repayments were made in relation to 53 solicitors, and in 22 of these instances the total re-payment arising from the solicitors defalcations was more than $200,000. In a further 12 instances it was between $100,000 and $200,000.

8. The position is even more serious than the above statistics indicate. For example, at 30th June 1984 the Fund

> had paid out $2.9 million on claims in the preceding year;
>
> had decided to pay out a further $1.2 million;
>
> had made provision in its accounts for a further $1.5 million which it considered it was likely to pay out on claims already received; and
>
> had a “deficiency of funds” of $2.7 million.

In addition the Funds financial statements indicated contingent liabilities' of $2.8 million comprising

> claims totalling $1.1 million which the fund had received but was disputing or was expecting to dispute; and
>
> intended claims totalling $1.7 million of which the Fund had received notice.

9. These heavy demands on the Fidelity Fund have meant that very large amounts of the funds in the Statutory Interest Account and the Solicitors' Trust Account Fund have had to be allocated to the Fidelity Fund rather than to other purposes for which they might be allocated, such as legal aid and legal education During the five years to 30th June 1984 more than one-third ($14.4m) of total allocations from these sources went to the Fidelity Fund. Moreover, the profession is now paying more than $1.7 million to the Fidelity Fund each year. This cost forms part of solicitors overheads and ultimately must be met from fees paid by clients.

Other Considerations

10. As the above statistics demonstrate, many clients whose money is dishonestly mishandled and lost by solicitors subsequently receive re-payment from the Solicitors' Fidelity Fund. However, this re-payment may not always compensate fully for the loss suffered. For example, it may come too late for a client to purchase the house or business which the solicitor was instructed to buy with the money entrusted to him or her. Moreover, the Fund does not provide compensation for the stress suffered by victims nor for the time which they must devote to pursuing their claims for re-payment.

11. It must also be borne in mind that the Fidelity Fund figures to which we have referred do not indicate the mishandling which goes entirely undetected, is eventually compensated for by the solicitor (or his or her partners, relatives or friends), or arises from causes other than dishonesty. The Law Society's professional indemnity insurance scheme covers liabilities arising from negligence and other non-dishonest conduct by solicitors. Since its inception in 1980, the scheme has paid out hundreds of thousands of dollars on claims arising from the manner in which solicitors have handled moneys entrusted to them.

12. A further indication of the gravity of the situation in New South Wales can be obtained from statistics of disciplinary action for breaches of the law relating to trust accounts. During the three years to 30th June 1984,32 of the 33 solicitors who were struck off the Roll had committed breaches of this kind, as had 528 solicitors who incurred lesser disciplinary sanctions. it should also be noted that in 1979 the Royal Commission into Drug Trafficking in New South Wales expressed grave concern about the ways in which certain solicitors had allowed their trust accounts to be used to the advantage of drug traffickers with whom they were associated. Similar activities by solicitors in both Australia and New Zealand were mentioned in the report of a subsequent joint Royal Commission into Drug Trafficking in both countries.

Recent Trends

13. Assertions have been made from time to time over the last five years or so that the level of misappropriation of trust funds is decreasing and the situation is now well in hand. As the following table indicates, however, there seems to be no evidence of sustained improvement.

Solicitors' Fidelity Fund

Year	Claims Paid During Year	Accumulated Balance at End of Year
1978	$1.4m	-$132,000 (deficit)
1979	$1.8m	$159,000
1980	$4.4m	$28,000
1981	$2.8m	$277,000
1982	$1.6m	-$2.2m (deficit)
1983	$4.9m	-$2.5m (deficit)
1984	$2.9m	-$2.7m (deficit)

Comparison with Other Jurisdictions

14. The bad record of losses from solicitors trust accounts in New South Wales is frequently remarked upon at national and even international, conferences of lawyers. It shares this dubious distinction with Victoria but, in fact, records of the last 10 years show that the losses in that State, although very substantial are well below those in New South Wales. The following table throws light on the record in these States and in several other jurisdictions for the five years 1978-1983.

	Total Claims Paid by Fidelity Fund or Equivalent	**Approximate Number of Solicitors in Practice as at 30th June 1983**
New South Wales	$15,390,062	7,100
Victoria	$2,630,752	5,200
New Zealand	NZ$707,551**	4,500
Queensland	$861,000	1,900
Western Australia	$75,137	1,100

15. Certain aspects of the law and practice relating to solicitors and their trust accounts, and to the Fidelity Fund or equivalent, differ somewhat between the various jurisdictions. Accordingly, considerable caution is necessary when drawing conclusions from the above table. Nevertheless, it is remarkable that in New South Wales the level of Fidelity Fund payments per practising solicitor has been in recent years, in the order of

four times higher than in Victoria and Queensland; and

more than 10 times higher than in New Zealand.

Types of Mishandling

16. Our own investigations, and reports by consultants, lead us to conclude that in recent years the most prevalent and serious types of mishandling have included

transferring from trust accounts to solicitors' own accounts, moneys which are incorrectly believed, nor alleged, to be due to the solicitors professional charges ("costs") and out-of-pocket expenses ("disbursements");

investing clients' money without instructions or contrary to instructions;

borrowing money from clients without disclosing that it is for the personal use of the solicitor (or a relative or associated company) and without advising the client to obtain independent legal advice.

Types of Work and of Practitioner

17. There is a high incidence of mishandling by sole practitioners. More than 60 per cent of the 33 solicitors struck off the Roll in the three years to 30th June 1984 for matters relating to trust accounts were sole practitioners, yet sole practitioners comprised less than 20 per cent of all practising solicitors in the State. It must be borne in mind, however, that in some instances mishandling by a partner may not give rise to a complaint to the Law Society or to a disciplinary charge because other partners remedy the situation from their own resources.

18. Mishandling is prevalent in the course of investing clients' money, especially where solicitors conduct another business enterprise (such as that of land speculator, property developer, financier or mortgage broker) in association with their legal practice. These associated activities can give rise to real or apparent conflicts between the respective interests of solicitors and their clients. Thirty- four (62 per cent) of the solicitors struck of the Roll in the five years to 30th June 1984 were charged with matters

arising from investment of clients moneys. In 25 of these 34 cases an associated business enterprise of the solicitor was involved.

19. Our statistical survey of complaints made to the Commission in 1977 and 1978 found that all of the complaints about investment of clients' moneys, and about three- quarters of those about trust funds generally, were in relation to practitioners of at least 15 years' standing.

III. HANDLING TRUST MONEY (chapter 4)

General

20. Existing legislation in New South Wales about the handling of trust moneys by solicitors is less extensive and specific than in many other places. Bearing in mind the unusually high incidence of trust account defalcations in this State, we discuss in chapter 4 of the Report a number of ways in which the legislation could be made clearer and more rigorous.

21. In the light of this discussion we make a number of recommendations aimed at ensuring that

all money received on trust is paid into a trust account, unless a specific exemption applies;

payments into trust accounts are made promptly;

where trust money is not paid into a trust account, adequate records are kept of the manner in which it is handled;

in order to avoid confusion or dispute, non-trust money is not paid into trust accounts except where a specific exemption applies.

22. **The recommendations which we make include the following:**

***Solicitors should be required to pay all trust money into their trust account unless, not later than the end of the next banking day, it is to be disposed of in accordance with the client's written instructions or in the same form in which it was received (for example, by endorsement of a cheque) (R.5).**

Where money is required to be deposited in a solicitors' trust account it should have to be deposited not later than the end of the next banking day after receipt (R.4)

Where trust money is not paid into a trust account, details of the manner in which it has been dealt with should have to be recorded by the solicitor in a prescribed form of Direct Payments Register. The Register should constitute part of the solicitor's trust account records and be subject to independent scrutiny in the same manner as those records (RR.6.7).

Subject to certain very limited exceptions, solicitors should not be permitted to pay any of their own money into their trust account (R.8).

Professional Costs and Disbursements

23. In chapter 5 of the Report we look at three closely related topics concerning the handling of trust moneys. They concern the circumstances in which solicitors

If any, or must, pay into their trust account any money which they receive for their own costs or disbursements;

may, or must, withdraw money from their trust account in order to pay themselves for their costs or disbursements;

may refuse to pay trust money to a client until their costs and disbursements have been paid.

In each of these areas there is considerable uncertainty amongst New South Wales solicitors about the rules with which they must comply, and there are considerable variations in practice.

24. There has been a number of occasions in recent years when confusion or dispute has arisen between solicitors and clients as a result of the solicitor paying himself or herself from trust money. In some instances, the clients have been given little or no notice that the payment as been made or is about to be made, let alone any details of the alleged costs or disbursements being met by the payment. As a result, some clients have been charged excessive amounts and others have been left understandably confused or suspicious about the way in which their affairs have been handled. Independent scrutiny of trust accounts has sometimes been made very difficult, if not impossible, by the absence or inadequacy of solicitors' records concerning payments to them for alleged costs or disbursements. The difficulties and unfairnesses which have arisen have been exacerbated by the cost, delay and complexity involved in the main existing means by which solicitors' bills may be disputed, namely the procedure for “taxation of costs”.

25. For these and other reasons discussed in the Report, we conclude that the rules relating to the handling of money for costs and disbursements should

be clearer and more specific than at present

provide greater protection for clients from having their money appropriated by solicitors without their informed acquiescence;

not place unreasonable burdens on solicitors (especially in relation to out-of-pocket expenses), and

require clear records to be kept and to be subjected to independent scrutiny.

26. We make a number of detailed recommendations directed at achieving these goals. The major elements of these recommendations are as follows:

Direct Payment (RR.11-13). When solicitors receive money for costs or disbursements they should be required to pay it into their trust account, rather than directly to themselves, unless

- the work has been done or the disbursements have been made, and an outline bill has been delivered to the client; or

- the client has given written instructions for the money to be paid other than to the trust account, and before or upon receipt of the money the solicitor delivers an outline bill or receipt outlining the services or disbursements for which the money is being paid.

Where either of these exceptions apply, the transaction should have to be recorded in the Direct Payments Register.

Payment from Trust Account (RR.14-17). Solicitors should not be permitted to withdraw money from a trust account in order to pay themselves costs or disbursements unless

- the payment is for disbursements which have been made on the client's instructions;

- the client has been sent an outline bill and thereafter has given written instructions, in a prescribed form, for the payment to be made; or

- the client has been sent an outline bill and a statement in a prescribed form that the payment will be made unless the client objects within one month, and no such objection has been made within that period.

Witholding Trust Money from Client (R.18). The current uncertainty about whether solicitors are entitled to withold trust moneys from their clients until their own costs or disbursements are met should be resolved by legislation. We do not necessarily oppose them having such a right, provided that a new system for independent review of solicitors' bills, which is

simpler, quicker and cheaper than the existing procedure for taxation of costs, is established.

IV. RECORDING AND ACCOUNTING FOR TRUST MONEYS (chapter 6)

Opening Files and Retaining Records

27. In order to reduce the risks of uncertainty or dispute, and to assist effective scrutiny of trust account records, we recommend that solicitors should be required

> **to open an office file for every matter which involves the handling of trust money; and**
>
> **to retain all such files and certain trust account records for at least 12 years, and all other trust account records for at least 7 years (R.20).**

Computerised Trust Accounts

28. The current statutory regulations relating to the keeping of trust account records are not suitable for computerised trust account systems. A substantial and growing number of solicitors have adopted such systems, and have obtained the Law Society's approval to do so (although strictly speaking, this approval does not exempt them from compliance with the regulations). There can be little doubt that the regulations should be amended to allow appropriate computerised systems. It has been amply demonstrated that computers can make accounting systems much more efficient, with consequential benefits for both solicitors and clients. On the other hand, there is a clear need for caution. In some ways computer systems can be more vulnerable to fraudulent misuse, and less capable of being subjected to effective independent scrutiny, than some other systems. This applies especially if, for example, the system does not retain a full history of entries on the records or allows such history to be readily falsified. Difficult problems arise also in relation to preventing unauthorised access to the system, and in producing records in comprehensible form.

29. It is generally desirable for the regulations to comprise a specific and comprehensive collection of the rules with which trust account systems must comply, rather than leaving most of the requirements to be determined by the Law Society when considering applications for approval However, the complexity of the requisite rules in relation to computerised systems, and the rapid pace of technological innovation make this goal exceedingly difficult to achieve. Undue rigidity, and unfairness to the manufacturers and potential users of certain systems, might result from over-emphasis on the importance of expressing all necessary principles in the form of regulations. The use of computerised systems is still relatively new within the legal profession, especially in small or medium-sized firms, as well as in other professions. A few more years of experience may make it easier to develop specific and reasonably comprehensive regulations, notwithstanding the unlikelihood of a slackening in the pace of innovation.

30. Accordingly, we recommend that

> **as an interim measure, the trust account regulations should be amended to give the Law Society power to approve certain computerised systems;**

We also recommend, however,

> **the establishment of a special committee, chaired by the Auditor General, to recommend to the Attorney-General within three years a specific and comprehensive set of regulations for trust account systems, including those which are in computerised form (RR.21, 22).**

Statements of Account

31. Solicitors are under no general statutory duty to provide clients with statements of account concerning trust moneys which they have received for or on behalf of those clients. There is, however, a

specific duty to provide such a statement after receipt of money for a client in connection with a claim arising from death or personal injury.

32. We consider that the provision of statements of account especially on a regular basis, can be of great benefit to clients and can also have advantages for solicitors. A requirement to provide such statements can reasonably be expected to reduce the incidence of deliberate or unintentional mishandling of trust moneys. In our view, these advantages outweigh the resources required to provide the statements, especially since the development of efficient office systems can reduce substantially the additional resources required for this purpose.

33. Accordingly, **we recommend that where solicitors receive trust money for a client they should be required to provide the client with a statement of account in relation to that money**

> **where the matter is not completed within six months - not more than six months after its commencement and at intervals of not more than three months thereafter;**
>
> **within one month of completion of the matter in question; and**
>
> **at any other time upon request by the client.**

V. INDEPENDENT SCRUTINY OF TRUST ACCOUNTS: GENERAL ISSUES (chapter 7)

Introduction

34. At present, there are two principal forms of independent scrutiny of trust accounts in New South Wales. Law Society Inspections are undertaken by Trust Account Inspectors employed by the Law Society. The Society now employs 12 qualified accountants as Inspectors and has adopted the objective, which it has almost achieved, of inspecting every solicitor s accounts at least once each year. Accountants' examinations are undertaken by a registered public accountant chosen by the solicitor whose accounts are being examined. Every solicitor must submit each year a prescribed form of certificate, signed by such an accountant, stating certain matters relating to the accounts.

Law Society Inspections (chapter 8)

35. The Law Society has made, and is continuing to make, significant improvements in its system of inspections. We believe that this system has a vital part to play in the prevention and detection of trust account irregularities, especially because of the opportunities which it provides for highly specialised, economical and co-ordinated scrutiny of the profession is trust accounts, and for an emphasis on education and prevention Law Society inspections have been the principal source of detection of defalcations in recent years.

36. We do not consider, however, that it would be appropriate for us to recommend further major changes in the inspection system at this juncture. Our reasons may be summarised as follows. First, the inspection system has already been developed as muck or further, than in any other jurisdiction yet there is no appreciable evidence of a decline in the incidence of defalcations. Before devoting substantially increased resources to the system it would be preferable to consolidate and refine the changes introduced in recent years and wait a few more years to see whether benefits flow through in the form of substantially reduced defalcations.

37. Secondly, and by the same token it is too early to conclude that the recent changes will not justify the resources devoted to them. Indeed, although there is a lack of hard proof, we believe that the changes have been generally worthwhile. Thirdly, there are considerable practical difficulties involved in seeking sufficient funds, and an appropriate calibre of well-remunerated recruits, for a substantially expanded system of Inspectors and inspections. Fourthly, for reasons discussed in chapters 9 and 10, we believe that the present system of accountants examinations in this State is patently inadequate, and worse than in any other State. We believe that the major emphasis in the near future should be on reform of these examinations rather than of inspections.

38. Accordingly, **we recommend that**

> **the Law Society should ensure that it achieves within the next year its recently stated objective of inspecting every practice in the State once each year, and should maintain that frequency of inspection thereafter;**
>
> **the Society should ensure that this increased frequency is accompanied by further refinement of inspection techniques (R.26).**

We also recommend that

> **inspectors should have more extensive statutory powers to obtain information from solicitors relevant to their practices (R.27).**

39. We have referred earlier to the very high incidence of defalcations by sole practitioners. In response to this serious problem **we recommend that**

at least during the next few years, the Law Society should inspect sole practices more frequently than other practices and/or ensure that inspections of sole practitioners are particularly thorough (R.26).

Accountants' Examinations

40. In our view, the present system of accountants' examinations is manifestly and seriously inadequate. The examination requirements concentrate on relatively few and unimportant matters of form and arithmetical exactitude, rather than on thorough investigations, albeit on a sampling basis, of particular transactions (especially in known problem areas) and of the practice's financial control system. It is both remarkable and disturbing that, while New South Wales has a worse record of solicitors' defalcations than any other State, it also continues to have the least rigorous requirements concerning accountants examinations. These examinations detected none of the 79 defalcations of which the Law Society became aware in the four years to 1984.

41. The system of accountants examinations has been criticised trenchantly by eminent accountants, including the New South Wales Auditor-General, as being not only vague and superficial but also potentially misleading to clients, who may erroneously believe that their money is subject to independent scrutiny akin to that of an audit. We agree with the general tenor of their views and with many of their specific criticisms. We note also that the Law Society of New South Wales appears to accept that the present examination requirements need substantial change.

42. We are convinced that accountants' examinations should be required to be much more rigorous than at present. The question then arises whether they should have to constitute an audit, as is the case, for example, in Queensland, Victoria, South Australia, the Australian Capital Territory, and New Zealand. Audits are already required for the trust accounts of some professional groups in New South Wales, including stockbrokers, real estate agents and travel agents.

43. The use of the term "audit' carries with it a substantial corpus of legal principles, formal Statements of Auditing Standards and Auditing Practices, an extensive body of auditing literature, and many customs and connotations with which accountants are generally familiar. Not all of this corpus is relevant to the auditing of solicitors trust accounts but much of it is, and is of great value in providing definition and guidance for both accountants and lawyers about specific requirements and techniques. It would be impracticable and unwieldly to attempt to express in statutory form more than a very small portion of this corpus. There is no doubt that, as in Jurisdictions such as England and Ontario, an examination of considerable rigour (broadly akin to that of an audio can be defined by compiling an extensive statutory list of requirements even though the term "audit" is not used. However, while the general rigour of an audit can be matched, the breadth of specific definition and guidance cannot.

44. The introduction of an audit requirement would involve many solicitors paying appreciably more in accountants' fees than at present On the other hand, more than half the solicitors practices in New South Wales already have examinations that are more rigorous than is required by statute. If the current level of payments from the Fidelity Fund could be reduced in this State to the same level per solicitor as in say, Victoria or Queensland, the recent substantial increases in compulsory contributions from solicitors could be reversed dramatically Moreover, the cost of audits is already being borne by solicitors in most other parts of Australia (and by members of other professions in New South Wales), yet it is solicitors in this State who have the worst record of defalcations.

45. For these and other reasons explained in chapter 9, **we recommend that**

solicitors' trust accounts should have to be audited each year (R.29);

the principal purpose of the audit should be defined as the detection of frauds, defalcations, illegalities and irregularities (R.30);

it should have to be conducted in accordance with the current Statements of Auditing Standards and Auditing Practice published by the Institute of Chartered Accountants in Australia and the Australian Society of Accountants (R.31).

46. We also recommend that accountants conducting these audits should be required to state in their report whether, based on appropriate examination and sampling techniques, they are of the opinion that throughout the period covered by the report

trust moneys have been handled in accordance with the relevant statutory provisions (ie. at present, section 41 of the Legal Practitioners Act);

the proper accounting records have been kept, and all trust. moneys have been recorded and accounted for, in accordance with the relevant statutory provisions (ie. at present, sections 41 and 42(2) of the Legal Practitioners Act, and the Solicitors' Trust Account Regulations) (R.32).

They should also be required to report

whether, in their opinion, the practice's accounting and financial control systems are adequate for a practice of its particular nature;

any other matter which they consider should be brought to the attention of the Law Society (R.33)

47. We also recommend that accountants responsible for auditing a practice

should be required to make at least one unannounced visit (or in the case of sole practitioners, at least two such visits) to inspect the practice's accounts during the audit period (R.34); and

should have rights of access, for the purposes of their audit, not only to trust account records but also to office files, general accounts and all other documents relating to the practice (R.35).

VI. INDEPENDENT SCRUTINY OF TRUST ACCOUNTS: OTHER ISSUES (chapter 10)

Client Verification

48. It is widely accepted that the mere perusal by an accountant of trust account and other records provided by a solicitor may fail to detect deliberate or negligent mishandling of trust moneys, especially if the solicitor in question has sought to conceal it. The likelihood of detection may increase substantially, however, if the records are checked with the clients involved in order to ascertain whether the nature and amount of the various transactions shown in the records are accurate and in accordance with instructions. Moreover, the knowledge that such verification may be sought, even of a random sample of clients, can be expected to have a significant deterrent effect on potentially aberrant solicitors. In some circumstances it may be relatively easy to prepare records (such as forged instructions) which, while effective to deceive an Inspector or accountant, are patently false to the client The importance which accountants in New South Wales place on Client verification as a technique may be seen from the fact that, when asked by the Accounting Research Centre what checks they would make if required to conduct an audit- like examination some 74 per cent said that they would frequently or occasionally seek client identification.

49. In our view, client verification is one of the most sorely needed improvements in the regulation of solicitors' trust accounts. We have taken note of the degree of concern amongst solicitors that the technique may give rise to unfair suspicions and rumours. We are convinced, however, that this potential problem can be overcome by careful drafting of a prescribed form of communication with clients, extensive publicity to explain the new system and the adoption of client verification in relation to every solicitor. Indeed, if explained appropriately to the public, client verification procedures can improve the general reputation of the profession as being concerned to maintain the highest standards.

50. Accordingly, **we recommend that**

> **accountants' examinations should be required to include client verification of a sample of the solicitor's trust account records. The sampling basis should be determined by the individual accountant and explained in his or her report (R. 36).**

If it is considered, contrary to this recommendation, that client verification should not be required in every case, we consider nevertheless that accountants should be expressly entitled to seek client verification and should be required to include in their report the nature of any client verification which they have carried out or the reasons why such verification was considered unnecessary. We also make specific recommendations about a prescribed form in which client verification should have to be sought (R- 37), and we recommend that Inspectors should have power to seek verification where they consider it appropriate to do so (R-38).

Other Checks

51. In the Report we discuss, and make recommendations about, a number of specific checks which could be required to form part of Law Society inspections or accountants examinations. For example, **we recommend that**

> **specific checks relating to costs and disbursements, administration of estates, the Direct Payments Register, and borrowing transactions between solicitor and client should be required (R.39);**
>
> **the Law Society, in conjunction with the Auditor General and the principal associations of accountants, should issue an advisory Audit Program relating to solicitors' trust accounts (R.40).**

Appointment and Removal of Accountants

52. An accountant s independence is seriously compromised if he or she is not only appointed, but can be removed at will by the solicitor being examined. There is reason to suspect that lack of independence on the part of some accountants has contributed to the failure of accountants examinations to play a significant role in reporting fraud or serious irregularities to the Law Society in New South Wales. Dishonest or incompetent solicitors may have little difficulty in finding an accountant with characteristics similar to their own, and in dispensing with the services of one whose diligence and responsibility threatens exposure.

53. In our view, the lack of procedures designed to enhance accountants' independence is a major weakness of the present system of accountants examinations in New South Wales. Moreover, in order to provide continuing, well-informed scrutiny, accountants should be appointed permanently rather than at the beginning or end of the year under examination Accordingly, **we recommend that**

> **appointment of the accountant by whom a solicitor's trust accounts are to be examined should be made by the solicitor, and notified to the Law Society, within one month of the solicitor first holding any trust money;**
>
> **appointments should be subject to the Law Society's approval, and the Law Society should be entitled to withhold or withdraw approval if it believes on reasonable grounds that the accountant in question may not properly perform his or her duties or has not properly performed them in the past;**
>
> **removals or resignations of accountants should be subject to the Law Society's approval (RR.43-48).**

We also recommend that

> **in order to preserve due independence, accountants auditing a solicitor's practice should, generally speaking, not be permitted to carry out other work for the solicitor (R.51).**

Qualifications and Training of Accountants

54. At present, the required examinations of solicitors trust accounts must be conducted by accountants who are registered as public accountants under the Public Accountants Registration Act, 1945. In order to become so registered, an accountant must have specified professional qualifications and auditing experience (not necessarily, of course, in relation to solicitors trust accounts). There are approximately 6,500 registered public accountants in New South Wales. It is sometimes suggested that registration as a public accountant should not be sufficient for this purpose. For example, accountants could be required to undergo special training in examination of solicitors trust accounts before becoming qualified to conduct such examinations, and/or to attend special lectures or courses on an ongoing basis if they have been appointed to examine any solicitors accounts.

55. The examination of solicitors trust accounts is a difficult task and requires some areas of knowledge which accountants are unlikely to acquire in carrying out other work such as company audits. On the other hand, many accountants have to become familiar with specialist types of work and specialist jargon even within, for example, the general field of company audits. Moreover, if onerous special training became a pre- requisite for appointment to examine solicitors trust accounts, there might be serious adverse effects on the availability and cost of those who are qualified for such appointment, especially in country areas.

56. We recommended earlier in the Report that certain specific checks in the course of examining solicitors trust accounts should be required by statute, and that others should be included in advisory Audit Programs and Circulars sent to all accountants carrying out such examinations. In our view, these measures, together with a modest requirement for attendance at special seminars on solicitors' trust accounts, would meet much of the need for special training and guidance. Unless these measures prove

to be insufficient, we do not believe that it would be desirable to introduce any form of special certificate as a pre-requisite for appointment to examine solicitors trust accounts.

57. Accordingly, **we recommend that**

> **as at present, accountants' examinations should have to be conducted by accountants registered under the Public Accountants Registration Act, 1945-,**
>
> **the Law Society, in conjunction with the principal associations of accountants, should organise at least once each year a seminar relating to examination of solicitors' trust accounts;**
>
> **accountants who are responsible for examining such accounts should be required to attend at least one of these seminars every two years (RR.49-50).**

Duties to Disclose Reasonable Suspicions

58. In light of the unacceptably and uniquely high incidence of defalcations in New South Wales, **we recommend that**

> **solicitors and examining accountants should be under certain statutory duties to report to the Law Society any reasonable suspicions they form about specified aspects of a solicitor's handling of trust money (R.53);**
>
> **banks should be required to report certain irregularities concerning solicitors' trust accounts held by them (R.54).**

VII. INVESTMENT OF CLIENTS' MONEY (chapter 11)

General Issues

59. Solicitors in New South Wales are commonly asked by clients to play some role in investing their money. Often the intended investment is a loan secured by a mortgage. In some instances, the money is received and invested by the solicitor through his or her trust account In many other instances, however, it is received and invested by a nominee company, or a private finance company, in which the solicitor has an interest (often the controlling interest).

60. We mention earlier in the Report the substantial number of irregularities and defalcations which have arisen from solicitors involvement in investing money for their clients. In a number of these instances the investments have included loans to the solicitors themselves or to companies which they control These defalcations have caused considerable loss and hardship for members of the public, who may be only partially compensated, if at all by the Solicitors' Fidelity Fund and, moreover, usually have to wait some months or even years before receiving any compensation from the Fund. This huge drain on the Fund's resources has caused an increase in recent years of more than $1 million in the annual level of compulsory contributions from solicitors to the Fund. Millions of dollars each year have been transferred to the Fund from the Statutory Interest Account instead of being allocated to legal aid and legal education.The Law Society and other authorities have had to devote very considerable amounts of time and money to investigating irregularities and defalcations, pursing disciplinary and criminal proceedings, and attempting to prevent similar conduct in future. The reputation of the profession has also suffered significant harm.

61. Disputes and difficulties can arise, and have arisen, over the nature of investments made by solicitors on their clients' behalf. For example, clients have asserted that they directed that the investment be secured in a certain way, or be made at not less than a specified rate of interest, and that the direction has not been followed. Even where no dispute arises, the task of an examining accountant or Inspector may be made more difficult, time-consuming and expensive by the lack of adequate documentation to explain investment transactions and to establish their propriety.

62. In order to regulate solicitors activities in the investment of clients' money, and to improve record-keeping and independent scrutiny in this area, **we recommend that**

> **the Law Society's existing non-statutory restrictions about solicitors borrowing from their clients should be given statutory effect (R.56);**
>
> **solicitors should be required, subject perhaps to certain limited exceptions, to obtain their client's written authorisation in a prescribed form before using trust money for the purposes of investment on behalf of that client (R.57);**
>
> **solicitors should be required to maintain a Securities and Investments Register containing prescribed details of securities and Investments transactions handled by them for clients (R.58), and to provide clients with a Summary containing similar details relating to their money (R.60);**
>
> **the Securities and Investment Register should form part of the solicitor's trust account records, and thus be subject to independent scrutiny (R.59).**

We also foreshadow that it may become necessary at some future time to impose an absolute prohibition on solicitors acting for clients in relation to borrowing transactions between the solicitor and a client, irrespective of whether the client also obtains independent advice.

Nominee Companies

63. Many solicitors in New South Wales operate nominee companies. A common purpose of these companies is to act as trustee of those clients of a solicitor who wish to lend money on mortgage. The companies usually have no assets of their own (except a nominal amount of paid- up capital) and earn no income of their own. They are merely means for making investments on behalf of solicitors' clients.

64. Money received by solicitors nominee companies is not thereby money received by solicitors themselves Accordingly, it is not subject to the statutory provisions relating to the handling and recording of trust moneys by solicitors, independent scrutiny of solicitors' trust accounts, and reimbursement of defalcations through the Solicitors' Fidelity Fund The nominee company must, however, comply with the general law of trusts.

65. We mention in the Report a number of benefits which can be obtained by solicitors and clients through the use of nominee companies. Generally speaking, these benefits seem unobjectionable from the viewpoint of the public interest However, it seems clear that most, if not all people who lend money through solicitors nominee companies do so because of their relationship with and confidence in, the solicitor as a solicitor. It is often only the professional status of the solicitor which gives the investor the confidence to invest his or her money through the solicitor. Also, it is often only that status which gives the investor confidence to allow the solicitor to choose the form of the investment. The investor usually pays little regard to whether the mortgage is taken in the name of the solicitor or the name of the solicitors nominee company. Yet, under present law, the choice can have crucial effects on the degree of protection afforded to the investor.

66. **We recommend that**

> **solicitors should be entitled to operate nominee companies, subject to certain conditions specified in the Report (R.61).**

The conditions include the following

> **any such solicitors should be required to guarantee personally the repayment of all money lent to the company;**
>
> **money received by the company should be subject to the same statutory controls (including those relating to independent scrutiny) as money received on trust by the solicitors themselves (R.61).**

Private Finance Companies

67. Broadly speaking, solicitors private finance companies may be described as companies which are operated or controlled by solicitors or “associated parties” (such as close relatives, employees, or companies in which solicitors have an interest) and conduct the business of borrowing and lending money. The usual practice is for the companies to make loans, secured by mortgages, out of a pool of money deposited with the company by various people, most of whom are clients of the legal practice run by the solicitor or solicitors involved in the company.

68. Since money received by a solicitors private finance company is not money received by the solicitor, it is not subject to the statutory provisions relating to solicitors trust moneys and trust accounts. Moreover, the company's relationship to the lender is that of debtor rather than of trustee. There are no statutory provisions in New South Wales relating specifically to solicitors private finance companies and there is considerable doubt whether they are subject to the provisions in the Companies Code or the Securities Industry Code relating to financial intermediaries dealing with the public.

69. Private finance companies can have a number of disadvantages which do not apply to nominee companies. For example, since the money lent to the company is not held by it on trust, the lender has less protection than with a loan to a nominee company. Also, private finance companies have, in practice, been more likely than nominee companies to be involved in making loans to the solicitor or an associated party, to become involved in financial and commercial activities of a kind and scale which the solicitor is not competent to manage, and to give rise to defalcations.

70. There are no accurate statistics about the prevalence of solicitors private finance companies in New South Wales in recent years, nor about the amounts of money which they have handled. There is no doubt, however, that during the latter part of the 1970s they were common and, in total handled hundreds (and perhaps thousands) of millions of dollars. The operations of some solicitors private finance companies have caused very serious problems, both in New South Wales and elsewhere. A heavy cost, both financial and otherwise, has been paid by both the public and the profession as a result of the irregularities and defalcations which have occurred.

71. Rulings made in 1979 by the Law Society of New South Wales appear to have reduced substantially the number of private finance companies and the incidence of problems arising from their activities. However, this decrease may be reversed, especially if economic conditions change or solicitors become subject to greater competitive pressures. Moreover, the current scarcity of private finance companies means that prohibition of them would cause less disruption than in previous years. By contrast, it seems reasonably clear that a major and perhaps determining factor in the recent decision to control rather than prohibit solicitors private finance companies in Victoria has been the continuing prevalence of such companies in that state.

72. There's a substantial body of opinion amongst solicitors, including some leaders of the profession that private finance companies should be prohibited. The Court of Appeal in *Harvey's Case* clearly considered their operation to be generally contrary to the proper role of a solicitor. Most if not all of the benefits which such companies can provide to members of the public can also be provided by nominee companies, and the latter type of companies provide greater protection for the public. Moreover, most of the benefits which private finance companies can provide for solicitors in New South Wales are also obtainable from the use of nominee companies.

73. For these and other reasons explained in the Report, **we recommend that**

> **solicitors' private finance companies should be prohibited;**
>
> **solicitors currently having an interest in such companies should be give a reasonable time (say, two years) within which to withdraw from them or wind them up (P,62).**

We recommend also, however, that

> **if it is considered that such companies should not be prohibited, they should be required to be licensed by the Corporate Affairs Commission in accordance with a scheme of the kind currently administered by the Commissioner for Corporate Affairs in Victoria (R.62).**

LEGAL PROFESSION INQUIRY PUBLICATIONS

The following publications have been issued in the course of the Legal Profession Inquiry.

Reports

First Report on the Legal Profession.

(General Regulation, The Division into Barristers and Solicitors, Queen’s Counsel and Court Dress)

Second Report on the Legal Profession

(Complaints, Discipline and Professional Standards)

Third Report on the Legal Profession

(Advertising and Specialisation)

Fourth Report on the Legal Profession.

(Solicitors' Trust Accounts)

Discussion Papers

1. General Regulation.

2. Complaints, Discipline and Professional Standards - Part 1.

3. Professional Indemnity Insurance.

4. (1) Structure of the Profession - Part 1.

(2) Structure of the Profession - Part 2.

5. Advertising and Specialisation

6. Solicitors' Trust Accounts and the Solicitors' Fidelity Fund.

Background Papers

1. Background Paper - I.

(Complaints, Discipline and Professional Standards)

2. Background Paper - II.

(Professional Indemnity Insurance)

3. Background Paper - III.

(Complaints, Discipline and Professional Standards)

4. Background Paper- IV.

(Structure of the Profession)

5. Background Paper - V.

(Solicitors' Trust Accounts and the Solicitors' Fidelity Fund)

Options Paper

Solicitors' Costs and Conveyancing.