

## The Law Society of Hong Kong

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Briefing Paper for the LegCo Panel  
on Administration of Justice and Legal Services  
on the  
Proposed Qualifying Insurers Scheme

### **Background**

1. Compulsory professional indemnity insurance for solicitors was introduced at the instance of the Society in 1980. It provided a measure of protection to both solicitors and the public in respect of the civil liability of solicitors arising out of their practice. It was called the Professional Indemnity Insurance Scheme (the First Scheme) because indemnity was provided by insurers.
2. Under the First Scheme the Society negotiated the terms and conditions of cover with authorized insurers who entered into a Master Policy with the Society as agent for its Members and issued individual certificates of insurance to firms. The question of insurer insolvency was not an issue at the time.
3. The current Professional Indemnity Scheme (the Current Scheme) was put in place on 1 October 1989 to replace the First Scheme because it was considered to be able to provide the same cover to solicitors and the public but on more favourable terms to Members. Instead of insurers, indemnity was provided by a fund (the Fund) established pursuant to the Solicitors (Professional Indemnity) Rules 1989 (the Rules). If a Member is held to be civilly liable in respect of a matter arising out of the Member's Practice (as defined in the Rules) the Current Scheme will provide indemnity to such Member up to a limit of HK\$10 million per claim.
4. Under the Current Scheme the Fund has primary liability but has always reinsured its obligations with a number of re-insurers.
5. One feature of the Current Scheme is that Rule 4 of the Rules provides that the Fund "shall be established and maintained by contributions which shall be made or caused to be made by solicitors". This was a necessary consequence of the fact that the Fund has primary responsibility for providing indemnity. The Rules also provide under paragraph 2(5) of Schedule 1 that Members are liable to pay additional

contributions to make up a deficit or anticipated deficit in the Fund.

6. In March 2001 one of the Current Scheme's re-insurers the HIH Group (HIH) went into liquidation. As a result HIH was unable to meet its obligations to the Fund in respect of unsettled claims notified during the period from 1 October 1989 to the day it went into liquidation. The loss was to some extent absorbed by the reserves of the Fund but there was calculated to be a deficit of HK\$132 million as at the indemnity year ended 30 September 2002. Consequently an additional contribution had to be required for Members to make up the deficit.

7. After the additional contribution was made by Members no further deficit has occurred in the subsequent indemnity years up to 30 September 2004.

8. However, as a result of the HIH insolvency Members have had their attention drawn to the implication of the Current Scheme that they are effectively the guarantors of the solvency of the Fund or insurers of last resort.

9. No such obligation was intended or required when the First Scheme was implemented voluntarily by the Society, and no such obligation was intended to be imposed on Members when the Current Scheme was implemented to replace the First Scheme. In fact insurer insolvency was not an issue in respect of either the First Scheme or the Current Scheme.

10. As a result of the effect on Members of the HIH insolvency under the Current Scheme Members have called for the entire basis of the Current Scheme to be re-examined.

11. The Society accepts that protection of the public is a proper and important consideration in relation to professional indemnity cover, and has since 1980 duly implemented measures by which this goal is achieved. However, in the events that have occurred, the Society and its Members consider that the obligation to protect the public should not result in Members undertaking the role of insurers of last resort. The Society would point out that in Hong Kong no other professional body has such an obligation.

12. The Society would therefore ask the Panel and Government to accept the principle that where professional indemnity cover is concerned, there should be

reasonable protection for the public, but not absolute protection to the extent of making solicitors the insurers of last resort.

### **The Qualifying Insurers Scheme (QIS)**

13. On 16 November 2004 the Members of the Law Society resolved in an Extraordinary General Meeting to authorise the Council to seek amendment of the Solicitors (Professional Indemnity) Rules to establish a Qualifying Insurers Scheme including an Assigned Risk Pool and to do all things in connection therewith in replacement of the existing Professional Indemnity Scheme.

14. The features of a QIS are set out in Appendix A.

15. In terms of indemnity or insurance cover, it is intended for QIS to provide the same amount of cover to the public as the Current Scheme.

16. The issue of insurer insolvency has been raised. In this respect the Society makes the following observations:

- (a) Where there is a claim against a solicitor the primary liability rests on the solicitor who is found liable to compensate the claimant: he is personally liable and if he practises in partnership he and his partners are jointly and severally liable, and that is so irrespective of the position regarding professional indemnity;
- (b) where substantial transactions are involved, a prospective client such as a bank will require to be satisfied that the firm intended to be retained has professional indemnity cover considered to be adequate by the client before that firm will be retained;
- (c) as the term implies, only “qualifying” insurers will be entitled to issue the required policies and admission of insurers into the QIS pool will be dependent on an insurer being able to meet set criteria which are being developed. There is no question of just any insurer being entitled to offer the required cover.

17. Further, a likely effect of the implementation of a QIS is that strict risk management procedures will be imposed on solicitors firms by their insurers. The Society regulates its Members in respect of professional conduct and practice, but it is

not in a position to review and supervise the business practices of each and every firm. Currently excess insurers, namely insurers in respect of liability in excess of that covered by the Current Scheme, already impose extremely strict and detailed requirements as to practice and risk management on firms seeking excess cover. With the introduction of QIS this will become common practice and is likely to improve practice standards generally.

18. Another feature of QIS is that firms that are uninsurable will be put into the Assigned Risk Pool (ARP) where punitive premiums will be charged, and if they are unable to attain insurable status after a period, they will not be permitted to remain in the ARP and have to go out of business.

### **Implementation of QIS**

19. The implementation of a QIS involves –

- (a) the passing of a set of QIS Rules;
- (b) the signing of a Qualifying Insurers Agreement (QIA);
- (c) the issue of policies pursuant to the QIS; and
- (d) the implementation of “run-off” arrangements in respect of the Current Scheme.

20. A draft of the QIS Rules has already been forwarded to this Panel and to the Department of Justice. The finalization of the QIS Rules will depend on the finalization of the Minimum Terms and Conditions being negotiated with prospective insurers. The QIA will be drafted as Minimum Terms and Conditions are finalized and likely insurers for QIS are identified

21. Negotiations have been undertaken with more than 40 insurers since April 2005 and expressions of interest have been received from the majority of them. The major issues that require to be settled are the Minimum Terms and Conditions. In this respect consultations will be held as specific issues are crystallized. Many of these issues have financial implications for Members and they will be given adequate opportunities for consideration and discussion.

22. An exercise being discussed with insurers is that firms that fit into representative profiles will be asked to participate in a costing exercise with an intending insurer,

with an understanding that the results will be given to Members for information but on a no-names basis. Inquiries have been made of a number of individual Members and they appear to be receptive to the idea.

23. Upon implementation of QIS all claims notified on or after such implementation will be dealt with under QIS, whereas all claims notified prior to that date will be dealt with under the Current Scheme.

24. The Current Scheme will have to be continued until all claims notified thereunder shall have been concluded. It is envisaged this will take a number of years. It is probable that a large number of claims will be notified under the Current Scheme prior to QIS coming into effect as it would be sensible for Members to start life under QIS with a clean slate. The Current Scheme will therefore require sufficient funds to ensure that all substantiated claims are met. As it presently operates the Current Scheme makes projections of its liabilities and revises those projections from time to time as claims develop, and has the power to call for further contributions to cover a deficit or anticipated deficit. However, it does not appear that it would have such a power when the Current Scheme is in “run-off” mode. Suitable amendments shall have to be made to the Rules to ensure that the Current Scheme could fully discharge its obligations, if necessary by making calls on Members, until all claims notified thereunder are concluded.

25. Given the outstanding issues and the practical steps required to be taken it is not realistic to expect a QIS to be implemented by 1 October 2005 which is the commencement of the next indemnity year under the Current Scheme. A more realistic date would be 1 October 2006 subject to all outstanding issues being resolved to the satisfaction of all parties concerned.

Dated 22 June, 2005.

The Law Society of Hong Kong.

# APPENDIX A

## **Summary of the principal provisions of the 4<sup>th</sup> Draft of the QIS Rules**

(Please note that the following is a summary of the principal provisions and the effect of those provisions of the 4<sup>th</sup> Draft of the QIS Rules and should only be used in conjunction with the 4<sup>th</sup> Draft as they may be subject to further change and modification. The draft Rules contain the full terms including the definitions used in this Summary and should be referred to for those definitions and wherever there is doubt as to the effect of the Rules.)

1. The intention of the Rules is that each Firm and each Principal of a Firm has a continuing obligation to ensure that it has Qualifying Insurance in place at all times with effect from the date set by the Council from a list of Qualifying Insurers available from the Law Society.
2. The insurance may take two forms:
  - an insurance contract with one or more Qualifying Insurers on terms negotiated between the Firm and that insurer but which include the Minimum Terms and Conditions negotiated by the Law Society; or
  - an insurance contract with all the Qualifying Insurers by way of an Assigned Risk Pool Policy on terms negotiated between the Law Society and those insurers which also include the Minimum Terms and Conditions.
3. Under the Minimum Terms and Conditions, the insurance must include Run-off Cover for a Firm's liabilities for a minimum number of years (anticipated to be 6) after it has ceased Practice. If such cover does not exist for any reason, then the Firm must obtain either Qualifying Insurance re the Run-off Cover whether in the market or by way of an Assigned Risk Pool Run-off Policy.
4. Each Firm carrying on a Practice is required to take out its own Policy of Qualifying Insurance. It is not possible for more than one Firm to be covered under a single Policy of Qualifying Insurance.
5. If a Firm cannot obtain a Policy from a Qualifying Insurer it should apply to join the Assigned

Risks Pool in accordance with the Rules, if it is an Eligible Firm. If it is not an Eligible Firm, it must cease Practice.

6. Under the Minimum Terms and Conditions, a Policy, once taken out, cannot be cancelled before the end of an Indemnity Period unless:
  - the Policy is an Assigned Risk Pool Policy and the Firm has replaced it with a Policy of Qualifying Insurance outside the Assigned Risk Pool; or
  - the Firm merges with another Firm and a Policy of Qualifying Insurance is in place for the merged Firm; or
  - the Qualifying Insurer which issues the Policy becomes the subject of an Insolvency Event, and the Firm has replaced the Policy with another Policy of Qualifying Insurance.
7. The arrangements for professional indemnity insurance put in place by the Society do not seek to protect Firms against the insolvency of a Qualifying Insurer. If an Insolvency Event occurs in respect of an Insurer, that Insurer will cease to be a Qualifying Insurer for the purposes of these Rules. This is because, in such circumstances, the Insurer may not be in a position to pay claims in full. Any Firm which has Qualifying Insurance with a Qualifying Insurer which is the subject of an Insolvency Event must obtain replacement cover as soon as possible, and in any event within 4 weeks of the Insolvency Event occurring by either obtaining Qualifying Insurance from another Qualifying Insurer or, if an Eligible Firm, by applying to enter the Assigned Risk Pool.
8. A Firm which for any reason does not have Qualifying Insurance in place should apply to the Assigned Risk Pool before the start of the relevant Indemnity Period if it is an Eligible Firm. Premiums payable to the Assigned Risk Pool are high.
9. Application for admission to the Assigned Risk Pool must be made to the Assigned Risk Pool Manager on the proposal form which is from time to time prescribed by the Council.
10. It is the Firm's responsibility to ensure that its application has been made and to provide to the Assigned Risk Pool Manager all such information as the Assigned Risk Pool Manager may reasonably require in order to process the application. Where a Firm does not receive acknowledgment of its application within 30 days it is obliged to seek confirmation that it has been received by the Assigned Risk Pool Manager.
11. An Assigned Risk Pool Policy can be cancelled if it is replaced by a Policy with a Qualifying Insurer.

12. Firms should also be aware that there are other consequences of being insured through the Assigned Risk Pool, including the need to comply with any Special Measures and the limitations on eligibility set out in the definition of “Eligible Firm”.
13. The Council may determine the range of Special Measures which may be applied to Firms within the Assigned Risk Pool. Firms may be subject to investigation and monitoring in order to determine what Special Measures are appropriate for that Firm, and to ensure that those measures are fully implemented. The costs of investigation and monitoring, the costs and expenses incurred through any failure or delay by the Firm to comply and the implementation of the Special Measures are intended to be payable by the Firm concerned, in addition to paying the Assigned Risk Pool Premium. The amount of such costs and expenses will be determined by the Society. A Firm may request a breakdown of the costs as determined by the Society and, where such a request is made, the Society must provide a breakdown subject to the costs of providing that breakdown being paid by the Firm. In the event of a dispute as to the costs determined by the Society, the matter shall be referred to the Standing Committee on Policy and Resources for determination. The Standing Committee’s decision is intended to be binding and final.
14. Except in an exceptional case, a Firm may only remain in the Assigned Risk Pool so long as it is an Eligible Firm or if it becomes a Run-off Firm. Firms, other than Run-off Firms, cannot remain insured through the Assigned Risk Pool for more than 24 months in any 5 year period, and should therefore seek insurance in the open market with a Qualifying Insurer as soon as practicable. A Firm which is no longer an Eligible Firm (because, for example, it has already been insured through the Assigned Risk Pool for 24 months in the last 5 years) must either obtain Qualifying Insurance on the open market or cease carrying on Practice.
15. The Assigned Risk Pool Manager, on behalf of the Society, shall make arrangements with Qualifying Insurers to cover any Claim against a Firm in Default and a Run-off Firm, including any Defence Costs relating to a Claim, in like manner and to the like extent as the Claim and the Defence Costs would have been covered had that Firm during the Period of Default been in the Assigned Risk Pool and been issued with an Assigned Risk Pool Policy and/or, as the case may require, an Assigned Risk Pool Run-off Policy.
16. If a Firm fails to make an application to the Assigned Risk Pool at the start of an Indemnity Period, and does not have any other Policy of Qualifying Insurance in force for that Indemnity Period, it may still be eligible to be issued with an Assigned Risk Pool Policy provided that it meets all of the requirements of Rule 5.3. However, each Principal of the Firm will have



committed a disciplinary offence, and the Firm will be required to pay the Assigned Risk Pool Default Premium under any Assigned Risk Pool Policy issued.

17. If a Firm fails to make an application to the Assigned Risk Pool, but carries on Practice without having obtained Qualifying Insurance, each Principal in that Firm will have committed a disciplinary offence. The same is true if a Run-off Firm fails to apply to be issued with an Assigned Risk Pool Run-off Policy. In each case, that Firm, and each Principal in that Firm, will also be liable under these Rules to:-
  - pay an amount to the Society equivalent to the Assigned Risk Pool default premium calculated for the whole of the Period of Default; and
  - reimburse to the Society in full the amount of any Claim (together with Defence Costs) made against the Firm and relating to the period when it did not have Qualifying Insurance in force.
18. The Assigned Risk Pool is intended to be managed by the Assigned Risk Pool Manager who under the Rules is given authorisation to release information to the Society relating to certain matters including suspected professional misconduct and fraud.
19. Provision is made for the Society to waive any Rule but it is expected that waiver will only be granted in exceptional circumstances. The Rules set out the procedure and time limits in which an application for waiver can be made. The Council may attach such conditions as it thinks fit to any waiver, and may revoke any waiver that it has previously granted without notice. Unless and until any waiver is granted, the person concerned must comply with the requirements of these Rules in full.
20. Appendix 1 to the Rules sets out the Minimum Terms which any Qualifying Insurance Policy must contain.
21. Appendix 2 sets out the method for calculating the Assigned Risk Pool Premium, Assigned Risk Default Premium and Assigned Risk Run-Off Premium.