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What next in Professional Indemnity Insurance? The implications of change

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The answer to what needs to be done about solicitors' compulsory professional indemnity insurance in England & Wales is about as clear-cut as whether the UK should leave the EU, or remain in, and if so on what terms. In equal measure, it depends on the differing interests of the various constituents, and it is probably fair to say that there is no 'right' answer. Some will inevitably be disappointed by the outcome to the first stage of change, the proposed reduction in cover to £500,000; the Legal Services Board's decision at the time of writing is awaited but will be known by the time this is in print.

That something needs to be done must be beyond peradventure: approximately 4,500 policies have been sold to solicitors in the past six years by insurers who have become insolvent.

The SRA's recent consultation on the subject was entitled 'Proportionate regulation: changes to minimum compulsory professional indemnity cover'. At present, the cover required by the SRA's Minimum Terms and Conditions ("MTC") is probably the widest for any profession in the world. (The writer recently reviewed 20 schemes for the purpose of an expert report for another scheme which was under review.)

Law firms large and small should have a keen interest, whatever the outcome of the SRA's consultation, as all may be affected. And as we shall see, regardless of the outcome of the consultation, the issue may remain firmly on the agenda for some time to come.

The paper identified the issue as follows –

> 3. Professional indemnity insurance (PII) is widely recognised as an important protector of consumer and public interests. While the cover directly protects solicitors and law firms (regulated by the SRA) from the cost of claims against them, there are clear benefits to consumers. It provides consumers with greater certainty that any loss incurred (within the scope of the insurance) will be paid without reliance upon the solicitor, or the firm, neither of which may have assets to pay damages.
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> 4. However, as with any regulatory intervention of this nature, PII is not free of cost for solicitors, firms, or consequently, consumers. Thus, the requirement for PII has both costs and benefits for consumers. The setting of the minimum terms and levels of that insurance has to be balanced to achieve the optimum benefit for consumers and the public. If the protection is very weak (or not in place at all) then consumers should benefit from lower costs but some consumers would face detriment including irrecoverable losses. Conversely, if the cover is very high then few, if any, consumers will face losses, but all consumers will pay higher prices and some consumers will be excluded from the legal market entirely because of the cost of legal services.

Since the advent of an open market for compulsory professional indemnity insurance in 2000, scores of insurers have entered and left the market, many after only two or three years. Only a small handful have participated in every year of compulsory insurance. Several, mainly those who did not have a rating from one of the ratings agencies, have failed - Quinn, Lemma, Balva, and ERIC. Chaos was piled onto the renewal season in 2013 when it transpired, with only three weeks to go, that another unrated insurer, Berliner, was not authorised to underwrite this class of business.

This led to the SRA's consultation on whether to impose a minimum rating requirement. Many, including the writer, saw this as the wrong question, and said that we should instead be asking what fuelled the hunger for unrated cover. The SRA issued a policy statement on 7 May 2014 announcing that it had decided not to impose a financial rating requirement at this stage, and launching the second consultation on the MTC.

For every winner, there has to be a loser in this debate. So, every claim which is excluded from cover means that solicitors have to pay themselves, and, in default, the options are that the individual bears the loss, or it is shared by the profession through the Compensation Fund.

The elephant in the room is lenders' claims. They are not the only cause of problems for solicitors, as the writer has seen firms beset by difficulty arising from personal injury work too, whether claims arising from referral schemes such as The Accident Group ("TAG"), undervalue settlement of multiple claims, as in the case of many coal health claims, or simply a repeated incidence of missed time limits.

But lenders' claims remain a significant part of the problem. Many small firms with insurance problems (and some large firms) have sustained repeated losses from residential conveyancing work. It behoves any firm, when looking at the profitability of a particular work type, to compare the fees earned with the claims caused. Fees are current, and claims are historical, but it is still an equation worth considering, because claims experience will be the main factor in the availability of insurance, regardless of when the alleged act occurred.

It is concerning that causes of the lenders' claims which the writer sees now are really no different from those which occurred in the 1990s and emptied out Solicitors Indemnity Fund, resulting indirectly in the open market solution we have now. It may be unpalatable to many, but if solicitors were prohibited from acting for both buyer and lender on the same transaction, a very substantial proportion of claims would be avoided. Examples include failure to report price differences and allowances and recent transactions suggesting the property is overpriced. The Council of Mortgage Lenders ("CML") Handbook should have avoided many of these problems by introducing certainty in what the lenders required, rather than leaving conveyancers to guess where the boundaries lay, but the claims persist; many of these might be avoided by better supervision.

That raises a host of issues, not least because of the more relaxed conflicts rules enjoyed by licensed conveyancers, but avoiding claims which make firms all but uninsurable would be a significant achievement if those affected can stomach the cost.

Another approach might be independent audit, much as the large accountants are reviewed by the Financial Reporting Council.

Solutions come at a cost, and practitioners may protest that it is unaffordable, but paying out more in claims than firms pay in premiums is unsustainable.

The proposals in the SRA consultation paper should be viewed against that background. The SRA opted only to implement two of the proposals at this stage - a reduction in cover to £500,000 (but €1,120,200 for insurance mediation - approximately £900,000), and an outcome requiring firms to 'assess the need for and purchase cover beyond the minimum cover specified'.

Even if the result of the consultation is no, or little, change, nobody should assume the issue has gone away. One of the key issues is the 'aggregation clause', under which insurers may contend that multiple claims from the same or a series of related acts or omissions are treated as one claim with one limit of indemnity. The effect of this is the subject of a case due to come to trial later in the year, **Godiva Mortgages v Travelers Insurance**, arising from the defaults of Willmett Solicitors, described by the Solicitors Disciplinary Tribunal, in its judgment striking off partner Jonathan Gilbert, as one of the worst cases which had come before the Tribunal, leaving an insurance shortfall of some £50 million.

If insurers lose, then it may well mean the issue is still firmly on the agenda for review. The current consultation allowed little time for mature reflection on the issues and contained little background material, so a decision to take no or little action should not be assumed to be the last word on the subject. Pressure from the insurance industry might make change unavoidable, even at a later date.

So what of the proposals in the consultation paper? Much comment has focused on the level of premium, but as we have seen, a more significant issue may be whether firms can obtain cover from insurers whose businesses

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are sustainable. While a rating does not of itself assure the buyer that the insurer will remain in business in the long term, and it will not be forgotten that AA-rated Independent Insurance crashed in June 2001, it does give a measure of comfort.

Whether the proposed changes would result in reduction in premiums or increase in availability of cover is really an issue for insurers and brokers, but there are some indicators from the writer's experience of defending claims for over 30 years which may provide some pointers.

First was the SRA's decision to reduce the indemnity limit to £500,000 from the current £2 million, or £3 million for incorporated practices. The Law Society and the writer made submission to the Legal Services Board that this would not be the right way to go; the result of those representations will be known by the time this goes to press. Even if the rule change does not proceed now, the topic may resurface in the promised further consultation.

Many firms may argue that they only do low value work and do not need the current level of cover. The reality is that insurers know this too, and they are not really paying any more for the additional peace of mind. The profession has the benefit of its bulk purchasing power, and once lost this will be hard to regain. It is also worth mentioning that the aggregation clause, mentioned above, may make the additional cover of value and is more likely to be a point taken by insurers if the cover reduces to £500,000.

We noted earlier that the majority of claims which cause problems for firms obtaining insurance were lender claims on residential conveyancing. There are no current statistics available, but in the writer's experience the average such claim is probably around £70,000. So a reduction in cover to £500,000 would not save insurers anything at all, and may have little impact on the cost or availability of insurance.

Such a reduction may however reduce the level of cover available to many firms in a primary policy, and that would be a concern. A larger primary limit is generally preferable as it makes for easier claims handling and reduces the scope for dispute between insurers of different layers. It is worth noting in this context that the 2013 accounts of SIMIA, the top up insurer which is in run off, noted that –

> For many years the Company considered itself to be an Insurer of a "quasi-catastrophe" nature. This was because it generally insured the layers above £2m or £3m and very few claims resulted in payments In excess of £1m or £2m from the ground up.
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> The Company's more recent claims experience however suggests that the layers of insurance above £2m or £3m have become working layers.

Firms wishing to buy back the 'lost' cover may find it costs more, particularly for small firms, because minimum premiums may apply. Another consequence would be reduction in automatic run-off cover, and buying top up to replace this would be a significant annual (or biennial) burden on retired partners, even assuming it is available.

An indirect consequence of the reduction would be that it should be possible for firms to reduce their contractual limit of liability commensurately.

Tied in with the reduction to £500,000 is a proposed outcome for inclusion in the SRA Code of Conduct requiring that 'You assess and purchase the level of cover that is appropriate for your current and past practice, taking into account potential levels of claim by your clients and others and any alternative arrangements you or the client may make.'

In the real world, if a firm is in financial difficulty, it is hard to believe it is going to buy more than the minimum. A firm may be dependent on cover under either the run-off or successor practice provisions, and may have little practical ability to control the level of cover.

A further problem is that employees will have no say in the level of cover, and may have taken on work believing that the current minimum would protect them for the next six years.

We look at the other proposals in the consultation, which the SRA decided not to proceed with at present, because they may resurface in the proposed further consultation.

The second proposal in the consultation, was a reduction in the aggregate limit and it is suggested that this might be £5 million, though views are sought. As we have seen, this could have a significant impact. But whether it would have sufficient impact will depend on the amount and the individual case. An insurer is not going to be happy taking a £10,000 premium if it believes there is a material risk of multiple claims, and a cap of £5 million will not really make it any more palatable. US firms typically have a single policy limit with one reinstate-

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ment, so the effect is insurers are only exposed to twice the policy limit. A significant reduction in the level indemnity combined with an aggregate limit of this nature might increase the number of insurers willing to look at law firms in general, but would not assist the 'basket cases'.

The third proposal was requiring MTC cover only for claims by individuals, small and medium-sized enterprises, trusts and charities. This would exclude lender claims. It might make law firms a far more attractive proposition to insurers, but may have the unintended consequence of excluding them from lender panels: recent experience of three lenders excluding firms with unrated cover bears witness to that.

Reducing run off cover to three years instead of six would doubtless reduce what is generally available to a significant sector of the market. Even six years' cover may not suffice in practice. Partners in firms which are closing would have to consider obtaining further cover after three years, and may find it difficult to obtain at any price. It would be an unwelcome expense three years into retirement. They may also have difficulty funding it if the firm has failed.

What other changes might have made a difference? The requirement for insurers to provide cover even where the premium is unpaid seems ripe for review. Now at the start of the policy, the insurer should be able, with appropriate controls, to manage the risk, but where it cannot do so is in relation to run-off cover. Many insurers have been stuck with providing run-off cover for firms which have failed and not paid the additional run-off premium. That seems unfair, and it increases the credit risk at inception, which in turn impacts on availability of cover.

The requirement on insurers to provide cover even where the proposal is fraudulent is also open to possible change.

So too, is the provision requiring insurers to pay an excess if the firm does not pay in 30 days, and then seek recovery from the firm and possibly the principals. This, combined with the requirement to provide run-off cover even where the premium is not paid, puts a substantial credit risk on insurers.

Some may raise the question of the successor practice provisions, which can make a firm liable to insure the risk of another practice which has closed, and on occasions may appear to operate capriciously. This is unlikely to be susceptible to change however. It is possible to avoid the impact of the provisions in many cases, provided proper planning takes place; those who have been caught have generally been those who failed to apply their minds to it. Like tax, planning in advance is essential. The writer has seen cases where advice before the acquisition would have cost a small four-figure sum, and the firm now faces seven-figure losses which were wholly avoidable and may result in oblivion for the practice.

So what next? The Legal Services Board's decision on the proposed rule change will be significant. Any reduction in cover will impact on firms' purchase of additional layers of cover. While insurers have provided renewal terms for many firms, the consultation has had the unfortunate effect of delaying the renewal for others. While the writer believes this renewal will be relatively benign for most, those with foreseeable problems who have not taken the opportunity to address them in the meantime may face a similar scrum to the one faced last year.

If there is any reduction in cover, firms will need to exercise even greater care than usual in ensuring that they notify insurers of circumstances which may give rise to claims. Again, there may be a need for proper planning, as the writer's firm has seen examples of firms doing this without understanding the policy terms, the authorities on the point, and what is needed to make an effective notification; they have paid the cost later.

Many may think the consultation is only a small firm issue. However, from the writer's experience, if the proposals are accepted, they do have wider significance for the following reasons -

- They will impact directly on partners in firms which close, whether solvent or insolvent, reducing their personal protection. This will particularly concern partners who take personal appointments, as trustee, executor or otherwise, and members of firms which have not incorporated;
- It will increase the incidence and impact of coverage disputes, of which we are seeing an increasing number;
- Some of these changes will alter the market generally and influence the scope of cover which firms can buy.

The consultation was part of the SRA's review of 'red tape' and was welcome, but it really needs more debate and the obtaining of more

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evidence on the consequences of change than has been possible in the time available. We look forward to the proposed further consultation, and change may in any event be forced on the profession (and other industry sectors) if the **Godiva** case mentioned above goes against insurers.

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