

# **AILA National Conference**

## **Professional Indemnity**

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The subject that I have been asked to present today is such that I am going to need a top quality crystal ball if I am to do justice to the topic. Issues such as who is a professional, when is the current claims environment likely to change, and the state of the market are all questions which far more experienced people than myself have managed to get completely wrong at some point in time.

Even J. Patrick Gallagher, President & Chief Executive Officer of Arthur J. Gallagher & Co admitted to me on a recent trip to Australia that he is “a terrible predictor of insurance market cycles”.

So with this background picture painted, and subject to the usual disclaimers that I am not a lawyer, the views expressed are my own personal views, and if you have any difficult questions please put them in writing, send them to my lawyer and don't expect a clear-cut response, I will now try to cover some of the issues:-

### **Who is a Professional?**

In looking to describe what exactly a professional is, we need to look at the question both from a traditional, and also from a modern perspective. However, rather than exploring the various insurance aspects of the four traditional professions, being Medicine, Law, Divinity and the Military, (and completely avoiding mention of the “oldest profession”), my focus here will be on analyzing the description of a professional as it relates to “professional indemnity” or “PI” insurance.

### Traditional Perspective

Traditionally, there were certain “rules of entry” that had to be taken into consideration in order to become a member of a “professional” club. The principal rules that applied included belonging to a professional membership organization which required minimum educational standards, administered codes of conduct and enforced disciplinary proceedings against any members that did not follow the rules. The first participants in this club from a PI insurance perspective were the lawyers, doctors, accountants, architects and engineers. All of these professions meet the traditional criteria of:

- Exercising a special skill based upon an organized body of learning
- Self regulation through codes of practice and disciplinary proceedings

A slightly more stuffy interpretation of the traditional professional, but one that I like, can be found on the Lloyd’s of London website:-

*“a professional’s actions remain in accordance with specific rules, written or unwritten, pertaining to behavior, dress and speech”.* [www.lloyds.com](http://www.lloyds.com)

The first examples of professionals insuring their negligence was seen in England in the 1920’s with the UK medical mutual’s and societies, closely followed by the Solicitors and Chartered Accountants effecting PI policies at Lloyd’s.

Whilst definitely not considered to be professionals, coverage also become available around this time for insurance brokers, financiers and stock brokers under the banner of trade “errors & omissions” insurance. At that time this was a very different concept to that of “professional indemnity”.

### Modern Perspective

In the modern insurance era, any occupation that “exercises an acquired skill and knowledge” is now considered fair game when it comes to selling PI insurance. Gone are the requirements for the acquired skill to have been gained through structured learning, as too is the requirement for self regulation and codes of conduct. This broader interpretation clearly widens quite considerably the number of professions now seeking PI coverage.

In fact, there is one Australian insurer that now offers 37 Supplementary Proposals Forms to cater for different “professions” such as beauty therapists, funeral directors, conference organizers and vehicle inspectors to name just a few.

### Summary

Whilst I have no issue with this broadening of the definition of a professional, it is clear that “Professional Indemnity Insurance” is now very much an amalgam of traditional professional indemnity and trade errors & omissions coverage under the one banner.

So what is the modern day “professional” when it comes to professional indemnity insurance? Quite simply put, it is generally accepted in the insurance industry that any person or entity that provides advice or services in which they use an acquired skill and knowledge now has the potential to fall into the definition of being a “professional”, and they should at the very least consider the possibility of arranging a “professional indemnity” insurance policy.

### State of the Market

In looking to provide an analysis of the state of the market, we need to consider that there are two separate and distinct types of insurance, and that the factors that influence each are quite different.

Generic local insurance products, (such as car, house, contents and boat insurance) are all actuarially assessed based on statistical analysis of the frequency and severity of the class. As an example, if you were to ask the NRMA for a quotation on your red Subaru WRX and tell them your postcode, not only will they tell you the premium that generates exactly the return that they want, but they will also be able to tell you on what day of the week your car will be stolen, and probably what time it will then be used in a ram-raid.

These generic local products (Mums & Dads insurance) are subject to limited influence from global events and economic conditions, and have limited fluctuations in base pricing during the peaks and troughs of the market cycle.

Specialized products (such as professional indemnity, commercial and corporate property) are in effect tradable commodities that are driven by the basics rules of supply and demand, and which can be significantly impacted by global events, economic conditions and a need for return on capital. It is in relation to these specialized products that we now explore the “state of the market”.

#### Current State of the Market

Strong financial performance of insurers over the past three years, combined with a continued increase in competition and an influx of new capital, principally on SME business, presents a very positive position for insurance buyers in the current market.

Despite an increased frequency and severity in global catastrophes in recent years such as the Asian Tsunami and the USA hurricanes, there remains a heavy focus by insurers on increasing market share, and this has resulted in extremely competitive market conditions for insurance buyers.

In some cases, the current market pricing is back to 1999 levels – For example, base professional indemnity rates for Accountants are now below many Insurers “technical” break-even points, but this does not appear to stop many of them from going after market share.

#### Prediction for the future

For there to be any shift in the market cycle, there needs to be a trigger. Whilst insurers continue to provide a profitable return to shareholders, there will be little or no market movement.

As a result of the continued increase in regulation, licensing and solvency margin controls we are very unlikely to see another HIH style collapse in the short term (which was one of the key contributors to the last Australian market shift).

However, based on the aggressive competition and market share underwriting strategies, the profitable return to shareholders is very finely balanced at present, and any meaningful deterioration in loss ratio's could see a quick and significant shift in the market.

In most previous market cycle shifts this deterioration in loss ratios is intrinsically linked to the state of the economy, and so the prediction is that the current market conditions will remain until we see a downward turn in the economic cycle.

## Current Claims Environment

Economical stability has always been associated in the insurance industry with periods of benign claims activity and relative calm, and this is the position that we are now enjoying. However, when the boom eventually busts, history tells us that we can expect a rush of claims activity arising from areas such as audit, valuation, building industry and directors & officer's liability. We have seen in recent years a positive shift in risk management activities. Previously many insurance buyers were quite clearly paying "lip-service" to their risk management strategies, but during the course of the last hard market the majority are now doing it for real.

There is no doubt that tort reform and increased regulation are both seen as very positive steps for the insurance industry, but it needs to be understood that Insurers react to historical facts and statistics, not to presumptions and predictions as to the impact that these changes will have on claims frequency and severity.

In particular with professional indemnity, (being a long-tail class of business), Insurers will react to tort reform and increased regulation by reducing prices and increasing coverage only when there is evidence that these steps have had a positive and quantifiable impact on frequency & severity. The claims environment is directly impacted by societies attitude ("Who can I blame?) and we have all seen numerous cases in the press in Australia detailing litigation outcomes which have left the majority of us scratching our heads in bemusement.

Take for example the well publicized case of the triathlete recently awarded \$3.5m after he became a quadriplegic when he hit his head on the storm water pipes at Manly beach. The damages were reduced by 50% for contributory negligence as the man was a highly experienced surfer and he knew of the risk. He had in fact warned his friends of the dangers of the pipes (which had been there for over 100 years) shortly before the accident. An interesting observation is that the pipes should have had a sign on them warning of the danger – and what if the triathlete had hit the warning sign? A warning sign for the warning sign perhaps?

The Insurance industry is also now far more exposed to the pressures of consumerism, where the power and rights of insurance buyers are increasing to the detriment of the insurance seller. The old days of "Caveat Emptor" appear to be long gone, and this shift in responsibility is also having a direct impact on the claims environment as the insurance buyers gain more rights.

## State of the Law

As mentioned earlier, I am not a lawyer and the following viewpoints may therefore appear quite simplistic, but I am struck by the following thoughts:

- 1) Legislation appears to be driven at present largely by consumer protection, the result of which is that professionals are being exposed to ever increasing responsibility and liability.
- 2) Insurance policies that in theory are designed to protect the professional are actually being drafted in many cases by lawyers with the aim of limiting the insurance companies' exposure.

The net effect of these two factors is that professionals are being exposed to an ever increasing gap between their responsibilities and the insurance protection that they are able to secure.

Equally, the insurance buyer (the consumer) is now in a position where they have extensive protection "at law" from the actions of the professional, but if that professional's insurance protection does not respond then the consumer is left exposed to an uninsured professional.

Instead of a professional indemnity policy being a mechanism to provide an indemnity to the professional, the way that both legislation and policies are drafted suggests that they are now simply nothing more than a compensation mechanism for third parties, and not a particularly effective mechanism at that.

Cuthbert Heath, who was generally considered to be the father of non-marine insurance, once said to his staff that *"the Insurers job is to get a man out of trouble. After all, that is what he has paid you for"*. It seems to me that the modern day philosophy is to *"get the man's client out of trouble, and if the man's insurance does not respond we will make him liable anyway"*

As an example of the above issues, take the scenario of a Financial Services Licensee who (with certain exemptions) assumes a strict liability under Section 917B of the Corporations Act 2001 for the conduct of representatives.

- Based on the advice of the Representative, a Client decides to invest in Westpoint.
- The Licensee has a PI policy covering themselves and their Representative for any liability arising out of advice given on "Approved Products"
- Westpoint is not on the "Approved Products" List

- The Representative knew that it was not an Approved Product, but deliberately acted outside of his authority as the commissions were too good to ignore!
- The Licensee is held liable for the actions of his “rogue” representative
- The policy does not respond to either the Licensee or the Representative
- The Client is not protected.

#### Trends against professionals

One of the most interesting and controversial trends that we are seeing at present for both professionals and insurers is the apparent push toward class actions in Australia, aided significantly by the evolution of the litigation funding markets.

In the recent case of *Fostif Pty Ltd v Campbells Cash & Carry Pty Ltd* the High Court has sanctioned the actions of litigation funders.

This is a significant shift in thinking and a fundamental change in public policy which will undoubtedly lead to an increase in the number of cases that are brought. In addition, the involvement of litigation funding companies will mean that defendants will now face better resourced plaintiffs, with a consequential growth in the number of settlements and the size of payouts.

We would expect that these actions will be pursued predominantly against defendants with deep pockets which in simple terms will mean those defendants with insurance protection. I am sure that a number of D&O Insurers are particularly nervous about the consequences of this recent decision.

#### Insurance Policy Drafting

Another worrying trend in the professional indemnity insurance market at present is the ever increasing number of marketing tricks being adopted by Insurers to sell products. Convoluted insuring clauses and gimmick “extensions” of coverage are all the rage, and can be very misleading for the unwary.

- One classic example is the civil liability policy that “extends” coverage to include Loss of Documents, but sub-limits the extension to \$50,000 in the aggregate during the policy period. Without the “extension” you would have had coverage to the full policy limit for any civil liability arising out of loss of documents.
- Another favorite, but less common in the current market conditions, is the full “Civil Liability” insuring clauses that are restricted to losses arising from any negligent act, error or omission.

#### Professional Standards Regime – Liability Caps

Professional standards legislation is a system of state and territory based legislation to cap liability for professionals in return for continuous improvement of occupational standards, and reduced risk through the provision of compulsory insurance cover, professional education and complaints and disciplinary mechanisms.

In order for this system to work, there needs to be some form of Federal alignment of the Trade Practices Act, the ASIC Act and the Corporations Act otherwise plaintiffs can simply walk around the various conflicting legislation to their best advantage.

Since the implementation of the NSW Professional Standards Act in 1995, virtually every action brought against a professional covered by this act has included as an alternate allegation a breach of the Trade Practices Act (normally Section 52).

Given that the overriding intention of professional standards legislation is to enhance consumer protection, the challenge now is to draft a scheme which accommodates each of the State, Territory and Federal Acts, the different commencement dates of each Act, and the various needs of the members of each participating profession.

It is worth noting that in some States the professional standards legislation will resolve neither claims for bodily injury, nor for fraud & dishonesty.

Given earlier comments in this paper in relation to an expected increase in class actions, it would be very interesting to see to what extent the Westpoint investors would have been better or worse off if their financial planners and accountants had liability caps in place, and to see just how quickly these caps would be reached with a class action against them.

The Insurance Council of Australia has stated that there are four pillars to improve the availability and affordability of professional indemnity insurance and they are:-

- 1) Implementation of professional standards legislation
- 2) Amendments to Section 54 of the Insurance Contract Act 1984
- 3) Implementing proportionate liability for economic loss, and
- 4) Amending the Trade Practices Act 1974

The question as to whether Insurers will be inclined to improve the availability and affordability of professional indemnity coverage based on the implementation of these four pillars remains to be seen. What is clear, however, is that professional indemnity is a long tail class of business and it will be some time before Insurers are able to assess the effectiveness of the proposed changes. I would suggest therefore that there are any number of other influencing factors that will impact availability and affordability of professional indemnity insurance more quickly and more dramatically than the implementation of the professional standards legislation.

Another interesting point is that discussions and negotiations have been going on for so long now between the States, Territories and Federal Government that the original intention to improve the availability and affordability of professional indemnity coverage does seem a little redundant given that professional indemnity insurance has never been more widely available, or better priced than at the present time.