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Panel on Administration of Justice and Legal Services

Background brief for the meeting on 26 February 2007

**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 review of the Professional Indemnity Scheme (PIS) of the Law Society of Hong Kong.

Background

Review of the PIS

2. PIS is a mandatory scheme which provides indemnity against negligence claims made by the public against members of the Law Society. Section 7 of the Legal Practitioners Ordinance (Cap. 159) 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. 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 PIS had a three-year reinsurance programme which expired on 30 September 2001. Under the Scheme, the 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, the 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. In September 2000, the Law Society decided 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 the 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 the 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 in the Solicitors (Professional Indemnity) Rules to raise the amount of contributions from members of the Law Society.

6. The Amendment Rules which sought to increase the contributions by 150% was considered by a LegCo Subcommittee and came into operation on 1 October 2001. The Subcommittee noted the concern of many solicitors firms, particularly the smaller firms operating with margin profits, about the marked increase in contributions. They requested the Law Society to conduct an immediate and independent review of the existing PIS with a view to adjusting or replacing it with other alternative schemes. At the request of the Subcommittee, the Law Society agreed to undertake such a review and consult its members on the way forward in the light of the recommendations of the review, and report to the Panel on Administration of Justice and Legal Services (the Panel).

Related development

7. In March 2001, the HIH Group, the reinsurer of the SIF, collapsed. This had necessitated two calls to solicitors in April and July 2003 for extra contributions to the SIF to make up for the deficit caused by the collapse of the HIH Group. In response to the concern expressed by many solicitors about the heavy burden imposed upon them by PIS, Hon Margaret NG, in her capacity as the LegCo Member representing the Legal Functional Constituency, conducted an opinion survey in October 2003. As many solicitors had commented on whether the existing PIS should be maintained in responding to the survey, Ms NG reported the result of the survey to the Panel on 18 December 2003. In brief, the result indicated that the majority of the respondents considered that, first, it was wrong for solicitors to be exposed to unlimited liability in order to make up for the entire shortfall in the SIF brought about by the collapse of the reinsurer. Second, PIS as currently operated was unfair and unreasonable in that it effectively made solicitors responsible for each other's liability as insurers of last resort. Third, PIS should be scrapped, reviewed, or replaced by a scheme under which firms could get their own insurance.

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

8. The Law Society commissioned Willis China (Hong Kong) Limited to review 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 PIS for solicitors in Hong Kong. The Law Society presented the salient features and findings of the Willis Report to the Panel at its meeting on 18 December 2003.

9. The Willis Report had proposed two major schemes alternative to the existing PIS, i.e. a Master Policy Scheme (MPS) and a Qualifying Insurers Scheme (QIS). The features of the two alternative schemes are highlighted below.

10. The major features of the proposed MPS were as follows -

- (a) a Master Policy Agreement is entered into between the Law Society on behalf of all practising members and a minimum of three insurers for \$10 million for each and every claim less an agreed level of retained mutual liability (MPS Retained Level), if any;
- (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 (proposed to be not exceeding \$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 liable solely 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.

11. The major features of the proposed QIS were as follows -

- (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.

12. The Panel noted that in England, the QIS was 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

13. The Administration's provisional views were 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 for a number of reasons. First, a number of common law jurisdictions imposed mandatory insurance requirements on legal practitioners. Second, it was reasonable to require solicitors to take out adequate insurance as they were different from other professions in that they often held a large amount of clients' money in performing their duties for their clients. Third, 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;
- (b) as a matter of policy, the Administration did not consider it essential for a future professional indemnity scheme to make solicitors the insurers of last resort in every situation regardless of the amount at stake. Under the present PIS, those with a valid claim against a solicitor were guaranteed compensation not exceeding \$10 million even in the event that an insurance company providing professional indemnity cover became insolvent. The Administration considered that any new scheme should provide at least the same guarantee; and
- (c) the Administration did not support the proposed MPS or QIS unless they were backed up by a mechanism such as the PPF or "insurance on insurance".

Views of the profession

14. The PIS Action Group, which represented a group of solicitors, had attended a number of Panel meetings to give views on the exiting PIS and the progress of implementing the proposals in the Willis Report. About 270 solicitors and solicitors firms had submitted an identical letter to the Panel expressing views on the insurance arrangements under the present indemnity scheme. In general, the solicitors

considered that the existing scheme was unsatisfactory and should not be maintained. The existing scheme was totally unfair in that solicitors were made the insurers of last resort for each other in the event of insurer insolvency, as in the case of the collapse of the HIH Group. They agreed that adequate protection, but not absolute protection, should be provided to the public. They pointed out that the solicitors' profession was the only profession in Hong Kong which had such an indemnity scheme.

15. The Law Society supported mandatory indemnity insurance for solicitors. 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 put solicitors at risk in the event of insurer insolvency, would have to be changed.

16. Regarding the Administration's position that it would not support a MPS or QIS unless it was backed up by a PPF or "insurance on insurance", the Law Society pointed out that a PPF, even if approved, would need three to five years to come into existence. "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.

Progress of implementation of QIS

17. At an Extraordinary General Meeting (EGM) on 16 November 2004, members of the Law Society voted in favour of a QIS to replace the existing PIS. In June 2005, the Law Society briefed the Panel on the proposed QIS and provided a copy of the 4th draft of the QIS Rules for members' reference. The Law Society advised the Panel that a more realistic date for implementing the QIS would be 1 October 2006, instead of 1 October 2005.

18. The Administration maintained its position that any new scheme to replace the existing PIS should be in the public interest. Its prime concern was that consumers should not be subject to a large degree of risk of non-recovery in the event of insurer insolvency. In view of the Administration's position, the Law Society had explored ways of providing, under the QIS, some protection to consumers against insurer insolvency, but none of them was a viable option.

19. The Panel considered that any new scheme to be adopted by the Law Society should provide reasonable and not maximum protection to consumers. As the QIS was a reasonable solution, the Administration should not object to its implementation. The Panel requested the Administration to be more proactive in its discussion with the Law Society on the implementation of the QIS.

20. In February 2006, the Administration advised the Panel that it considered that the Law Society had done its best to produce a scheme that would generally ensure that valid claims against solicitors would be met. It therefore supported in principle

the implementation of the QIS, on the condition that the Law Society should continue to give adequate consideration to the interests of consumers when finalising the details of the new scheme and proactively publicise and explain the new scheme through the media and the Consumer Council.

21. In March 2006, the Law Society briefed members on the progress of the implementation of the QIS. Members were informed that the Society had held two fora in March 2006 to explain the proposed QIS to its members and to hear their views. The Law Society and the Administration had engaged in working sessions to finalise the draft QIS Rules. As a result of the working sessions and the fora, a number of "domestic" issues had been identified and required to be resolved. These issues, which arose mainly out of the effect of the proposed change on the cessation of practice by members both before and after the date on which the QIS was implemented in replacement for the PIS, were as follows -

- (a) Run-off cover - to safeguard the interests of the public, there was a requirement for run-off cover for a period of six years after cessation of practice of a firm under the QIS. Members of the Law Society were concerned about the high cost for run-off cover which was estimated to range from 250% to 400% of the last premium paid. The details and cost implications were being worked out by the Law Society;
- (b) Unnotified claims - if a firm ceased practice before the implementation of the QIS, it would not have a QIS policy. There would not be run-off cover except to the extent that claims notified to the PIS before the implementation of the QIS would be covered by the PIS. Claims or circumstances that were not notified to the PIS before the implementation of the QIS would not be covered by either of the schemes; and
- (c) Assigned Risks Pool (ARP)- a firm which did not have insurance coverage would not be permitted to practise. Under the QIS, firms which were unable to obtain coverage from Qualifying Insurers would be covered by ARP, but at premiums which were punitive and deterrent. An indication of the ARP premium based on the experience in the United Kingdom was 27.5% of the gross fee income of a firm. No firm was entitled to remain in the ARP for more than 24 months in a five-year period. If a firm was unable to obtain coverage from Qualifying Insurers outside ARP after the 24 month period, it must cease to practise. Members of the Law Society expressed concern about the level of premiums to be charged. The matter was being discussed on an urgent basis with the proposed Qualifying Insurers.

22. The Panel was informed that subject to the resolution of all outstanding issues, the Law Society would present a complete package of the QIS to its members for approval at an EGM on 27 April 2006.

23. The Law Society informed the Panel in May 2006 that its members had voted by a large majority not to replace the existing PIS by the QIS at its EGM on 27 April 2006. The Council of the Law Society at its meeting on 16 May 2006 resolved to set up a Professional Indemnity Scheme Review Working Party to identify deficiencies in the existing scheme, consider how they might be remedied, and make appropriate recommendations to the Council. In the meantime, arrangements would be made to negotiate with insurers for renewal of the existing cover. The Law Society would report further developments to the Panel in due course.

Latest development

24. The Law Society will make a short report on the progress of the Review Working Party at the coming meeting on 26 February 2007.

Relevant papers

25. A list of the relevant papers available on the LegCo website is in the **Appendix**.

Council Business Division 2
Legislative Council Secretariat
22 February 2007

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

Relevant documents

<u>Meeting</u>	<u>Meeting Date</u>	<u>Paper/Question</u>
Panel on Administration of Justice and Legal Services	18 December 2003	<p>Review Report on Insurance Arrangements of the Hong Kong Solicitors Indemnity Scheme prepared by Willis China (Hong Kong) Limited [LC Paper No. CB(2)1092/03-04(01)] (<i>English version only</i>)</p> <p>Letter dated 13 December 2003 from Rene Hout & Co. acting on behalf of the Action Committee on Professional Indemnity Scheme Reform [LC Paper No. CB(2)725/03-04(01)] (<i>English version only</i>)</p> <p>Copy of letter dated October 2003 from Mr Larry KO to the Registrar of Companies [LC Paper No. CB(2)725/03-04(02)] (<i>English version only</i>)</p> <p>Paper dated 26 October 2003 prepared by Mr John KU on the Professional Indemnity Scheme [LC Paper No. CB(2)725/03-04(03)] (<i>English version only</i>)</p> <p>Results of an opinion survey conducted by Hon Margaret NG in October 2003 on the Solicitors Professional Indemnity Scheme [LC Paper No. CB(2)731/03-04(03)] (<i>English version only</i>)</p> <p>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 [LC Paper No. CB(2)773/03-04(01)] (<i>English version only</i>)</p>

<u>Meeting</u>	<u>Meeting Date</u>	<u>Paper/Question</u>
		<p>Minutes of meeting [LC Paper No. CB(2)1104/03-04]</p>
	<p>26 April 2004</p>	<p>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 [LC Paper No. CB(2)2129/03-04(03) and LC Paper No. CB(2)2303/03-04(01)] <i>(English version only)</i></p> <p>Letter dated 24 March 2004 from Hon Margaret NG to the Commissioner of Insurance on the proposed Policyholders' Protection Fund [LC Paper No. CB(2)2185/03-04(01)] <i>(English version only)</i></p> <p>Minutes of meeting [LC Paper No. CB(2)2425/03-04]</p>
	<p>14 June 2004</p>	<p>Paper dated May 2004 provided by the Administration on "Review of Professional Indemnity Scheme of the Law Society of Hong Kong" [LC Paper No. CB(2)2582/03-04(01)]</p> <p>Letter dated 8 June 2004 from the Administration on the operation of the Unified Exchange Compensation Fund and the Investor Compensation Fund [LC Paper No. CB(2)2700/03-04(01)]</p> <p>Letter dated 29 May 2004 from Hon Margaret NG to the Solicitor General on review of the Scheme [LC Paper No. CB(2)2701/03-04(01)] <i>(English version only)</i></p>

<u>Meeting</u>	<u>Meeting Date</u>	<u>Paper/Question</u>
		<p>Written response dated 7 June 2004 from the Solicitor General to Hon Margaret NG's letter dated 29 May 2004 [LC Paper No. CB(2)2701/03-04(02)] <i>(English version only)</i></p> <p>Paper entitled "Presentation by Mr Larry KO on behalf of the Professional Indemnity Scheme Action Group (PIS Action Group)" for the Panel meeting on 14 June 2004 [LC Paper No. CB(2)2701/03-04(03)] <i>(English version only)</i></p> <p>Written submission dated 8 June 2004 from Mr HO Kai-cheong, a member of the Law Society [LC Paper No. CB(2)2724/03-04(01)] <i>(English version only)</i></p> <p>Written submission dated 14 June 2004 from Ms Phyllis KWONG Ka-yin, a member of PIS Action Group [LC Paper No. CB(2)2775/03-04(01)] <i>(English version only)</i></p> <p>Copy of letter dated 9 June 2004 from Mr Benny YEUNG to the Solicitor General and the Solicitor General's reply to Mr YEUNG [LC Paper No. CB(2)2775/03-04(02)] <i>(English version only)</i></p> <p>Copy of questionnaire issued by the Law Society to its members seeking their views on the preferred structure of the future scheme [LC Paper No. CB(2)2800/03-04(01)] <i>(English version only)</i></p> <p>Minutes of meeting [LC Paper No. CB(2)3321/03-04]</p>

<u>Meeting</u>	<u>Meeting Date</u>	<u>Paper/Question</u>
	22 November 2004	<p>Background brief dated 17 November 2004 prepared by the LegCo Secretariat on "Professional Indemnity Scheme of the Law Society of Hong Kong" [LC Paper No. CB(2)226/04-05(01)]</p> <p>Paper dated November 2004 provided by the Administration on the Administration's updated position relating to the review of professional indemnity insurance [LC Paper No. CB(2)248/04-05(06)]</p> <p>Minutes of meeting [LC Paper No. CB(2)386/04-05]</p>
	27 June 2005	<p>4th draft of the Solicitors' Professional Indemnity Qualifying Insurance Rules [LC Paper No. CB(2)1903/04-05(01)] <i>(English version only)</i></p> <p>Background brief dated 24 June 2005 prepared by the Secretariat on "Professional Indemnity Scheme of the Law Society" [LC Paper No. CB(2)2060/04-05(03)]</p> <p>Paper on the proposed Qualifying Insurers Scheme (QIS) and summary of the principal provisions of the 4th draft of the QIS Rules [LC Paper No. CB(2)2060/04-05(04)] <i>(English version only)</i></p> <p>Minutes of meeting [LC Paper No. CB(2)2502/04-05]</p>
	--	<p>Letter dated 3 November 2005 from Hon Margaret NG enclosing a set of key correspondence provided by Mr Rene Hout concerning the Claims Committee of QIS [LC Paper No. CB(2)311/05-06(01)] <i>(English version only)</i></p>

<u>Meeting</u>	<u>Meeting Date</u>	<u>Paper/Question</u>
		<p>Reply of the Law Society to Hon Margaret NG's letter in Appendix VII to LC Paper No. CB(2)311/05-06(01) concerning the Claims Committee of QIS [LC Paper No. CB(2)338/05-06(01)] <i>(English version only)</i></p>
	23 January 2006	<p>Background brief dated 18 January 2006 prepared by the LegCo Secretariat on "Professional Indemnity Scheme of the Law Society of Hong Kong" [LC Paper No. CB(2)899/05-06(04)]</p> <p>Letter dated 13 January 2006 from the Administration on "Professional Indemnity Scheme of the Law Society of Hong Kong" [LC Paper No. CB(2)899/05-06(05)]</p> <p>Letter dated 13 January 2006 from the Law Society in response to the issue raised by the Administration [LC Paper No. CB(2)935/05-06(01)] <i>(English version only)</i></p> <p>Paper provided by the Administration in response to the Law Society's letter dated 13 January 2006 [LC Paper No. CB(2)935/05-06(02)]</p> <p>Progress report dated 20 January 2006 from the Law Society [LC Paper No. CB(2)950/05-06(01)] <i>(English version only)</i></p> <p>Minutes of meeting [LC Paper No. CB(2)1491/05-06]</p>
	27 March 2006	<p>Correspondence between the Law Society and the Department of Justice on the proposed Qualified Insurance Scheme [LC Paper Nos. CB(2)1204/05-06 (01) - (03)] <i>(English version only)</i></p>

<u>Meeting</u>	<u>Meeting Date</u>	<u>Paper/Question</u>
		<p>Progress report dated 27 March 2007 from the Law Society on "The Professional Indemnity Scheme and the Qualified Insurers Scheme " [LC Paper No. CB(2)1559/05-06(01)] <i>(English version only)</i></p> <p>Minutes of meeting [LC Paper No. CB(2)2048/05-06]</p>
	--	<p>Correspondences between the Panel Chairman and Ms Susan LIANG on "Qualifying Insurers Scheme of the Law Society of Hong Kong" [LC Paper Nos. CB(2)1854/05-06(01) and (02)] <i>(English version only)</i></p> <p>Letter dated 18 May 2006 from the Law Society on the latest position on "Qualifying Insurers Scheme of the Law Society of Hong Kong" [LC Paper No. CB(2)2079/05-06(01)] <i>(English version only)</i></p>