M E M O R A N D U M

TO	**:**	**LEGCO / LAW SOCIETY OF HONG KONG**
FROM	**:**	**PAUL WORDLEY**
DATE	**:**	**09 OCTOBER 2001**
RE	**:**	**HONG KONG LAW SOCIETY PROFESSIONAL INDEMNITY INSURANCE SCHEME**

The apparent problems with the Compulsory Professional Indemnity Insurance scheme in Hong Kong have parallels with problems in similar schemes in other Anglo Saxon jurisdictions, particularly in Eire, England and Wales and Australia. In respect of the reforms introduced by Law Society of England and Wales the following chronology may assist in understanding the problems faced by the Law Society of Hong Kong:

The Background to Reform

1. The Solicitors Indemnity Fund ("SIF") was set up under the Solicitors Act 1976 which gave the Law Society one of several options in terms of arranging the GBP1 million primary insurances: a Master Policy, a Qualified Insurers Scheme or a Mutual Fund. Prior to 1977 the Law Society had operated a Master Policy. SIF came into effect on 1 September 1977 and continued in operation until 1 September 2000, when a Qualified Insurers Scheme replaced it. The introduction of the Qualified Insurers Scheme means that the Law Society has now utilised all of three options granted to it under the Solicitors Act 1976.

2. SIF did not operate as a true Mutual, which would require it to maintain equity between its members (or insureds). Rather SIF operated as a pure insurance fund, requiring contributions from members to ensure that the costs on the fund – the management costs of Solicitors Indemnity Fund Ltd ("SIFL"), the defence costs of panel lawyers appointed to defend claims and claims payments - were adequately covered by the funds available. Further, SIF operated on a cash flow basis, namely it ordinarily sought to raise funds in any one year to match its outgoings in that year and did not necessarily hold funds in respect of future claims payments. This is important

in professional insurance because, as a class of business, it is long tail in two aspects. Firstly, there may be a considerable period of time between the act of negligence (or occurrence) and a claim being made against an insured law firm and notified to insurers. Secondly, and more importantly from the point of view of SIF, there is a considerable period of time between a notification or claim being made to SIF and payment out. It is therefore necessary for a professional indemnity insurer to maintain significant funds to match, on a discounted basis, anticipated future claims payments.

3. SIF ran into problems in the early to mid 1990s when, on the back of the 1990 – 92 recession in the United Kingdom and the resultant collapse in the property market, a wave of negligence claims were brought against solicitors, often by lenders, leading to SIF having to levy supplementary calls on all law firms in England and Wales, payable rateably in proportion to their fee income. At one stage SIF was unofficially estimated to have a shortfall of assets to liabilities of some GBP700 million, representing approximately 300% of its annual premium income of GBP240 million.

4. The reasons for the shortfall were many. Obviously the increase in claims was significant. Perhaps equally significant was the lack of control by SIFL in relation to the cost of the investigation and defence of claims and circumstances. In its later years SIF was, in addition to the management costs of running SIFL, paying out around GBP80 million from SIF each year in defence costs to a panel of law firms who specialised in insurance and professional indemnity claims. Within this group there was an element of self-interest in maintaining the status quo and for several insurance firms in England and Wales SIF was by their largest individual client in terms of billing.

5. As a result of the escalating costs and, perhaps more importantly, the complete lack of control that many firms of solicitors felt they had over a significant overhead in their business, a number of interest groups were formed to put pressure on the Law Society to change the way SIF operated. These were as follows:

   - **The Millennium Group**. The Millennium Group wanted to abolish SIF and replace it with a Qualified Insurer Scheme. This Group consisted of some 2000 sole practitioners and small regional firms. The Millennium Group eventually brought judicial review proceedings against the Law Society claiming that the

SIF monopoly was a breach of European Union Competition Regulations, in that it prevented inter-state trade and provision of insurance services, and further, as an exercise of their discretion, was ultra vires the Law Society.

- **The City of London Solicitors Group**. This consisted of some of the largest City firms. Their interests were aligned with the November Meeting Group (see below).

- **The November Meeting Group**. A group of some twenty commercial and insurance firms (not including SIF defence panel firms) who sought either to be released from the compulsory obligation to insure with SIF or that SIF should introduce proper commercial underwriting criteria to reflect work areas and claims experience in its underwriting. Specifically The November Meeting Group did not seek the abolishment of SIF since this would have caused problems in its own right.

6. Following establishment of the pressure groups and, perhaps more importantly, the judicial review of the Law Society by the Millennium Group (assisted by The November Meeting Group who procured the insurance related evidence for the proceedings) and following consultation by the Law Society of all solicitors in England and Wales, it was ultimately concluded by the Law Society that SIF would cease with effect from 1 September 2000 and that a Qualified Insurer Scheme would be introduced.

The Consultation Exercise

7. The consultation exercise was a very important part of the Law Society's review of the existing arrangements. There was, it is fair to say, a perceived bias within the Law Society in favour of SIF and a very close relationship between SIF, SIFL and the Office for the Supervision of Solicitors. This bias had to be overcome in terms of implementing change. The actual consultation process involved various reports prepared by Law Society external committees, who received submissions from the interest groups mentioned above and various other interested parties. More importantly the Law Society balloted the whole profession. In that ballot the Law Society experienced the highest ever percentage turnout for a postal ballot. Although

only 30% of the profession in England and Wales voted, approximately 70% of those who did vote expressed a preference for a Qualified Insurer Scheme.

8. In addition to consulting the profession, the Law Society had to satisfy both the Legal Ombudsman and the Lord Chancellor that the Qualified Insurer Scheme proposed would provide adequate protection for members of the public.

Implementing the Reforms

9. During the consultation process the Law Society set up a special Task Force - the Indemnity Task Force ("ITF") – to look at changes to the operation of SIF, alternatively the implementation of wholesale change through the introduction of either a Qualified Insurer Scheme or a Master Policy. The ITF consisted of a cross section of members of the Law Society including representatives of City firms, commercial firms, regional firms and sole practitioners. It should be stressed that during this process the views of all parts of the profession were taken into consideration and there was a considerable degree of internal political management at the Law Society.

10. Following the judicial review in the spring of 1999, which was compromised as between the Millennium Group and the Law Society, the ITF requested that a representative of The November Meeting Group join to assist the implementation of the reforms.

11. Thereafter the ITF sought to implement the Qualified Insurer Scheme under an extremely tight timetable. The decision by the Law Society to end the SIF's compulsory monopoly provision of insurance was made in the spring of 1999 and the implementation was intended to occur on 1 September 2001.

12. The objective of the ITF was to obtain the best professional, but importantly impartial, advice as to how to implement the changes. At the outset of the ITF's work it was necessary to appoint an insurance professional to advise the Law Society and the ITF. The ITF invited the main international and professional indemnity insurance brokers and consultants to provide proposals to how they would be in a position to assist the Law Society and the ITF. Following that invitation, in the summer of 1999, two major international firms were invited to formally tender for the appointment. After a

panel interview, a major international firm was appointed to advise the Law Society on the introduction of the Qualified Insurer Scheme and to co-ordinate the approach to and relationship with the international insurance markets which would be required in order to launch the new arrangements.

13. Thereafter the ITF met at least on a monthly basis and occasionally more frequently to oversee the drafting and content of the Qualified Insurer Agreement, as well as the Minimum Terms and Conditions of Coverage and to deal with a host of legal, regulatory and management issues that arose from the decision to unravel the SIF's compulsory monopoly and introduce, in its place, the Qualified Insurer Scheme. Those issues were complicated by the decision of the ITF that, in order to ensure that a Law Society influenced infrastructure would be maintained in place should the commercial market fail in its provision of insurance at some time in the near future, the infrastructure of SIF management, namely SIFL, should be maintained in some form. This was achieved by transferring the resources of SIFL to a joint venture company owned by a major international insurer (who had been chosen by the Law Society to be partner in setting up a Law Society approved Qualified Insurer) and the Law Society, namely Solicitors Professional Indemnity Ltd ("SPIL").

14. The Qualified Insurer Agreement and the Minimum Terms and Conditions of Coverage were promulgated in the spring of 2000 and were subject to criticism from the insurance market which claimed that they were far too onerous for any professional indemnity insurer to sign up to. However, the ITF's view that the terms although tough represented a level playing field prevailed, and the Qualified Insurers did eventually sign up. As at the 1 September 2000 over thirty Qualified Insurers provided primary professional insurance for solicitors. This was an important development in the insurance markets since the volume of premium that was being put into the professional indemnity insurance market – some GBP250 million – was around 50% of the existing premium volume that went through London for all classes of professional indemnity insurance. That was clearly a very attractive proposition to the international insurance market.

Post Reform Experience

15. One considerable concern about the new arrangements was that small firms doing conveyancing work might be penalised by the commercial market. Accordingly, the Law Society made it a requirement of its joint venture partner in SPIL that SPIL would offer terms to all classes of solicitor. Whilst this would not stop a firm being denied cover on the basis of its own claims record, this would prevent a firm being denied cover by SPIL solely because of the type of work undertaken.

16. Since the introduction of the Qualified Insurer Scheme a new reality has been introduced into dealing with professional indemnity claims for solicitors in England and Wales. That reality is noticeable in two key areas:

- Firstly, the commercial market has placed great emphasis on risk management and the efforts made by firms small and large to avoid claims in the first place. This has led to a number insurers setting up and operating Risk Management programmes which help insured firms develop ways in avoiding claims, which is clearly of benefit to not only to those insured firms but also to the public users of those firms.

- Secondly, and perhaps more significantly, the commercial insurance market has brought a discipline to the handling of claims that was previously absent. Many members of the pressure groups (and in particular The November Meeting Group) had experienced of an un-commercial approach to dealing with the investigation and defence of professional indemnity claims against solicitors under the SIF regime. Formerly the conduct of the defence of claims by panel solicitors could be criticised for being excessive in both terms of time and cost. This had led to a high percentage of SIF's premium income (approximately 30%) being paid out by way of defence costs, when the guideline in the insurance industry would suggest that perhaps only 10% to 15% for this class of business.

17. To date the introduction of the Qualified Insurer Scheme in England and Wales has been a success although caution is required given that we are still in the early stages of the new arrangements and the international insurance market. That market has hardened during the summer of 2001, and secondly, is subject to the broader

insurance consequences of the World Trade Centre and Pentagon attacks. Both of those factors will result in a significant hardening of insurance terms at the next renewal in 2002.

18. In summary there are striking parallels between the current issues in Hong Kong and the problems that led to the developments that took place in England and Wales. There were similar situations in Eire and Australia, although problems in those jurisdictions were driven more by concerns about defence costs. In short the problems faced by the Hong Kong Law Society and its membership are not uncommon and are perhaps to be expected in a professional indemnity insurance regime that not only requires compulsory insurance (which is normal in developed countries) but makes mandatory a compulsory source of insurance.

19. This paper, produced for discussion purposes only is, as a result of short notice, necessarily brief. Accordingly it lacks detail in relation to dates which, given more time, could be supplied.

HFW3\365800-1