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Client Protection – too good to be true?

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Can our best intentions to protect clients from negligence, fraud and law firm insolvency work against the interests of those we seek to protect? This article looks at a recent report and its implications in relation to law firms' clients in particular, following the recent closure of three insurance companies on which many solicitors' practices relied for cover.

Collapsing insurers

Irish insurer, Quinn, went into administration in March 2010. The collapse of Lemma, a Gibraltarian subsidiary of a Ukrainian insurer, in September 2012 left many law firms without cover and the withdrawal of Balva's licence by its Latvian regulator in March 2013 has left one in seven firms worrying that they too may face similar issues. Balva is said to be solvent, though the unaudited 2012 accounts on its website give no cause for comfort.

Approximately 2,900 firms were insured by Quinn, 300-400 firms by Lemma, and 1,300 by Balva:, according to the Law Society's Annual Statistical Report 2012, there were 10,102 solicitors' practices in England and Wales as at 31 July 2012. Many have been hit twice, and no doubt some by all three failures.

All three were unrated insurers. Firms insured by Quinn appear to be well protected by the Irish compensation arrangements under which the Irish premium-paying public, perhaps unwillingly, subsidise solicitors in England and Wales. The Financial Services Compensation Scheme ("FSCS") provides a measure of protection in other cases – 90 per cent cover, but only for firms, broadly, with turnover not exceeding £1 million. There are also other limitations on the FSCS which could mean the problems of falling back on its protection are not limited to the 10 per cent shortfall in cover.

Ratings are no guarantee of insurer solvency. They are paid for by the insurer. The limitations on the work of ratings agencies were exposed by the global financial crisis in 2008. There has also been a failure of a rated UK insurer of solicitors and other risks: Independent Insurance was AA rated immediately prior to its collapse. Nonetheless, a rating may be an indicator, if not a guarantee, of stability.

To put this into context, the writer was recently instructed by a law firm which had taken out insurance with Lemma. It faced two claims, one exceeding £400,000 and another for £30,000. The firm's turnover exceeded the £1 million limit by a small margin, and the FSCS duly rejected the claim for support. Fortunately, a solution was found which enabled the firm to obtain protection, much to the relief of the four partners whose future was on the line, though they still have to find the shortfall of 10 per cent.

> ***"There has also been a failure of a rated UK insurer of solicitors and other risks…"***

Regulatory requirements

The Legal Services Act 2007 requires Approved Regulators to have appropriate insurance and compensation arrangements as part of their regulatory arrangements. The Approved Regulators include the Solicitors Regulation Authority ("SRA"), the Bar Standards Board and the Council for Licensed Conveyancers. The insurance and compensation arrangements may include professional indemnity insurance, fidelity schemes and/or compensation funds.

SRA-regulated practices are required to have cover of £3 million per claim if they are incorporated firms (limited liability partnership or limited company), otherwise £2 million. Licensed conveyancers are required to have £2 million, and barristers £500,000, by way of illustration; the report contains a useful table of the various requirements.

The Institute of Chartered Accountants, which is applying for certain rights to regulate the provision of probate services, proposes to require

£500,000.

There are also considerable variations in the requirements for run-off cover when a practice closes. Solicitors and licensed conveyancers are required to purchase six years' cover, barristers are covered for the life of the Bar Mutual Indemnity Fund. The Institute of Chartered Accountants proposes to require only two years. Notaries, who provide conveyancing among their range of services, are not required to buy any at all.

The writer recently carried out a survey of 20 overseas law societies and bars to find out more about their compulsory insurance arrangements, as part of a review he was carrying out for an offshore law society on its compulsory insurance scheme.

There is a wide variety of arrangements: some, for example, have master policies or statutory funds (similar to the Solicitors Indemnity Fund which provided cover in England and Wales until 2000), some have requirements to insure up to a certain level of cover without imposing specific terms, which can mean a claim is excluded from cover due to breach of policy terms, and others have no requirements at all.

The SRA's compulsory requirements for insurance are probably the widest in the world, and include obligations on insurers to pay claims even where the insurance has been provided on the basis of a fraudulent proposal form, and to provide six years' run-off cover, even if the premium is unpaid, as often happens when a firm becomes insolvent.

Cover cannot be provided on terms which exclude liability for a known problem, the extent of which may have been inadequately determined – for example, a rogue partner, where many mortgage frauds have been identified but it is feared there may be more. The opportunity to exclude further claims from cover on renewal might afford some firms a better prospect of obtaining cover from insurers with better security.

The Consumer Panel Report

The Legal Services Consumer Panel ("the Consumer Panel") is established under section 8 of the Legal Services Act 2007 and is required to provide independent advice to the Legal Services Board ("LSB") about the interests of users of legal services. The Panel consists of eight lay people, who bring expertise from a range of backgrounds, and is supported by a small policy secretariat.

The Consumer Panel published a report to the LSB on 10 June 2013 entitled 'Financial protection arrangements'. The report examines the client protection requirements of each of the Approved Regulators.

The report raised a number of concerns. These included, for example, the inconsistent levels of cover, the regimes being based on professional title rather than activity or risk, and, relevant to this article, the risk of insolvency presented by unrated insurers.

Rated insurers only?

The closure of Quinn, Lemma and now Balva has caused many to ask whether the SRA should require firms only to insure with rated insurers. Doubts have been expressed in the past as to whether it has statutory power to do so. Certainly, the SRA itself would be ill-qualified to undertake its own rating of insurers –regulation of insurers is the responsibility of the Financial Conduct Authority and the Prudential Regulation Authority and their equivalents in other European Economic Area jurisdictions, and the SRA has enough on its plate assessing the financial stability of law firms.

The SRA has now announced that it is considering the possibility of a rating requirement.

The more a regulator insists on breadth of cover and removal of exclusions, the more they will push firms to obtain insurance from unrated insurers. If they have the statutory power to restrict firms to rated insurers or a panel of insurers (a point which depends on there being statutory power to do so, which is not beyond doubt), they risk putting firms out of business and reducing consumer access to the profession.

Is SRA cover too gold-plated?

Perhaps the time has now come to take stock and ask whether, in requiring greater protection for clients than other professions, the SRA's requirements are risking firms having worthless cover and potentially putting very many firms out of business. If that is the case, is it really in the public interest?

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