Respecting the "trust" in trust account

It may be because of difficult economic circumstances …or the need to keep a client happy …or simply a lack of understanding of what a trust account is and how it should be used.

Whatever the underlying reason, the end result is the same: An increasing number of lawyers are facing claims related to inappropriate use of their trust accounts. In some instances, lawyers are being duped into activities involving subsequent allegations of fraud or money laundering. More commonly, they are merely letting clients use their trust accounts as bank accounts, or acting purely as escrow agents. Often, there is some question as to whether or not the lawyer provided any legal services in connection with the monies that flowed in and out of their trust account – leaving open the door to a potential denial of coverage under the LawPRO insurance policy, and leaving the lawyer potentially exposed to the full costs of the claim being made.

Why are lawyers' trust accounts such an attractive option for their clients? Because lawyers are in a unique position of trust.

A lawyer's professionalism is held in the highest esteem, so their services automatically are imbued with an aura of respectability and confidence. Their activities on behalf of their clients are protected by solicitor/client privilege (subject to requirements of new federal anti-money laundering legislation). For those who prefer not to leave a paper trail, lawyers' trust accounts are an attractive alternative to traditional financial institutions. Among the most vulnerable is the sole practitioner who – perhaps of economic necessity – closes his eyes to the improper ways in which he is being asked to use his trust account, or simply does not understand that his trust account is being used for purposes that have nothing to do with his legal expertise, and everything to do with moving money in inappropriate, and sometimes illegal, ways.

The following are summaries of typical claims that LawPRO has seen in the last few months involving improper use of trust accounts.

The construction project front

A small, but sophisticated, developer decided to be his own general contractor on Project A through companies he owned.

He retained his lawyer to help him. The lawyer also acted for the bank that was funding the construction. Advances from the bank loan were paid to the lawyer in trust. Rather than immediately paying out these funds to the client, the lawyer left the money in his trust account. Over the next few months, he took instructions from the developer about whom to pay and how much. As it turns out, many of the payments paid debts on other projects, the developer's overhead, and other items not connected with Project A. Subcontractors for Project A have now sued the developer and the lawyer directly for breach of trust under the *Construction Lien Act*.

While this points out the need for the lawyer to have understood the *Construction Lien Act*, it also highlights the problems that can arise when a lawyer allows the client to use her trust account indiscriminately. The lawyer has created an opportunity for strangers to make claims against him. Regardless of the outcome, she faces the financial and other costs of dealing with a claim.

Letting clients use trust accounts as bank accounts

On some claims involving trust accounts, lawyers let their clients use trust accounts as bank accounts: They will accept and deposit cheques from clients and then make payments on their trust accounts on client instructions – without providing any legal services related to the transactions.

We have examples where lawyers have consented to requests from clients to run dozens, even hundreds of transactions through their trust accounts, even though they have no knowledge of the source or payee; in some instances, the transactions did not relate to any file or matter that the firm knew about. Subsequent inappropriate activity on the part of the client in situations such as these inevitably leads to disputes that involve the lawyer – and raises the issue of liability insurance coverage if the lawyer cannot prove that he or she provided legal services related to the transaction under dispute.

In another example, a client asked the lawyer to let him use the lawyer's trust account to facilitate the process of lending money to a relative who was purchasing property. The lawyer did not act for either party in the real estate transaction, but did deposit into his trust account a handwritten, certified cheque from the client, and subsequently wrote cheques on that trust account to various parties, as directed by the client. It turned out the certified cheque had been altered, and had been certified for only a few hundred dollars and not hundreds of thousands of dollars. A claim was the inevitable result.

Lessons learned

What lessons can lawyers learn from these examples?

Firstly, your trust account should be under your control. No matter how benign the transaction looks or how much confidence you have in the client, if you are being asked to use your trust account in ways that are not appropriate, and not consistent with the Rules of Professional Conduct and related guidelines (see sidebar on page 23), you do have the option to say NO.

Second, be mindful of the role you are being asked to fulfill in the transaction, your potential liability and the possibility that you may not be covered for this "service" under your professional liability insurance policy. If you are **not** providing legal services related to the transaction involving your trust account (or any other type of transaction, for that matter), you may be denied coverage if a subsequent dispute arises.

The issue of coverage: Is there or is there not?

Everyone knows that in real estate transactions, purchasers' solicitors receive purchase funds into their trust accounts. The source of these funds are the purchasers themselves, or the purchase mortgagees. Purchasers' solicitors then pay the money over to the vendors' solicitors, who deposit the money into their trust accounts, and then pay the proceeds to the vendors. Defendants' solicitors receive settlement funds from their clients, deposit them into their trust accounts, then pay the money to the plaintiffs' solicitors, who deposit the money into their trust accounts for payment out to the plaintiffs. We could multiply examples.

The point is, these solicitors receive money into their trust accounts in connection with some transaction which forms part of their legal practice. Solicitors do not operate as bankers, simply receiving money and paying it out again, as their "depositors" demand.

Several English cases make the point that it is not the practice of law to simply receive money into a solicitors' trust account, and pay it out again, without any underlying transaction in which the solicitor provides legal services.

In *United Bank of Kuwait Ltd. v. Hammoud and others* [1988] 3 All E.R. 418, the English Court of Appeal held at pp. 427 – 428:

> "The evidence establishes that two requirements must be fulfilled before an undertaking is held to be within a solicitor's ordinary authority.
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> "First, in the case of an undertaking to pay money, a fund to draw on must be in the hands of, or under the control of, the firm; or at any rate there must be a reasonable expectation that it will come into the firm's hands. Solicitors are not in the business of pledging their own credit on behalf of clients unless they are fairly confident that money will be available so they can reimburse themselves.
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> **"Second, the actual or expected funds must come into their hands in the course of some ulterior transaction which is itself the sort of work that solicitors undertake. It is not the ordinary business of solicitors to receive money or a promise from their client, in order that without more they can give an undertaking to a third party. Some other service must be involved."**

The *United Bank of Kuwait* case was followed in *Hirst v. Etherington* [1999] Lloyd's Rep P.N. 938 (Eng.C.A.). An English solicitor, Mr. Etherington, acted for a Mr. Wilkinson. He also represented Wilkinson's companies. The plaintiff Hirst agreed to loan £30,000 for a period of six months to a firm controlled by Wilkinson. Etherington gave Hirst's solicitor, Miss Hedges, an unconditional undertaking to pay £36,000 to Hirst at the end of six months. Hirst's solicitor knew that Etherington had a partner, Miss Bassett. Miss Hedges asked Etherington whether the undertaking was given in the ordinary course of the firm's business. Etherington assured her that it was.

The money was never repaid. Etherington became bankrupt. Hirst sued Miss Bassett on Etherington's undertaking. The trial judge gave judgment to the plaintiff.

The Court of Appeal allowed Miss Bassett's appeal. The undertaking in question was in reality nothing more than a guarantee of the client's indebtedness. Such undertakings are not within the ordinary course of a law partnership's business. **It is within the scope of a solicitor's business to undertake to apply funds received from an underlying transaction in a certain way**. Miss Hedges was not justified in simply accepting Etherington's assurances that the undertaking was given within the ordinary course of the firm's business. **She should have inquired concerning the "underlying transaction."** There was in fact none.

While *United Bank of Kuwait* and *Hirst* are "undertaking" cases, the same logic applies to "deposit and pay out" transactions. Simply taking in money and paying it out again is bankers' work, not solicitors' work.

Withdrawal of money from trust accounts

By-Laws 18 and 19 of the Law Society's Rules of Professional Conduct provide lawyers with some specific guidelines on how to use a trust account.

Money that may be withdrawn

Lawyers shall only withdraw the following from a trust account:

- money properly required for payment to a client or to a person on behalf of a client;
- money to reimburse the lawyer for money properly expended, or incurred on behalf of a client;
- money required for, or toward, payment of fees for services performed for which a billing has been delivered;
- money directly transferred into another trust account and held on behalf of a client;
- money that should not have been paid into a trust account but was inadvertently paid into a trust account;
- other money if authorized to do so by The Law Society of Upper Canada.

Manner of withdrawal

Lawyers shall only withdraw money from a trust account by:

- cheque drawn in favour of the lawyer;
- transfer to a bank account kept in the name of the lawyer and is not a trust account;
- electronic transfer according to the procedure set out in By-law 19, s.7.

Withdrawal by cheque

Lawyers shall ensure that cheques drawn on a trust account shall not be:

- made payable to either cash or bearer;
- signed by a person who is not a lawyer, except in exceptional circumstances and if conditions exist as set out in By-law 19.

Withdrawal by electronic transfer

Lawyers shall only withdraw money from a trust account by electronic transfer if the conditions in By-law 19 are met. Conditions to be met include:

- electronic system requirements;
- timely production of confirmation of certain information relating to the electronic transfer;
- use of electronic transfer requisition, Form 19A.