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**Paper for the House Committee meeting
on 26 October 2001**

**Report of the Subcommittee on
Solicitors (Professional Indemnity) (Amendment) Rules 2001**

Purpose

This paper reports on the deliberations of the Subcommittee formed to study the Solicitors (Professional Indemnity) (Amendment) Rules 2001.

The Subcommittee

2. At the House Committee meeting on 5 October 2001, Members agreed to form a subcommittee to scrutinise the Solicitors (Professional Indemnity) (Amendment) Rules 2001 (L.N. 162 of 2001) (the Amendment Rules).

3. Under the chairmanship of Hon Margaret NG, the Subcommittee has held three meetings with representatives of the Law Society of Hong Kong and the Hong Kong Solicitors Indemnity Fund Limited (HKSIF), the Administration as well as representatives from a few law firms. The Subcommittee has also considered a number of representations made by law firms. The membership of the Subcommittee is in **Appendix I**.

The Amendment Rules

4. The Council of the Law Society is empowered to make rules concerning professional indemnity insurance for solicitors in Hong Kong under sections 73 and 73A of the Legal Practitioners Ordinance (Cap.159) with the prior approval of the Chief Justice.

5. The Amendment Rules were tabled in the Legislative Council on 11 July 2001 and came into operation on 1 October 2001.

6. The purpose of the Amendment Rules is to amend the Solicitors (Professional Indemnity) Rules (Cap. 159 sub. leg.) (the principal Rules) to -

- (a) revise the definition of "relevant date" in order to clarify that the relevant date shall mean the date when the cause of action first accrued against the firm in certain cases (rule 2(b));
- (b) increase the contributions to the fund referred to in rule 3(1) of the principal Rules (rule 6);
- (c) exclude the entitlement to the indemnity for an innocent partner in respect of losses arising out of any claim brought about by the dishonesty or fraud of his fellow partner (rule 7(a)(ii));
- (d) clarify the position regarding a former solicitor where a claim is made after the retirement of the former solicitor (rule 7);
- (e) introduce a further deductible in respect of the indemnity if more than one claim is made against the indemnified or a former solicitor during any three consecutive indemnity periods (rule 7(b)); and
- (f) provide for other miscellaneous amendments.

Deliberations of the Subcommittee

Increase in contributions to the Fund

7. A major concern of many small to medium sized law firms, which are already operating in depressing economic situation, is that the 150% increase in contributions are untenable.

8. According to the Law Society's explanations, the HKSIF was established by the Council of the Law Society to manage and administer the Solicitors Professional Indemnity Scheme (the Scheme). The Scheme had a three-year reinsurance programme which was due to expire on 30 September 2001. Under the arrangement, the HKSIF provided coverage of \$10 million per claim to its membership. Of this amount, the HKSIF retained the first \$1 million of every claim and reinsured the remaining \$9 million. To further limit the aggregate impact of the \$1 million retention of each claim, the HKSIF also purchased Stop Loss Reinsurance which provided coverage if the aggregation of retention is in excess of a predetermined amount.

9. In view of the substantial increase in claims payments in recent years, the HKSIF commissioned the Scheme's broker to conduct a benchmarking exercise in April 2000. The exercise showed that based on the Scheme's historical claims data, it was likely that reinsurance premium would increase by 400% after 30 September 2000.

10. The HKSIF considered several options and a Members' Forum was held on 15 September 2000 to discuss the options available. The option chosen was to cancel the three-year programme and re-write a five-year programme which allowed an increase in reinsurance premium phased in over a period of five years on a progressive basis. The five-year programme has the effect of subsidising the Scheme in early years and capping the premium for the five years even if the claims situation was to deteriorate in future. There is a reduction on premium and/or a profit-sharing arrangement should claims improve during the five years, depending on the underwriters involved. The five-year programme commenced on 1 October 2000.

11. However, the new reinsurance programme requires the HKSIF to increase the Fund's retention for the self-insured layer from \$1 million to \$1.5 million per claim from 1 October 2001 to 30 September 2005. Based on projections made by actuaries, the costs of the premium and the HKSIF's retention over the five years when projected are found to have exceeded the income which the Fund could have received from members' contributions based on the existing contribution assessment formula. It is therefore necessary to amend the formula to raise the amount of contributions as proposed in the Amendment Rules.

12. The contributions based on the proposed new formula are 2.5 times the existing contributions. This represents an increase of 150%. Members of the Law Society were informed of the increase and the reasons for the increase in the Members' Forum held on 15 September 2000.

Implications of the Amendment Rules on solicitors firms

13. Some members of the Subcommittee point out that many small solicitors firms operating with marginal profits may be forced out of business because of the increase in contributions which they cannot afford to pay. They request for information on how the increase would affect solicitors firms of different sizes and types of practice.

14. The Law Society has advised that 86.05% of firms with no claims loading will pay 5% of their gross fee income in contributions to the Scheme under the new Rules, but that it could not comment on the impact of the increased contributions on individual firms which would depend on the individual circumstances of each firm.

15. Hon Margaret NG, the Chairman of the Subcommittee, in her capacity as the Member representing the Legal Functional Constituency, has conducted a survey on the impact of the Amendment Rules on solicitors firms. A questionnaire was sent to over 600 firms and 198 responded, of which 75 are sole proprietors and 102 are small firms with two to five partners. Of the 74 firms which claim that the increase in contributions will cause serious difficulty to them, 71 are sole proprietors or small firms with two to five partners and 16 are engaging in predominately or up to 50% of conveyancing. Of the 11 firms (sole proprietors or firms with two to five partners) which claim that the increase will be fatal, eight are engaging in predominately or up to 50% of conveyancing. The results indicate that the majority of the small firms which are hardest hit by the increase are engaging in areas of work other than conveyancing.

Claims loading and risk banding

16. Another concern of the profession is that under the existing arrangements of the Scheme, firms with good claims experience and little conveyancing practices are heavily subsidising the premium cost of those firms with poor records, and those heavily engaged in conveyancing work. The Subcommittee has requested the Law Society to consider adjusting the amount of contributions payable by a firm to take into account its claims record and type of practice.

Claims records

17. The Law Society has explained that a mutual indemnity scheme would inevitably involve cross-subsidisation between members. The claims records in Hong Kong are not any worse than that of comparable common law jurisdictions. Historically, claims arising from conveyancing made up about 80% of the total value of claims in any year. The situation has been exacerbated by the collapse of the local property market. Another contributing factor might be the change in conveyancing scale fees, i.e. the reduced fees charged by lawyers, which could possibly have affected the quality of work in certain cases.

Claims loading

18. The Law Society has advised that Schedule 1 paragraph 6 of the Rules have already provided for "claims loading" whereby firms with a claim during the preceding indemnity year are required to pay a contribution at a level increased by up to 350% of the basic contribution over the following four years. In addition, on settlement of any claim, a firm is required to pay a proportion of the claim dependent upon the number of principals, consultants, and assistant solicitors it has. These payments are known as deductibles.

19. In addition, in response to suggestions made by some members at the Members' Forum held on 15 September 2000 that measures should be introduced to alleviate claims, and after consultation with its insurance brokers, the HKSIF and the Council of the Law Society decided that the introduction of the penalty deductibles would be a useful deterrent to firms with frequent claims. Clause 7(b) of the Amendment Rules provide for a further deductible for those firms against which more than one claim is made in any period of three consecutive indemnity years.

Risk banding

20. While the Law Society will consider risk banding in its review, it has pointed out that this is not an issue that can be resolved in isolation or in haste. Professional indemnity insurance is a complex issue involving the correlation of risk against known factors and variables. The calculation of the formula for payment of contributions is a delicately balanced equation in which the variables of gross fee income, number of fee earners, claims loading and deductibles all play an intrinsic part.

21. The Law Society has explained that there has never been an element of risk banding within the Scheme. One of the reasons is that historically the majority of the profession has engaged to a greater or lesser degree in conveyancing which is regarded by insurers as being the highest risk area of practice in Hong Kong. It should also be noted that some of the largest firms which are known to subsidise the Scheme by payment of proportionately high premium for the cover provided do not practise conveyancing. If the contribution which these firms make to the total revenue was to be significantly reduced, the shortfall in contributions would have to be compensated by a large increase in the contributions levied upon the conveyancing firms which traditionally have been the smaller, local firms. It is the considerations such as these as well as the propensity for firms to change the nature of their practice during an indemnity year that need to be looked at carefully and resolved.

Independent review of the Scheme

22. The Subcommittee has noted the request of many law firms for the Law Society to conduct an immediate and independent review of the existing Scheme with a view to adjusting it or replacing it with some other schemes such as the Qualified Insurers Programme (QIP). The Subcommittee has also noted the result of a survey conducted by the Horvath & Giles and Erving Brettel, two law firms making representations to the Subcommittee on the Amendment Rules. 314 or 51% of the 617 firms polled in the survey have made responses. Of these responses, 99.7% request that an immediate and independent review of the Scheme should be conducted. The Subcommittee has also received a briefing from a legal practitioner of Holman, Fenwick and

Willan, on the developments that led to the introduction of the QIP to replace the Solicitors Indemnity Fund by the Law Society in England and Wales.

23. The Law Society has explained that it is not at all opposed to the concept of a QIP provided the advantages and disadvantages are fully considered and the difficult issues identified resolved. It further cautions that if the QIP is adopted hastily when insurance markets are hardening, many of the Society's members would, if not initially but probably on renewal, be left to the "tender mercies" of the insurance companies which are in business to make a profit for their shareholders.

24. The Subcommittee has requested the Law Society to conduct an independent review of the existing Scheme to address the various issues raised by its members. It has also suggested that the Law Society should consult its members on the recommendation of the review to decide on the way forward and make a progress report to LegCo by a certain date.

25. The Law Society has advised that it intends to carry out an independent review of the current insurance arrangements under the Scheme with a view to considering whether at the expiration of the five-year reinsurance contracts the Law Society should maintain the existing mutual scheme with or without amendment, or to demutualise the Scheme and put into effect such other options as may be proposed as a result of the review. As the review will be an in-depth one and undertaken by an independent person/body, it will need to seek a mandate from its membership for such a review and the considerable expenditure which will be incurred. While the Law Society regards the review as a matter of priority, it is not in a position to advise on the timetable at this stage.

26. The Subcommittee has noted the legal implications of repealing or amending the Amendment Rules which have already come into operation on 1 October 2001. The repeal or amendment would be without prejudice to anything done under the Amendment Rules before such repeal or amendment. According to the Law Society, the contributions from members in respect of the indemnity year 2001-02 have already been collected and the premium paid to reinsurers in accordance with the contractual obligations of the HKSIF. In order to ensure that the review of the Scheme will be carried out expeditiously by the Law Society, the Subcommittee has considered a proposal to amend the Amendment Rules to the effect that they have a certain validity period, e.g. two years or until 30 September 2003. Upon their expiry, the pre-existing provisions of the principal Rules which are amended by the Amendment Rules shall be revived in force as if the amendments effected by the Amendment Rules had not been made.

27. The Law Society has pointed out that if the proposal is passed, the former rules including the contribution formula will re-apply upon expiry of

the validity period. This would prevent the Law Society from carrying out its statutory function of providing a self insured professional indemnity scheme and place the Society in a position where it will be in breach of contract with reinsurers as well as depriving the public of the protection. It will therefore be necessary for the Law Society to repeat the exercise of seeking increases in contributions to meet the premiums payable to re-insurers for the remainder years of the contract and to fund claims in respect of that part of the claims exposure retained by the Scheme. The Law Society has reiterated that it has the statutory duty to maintain a fund to provide indemnity against claims made by the public against members of the profession. In any event, the Council of the Law Society is authorised under Schedule 1 paragraph 2(5)(a) of the principal Rules to call on its members for contributions to make up for a deficit or anticipated deficit in the fund. The Law Society has also pointed out that any solicitor who is unable to obtain professional indemnity cover under the Rules because of inability of the HKSIF to provide cover as a result of lack of funds will cease to be qualified to practise as a solicitor in accordance with section 7 of the Legal Practitioners Ordinance.

28. After discussion, the Law Society has suggested that it will give an undertaking which would have the same effect as the proposal being considered by the Subcommittee. The Subcommittee has considered the undertaking, in the form of a draft letter from the President of the Law Society to the Chairman of the Subcommittee. In the draft letter, the Law Society assures Members that once the parameters and likely cost are determined, it will seek a mandate from its members to carry out expeditiously an independent review and will inform LegCo of the progress of the review on or before 30 September 2003. Any recommended arrangements will have to be acceptable to members of the Law Society, approved by the Chief Justice and transformed into amendments to the statutory rules to be approved by LegCo before the expiration of the five-year contracts at the end of September 2005.

29. The Chairman has proposed an amendment to the draft letter to the effect that the Law Society will consult its members on the recommendation of the review to decide on the way forward and that it will inform LegCo of the progress on such matters on or before 30 September 2003. The aim of the amendment is to ensure that the Law Society will do its best to complete the review and consult its members to arrive at a decision on the way forward by 30 September 2003, so as to allow sufficient time for complex and meticulous post-review work including documentation and drafting of legislation in the event that a decision is made to amend or replace the existing mutual scheme.

30. In the view of the Law Society, it is implicit in the draft letter that it will consult its members on the recommendation made as a result of the review. As to whether it will consult members on or after 30 September 2003, this would depend on the progress of the review. The Law Society is unable to forecast the exact timing of the exercise at this stage. However, it agrees that

that it would proceed with the review as quickly as possible and impose a time limit for the body/person commissioned to carry out the review. The Law Society also accepts that it should then proceed with consultation with its members as expeditiously as possible. In the circumstances, the Law Society has suggested that the wording of its original letter should remain unchanged.

31. The Subcommittee agrees to accept the undertaking as proposed by the Law Society, a copy of which is in **Appendix II**.

Recommendation

32. The Subcommittee agrees to support the Amendment Rules.

33. As the Law Society has undertaken to make a report to LegCo on the progress of the review on or before 30 September 2003, the Subcommittee recommends that the matter should be referred to the Panel on Administration of Justice and Legal Services for follow-up. Upon receipt of the report from the Law Society, the Panel shall report to the House Committee which will then decide whether the report should be referred to a Panel or a subcommittee for further action.

34. The Subcommittee also recommends that the Chairman should address the Council on the Amendment Rules at the Council meeting on 31 October 2001.

Advice sought

35. Members are invited to note the deliberations of the Subcommittee.

Council Business Division 2
Legislative Council Secretariat
24 October 2001

Subcommittee on Solicitors (Professional Indemnity) (Amendment) Rules 2001

Membership List

Chairman

Hon Margaret NG

Members

Hon Albert HO Chun-yan

Hon Martin LEE Chu-ming, SC, JP

Hon Eric LI Ka-cheung, JP

Hon Bernard CHAN

Hon Jasper TSANG Yok-sing, JP

Hon Mrs Miriam LAU Kin-yee, JP

Hon Ambrose LAU Hon-chuen, GBS, JP

Hon Audrey EU Yuet-mee, SC, JP

Hon MA Fung-kwok

(Total : 10 Members)

Clerk

Mrs Percy MA

Legal Adviser

Mr Stephen LAM

Date

10 October 2001

LETTERHEAD OF THE LAW SOCIETY OF HONG KONG

Appendix II

SG/FA/1637

From the President

22 October, 2001

The Hon. Ms. Margaret Ng,
Chairman,
LegCo sub-committee on Solicitors' PI Rules,
Legislative Council Building,
8 Jackson Road, Central
HONG KONG

Dear

**Sub-committee on Solicitors (Professional Indemnity)
(Amendment) Rules 2001**

I refer to the discussions at the meeting on 16 October.

The Council of the Law Society is empowered under s. 73A of the Legal Practitioners Ordinance ("the Ordinance") to make rules concerning professional indemnity insurance for solicitors in Hong Kong.

Hong Kong Solicitors Indemnity Fund Ltd. ("the Company") was established by the Council to manage and administer the Professional Indemnity Scheme ("the Scheme") on behalf of the Law Society.

The Company has entered into a 5-year reinsurance contract with various reinsurers to reinsure the Scheme. The contracts expire on 30 September 2005.

With the prior approval of the Chief Justice the Council has made the Solicitors (Professional Indemnity) (Amendment) Rules 2001 ("the Amendment Rules") under s. 73A of the Ordinance.

The Amendment Rules came into operation on 1 October 2001.

The Amendment Rules are being considered by the Legislative Council under its powers of "negative vetting" under s. 34 of the Interpretation and General Clauses Ordinance (Cap. 1)

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Incorporated with limited liability

The Law Society of Hong Kong

From the President

The Law Society fully intends to carry out an independent review of the current insurance arrangements under the Scheme with a view to considering whether at the expiration of the 5-year reinsurance contracts the Law Society should maintain the existing mutual scheme with or without amendment or to demutualise the Scheme and put into effect such other options as may be proposed as a result of the review.

The Law Society wishes to assure the Honourable members of the Legislative Council that once the parameters and likely cost are determined it will seek a mandate from its members to carry out expeditiously an independent review and will inform the Legislative Council of the progress of that review on or before 30 September 2003. Any recommended arrangements will have to be acceptable to members of the Law Society, approved by the Chief Justice and transformed into amendments to the statutory rules to be approved by the Legislative Council before the expiration of the 5-year contracts at the end of September 2005. At this stage that is the "timetable" to which we shall be working.

If there are any points arising from this letter please do not hesitate to contact me.

Yours sincerely,

Herbert Tsoi
President

HT/PM/dp