Dear Mr Woolford

Open Bank Resolution Pre-positioning Requirements Policy

1 Introduction

1.1 We refer to the consultation paper of the Reserve Bank of New Zealand (Reserve Bank) in respect of the Open Bank Resolution Pre-positioning Requirements Policy dated March 2013 (Consultation Paper).

1.2 The New Zealand Law Society (Law Society) welcomes the opportunity to make submissions in relation to the Consultation Paper.

2 Overview

2.1 The Law Society understands that the purpose of the Open Bank Resolution (OBR) policy, if adopted, is to avoid significant damage to the financial system in the event of a bank failure by providing the flexibility to assign a portion of the bank’s losses to creditors immediately without disrupting the payments system, and allowing for continued access to a portion of each creditor’s deposits.

2.2 The Law Society understands the OBR policy is to apply to locally-incorporated registered banks with retail deposits of more than $1bn (and other banks which opt in) and also understands the initiative of planning for an emergency such as a bank becoming distressed.

2.3 However, the Law Society firmly submits that the OBR policy, including both the pre-positioning by the affected banks in the form of the necessary systems to allow the OBR to be carried out within the necessary timescales and any ‘freeze’ of a portion of depositors’ accounts should not be applied to lawyers’ trust accounts. The basis for this submission is set out below.

3 Statutory provisions relating to lawyers’ trust accounts

3.1 Section 110(1) Lawyers and Conveyancers Act 2006 (LCA) provides:

   (1) A practitioner who, in the course of his or her practice, receives money for, or on behalf of, any person—
(a) must ensure that the money is paid promptly into a bank in New Zealand to a general or separate trust account of—

(i) the practitioner; or

(ii) a person who, or body that, is, in relation to the practitioner, a related person or entity; and

(b) must hold the money, or ensure that the money is held, exclusively for that person, to be paid to that person or as that person directs.

Section 110(3) relevantly states:

For the purposes of this section, a practitioner or an incorporated firm is deemed to have received money belonging to another person if—

(a) ...

(b) the practitioner or incorporated firm takes control of money belonging to that person.

3.2 The effect of the above provisions is that a lawyer must promptly pay into his or her trust account at a bank in New Zealand all monies received by the lawyer on behalf of any person. In fact, it is an offence not to do so. Further, by virtue of section 110(3), money is deemed to be received if the lawyer takes control of the money.

3.3 Section 114 LCA provides as follows:

It is the duty of every practitioner and of every related person or entity and of every incorporated firm to ensure that, wherever practicable, all money held on behalf of any person by that practitioner, related person or entity, or incorporated firm earns interest for the benefit of that person, unless—

(a) that person instructs otherwise; or

(b) it is not reasonable or practicable (whether because of the smallness of the amount, the shortness of the period for which the practitioner, related person or entity, or incorporated firm is to hold the money, or for any other reason) for the practitioner, related person or entity, or incorporated firm to invest the money, at the direction of the person for whom the money is held, so that interest is payable on it for the benefit of that person.

3.4 Accordingly, unless a client instructs to the contrary or it is not reasonable or practicable to do so, a lawyer must arrange for monies held to be placed on interest-bearing deposit. In practical terms, the combined effect of sections 110 and 114 LCA is that monies held by lawyers in the course of their practice must be placed on interest-bearing deposit at a bank.

3.5 The requirements of section 110 LCA are absolute. Lawyers must place all monies held by them for any person in a trust account at a bank in New Zealand. The only way this requirement can be avoided is for the lawyer concerned not to receive or take control of monies. This is impractical in most property and commercial transactions involving payment of monies.
4 Application of policy to lawyers’ trust accounts

4.1 Whilst, as stated above, the Law Society understands the rationale underpinning the OBR policy, we are concerned that its application to the trust accounts of lawyers would create a number of difficulties. These concerns are set out in paragraphs 4.2 to 4.9 below.

It needs to be recognised that a lawyer’s trust account consists of funds of different amounts held by the lawyer on behalf of different persons. In the case of a large law firm, trust account monies may be held on behalf of hundreds of clients at any one time.

4.2 Lawyers are subject to a statutory requirement to place money held on behalf of other people at registered banks. Given this restriction, the Law Society submits that it is unsatisfactory for any ‘freeze’ (as described in the Consultation Paper) to be applied to such money held in lawyers’ trust accounts under the OBR policy.

4.3 Sections 110(1) and 110(2) of the LCA each state that money held in any such trust account for another person must be held exclusively for that person and is to be paid as that person directs. Any application of a ‘freeze’ to a trust account would be unsatisfactory as a lawyer holding money in a trust account would then be unable to pay that money as directed (and would be in breach of the requirements of the LCA).

4.4 At a broader policy level, two of the express purposes of the LCA (see sections 3(1)(a) and (b)) are to maintain public confidence in the provision of legal services and conveyancing services, and to protect the consumers of legal services and conveyancing services. It is the Law Society’s view that to impose any ‘freeze’ under the OBR policy on trust accounts held by lawyers would be inconsistent with those purposes. Further, the service rendered by lawyers in providing trust account facilities promotes confidence in and enables a wide range of domestic and commercial transactions. The OBR policy, as currently proposed, would limit the legal profession’s ability to meet those statutory objectives by restricting the ability of lawyers to provide their usual undertakings in respect of money held on behalf of clients, and by preventing the continued flow of funds in transactions in circumstances where a freeze was imposed as a result of OBR being implemented. The giving of undertakings by lawyers in property and commercial transactions which involve the transfer of money and the reliance upon such undertakings by the parties is a critical factor in virtually all such transactions.

4.5 The Reserve Bank has stated that the OBR policy will strengthen the incentives for creditors to scrutinise bank management closely. The Law Society understands that such methods may promote the commercial strength of the banking environment. However, we submit that, as lawyers have no alternative but to place money held for any other person in a trust account with a registered bank, the legal profession’s hands are tied (by virtue of the LCA limiting or removing the profession’s ability, following any such scrutiny, to act on it in the manner contemplated) in respect of trust accounts. We also add that the requirements of the LCA result in the provision of valuable liquidity to registered banks. Consequently, we believe that to require the legal profession to undertake its own monitoring of the sector, in addition to the supervisory role of the Reserve Bank, when there is no alternative is unsatisfactory. The Law Society also notes that, because it is proposed that the OBR policy would not apply to any New Zealand registered bank operating as a branch of an overseas-incorporated bank, one result of the policy may be to create the potential for a significant mismatch of treatment between banks that are subject to OBR and those New Zealand registered banks operating as branches of overseas-incorporated banks where they offer services in respect of lawyers’ trust accounts.

4.6 While the Law Society has not exhaustively examined the impact of the OBR policy, one potential outcome is that the policy, when implemented, could result in a practice developing whereby lawyers
must inform their clients of the risks of placing money in their trust accounts compared with other available options and, potentially, of the steps they take to monitor the stability of the banks with which their trust accounts are held. Further, in the event that the OBR policy is implemented, lawyers could be subject to claims of negligence in failing to monitor appropriately the banks with which their trust accounts are held. The Law Society does not consider that the wider objective (see paragraph 4.4 above) of promoting public confidence in the banking and legal services systems would be well served as a result of such developments.

4.7 Additionally, the Law Society is concerned that there could be a general reduction in client use of lawyers’ trust accounts, to provide certainty and security of funds for any lengthy period of time including, for example, holding money that is under dispute, holding money that is subject to conditionality in commercial arrangements, and holding money in escrow. Such arrangements are often crucial in facilitating both domestic and commercial transactions and are often specific requirements of contracts.

4.8 Furthermore, in the event of OBR taking place, it is likely that (in spite of the OBR policy objective of avoiding unnecessary disruption) a significant hiatus in the efficient completion of pending property and commercial transactions could result, while lawyers with affected trust accounts work through how to apportion partially frozen funds among the various clients with funds in the trust account. The Law Society does not expect that the application of the *de minimis* (as described in the Consultation Paper) to a lawyer’s trust account would be of material assistance. The Consultation Paper suggests that the *de minimis* would, if applicable at all, apply to the trust account as a whole (rather than to each client ledger account making up the global amount in the trust account). As noted above, a lawyer’s trust account is always made up of funds belonging to a number of individual clients. For most purposes, including the application of *de minimis*, it is wrong to treat the trust account as a global fund.

4.9 In any case, funds held in a lawyer’s trust account are typically considerably in excess of any likely *de minimis* threshold, and it is generally the case that the whole of any trust account funds held in respect of any client are necessary for the completion of a particular transaction. In other words, the release of a nominal amount would leave insufficient funds available to achieve the purpose for which the funds are being held for that client.

4.10 For completeness, it should be noted that, if the OBR policy did not apply to lawyers’ trust accounts, the Law Society does not anticipate that lawyers’ trust accounts could be used by clients as a means to avoid, or isolate funds from, the potential effect of the OBR policy of requiring bank creditors to take some risk. Trust accounts are intended to be used for the purposes of identified legal and conveyancing transactions, and not for general investment or day-to-day banking purposes. Guideline 7.7 of the Law Society’s Trust Account Guidelines states that, unless otherwise directed, lawyers have a duty to pay to the client any balance of money held after the task for which it was held has been completed.

It should also be mentioned that a law firm’s own funds are not held in the firm’s trust account but in a separate general account. Accordingly, a law firm could not use its trust account to avoid the application of the OBR policy to its own funds.

5 Alternatives

5.1 In order to assist discussion in respect of the OBR policy and how it affects trust accounts held by lawyers, we set out some alternative proposals below.
5.2 The Law Society’s preference would be for lawyers’ trust accounts to be exempt from the scope of the OBR policy.

This could be done by way of a specific exception as part of the OBR policy that would provide for all money held in lawyers’ trust accounts to be treated similarly to any *de minimis* imposed and not subject to any ‘freeze’. In order for this to be a satisfactory alternative, the pre-positioning requirements would need to be developed in such a way to ensure that the systems put in place by a bank subject to the policy were sophisticated enough to identify relevant trust accounts and ensure that the full balance was not subject to any ‘freeze’.

5.3 As lawyers are required by law to place money held on behalf of other people at registered banks and also required to distribute that money as directed, the Law Society submits that, in the event of lawyers’ trust accounts not being exempted from OBR, the Government should provide a deposit insurance scheme or some other protective measure in respect of that money (on the basis that the LCA has removed the ability for significant discretion to be exercised in determining where such money will be held). If a deposit insurance scheme or some other protective measure were put in place in respect of trust account monies, the detrimental effect on confidence in lawyers’ trust accounts, together with possible imposed breaches of the LCA caused by the OBR policy, would be mitigated.

5.4 In the event that an exemption is not acceptable, the Law Society suggests that it would be necessary for the pre-positioning requirements to recognise trust accounts not as a global amount but as numerous different amounts held exclusively for other people. Further, that it would be necessary for banks subject to the policy to put systems in place to recognise each individual amount held and to apply the *de minimis* and ‘freeze’ in respect of each of those amounts and not to the entire global amount. However, as noted above, the Law Society does not expect that the release of nominal amounts (even on a per client basis) would greatly assist the efficient completion of the transactions for which the monies are being held in any trust account.

We would be happy to discuss any aspect of these submissions with you.

Yours sincerely

Chris Moore
President