LEGAL RISK LLP
SOLICITORS

Insurance: The Solicitor's Profession in Crisis

FIRST PUBLISHED IN APP, ISSUE 39 NOVEMBER 2013

"As firms are forced to close, the toll on the profession and consumers will be significant"

Head office of failed insurer of solicitors, Lemma, in Gibraltar - above the restaurant.

In the writer's previous article, in the July 2013 edition of A Propos Partnership (no. 38), the writer asked whether the cover required of solicitors was too gold-plated, and driving firms to take out cover with insurers which posed unacceptable risk. This article examines this further in the light of events which followed.

Solicitors in England and Wales were all required to renew their professional indemnity insurance ("PII") on 1 October 2013, the last year with a compulsory common renewal date. At the time of writing 153 firms are reported to have failed to find cover. As the deadline for renewing practising certificates expired on 31 October 2013, it remains to be seen how many dropped out without first having notified the Solicitors Regulation Authority ("SRA") that they were unable to find cover.

As firms are forced to close, the toll on the profession and consumers will be significant. Firms facing unplanned closure will have to deal with the cost of redundancy and the loss of livelihood of all involved with untold human cost. So how did it come to pass?

This was the first year that there was no fallback position. In previous years, the Assigned Risks Pool ("ARP") provided cover for those unable to find cover. This was backed by all the insurers offering cover in proportion to their market share. Insurers balked at this, because it meant that after declining firms as unacceptable risks, they then picked up the tab for insuring them. Although the ARP premiums were massive (up to 27.5 per cent of gross fees), they often went unpaid, leaving a huge burden which ultimately was shouldered by the rest of the profession.

So this year, firms unable to obtain cover were entitled to a further 90 days cover from their existing insurer. They could carry on as normal for 30 days in what is known as the Extended Indemnity Period' ("EIP"), but then had to wind down over the next 60 days - the Cessation Period - without taking on more work.

Most of the firms who faced difficulty were small – up to four partners. But at least three top 100 firms had significant trouble obtaining cover to the writer's knowledge. All firms should study their claims record and compare the cost of claims with premiums paid over the past six years, without any attempt at sanitising them by explaining the figures away

on the basis that, for example, the partner concerned has now left.

One of the three firms mentioned had claims figures which were all but the law firm equivalent of the catastrophic losses sustained following Hurricane Katrina, yet was in denial, apparently deluding itself that the figures could be explained away, and that other firms were probably the same; they were not. That firm obtained cover, but only at the eleventh hour, and on terms which would bring tears to the eyes of most law firm partners with a self-insured excess larger than many firms' total cover.

However, claims history is not the only concern for insurers: credit risk is also a problem. If the firm does not pay the self-insured excess on a claim, the insurer has to pay it and seek reimbursement later. And if the firm closes, the insurer has to provide six years' run-off cover, even if the premium is not paid.

"There were several reasons why the problem focused primarily on smaller Firms"

There were several reasons why the problem focused primarily on smaller firms. First, simple mathematics dictate that even a modest claim is likely to mean the insurer has lost money insuring the firm. A large firm paying large premiums is more likely to remain profitable for insurers.

Secondly, small firms have been more exposed to the rash of conveyancing claims from lenders, partly triggered by the state of the economy – a lender is less likely to lose money as a result of negligence when property prices are rising; when borrowers default and property prices have fallen, they will look to recover the shortfall from professionals.

Third, the economics of insuring small firms meant that many of the larger and better-known insurers pulled out of offering cover. This created a gap in the market, which was filled by unrated insurers. Some unrated insurers may be properly run, but others evidently were not. The market has been hit by multiple failures, as recounted in the writer's previous article. Readers may recall that approximately 1300 firms out of 10,000 or so – were insured with Latvian insurer Balva, which had its licence withdrawn in March 2013.

Since the last article, things went from bad to worse. Balva policyholders were offered the opportunity to cancel their Balva policy and replace it with a two year policy from German insurer, Berliner – again, unrated, and with only €6 million capital. While the choice of yet another unrated insurer was unpalatable, given the 'known knowns' of Balva's problems, with acknowledgements to Donald Rumsfeld, many firms took up the option, reassured by the belief that they had put their insurance problems to bed for two years. Sadly, that was not to be.

The bombshell hit in the second week of September 2013. It transpired that the Financial Conduct Authority had concluded that Berliner was not authorised to offer solicitors' PII cover. There were several consequences to that. The seriousness of any one of these could not be underestimated, but together they were catastrophic for many firms.

First, it meant that they had failed in their endeavours to escape cover with Balva, which by now had appointed a liquidator (though still said to be solvent, but see below). Because there had

LEGAL RISK LLP
SOLICITORS

beenno effective replacement cover, it meant under SRA rules that the Balva policy was still in force.

Secondly, and more critically, they were thrown into the renewal market with only two weeks to go. Those who lost out in the scramble for cover, were not necessarily the worst firms, though many did have severe losses on their claims history. The problem was exacerbated because XL had withdrawn from the market, having covered approximately 25 per cent of firms on the previous renewal, according to the Law Society's survey.

Contrary to popular speculation among smaller firms that insurers are making large piles of cash out of insuring them, one has to assume that XL did not withdraw from the market because they were making too much money out of insuring solicitors. Other well-known insurers such as Aviva and RSA had already withdrawn from this market sector. Firms with 25 per cent or more conveyancing income, which means very many small firms, were not even being considered by a number of insurers.

While some took advice on what to do next, many panicked, and liberally sprayed the insurance market with copies of their proposal form. This meant that some insurers saw the same, not always wholesome, proposal four times.

Third, many of these firms were unable to obtain replacement cover by 1 October 2013, which meant they were reliant on the Extended Indemnity Period for cover. But that meant paying another premium – to Balva. Many were understandably reluctant to pay any more money to Balva, now in liquidation, particularly as they thought they had already paid Berliner for this year's insurance.

If they were already feeling the pinch of the general economic woes, the personal injury costs and referral reforms, the legal aid cutbacks and the lack of conveyancing and other transactional activity, the prospect of borrowing yet more money was daunting, and the opportunities for doing so everdiminishing. And the practising certificate renewal bill loomed large for the end of October – to cover a full 12 months for a firm that may cease to exist before the year was through.

"Those firms who were – and therefore still are - insured by Balva face a further unsavoury dose of Balva cover..."

Those firms who were – and therefore still are - insured by Balva face a further unsavoury dose of Balva cover, because if they close, they must take out, and pay for, six years' run-off cover with Balva. In practical terms, they cannot buy it anywhere else.

The finances of Balva will be a matter of acute interest for firms insured by them. As noted in the writer's previous article, although Balva is said to be solvent, theunaudited 2012 accounts on its website give no cause for comfort. It is far from clear whether the 2012 premiums of £16.5 million have been yet been paid to Balva. The understandable reluctance of firms to pay any additional premiums due for extended cover and run-off cover may only exacerbate Balva's problems.

It must be remembered that firms will be dependent on Balva's solvency for many years to come: even though Balva cannot write any new policies, claims already notified and those which may be notified under extended and run-off

policies may take years to resolve. In the writer's experience, it may take 20 years to close the book. 'Balva' means 'prize' in Latvian: many must fear it will turn into a booby prize.

If Balva were to fail, firms may have recourse to the Financial Services Compensation Scheme ("FSCS"), but this only provides 90 per cent cover, and in the writer's experience from past insurer failures it is hard in practical terms to settle a claim with a claimant if you are not going to pay the full amount for which you are settling the claim. Even 90 per cent cover does not equate to peace of mind if, as one small firm found, there is a large six or seven figure claim.

In addition, in broad terms, firms which have turnover exceeding £1 million in the accounts prior to the last policy's inception are ineligible for any FSCS cover at all. There are firms with claims under Lemma policies facing this problem, following Lemma's collapse into liquidation as mentioned in the previous article.

Insurer failure puts the risk back onto the solicitors' own assets. While there may be some comfort from incorporation as a limited company or limited liability partnership, the latter untested, there are still individuals exposed on any analysis. Personal appointments as trustee or executor may be an issue, as may liabilities predating incorporation.

A further risk of personal liability lies on firms which have closed and been taken over by practices which insured with an insurer which later failed. Many older practitioners have retired in the belief that they had peace of mind because someone else was taking on the responsibility of providing cover for their past liabilities. If that was provided with an insurer which fails, the clock may be turned back unexpectedly.

The picture in conclusion is unsatisfactory. A grandiose scheme aimed at client protection is failing clients and failing the profession. Some are asking whether unrated insurers should be banned from participating in the solicitor market. While superficially attractive, assuming it were lawful (which is not beyond doubt), it would probably make a large part of the profession uninsurable. The answer can only be a root and branch analysis of the reasons why insuring solicitors is unattractive to a large proportion of the insurance market. Some have called for the revival of a mutual such as Solicitors Indemnity Fund. The writer has grave doubts whether that is practicable, but that is a topic for another day.

" 'Balva' means 'prize' in Latvian: many must fear it will turn into a booby prize"

Frank Maher is a partner in Legal Risk LLP, solicitors, specialising in professional regulation and professional indemnity for law firms. He can be contacted on 0845 330 6791 or frank.maher@legalrisk.co.uk