Report on the Progress of the Review of the Professional Indemnity Scheme

A report by the Law Society of Hong Kong to the Legislative Council Panel on the Administration of Justice and Legal Services on 26 February 2007

1. Introduction

1.1 Compulsory professional indemnity insurance for solicitors was introduced by the Society in 1980. The intention was and is to provide a measure of protection to both solicitors and the public in respect of the civil liability of solicitors arising out of their practice. The first scheme was called the Professional Indemnity Insurance Scheme because indemnity was provided by insurers who entered into a Master Policy with the Society as agent for its Members and issued individual certificates of insurance to firms.

1.2 The current Scheme was set up in 1989 because it was considered to be better 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 the Solicitors Indemnity Fund ("the Fund").

1.3 The Scheme is governed by the Solicitors (Professional Indemnity) Rules ("the Rules").

1.4 Under the Scheme the Fund has primary liability but has always reinsured its obligations with a number of re-insurers.

1.5 In 2001 the principal re-insurer of the Scheme, the HIH Group ("HIH") went into liquidation. The Scheme suffered a substantial loss and a call for additional contributions from Members had to be made to restore the Fund to solvency. This highlighted the mutual nature of the Scheme whereby Members were effectively mutual insurers for each other. This created great dissatisfaction amongst Members.

1.6 In August 2002 Willis Ltd. ("Willis") were commissioned by the Society to conduct a review. They reported in November 2003 with a recommendation, inter alia, to adopt a Master Policy Scheme ("MPS").

1.7 The essence of MPS was that apart from a retention to be borne by the Fund, the balance of the liability would be borne by insurers under a Master Policy.

1.8 Proposals for MPS were put to Members in early 2004 in an Extraordinary General Meeting ("EGM") but the proposals were effectively rejected when Members voted to adjourn the EGM sine die.

1.9 A further EGM was held in November 2004 at which Members were asked to choose between MPS or a Qualifying Insurers' Scheme ("QIS"). The Council recommended the adoption of MPS but Members voted in favour of QIS and authorized the Council to establish the same in replacement of the Scheme.

1.10 Steps were taken by the Society to implement the QIS. The Society negotiated minimum terms and conditions of cover with prospective QIS insurers, and compiled the selection criteria for the establishment of a panel of qualifying insurers and the Assigned Risks Pool ("ARP"). Draft QIS Rules were prepared.

1.11 In the EGM on 27 April 2006, the full set of the QIS Rules, qualifying insurers' agreement, and a new set of Solicitors (Professional Indemnity) (Insurance) Rules which would govern the run-off of the Scheme, were put before the Members.

1.12 Members raised concern over:

(i) The uncertainty of the amount of premium payable.

(ii) The necessity of run-off cover for firms which would cease practice after the establishment of a QIS; and the premium payable for such run-off cover.

(iii) The problem of unnotified claims where a firm has ceased practice before the implementation of the QIS but claims are made only after the cessation of practice. These claims would not be covered by the Scheme nor the QIS.

(iv) The premium payable by firms in the ARP which would cover firms unable to obtain insurance from Qualifying Insurers.

1.13 After considering the implications of QIS Members voted against the implementation of a QIS by a majority of 1873 to 506.

1.14 The Working Party was established by the Council after Members rejected the proposal for a QIS with the following terms of reference:-

- To review the structure and operation of the Scheme;

- To invite and consider the views of Members of the Society;

- To make recommendation to the Council in connection therewith.

1.15 This report sets out the work done by the Working Party up to date and the observations they made in respect of various aspects of the Scheme.

2. **Limit of Indemnity**

2.1 The limit of indemnity was raised from HK$5m to HK$10m per claim in 1994 because of inflation and in particular, the rise in the prices of properties, hence the exposure to conveyancing claims undertaken by the Fund.

2.2 In 2003, Willis recommended that, in the light of the increase in the level of damages awarded in personal injury claims, the present limit of indemnity should be maintained. However, there were suggestions from Members that the limit should be lowered.

2.3 To enable the Working Party to consider whether to adjust the limit of indemnity, the Society commissioned the Scheme Manager, ESSAR Insurance Services Ltd. ("ESSAR") to conduct an analysis on the number and value of claims since 1986 which are above HK$5m.

2.4 The analysis shows that as at 30 September 2006, 7.28% of the number of claims and 41.5% of the value of claims exceeded the HK$5m benchmark.

2.5 The Working Party also noted there is a large number of conveyancing transactions in the property market close to the value of HK$10m, and it is not uncommon for damages awarded in personal injury claims to exceed HK$6m to HK$7m.

2.6 According to ESSAR, reinsurance premium payable by the Scheme is loaded towards claims whose values fall below HK$5m with the result that any reduction in the limit of indemnity is unlikely to have a substantial impact on the level of reinsurance premium.

2.7 It should be noted the issue was also canvassed during the establishment of the QIS and the advice of the QIS Broker of the Society at the time was to maintain the present limit.

2.8 The Working Party did not consider that the limit of indemnity should be reduced.

3. **Contributions**

3.1 The Working Party approached the following jurisdictions to enquire about their methodologies of calculating the contributions:

(i) England & Wales

(ii) Australia:
- Queensland
- New South Wales
- Western Australia
- Victoria

(iii) Malaysia

(iv) Singapore

(v) Canada:
- Ontario
- Manitoba
- Alberta
- British Columbia

3.2 Under the Scheme a firm's contribution is calculated on the basis of the number of solicitors and the gross fee income. There is no correlation between the risk profile of a firm and the amount paid, except that claims loading is imposed on a firm when the Fund has paid a claim on its behalf in any four indemnity years.

3.3 Some of the jurisdictions considered by the Working Party have adopted risk banding.

3.4 Different methodologies are used e.g. a loading in tapering scales on the different areas of practice which are perceived to carry higher risks like personal injuries; civil litigation; mortgages, loans, securities with respect to interests in land and conveyancing.

3.5 In England, risk banding was introduced as early as 1998. Prior to the establishment of the QIS in England, the following formula was adopted:

(i) The gross fee income of a firm was broken down in accordance with their different areas of practice.

(ii) A standard contribution rate was applied to the gross fee income in each area of practice to give a base contribution.

(iii) The base contribution would be multiplied by a risk factor to give the actual contribution payable by the firm. The risk factor was calculated on the basis of the claims ratio of that particular area of practice for the whole profession. The claims ratio is the percentage by which the total claim payments exceed the contributions. For example, a claims ratio of 200% would produce a risk factor of 2.

3.6 If a firm's gross fee income is £300,000, the contribution payable after risk banding would be:

Work type	Gross fees	Standard contribution rate	Risk factor	Contribution
Conveyancing	£150,000	x 8.48%	x 2.0	= £25,440
Matrimonial	£ 50,000	x 8.48%	x 0.2	= £ 848
Trust & probate	£100,000	x 8.48%	x 0.5	= £ 4,240
			Total contribution	= £30,528

3.7 Finally, under the English formula, the amount of contribution payable would be subject to claims adjustment i.e. there would be a discount or loading depending on the firm's claims experience.

3.8 The English formula only took into account the claims ratio. Other factors which a commercial insurer may take into account in assessing risk include: the number of conveyancing transactions; the ratio between qualified and unqualified staff; the number of branch offices; the age of the partners; years of qualification of the partners; experience of business; size of the firm etc.

3.9 Some jurisdictions impose loadings on specific risks only e.g. failure to comply with risk management practices.

3.10 Implementing risk banding will entail an administrative cost. Under a QIS, insurance companies conduct their risk assessment on firms on the basis of the information provided in the proposal forms. Under the Scheme, such an assessment will have to be conducted by the Scheme Manager. At the moment, firms are not required to provide a breakdown of their gross fee income in accordance with their different areas of practice. A procedure will have to be implemented for such information to be assessed, monitored, and the disputes on the assessment to be resolved.

3.11 There is one additional consideration involved in implementing risk banding. Unlike the English Solicitors' Indemnity Rules, which are enacted every year, changes to the Rules require the approval of the Chief Justice and the Legislative Council. It will not be practicable to adapt the Rules to changing circumstances in each year as is done in England.

3.12 The Working Party will in due course resolve whether any form of risk banding is desirable and feasible, and if so, whether it should be introduced in conjunction with a no claim bonus or discount for good claim record. It will be necessary to assess the impact of any proposed risk banding on the Fund, the Members, and the contributions payable.

4. Deductibles

4.1 Under paragraph 2 of Schedule 3 to the Rules, the deductible payable by an insured is calculated on the basis of the number of solicitors in the firm multiplied by the sum of HK$20,000 or HK$15,000, depending on whether the solicitor is a partner, or a consultant/assistant solicitor of the firm. Currently, deductibles range from HK$30,000, for a sole practitioner to HK$200,000 for large partnerships. The actual deductible is based on a formula in the Rules.

4.2 Willis in their report dated 28 November 2003 recommended raising the maximum deductible from HK$200,000 to HK$500,000.

4.3 There are different methodologies of adjusting the levels of deductibles:

(i) To adjust the relative balance between the firms i.e. to collect the same amount of deductibles but to redistribute it amongst the firms;

(ii) To penalize some firms by imposing a higher deductible for failure to comply with risk management practices in the hope of reducing claims in the long run;

(iii) To increase the base level of all deductibles taking into account the rate of inflation and the awards of damages in recent years.

4.4 One way of implementing methodology (i) is to impose a higher deductible where a mistake giving rise to a claim is repeated by the same firm. Other factors which may be taken into account in determining the higher amount include: the time gap between the first and the second claims; the nature of the acts and omissions involved; how the 2nd claim may be related to the 1st claim.

4.5 Imposing a higher level of deductible on specific acts and omissions i.e. methodology (ii) accords with the "user pays" principle. This method is in fact adopted in Queensland: an amount equal to twice the amount of any deductible is payable under the Queensland Law Society Indemnity Rule 2005 in respect of claims arising out of e.g. failure to prosecute any claim with due diligence; failure to endeavour, *bona fide*, to comply with the Conveyancing Protocol etc.

4.6 There is also justification for raising the base level of the deductibles i.e. methodology (iii), as the current rates have not taken into account inflation. They have not been raised since the inception of the Scheme. Even when the limit of indemnity was raised from HK$5m to HK$10m in 1994, there was no corresponding increase in the deductibles. Although the Scheme is not operated for the purpose of generating profit it should nevertheless be run on proper business principles.

4.7 The Working Party will consider whether and how the levels of deductibles should be adjusted.

5. **Loadings on Conveyancing Transactions**

5.1 The state of Ontario, Canada, imposes a levy of C$50 on every real estate transaction in which a lawyer is acting for any of the following parties: transferor; transferee; chargee; chargor; or the title insurer of either or both of the transferee and chargee. The levy is additional to the professional liability insurance payable by firms.

5.2 The Working Party is considering whether such a levy is justified and feasible in Hong Kong and, if so, the methodology of implementing the levy.

6. **Composition of the Claims Committee**

6.1 The Claims Committee was set up by the Society to determine the conduct of claims in conjunction with the Claims Manager, ESSAR.

6.2 Traditionally, solicitors with experience of claims handling which included solicitors who were members of Panel Solicitors have sat on the Committee because their "hands-on experience" would assist the Committee in its deliberations.

6.3 Re-insurers of the Scheme had at one time also specified that Panel firms should be represented on the Committee to ensure the relevant expertise was available in the Committee.

6.4 Notwithstanding their membership, members of the Committee who are also members of Panel Solicitors are excluded from participating in the discussions whenever claims handled by their firms are considered in the meetings.

6.5 There is no suggestion that any Committee member who is also a member of Panel Solicitors has unduly influenced the Committee in respect of any decision made by the Committee.

6.6 However, the presence of members of Panel Solicitors on the Committee (3 out of 9) has caused unease and the Working Party recommended and the Council has accepted that with effect from 31^{st} January 2008 no member of Panel Solicitors shall be on the Committee.

6.7 The date of 31 January 2008 was fixed in order to provide a transitional period to find replacements for the 3 experienced members of the Committee who are also members of Panel Solicitors. The end of the transitional period also coincides with the termination of the current appointment of Panel firms.

7. **Outstanding Issues**

7.1 The Working Party will proceed to consider the following issues in the next few months: mutuality; whether MPS should again be put to Members; the Fund's retention and reinsurance; claims loadings; geographical extent of cover; and any necessary amendments to the Rules.

7.2 A full report with recommendations will be submitted to the Council once the deliberations on the outstanding issues are complete.

The Law Society of Hong Kong

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