

THE HONG KONG LAW SOCIETY
PROFESSIONAL INDEMNITY INSURANCE SCHEME

Memorandum to the Panel on Administration of Justice
and Legal Services, Legislative Council

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I. Statutory Framework of Hong Kong Solicitors' Indemnity rules

Pursuant to Section 73A of the Legal Practitioners Ordinance, Cap. 159 ("LPO"), the Council of the Law Society *may* make indemnity rules concerning indemnity against loss arising from claims in respect of any description of civil liability incurred

- (a) by a solicitor or former solicitor in connection with his practice or with any trust or of which he is or formerly was a trustee;
- (b) by an employee of a solicitor or former solicitor in connection with that solicitor's practice or with any trust of which that solicitor or the employee is or formerly was a trustee.

Section 73A (2) provides for 3 models of indemnity rules which:

- (a) *may* authorize or require the Society to establish and maintain a fund or funds; (the '*Mutual Fund*' model)
- (b) *may* authorize or require the Society to take out and maintain insurance with authorized insurers; (the "*Master Policy*" model);
- (c) *may* require solicitors or any specified class of solicitors to take out and maintain insurance with authorized insurers (the '*authorized insurers*' model)

Section 73A (4) prescribes that a solicitor failing to comply with the indemnity rules *may* be subject to disciplinary proceedings.

Section 73A (6) prescribes that every rule made by the Council under this section *shall be* subject to the prior approval of the Chief Justice.

The 3 models permissible under S73A (2) of LPO are not necessarily mutually exclusive of each other and on a proper construction of the section, an indemnity regime which is a combination of two or more of these models, or consisting of the co-existence of more than one of these models is permissible, subject to the prior approval of the Chief Justice, ‘having regard to the Law Society Council’s consultation with Law Society members’.

II. The Indemnity models under S73A (2), LPO

In the Willis Report,

‘Mutual Fund’ is defined as an arrangement under which members of a group decide and agree to pool the risks of all of them and to contribute to the losses that might be incurred by all or any of them. The mutual sets the terms of indemnity to its members which are the same for all; the mutual sets the contribution each member must make and establishes the administrative arrangements for managing the mutual, appointing persons to manage, and the rules for calculating and collecting each members contribution, the management of claims, compliance with statutory requirements, investment of funds, control mechanisms such as voting rights and ultimately for winding up the mutual and distribution of any of its remaining assets.

‘Master Policy Scheme’ is defined as an arrangement where a single insurance policy is issued by commercial insurers to a body representing the members of a profession and covers every member of the profession within limits and terms and for a premium that is predetermined by agreement between the master policy holder [the Society] and insurers.

‘Qualifying Insurer Scheme’ is defined as 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. [pre-supposes that the insurer is

otherwise authorized by law to trade as an insurer]

'**Captive**' is described as similar to a mutual scheme, but it is conducted through the medium of licensed insurer that is subject to similar regulation, but lower capital requirements as any licensed insurer. The Captive insures only the profession that owns it and operates for the benefit of its owner. Its management can be retained by representatives of the professional body or outsourced to a professional captive manager.

A captive insurance company is the epitome of a self-insurance program. The term 'captive' as defined by the Webster dictionary means 'owned or controlled by another concern and operated for its needs rather than for an open market'.

Since 1980, when professional indemnity insurance became compulsory for solicitors, a Master Policy regime under S73A (2) (b) was set up.

The current Mutual Fund regime is constructed pursuant to S73A (2) (a) since 1989.

It is open for the profession to opt for, and within the discretionary power of the Law Society Council to make rules of, one or more of the models allowable under S73A, or a combination or hybrid of them.

In my view, both the Qualifying Insurer Scheme (QIS) and the Captive fall within the 'authorized insurer' model under Section 73A (2) (c). Whereas a QIS is a commercial open market insurance scheme, a Captive is a non-commercial self-insurance scheme.

III. The Way Forward

In exploring the way forward, it is imperative to investigate firstly, the flaws with the existing system so as to avoid making the same mistakes in future. Secondly, it is important to lay down the basic principles for the choice of the future solicitors professional insurance scheme. The 4 million Willis Report was conducted by a commercial insurance consultant, which sees its role as 'to

assess information, statistics and facts about forms of insurance and their suitability for Hong Kong circumstances and their availability, price and sustainability in the *commercial* insurance market.’ Non-commercial considerations, such as matters of public policy, seem to be of peripheral significance for Willis’ recommendations, and is therefore unsatisfactory. The Willis Report had also failed to provide any pricing indication for each of the future options which it proposes.

(a) **The Flaws of the existing Professional Insurance Scheme**

1. The main dissatisfaction with existing PIS scheme is that the solicitors ‘have to act as insurers of last resort for each other’, or in insurance terminology, the profession retains to itself the ultimate underwriting risk. The HIH collapse had exposed this risk, which is constituted by the following arrangements:
 - i. The HKSIF is its own insurer or the lead insurer and all solicitors are subjected to the liability to indemnify the Fund for the full ten million limit on each and every claim, less the reinsured risk of HK\$8.5 million on each claim.
 - ii. Since 1st October 2001, HKSIF did not have stop loss reinsurance for the retained liability of HK\$1,500,000 for each claim.

Any future scheme must be designed to transfer the ultimate underwriting risk outside the profession. This can be achieved by restructuring the reinsurance arrangement. It must be noted however that there is no legal requirement at all that solicitors must retain the underwriting risks within the profession.

2. The Willis Report mentioned about ‘modernizing the decision-making process and management structure’ of the insurance scheme, but did not go into detailed analysis of the problems. In my view, this is in fact the root of the problems surrounding the existing PIS regime, which are briefly summarized as follows:

i. Had there been mis-management ?

The main object of the HKSIF is to hold, manage and administer the

fund established by the Law Society under Section 73A of LPO and in accordance with the Rules. It is specifically provided at its Memorandum of Association that HKSIF is not authorized to carry on any insurance (including reinsurance) business governed by the Insurance Companies Ordinance (Cap.41). All the directors of HKSIF are current Council members of the Law Society appointed by the Law Society Council. Day-to-day management of HKSIF is performed by Essar Insurance Services Ltd. ('Essar') which reportedly manages the PIS Scheme 'as directed by the Law Society Council'. The Law Society Council members are not insurance professionals, and there had not been any reported supervision system in place, such as periodic financial reporting (other than its annual report) and performance audit over the operation of HKSIF. What are the roles of the Board of Directors of the HKSIF vis-à-vis the operation of the PIS fund? How are investment decisions made? How are premium/contribution-rating strategy set?

ii. Had there been conflict of interests?

All claims under the Fund are handled by the Claims Committee, a committee set up by the Law Society Council. Claims are either defended, or settled. The Claims Committee refers the claims to the 'Panel Solicitors', consisting of about 10 appointed solicitors firms, for defending/settling the claims. According to the Willis Report (Table No.4 at p.51), the defence costs for the years 2000 to 2002 are as follows:

Policy Year	Total Payment (HK\$)	% of payment for defence costs
2000	26,105,191.17	54.8%
2001	11,415,442.67	88.7%
2002	1,213,197.62	67.0%

It seems that most of the members' contribution goes to payment for the Panel solicitors defending the claims. It was remarked in the Willis Report that 'Assume for the sake of argument that 20% of all liabilities

of the Scheme is the cost of defending claims, that is HK\$277,000,000.' The actual figure is probably much higher. The shortfall contribution, the central theme of the current dispute between the Law Society Council and the membership, amounts to HK\$132,893,268.00, which is less than half of the aforesaid estimated defence costs.

There is a high degree of overlap of the Law Society Council members, the Claims Committee members and the Panel Solicitors. There is therefore an apparent and *prima facie* conflict of interests situation.

iii. Is there sufficient transparency and accountability?

The general membership of the Law Society are not members of HKSIF. The HKSIF is therefore not directly accountable to the Law Society members. The Law Society Council had refused to respond to enquiries of members regarding the operation of the HKSIF, and had refused to disclose relevant documents, such as the management contract between HKSIF and Essar. This has aggravated the loss of confidence of the general membership towards the Law Society Council.

iv. Lack of supervision and regulation of the operation of HKSIF

The Fund administered by the HKSIF is not registered as a Mutual Fund and HKSIF is not a licensed insurer. The administration of the Fund is therefore not regulated or supervised by any regulatory body, such as the Monetary Authority, or the Insurance Commissioner. Had there been proper corporate governance? Are the interests of the payers of contribution (equivalent to policy holders under a typical insurance regime) properly protected? Is there any recourse for the members who feel aggrieved?

(b) The Basic principles for a professional insurance scheme

I suggest that any future solicitors professional insurance scheme must have features which are in line with some basic principles, which I set out briefly below:

1. Public Policy considerations

In the DOJ paper to the Legco of May 2004, it was mentioned that the professional indemnity insurance scheme must remain compulsory on grounds of public interests, namely, firstly, 'in ensuring that persons who sustain loss or damage through the default of their solicitors will not fail...to obtain compensation because their solicitors may not have sufficient funds'. (paragraph 7) Secondly, it will augment Hong Kong's position as a legal services centre offering an equivalent level of protection [to the users of legal services] as in other major common law jurisdictions. (paragraph 17 and 18)

However, the DOJ paper (at paragraph 15) is misconceived in referring to solicitors holding clients' money as a ground for requiring mandatory professional insurance, in that under the statutory framework of S73A LPO, only civil liabilities are protected. Solicitors' default involving fraud or dishonesty are not covered.

It is equally misconceived that mandatory professional insurance would promote competition among law firms of different sizes, that 'without 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'. (paragraph 16) By imposing a uniform premium/contribution formula, smaller firms are put in a less competitive position than their bigger counter-parts. One of the criticisms of the current system is that there is no differentiation of premium rates for high risk work (such as conveyancing and civil litigation) and low risk work. There is also no differentiation of geographical cover. Being mandatory should not preclude an insurance scheme from the flexibility of providing tailored-made programs that suits the specific modes of operation of individual law firms of different sizes.

The DOJ paper had totally ignored the interests of the profession. In my respectful submission, it is in the public's best interest to maintain an affordable, equitable and effective professional insurance scheme that would promote the delivery of a strong, independent and efficient legal services industry. Not only will this be conducive to the upholding of the Rule of Law, it will enhance protection of consumers (users of legal services) interests by ensuring access to justice for all (there being no anti-competition mechanism) , and protection of consumers interests through higher quality and lower prices. The existing PIS scheme is such a cumbersome and inequitable burden on the profession that it threatens the very survival of the whole profession. This is definitely not in the public interests and is inconsistent with Hong Kong's goal of being a major services centre for the Asia Pacific region.

In short, it is in the public interest that the future solicitors' professional insurance scheme strikes the right balance between protecting the consumers' interests and the profession's interests. It should not be anti-competitive and it should be flexible enough to suit the different needs of different legal practices.

2. Segregation from the other functions of the Law Society

Insurance is a specialized business needing specific expertise. As lawyers we are not trained or qualified to be insurers. Insurance business is a regulated business and the Law Society should be no exception. The present PIS scheme run by the Law Society is un-regulated, non-transparent and non-accountable, breeding conflicts of interests and abuses.

Any future insurance arrangement for the profession should be segregated from the Law Society's other functions which should be regulated, run by insurance professional, accountable to the members of the Society, and subject to stringent corporate governance in line with best management practice.

3. Basic features of a Professional Insurance Scheme

Irrespective of which of the model under S73A of LPO the profession will opt for, any future PIS should embrace the following non-exhaustive features:

- ✧ An independent, professional management team with strong, professional ethics, adhering to modern corporate governance standards;
- ✧ Regulated and supervised by appropriate regulatory authority(ies);
- ✧ Equitable and transparent premium structure that features
 - Reasonable and affordable basic premium rate;
 - Premium loading/ surcharge for high risk practice, such as conveyancing and civil litigation;
 - Claims handling and monitoring mechanism that are cost-effective, efficient, and fair
 - Minimal operation costs
 - Optimal insurance coverage
 - Flexibility that caters for the different needs of different modes of legal practices
 - ‘users pay’ principle that links premium rate to firm size and claims history
- ✧ transfer of ultimate underwriting risk outside of the profession.

IV. What Hong Kong can learn from other common law jurisdictions?

The Willis Report had devoted one section outlining the professional insurance arrangements in other common law jurisdictions. Strangely, however, the Willis Report concluded that the status quo, with slight modification, should be maintained, and put forward only the QIS modeled on the England and Wales scheme as the only alternative option for Hong Kong.

I highlight below the professional insurance arrangements in England and Wales, New South Wales of Australia, as well as Quebec and Ontario of Canada.

England and Wales: Mutual → QIS → ???

England and Wales had a Master Policy since 1977. The Solicitors Indemnity Fund (SIF) came into operation on 1 September 1977 and continued in operation until 1 September 2000, when a Qualified Insurers Scheme replaced it. The reasons for the shift from SIF to QIS are as follows:

- ✧ Similar to the Hong Kong situation, in early to mid 1990s, there had been a

significant increase of claims resulting in a shortfall of assets to liabilities of the Fund, and a call for levy/supplementary contributions on law firms. The shortfall was aggravated by high costs of investigation and defence of claims and high management costs of the SIF. A group of small and medium law firms brought judicial review proceedings against the Law Society claiming that the SIF is a mandatory monopoly and was in breach of European Union Competition Regulations and was ultra vires the Law Society. After a consultation process that involved preparing various reports, receiving submissions from various interests groups and parties, and a postal ballot on all the members, the SIF scheme was scrapped and a QIS put in place in 2000.

- ✧ The aim of the QIS was expressed to be *'to transfer underwriting risk outside the profession and to give individual firms a choice of insurer, whilst retaining to the maximum degree possible the protection for the consumer and certainty of cover for solicitors' firms provided by the [present] SIF arrangements.* (paragraph 14 , 13.04.00 Council paper – future arrangements for Professional Indemnity cover)
- ✧ As mentioned, the QIS is an open-market commercial insurance scheme. The main advantages are freedom of choice and transfer of underwriting risk.
- ✧ The QIS enjoyed an initial honey-moon period of success, with a reduction of GBP 100m premium in its first year. By 2002, premium price increases from 20% to 50% (there had been estimates of 300% increase). (Law Society Gazette, Vol 99 No.31 p 20) The open-market commercial insurance hardened since 9-11 and Enron, and it is interesting to note that in a recent article published in the Law Society Gazette, UK (21/05/04), whether the open market gives solicitors a better deal on indemnity was questioned.
- ✧ In an article entitled 'Death by insurance' (26/06/03 Law Society Gazette, UK), it was written:
*'It is worthy to note that other professions and industries have been similarly squeezed. The remedy for some has been to form **captive insurers**. The Society did this with the formation of the SIF. As we walk away, others, perhaps better informed, are moving in...
The legal profession is now in a complete mess over professional indemnity insurance. **We need to go back, and revive the SIF to act in tandem with the market.** This will at least extend capacity, and choice for solicitors.
The stronger firms can secure better firms in the market, leaving the weaker*

firms covered by the SIF. The weakest will be refused cover. Think back to those halcyon days, when indemnity insurance was just a small cloud on the horizon. Little did we know that we were about to face gale-force winds.'

Should Hong Kong follow the footsteps of England and Wales in its search for the future professional indemnity insurance model?

New South Wales, Australia: Mutual → Master Policy → **Captive**

The experience of New South Wales (NSW) is interesting in that at the time of the crash of HIH in April 2001, the *entire* underwriting for the three year period 1999-2001 was with the failed company. (Willis Report, p.143)

The Willis Report wrote: *'When HIH collapsed, it was estimated that there were outstanding PI claims liabilities of some A\$112 million. At that time the funds held by the Solicitors Mutual Indemnity Fund (SMIF) were of the order of A\$85 million, leaving a potential deficit of A\$27 million. The NSW government quarantined the SMIF surplus fund to help meet the HIH shortfall'*.

Lawcover, a not-for-profit company and wholly owned subsidiary of the Law Society, administer the professional indemnity insurance on behalf of the Law Society of NSW.

In the year 2002-3, the total Scheme premium increase was kept at 5%. In 2003-4, scheme premium increase was kept at 10.5%.

On 16th April 2004, the Australian Prudential Regulation Authority (APRA) has granted LawCover Insurance Pty Limited (LawCover Insurance) an insurance licence, and the NSW professional insurance scheme had moved towards a risk retention model involving an APRA-regulated on-shore captive insurer.

In the Media Release of April 16 2004, it was mentioned that *'the establishment of LawCover Insurance is a strategic move away from the previous*

agency model and is designed to better insulate the NSW legal profession from the capacity and pricing volatility of the general insurance market, which should in turn provide increased stability and affordability of Compulsory Professional Indemnity Insurance than has been the case in the recent past.'

The NSW legal profession had opted for the Captive model rather than the QIS, Master Policy or Mutual Fund model.

Canada – Quebec : shining success: mutual + Captive

The Willis Report wrote (P.152) : *'Quebec's captive is a shining example of a successful mutual arrangement operated through a licensed captive insurer....It provides cover with a limit of C\$10 million against all civil liability. The scheme has averaged about 800 claims per year over the last 10 years. In 1999 the contribution by the lawyer was C\$1. It now offers cover for no premium and that premium holiday has lasted for 5 years!'*

In its Annual Report of 2003, the following features were highlighted:

- ✧ All operating expenses were entirely paid from investment income generated by members' equity;
- ✧ Total return on investment was 10.9%,
- ✧ Dispute resolution through negotiation, with or without mediation, was one of the priorities. In a majority of cases, the settlement occurred without any proceedings having even been filed. A significant proportion of claims having no basis in law were withdrawn after explanations were provided to the client.
- ✧ The general insurance coverage was doubled
- ✧ The Fund added insurance covering misappropriation of funds deposited in trust with coverage of C\$1,000,000 for related legal costs.
- ✧ Coverage was added for proceedings instituted worldwide outside Canada.

The Report concluded that 'consistently affording greater protection to the public and members while maintaining a premium holiday is not an easy task, given that we offer the **most comprehensive** compulsory liability coverage in North America'.

Canada – Ontario: Master policy + captive

The Ontario model is described in the Willis Report (p.152) as follows:

- ✧ Lawyers' Professional Indemnity Company (LawPro), a captive licensed insurer owned by the Law Society of Upper Canada is the sole compulsory provider of Professional Indemnity Insurance in Ontario and Newfoundland.
- ✧ The policy is issued to the Law Society of Upper Canada and the scheme can be characterized as a Master Policy scheme in which the insurer is a captive.
- ✧ A Levy is charged on conveyancing and civil litigation on a transaction basis on the client as a disbursement.

It is interesting to note the following paragraph from the Willis Report (at p.153)

'In the early 1990's Ontario's scheme faced a crisis that has some similarities to Hong Kong. Escalating claims, largely arising from conveyancing and litigation work, left the (then) mutual with a shortfall between outstanding claims liabilities and its assets. The response was to isolate the insurance arrangements from the other activities of the Law Society and allow it to be managed on commercial lines by professionals with insurance expertise. The control of captive remains ultimately with the Law Society as the owner for the benefit of the members of the Society but the day to day and overall management of the insurance arrangements are done by professionals in insurance. The company is a licensed insurer and a corporation with its directors and officers being subject to the usual corporate governance and accountability standards of corporations....'

Another interesting point to note is that in LawPEO's 2003 Annual Report, it was stated that *'in 2003, LawPro opted to retain all of the risk under the Law Society's primary program itself, rather than place a portion of the risk with the reinsurance markets.....When insurance market 'hardened' in 2003, and pricing for reinsurance increased dramatically, we were ready to assume all of the risk for the Ontario primary program within LawPRO. Our ability to take this course of action enabled us to avoid premium increases for both 2003 and again for 2004 – a rarity among insurers today.'*

V. Exploring the suitability of the Captive Model as Hong Kong's future

professional insurance Scheme

At p.132 of the Willis Report, it was stated:

'A captive insurer licensed under the Insurance Companies Ordinance and incorporated in Hong Kong could provide to the public and to solicitors all the benefits of the current scheme with the added benefits to the members of the profession that it would limit their liability for losses in the event of a reinsurer's insolvency of a catastrophic claims loss that had not been anticipated and for which there were insufficient assets.'

At p.133, it was stated that:

'the government of the HKSAR is encouraging the establishment of captive insurers in the territory to promote Hong Kong as a captive centre within the Asian Region.'

Prima facie, the Captive Model is in line with public policy of protecting public interests and affording adequate protection to the profession, with the added benefit of limited liability and being regulated.

Advantages of the Captive Insurance

The advantages of Captives include:

Alignment with the profession's goals: Captive insurance companies underwrite policies that are custom-made for its owner/program participants, allowing the insured to enjoy the benefit of purchasing specific coverages that they might not be able to purchase from a commercial insurer, or at all, and at competitive rates.

Stability: As the insured designs its own program, it also avoids the impact of insurance industry coverage and pricing fluctuations.

Control over claims: Captive insurance, essentially being self-insurance, provides incentives for owners to reduce or eliminate the potential for claims

through proactive risk control and claims management techniques.

Direct access to reinsurance: Captive insurance allows owners/program participants direct access to the reinsurance market, thereby resulting in lower rates of without paying commissions to commercial insurers.

Disadvantages of Captive Insurance

Capitalization and commitment: Establishing a captive insurance company requires a substantial amount of initial capital to ensure that the captive remains financially healthy during tumultuous times.

Potential for inadequate loss reserves: When actual losses exceed initially expected levels, captive insurance companies might need additional funds to be allocated. If risks are not well-assessed initially, the captive owner could suffer adverse financial consequences.

(Source: Spring Consulting Group, LLC)

Another trend which we see from other common law jurisdictions is that there is a shift from commercial insurance to self-retention of risks. The current insurance market situation where insurance is available only at a high price, if at all, is the underlying reason for such trend.

It is pointed out that *'the self-insurer is not exposed to the moral hazard problem because it has an incentive to minimize losses. The aggregate limit of all retained loss exposures will be affected by three main factors:*

- (1) the predictability of this limit*
- (2) the availability of protection for catastrophic losses*
- (3) the financial strength of the self-insurer'*

The advantages for self-insurance are:

- ✧ Reduce or eliminate the loading for transaction costs
- ✧ Assume a credibility of 100% to its own experience

- ✧ First beneficiary of risk control measures
- ✧ Funds available immediately
- ✧ Investment income through the investment of premiums until they are required to pay claims

Disadvantages for self-insurance are:

- ✧ No protection against adverse frequency (to be overcome by stabilization program)
- ✧ Cost of technical, actuarial and legal services (to be overcome by cost-reduction program)

(see: Theory and Practice of Insurance, J. Francois Outreville, p.186)

VI. Recommendations

It is suggested that the Law Society, the Administration and the Legislature conduct further investigation on the suitability and desirability of replacing the current mutual scheme with a Captive insurance scheme in Hong Kong.

It is further suggested that the initial capital of the Captive be consist of:

- ✧ Contribution from the Hong Kong Law Society from its reserve (the Law Society of NSW has contributed \$6 million from its Special Reserve as initial capital to LawCover Insurance);
- ✧ Contribution/loan from the HKSAR government as a special relief fund (essentially, to cover the HKSIF shortfall).

The proposed Captive will be further funded by:

- ✧ Premium payments from the Law Society members;
- ✧ Special levy surcharge on conveyancing and civil litigation services on transaction basis, to be charged on clients on an ad volerem basis as a disbursements, and to be collected by the Land Registry and

Court Registry respectively. The fund collected from the levy surcharge can be designated for protection of the clients' interests against solicitors' fraud (not a civil liability) or re-insurer insolvency/default.

Upon the establishment of the Captive, all the assets and liabilities of HKSIF will be transferred and vest absolutely in the Captive, and thereafter HKSIF be wound up.

The Captive will be empowered to administer the runoff of claims notified up to September 2005 before the dissolution of HKSIF.

It is imperative that the management and operation of the Captive be separate and independent of the Law Society Council and be in line with best corporate governance benchmark. Its Board of Directors should be appointed by the Chief Justice and shall consist of members of the public, representative(s) from the HKSAR government, and financial professionals such as actuary(ies), merchant banker(s), financial advisor(s), and of course, insurance expert(s).

The survival and well-being or otherwise of the solicitors professions hinges on how well the HKSIF crisis is managed. The existing scheme whereby the profession is required to underwrite the risk of re-insurer default is unreasonable and is catastrophic to the profession. A strong, independent legal profession, including the solicitors profession, is in the best interest of Hong Kong.

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This paper is for the reference of the Panel on Administration of Justice and Legal Services, Legco and will be copied to the Chief Justice, the Secretary for Justice and the President of the Law Society of Hong Kong for their reference.