Paper in response to the issues raised in the Panel on Administration of Justice and Legal Services meeting on 26 April 2004

Review of Professional Indemnity Scheme of the Law Society of Hong Kong

(a) The Policy objectives of the existing legislative requirements on professional indemnity insurance of solicitors, having regard to the concern expressed by solicitors that there is no other profession in Hong Kong whereby its members have to act as insurers of last resort for each other

Legislative Provisions

Section 7 of the Legal Practitioners Ordinance ("the Ordinance") provides that no person shall be qualified to act as a solicitor unless he complies with any indemnity rules made by the Law Society Council or is exempt from them.

2. Pursuant to the Solicitors (Professional Indemnity) Rules ("the Rules") made by the Law Society, the Law Society has established and is maintaining a Solicitors Indemnity Fund ("the Fund"), and all practising solicitors are required to make contributions to the Fund. The current arrangements are known as the Professional Indemnity Scheme ("the Scheme").

3. The Scheme is managed by the Hong Kong Solicitors Indemnity Fund Ltd. ("the Company") which was incorporated with limited liability by the Law Society in 1989. Its sole function is to manage and administer the Scheme. The Company has the power to delegate any aspect of the management and administration of the Scheme to a third party.

4. Rule 6 of the Rules provides for compulsory insurance as follows –

"(1) Subject to rule 7, every solicitor who is, or is held out to the public as, a solicitor in Practice in Hong Kong shall be required to have and maintain Indemnity.

(2) Any current practising certificate which has been issued to a solicitor who is required to have and maintain Indemnity and who fails to have Indemnity shall be suspended and such person shall not be qualified to act as a solicitor pursuant to section 7 of the Ordinance while he shall fail to have Indemnity."

5. Rule 7 relates to the exemption by the Law Society Council from compliance with the Rules.

Background of compulsory professional indemnity insurance

6. A mandatory professional indemnity insurance scheme was introduced in 1980 by way of amendments to the Ordinance ("Legal Practitioners (Amendment) Ordinance 1980"). This legislative amendment was initiated by a resolution of the Law Society in 1980 to implement as soon as practicable a compulsory professional indemnity insurance scheme.

7. In moving the second reading of the Legal Practitioners (Amendment) Bill 1980, the Law Draftsman said –

"The Law Society of Hong Kong resolved in July this year to implement as soon as practicable a compulsory professional indemnity insurance scheme. Such a scheme will not only be of advantage to solicitors, who will be able to secure insurance at favourable rates and upon advantageous terms; it will also be of significant benefit to the public in ensuring that persons who sustain loss or damage through the default of their solicitors will not fail, within the limits that I will explain in a moment, to obtain compensation because their solicitors may not have

sufficient funds. Compulsory professional insurance of the sort proposed is not unusual and already exists for instance in the United Kingdom, Canada and some of the States in Australia."

8. The Legal Practitioners (Amendment) Ordinance 1980 made compliance with such rules or exemption from them a condition precedent to qualification to act as a solicitor, and to the issue of a practising certificate, without which a solicitor may not practise. In legal and practical terms, professional indemnity insurance became compulsory by reference to the issue of practising certificates.

9. The type of professional indemnity insurance adopted in 1980 was a master insurance policy negotiated by the Law Society through an international firm of insurance brokers and was underwritten by several reputable insurance companies. The scheme was funded by annual premiums paid by all solicitors in private practice, and was similar in concept to schemes in England and Australia.

10. Under the Legal Practitioners (Amendment) Ordinance 1980, the details of the scheme and the requirement to take out insurance were to be provided in the professional indemnity rules made by the Council of the Law Society with the approval of the Chief Justice. The Council of the Law Society was conferred with the necessary power to make such rules.

11. Although the nature of the scheme has changed since 1980, the principle of compulsory professional indemnity insurance has remained firmly in place.

Administration's position

12. The Administration is strongly of the view that a mandatory professional indemnity insurance should remain in place for the

protection of the public. This view is supported by the Willis Report which stated, at p.121, that –

> "… in most Common Law jurisdictions in the developed world we report that the policy of the Administration of Hong Kong accords with that of most governments, regulatory authorities of the legal profession as well as with the opinion of bodies representing other professions, namely that the public interest requires insurance to be in place."

13. This department notes that a number of common law jurisdictions, such as Australia, Ireland, England and Wales, Scotland, Singapore, Malaysia and Canada, impose mandatory insurance requirements on legal practitioners. Details of the statutory insurance schemes of the respective jurisdictions are set out in section 5 of the Willis Report at pp. 138 – 156.

14. We also consider that the Law Society of Hong Kong owes a duty to the public in exercising the rule-making power vested in it under sections 73 and 73A relating to professional indemnity insurance. In *Swain v Law Society* [1982] 2 All ER p.827, Lord Diplock stated at p.830–

> "The Solicitors Act 1974 imposes on the Law Society a number of statutory duties in relation to solicitors whether they are members of the Law Society or not. It also confers on the council of the Law Society, acting either alone or with the concurrence of the Lord Chief Justice and the Master of the Rolls or of the latter only, power to make rules and regulations having the effect of subordinate legislation under the Act. Such rules and regulations may themselves confer on the Law Society further statutory powers or impose on it further statutory duties. **The purpose for which these statutory functions are vested in the Law Society and the**

> **council is the protection of the public or, more specifically, that section of the public that may be in need of legal advice, assistance or representation. In exercising its statutory functions the duty of the council is to act in what it believes to be the best interests of that section of the public, even in the event (unlikely though this may be on any long-term view) that those public interests should conflict with the special interests of members of the Law Society or of members of the solicitors' profession as a whole** (*emphasis added*). The council, in exercising its powers under the Act to make rules and regulations and the Law Society in discharging functions vested in it by the Act or by such rules or regulations, is acting in a public capacity and what it does in that capacity is governed by public law; and, although the legal consequences of doing it may result in creating rights enforceable in private law, those rights are not necessarily the same as those that would flow in private law from doing a similar act otherwise than in the exercise of statutory powers."

15. There are many reasons of public policy why solicitors should be required to take out mandatory insurance. They are different from other professions in that solicitors often hold a large amount of clients' money in performing their duties for their clients. A default by a solicitor, therefore, could potentially have very serious consequences for his or her clients. It is therefore reasonable to require the profession to take out adequate insurance in order to ensure that the interests of their clients are adequately protected.

16. From the perspective of solicitors, there is also the question of competition to be considered. Without an assurance that all solicitors are insured, prudent clients would be likely to turn to the bigger and more established firms for legal services, and small firms might have difficulty

in competing for business.

17. Since 2001, the Secretary for Justice has been actively promoting Hong Kong as a legal services centre for the resolution of international trade disputes. In pursuing this aim, we must ensure that the Hong Kong legal system and the legal profession are of an international standard and remain competitive in the region.

18. We quote from the Willis Report, at p.121 –

> "Hong Kong is and aims to continue as a world class centre of commerce and finance. Businesses operating in other jurisdictions where indemnity insurance is mandatory expect an equivalent level of protection and Hong Kong may risk a decline in users of its financial and other trade and commercial services if the users of those services perceive that standards of consumer protection in Hong Kong are below that available from Hong Kong's competitors. Singapore was one of the latest jurisdictions to introduce mandatory indemnity insurance for lawyers in 1991 and the above commercial reality was one of the driving forces."

19. Based on the above factors, this department considers that it is essential that mandatory professional indemnity insurance should be maintained in order to provide adequate protection for users of Hong Kong legal services.

(b) <u>Whether under the existing legislation and the mandatory indemnity scheme solicitors have a liability to mutually pay for any shortfall in compensation of unlimited amount, and if so, whether it is the intended policy</u>

20. Pursuant to the Rules, the Fund was established in 1989 and has been maintained since then. As noted in paragraph 3.1 of the Willis Report,

> "This development was a fundamental change from previous arrangements as the Profession became the direct

underwriter of all of its risks with primary obligations for providing indemnity."

21. After checking through our internal files for the background of the making of the Rules in 1989, we understand that the Fund established by the Law Society was designed with reference to the scheme then operated by The Law Society in England and Wales. In 1987, a self-insurance scheme was introduced in England and Wales when the market of the insurance industry was hard. The scheme was reinsured at first but from 1990-1994 was wholly funded by the profession (Willis Report, p.79). The setting up of a solicitors' indemnity fund in England and Wales brought about a fundamental change by substituting self-insurance by the profession in private practice for commercial underwriters. It was then considered by the Law Society of England and Wales that the financial strength of the profession was more than adequate for the purpose.

22. In the course of tracing the background of the making the Rules, we also note that a copy of an article, entitled "Future Basis of Professional Indemnity Insurance – Self-Insurance", published in the English Law Society's Gazette dated 29 October 1986, was supplied by the law firm acting on behalf of the Law Society in the drafting of the relevant rules in order to support the scheme proposed by the Law Society. This appears to provide an insight as to why the present scheme was proposed in 1989. The article noted that the introduction of self-insurance would enable the profession to participate in claims handling through claims monitoring. It was considered that the introduction of self-insurance in England and Wales would enable the profession to participate in claims handling through claims monitoring, which had three obvious advantages –

(a) the standards of those handling claims would be the subject of scrutiny;

(b) there was the possibility of more effective action being taken early in a claim's history to mitigate the damage by taking action to "nip the claim in the bud";

(c) the chance to take active steps to improve standards of office management in particular solicitors' practices with a view to reducing their incidence of claims.

23. Apart from the above, we are not aware from our internal files of any express discussion among the Administration, the Law Society and the Legislative Council about the legislative intent

concerning the issue whether solicitors should be liable to mutually pay for any shortfall in compensation of unlimited amount.

24. However, the legislative intention of the relevant provisions can be ascertained by applying the normal rules of statutory interpretation.

25. Our view of the legal position is that (consistently with the intended policy) solicitors do, under the existing legislation and the mandatory indemnity scheme, have a liability to pay for any shortfall in compensation, but not to an unlimited amount.

26. Under the current scheme, the fund is required to provide indemnity against specified loss up to a sum not exceeding $10 million (less deductibles) in respect of any one claim. Since the Law Society must maintain that fund, it has lawfully required solicitors to pay the shortfall between the assets of the fund and liabilities of the fund, based on that indemnity principle. The liability of solicitors to pay for the shortfall is not therefore of unlimited amount.

27. We also consider that the public duty of the Law Society and the profession to compensate clients not only arises directly from the policy and objects of the Legal Practitioners Ordinance but also is an aspect of a general policy of protecting the client public which is so entrenched in the values of the common law system that it qualifies as an established principle of legal policy. An example of such general policy is *Royal Bank of Scotland plc v Etridge (No. 2)* [2001] 3 WLR 1021, 1031G-H, a case on undue influence, in which Lord Nicholls said –

> "The law has adopted a sternly protective attitude towards certain types of relationship in which one party acquires influence over another who is vulnerable and dependent. … Examples of relationships within this class are parent and child, guardian and ward, trustee and beneficiary, solicitor and client, and medical adviser and patient. In these cases the law presumes, irrebuttably, that one party had influence over the other. The complainant need not prove he actually reposed trust and confidence in the other party. It is sufficient for him to prove the existence of the type of relationship."

<u>Future Position</u>

28. Provided that solicitors' clients are adequately protected by insurance arrangements, the Administration does not consider that, as a

matter of policy, it is essential for a future professional indemnity scheme to make solicitors the insurers of the last resort in every situation regardless of the amount at stake. However, we consider that it is not in the interest of the public that consumers should be subject to a large degree of risk.

29. Any new professional indemnity insurance scheme should provide adequate protection for both the solicitors and the public in the event that any relevant insurer goes into liquidation. Under the present scheme, those with a valid claim against a solicitor are guaranteed compensation not exceeding $10 million even in the event of such a liquidation. We consider that any new scheme should provide at least the same guarantee.

30. We note from section 2 of the Willis Report that there are two suggested options for the future arrangement of professional indemnity insurance. Those two options have been put forward by the Law Society for its members to vote on in an Extraordinary General Meeting. Our views on the two options are as follows.

Master Policy Scheme

31. Our understanding of this option is that, under a Master Policy Scheme, the fund would only be liable for the first $1.5 million of any claim. The remaining $8.5 million would be covered by several insurance companies. If any one of the insurance companies went into liquidation, each law firm which is subject to claims would have to assume an equivalent proportion of the liability.

32. The implementation of this scheme would require legislative amendments. Our provisional view is that, under such a scheme, even though a proportion of clients' claim is protected under the fund for the first $1.5 million of any claim, nevertheless, there would be a large reduction in the present protection offered to clients. The Administration considers this undesirable, given the Law Society's public duty to safeguard the lay public and not professional practitioners, in case of a conflict. The Administration considers that this scheme should not be supported unless it is backed up by a mechanism, such as a Policyholders' Protection Fund or arrangement of some form of "insurance on insurance" to deal with the risk of insurer's default. Without a back-up mechanism, we consider that there will be inadequate protection of both the solicitors' interest and their clients' interest.

Qualifying Insurance Scheme ("QIS")

33. This scheme is an arrangement under which an insured professional qualifies to carry on business by purchasing cover from an insurer who has previously agreed to comply with qualifying pre-conditions set by the profession's representative body. Our understanding of the QIS is that, should an insurer default, the loss would pass back to the solicitors and, if the solicitors were bankrupted, to their clients. Unlike a Master Policy Scheme, under which clients are at least covered for the first $1.5 million, clients may ultimately be unable to receive any compensation if the insurance company goes into liquidation and the solicitors go bankrupt.

34. The Administration considers that this scheme should not be supported unless it is backed up by a mechanism, such as a Policyholders' Protection Fund. Without a back-up mechanism, we consider that there would be inadequate protection of both the solicitors' interest and their clients' interest.

35. We understand that the proposed QIS is largely based on the present scheme adopted in the United Kingdom. We note that, unlike the situation in Hong Kong, the United Kingdom's QIS is supported by a PPF. We consider that, in Hong Kong, any QIS should similarly be backed up by a general PPF. However, the Commissioner of Insurance has advised us that, in the event that it is decided that a general PPF is to be implemented in Hong Kong, it would take a period of 3-5 years for implementation.

36. As an interim measure, for the purpose of backing up a QIS, the Commissioner of Insurance has suggested the arrangement of some form of "insurance on insurance" in order to deal with the risk of insurer's default. This involves negotiating with the insurers or reinsurers to provide some form of protection against the default of individual insurers participating in the scheme in exchange for the payment of an additional premium. This suggestion has been put forward in a letter from the Solicitor General to the Law Society on 25 March 2004.

37. The Administration fully appreciates the difficulties faced by solicitors in the present situation. In addition to dealing with the question of insurance, we consider that it important to find ways to reduce the potential amount of claims against solicitors. This can be done through good risk management by way of peer pressure, promoting self-discipline in the profession, and introduction of the concept of best practices in terms of internal management control and professional conduct.

(c) <u>The Administration's position on the option of an indemnity scheme for solicitors funded by levy imposed on certain types of transactions.</u>

38. It is pointed out in the Willis Report that insurance is a cost of business. As with other business costs, it is up to solicitors to decide whether and how to pass it on to their clients, e.g. through a slight increase in fees.

39. An example of a levy was given in paragraph 3.8.4 of the Willis Report which states that firms in Ontario, Canada, engaged in conveyancing work are obliged to pay a sum of CA$50 per transaction as part of the insurance contribution. Failure to make the payment or the provision of an inaccurate return amounts to professional misconduct enforced by disciplinary proceedings and ultimately by striking off. However it is noted that there is no statutory warrant for the so-called "insurance contribution" of CA$50 per transaction and the levy does not seem to be mandated by the Ontario government.

40. In Hong Kong, the operation of the Travel Industry Compensation Fund is different. The fund, in effect, is a compulsory insurance scheme for all package tour travellers to protect themselves against losses suffered from the default of a travel agent. The Employees' Compensation Insurer Insolvency Scheme, on the other hand, operates as a specialized policyholders' protection fund ("PPF") for the compulsory employees' compensation insurance scheme. The purpose of the scheme is to provide employees' compensation in the event of insolvency of an employer's insurer.

41. The idea of a conveyancing transaction levy proposed by Willis does not seem to serve any of these purposes. Rather it appears to be an attempt by the solicitors to transfer the insurance cost of the high risk conveyancing business to their clients. We consider that the scheme affords no additional protection to the clients.

42. The Administration considers that a levy imposed on consumers to cover loss arising from the default of insurance companies, or to cover solicitors' costs for insuring against their own negligence, is unacceptable. Similarly, it is unacceptable to impose a levy on consumers for the purpose of meeting claims against solicitors for fraud, which are presently not covered by the Scheme. It would be unfair for consumers to be required to pay such levy, since it would make them legally liable to pay insurance in respect of their solicitors' default. Moreover, this would adversely affect the image and reputation of the solicitors' profession.

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