PII: where is the battle being fought?

Francis Dingwall

July – time for school sports day. But in the legal world this summer, a different kind of race is being run: the race to the bottom, some would say

'Niche regulator moves to attract conveyancers from SRA', read the *Law Society Gazette*'s recent headline (5 May 2016). The Council of Licensed Conveyancers (CLC) now only requires a licensed conveyancer who ceases practice to have six years' run-off cover for £2 million in the aggregate. That means that if five former clients each make a valid claim for £500,000 during the six-year period, the fifth former client will whistle for his money (unless he recovers it against the retired principals of the firm or obtains a grant from the CLC's compensation fund). The cover excludes claims arising out of fraud. The insurer will never pay out more than £2 million.

Currently, the SRA requires a solicitor to have six years' run-off cover for £2 million on each and every claim (£3 million for a limited liability partnership or limited company) with no aggregate limit. That means that if 20 former clients each make a valid claim for £500,000 over the six-year period, they will all be paid by the insurer. The insurer will pay out £10 million and is potentially liable to pay out a limitless sum.

Does that mean that clients will flock to solicitors for the better protection? No. The cost of cover for £2 million in the aggregate is cheaper than cover for £2 million on each and every claim. In fact, the cost under the CLC scheme is hidden altogether because there is no separate premium payable on inception of the run-off cover, in contrast to the solicitors' scheme where the premium payable at the point of closure is typically 200–300 per cent of the annual premium. In theory (ignoring complicating factors such as will licensed conveyancers be able to buy cover if insurers fear they may close or retire?), the licensed conveyancer can offer his or her services at a lower price than the solicitor. So, it is good for competition, the CLC will tell you.

The Solicitors Regulation Authority (SRA) would probably agree with the CLC. Its plan in 2014 was to reduce the requirement for run-off cover to three years at £500,000 on each and every claim subject to an aggregate cap of somewhere between £1.5 million and £5 million (it did not make up its minds on the figure) in any one year.

But the starting pistol has led us to get ahead of ourselves. Is professional indemnity insurance (PII) a legal compliance issue at all? Yes. It serves a dual purpose.

- From the solicitor's perspective, it provides the last line of defence in his or her risk management armoury. If a mistake does get through, the other lines of defence (recruitment of suitably qualified staff, training, allocation of work to competent and honest staff working within their capacity, a good system of work, checking, supervision, etc.), it covers liability to the client for the financial loss. The solicitor does not have to sell his or her home to pay the claim.
- From the client's perspective, it ensures that, in the event that the solicitor makes a mistake, the client will be compensated. As with the solicitor, this is a backstop for the client: the client wants a job well done, not the right to sue for a job badly done.

In the SRA Handbook, the topic comes under the heading 'Client protection'. In fact, that section of the Handbook covers 71 pages of the 581 pages in total, i.e. 12 per cent of the Handbook is devoted to client protection. This includes the provisions on the compensation fund, the run-off of the SRA Indemnity Fund and interventions. The SRA Indemnity Insurance Rules 2013 account for 4 per cent of the Handbook. As other parts of the Handbook are slimmed down, this percentage will probably go up.

'Client protection', or the protection of the third party who suffers as a result of your mistake, is a well-established purpose of insurance. Employers are required to carry employers' liability insurance for the benefit of their employees. Drivers are required to carry car insurance for the benefit of third parties they may crash into, and so on.

These other forms of compulsory insurance commonly give the insurer a very limited scope for refusing to pay claims on the basis of the insured's non-disclosure or other non-compliance with the terms of the policy, which would otherwise let the insurer off the hook. In the context of motor vehicle insurance, s.147 of the Road Traffic Act 1988 provides broadly that an insurer must pay a third party's claim notwithstanding that the insurer may be entitled to avoid or cancel the policy or may in fact have done so. The SRA Indemnity Insurance Rules 2013 require insurers who insure solicitors to provide cover on very wide terms, including:

- no power to avoid the policy at all;
- no power to decline payment of a claim on the grounds of non-disclosure, misrepresentation, late notification, breach of policy condition, etc;
- cover regardless of non-payment of the premium;
- payment of the claim without deducting the policy excess due from the insured;
- cover for losses of client money for which the solicitor is liable as a result of the strict liability imposed by rule 7 of the SRA Accounts Rules 2011;
- extended definition of employee.

The SRA Indemnity Insurance Rules 2013 give a little back to the insurers:

- it is a disciplinary offence for a solicitor to fail to pay the premium and policy excess;
- there is a provision for aggregation of claims, where a number of claims arise out of a single act, etc;
- there is a right of reimbursement against any individual responsible for non-disclosure, misrepresentation, late notification, breach of policy condition, etc, to the extent that it has prejudiced the insurer;
- cover can be excluded altogether for claims arising from fraud where a sole practitioner has been fraudulent or where all the principals in the firm have been fraudulent;
- the successor practice rule makes it less likely that an insurer will have to provide run-off cover without receiving the premium.

The result is that the battleground for policy coverage disputes centres on the following areas.

The dishonesty exclusion

The test of dishonesty is easier to state than to apply. Any individual's conduct must be dishonest by normally accepted standards of honest behaviour. They must know of the elements of the transaction which make it dishonest. Their opinion as to whether their conduct is dishonest is irrelevant, but the court may take account of what the individual knew; their experience, intelligence and reasons for acting as they did. If a solicitor has been the victim of an obvious cyber scam, an insurer might say he or she was reckless to the point of dishonesty in paying a round sum to a third party. The insurer might say that everyone ought to have an awareness of the obvious scams by now.

Scope of cover

An insured may not be entitled to indemnity if the claim arises out of activities which fall outside the provision of services in private practice as a professional. An example would be where a solicitor effectively acts as a banker for his or her client in breach of rule 14.5 of the SRA Code of Conduct 2011 without providing any underlying legal services. But there is sometimes room for argument. For example, the exclusion for 'debts and trading liabilities' will not apply if the claim arises out of obligations that are 'essentially part and parcel of the obligations assumed by a solicitor in respect of his professional duties to his client rather than obligations personal to the solicitor'.

Block notification of circumstances

A prospective insurer wants to see how well a firm is going to operate during the policy period. But the claims/circumstances the firm is going to notify in the next 12 months are more likely to arise out of work that was done in earlier years: two or three, even six or seven, years ago. A firm may have had a claim and may realise that there are more in the pipeline, for example, if it has operated a stamp duty land tax scheme multiple times. If there are identifiable 'circumstances', a firm may be able to make itself insurable by drafting an effective block notification, to park those circumstances with the current insurer and start again with a clean sheet.

Block notification depends on an understanding of what circumstances are notifiable. For a set of facts to qualify as a circumstance capable of, and requiring, notification under the policy, a claim must be 'at least possible' on an objective measure. There has to be a possibility of a claim which is more than just some fanciful or speculative chance of a claim. How material does the possibility have to be? The courts have indicated that the 'test of materiality for notice is a weak one'. The anticipated claim does not have to be a well-founded one. It may not be possible to determine whether any given claim which materialises in the future falls within the circumstances notified, until the claim is actually made.

Aggregation of claims

If there are multiple big claims which together exceed the policy limit, the aggregation clause entitles insurers to treat them as one, with only one limit of indemnity, if they arise e.g. from the same act or omission, or from similar acts or omissions in a series of related matters or transactions. Alternatively, if there are multiple small claims, the insurer may want to argue that they should not be aggregated, even though there seems to be a pattern, because then the insured has to pay multiple policy excesses.

The point was addressed recently by the Court of Appeal in *AIG Europe Ltd v OC320301 LLP and Others* [2016] EWCA Civ 367. Although the court gave welcome guidance, there is still room for argument over when claims are to be aggregated.

Successor practice issues

A firm may find opportunities to grow by merger, bolt-on, or by lateral hire. There is a risk that if they pick up another firm's claims (and claims history) under the successor practice, they may make themselves uninsurable. The effect of the rule may be that they unintentionally become the successor for insurance purposes. Careful planning may prevent this.

Equally, a firm may want 'out' altogether: the principals may want to retire, but they may not want to meet the heavy cost of run-off cover (as noted above, typically 200-300 per cent of the annual premium), so may want another firm to become the successor practice.

And from the insurer's perspective, it will not want to insure a firm's run-off, even if the premium is paid, if the closed firm is a can of worms – still less if the firm is closing without paying the premium.

The Legal Ombudsman may have the power to treat a firm as a successor practice for the purpose of awarding compensation, using a different definition from that applicable for the purposes of PII.

SRA's involvement

The SRA is by no means always outside the battle on policy coverage issues. For example, it was mentioned above that non-payment of the premium is a disciplinary issue. This will be so even if the policy does not stipulate that the individual principals are personally liable for the premium. An insurer may use this as the basis for arguing that the individuals are liable for the premium if the policy wording is silent or ambiguous on the point.

But the SRA's main involvement is in setting the rules of the game. Although rebuffed by the Legal Services Board in 2014, it will shortly be issuing a fresh Consultation on Professional Indemnity Insurance. It has armed itself with 10 years' worth of statistics on the insurers' claims data and wants to focus the mandatory insurance on the risks to consumers. If it is trimmed down to what is proportionate to meet consumers' reasonable needs for protection, as opposed to what is desirable to solicitors (for their own protection), the SRA's hope is that the cost of insurance will come down, bringing down the cost of legal services. It does not expect insurance to eliminate the risks altogether, for example, from unpredictable catastrophes.

The author's view is that PII should be aimed precisely at unpredictable catastrophes. When we buy household insurance, we do not do so in the belief that we will be making a claim on it every five years or so. We do not expect the house will ever burn down and, if we break a vase, we go out and replace it. We buy the insurance hoping never to make a claim on it. All the more so when we buy a term policy of life insurance (e.g. one which pays only in the event of death before the age of 65)!

PII has all too often been used as an alternative to thorough risk management to meet avoidable claims which are dismissed as 'the cost of doing business'. What if the assured took that approach towards life insurance? It is true that professional negligence claims are an occupational hazard, but to receive a

claim is one thing, to pay a claim is another. As noted above, insurance is intended to be the very last line of defence, to meet catastrophes and not claims which could and should have been averted by recruitment of suitably qualified staff, training, allocation of work to competent and honest individuals operating within their capacity, a good system of work, checking, supervision, and so on.

When law firms and the SRA consider risk management, they should not spend all their energies on seeking to identify, evaluate and control the particular risks they face. It is a worthwhile exercise, but it is a fool's game to think that you can identify them all. As to historical claims data, past performance gives no indication of future performance. It is the very essence of risk that it includes what is uncertain, unpredictable, unknowable – sometimes even when it stares us in the face. This is one of the lessons of the 2007 financial crisis. And a year ago, who predicted Brexit? If we apply to law firms what Naseem Taleb prescribed in *The Black Swan*, we should be directing significant energy and resources towards making ourselves resilient so that, whatever happens, the firm can withstand the shock. That entails building a margin of error into all the firm's systems and controls, including plentiful insurance cover, which may look like a luxury at the time it is bought, a luxury the cynic might think the solicitor can afford because it is indirectly at the client's expense. When disaster strikes, that margin of error will serve the best interests of the client as well as of the law firm. Both will be winners and that means the SRA wins too.

Francis Dingwall *is a partner with Legal Risk LLP Solicitors.*