

2nd 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

1. Introduction

- 1.1 The Law Society of Hong Kong (“the Society”) last reported to the Panel on 26 February 2007.
- 1.2 In this progress report, the Society recapitulates the issues previously discussed, advises on their further developments, and elaborates on other aspects of the Professional Indemnity Scheme (“the Scheme”) which have been considered by the PIS Review Working Party (“the Working Party”) since 26 February 2007.

2. Limit of Indemnity

- 2.1 The Working Party considered whether to reduce the present limit of indemnity of HK\$10m per claim and resolved to recommend to the Council the limit should not be reduced.

3. Contributions

- 3.1 Under paragraph 2(1)(a)(i) of Schedule 1 to the Solicitors (Professional Indemnity) Rules (“the Rules”), the contribution payable by a law firm is calculated by reference to its number of partners, assistant solicitors, consultants and gross fee income.
- 3.2 Partners are rated differently from assistant solicitors and consultants in the formula as the former are perceived to carry higher risk, and the work they conduct in general command a higher level of income.
- 3.3 The Society conducted an actuarial analysis in July 1996 on the fairness of the contribution formula by looking in particular into the following questions:
 - (i) Is it fair to rate differently between partners and assistant solicitors?
 - (ii) Is it fair to distribute the contributions amongst firms by reference to their gross fee income only?

- (iii) Is there inequality between the rates paid by small and large firms?
 - (iv) What is the correlation between the claims experience and the number and ratio of unqualified staff to solicitors?
 - (v) Is there any correlation between the size of firm and claims experience?
 - (vi) Is the type of practice relevant?
- 3.4 The Working Party is proposing to update the actuarial analysis for the purpose of the present review.
- 3.5 The present contribution formula will be re-examined in the light of the updated actuarial analysis.
- 3.6 The Working Party has considered the issue of risk banding i.e. how the liability to make contributions may be calculated to ensure greater correlation between the risks of firms and the amount paid.
- 3.7 In order to achieve a fair result, there must be an accurate assessment of the risk. Individual insurers are in a position to quote that premium to a firm based on their assessment of the risk in respect of that firm, but to arrive at a formula applicable to all practitioners and which could be demonstrated to be fair to all parties would be a difficult exercise. As an alternative the Working Party is considering the imposition of a levy on conveyancing transactions as referred to later on in this report.

4. **Deductibles**

- 4.1 The Working Party considered adjusting the levels of deductibles by collecting the same amount but redistributing it amongst the firms; by imposing a higher level of deductible on specific acts and omissions; or increasing the base level of all deductibles taking into account the rate of inflation and the increase in the awards of damages in recent years.
- 4.2 The Working Party will put before the Council the pros and cons of the 3 methods of adjusting the levels of deductibles and the implications for the Solicitors Indemnity Fund (“the Fund”) and the Society’s members.

5. **Levy on Conveyancing Transactions**

- 5.1 Empirical evidence shows that conveyancing is the area which gives rise to the largest number and amount of claims made against the Fund.

- 5.2 The Working Party considered how it might:
- (i) Ensure the risks undertaken by law firms in their conveyancing practice are commensurate with the contributions paid; and
 - (ii) Reduce subsidization between firms which generate claims arising from their conveyancing practice and those which do not practise conveyancing at all e.g. criminal practices. It is believed that the abolition of scale fees and the ensuing offers of cut-throat prices for legal services might have contributed to the increase in conveyancing claims in recent years due to practitioners probably finding it unprofitable to spend time and effort on checking titles, and relegating such work to junior or unqualified staff.
- 5.3 Several approaches were considered:
- (i) The Society had previously commissioned a firm of accountants to conduct time-cost modelling to calculate the actual costs incurred by various law firms in performing different types of conveyancing transactions. Such costs may be compared to the fees charged by the profession since the abolition of scale fees to check whether there is any undercutting and the extent of such undercutting. A loading can be prescribed with reference to the amount undercut to the extent that a firm's income is not reflective of the risks arising from its conveyancing practice;
 - (ii) To impose an *ad valorem* loading on each conveyancing transaction;
 - (iii) To impose a fixed amount of loading regardless of the amount of transaction.
- 5.4 Within each approach, there may be variations as to whether certain transactions e.g. a Release may be exempt from the loading, and that the value of different conveyancing transactions may be banded together and different rates apply to different bandings.
- 5.5 The Working Party also considered whether to segregate conveyancing for the purpose of insurance but noted that the Law Society of England & Wales had previously obtained advice to the effect it would be ultra vires to limit professional indemnity cover so as to effectively impose a requirement to charge a particular level of conveyancing fees. Willis Ltd. ("Willis"), the consultants previously engaged by the Society to conduct the review of the Scheme also advised this option would not be feasible as the premium pool for the remaining non-conveyancing

categories of legal services would be reduced to such extent as to render the Scheme inoperable.

- 5.6 The Working Party considered the justification for imposing the loading, the persons to be subject to its liability, whether it should be the solicitor, the client (purchaser, vendor, mortgagee, mortgagor etc.) and the means of enforcement. For example, LawPro, the captive insurance company of the Law Society of Upper Canada, imposes a surcharge of \$50 on each real estate transaction. The levy is called “Real Estate Levy Surcharge”. LawPro requires the solicitor to pay the surcharge in respect of each real estate transaction in which he acted for one or more of the following parties: transferor, transferee, chargee, chargor. The principals of law firms are required to file a transaction summary form on the number of transactions and the names of the lawyers who conducted the transactions. The law firms must return the form with a cheque for the surcharge within 30 days of the quarterly period ending on the last day of March, June, September and December. Failure to file the form or effect payment amounts to a disciplinary offence.
- 5.7 To check whether there is any evasion by the law firms in completing the transaction summary form, the Working Party also considered enlisting the assistance of the Land Registry. The information provided in the transaction summary form can be checked against the statistics to be provided by the Land Registry and random audit may also be conducted on firms.
- 5.8 The imposition of a levy might be a more practicable alternative to risk banding. The Working Party will put before the Council the pros and cons of imposing a levy on conveyancing transactions, the means of enforcement and the implications for the Fund and the Society’s members.

6. Membership of the Claims Committee

- 6.1 The Working Party advised in the last progress report the Council had accepted the recommendation that no member of a Panel firm should be a member of the Claims Committee. A transitional period was imposed for the implementation of this resolution. A new Panel for conducting the defence of claims made against the Fund was appointed on 1 February 2008 and during the transitional period, members of the Claims Committee whose firms were on the Panel, including the Chairman and Vice-Chairman, were succeeded by other solicitors.
- 6.2 The Working Party also considered it would be efficacious to have solicitors who specialize in different areas of practice to serve on the

Committee. Accordingly, in addition to solicitors who specialize in litigation and insurance, conveyancers were appointed to the Committee.

7. Claims Loadings

- 7.1 Under the Scheme, a firm is subject to a claims loading if a payment has been made out of the Fund in settlement of a claim in any 4 indemnity years.
- 7.2 If a firm has ceased practice by the time the payment is made, no claims loading is imposed unless the partners of the firm continue to participate in the partnership of another firm, in which case the firm which these former partners have joined will be subject to the loading. If these former partners are merely consultants and associates in the other firm, no loading will be imposed.
- 7.3 The Working Party considered whether to impose claims loadings on those principals of ceased practices who had become consultants and assistant solicitors.
- 7.4 The purpose of claims loadings is to achieve a fairer distribution of liability on the basis the user pays; and to act as a deterrent to firms and/or principals repeating the acts or omissions giving rise to the claims. For the innocent partners who are not responsible for such acts or omissions, it does not accord with the “user pays” principle to impose a loading on them and it is queried whether there is any necessity to reinforce the loading as a deterrent.
- 7.5 For those who are responsible for giving rise to the claims, whilst it accords with the “user pays” principle that they continue to be liable for their negligence, it would be impracticable for the Society to investigate whether those consultants are de facto principals in the other firms or whether they are not actually engaged in practice but merely retaining their practising certificates and receive no income from the business. Apart from the practical difficulties in enforcing the loading, the issue affects the employment prospects of the members of the Society and the possibility of bankruptcy of solicitors.
- 7.6 The claim statistics show that the number of former principals concerned are not significant and not many new claims have been notified by the other firms since the former principals joined them as consultants and associates.
- 7.7 The Working Party will proceed to consider whether to increase the amount of claims loadings on existing firms and Willis’

recommendation to impose loadings on all open claims with liabilities after 2 years of their notification.

8. Master Policy Scheme (“MPS”)

8.1 The Working Party considered the MPS in other jurisdictions like Western Australia, Queensland and Singapore.

8.2 The following are perceived to be the advantages of MPS:

- (i) The MPS gives market power to the group. The market power is commensurate with the size of the profession in Hong Kong. The ability of an insurer to assess the risk and set a premium for the whole group increases the appetite of an insurer for that risk.
- (ii) Under the MPS all risks are placed outside of the profession in the commercial market. If there is an unanticipated rise in claims during the life of the claims that is greater than the premium collected for the year the claims are notified, there is no recourse to the solicitors. The premium may rise in future years because of the claims, but if there is sufficient market competition and a new insurer takes the risk, the MPS creates the best opportunity to minimize the consequences to the group of an adverse claims history.
- (iii) All law firms are guaranteed cover regardless of individual claims experience. Therefore MPS provides protection against uninsurability although it is possible in a hard market for an insurer under a master policy to refuse insurance. According to Willis, this is rare but it is possible.
- (iv) Because of the group purchasing power, run-off cover may be effected if the master policy holder were to insist on it.
- (v) Access to data on claims and premium pool is usually available to the master policy holder.
- (vi) Uniformity in the terms of cover facilitates the administrative process of renewing practising certificates.
- (vii) Because group claims experience determines the group premium there are incentives for the profession to implement risk management programmes on a long term basis.

- (viii) Because of the group bargaining power, it is possible to negotiate a multi-year policy when the market is soft and to lock in the premium prior to the market hardening.
- (ix) The existence of a master policy relieves the insured member firms from having to complete a proposal form.
- (x) The master policy holder has the ability to allocate the insurers' premium differentially amongst those insured if it chooses.
- (xi) From a consumer's point of view, a master policy negotiated by the Society provides a chance for the public to be considered in negotiations that would otherwise be solely on commercial terms in so far as the Society takes into consideration the interest of the public.
- (xii) A master policy provides complete protection from liability for the losses of other solicitors in the profession. A hybrid MPS i.e. a mutual scheme set up as a fund to pay a deductible under a single commercial policy also affords a high level of protection. In the event of insolvency of a master policy insurer, there would be no liability for the profession to meet that insolvent insurer's share.

8.3 The following are perceived to be the disadvantages of MPS:

- (i) The MPS ranks behind a mutual fund and a Qualifying Insurers Scheme ("QIS") with an assigned risk pool ("ARP") insofar as long term availability of protection is concerned. Run-off cover cannot be guaranteed and in a hard market exclusions may be imposed to limit the insurer's risk.
- (ii) A master policy ranks behind a mutual fund in terms of lowest long term price. A mutual insurance arrangement can keep premiums down because investment income on premium pending payment of claims is used to subsidize administration costs. No profit is retained and thereby premiums are lowered. The MPS requires insurers who subscribe to it to underwrite all risks and they cannot refuse any insured. They have to make a profit. Unlike the mutual, the pricing is subject to fluctuations of market forces.
- (iii) From the point of view of the members of the Society, there is no individual freedom to choose an insurer or to negotiate terms.

- (iv) It may be criticized if claims management is conducted by commercial insurers on commercial terms only, disregarding the public's reasonable expectation of prompt compensation, or taking no account of the need to avoid undesirable precedents or other principles with application to the standing of the legal profession or the Society.
- 8.4 Willis in their report dated 28 November 2003 recommended the Society to consider replacing the Scheme with the MPS. Willis advised the decision for the Society and the solicitors of Hong Kong was whether or not the unacceptable aspects of MPS were outweighed by the benefit of transferring all the risks to the commercial market.
- 8.5 It is noteworthy that the Society had 3 master policies in the 1980s.
- 8.6 Before the Society resolves whether to recommend to the members to adopt MPS, the Society has asked Willis to update its advice on the advantages and disadvantages of MPS in comparison with the current Scheme structure, its suitability and feasibility in Hong Kong, particularly in terms of the availability of run-off cover for firms in the present economic conditions; the extent to which the Fund can retain control over claims handling for the benefit of the profession and the public; and whether in general, smaller firms will be worse off despite terms are collectively negotiated between the Society and insurers.
- 8.7 The pricing of MPS is determined by a number of factors: whether the market is hard or soft, how much data is available to assess the risk, how keen the insurer is in underwriting the business, whether the insurer is more interested in gaining market share than underwriting profit for that year, the economic conditions which will affect the return on investments. The overwhelming determinant of price will be the claims experience of the profession.
- 8.8 A costs comparison exercise was conducted between QIS and the Fund in 2005. The Working Party will consider the pricing of MPS once the advice from Willis is available.
9. **Reinsurance of the Scheme**
- 9.1 The Panel enquired about the reinsurance of the Scheme in the meeting on 26 February 2007 and was advised the reinsurance contract of the Scheme had been renewed with effect from 1 October 2006 for a period of 3 years, with an option to terminate after 2 years.

- 9.2 The Society will consider whether to exercise the option to terminate the existing reinsurance and the feasibility of entering into a cancel and re-write programme. Any decision will be made by 1 July 2008.
- 9.3 Any changes to the structure of the Scheme and amendments to the Rules will be made with reference to the duration of the reinsurance contract of the Scheme.

The Law Society of Hong Kong
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