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Professional Indemnity Insurance: Compensating Consumers and Regulating Professionals

John K Morgan

Allens

john.morgan@allens.com.au

Pamela Hanrahan

University of New South Wales, Business School

p.hanrahan@unsw.edu.au

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1. Introduction

This paper considers the role of professional indemnity insurance (PI insurance) in the professional relationship. The aims are first to understand how the requirement to hold PI insurance, and PI insurance itself, operates as regulation, and secondly, the part that PI insurance plays in ensuring that clients who suffer loss or damage as a result of defective professional advisory services can be meaningfully compensated.

2. Framework

This section considers the theoretical framework for the analysis of PI insurance from the dual perspectives of regulation and compensation.

Insurance as regulation

The authors define regulation as the purposeful intervention by an actor with authority to influence conduct through various means (ranging from prohibition to incentive) towards outcomes that have regard to a purpose or interest broader than that of the parties directly involved.

Insurance has the potential to alter behaviour. A prevailing economic view is that holding insurance may cause the insured to act more carelessly and in disregard of the insurer's interests (and so against the client interest) – giving rise to the moral hazard problem.[1] Baker and Longue identify a number of strategies adopted by insurers for reducing moral hazard, such as premium differentials, deductibles, cancellations and decisions not to renew, requirements to meet external risk management codes and insurers acting as 'gatekeepers' (the use of insurance as a prerequisite for other activities).[2] These strategies may perform a regulatory function, however the insurer's decisions about whether to offer PI insurance and the terms on which it is offered are driven largely by self-interest. The insurer is unlikely to give consideration to the need for adequate and reliable compensation for those who suffer loss from defective advice.

Insurance as risk transfer

With PI insurance, not all risk is transferred to the insurer. The uninsured loss that remains with the insured may include any loss that is not covered by the policy, loss of reputation and consequent impact on the insured's business, and time that the insured and its employees may need to set aside to deal with the claim.

The residual risk of defective advice should play an important part in the moderating of the insured's behaviour if it is recognised and understood. However, insureds will lack the information and actuarial tools available to the insurer, and individual professionals may only experience an occasional claim so may not understand or recognise the risks that may emerge.[3] The authors

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[1] Won't the uninsured professional adviser act more carefully? There seems to be no comprehensive behavioural study of the behaviour of advisers who hold or do not hold liability insurance although R V Ericson, A Doyle and D Barry, *Insurance as Governance* (University of Toronto Press, 2003) circles this issue without directly dealing with it. Recent American literature seems to be asserting that steps to reduce moral hazard result in positive changes of behaviour but the underlying evidence is not that clear. See Omri Ben-Shahar and Kyle D Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, (2012-13) 111 Mich L R 197.

[2] Tom Baker and Kyle D Logue, *Insurance Law and Policy – Cases, Materials and Problems* (Aspen Casebooks, 3rd ed, 2013) 8-11.

[3] Howard C Kunreuther, Mark V Pauly and Stacey McMorrow, *Insurance and Behavioural Economics: Improving Decisions in the Most Misunderstood Industry* (Cambridge University Press, 2013) 68-83.

suggest that good education of insureds as to what is covered and what is not covered could be an important factor in changing behaviour.

The distinctive nature of PI insurance

Liability insurance insures the insured in respect of legal liability to another person arising from the act or omission of the insured (or its employees and agents). Moral hazard is heightened as the risk insured is largely related to the policyholder's own skill, business systems and behaviour and not the behaviour of others or external events. Consequentially, pricing of PI insurance is complicated. Estimation of the outcome and recoverable loss is very uncertain, due to potentially long periods between the wrongful act (advice) and the third party claim. Further, other external causes or actions may have contributed to the loss.

The article then discusses some of the features of PI insurance, including boundaries of the cover and 'claims made and notified' policies, which require that a claim made against the insured is notified to the insurer in the same policy period.[4] Claims made policies reduce uncertainty by providing a strong incentive for insureds to notify of facts and circumstances that may give rise to claims, however the insured may avoid early notification if they perceive that this will lead to adverse action by the insurer. To achieve compensation objectives, there may be potential for requiring that the insurer will not act in a matter adverse to the insured on the basis of a mere notification.

The compensation effect when insurance responds

There are a number of factors that influence the effectiveness of PI insurance in compensating clients who have suffered loss. These include whether the loss is recoverable by legal action[5] and the propensity of the person to claim. Under most current arrangements the resolution of the claim will be largely in the hands of the insurer, who will act in its own interests and is only constrained by the principles of legal liability and the duty of good faith owed to the insured.[6]

PI insurance as a protective scheme for users of professional advice

One justification for a common requirement for minimum insurance for a profession is that clients who are adversely affected by defective advice have more certainty about the compensation effect of the PI insurance across the industry.

The article then discusses the compromise between compensation and regulation of the insured's behaviour. Where access to compensation is most highly preferenced (such as for motor accident personal injury liability), schemes typically specify wide comprehensive cover and regulate the rights of parties to recover and the recovery procedure. At the other end of the spectrum is a voluntary choice of whether to hold insurance.

Schemes with wide compulsory liability cover remove any personal liability of the insured. However, sitting behind motor vehicle accident liability schemes are detailed traffic laws and strong

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[4] However, it has now been determined that the late notification of a claim is permitted under s 54 of the *Insurance Contracts Act 1984* (Cth), other than to the extent that the insurer is prejudiced by the late notification. See generally I Enright and R Merkin, *Sutton on Insurance Law* (Lawbook, 4th ed, 2015) [15.190]-[15.280].

[5] Desmond Derrington and Ronald S Ashton, *The Law of Liability Insurance* (LexisNexis Butterworths, 3rd ed, 2013) 2406-2519.

[6] *Distillers Co Bio-Chemicals (Australia) Pty Ltd v Ajax Insurance Co Ltd* (1974) 130 CLR 1 (Stephen J); now ss 13-15 of the IC Act.

monitoring and enforcement, which is not found in respect of professional activity. For PI insurance it is not desirable for all risk to be transferred to the insurer, otherwise the insured would have little incentive to take care. PI insurance thus falls between these extremes, towards the voluntary end of the spectrum.

3. PI insurance in the Australian professional advice market

This section explains how PI insurance currently operates in relation to lawyers and accountants in Australia.

The requirement to hold PI insurance

Where the requirement to hold PI insurance comes from a state or self-regulatory body there is an increased likelihood that considerations other than insurer self-interest and market conditions will be taken into account in shaping the cover, including the public interest. To varying degrees the state and professional bodies undertake this task in relation to lawyers and accountants.

This requirement can arise under statute, as a requirement of membership of a professional body, or both. Lawyers (other than in-house and government lawyers) are required by law to hold PI insurance in order to practice.[7] For accountants, generally the requirement to hold PI insurance is imposed contractually by the relevant professional body as a condition of membership of that body.

The emergence of professional standards schemes has provided an additional impetus for certain professional advisers (including accountants) to hold PI insurance even where it is not a legal requirement. This is because holding insurance is one of the ways to access the limitation of liability offered to members of professional associations.[8]

Policy Features

The requirement to hold PI insurance for lawyers and accountants is supplemented by rules in relation to the design of the policy itself. Under the professional standards legislation, the required policy features are determined by the professional association and the Professional Standards Councils (PSC) decide whether to approve the scheme. Relevant considerations include:

- the identity of the insurer – the PSC is concerned to ensure that the insurer it is able to meet its obligations;
- compulsion, adverse selection and price – the arrangement often operates so that the insurer will not decline cover and must provide it at the standard price or some explicit variation to all eligible professionals, which reduces the potential for adverse selection and provides certainty as to the availability of cover;
- the definition of the insured – typically this will include past and present employees and principals and their legal representatives, and it may also extend to consultants and contractors;
- how premiums are set;

[7] *Legal Profession Act 2007* (Qld); *Legal Profession Uniform Law* (NSW); *Legal Profession Uniform Law* (Vic); *Legal Practitioners Act 1981* (SA); *Legal Profession Act 2008* (WA). The existence of the compulsory cover must be verified annually when practicing certificates are renewed.

[8] *Civil Law (Wrongs) Act 2002* (ACT); *Professional Standards Act 1994* (NSW); *Professional Standards Act 2004* (NT); *Professional Standards Act 2004* (Qld); *Professional Standards Act 2004* (SA); *Professional Standards Act 2005* (Tas); *Professional Standards Act 2003* (Vic); *Professional Standards Act 1997* (WA); *Treasury Legislation Amendment (Professional Standards) Act 2004* (Cth); ASIC Act; Corporations Act; CC Act. The rationale for and operation of the professional standards legislation is discussed in Part 3 below.

- excesses;
- deductibles, limits and claims definitions;
- limits of cover – including whether policies have an aggregation provision meaning that a series of related acts or omissions or a series of related matters or transactions will be regarded as 'one loss' under the policy, which may have a policy limit for example of $1 million;[9]
- time periods covered by the policy;
- run-off cover – to provide cover for claims arising after the end of the policy; and
- insolvency of the insured.

Risk management and the feedback loop

A third key feature of PI insurance held by professional advisers in Australia is the existence of formal and informal feedback loops between insurers and insureds about risk management in the insureds' business practices. PI insurance operates as regulation partly through insurers adjusting the terms of the cover over time to reduce their risk, which allows insurers to identify 'hot spots' in practice,[10] and feedback loops improve the provision of information to all parties.

In Australia, the lawyers' and accountants' professional associations (and affiliated insurers in the case of lawyers) play an important part in creating this feedback loop. Information about risks is collected on a profession-wide basis and used to create risk management strategies and programs for members, with the intention to improve professional practice. Under the professional standards schemes, each professional association is required to collect comprehensive data about the claims experiences of its members and report the information annually to the PSC.[11]

4. Observations and conclusions

PI insurance potentially protects clients in two ways. First, as a form of regulation, it reduces the likelihood of an adviser engaging in conduct that results in loss. Secondly, it improves the likelihood that an adviser will be able to meet a client's claim if a client suffers compensable loss.

In Australia, the regulatory function of PI insurance depends on the involvement of the professional associations through the creation of the feedback loop. The closer the relationship between the professional association and the insurers, the more effectively the PI insurance itself appears to work as regulation.

Where there is less uniformity in the features of different PI insurance policies offered to members of the same profession, the extent to which requiring PI insurance achieves the public interest purposes of both access to compensation and maintaining trust in the profession is diminished. Arrangements that favour standardised terms or minimum forms of cover are more easily understood by advisers and clients, and reduces the uncertainty as to whether loss is covered.

The authors conclude by stating that their findings have implications for the professionalisation of other types of advice relationships, include in the financial sector.

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[9] See for example ATMA *ATMA Limitation of Liability Scheme – Information Sheet* (at 22 November 2015).
[10] See for example http://lplc.com.au/risk-management/risk-hot-topics/ (accessed 29 February 2016).
[11] PSC *Professional Standards Improvement Program,* available at http://www.psc.gov.au/advice-for-scheme-associations/improvement-program/annual-reporting (accessed 22 February 2016).