
Professional indemnity insurance: Protection or an exercise in public relations

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Abstract

Insurance policies for professionals have been broadened substantially over recent years. But who is actually benefiting? The author considers the drivers to whether the wider cover is practically worthwhile to the various parties and the costs associated in having such, and the amount of coverage purchased—Limit of Indemnity—and the merits as to whether they should be *each claim* or aggregate bases. The speeding up of Claims Settlements and how the introduction of Mediation will affect Professional Indemnity costs in the medium and long term are highlighted. Lastly, an insight into developments that may change how Professional Indemnity is purchased in the future is provided. *Journal of Building Appraisal* (2006) 2, 240–245. doi:10.1057/palgrave.jba.2950039

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INTRODUCTION

Over the last 20 years, the reasons behind the purchase of Professional Indemnity Insurance have changed significantly. The rise of consumerism, as well as certain Professional Bodies wishing to homogenise insurance cover purchased by their members, has led to the consumer being potentially over-protected at the expense of the Professional themselves.

SCOPE OF COVER

The scope of Professional Indemnity Insurance — described as *minimum terms* — required to be purchased by each member of a Professional Body, is in reality the maximum cover available from a reasonably broad range of insurers of certain financial standing. Any broader cover might mean that the number of suppliers would reduce to effectively create an oligopoly or otherwise the quality of insurers might be such that they would be unable to meet their financial obligations.

Who is the beneficiary of this broad cover? Is it the Client, the Professional, the Insurer, the Insurance Broker or the Professional Body? The initial reaction might be to say the Client because when they seek the services of a professional, they have the peace of mind that in the event the professional makes an error or omission they can be recompensed. This is a laudable principle, but the scope of Professional Indemnity Insurance required to be purchased probably increases the premium paid, which in turn will be passed on to the Client.

This could be deemed to be a benefit if the cost of broadening the cover is less than the amount of the claims that would have not otherwise been insured. It would be very difficult to try and put a cost on the broadening of cover, but the author claims that from his 27 years of experience in the insurance market, he would guesstimate that over 95 per cent of Professional Indemnity claims would be covered by the basic cover provided by a *Breach of Professional Duty* wording, which is essentially *negligence*.

So who is actually benefiting from the broader cover?

- The Client: No, because he will indirectly be paying for protection he will rarely — if ever — need.
- The Professional: No, because if the additional risk is so rare most professionals are prepared to carry the risk; furthermore, if there is no insurance for this unusual and rare risk, the Client's solicitors may advise against bringing an action in the first place!
- The Insurer: Yes, but if asked, most insurers would prefer to issue a narrower wording, perhaps even with a small discount on the premium.
- The Insurance Broker: Possibly yes, by virtue of the potential reduction in their own professional indemnity risk insofar as they do not have to advise on the 'core' Scope of Cover, although they may need to rationalise existing and new endorsements plus advice is required in respect of the premium levels and markets used.
- The Professional Body: They are the main beneficiary; however, in the event that there were to be a cataclysmic hardening of the insurance market thus rendering the broader cover unavailable from all but a few insurers, this could result in either the Scope of Insurance being reduced or the (re) introduction of a Mutual Insurance to combat the possibility of the formation of an oligopoly forming.

The insurance market is just that; it is a market, and accordingly prices rise and fall, and products change. Professional Indemnity is essentially a retrospective protection, covering *claims made* today from advice given and/or design(s) undertaken previously, and how can the Client of today be assured that the Scope of Cover will be the same in the future. This conundrum is a constant challenge to the purchasers of Professional Indemnity Insurance, with Professional Bodies looking at 'run-off' provisions for members who have ceased to trade for whatever reason, and ongoing members either adhering to the regulations of their Professional Body or fulfilling specific contractual obligations. One way to potentially aide certainty would be to curb the cover to that which is normal in the worldwide Professional Indemnity market. This should minimise problems, in the event of a cataclysmic hardening giving Clients more opportunity to purchase a product, thus avoiding wholesale changes in the rules and regulations of Professional Bodies and/or re-negotiation of existing and past contracts. The skill and experience of the Insurance Broker will then be brought to bear, in designing appropriate policy coverage and structure from a wider market.

LIMIT OF INDEMNITY

Every policy has a Limit of Indemnity, sometimes referred to as the Limit of Liability or even the Sum Insured, which is the amount of cover available. Typically the Limit of

Indemnity relates to the maximum amount of compensation *each claim*, with costs and expenses incurred in the defence of that claim payable in addition to the compensation by the limit. The perceived wisdom is that an *each claim* basis of cover provides the Professional and his Client with the best protection, as this allows for an unlimited number of claims to be brought in any one period of insurance. In theory this premise is correct, but in practice rarely are there multiple claims paid for the Total Limit of Indemnity in one year, and there could be situations where the definition of claim actually inhibits how much can be recovered from the Insurer.

The potential weakness of an *each claim* basis of cover is in the definition of what a claim is and/or the series clause that will seek to link 'similar' claims together arising from the original mistake. For example, should there be an incorrect design of a roof truss that is used in a number of different structures, then, depending upon the basis of cover in the policy wording, Insurers may seek to link the claims from different claimants as one claim under the insurance policy. Why should Insurers wish to link the various claims (ie 'stacking' multiple claims due to a common cause as opposed to a 'sideways' exposure)? It is because, when Insurers purchase reinsurance, usually it is arranged on a non-proportional excess of loss basis, and by linking claims will assist them in their ability to recover from reinsurers.

The problem is further exacerbated by the use of other terminology for *each claim*, including 'any one claim', 'each and every claim' and even the use of 'any one occurrence'. The last of these is persistently used (incorrectly) by lawyers, when drafting Collateral Warranties and other similar contractual instruments, and all too often it has to be explained that Professional Indemnity is not an occurrence-based insurance but one written on a 'claims made' basis.

When there is a major incident, be it the World Trade Centre disaster or even the recent devastation caused by Hurricane Katrina, there is often a dispute as to how many actual claims can be paid by insurance or reinsurance. Professional Indemnity insurance is not immune to such debate and the Pensions Mis-selling debacle spawned such a dispute. To clarify the position, the Law Society amended the minimum terms for English and Welsh Solicitors, but it will probably require a legal case to test the drafting of that alteration. As part of this amendment to their minimum terms, the Law Society required the minimum Limit of Indemnity to be doubled (from £1,000,000), and for Limited Liability Partnerships (LLP) it was trebled.

There is a viable alternative to an *each claim* basis of cover, and that is for the Limit of Indemnity to be arranged on an aggregate basis for the period of insurance. This historically was the basis of all Professional Indemnity Insurance policies, and is still the prevalent basis of cover for all classes in most countries outside of the United Kingdom and continues to be the basis for certain classes in the United Kingdom such as 'Design & Construct' and 'Lloyd's Insurance Brokers'. Often expressed as *any one claim and in all*, in the event of a very severe loss, an aggregate Limit of Indemnity could afford better protection than *each claim*, the latter being more beneficial if a frequency problem is perceived. But the statistics, as per the author's experience, would seem to indicate that severity is more prevalent than frequency.

Moving to an aggregate basis of cover does present its own challenges, the main one would be the Professional Body's requirement for Clients to be protected adequately. Bearing in mind the rarity of a paid total loss claim in one period of insurance, perhaps a doubling of the Limit of Indemnity would be more than sufficient to cover multiple claims and any related costs and expenses incurred to defend such claims (an aggregate limit is normally inclusive of costs and expenses).

It is recognised, by Insurers, particularly in the construction industry, that when major projects are undertaken a single aggregate limit does not always provide the comfort Clients require, and that alternative options need to be considered. A reinstatement of the Limit of Indemnity can be an option, but the method by which the Limit of Indemnity is reinstated is absolutely critical, and clarity as to what is an unrelated claim has baffled a number of the best legal minds in the Professional Indemnity Market. A simple solution is to purchase a separate aggregate limit — where contractually required — for each project within the annual arrangements. Unlike single project insurance, the annual Professional Indemnity arrangements provide an ideal vehicle by which specific projects reinstatements can be maintained.

CLAIMS SETTLEMENTS

Access to justice for the consumer has never been easier, and coupled with the Woolf reforms, the legal process has been streamlined. Mediation and negotiation has figured large in these reforms following the increased emphasis of alternative dispute resolution. Additionally, Ombudsman Awards and the introduction of Arbitration Schemes provide a number of different alternatives by which disputes maybe resolved, while claimants retaining the ability to follow the more traditional routes in the courts. Without doubt, these reforms have quickened the pace of justice and assisted in sorting out the less complex claims at an early stage in proceedings — but at what and who's cost?

When the reforms were mooted, it was felt that one of the main benefits would be to reduce legal costs and expenses. While, what has been referred to as the 'gravy train' may have been curtailed, the timetables introduced with the changes mean that statements and arguments have to be presented promptly. The consequence is that frequently significant resources have to be dedicated to a case, which can increase the costs claimed under Professional Indemnity Policies.

Mediation and negotiation plays an important part within the new reforms and can frequently bring matters to a speedy conclusion; however, this process often results in payments being made, when quite frankly they are not justified. If there is a potential claim against a professional estimated by the claimant to be in the region of £100,000, and there is any possibility that some liability may devolve upon the professional, a prudent Insurer will have to reserve some amount — including any legal costs and expenses — for the claim. It is expected — as part of the reforms — that the route of alternative dispute resolution would have been explored before a claim is brought in the courts.

Within the terms of Professional Indemnity Insurance, Insurers have the right to take over and to conduct the claim in the name of the professional. The alternative is to convene a Mediation; unfortunately, the frequency of claims where the quantum of those settled for about £50,000 is unerring high. Initially Mediation may look like a 'good' negotiation, but too often the reasoning for the settlement is the economic cost of pursuing a defence, and it is difficult to attend Mediation meetings if it were never the intention to negotiate in the first place! Yes, the settlement may be less than the reserve, but it is a payment nonetheless, and in all likelihood, monies have been paid much earlier than would have been the case if the claim had been settled in the courts.

This early settlement of claims is resulting in changing payment patterns, which in turn is adversely affecting Insurers actuarial models, thus potentially pushing up premium rates. Is the Professional happy with this settlement? In certain circumstances the

Professional may be happy for closure of a claim for whatever reasons (perhaps so they might continue a trading relationship with the claimant), but against this is the fact that they have a settled claim of £50,000 that forms part of their claims experience. This probably means upwards pressure on the Professional Indemnity premium, and, in addition, the professional would also have to pay the policy excess at the time of settlement of the claim that might otherwise not have been paid.

Ombudsman Awards are another route by which disputes can be resolved, particularly disputes with a low quantum, or those that may merely result in an apology rather than a payment. This method of resolving disputes is very efficient from both the point of view of cost and time, and the success of this route will undoubtedly be extended into other areas and/or for larger amounts. Ombudsman Awards differ from other disputes because the Award will be based on 'fairness' rather than a legal liability; therefore, professionals should be wary, as without an extension these would not be covered by most Professional Indemnity Policies.

The majority of disputes going to the Ombudsman are of low value and fall below the Professionals self-insured excess and so have had little effect — so far — on Professional Indemnity Insurers but this could change if larger quantum claims are considered. The Client can benefit from Ombudsman Awards, and if this method of dispute resolution prevents claims being brought in the courts, then the other stakeholders in Professional Indemnity Insurance will also benefit. The potential downside is that the frequency of claims may be increased which will initially affect Insurers who will be making increased payments, but it will also affect the Professional by virtue of the subsequent upwards pressure on premiums, and, in addition, the Professional has, of course, to pay their Policy excess for each Award.

FUTURE DEVELOPMENTS

The march of consumerism by empowering the public is continuing. In the insurance field the new regulatory environment for Insurance Brokers has reflected this, which is to continue with the Financial Services Authority's initiatives of 'Contract Certainty' and 'Treating the Customer Fairly'. Significant advances have been made in a number of areas, but from a Professional Indemnity Insurance point of view the author is not sure if the Professional or the Client have — or will — really benefit from either: the Broader Scope of Cover, the insistence that the Basis of Cover be for *each claim* or the alternative dispute resolution routes introduced by the Woolf reforms.

Where could there usefully be developments that benefit all the stakeholders within Professional Indemnity Insurance? An obvious area of investment must be in the area of loss prevention, which means reducing the number of disputes. How can this be achieved? It requires all the stakeholders in Professional Indemnity working in partnership with each other to play a part.

Unlike other countries it is very difficult in the United Kingdom to collate accurate statistics to understand and measure disputes. Historically, Insurers have collated their own loss statistics, each adopting their own loss codes. While there is an increasing obligation to report these loss statistics, these are at a very high level, without the granularity required to be able to drill down to the losses for specific classes of Professional Indemnity Insurance, or even the various areas of loss in those classes of Professional Indemnity Insurance. The Financial Services Authority and Professional Bodies have an opportunity — with today's technology — to require Insurers in future to report loss statistics to a lower level. These loss statistics initially might only apply for

future disputes; however, in time this information can be used to identify the ‘problem’ areas that can be addressed by the way of increased professional training or other risk management approaches.

Insurance Brokers over the last few years have started to focus on providing risk management services, realising that their brief extends beyond the mere placement of the insurance contract. This is a step in the right direction but all too often the risk management approach is the result of a previous problem, which may have given rise to a claim under particular policy and/or something which has affected the profession as a whole. Rather than being reactive, a proactive approach should be the starting point, through risk awareness and risk assessment and this is where the professional can play their part by working in partnership, with their broker, to understand and address the risks inherent in providing professional services in today’s litigious society.

The investment in these practical approaches — by all concerned — will aid loss prevention. Fewer disputes and the lower level of claims plus a reduction in distractions facing management would be a positive outcome. To ignore this leads to the possibility of an inexorably increasing number of disputes and Professional Indemnity Insurance claims.

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