A FIDELITY FUND FOR HONG KONG SOLICITORS?

SUBMISSION BY THE LAW SOCIETY OF HONG KONG TO THE LEGCO PANEL ON THE ADMINISTRATION OF JUSTICE AND LEGAL SERVICES

The Law Society is not opposed to the establishment of a Fidelity Fund in Hong Kong but urges caution for a number of reasons which are set out below.

For more than 15 years the Law Society has, through the Hong Kong Solicitors Indemnity Fund Limited, operated a mandatory professional indemnity scheme ("the scheme") for all solicitors with practising certificates. This covers all solicitors who hold themselves out to the public as being qualified to practise Hong Kong law in Hong Kong. Registered foreign lawyers also have to produce evidence that they have a level of cover comparable to that required of a Hong Kong solicitor (HK$10 million) before they are permitted to practise in Hong Kong. Many firms voluntarily carry "top up" cover in excess of the minimum cover under the scheme to meet the exigencies of their practices.

The mandatory cover provides indemnity to any principal in the firm, any person employed in connection with the practice (including any assistant solicitor, any solicitor who is a consultant in the firm, and any trainee solicitor), any solicitor who has ceased by reason of death, retirement or otherwise to practise as principal in the firm, any former employee employed in or in connection with the practice (including any assistant solicitor, any consultant and any trainee solicitor as aforesaid) and the estate and the legal representatives of any of the foregoing, and also includes any service, administrative or nominee company or trust in so far as its activities are carried out in connection with the practice. [Rule 2 of the Solicitors Professional Indemnity Rules]

As with all forms of re-insurance there are exceptions to the indemnity provided under the scheme. The most relevant of these is that no indemnity is provided in respect of losses brought about by the dishonesty, fraudulent act or fraudulent omission of an employee of the firm or the indemnified (i.e. a principal in the firm) unless the indemnified can prove or show to the satisfaction of the Hong Kong Solicitors Indemnity Fund Limited that such dishonesty, fraudulent act or fraudulent omission of the employee did not occur as a result of recklessness or dishonesty or a fraudulent act or fraudulent omission on the part of any person who was a principal at the relevant time in the conduct or management of the practice. [Schedule 3 (1) (iv) of the Solicitors Professional Indemnity Rules]. Such

exception follows the well-established legal principle that it is not possible to insure against one's own fraud.

In 2000 the scheme's brokers, Aon, were asked to identify claims that had been refused on the basis of fraud by a principal in the firm. At that time their records showed some 4 cases between 1991 and 2000 in which indemnity had been refused. Since then there have been 6 instances in which solicitors have ceased to practise in circumstances which may give rise to claims by former clients. The number of such claims and the extent of any losses are not within the knowledge either of the Law Society or Aon since claimants have whenever they have made themselves known, been advised to make a report to the Commercial Crime Bureau.

Currently there are 638 firms of solicitors and 4,909 solicitors with practising certificates. All firms are required to have their clients' accounts audited annually and to provide the Law Society with a certificate from a qualified auditor that their accounts comply with the Solicitors Accounts Rules. Failure to provide such a certificate is a bar to practise. Additionally the Law Society employs a monitoring accountant to carry out inspections of firms' books of account on a random basis to ensure compliance and to advise members as to the correct way in which to keep their books of account. Those firms which fail to comply are re-visited and may face disciplinary proceedings.

Between 1992 and 1994 the Law Society set up a working party to look into the possibility of establishing a fidelity fund in Hong Kong. A considerable amount of research was done and a firm of solicitors was instructed to draft a detailed proposal in conjunction with Aon with a view to taking the matter forward. However there emerged considerable difficulties in financing the establishment of such a fund. The advice that was received at the time was to the effect that a very substantial amount of capital would be required to set up the fund and that this would have to be "topped" up whenever there were claims. After a great deal of discussion it was decided not to pursue the proposal because of the financing difficulties and because of the absence of demand for such a fund.

The issue was looked at again in 1995 at the time of the Government's Green Paper on Legal Services and a proposal to set up such a fund contained in the 1997 White Paper was opposed by the Law Society for the same reasons.

In 1999 further discussion took place and data was sought from overseas as to the operation of fidelity funds in other jurisdictions. Much of the experience gained was from the Australian states where fidelity funds had existed for some years. In virtually all of the states of Australia fidelity funds were the beneficiaries of monies paid to their credit from long-

standing arrangements relating to interest on clients' accounts. The concept in those jurisdictions was that although legally the interest on such accounts might belong to the client nevertheless there were arguments as to why it might be applied in other ways than repayment to the client.

Historically interest on clients' accounts had never been repaid to the clients but had been held by the banks, which had accumulated large sums without payment of interest to anyone. This was changed, for example in Victoria in 1963 when the banks were required by statute to pay one third of the lowest trust account balance in the preceding year in each solicitor's account into an investment account controlled by the Law Institute of Victoria. Contributions from the investment account enabled the fidelity fund set up in 1946 to meet claims arising from a number of serious defalcations which at the time threatened the fund. With the passage of time, a reduction in the property market and a marked reduction in interest rates many of the Australian states now have to supplement funds from this source with levies on members. The majority of such funds may be capped within the discretion of the regulatory authority.

In 1991 the Law Society of Hong Kong commissioned KPMG Peat Marwick to undertake a study of interest retention policies by solicitors firms in Hong Kong. At that time the conclusion was that the average number of deposits received annually by a firm was 2,004 and the average amount of each deposit was HK$197.60. The total earned from deposits at a time when the property market was booming was thus $396,000 per firm against which had to be set off the administrative costs of putting in place such accounts and having them audited.

In January 1997 the Law Society issued a Practice Direction requiring solicitors to account to their clients for all interest on monies held for a certain length of time or above a certain amount.

From the above it will be seen that the establishment of a fidelity fund in Hong Kong financed to any extent by interest on clients' accounts is not a viable proposition. Times have changed since the states of Australia were able to establish such funds and now revenue from conveyancing and property work with the attendant accrual of interest are of historical interest only.

Whilst there have been adverse reports recently concerning the activities of a solicitor who has allegedly defrauded clients there have not been the level of defalcations that were experienced by jurisdictions in which fidelity funds existed such as, for example, Victoria and New Zealand. This may be due in part to the fact that in Hong Kong there is very little solicitors'

mortgage lending practice whereas in both Victoria and New Zealand this was an area of practice which gave rise to a number of such claims.

Whilst the Law Society of Hong Kong is not opposed to the establishment of a fidelity fund and would be fully prepared to administer it nevertheless there are concerns as to whether such a fund is necessary given the absence of a number of cases giving rise to claims against the fund, the level of professional indemnity cover now provided. The major question remains as to how it would be funded. Even in 1993/4 when the profession had a higher margin of profit there were such concerns at the ability of the profession to establish and continue to maintain a fund that the proposal was shelved at an advanced stage. The financial position of the profession as a whole is now more parlous. It is expected that following the collapse of the HIH Group of insurers the profession will be facing a call for contributions to make good the shortfall brought about by the collapse of the insurers and to compound the profession's financial burden by requiring a substantial commitment to a fidelity fund might well prove to be the "final straw that broke the camel's back" although inevitably in due course, the cost of providing monies for such a fund will be borne by the client in the form of increased fees.

There are precedents in Hong Kong for the establishment of funds to aid victims of fraud or misappropriation or loss financed by levies on the user. These include the Travel Industry Compensation Fund, the Stock Exchange Trading Fee and the recently announced levy by banks for a deposit insurance scheme. There appears no reason why a levy should not be imposed on the users of legal services to ensure no loss accrues to them in the same way that banks seek to do. A levy would be the most transparent and equitable method for the consumer to witness that their payment is credited to the fund in accordance with the amount of the legal fee paid.

However time would be needed to accumulate sufficient funds so that the fidelity fund could meet claims that might be made and accordingly a "lead in period" would be needed. A number of issues would need to be resolved such as whether the fund should be capped, whether the same levy would apply to all transactions or only those where funds are deposited and generally how the fund should be administered. The experiences relating to fidelity funds in overseas jurisdictions would be of considerable assistance if it were decided to take the matter further.

18 April 2002

doc. 58224