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Policy and Strategy Unit – Professional Indemnity Insurance

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Contact: Frank Maher
Our Ref: FRM SRA PII Discussion
Your Ref:
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Dear Sirs

Response to the SRA's Discussion paper "Protecting Clients' Financial Interests" (the "Discussion paper")

1. This is our response to the Discussion paper. Our response includes general submissions, sets out our submissions in relation to the regulatory objectives, responds to each of the SRA's questions, and sets out our experience. We have copied it to the Law Society.

General submissions

2. The Discussion paper fails adequately to address the regulatory objectives in accordance with sections 1 and 29 of the Legal Services Act 2007 in the respects set out below.
3. We agree with the Law Society's response, which adopts many of the arguments the writer has raised in recent published articles, and will not repeat them here save as necessary.
4. No regard has been taken to the retrospective impact of the proposals, which will remove protection for work already done.
5. The focus on insurance is probably the wrong place to start: we suggest that it is not the cost of insurance which is the problem, but the cost of claims. Many of the proposals under consideration involve the sacrifice of client protection and the peace of mind of those who practise law on the altar of reducing regulation. Removing cover means some claims must be uncompensated, risking the reputation of the profession, or fall at the door of solicitors and their staff, who may have had no say in the decision to purchase appropriate cover, or may not be personally responsible for policy breaches which put the cover bought at risk.

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6. The proposals are particularly damaging to the interests of small firms, placing them at a significant disadvantage to larger ABSs and other competitors, but may also be detrimental to large firms, and may destroy competition.

7. The proposals may *increase* the cost of cover for many firms which have to buy back the cover 'lost' by reform, on less advantageous terms and without the benefit of bulk buying which arises from the current compulsory cover.

8. The removal of compulsory cover from most claims would render the SRA powerless to direct that one or other insurer defend a claim pending resolution of a coverage dispute.

9. Reductions in cover may impact on the breadth of cover in the excess layer market, so adversely affecting firms large and small.

Regulatory objectives in section 1 of the Legal Services Act 2007

Protecting and promoting the public interest

10. Reducing compulsory cover for commercial clients such as lenders increases the risk that their claims will not be met, and this may result in a reduction in consumer choice for conveyancing services, with consequential reductions in provision of other services.

11. Protection of the public interest cannot be judged solely by reference to the contractual arrangement between consumer and solicitor. The public, or sections of it, can be affected even when they are not clients in a direct contractual relationship with a solicitor, for example beneficiaries of charities or pension funds, and employees of commercial clients who may lose their jobs if an employer is adversely affected by solicitors' services.

Supporting the constitutional principle of the rule of law

12. Section 37 of the Solicitors Act 1974 requires the Law Society, through the SRA, to consider the interests of –

    (a) *all* categories of clients (i.e. not just consumers, micro-enterprises etc.),

    (b) solicitors, and

    (c) solicitors' staff.[1]

    The paper focuses substantially on the relationship between consumer and solicitor, with little or any regard to the effect on these other parties' interests, as explained further below.

13. Solicitors are and have long been prevented from limiting liability below the current minimum compulsory level of insurance (£3 million for incorporated practices, £2 million for

[1] **Swain v The Law Society** [1983] 1 AC 598

sole practitioners and partnerships). A reduction in future compulsory cover may mean that there is insufficient cover for past liabilities already incurred. As a matter of commercial practice, solicitors and their staff who have left a firm, whether by retirement or otherwise cannot purchase insurance cover in relation to risks to which the they may be subject arising from their former practice. The existing restriction on limiting liability may therefore put the assets of solicitors and staff at risk, when they are unable to protect themselves by insurance. In that respect, therefore, the proposals fail to take account of the interests of solicitors and their staff.

14. The Minimum Terms and Conditions ("MTC") protect clients, solicitors and solicitors' staff from the consequences of breaches of policy terms and decisions on levels of cover made by individuals over whom they have no control.

Protecting and promoting the interests of consumers

15. Consumers may have instructed solicitors in the mutual belief that they are insured for the current compulsory minimum. By the time a claim is made, the proposals for change may mean there is insufficient cover.

Promoting competition in the provision of services

16. Reduced limits and protection for commercial claimants may reduce conveyancing firms' ability to act for lenders. In the event of coverage disputes, the SRA would be unable to direct that one or other insurer dealt with a claim. Firms acting for buyers would be inhibited from relying on undertakings from the sellers' solicitors on completion.

17. Reduction in conveyancing would undermine the financial stability of many firms, imperilling the provision of other legal services.

Response to questions in the Discussion paper

Question 1: Do you agree that the best model for professional indemnity insurance remains a regulated open market? What problems do you see with the way the market currently operates?

18. Yes. The market is currently operating well with few firms likely to be unable to obtain cover from a rated insurer this October. We have however identified some particular aspects for possible reform in answer to Question 5.

Question 2: What are your overall views of the impact of the current financial protection regime in terms of the balance between the level of protection provided to consumers and the cost and regulatory burden on law firms?

19. The financial protection regime is affordable for the vast majority of the profession. Removal of cover does not abolish claims: someone has to bear the loss.

20. Reducing the compulsory requirements will make it more expensive, and more difficult, indeed impossible, for firms (particularly small ones) to obtain the same degree of protection. It would be naïve to assume that the issue is addressed simply by firms buying top up cover, which does not carry the protection of the MTC and may not be commercially available. Solicitors' staff, and partners who have left a firm, have no say in how much cover a firm buys.

Question 3: What protections do you think are necessary for consumers? What are the potential consumer impacts from changing the current arrangements?

21. The current level of protection should continue. No other alternative provides protection for liabilities already incurred. The level of compulsory cover is proportionate. Reduced levels take no account of the impact of claimants' costs.

22. As explained below, consumers cannot be protected by provision of information on firms' levels of cover: most claims occur after the policy year and because of the claims made basis of cover, information would be worse than meaningless, it would be positively misleading.

Question 4: Do you have views on the impact of removing compulsory requirements for insurance for more sophisticated clients in particular on the conveyancing market?

23. This proposal is probably the most damaging of those in the Discussion paper. It would have a severe adverse effect on small firms dependent on conveyancing as lenders would instruct only large firms or do the work in-house. This would reduce consumer choice and undermine the financial stability of small firms.

24. No firm could rely on another firm's undertaking. This would cause major disruption in the conveyancing market.

Question 5: Do you have any further evidence or issues that we should consider in relation to client coverage for the MTC?

25. There were 126 responses to the May 2014 consultation. We provided evidence in response to the September 2014 call for evidence, and doubtless others did too. We are surprised that there is no reference in the Discussion paper to any evidence received as a result of that request. 92 out of 126 respondents to the May 2014 consultation disagreed[2] with the reduction in minimum cover to £500k, yet it is remarkable that the proposal remains on the agenda in this current consultation.

[2] Those disagreeing included The Law Society and the City of London Law Society as representative bodies.

26. Nor is there any reference to the responses to the initial May 2014 consultation, nor the many submissions to the Legal Services Board opposing the 2014 changes.

27. The proposals would introduce an undesirable degree of randomness as to whether a client is covered or not, dependent on its financial circumstances at the time of a claim.

Question 6: What are the issues that we should consider in relation to the imposition of an aggregate limit? Are there particular types of client more likely to be affected by such a limit?

28. The arguments against an aggregate limit were well put in the SRA's own submissions to the Court in **AIG Europe Ltd v OC320301 LLP & Others**.[3] They said:

> The SRA is concerned that if an unduly broad interpretation of the aggregation wording in paragraph 2.5 of the Minimum Terms is adopted by the Court, along the lines contended for by the Claimant, AIG, the Compensation Fund may receive very substantial applications for grants, which it would not otherwise have received. The implications of such a result extend beyond the risk of claims made by the underlying claimants in the Proceedings. If paragraph 2.5 is construed to permit wide ranging broad-based aggregation of multiple claims, the Compensation Fund could well be faced with applications from a range of applicants who for that reason are unable to access their solicitors' insurance cover.

29. It is surprising, therefore, that the SRA's proposals for change in the Discussion paper seem to support an entirely different case. Unless the burden of claims shifts from insurance to the Compensation Fund, there will be a risk of an increase in the incidence of uncompensated claimants arising from dishonesty or suffering loss or hardship in consequence of a failure to account for money.

30. It is impossible to identify particular types of client more likely to be affected by such a limit. That is really the crux of the objection – it is entirely random who will be impacted adversely, depending on the order of claims payments. On the one hand it might be a commercial lender with extensive assets, on the other, it might be a disabled cerebral palsy claimant with lifetime care needs. Or it might not even be a client – it may be a beneficiary under a will, another firm's client relying on an undertaking, or a pension fund or trust beneficiary.

[3] [2015] EWHC 2398 (Comm)

Question 7: Do you have any further comments or evidence on the issue of minimum cover?

31. The proposal continues to take no account of the fact that the limit of indemnity includes claimants' costs. Claimants' costs may exceed the value of the claim. A return to 1989 levels of indemnity[4] is fundamentally flawed.

32. While it could, in theory, be possible to provide that a reduction in the limit would apply only to future acts or omissions, in order to address our concerns about the retrospective nature of a reduction in cover, a reduction in cover is in any event inappropriate in our view, as there are more large claims than in the past; the 2014 accounts for top-up insurer SIMIA, the Solicitors Indemnity Mutual Insurance Association, now in run-off, note that 'The Company's more recent claims experience however suggests that the layers of insurance above £2m or £3m have become working layers.'

Question 8: What further issues should we consider in relation to run *off cover?*

33. Cover should be conditional on payment of the premium. An option is to follow the Licensed Conveyancers' example of paying for the run-off premium out of the Compensation Fund.

34. Cover should continue to be for six years: the Charles River Associates report identified that around 40% of claims relate to work that was done more than three years before the indemnity year in which the claim was actually made. The impact of a reduction to three years' run-off would be completely random as to whether it involved financial institutions or cases of severe hardship, but either would be damaging to the profession, either risking withdrawal of lender instructions to conveyancers in the former case, or creating bad publicity in the latter.

Question 9: Do you have any views on whether the post six-year run-off cover provided by SIF should be extended beyond 30 September 2020, and if so, whether the extension should be for one or two years?

35. It is not possible to comment on this without knowing the claims experience of SIF, which should be made available.

Question 10: What further issues and evidence should we consider in relation to the payment of defence costs?

36. As is apparent from the Discussion paper, some firms already agree to pay defence costs, subject to the overarching provision of the MTC. Removing the additional cover for defence costs would erode the limit of indemnity and create potential conflicts of interest for

[4] The limit increased from £500,000 to £1m on 1 September 1989

defence panel firms, leading to difficulty in claims handling arrangements. There is therefore no need for change.

Question 11: What further issues and evidence should we consider in relation to funding of the excess?

37. The commercial insurance market is better able to assess credit risk than the SRA.

38. We note the Law Society's suggestion that 'Consideration should be given to making it a breach of regulatory obligation to default on payment of excess'. However, it is already a disciplinary offence under rule 16.1 of the Solicitors' Indemnity Insurance Rules 2013 to fail to reimburse an excess.

Question 12: What further issues and evidence should we consider in relation to the provision which prevents policies being repudiated for non-payment?

39. Non-payment at inception is entirely within the control of insurers, who should not issue a policy unless they are paid. No change is required in that respect.

40. Non-payment of the run-off premium is different. An option would be for the Compensation Fund to pay the premium, as in the case of the Licensed Conveyancers.

Question 13: Do you have any evidence on the option of a hardship fund for run off cover premiums?

41. The insurance is not the real problem: it is the accumulated liabilities of the practice. But there is no doubt that the issue of run-off premiums is colouring the debate, and the point should be considered further. However, the money has to come from somewhere, whether it is the profession in Compensation Fund contributions, or some other source such as client account balances, which would have a knock on effect on the Solicitors Benevolent Association.

Question 14: What further issues or evidence should we take into account when considering the current provisions in MTC 4.1 and 4.2 restricting repudiation, avoidance, denial or reduction of liability?

42. This is one of the more significant provisions providing client protection and value to the solicitor brand for clients of all types. Without it, the value of undertakings also diminishes substantially.

Question 15: What *other factors should we take into account in considering the issue of cover for partner fraud?*

43. The SRA suggests that the removal of the element of compulsory cover for partner fraud might provide better incentives for principals to undertake risk management in respect of fellow principals.

44. This, however, is fundamentally flawed. Risk management is intended to manage risk, not eliminate it. Insurance is a risk management tool by which risks which cannot otherwise be managed effectively can be transferred. The examples are legion of rogue partners who have not been discovered in even the largest, most prestigious and well-managed firms. Risk management, like an audit, is a 'watch dog not a bloodhound': if a partner sets about avoiding controls, it may be difficult to prevent, as it is a regrettable fact of life that fraudsters will find ways round systems.

45. We have defended many claims arising from fraud, particularly mortgage fraud where a partner has, unbeknown to his fellow partners, dishonestly misrepresented material information to a lender. In one case, a rogue partner overstated the proportion of the purchase price being paid by the borrower and produced a dummy set of accounts to conceal this from others in his firm. While naturally the insurers wished to satisfy themselves that our client, the innocent partner, was uninvolved in this, they eventually confirmed indemnity for him, as they were bound to do.

Question 16: Are there any other arguments for or against the retention of cover for Ombudsman awards in the MTC?

46. Consumers are unlikely to distinguish between Ombudsman awards and other claims, and making a distinction is hard to justify. The sums involved are generally low and removal of cover is unlikely to have any impact.

Question 17: Do you have any further evidence or comments in relation to the continuation of the extended policy period in particular its impact on the cost of insurance and of removing it from the MTC?

47. The extended policy period has significant value, given that the renewal for most firms will continue to be 1 October for many years to come, and renewal can be adversely affected by external events.

Question 18: Is there a case for a requirement to provide better information to clients about insurance cover and CF arrangements?

48. The Charles River Associates report demonstrates[5] that approximately 80 per cent of claims do not arise in the policy year. Information provided to consumers on a firm's insurance, would therefore be positively misleading in approximately 80 per cent of cases. section 28(3) (a) of the Legal Services Act 2007 requires that the SRA's rule-making must be 'proportionate, consistent and targeted only at cases in which action is needed'; any rule requiring the provision of largely meaningless information to clients would fail to satisfy that requirement.

Question 19: Do you have any evidence or examples from other professions or jurisdictions where providing this information is a requirement?

49. No, but as explained above, it would be pointless.

Question 20: Are there any other changes to the insurance arrangements that we should consider for consultation?

50. Our response to the Call for Evidence dated 25 September 2014 contained the following –

> It is often assumed that firms which have difficulty obtaining insurance are 'bad firms'. That is not necessarily so. The impact of a large claim (or series of claims) is very much less on a large firm which pays more in premium and may be less of a credit risk. The size of a claim is not necessarily linked to the degree of negligence and the liability of a firm to compensate clients may be influenced by the fact that they are insured.
>
> We understand that during the 1990s, when many property firms experienced significant claims, the RICS granted waivers from some of their compulsory insurance requirements. An element of flexibility would assist in some cases.

Question 21: Do you think there is evidence to support the introduction of a lower limit for the maximum award made from the Fund or to limit the types of payment made out of the Fund?

51. Evidence is needed on the extent to which this may affect vulnerable clients, and further detailed review is required into the impact of change before considering change.

Question 22: Do you think there are fairer ways of calculation for firms and individuals contributions to the CF and what do you think are the pros and cons of the alternatives we have set out?

52. Flat fees are simple to administer. It would not be practicable to apportion fees by reference to average client balances which distinguished between qualifying claimants (i.e.

[5] Figure 6

consumers etc.) and non-qualifying ones, and failure to apportion between qualifying and non-qualifying claimants would be patently unfair, shifting the burden to larger firms whose clients would never be able to claim on the Compensation Fund. It would not satisfy the requirements of section 28 of the Legal Services Act 2007, set out above (proportionate etc.)

Summary of our experience

53. Our clients include a cross-section of the profession, from the largest international firms and overseas firms to small high street practices. Since admission in 1983 the writer has had extensive experience of advising on solicitors' insurance, including –

    - Defence of claims under the Master Policy Scheme (1976 to 1987), Solicitors Indemnity Fund (1987 to 2000) and the open market (2000 to date);
    - Advice to firms on claims exceeding their insurance cover, or where coverage is in dispute;
    - Advice on insurance arrangements for firms merging or closing;
    - Drafting policy wordings;
    - Advice to insurers of compulsory solicitors' schemes in Australia;
    - Expert evidence on behalf of the Isle of Man Law Society in a challenge by an international offshore firm to its Master Policy scheme;[6] this involved a review of lawyers' insurance arrangements in 20 jurisdictions.

Yours faithfully

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[6] **Appleby (Isle of Man) LLC v Isle of Man Law Society**
http://www.gov.im/lib/docs/courtservice/PressRelease/lsa13_0002_visitor_decision.pdf