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# Professional indemnity—where now?

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*"Even where there is FSCS eligibility, there may be another time bomb ticking…"*

A substantial number of firms failed to renew their compulsory professional indemnity insurance on 1 October 2013: at the time of writing, the official figure was 141 firms out of 10-11,000, but it is understood that the returns from insurers indicate there are many more who are in breach of their obligation to notify the Solicitors Regulation Authority ("SRA"). Others closed in anticipation of such failure, or were taken over.

Of those who did find cover, many had to resort to unrated insurers: even global brokers could not source rated cover for a large sector of the profession. That is not to say that "rated = good, unrated = bad", but a rating is evidence of some external assessment.

In 2012, 16 per cent of firms resorted to unrated insurers. Final estimates for this year will have to await the Law Society's annual survey: published data on insurers' market share of premium have not painted the full picture, and now the Assigned Risks Pool ("ARP") has closed, there will be no premium data available this year. However, one unrated insurer, Elite, announced in November that 'sales of Solicitors' PII in England and Wales are up £11m on last year, taking figures up to a record £13.4m'. Putting this in some context, last year's total premium income across the profession was £239 million, of which £16.5 million was attributed to Balva, of which more anon; industry sources believe that this year's total premium may have been in the order of £250 million.

Many firms are at the mercy of unrated insurers who have failed. On 24 January 2013, the Supreme Court of Gibraltar made an order winding-up Lemma Europe Insurance Company Limited. This was a subsidiary of a Ukrainian insurer, passported into the UK, which insured a number of firms in the 2010 year – the precise number has not been publicised, but the writer estimates that it may be 250-350.

The situation for Lemma-insured firms is dire. Most will be entitled to some protection from the Financial Services Compensation Scheme ("FSCS"), but that is far from the end of the matter. The FSCS only provides 90 per cent cover to those eligible.

We should not underestimate the significance of the 10 per cent shortfall: the firms themselves, and in many or most cases individuals, will remain liable for the shortfall, and if they cannot meet it, that *may* fall on the Solicitors' Compensation Fund - though the point is not entirely beyond doubt, as the objects of the Fund are, broadly, to replace money misappropriated and claims where a solicitor should have had, but did not have, insurance, which may be contrasted with a policy with an insurer which has become insolvent. Remember, too, that some of these will be sole practitioners or partners in small firms who have retired and were counting on six years' run-off cover, while even those who continue in practice may face claims for years to come which arise from circumstances notified to Lemma and therefore fall under their (worthless) Lemma policy. A small number of Lemma-insured firms fall outside the scope of the FSCS and face claims with no cover at all.

Even where there is FSCS eligibility, there may be another time bomb ticking, as there is a requirement for the FSCS to set a 'quantification date' for assessing claims, and this could potentially operate to deny firms a full indemnity for matters which have been notified as circumstances but have not yet turned into claims.

Some who are affected by all this may have had no choice in the insurance process – their firms taken over by other practices who were bound to arrange cover for them under the

'successor practice' provisions. Occasionally, too, claims are made against individuals rather than firms, particularly in the case of trust claims, and occasionally by litigants in person. Claims against individuals are more likely where a firm has ceased to exist, as happened in the surveyor's claim of **Merrett v Babb**, where an individual employee was held personally liable. Risks associated with personal appointments and duties should be considered as part of a firm's overall asset protection strategy.

The Financial Services Commission ("FSC") in Gibraltar has been investigating Lemma and reached a settlement agreement with one individual. While he does not accept the FSC's findings, they concluded that he –

> participated in an arrangement whereby Lemma Europe furnished to the FSC Audited Financial Statements and Annual Statutory Returns that were false and that contained incorrect information that purported to demonstrate that the Company was in compliance with solvency requirements set out in Gibraltar laws and regulations; and
>
> failed to play his part in establishing appropriate controls to ensure that all liabilities or potential liabilities notified to Lemma Europe, in particular Outstanding Loss, IBNR *[Incurred But Not Reported]* and IBNER *[Incurred But Not Enough Reported]* reserves and provisions, were recorded promptly and accurately in the Company's financial statements.

The FSC continues its investigation into the role of other individuals. Among points identified in "Why insurance companies fail," a working party report given at GIRO 2002 under the chairmanship of Roger Massey, were outsourcing and delegated management authority, over-reliance on reinsurance, under-reserving and unforeseen claims, all features of Lemma.

The failure of Lemma was all but inevitable. Its failure is expected to cost the FSCS £25 million – almost a third of the total claims paid out last year arising from collapsed insurers.

Lemma was a 2010 policy year player. For the 2012-13 year, the casualty was Latvian insurer Balva. Approximately 1300 firms - out of 10,000 or so – were insured with Balva, which had its licence withdrawn in March 2013.

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.

This meant that cancellation of the Balva policy was ineffective under the SRA's Minimum Terms and Conditions ("MTC"), so the firms were still stuck with Balva, which in July appointed a liquidator. It is still said to be solvent, but see below.

Worse still in many ways, they were thrown into the renewal market with only two weeks to go. The problem was exacerbated because XL had withdrawn from the small firm market, having covered approximately 25 per cent of firms on the previous renewal, according to the Law Society's survey –

> "The purpose of insurance is to transfer risk, not to create it."

mainly small firms.

This was a problem caused in substantial part by the common renewal date. The writer warned of the dangers of the common renewal date some years ago. Discussion on the topic in the past was focused too heavily on price, overlooking the bigger picture.

The single renewal date has now gone, but there will be many firms with a 1 October renewal date for years to come, so it remains a risk issue for the Law Society, the SRA and the profession. A large number of firms coming to the market in a tight timescale could lead to over-dependence on riskier insurers. The purpose of insurance is to transfer risk, not to create it.

While Balva is said to be solvent, it must continue to be so for perhaps 20 years if it is to see out all the claims which may be made on its policies, including six-year run-off policies of firms which close without obtaining alternative cover (either on their own or through another firm's successor practice cover).

Quinn was the first unrated insurer of solicitors to fail, in 2010. Initially, the joint administrators reported to the High Court that Quinn would not have to avail itself of the Insurance Compensation Fund (set up by the Government to protect all policyholders in the event that an insurer could not meet its liabilities). That proved over-optimistic: to date, the Compensation Fund has approved drawdowns of €1.118 billion. The levy on Irish general insurance policies is expected to continue until 2030. Such a change in the position does not augur well for Balva policyholders.

If Balva cannot meet its liabilities, the position will be as set out above for Lemma – most, but by no means all, firms will probably be eligible for 90 per cent of their claims to be met by FSCS.

So, to summarise the problem, we have –

- 1300 firms insured with Balva waiting to see whether or not all their claims will be met, and some may have this hanging over them for 20 years;
- Firms insured with Lemma, perhaps 250 to 350, with either FSCS cover for 90 per cent of claims, leaving a shortfall, and subject to other limitations, or none at all;
- Very many firms with no cover at all, forced to close;
- Many more wondering if it is their turn next, either to see a catastrophic insurance failure, or to be unable to obtain cover at all, forcing them to close;
- The rest of the profession waiting to pick up the bills for some of the above, either through the Compensation Fund (perhaps), or the cost of interventions; and, most importantly,
- Claimants, whose claims against firms may be delayed by administrative problems or possibly unsatisfied.

Some firms fall into more than one of these categories.

This can hardly be described as a success. As well as protecting the public, the compulsory insurance scheme was set up to protect solicitors and their staff. There will also be reduction in consumer choice as high street firms disappear, whereas the Legal Services Act 2007 was supposed to increase consumer choice. The regulatory objectives in section 1(1) of the Act include –

> protecting and promoting the public interest;
> ..
> (c) improving access to justice;
> (d) protecting and promoting the interests of consumers;
> (e) promoting competition in the provision of services…;
> (f) encouraging an independent, strong, diverse and effective legal profession;

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The scheme may have served the profession and the public well for years, but it is now in need of reform. Difficulty in obtaining cover has caused some to lament the abolition of the Solicitors Indemnity Fund ("SIF"), which covered all firms until 2000, and some have called for its return. Regrettably, the writer's conclusion is that that is impracticable. It would need the commitment of a large number of firms without adverse selection. It is inevitable that firms would express interest, but when they found cover cheaper elsewhere, would take the cheaper option. Solicitors outside the largest firms are notoriously fickle when it comes to their insurance, and have been known to change insurers for a few pounds, even sacrificing the benefit of rated cover in the process. That said, many firms face unprecedented financial difficulty and may have little choice. How did we end up in this predicament?

The problem has multiple causes. At the most simplistic level, is simple mathematics one claim, particularly a lender claim, can exceed the premium paid by a small firm, so the firm rapidly becomes uneconomic to insure.

But the problems are more deep rooted than that. Over the years of open market insurance, since the demise of Solicitors Indemnity Fund in 2000, many insurers have come into the market and left fairly soon with talk of severe losses, with one scheme reported to have sustained loss ratios of 1000% - i.e. claims of ten times the premiums. Only a handful of insurers have stayed for the duration, and they have done so by being very selective. The issue has been particularly acute in the small firm sector. Insurers have learned to their cost that insuring solicitors comes with strings attached. Many were put off by having to prop up the ARP, covering a share of the risk for the very firms they had declined to cover. But the wide cover required by the MTC means that solicitors in England & Wales almost certainly have the widest cover of any profession in the world. It is helpful to identify what the key features are, because the time is ripe to consider whether they are all necessary or desirable.

First, the cover is for any one claim – so despite the policy limit of £2 million for sole practitioners and partnerships, and £3 million for incorporated practices, insurers' exposure on each policy is unlimited. In contrast, an American firm (for whom cover is not compulsory, outside Oregon) would typically have an aggregate limit of cover, perhaps with a reinstatement provision which applies if the cover is used up – so, effectively, just two policy limits, not an unlimited number.

There are circumstances in which insurers may contend that claims arising from similar circumstances should be subject to one policy limit, but the application of the relevant provision is often shrouded in uncertainty, and a major dispute on the point awaits resolution in the case of **Godiva Mortgage Ltd v Travelers Insurance**, with approximately £50 million of claims involved, and any shortfall at risk of falling on the Compensation Fund. The Law Society and the SRA have intervened. Whichever way the case is determined, there will be consequences.

Insurers cannot decline cover for firms who complete fraudulent proposal forms – they cannot refuse to pay claims, and they cannot void the policy. Nor can they decline to cover claims arising from fraud, save that cover will extend only to innocent parties who are vicariously liable and not to the fraudster, so fraud claims are generally covered, unless they arise from the fraud of a sole practitioner or all the partners. Instead, insurers have to seek reimbursement from the fraudster, which may be a worthless remedy.

Insurers cannot tailor the terms to meet the problems of a particular risk, for example by excluding claims arising from a particular individual, or practice to which the firm has succeeded. The 'successor practice' provisions can be capricious in their effect, and firms can unwittingly find that a practice

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which has closed is covered on their policy. This in turn can mean a liability for their insurers, notwithstanding any failure to disclose in the proposal form, and insurers have no choice but to meet the claims, subject to an uncertain remedy against their insured for non-disclosure. If the succession occurred during the policy year, the position may be more complex.

Defence costs are in addition to the policy limit, and without limit, save that the cover may reduce pro rata if there is a claims payment over the limit of indemnity.

Insurers may seek to encourage firms to act responsibly by imposing a policy excess on them. In the commercial world, this can be help firms with a problem claims history obtain cover, as the excess can be pitched at such a level that expected claims will be paid by the insured not the insurer. For solicitors, however, this rarely assists, because if the firm does not pay an excess which is due, the insurer has to pay it and seek reimbursement later.

A further credit risk arises at the end of the policy, if the firm cannot find replacement insurance. The insurer must provide 30 days' extended cover under the Extended Indemnity Period, and a further 60 days' cover under the Cessation Period. At the end of that, if the firm has not found replacement cover and there is no successor practice, the insurer must provide run-off cover, which is for six years. The cover must be provided, even if the firm fails to pay any additional premiums due.

The provisions for advancing excesses and the extended cover mean that insurers carry a substantial credit risk, and it has become far more common for insurers to require disclosure of firms' financial position, including management accounts.

The writer recently reviewed 20 compulsory lawyers' profession indemnity schemes in the course of preparing an expert report for another Law Society which was facing a challenge from a larger firm which wished to opt out of the compulsory scheme. While many of the schemes reviewed had wider cover than other professions may customarily obtain, none matched the SRA's requirements.

The cumulative effect of the various provisions in the MTC broadening cover is that it has become increasingly unattractive for prudent insurers to cover a large sector of the profession

So what is to be done, given the problems outlined earlier? No other profession provides the same guarantee as solicitors. Financial advisers can mis-sell you a pension or an investment product on which you depend for your retirement and you may only recover £85,000 from the FSCS. You can split your savings between multiple banks, only to find, if they fail, that there is only one £85,000 limit available.

Even more extreme, if a client told his or her solicitor who was completing a transaction to put £1 million in a current account at a particular bank which then failed, the client would recover £85,000 from the FSCS. If the solicitor had transferred the money to deposit to attract some interest, and the bank then failed, the client may have a claim for the full amount against the solicitor (less £85,000 from the FSCS). It cannot be right that solicitors provide a significantly larger guarantee than banks.

For all these reasons, the time is ripe to debate what the proper and fair limits of our guarantee should be.

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