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How other regulators and jurisdictions manage consumer compensation funds

Research to inform the SRA's consumer protection review

Background

Legal sector consultancy Hook Tangaza undertook research for the SRA in May-June 2024 into consumer compensation arrangements in jurisdictions outside England and Wales, as well as those offered by other professions. The purpose of this was to ascertain if there were any useful experiences or ideas on which the SRA could draw on when considering the future of its own Compensation Fund.

Methodology

The research was undertaken by a combination of desk research and interviews/online exchanges with the relevant regulatory bodies or compensation fund organisations in other jurisdictions. Research focused on twelve jurisdictions selected for the comparable nature of the work undertaken by lawyers in those jurisdictions and the existence of compensation arrangements. These were: Victoria and New South Wales in Australia, New Zealand, Malaysia, South Africa, Singapore, Ireland, California and New York in the US, and Ontario, Alberta and British Columbia in Canada. Information was also received about Zimbabwe, Malawi and from the American Bar Association in relation to practice across all US states.

Exploratory discussions with authorities in Hong Kong, UAE and the Netherlands revealed that compensation arrangements for lawyer fraud of theft either had never existed, or (in the case of the Netherlands) had been discontinued when other changes in the handling of money were put in place.

Compensation arrangements covering Independent Financial Advisers, notaries, real estate agents, the construction industry and surveyors were also investigated. This was undertaken by desk research. Desk research methods involved consultation of online databases (Google Scholar, Lexology), keyword and AI prompt search.

Key findings

The problem

Some lawyer theft of client money occurs wherever lawyers have unfettered access to it. The vast majority of cases are relatively small and often related to mismanagement, but there are also striking instances of lawyer criminality. In a surprising number of jurisdictions, there have been cases of lawyers running, or facilitating, fraudulent financial or investment schemes entirely unrelated to legal services, which have had systemic consequences for compensation arrangements. As such incidences of theft and fraud have come to light, compensation funds in the affected jurisdictions have narrowed the scope of eligible claims.

The profile of practitioners most likely to be involved in theft or fraud is remarkably common across jurisdictions – usually (but not always) one- or two-person owned firms. Whilst regulators have historically reported[1] that perpetrators were often late middle-aged men, the incidence of women defrauding clients has increased internationally, which reflects their increasing share of ownership roles in firms. Younger lawyers running their own firms have also been more noticeably involved since the financial crisis, notably in the US. The work giving rise to theft is consistent across jurisdictions and mostly related to conveyancing, probate, litigation or insurance settlements.

What do other jurisdictions do?

The origin of lawyer compensation funds can be traced to New Zealand in 1929, when the Law Society struck a deal with the Government, establishing the fund as a quid pro quo in exchange for the maintenance of the solicitors' conveyancing monopoly and the associated right to hold client money. The concept has spread to most common law jurisdictions where lawyers hold money on behalf of their clients.

Most compensation funds are established in statute – either the lawyer statute, or in a few cases a separate specific Act relating to the creation of a compensation fund. Funds may be run as subsidiaries of Bars/Law Societies or sometimes as separate insurance organisations that also provide indemnity cover (for example, British Columbia, Alberta and South Africa).

The principles underlying compensation funds are fairly common across jurisdictions:

- They are generally funds of last resort, which require that all other reasonable avenues for recovery must have been exhausted first.
- As a general rule there is no automatic entitlement to compensation and funds have broad discretion over awards.
- They only cover theft or fraud, not negligence, and will only pay for actual losses, usually following investigation.
- Some, but not all, allow consumers to appeal award decisions. In Ireland there is an independent adjudicator who deals, alongside other responsibilities, with appeals against Law Society decisions relating to compensation fund claims.

What can be claimed?

Most lawyer compensation funds attach at least two conditions to claims:

[1] Eg to the International Conference of Legal Regulators

- Any claim must relate to a loss resulting from dishonesty. New Zealand has narrowed this purely to 'theft'.

- The funds lost must have been received by a lawyer acting in the 'ordinary course of legal practice'. Since the emergence of various investment and mortgage scams following the financial crisis, many compensation funds have tightened their definitions to exclude financial or investment services and mortgage financing. The British Columbia fund rules also state that claims cannot relate to unlawfully obtained property. The Australian compensation fund regulators stipulate that eligible losses must arise from funds held in client accounts or in transit to them.

Who can claim?

Seven of the twelve jurisdictions reviewed state that a claimant must have been a client, but all retain discretion over who to pay. This discretion has been most commonly used to restrict payouts to entities. In Ontario, for example, the compensation fund rules explicitly exclude client banks or financial institutions from claims, whilst various US states also exclude insurers and the funders of surety bonds.

In a few jurisdictions, more emphasis is placed on ensuring access to compensation for individuals who might be justly entitled. In California, for example, third parties are allowed to claim from the compensation fund, a provision which is designed to ensure that individuals who may be entitled to a share of a divorce settlement, for example, are able to make a claim, even if they were not the client.

How are claims handled?

All funds investigated maintain discretion on when and how much to pay out. None of the twelve funds investigated will automatically pay a claim, or pay the full amount of any individual claim. Factors taken into account in determining compensation will include: eligibility criteria, client negligence and fund sustainability. Annual total payouts usually range, on average, between 1-10% of fund size.

Most funds also impose time limits on claims – usually six months after the client is aware of their loss, but British Columbia allows a 10-year period for claims. In 2019, Ireland extended the period in which the Law Society would accept claims on the compensation fund from six months to 12 months.

Claims are generally capped either by amount per claimant, or by a total amount that can be claimed in relation to a single law firm.

Certain jurisdictions (for example, Ontario and New York) only pay out if the lawyer concerned is disbarred and then only once this has happened.

How are compensation funds funded?

Five sources of finance are most commonly used for compensation funds:

Individual lawyer contributions

The vast majority of lawyer compensation funds are derived from individual lawyer contributions levied alongside the renewal of practising certificates.

In some jurisdictions, such as New York, all lawyers are required to contribute, regardless of where and how they are practising[2], whilst other jurisdictions, such as Malaysia, restrict contributions to those holding practising certificates. In Alberta and Victoria there are exemptions for in-house and government lawyers, lawyers in community legal services and others who are exempt from holding a client trust account. On the other hand, British Columbia requires all partners in Multi-Disciplinary Practices (MDPs) to pay, regardless of whether or not they are lawyers, and Ontario also requires a small contribution from regulated paralegals. Only Victoria distinguishes between principals and employees, and requires principals in firms holding more than A$750k on their client account[3] to pay twice as much as their counterparts in firms with smaller amounts of client funds under their control.

Investment income

Investment income provides the second largest source of funding for compensation funds. Many jurisdictions have large and actively managed investment portfolios with a balanced risk profile that combines growth with protection of assets. In many cases this has produced a separate governance structure dedicated to the oversight of compensation funds (which are often combined with collective insurance arrangements), supported by actuaries and auditors.

Interest on lawyers' client accounts/trust accounts

There are a few jurisdictions that direct interest on client accounts to their compensation funds. In the case of the South African and Zimbabwean legal practitioner fidelity funds, this is managed by direct payment of interest into the compensation fund account by the financial institutions that provide client accounts. In the case of Victoria, practitioners must transfer a proportion of the average monthly balance of their client account held in the previous quarter to the regulator. This money is held on a precautionary basis and gives the regulator direct and immediate oversight over the state of client accounts. The interest on the cumulative funds held are retained by the regulator.

Excess insurance

Stop-loss insurance is used to manage risk in certain jurisdictions, such as Alberta, South Africa, Ireland and Zimbabwe[4]. This helps to limit the impact of any disastrous losses on professions made up predominantly of small firms. Under such arrangements, claims are covered by the fund up to a threshold amount, with insurance covering claims above this limit. The annual liability of the profession in aggregate is therefore capped (C$25m in Alberta =£14m, $17.5m in South Africa =£13.7m, €5m in Ireland) and this helps to ensure the sustainability of the fund. This form of insurance is expensive but its cost is mitigated by the fact that in both

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[2] There is no non-practising New York status
[3] Known in Victoria as "Trust money"
[4] Excess insurance is also provided for as an option in Malawi's legislation but the regulations to establish a compensation fund have not yet been enacted.

cases quoted the insurer is managing the general professional liability insurance for the professions concerned, as well as the theft excess.

Recoveries and fines

Most jurisdictions pay recovered monies into their funds, although these, on average, only amount to 5% or less of the claims made. The State Bar of California fund, as a government agency, is also able to receive proceeds from other disciplinary fines and sanctions imposed by the court.

Risk management

Most jurisdictions with compensation funds have experienced large, one-off claims that have threatened their sustainability. This has led to the adoption of the following approaches:

Up front controls

There are some jurisdictions with compensation funds that require lawyers to have explicit permission to open a client account and often to go through additional due diligence or training (for example, in New Zealand, Singapore, Victoria). Some also impose tight controls on where lawyers can hold client accounts and receive regular reports from the banks in which those accounts are held, including of exceptional movement of funds or overdrafts. In New South Wales, the use of trust accounting software is mandatory and in Victoria, as already noted, lawyers must deposit a proportion of the funds they are holding with the regulator.

Mechanisms to manage fund balances

Ensuring the continued integrity of compensation funds is a challenge everywhere. Jurisdictions use different tools to do so, most often relying on exceptional professional levies to make up shortfalls, if annual contributions are insufficient. Actuaries are used by various jurisdictions to keep funds within an acceptable range.

In addition to stressing the discretionary nature of payouts, funds in some jurisdictions are permitted to make partial or staged payments or postpone payment to a later date. In North America, funds will often only pay out if a lawyer has been disbarred, which more explicitly links compensation to disciplinary action. In Ireland, the Law Society may require a report to be made to the police before accepting a claim. Many US states also incorporate the repayment of stolen funds in their disciplinary sanctions. The State Bar of California can also obtain reimbursement from the future earnings of disbarred lawyers through the tax system.

Alternatives to compensation funds

Legal sector alternatives

Within the legal sector, the main options appear to be:

No fund

Clients in Hong Kong and the UAE must rely on civil action in the courts for recovery of losses, although in Hong Kong judges can award compensation following criminal prosecution of lawyers for theft. The Hong Kong Government has considered requiring the Law Society to establish a client compensation fund on more than one occasion, but rejected it on grounds of the prohibitive cost and impact on small firms.

Controlled accounts or third party managed accounts (TPMAs)

The controlled account approach requires lawyers to open dedicated accounts with specific banks and places tight controls on the release of funds. In some countries where this approach is used (for example, in Belgium and the Netherlands) the role of lawyers is quite different to the UK and client money is less frequently held. In cases like these, lawyers managing these accounts require dual authority to move money and the regulator must be granted irrevocable power of attorney over such accounts. Singapore has gone further and introduced TPMAs for conveyancing which, along with the alternative of entirely separate and more tightly controlled conveyancing accounts, keep conveyancing funds entirely separate from solicitor client accounts. This has reduced the incidence of theft but has come in for criticism as a more expensive and cumbersome approach than traditional client accounts.

Beyond the legal sector

Beyond the legal sector, the best-known consumer guarantee schemes can be found in:

Deposit guarantee schemes

These are most common in the financial sector across the UK where they exist to maintain trust in the ability of financial institutions to look after consumers' savings and investments. There are also similar schemes run for builders and comparable contractors (see, for example, the Consumer Protection Association DGS), but these cover business failure rather than theft and are capped at very low amounts (maximum £7,500). Alternatively, the mandatory Deposit Protection Service for property tenancies offers two alternatives – custodial or insured deposits, the first type is free and the second attracts a small insurance premium. Such schemes reduce the opportunity for fraudulent deductions by landlords. They work because funds can be held over long periods and interest is only payable after six months.

Surety bonds

Surety bonds are used in the Court of Protection in England and Wales to protect the assets of vulnerable individuals when these are managed by Court appointed deputies. The Office of the Public Guardian, which oversees the registration of powers of attorney in England and Wales, has made it clear that solicitor client accounts are unsatisfactory as anything other than a very short-term solution until a full third party managed account can be put in place[5].

Surety bonds are also used to protect funds in New York real estate transactions and for some US and Canadian probate matters. These bonds are generally ordered by the Court and are

[5] Public Guardian practice note (SD13) on the OPG's approach to solicitor client accounts

expensive. The US Surety Bond Authority suggests that the premium for a bond would be around 0.5%-1% of the amount covered. This would add £500-£1000 to solicitors' costs for every £100,000 protected and would almost certainly be passed on to clients.

Surety bonds have also been used in the UK property sector, but the UK Surety Bonds National Council also expressed concern in its 2023 Market Conditions update[6] that insurers were increasingly reluctant to provide these products.

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[6] Market Conditions Update 2023 – Surety Bonds National Council (sbnc.org.uk)