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Panel on Administration of Justice and Legal Services

Background brief for meeting on 27 June 2005

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

Purpose

This paper highlights the past discussions of Members of the Legislative Council (LegCo) on the Solicitors Professional Indemnity Scheme of the Law Society of Hong Kong (the Scheme).

Background

The Scheme

2. The Scheme is a mandatory scheme which provides indemnity against negligence claims made by the public against members of the Law Society. In accordance with the requirements of the Legal Practitioners Ordinance (Cap. 159), a Solicitors Indemnity Fund (SIF) was established and maintained by the Council of the Law Society for administering the indemnity scheme.

3. Previously, the Scheme had a three-year reinsurance programme expiring on 30 September 2001. Under the Scheme, SIF provided indemnity cover to all members of the Society, up to a limit of \$10 million for each and every claim. Of this amount, SIF retained the first \$1 million of every claim and reinsured the remaining \$9 million.

4. In view of the substantial increase in claims payments, the Law Society commissioned a benchmarking exercise in April 2000, which predicted an enormous reinsurance premium increase after 30 September 2001. At a forum attended by members of the Law Society in September 2000 to discuss the options available, the decision was taken 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 commenced on 1 October 2000.

5. However, the new reinsurance programme required an increase in SIF'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 SIF's retention over the five years were found to have exceeded the income which SIF could have received from members' contributions based on the then existing contribution assessment formula. It was therefore necessary to amend the formula to raise the amount of contributions from the membership of the Law Society sufficient to administer the total coverage.

Solicitors (Professional Indemnity) (Amendment) Rules 2001 (The Amendment Rules)

6. Under sections 73 and 73A of the Legal Practitioners Ordinance, the Council of the Law Society is empowered to make rules concerning professional indemnity insurance for solicitors in Hong Kong with the prior approval of the Chief Justice.

7. The Amendment Rules were tabled in LegCo on 11 July 2001 and came into operation on 1 October 2001. A major object of the Amendment Rules was to amend the Solicitors (Professional Indemnity) Rules (Cap. 159 sub.leg.) to increase the contributions to SIF by 150%. A subcommittee was formed by the House Committee to study the Amendment Rules.

8. The subcommittee noted the concerns expressed by the profession about the marked increase in contributions. Many solicitors firms, particularly the smaller firms operating with marginal profits, feared that under the poor market conditions they would be forced out of business because of inability to pay the contributions. As many solicitors requested the Law Society to conduct an immediate and independent review of the existing Scheme with a view to adjusting or replacing it with other alternative schemes, the subcommittee had asked the Law Society to undertake such a review and consult the membership on the way forward in the light of the recommendations of the review, and to report to LegCo on the progress in due course.

9. The Law Society agreed that it would carry out a review and consider whether at the expiry of the five-year reinsurance contract the Society should maintain the existing mutual Scheme with or without amendment, or to demutualise the Scheme and put into effect such other options as might be proposed as a result of the review. In a letter dated 22 October 2001 to the subcommittee, the President of the Law Society assured that it would seek a mandate from its members to conduct expeditiously an independent review, and would inform LegCo of the progress of the review on or before 30 September 2003. Any recommended arrangements would have to be acceptable to its members, approved by the Chief Justice and transformed into amendments to the statutory rules to be approved by LegCo before the expiry of the five-year contract at the end of September 2005.

10. While the subcommittee agreed to support the Amendment Rules, it had recommended that the review of the Scheme should be followed up by the Panel on

Administration of Justice and Legal Services (AJLS Panel).

Review Report on Insurance Arrangements of the Hong Kong Solicitors Indemnity Scheme prepared by Willis China (Hong Kong) Limited (the Willis Report)

Findings and recommendations by the Willis Report

11. The Willis Report provided by the Law Society was discussed by the AJLS Panel at its meetings on 18 December 2003, 26 April and 14 June 2004. According to the Law Society, the purpose of the review was to re-examine the current insurance arrangements and report on what arrangements were in the best interests of the legal profession and the public, having investigated into the problems with the existing professional indemnity scheme for solicitors in Hong Kong. In its consideration of the Report, the Panel had discussed with representatives from the Law Society, the Administration and the Professional Indemnity Scheme Action Group (the PIS Action Group), and considered the written submissions received from individual solicitors and solicitors firms on the indemnity scheme.

12. The major findings and recommendations of the Willis Report are summarised as follows –

- (a) solicitors were generally dissatisfied with the existing Scheme under which solicitors were made the insurers of last resort for each other in the event of failure of the insurer, as in the case of the collapse of the HIH Group. The arrangements were considered unfair, giving rise to grave problems as solicitors were required to meet calls for extra contributions to SIF to make up for any deficit of the fund. The issue about balance of risk between solicitors who were responsible for the negligence claims and solicitors who were not should be addressed;
- (b) the Willis Report had looked at possibilities of adopting different types of schemes and altering the current arrangements, so that in the event of insurer failure the liability would not fall on members of the profession as a whole. Such new arrangements, however, represented a fundamental and significant policy change and would involve legislative amendments for implementation;
- (c) two major schemes alternative to the existing Scheme were proposed, i.e. a Master Policy Scheme (MPS) and a Qualifying Insurers Scheme (QIS). The features of the two alternative schemes are highlighted in paragraphs 13 and 14 below; and
- (d) the Willis Report also proposed risk banding so that solicitors who practised in areas of law that could more likely result in claims should

contribute more, as well as increased claims loading for firms making claims.

MPS

13. As advised by the Law Society, the major features of the proposed MPS are as follows –

- (a) a Master Policy Agreement is entered into between the Law Society on behalf of all practicing members and a minimum of three insurers for \$10 million for each and every claim less any agreed level of retained mutual liability (“MPS Retained Level”), if any, borne by a mutual fund;
- (b) a mutual fund may be established by contributions from members. Any such fund would only have liability to its members for the agreed MPS Retained Level (which it is proposed should not exceed \$1.5 million);
- (c) liability for the balance of \$8.5 million would be assumed by the Master Policy insurers, which are not jointly and severally liable so each is only liable for its specified share; and
- (d) in the event of insurer failure, members of the profession do not have any liability as insurers of last resort. The responsible solicitor will be solely liable for that amount left uncovered by the failed insurer. If a mutual fund has been set up to cover the MPS Retained Level, members will only be liable as insurers of last resort if any deficit arises in that fund.

QIS

14. Under the proposed QIS, –

- (a) minimum terms of insurance and qualifying insurers (which may include insurers of specific risks such as conveyancing) are determined by the Law Society;
- (b) each individual law firm obtains insurance by direct negotiation with the qualifying insurers; and
- (c) if a firm cannot obtain insurance from a qualifying insurer, it will be placed in an Assigned Risks Pool (ARP) whereby all qualifying insurers agree to insure jointly such firms. If a firm is still within the ARP within a specified time, expected to be two years, that firm will no longer be insurable and must cease practice.

15. It is noted that in England, QIS is backed up by a Policyholders’ Protection

Fund (PPF). In the event of a failure of an insurer, the insured might turn to the PPF for the amount which the insurer in default would have paid.

Views of the Administration

16. The Administration had explained to the Panel its position as follows –
- (a) the Administration was strongly of the view that a mandatory professional indemnity insurance scheme should remain in place for the protection of users of legal services. An assurance that all solicitors were insured would enable small firms to compete with the larger firms for business, and a thriving legal profession was essential for promoting Hong Kong as an important legal services centre; and
 - (b) any new scheme should offer the same protection to both the profession and the public as the current Scheme. The Administration did not support the proposed MPS or QIS unless the schemes were backed up by mechanisms such as a PPF or “insurance on insurance”. With regard to “insurance on insurance”, the Solicitor General had requested the Law Society to explore the possibility of introducing such arrangements.

Views of the Law Society

17. The Law Society supported mandatory indemnity insurance for solicitors. It had pointed out that although some of its members considered that indemnity insurance should not be compulsory and that clients should be given an informed choice as to whether or not to engage an insured or uninsured solicitor, these views did not represent the overall position of members of the profession. The majority of practitioners were in support of mandatory insurance, as borne out by the survey results shown in the Willis Report. Nevertheless, the Law Society shared the concern of its members that unlimited mutual liability for the wrongdoings of individual practitioners was fundamentally unacceptable, and that the existing system, which had put solicitors at risk in the event of failure of the insurer, would have to be changed.

18. The Law Society informed the Panel that it had considered the possibility of removing mutuality of liability altogether. However, it was recognised that to do so might result in prohibitively high insurance premium, or insurers refusing to provide cover at all.

19. The Law Society also referred to the observation in the Willis Report that the majority of the respondents in the surveys preferred to arrange their own insurance. In its view, however, there were law firms, particularly the smaller firms, which would find it extremely difficult to purchase their own insurance in the present hard insurance market where there was a high demand for insurance. They would be charged with hefty premiums. Also, there would be the risk that the insurance might be placed in undesirable insurers, and public interests might be prejudiced. The Willis Report did

not consider this to be to the benefit of both solicitors and the public.

20. The Law Society did not agree with the Administration that the alternatives of an MPS or QIS should not be supported unless they were backed up by a PPF or “insurance on insurance”. It had pointed out that a PPF, even if approved, would need three to five years to come into existence. The Law Society considered that the Administration should provide more details such as how a PPF would operate and how it would be funded. “Insurance on insurance”, on the other hand, was an unusual concept. The general view of professional insurers was that such arrangement was not readily available, and even if such insurance cover could be obtained, the cost would be prohibitively high.

Views of members of the profession

PIS Action Group

21. Members of the Action Group attended the Panel meeting on 14 June 2004. They pointed out that while there was general consensus within the profession that the Scheme should provide reasonable protection to the public, this did not mean zero risk to the public. The existing Scheme, which made solicitors the insurers of last resort for each other and for unlimited amounts in the event of insurer insolvency, was totally unjust and unfair. It was also unfair for the solicitors’ profession to be the only profession whose members were mutually liable for the negligent acts of other members where claims arose.

22. On the proposed MPS, a member of the Action Group suggested that further safeguards might be introduced, such as –

- (a) having three or four participating co-insurers for the spreading of risks; and
- (b) limiting the single largest share of a co-insurer and introducing provisions to deal with merger of the co-insurers, and setting requirement for a minimum credit rating of the participating co-insurers.

23. Regarding mutuality of liability under MPS, a member of the Action Group expressed the view that an MPS Retained Level of \$500,000 might be acceptable.

24. Another member of the Action Group pointed out that the high proportion of claims against practitioners in the profession resulting from conveyancing matters was an important factor contributing to the hardship facing solicitors. In her view, the problem was related to the absence of a comprehensive land title legislation and the absence of a minimum fee for conveyancing. The member considered that means to reduce the potential risks to practitioners connected with conveyancing transactions would need to be examined in addressing the problems related to professional indemnity.

Individual solicitors and solicitors firms

25. About 270 solicitors and solicitors firms had submitted an identical letter on the Scheme to the Panel. They strongly urged the Panel to take urgent steps to stop solicitors acting as insurers of last resort for each other. They considered that any future scheme would be acceptable to the profession provided that this could be done.

Survey conducted by Hon Margaret NG in October 2003

26. Hon Margaret NG, in her capacity as the LegCo Member representing the legal functional constituency, conducted a survey on solicitors' views on the Scheme in October 2003. She reported the findings of the survey to the Panel at its meeting on 18 December 2003. The survey related to the two calls on law firms in 2003 for extra contribution to SIF in order to make up for the shortfall caused by the collapse of the HIH Group, which was the reinsurer of SIF.

Views of the AJLS Panel

27. A member of the Panel opined that an element of mutual liability should be retained, without which the smaller-sized solicitors firms would face difficulties in obtaining insurance cover at affordable costs. However, mutuality should be limited to a certain level without the requirement for solicitors to make top-up contributions to meet any unexpected shortfall of the mutual fund. The member was in favour of the MPS option which featured an agreed level of retained mutual liability.

28. Members of the Panel were generally dissatisfied with the lack of constructive advice offered by the Administration on means to help solicitors to deal with the problems and difficulties encountered in relation to professional indemnity. They urged the Administration to adopt a helpful attitude and take urgent steps to assist the profession in appropriate ways, particularly in matters involving policy and law drafting.

29. As agreed by members, the Chairman of the Panel had written to the Secretary for Justice on 16 June 2004 urging the Administration to –

- (a) consider whether it was essential for any proposed schemes to be backed up by a PPF or “insurance on insurance” arrangement; and
- (b) respond without delay to any decision reached by the Law Society after its consultation with members of the profession.

The Law Society's option of a QIS

30. At the Panel meeting on 22 November 2004, the Law Society informed members of its updated position on the future scheme as follows –

- (a) members of the Law Society voted in favour of a QIS at an Extraordinary General Meeting in November 2004. The Society had commenced the drafting of a new set of rules for putting in place a QIS to replace the existing scheme;
- (b) it was expected that the rules could be approved by the Council of the Law Society in May 2005, and thereafter submitted for approval by the Chief Justice and scrutiny by LegCo. Meanwhile, the Law Society was discussing with the insurance sector concerning the practicalities of implementing a QIS; and
- (c) as the Administration had reservation about the proposal on QIS, the Law Society would continue discussion with the Administration with a view to achieving a compromise.

31. The Administration explained that a major issue of concern was the proper safeguarding of consumers' interests in the event of the insurer going into liquidation. In its opinion, a QIS would expose a client to the risk of a complete loss if the insurer went insolvent. The Administration considered that if the Law Society decided to proceed with a QIS, safeguards should be built into the system to afford adequate protection for the clients as well as for solicitors. The Administration pointed out that in UK, for example, the QIS was supported by a PPF. However, in Hong Kong, it was uncertain at this stage whether, and if so when, a PPF would be up and running. According to the Commissioner of Insurance, a public consultation exercise on PPF had been concluded, and a report on the way forward was expected to be issued in early 2005. The Administration maintained the view that an MPS with arrangements for more than one insurer and the insurers taking out re-insurance would provide better consumer protection than under a QIS.

32. The Law Society explained that under a QIS, the insurers would be well-established and qualified insurers acceptable to the Commissioner of Insurance. Solicitors might be able to take out insurance cover with more than one insurance company. For example, solicitors might choose an insurer to cover specifically conveyancing risks, and place insurance with another insurer for the other aspects of practice.

33. Members of the PIS Action Group expressed the view that a QIS backed by qualified insurance companies, which would be effectively regulated under the checks and balances exercised by the Commissioner of Insurance, would be a sufficient scheme for the profession. They considered that the wish of members of the Law Society to implement a QIS should be fulfilled.

34. A member of the Panel urged that the Administration to reconsider its bottom-line of consumer protection, as the costs of a "full-proof" scheme would be unbearable to the solicitors. Another member opined that a proper balance should be

struck between addressing the hardship of solicitors and protecting the clients' interests. Both the Administration and the Law Society should work out details of the future scheme as soon as possible.

Latest development

35. The Law Society had provided a copy of the 4th draft of the Solicitors' Professional Indemnity Qualifying Insurance Rules for the consideration of the AJLS Panel at its meeting on 27 June 2005.

Relevant papers

36. A list of the relevant papers considered by the AJLS Panel is in **Appendix I**. Members are invited to note that these papers are available on the LegCo website at <http://www.legco.gov.hk>.

Council Business Division 2
Legislative Council Secretariat
24 June 2005

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

Relevant papers/documents

LC Paper No.

Papers/Documents

Papers provided by the Law Society of Hong Kong

- CB(2)1092/03-04(01)
(English version only) -- Review Report on Insurance Arrangements of the Hong Kong Solicitors Indemnity Scheme prepared by Willis China (Hong Kong) Limited
- CB(2)773/03-04(01)
(English version only) -- Letter dated 18 December 2003 from the Law Society setting out some of the salient features of the report by Willis China (Hong Kong) Limited
- CB(2)2800/03-04(01)
(English version only) -- Copy of questionnaire issued by the Law Society to its members seeking their views on the preferred structure of the future scheme

Papers provided by concerned solicitors

- CB(2)725/03-04(01)
(English version only) -- Letter dated 13 December 2003 from Rene Hout & Co. acting on behalf of the Action Committee on Professional Indemnity Scheme Reform
- CB(2)725/03-04(02)
(English version only) -- Copy of letter dated October 2003 from Mr Larry KO to the Registrar of Companies
- CB(2)725/03-04(03)
(English version only) -- Paper dated 26 October 2003 prepared by Mr John KU on the Professional Indemnity Scheme
- CB(2)2129/03-04(03) &
CB(2)2303/03-04(01)
(English version only) -- Sample of a letter submitted by solicitors/solicitors' firms for the Panel meeting on 26 April 2004 expressing concerns about the Scheme, and an updated list of the names of the solicitors/firms
- CB(2)2724/03-04(01)
(English version only) -- Written submission dated 8 June 2004 from Mr HO Kai-cheong, a member of the Law Society

- CB(2)2701/03-04(03)
(English version only) -- Presentation at the Panel meeting on 14 June 2004 by Mr Larry KO on behalf of the Professional Indemnity Scheme Action Group (PIS Action Group)
- CB(2)2775/03-04(01)
(English version only) -- Written submission dated 14 June 2004 from Ms Phyllis KWONG Ka-yin, a member of PIS Action Group
- CB(2)2775/03-04(02)
(English version only) -- Copy of letter dated 9 June 2004 from Mr Benny YEUNG to the Solicitor General and the Solicitor General's reply to Mr YEUNG

Papers provided by the Administration

- CB(2)2582/03-04(01) -- Paper dated May 2004 provided by the Administration on "Review of Professional Indemnity Scheme of the Law Society of Hong Kong"
- CB(2)2700/03-04(01) -- Letter dated 8 June 2004 from the Administration on the operation of the Unified Exchange Compensation Fund and the Investor Compensation Fund
- CB(2)248/04-05(06) -- Paper dated November 2004 provided by the Administration on the Administration's updated position relating to the review of professional indemnity insurance

Correspondence between Hon Margaret NG and the Administration

- CB(2)2185/03-04(01)
(English version only) -- Letter dated 24 March 2004 from Hon Margaret NG to the Commissioner of Insurance on the proposed Policyholders' Protection Fund
- CB(2)2701/03-04(01)
(English version only) -- Letter dated 29 May 2004 from Hon Margaret NG to the Solicitor General on review of the Scheme
- CB(2)2701/03-04(02)
(English version only) -- Written response dated 7 June 2004 from the Solicitor General to Hon Margaret NG's letter dated 29 May 2004

Minutes of meetings of Panel on Administration of Justice and Legal Services

CB(2)1104/03-04 -- Minutes of meeting on 18 December 2003

CB(2)2425/03-04 -- Minutes of meeting on 26 April 2004

CB(2)3321/03-04 -- Minutes of meeting on 14 June 2004

CB(2)386/04-05 -- Minutes of meeting on 22 November 2004

Others

CB(2)731/03-04(03) -- Results of an opinion survey conducted by
(*English version only*) Hon Margaret NG in October 2003 on the
Solicitors Professional Indemnity Scheme