LawyersInsurance

Practice Note: How much Professional Indemnity Insurance Is Enough?

Depending on the jurisdiction in which your legal practice operates and the size of your practice, you may need to consider issues relating to the Limit of liability for Top-Up PI insurance.

In each state in Australia, minimum compulsory layer professional indemnity insurance must be purchased by legal practices. The limit of liability of such compulsory layer coverages throughout Australia (offered via compulsory layer arrangements) is $1,500,000 any one claim. Many firms do not purchase limits beyond $1,500,000 any one claim, but do not apply a rational process to this decision. This Practice Note is to provide some informed commentary around this issue to assist firms when considering appropriate limits to be purchased.

Like most areas of liability insurance, it is difficult to know in advance what exposures your practice may face. With regard to Professional Indemnity insurance limits, a number of factors should be considered:

- Whether your practice is a member of a scheme which qualifies it for limited liability;
- The areas of work undertaken by the firm;
- The fee income of the firm;
- Minimum limits in comparable overseas jurisdictions;
- The affordability of Professional Indemnity insurance.

1. Limitation of Liability Schemes

Various states in Australia have enacted Professional Standards legislation which attempts to limit the liability of professional service firms that qualify as members of a scheme. With respect to law firms, the only existing Scheme applies to member firms of the Law Society of New South Wales. The scheme operates to limit liability using the number of principals as a proxy for the size and complexity of the firm.

The New South Scheme limits are as follows:

Class	Principals in the Legal Practice	Scheme Liability	Class	Principals in the Legal Practice	Scheme Liability
1	1 to 3	**$1.5Mn**	13	15	**$7.5Mn**
2	4	**$2.0Mn**	14	16	**$8.0Mn**
3	5	**$2.5Mn**	15	17	**$8.5Mn**
4	6	**$3.0Mn**	16	18	**$9.0Mn**
5	7	**$3.5Mn**	17	19	**$9.5Mn**
6	8	**$4.0Mn**	18	20	**$10.0Mn**
7	9	**$4.5Mn**	19*	Persons in a legal practice where the sole practitioner or principals in Classes 1-18, as the case may be, select and specify a maximum amount of liability greater than that specified for the class	**The selected maximum amount of liability greater than that specified for the class but not exceeding a maximum amount of $50.0 million**
8	10	**$5.0Mn**			
9	11	**$5.5Mn**			
10	12	**$6.0Mn**			
11	13	**$6.5Mn**			
12	14	**$7.0Mn**			

**Class 19 Limits must be approved by the Law Society of New South Wales.*

Notwithstanding the statutory capping in New South Wales, there remains a degree of uncertainty as to the application of the Professional Standards Scheme historically *and* prospectively.

The Scheme operates on a “costs plus” basis – i.e., the Scheme Liability specified above is for the Limit of Indemnity only (i.e., “occupational liability” only) and any additional costs to defend a claim are supposed to be in *addition* to the Limit of Liability. A problem arises because the compulsory Limit of Liability in New South Wales is $1.5Mm *inclusive* of costs (as it is in other States and Territories and as is largely the practice for insuring lawyers professional indemnity globally). The issue of costs being in *addition* compared to costs being *inclusive* may invalidate the statutory capping regime. If this is so, as historically firms who believed they were subject to the statutory capping regime may not have complied with s.21 of the Professional Standards Act 1994 (NSW), the effect being that, contrary to expectations, the NSW limitation of liability scheme has not been complied with.

We understand that the Attorney General’s Department in New South Wales is currently reviewing this matter and may well have some legislative amendments before Parliament prior to July 2006. However, unless the legislative amendments apply retrospectively, law firms will be exposed to potential claims as the legislation will apply prospectively, whereas your insurance cover (being written on a claims made basis) applies to both prospective and retrospective matters. It is the retrospective matters – legal service provided by your firm prior to any legislative amendments – that may create an exposure for New South Wales law firms.

In addition to this matter, in the wave of State and Territory based tort reform from 2001 to 2004, there emerged a requirement under the Trade Practices Act 1974 (Cth) for *complementary* legislative reform. This has been done, however appropriate regulations need to be enacted with respect to each Scheme to mitigate the chance of a claim referencing a breach of professional duty citing an alleged breach of the Trade Practice Act.

Many claims against professionals do reference an alleged breach of the Trade Practice Act. When such regulations are enacted, again they are likely to be prospective and *not* retrospective. This may give rise to the possibility that certain aspects of professional indemnity claims against law firms may not, despite best intentions, be subject to a limitation of liability.

2. Areas of Work Undertaken by the Firm

All "Top-Up" Professional Indemnity facilities for law firms attach in excess of $1.5 million any one claim. As such, each firm should review its exposures to potential losses in excess of this amount. In particular, law firms with exposures to large transactions are exposed to potential liability greater than $1.5 million any one claim. Examples include larger property related transactions, merger & acquisition work, taxation advice and intellectual property / patent infringement, to name a few.

In addition as many compulsory layer insurers have attempted to "batch" similar or related claims under a "*one loss*" or "*one claim*" clause, if your practice is exposed to potential multiple losses / claims arising from advice that fall under the definition of one loss or one claim, there is the potential to breach the compulsory layer limit of $1.5 million. Without Top-Up cover, your practice may be unduly exposed.

3. Fee Income of Your Firm

Within any given occupational class, most professional indemnity insurers use fee income as the best proxy for any risk exposures that they face. Put simply, this means that as fee income increases, each firm should consider higher limits of liability.

In those jurisdictions where a statutory capping of liability for law firms does not apply, firms should consider the following as a guide to <u>minimum</u> limits of liability to be purchased. Other discussion points in the Practice Note should also be taken into account when concluding the adequacy of the limits of liability that your firm purchases.

Gross Fee Income	Minimum Range of Limits to be Considered	Gross Fee Income (cont)	Minimum Range of Limits to be Considered
Up to $2M	**Up to $5Mn**	$20M	**$20Mn to $50Mn**
$3M	**$5Mn to $10Mn**	$30M	**$30Mn to $60Mn**
$4M	**$5Mn to $10Mn**	$40M	**$40Mn to $75Mn**
$5M	**$5Mn to $10Mn**	$50M	**$50Mn to $100Mn**
$7.5M	**$10Mn to $20Mn**	$75M	**$75Mn to $125Mn**
$10. M	**$10Mn to $50Mn**	$100M	**$100Mn to $150Mn**

4. Minimum Limits in Comparable Overseas Jurisdictions

The compulsory layer PI market in Australia has recently settled on $1.5Mn as the benchmark minimum limit of liability (as required by various State and Territory based legal regulatory authorities). Many firms wrongly believe that this is level of indemnity is therefore an adequate limit to purchase. It is fair to conclude that not a lot of (actuarial) science has been used to adopt the $1.5Mn standard limit.

So what happens elsewhere? Basically there are very few minimum limit of liability “standards” adopted on a national basis. Probably the most relevant comparison for Australian law firms is to look at UK minimum limits mandated by the Law Society of England and Wales. The table below details these limits from September 2003 onwards:

Year	Sole Practitioners & Partnerships	Incorporated Practices
2005/06	£2.0M (~A$4.8Mn)	£3.0M (~A$7.2Mn)
2004/05	£1.0M (~A$2.4Mn)	£1.0M (~A$2.4Mn)
2003/04	£1.0M (~A$2.4Mn)	£1.0M (~A$2.4Mn)

By UK standards, many Australian law firms underinsure their PI risks if they rely upon the statutory limit of $1.5Mn as being adequate. Consideration should be given to obtaining quotes for higher limits.

5. The affordability of Professional Indemnity insurance

The vast majority of law firms in Australia (70% plus) are sole practitioners who have typically not purchased Top-Up PI insurance. The Top-Up PI market is therefore usually the domain of firms other than sole practitioners, however sole practitioners are not immune from large claims. Depending on the affordability of cover, the take up rate for Top-Up insurance has historically varied between 15% and 25% of all firms.

We are currently experiencing a relatively soft market for lawyers Top-Up PI insurance and expect more firms to consider purchasing PI insurance in 2006/07 as prices will be relatively favourable when compared to recent years.

6. Next Steps

Only time will tell if your Professional Indemnity Limit of Liability is adequate. However we strongly believe there are significant risks in simply purchasing the minimum limit of $1.5Mn without giving any thought to the size of your Firm, the activities it undertakes, some practical limitations with respect to statutory capping regimes, what standards apply in other jurisdictions and the relatively softer Top-Up PI insurance market.

Think of a number and then double it!

Please note that this Practice Note is to assist law firms to understand risk exposures they face. The views expressed here do not represent specific advice given to a law firm to assist them to determine appropriate insurance cover.