

Professional Indemnity ('PI') Insurance

Introduction

PI insurance provides financial resources to respond to claims against a professional in respect of advice or services provided to clients.

Regulators, professional associations and professionals have overlapping but different interests in respect of PI insurance.

Regulators may be concerned with the public interest and protection of consumers to ensure that all professionals of a particular class have resources available to meet claims by clients. This interest is heightened where the entry to the profession is restricted and only those with professional accreditation can provide advice and other services in a particular field.

Professional associations may be particularly concerned with protecting their own reputation and the reputation of their members. This is closely aligned with ensuring that users of the professional services with valid claims are compensated for any loss they suffer. These associations may themselves have a delegated regulatory function under legislation or require that members hold PI insurance as a requirement of membership. They may also facilitate the provision of appropriate PI insurance to their members by operating mutual insurers or similar schemes or by arrangements with insurance brokers and underwriters. In this way, the association can better frame the cover to suit their members and provide feedback on risk management.

Individual professionals or firms have an interest in protecting their reputation, capital and cash flows and this interest may lead them to use PI insurance to protect themselves and their clients from professional failures. Also, they may be required by regulation (including participation in professional standards schemes) or by their professional association to hold PI insurance meeting requirements.

This title considers some of the main issues and characteristics of PI insurance available to professional advisers and aims to assist in the important decisions that regulators, professional associations and users may need to make in selecting an appropriate PI policy.

The Essence of PI Insurance

PI insurance indemnifies a professional against certain liabilities arising out of the practice of his or her profession and centrally the liability to compensate clients for advice failures. The terms and scope of cover of PI insurance will be framed having regard to:

- the normal structure of PI insurance adopted by insurers and available in the insurance market,
- the nature of the profession and the types of liability that typically may emerge from professional advice or other activities,
- the assessment of the risk of the professional seeking insurance by the prospective insurer,
- any regulatory or other requirements such as those set by a professional association specifying the scope of cover.

Where the insurance is compulsory or arranged through a mutual arrangement the cover may be better designed for the professional activity, it may result in less emphasis on the risks of professional, provide better risk management feedback¹ and may be more available and affordable.

The insurance typically covers the professional's own legal or defence costs in defending a claim as well as several ancillary covers.² Importantly (and not often adequately recognised) it also gives access to the expertise of the insurance industry in handling claims where the insurer is required to or elects to take over the carriage of the claim. This is particularly so where mutual arrangements allow for the development of specialist knowledge and claims handling expertise in respect of like professionals.

The cost of claims arising from professional advice or services that are not covered by PI insurance need to be managed by other means. Typically, PI insurance will not cover a liability arising from willful misconduct or fraud and may include other exclusions from cover that often are framed by reference to the characteristics of the relevant profession. The risks associated with these exclusions need to be understood by the regulator, professional association and the professional and other steps taken to avoid or mitigate them. For example, fidelity insurance may be used to provide protection against embezzlement involving loss of client monies. In some cases, last resort compensation schemes may be available.³

¹ See John Morgan and P Hanrahan, *Professional Indemnity Insurance; Protecting Clients and Regulating Professionals*, (2017) 40 *University of New South Wales Law Journal* 353, 383.

² These may include cover for defamation, the cost of regulatory investigations, loss of documents, public relations cover, and fidelity cover.

³ Examples are found in the fidelity schemes operated by the legal profession and by stock brokers.

Obligations to hold PI Insurance

Statutory obligations and rules of professional associations

Members of a number of professions are required by statute to hold PI insurance and in many cases the scope and minimum level of cover is set by the statute or regulator.⁴ So the first step for professionals is to determine whether in the jurisdiction in which they operate they are required by law or by the professional association they are a member of to hold PI Insurance and what requirements that insurance must meet.

Professional Standards Schemes.

For the last two decades, there has been an additional incentive for Australian professional advisers to hold PI insurance. It allows them to participate in legislative schemes that cap their potential civil liability for defective advice at a prescribed monetary limit.⁵ These schemes are 'legal instruments that bind associations to monitor, enforce and improve the professional standards of their members, and protect consumers of professional services'.⁶ In return, the schemes 'cap the civil liability or damages that professionals who take part in an association's scheme may be required to pay if a court upholds a claim against them'.⁷ Schemes may impose different limits of legal liability depending on the size of the professional firm or total annual fees. These limits are aligned with the level of PI insurance required but professionals should separately consider the limit of cover having regard to activities that may not be covered by a scheme and the possibility of multiple claims.⁸

Demands of Clients and other reasons

Another reason for holding PI Insurance arises from the insistence of clients that the professional agrees to hold PI insurance with limits of cover.

In addition, a professional may wish to protect its own assets and cash flow by holding this insurance.

⁴ See, e.g.:

- Legal Practitioners – *Legal Profession Act 2006* (ACT) s 311, *Legal Profession Uniform Law 2014* (NSW) s 211, *Legal Profession Act 2006* (NT) s 376, *Legal Profession Act 2007* (Qld) s 353(2), *Legal Practitioners Act 1981* (SA) s 19, *Legal Profession Act 2007* (Tas) s 45(2), *Legal Profession Uniform Law Application Act 2014* (Vic) sch 1 s 211, *Legal Profession Act 2008* (WA) s 40.
 - Medical Practitioners – s 129 Health Practitioner Regulation National Law,
 - Architects – cl 16 of the NSW Architects Code of Professional Conduct prescribed by Architects Regulation 2012 (NSW); *Architects Act 1991* (Vic) s 17A, *Architects Act 2004* (WA) s 30,
- Accountants – the Institute of Chartered Accountants prescribes as a condition for the issue of a certificate of public practice that the applicant holds professional indemnity insurance: see by-law 34(b) of the Institute of Chartered Accountants in Australia By-Laws, and regulations issued under by-law 34(b). For an auditor, reg 9.2.08 of the *Corporations Regulations 2001* (Cth) permits the Australian Securities and Investments Commission to impose as a condition of registration that the applicant has a current policy of professional indemnity insurance.

⁵ *Civil Law (Wrongs) Act 2002* (ACT) sch 4 s 4.17; *Professional Standards Act 1994* (NSW) s 21; *Professional Standards Act 2004* (NT) s 22; *Professional Standards Act 2004* (Qld) s 22; *Professional Standards Act 2004* (SA) s 23; *Professional Standards Act 2005* (Tas) s 24; *Professional Standards Act 2003* (Vic) s 23; *Professional Standards Act 1997* (WA) s 34; *Treasury Legislation Amendment (Professional Standards) Act 2004* (Cth) sch 1 items 3, 7–8, 11; *ASIC Act* s 12GNA; *Corporations Act* s 1044B; *CC Act* s 137.

⁶ Professional Standards Councils, *Professional Standards Schemes* <<http://www.psc.gov.au/professional-standards-schemes/what-are-schemes>> (accessed on 9 August 2017).

⁷ Professional Standards Councils, *Professional Standards Schemes*.

⁸ Most PI insurance has an aggregate limit of cover which is the maximum cover for all claims in the period of cover. This may be extended if the cover provides for a reinstatement or if the cover is on an 'each and every claim' basis where the limit is set in respect of a single claim with no overall aggregate limit (this type of cover seems to be limited to the legal profession).

PI Insurance as a benefit to the Profession

Governments may believe that, where professional monopolies are granted, one of the conditions should be that PI insurance is held to protect clients. Professional bodies have a significant interest in preserving the reputation of the profession in the community and consequently require members of the association to hold insurance. This is enhanced when the professional body establishes an approved professional standards scheme (discussed above). This is augmented when such schemes which allow the members to place caps on liability on condition they hold PI insurance, meet certain risk management obligations and notify their clients of participation in the scheme.

PI Insurance is claims made insurance

Insurers have structured PI insurance contracts as 'claims made and notified' policies rather than as occurrence-based policies. Occurrence-based policies typically respond to events such as an accident during the term of the policy regardless of when the claim is ultimately made. In contrast, a 'claims made and notified' policy responds to a claim made against the insured by a third party in the policy period and notified to the insurer in the same period.

Under this approach there are two factors that benefit insureds (and therefore claimants, whose ability to recover from the insured depends on the insured being able to access its PI insurance). These are:

- rights to notify facts and circumstances that may give rise to a claim in the policy period to engage the cover in respect of a future claim;⁹ and
- after the end of the policy period, there is a limited capacity to notify claims where these were not notified during the policy period.¹⁰

The right to notify facts and circumstances has some important consequences – firstly the identification of facts and circumstances that may give rise to a claim can be made before any actual claim has emerged; the notification locks in cover when a claim emerges. The notification to insurers is an important aspect of risk management. It benefits both the insured and ultimately the claimant. Providing, in limited conditions, the right to notify a claim after the end of the policy period likewise may benefit the insured and claimant.

Run-off cover

When a professional ceases practice, dies or becomes insolvent there are issues as to the continuation of cover and the impact of this on potential claimants. In many professions, the professional bodies put in place run-off covers or the regulations require that the insurers provide run-off cover in these situations. Often if there is no arrangement in place the professional can purchase run-off cover for a period of years to respond

⁹ *Insurance Contracts Act 1984* (Cth) s 40 ('*IC Act*') provides for this.

¹⁰ See *FAI General Insurance Co Ltd v Australian Hospital Care Pty Ltd* (2001) 204 CLR 641, 660 [46] (McHugh, Gummow and Hayne JJ) discussing the application of *IC Act*'s 54. In addition to this, some PI insurance has a continuity of cover provision which applies if the insurance is renewed (usually with the same underwriter) which permits a claim that should have been notified under an earlier policy to be notified under a later policy but with the consequence that it is subject to the terms of cover of the earlier policy.

to any claim that subsequently arises. The risk may also be mitigated by notification of facts and circumstances (to the extent they can be identified) to lock in cover.

Some key decisions on cover

It is not possible in this title to provide extensive commentary on all the elements of a PI insurance, but some elements are critical, and these are discussed below.

Levels of cover

The aggregate level of cover is the maximum amount that the insurer will pay under the policy for all claims under the policy. The factors that initially determine this are any regulatory requirement to hold a level of cover. But beyond this for an individual professional the considerations will include:

- a) an assessment of the likely type of claim and its value. Membership of a professional standards scheme that limit the liability of a professional and compliance with any conditions applicable to the effective application of these schemes is an important consideration;
- b) whether it is possible that multiple claims may arise – for example using standard models of advice or activity that is repeated;
- c) the likely legal costs that may be incurred in investigating and defending a claim;
- d) what other covers are provided under the policy and the likelihood of claims under these provisions;
- e) the premium and its affordability.

This is not an easy assessment and guidance can be obtained from professional associations or insurance professionals.

Deductibles or excess

This is the amount of any claim that must be met by the insured. Often higher deductibles may reduce premium, but care must be taken that the deductible is affordable especially if there are multiple claims and so multiple deductibles.

Claim definition

What is a covered claim being a critical issue as to the scope of the insurance. It needs to be understood to ensure it is adequate for the professional practice.

What constitutes a single claim determines when a deductible is payable. Some policies aggregate like claims and treat them as a single claim. This can have implications for the number of deductibles payable but also the level of cover.¹¹

¹¹ It is critical in each claim cover which provides for multiple claims up to the specified limit. It may mean that several claims only have one limit of cover in aggregate. It is less important for the aggregate level of cover in a policy with a single limit for all claims (but it may have some complex implications for the triggering of any reinstatement of that limit).

Exclusions

Exclusions of cover will further define what claims are covered (or the extent to which they are covered) and they need to be understood to effectively manage the risk of uncovered activities. The exclusions will in part reflect the profession but typically they may provide that there is no cover in the following situations:

- a) Claims arising from events prior to the retroactive date set under the policy (this may be a date on which the professional first held insurance);
- b) Claims that was or ought to have been notified under a prior policy or in a prior period,
- c) A liability assumed under a contract especially one that extends the liability of the professional beyond the normal common law and statutory liabilities;
- d) Waiving or limiting liability from other parties against whom the professional may have a right to recover all or part of a claim;
- e) Geographic limits often focused on claims arising from activities in north America.
- f) Damage to property or personal injury or death where these matters are not expressly covered such as in medical malpractice insurance;
- g) Advice to associates or relatives and their associated entities; and
- h) Various liabilities ordinarily covered by other types of insurance such as directors' and officers' liability insurance.

This is far from a complete list and each policy needs to be carefully reviewed to ensure that there are no inappropriate exclusions.

Claims Handling

Of the conditions that are typical in a policy the rights of the insured and insurer in handling and settling claims is extremely important. As noted, one of the advantages of PI insurance is access to the insurance company expertise in claims handling. Consideration also needs to be given to when the insurer can settle the claim and what rights and obligations an insured may have if they disagree on settlement.

Summary

The key issues identified in this title are:

- The source of requirements for PI insurance cover;
- The need for a professional or professional firm to make some assessment of their need for cover that is more extensive or with higher limits than that which may be required;
- The need to carefully understand the scope of cover and to frame any risk management system to particularly manage risks of liability that are not covered;
- The need to identify when claims arise and notify them and to notify facts and circumstances that may give rise to a claim to lock in cover.

The title has identified the main characteristics of PI insurance but clearly the cover will vary to reflect the needs of professions.

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