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14 September 2015

Dear Sir/Madam,

Response of the CLLS Professional Rules and Regulation Committee to the SRA's discussion paper "Protecting Clients' Financial Interests" (the "Discussion Paper")

The City of London Law Society ("CLLS") represents approximately 15,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its specialist committees. This response to the Discussion Paper has been prepared by the CLLS Professional Rules and Regulation Committee.[1]

On 7 May 2014 the SRA started a consultation, which closed on 18 June 2014 ("2014 Consultation") on changes to the minimum compulsory professional indemnity cover, to which the CLLS responded by letter dated 18 June 2014 ("2014 Response").

[1] A list of the members of the CLLS Professional Rules and Regulation Committee can be found here: http://www.citysolicitors.org.uk/index.php?option=com_content&view=category&id=151&ltemid=469

On 1 August 2014 the SRA issued a Call for Evidence on "Client Protection". Although the CLLS did not respond to that, we commend the Response of The Law Society dated 26 September 2014 ("TLS 2014 Response") and note that TLS's urging of further enquiries and seeking of empirical evidence, before considering changes, have not been taken up prior to the current Discussion Paper.

On 8 July 2015 the SRA published a Discussion Paper regarding its ongoing work to ensure there is an appropriate balance between the overall level of financial protection for clients and the cost and regulatory burden imposed on firms. Below are comments of the CLLS Professional Rules and Regulation Committee on the proposals. The closing date is 16 September and we note that while 10 weeks are allowed for comments, this covers the holiday period, which restricts the effectiveness of representative bodies to consult with their members on this important subject.

In effect, therefore, this is the third consultative-type document from the SRA on the subject, which was foreshadowed in the 1 August 2014 Call for Evidence[2]. So far, detailed research and analysis has not been done and a further consultation with detailed proposals is planned for early 2016. Of course, the SRA has statutory duties as a regulator for the benefit of consumers, but also for the benefit of law firm partners and staff,[3] and we note that, for example, in 2014, 92 out of 126 respondents disagreed[4] with the reduction in minimum cover to £500k, yet the proposal remains on the agenda in this current Discussion Paper.

We are heartened, according to recent publicity quoting Paul Philip,[5] to be reminded that the Discussion Paper contained “absolutely no recommendations”, though note that “Over the last 12 months we’ve been trying to build evidence to make changes ... We have to justify regulation, not justify change." We have sought to argue below that, for protection of clients, partners and staff of law firms, the status quo, built up over decades of experience, does indeed perform the desired purpose.

For convenience in this response, we refer to "proposals", referring to changes raised or implied by a question in the Discussion Paper, whether or not these are yet formal proposals by the SRA.

Whilst it is commendable that the SRA shares its thoughts in the form of a Discussion Paper, some questions simply ask if those commenting have anything to add. Nevertheless we thought it best to set out our observations at length, rather than leaving them until detailed proposals are circulated, so that there is no misunderstanding about the CLLS's position.

The questions and answers are inter-related, and it is impossible to compartmentalise, so to the extent relevant, each answer should be considered as being applicable also to other questions.

Question 1:

Do you agree that the best model for professional indemnity insurance remains a regulated open market?

What problems do you see with the way the market currently operates?

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[2] The dates set out in paras 2.11 to 2.13 of the Call for Evidence were wrong by a year, so 2014 should have been 2015 and 2015 should have been 2016.
[3] See below.
[4] Those disagreeing included The Law Society and the CLLS as representative bodies.
[5] http://www.legalfutures.co.uk/latest-news/sra-hits-back-after-law-society-attack-on-indemnity-reforms

There are two elements to the first question, *open market*: The potential models (open market v master policy v industry self-insurance (aka mutual)) were reviewed by Charles River Associates (CRA) in 2010 and they concluded, for the reasons set out in para 4.9, that there is strong evidence that the open market model should be retained.[6] This conclusion was supported by a number of factors, including cost effectiveness and sharpening incentives for risk management. We agree.

On this latter point, large law firms began to organise themselves for risk management shortly after the beginning of the open market (if not before) and the trend has developed and is continuing. How each firm is organised varies, but large firms generally now have a Head of Risk or General Counsel and dedicated staff, who deal with new client/matter inception, engagement terms, insurance, claims, regulatory compliance, information security, operational and other risks on a full time basis. The risk management and compliance role is now established as part of proper governance and management of large law firms. That is unlikely to change, but one advantage of the open market is that as market requirements change, so the market encourages law firms to adapt in their risk management.

The question is in respect of a *regulated* open market. Unless all minimum requirements were to be abandoned, which we would not advocate, it is inevitable that the requirements are set down by the regulator and, to that extent, it is a regulated market.

The market generally works well at present for large firms because of competition among brokers, their expertise and market power, and competition among insurers, ensuring that premium levels are market tested. Premiums reflect both fee income and risk profiles (particularly claims history), so further incentivising firms in relation to risk management. We support the continuation of the open market model.

Insurers have the relevant expertise and information to price insurance arrangements appropriately. The open market also assists in incentivising good financial and risk management within firms. The profession has tried various other methods in the past without success. They tend to be inflexible and fail when there are significant and unforeseen changes in market conditions. SIMIA is perhaps the nearest equivalent to SIF, and it closed to new business some years after the open market started, with several large calls on members. SIMIA had veered from its business plan and significantly under-priced the cover it provided. In particular it failed to recognise that the working layer had crept up from £3m to £5m and beyond.

The key concern for the profession as a whole with the open market model is whether there are, and will continue to be, sufficient qualified insurers who are prepared to offer cover in the market, whether to large or small firms. The SRA should consider evidence on this point.

Question 2:

What are your overall views of the impact of the current financial protection regime in terms of the balance between the level of protection provided to consumers and the cost and regulatory burden on law firms?

We take "consumers" here to refer to clients of law firms in general, without distinguishing between vulnerable clients, individuals and commercial clients.

[6] In particular the CRA 2010 Report at 4.1.1 Figure 16 showed average premiums (though fluctuating form year to year) of about 3.0% during the SIFF years and about 1.4% during the open market years to 2008/09.

The scope of the cover is the envy of the legal world, being without limit on the number of claims, all civil claims (arising from the practice, excluding regular business liabilities) fraud of one insured not affecting protection for the other insureds, etc.

One preliminary point: the SRA says in the Discussion Paper, "In our May 2014 Policy Statement we stated that the purpose of our regulation is to:

- protect *consumers* of legal services; and

- support the operation of the rule of law and the proper administration of justice."

However, in addition, the SRA has a statutory duty under section 37 of the Solicitors Act 1974, in relation to professional indemnity, to have regard to the protection of solicitors and their staff.[7] Therefore, with respect, Question 2 - and also Question 3 - are incomplete, as both questions should also address protections necessary for solicitors and their staff (and impacts on solicitors and their staff).

To be clear, PI insurance not only protects clients of law firms, it also protects partners and staff of law firms by indemnifying them from damages and costs which would otherwise increase risk of law firm failure and personal bankruptcy.

The CRA report was for the whole profession, not just large firms, and showed a cost of premiums at around 1.4% of gross fees, compared with 2.2 % under the master policy and 3% under SIF. Then, and continuing today, the cost of premiums for large firms is (on average) considered to be somewhat less than the 1.4% from the CRA report. That is for levels of cover hugely in excess of the £3m minimum.[8]

In principle, we would support the idea of reducing the insurance costs (subject to a mandatory minimum cover level). However, the Discussion Paper adduces no evidence that any of the proposals would in fact attract cost reductions of any meaningful magnitude. If reducing the minimum insurance requirements has no meaningful effect on premiums, then the proposals (see below) to reduce the compulsory cover level and scope of cover could have only downside risk, without any upside for law firms and consumers alike.

The CLLS would welcome evidence-based proposals from the SRA, but believes the solicitor brand should not be placed at risk of harm, without well-grounded assurance that any changes will lead to worthwhile savings. We have a strong concern that one impact of the changes under discussion may be a significant increase in the incidence of coverage disputes and uninsured claims, and so undermine confidence in the profession.

Our member firms, while purchasers of PI insurance, do not have the industry knowledge to respond, other than anecdotally or on the basis of certain inferences as to the behaviour of the market in response to the proposed changes. Our responses to the Discussion Paper questions below must be read in light of these reservations.

As a Committee we are not aware of comparative costs of PI insurance in, say, the US for law firms or the UK for accountancy firms, as such information is commercially sensitive. Both those groups have different limits of cover, written on different terms (for example with aggregate limits), different scope and in some cases materially higher excesses, than for

[7] See HL judgment in *Swain v The Law Society* [1983] 1 AC 598, quoted in the TLS 2014 Response para 19.
[8] The minimum is £2m for general partnerships, but for brevity this paper generally refers only to the £3m for limited liability partnerships as that is far more common.

England and Wales solicitors. We therefore lack a comparable market against which to assess cost.

Over the 15 years of open market, some permitted insurers have become insolvent and some have withdrawn from the market, so profits are clearly not so great that everyone who enters the market wishes to stay. We have no knowledge as to whether the cost of insurance drives some law firms to close, but offer the comment that, absent special circumstances, if the market assesses premium at a very high level as a measure of the risk and the firm closes as a consequence, then maybe that is the right outcome to protect consumers.

The *regulatory burden* is, in fact, the "burden" of running a risk and compliance function to manage risks as expected by insurers, but also for good business reasons in any event, and/or there is a positive business benefit.

We do not consider the costs or the regulatory burdens to be disproportionate to the level of protection provided to clients, partners and staff, certainly not in the case of City law firms.[9]

Question 3:

What protections do you think are necessary for consumers?

What are the potential consumer impacts from changing the current arrangements?

See 2 above for the need to consider also the protections for solicitors and their staff and impacts on them of changes.

The current MTC have built up over years, drawing on experience during the SIF era, and no doubt also the time of the Master Policy. This is not a situation where we are setting up a regime and starting with a blank sheet. We are not aware of discontent within large law firms of the scope of the MTC or limits. We are not aware of any desire for change from our members.

It is impossible to identify what protection is "necessary" as a generic matter. A firm which is sued for £2.9m would say that cover of £3m (or more to cover the claimant's costs) is necessary, but a firm which only works on transactions valued at less than £1m would think it unnecessary at that level for its business. A firm which has 3 or more large claims in a year would consider the lack of an aggregate limit necessary, but a firm which believes its risk is one or two very high value claims *might* consider it better off with a high overall aggregate limit of indemnity rather than a lower "each and every claim" limit. A firm which has a rogue partner would say that the rule protecting innocent partners is necessary. And so on.

Lawyers work to high standards and their clients have high expectations of them.[10] Multi-national corporates increasingly request contractual indemnities in their Outside Counsel Terms to back up negligence liability and often refuse to accept a limitation of liability. Thus, clients at all levels expect recompense if a solicitor makes a mistake. The PI insurance for solicitors in the London market is part of "brand solicitor" and there are significant benefits to the profession from a strong solicitor brand. The SRA should have compelling evidence that changes will bring real net benefits to firms before making changes that risk reducing consumer protection.

[9] See The Law Society's Legal Compliance Bulletin, July 2015, page 15: "Unlike other branches of the profession, solicitors have huge buying power with annual premiums over £250m for primary cover. That, in turn, has brought us unrivalled breadth of cover. To throw that away for minimal savings would be foolhardy."
[10] See CRA Report 2010 para 2.4.1 quotation, sourced in footnote 22 to that report. And also see the judicial quotation in para 17 of the TLS 2014 Response.

A reduction in the current compulsory level of cover below £3m is unlikely to affect the level of cover available to, and purchased by, large commercial firms both for good business reasons and because our clients sometimes expressly demand it. It is possible that changes to the scope of cover under the MTC would not affect the scope of cover available to, and purchased by, large commercial firms. However, there is a real risk that reductions in scope could lead to insurers refusing wider cover than the revised MTC even at higher "unregulated" levels.

We do have concerns at the potential impact of changes because of the "claims made" basis of insurance.[11] Suppose in 2014 a firm limited its liability to £3m, being the limit of its insurance cover[12], that the minimum requirement is reduced to £500k on, say, 1 October 2017 and, with effect from that date, the firm's PI insurance is limited to that new cover level. If in January 2018 a substantial claim is made in respect of work done in 2014, the claim is contractually limited to £3m, but the available insurance is now only £500k. If the claim is significantly above £500k the firm may not be able to pay the claim with the consequence that the firm may fail, the client and partners will lose out financially, and staff will lose their employment. The same risk is inherent also in any reduction in scope. Unless a firm could be confident that its claims would never exceed £500,000, it would be well advised for the firm to continue to purchase PI insurance on the current (unchanged) MTC for at least six years[13] after the date at which any change in MTC takes effect, assuming such cover remained available, and to start to use the lower £500k limitation in engagement letters from the date of change. In that case any cost reductions, so far unquantified, would be postponed (or maybe tapered) for the six year delay.[14] That pre-supposes of course that, if the changes are made, the market would still make old style cover available at a price.

Even the above scenario is dependent on a contractual limitation as low as £500k being enforceable and not prohibited under the Unfair Contract Terms Act 1997[15] as being an unreasonable contract term. Given the price of houses, no law firm in London or the South East doing conveyancing would be well advised to rely on a limitation as low as £500k being found to be reasonable by a court, so should not limit insurance to that level. Equally, no law firm advising commercial clients should assume that a contractual provision, excluding all liability, would be upheld, so should not discontinue insurance cover for commercial clients. We return to this subject as relevant below.

The 2012 SRA annual report says: "Consumers of legal services in England and Wales are better protected than in comparable jurisdictions abroad. This certainly enhances the reputation and offering of solicitors, who will generally see it as a price worth paying for". It would be a pity to consign that statement to the past tense, without compelling evidence of a net benefit. The current system protects clients, partners and staff at a price that, whilst expensive, is affordable and commensurate with the protection afforded.

As we said in our response to the 2014 Consultation, the overall concern would be that the proposed changes would give rise to a number of uninsured claims, exposing clients to a greater insolvency risk than before, quite aside from damage to the reputation of the profession as a whole.

[11] The CRA 2010 Report recognised this in para 6.1.2, but without exploring the detail.
[12] If an LLP it is not permitted to limit to a lower amount.
[13] Figure 6 in para 2.4.1 of the CRA Report 2010 shows how 90% of claims are brought within four years of the cause of action, and it appears the number commenced more than six years after is only one or two percent. The data was form the 2008/09 year and comes out of the ARP, so may be dated and skewed to conveyancing. Instinctively we suspect that claims from commercial work may have a longer lead time.
[14] This is not exactly true, as this is effectively a form of "run off" cover, ancillary to the mainstream cover, as insurers risk decreases year on year as new work is covered by the £500k contractual limitation.
[15] As amended by the Consumer Rights Act 2015.

The consequences of reducing minimum cover limit, and narrowing the scope of cover, for smaller firms could be uninsured claims, failure to compensate clients for negligence, insolvency of the firm, bankruptcy of partners and disruption at the least for staff, intervention costs for the SRA and the profession as a whole and disruption for the firm's other clients. All of these are costly for clients, individuals and the profession as a whole (through SRA costs). The insurance market already prices these risks in a system which works well.

Relationship between PII and the Compensation Fund

Question 4:

Do you have views on the impact of removing compulsory requirements for insurance for more sophisticated clients in particular on the conveyancing market?

Some professional services providers seek to limit their liability to a multiple (e.g. two, three or four) of fees, though this can be the fees for a specific assignment or fees in a particular year. We doubt whether even sophisticated clients would accept that as a change from the present position; they certainly would not accept total exclusion of liability. The courts would decide whether any particular limit is reasonable in the circumstances. One factor they would take into account would be the availability of insurance, which in principle would continue to be available, not just a regulatory requirement. What is required for individual clients would also be a consideration, at least in the sophisticated clients' minds. So, whether the limit were £500k or even remained £3m, for individual clients, a well advised law firm would insure against claims from individual clients and sophisticated clients equally.

Alongside individual clients, the SRA envisages protection continuing for "small and medium sized micro-enterprises, trusts and charities".[16] There is the difficulty of striking the right balance as some individuals can have enormous wealth (for example, oligarchs) and some businesses (bigger than micro-enterprises) can be owned by one or more individuals who are not, in fact, sophisticated users of legal services and little more able to absorb unmerited losses than individuals. The "consumer"/"professional" distinction exists in professional services legislation and in respect of Office for Legal Complaints' jurisdiction.[17] There is a danger in adding to bureaucracy on client intake as law firms seek to categorise their clients[18] and an increased risk of coverage disputes with insurers in the event of a claim because of difficulties in identifying a certain definition for "sophisticated" clients.

The rationale CRA gave for relaxing minimum PI insurance provisions for sophisticated clients is "market failure" in respect of individuals, but not sophisticated clients. Whilst that might be an argument as between solicitors and their clients, it overlooks the SRA's duty to regulate also in the interests of partners and their staff.

This proposal, plus others, detracts from the comprehensive cover provided under MTC, and at today's £3m level, more closely aligns law firms with other sellers of services, able to insure or not, able to set low contractual limitations (presumably) and able to carry on business with some PI losses uninsured (so own risk), or set above a limit which could be at a lower level (or indeed with no insurance required) and/or outside a narrower scope of cover. So the burden (as well

[16] Query what is the key date for the assessment: start of the matter, the date of the negligent act or omission, date of discovery of it or date the claim is lodged – status of a client dependent on income of net assets can change over time.
[17] If the proposal were to come to fruition, the list given at para 6.1 of the CRA 2010 Report is reasonable, though one might argue that £1m is too low for a trustee of a trust if only by reference to house prices in the South East.
[18] Particularly difficult where there is a financial test: is income or are net assets as at last formal accounts, what if late in producing accounts; would a client's written confirmation be acceptable for such categorisation.

as the benefit) of regulation is reduced and law firms are thereby more closely absorbed into the wider commercial market of service providers. It should be borne in mind, however, that solicitors (admittedly like accountants, and now to a lesser extent, surveyors) predominantly carry on business as sole practitioners, partnerships or LLPs, and rarely as limited companies. There are two observations:

the UK taxation regime for partnerships and LLPs is transparent, as for sole practitioners.[19] Accordingly, profits arising under UK GAAP are taxable as income. The combination of UK GAAP and the taxation regime does not allow the build-up of general provisions or any working capital reserve. Accordingly, no "rainy day" reserve can be built up, except after tax and as partner capital. Even partners' capital, if built up out of annual profits, has to be from after-tax profits.[20] So law firms tend, with - we expect - few exceptions, to distribute to partners all profits earned each year.[21] To that extent, law firms are not as financially robust as general commercial enterprises (such as limited companies) to absorb uninsured losses; and

the Limited Liability Partnerships Act 2000 did not provide any answer to the question whether a member (partner) is personally liable for his own negligence in the course of the LLP's practice.[22] The arguments have been well debated academically, and the legal community is awaiting a case to decide the point. The likely answer is that any such liability would be founded upon the member having incurred a personal duty of care to the client alongside the LLP's contractual and tortious duty. As such it would depend on the circumstances of each case and, as such, it could go either way. Given the nature of legal services as compared with general commercial services, personal liability is more likely to be found for legal services. Accordingly, this is another difference from carrying on business as a limited company.

These are reasons for regulating law firms' insurance arrangements, which do not exist for commercial companies.

We agree that very large clients should, if interested, be capable of investigating their law firm's insurance limits and then assessing whether such limits are adequate for their (the clients') needs. The reality is that the large corporate clients to which the Discussion Paper refers are likely to expect higher insurance than the £3m limit in any event; thus removing the MTC cover for these clients will not remove or reduce insurance costs. The proposal on its own is unlikely to have any effect on City law firms who would continue to insure in respect of all clients without distinction.

For the firms that we represent, this would have no impact (assuming they are still able to obtain insurance in respect of their work for sophisticated clients on the same terms), as their insurance arrangements (typically) far exceed any regulatory requirements. Further, the firms that we represent would not, we expect, discriminate among their clients as to who was entitled to the cover. We can, however, envisage difficulties in how this information is presented to clients. Those outside this particular category (who, by definition, would be more sophisticated clients) are unlikely to be comfortable with their law firm having no PI insurance at all. In which case, we can see no merit in making the distinction.

However a further consequence could be an increase in uninsured claims.

[19] And tends to be so outside the UK also.
[20] Whilst the same accounting requirements apply to a limited company, and it pays corporation tax on its profits, dividends can be less than the total profit in a year, so undistributed profit can be built up year by year, with the members only paying income tax on the distributed profit.
[21] With either the partners paying income tax or the firm paying it on their behalf.
[22] Of course, sole practitioners and partners in a general partnership have this personal liability.

Would the Code be modified to permit firms acting for clients outside these categories to cap their liability without reference to such compulsory insurance? If so, the question then arises of the impact of the Unfair Contract Terms Act 1977 as to the reasonableness of any such limitation.

Question 5:

Do you have any further evidence or issues that we should consider in relation to client coverage for the MTC?

Conveyancing is an area of risk for solicitors and their clients, as evidenced by insurers' claims records, as is the holding of client money. Consideration could be given to giving law firms the voluntary option of carving out of their authorisation conveyancing and/or holding of client money, with insurers being encouraged to grant more favourable terms to such law firms because of lower risks. This could be a valuable concession to such firms and, for those who undertake limited conveyancing, an encouragement to give it up.[23]

The MTC contain provisions that are non-standard in the insurance market affording very good protection to all clients and third parties (for example regarding undertakings). Currently firms are able to obtain higher levels of insurance on terms that mirror the MTC. If those terms were not compulsory, there is a danger that insurers would not offer the equivalent level of protection for the higher levels. It would then be irrelevant how sophisticated the client is; those protections would be lost to it.

Removal of the MTC would potentially increase disputes regarding coverage, which at present are rare. This could greatly complicate claims management which would not be in the interests of the profession or consumers.

Sophisticated clients need currently only be concerned about the quantum of cover, not the scope. Removing the MTC could greatly increase the due diligence clients need to carry out on firms. This is the case in all fields, not just conveyancing. Given the difficulties in defining "sophistication" this may lead to situations in which some consumers are inappropriately having to carry out complex comparisons of insurance cover written on differing terms. Some consumers may not for example appreciate the difference between insurance written on a per claim basis and insurance written on an aggregate basis.

Aggregation limit

Question 6:

What are the issues that we should consider in relation to the imposition of an aggregate limit? Are there particular types of client more likely to be affected by such a limit?

For the purposes of this discussion, we will take 2x cover limit as the aggregate limit for any proposal as insurance provided on an aggregate basis is quite often coupled with one reinstatement. Similarly, for this discussion we will assume that the minimum cover limit remains £3m for all clients, and we will ignore additional insurance to raise the cover limit, even though that is something which all CLLS member firms do.

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[23] See CRA 2010 Report para 6.1.3. Conveyancing represents 50% of all claims and lender claims 50% of that. Consideration should also be given to law firms not representing both borrower and lender, though that could drive up overall costs for clients.

By way of background most other types of insurance (group life, travel and accident, employers', buildings and contents, third party etc.) have an aggregation limit. PI, and indeed, English solicitors' PI, is unusual in not having one.

Claims are influenced by type of work, experience of the lawyer for the type of work, expertise of the firm, commitment of the firm to risk management, culture of the firm in preserving reputation etc. However, there is always an element of randomness also, which can be analysed, but not controlled, by statistics. That is the lifeblood of the insurance industry in pricing risk.

By way of illustration, suppose a pair of dice are thrown six separate times each time period (year), so the scores range from 1 + 1 (say, non-material circumstance) through to 6 + 6 (say catastrophic claim, just below £3m, in which judgment goes against the firm), with gradations in between.

So, on the above illustration, with six throws of the dice in a period, the probability of a catastrophic claim (6 + 6) in any one period is:

$$P1 = 6\ x\ \left(\frac{1}{6} x \frac{1}{6}\right)$$

So, on *average*, 1 in 6, so over a number of years and over a number of firms, there will be one catastrophic claim in each 6 periods (years).

By the same logic, the probability of two catastrophic claims in a single period is the above times 1/6, so 1 in 36, so two catastrophic claims in a single period each 36 periods (years). On an accumulation limit of 2x the cover limit, the two claims get paid out and there is no threat to the firm.[24]

A threat would arise, however, if a third claim arose in the same period which the firm could not pay out of its own resources, say a throw which produces 4 + 4 or higher. The probability of that alone is ½x½, so the overall probability of a combination of three claims in a single period that exceed the 2x aggregation and leave the firm bankrupt and client not fully compensated is:

$$P3 = \left(\frac{1}{2} x \frac{1}{2}\right) x\ 6\ x\ \left(\frac{1}{6} x \frac{1}{6} x \frac{1}{6}\right)$$

That is one in 144, which on *average* means for a single firm once in 144 periods or for a single period means 1 firm in every 144 firms, or any combination.

Even assuming conformity to the average, for a single firm the combination may not happen until the 144th period, or may happen in the first period, or any time in between. With a profession of 10,000 practices, assuming conformity to average, 69 would suffer that fate every year.

The above illustration is both laboured to make a point and also a gross simplification. The question it leaves is, which is best: (a) each period the 69 practices leaving a claim partially unsatisfied and partners and staff at the least out of a job, with SRA intervention costs and inconvenienced other clients or (b) the firm paying the additional premium for a 3x aggregation in place of the 2x aggregation? 3x aggregation would leave 11 firms out of the 10,000 with an

[24] That is superficial, of course, as it ignores, so far, smaller claims and also the uncertainties waiting for the claims to settle. It also assumes that defence costs are settled outside the £3m cover limit.

uninsured material loss. One can take the example further to propose that 4x aggregation is better than 3x and so on; indeed no aggregation is the ultimate preference.

What would be the cost difference in premium, calculated on an actuarial basis, as between no aggregation and 2x aggregation. Insurance is all about risk transfer and loss spreading. At a simple level, 10,000 firms are paying slightly higher premium to save 69 firms from insolvency, by meeting client claims. Admittedly the figures and assumptions here are arbitrary, but the point is that, because the risk of exceeding even a 2x aggregation are small, the cost to insurers is relatively small and (they are big enough to take it either on their own or with re-insurance) the potential premium saving by introducing aggregation, where none now exists, would also be small. To do so in fulfilment of an aim of lesser regulation is putting regulatory theory over tested practicality and commerciality.

The introduction of an aggregate limit within the MTC would reduce the available cover because it is a once-only limit (sometimes with a single reinstatement) regardless of the number of claims which are made. Firms which buy lower levels of cover, perhaps relying solely on the MTC, would need to consider carefully whether this approach remained appropriate and would be at an increased risk of uninsured claims (including from consumers) because a higher than expected number of claims in the same year could lead to the limits being breached. It would be very damaging for the solicitor brand if valid claims were uninsured as a result. Although City law firms purchase cover far in excess of the MTC limits, they also benefit from the broader coverage provided through "per claim" limits which is then replicated in their excess layers of insurance. Therefore, with one exception (see paragraphs 6.12 and 7.6 below), the CLLS does not support the introduction of aggregate caps.

One group of City law firms may not be adverse to an aggregate limit for themselves. US headquartered law firms typically insure on the basis of an aggregate limit, with the exception of MTC cover for the compulsory £3m in London. For these firms the introduction of an aggregate limit under the London PI insurance would have little effect.

For completeness, two situations call for comment. The first is that in excess layers PI there is already aggregation in one respect. Excess layers insurers impose small multiple cover limit aggregation on claims in the US or Canadian courts, so a London headquartered law firm has similar exposure to aggregation of US claims as does a US headquartered law firm. This is as a result of market forces and insurers being wary of litigation costs and outcomes in the US with jury trials and punitive damage awards.

The second is aggregation inherent in the policy wording, where multiple claims are treated as one. The 2003 decision in *Lloyds TSB General Insurance Holdings Ltd v Lloyds Bank Group Insurance Ltd* resulted in the amendment of the MTC, but left many questions unanswered. We now have *AIG Europe Limited v OC320301 and Others* [2015] EWHC 2398, which on the facts interpreted the aggregation so as not to aggregate, though an appeal is possible.

The 2014 Consultation included the question "Do you agree that the introduction of a cap should be balanced by reducing the opportunity for claims to be added together to treat them as one claim?" As we said in our 2014 Response, "The question of aggregation of claims is a vexed one, given that insurers may swing between seeking to aggregate claims in one set of circumstances and to disaggregate them in another. We think legal certainty in this arena is highly desirable - whether by the courts or by agreement between the SRA and the insurers." If the minimum cover level is reduced then we strongly urge the SRA to bring clarity to this area through agreement with insurers and amendment to the MTC.

Reduction of the minimum compulsory cover

Question 7:

Do you have any further comments or evidence on the issue of minimum cover?

We note that the SRA is proposing to be better informed by data and analysis. That is clearly essential before any change is proposed.

Historically the minimum cover level has increased to reflect increasing personal injury claims and/or increasing house prices. Arguably, on the basis of house prices in the South East a further increase beyond the £2m for partnerships is now due, though perhaps not urgent if firms are either buying cover above £2m (LLPs are required to buy £3m anyway) or limiting their liability by contract to the level of insurance cover. If firms were divided into those that do conveyancing and those that do not, then a lower limit could be considered for those doing solely advocacy in non-commercial disputes.[25]

The CRA 2010 Report at para 6.6 Figure 30 shows claims incurred by value in the 2005/06 – 2007/08 policy years as at 2009.[26] Unfortunately for present purposes, CRA did not show £500k as a break point, but they did show 33% of claims incurred or provided for were over £1m, so concluded that there was no evidence to reduce the minimum level to £1m. It would be interesting to see how this sort of analysis may differ as between conveyancing and others and/or as between individuals[27] and others (deemed sophisticated).

What would be saved? In the SRA's Summary of Consultation Responses dated 1 August 2014 at para 3.9 Marsh are quoted as having advised that reduction of the cover level to £500k would save "from 5% to 15% although they are more likely to be at the lower end of the range". In principle, the minimum level of cover itself is irrelevant to the vast majority of City firms as they purchase a primary (working) layer above that anyway (perhaps £5m or £10m) and purchase excess layers above that, and in the case of the largest firms way above that. Insurers are not obliged to conform to MTC above the SRA's minimum cover level, but in practice do so in the continuing soft market. Reducing the minimum cover level potentially reduces the negotiating balance as between firms and their insurers, should insurers seek to depart from MTC above the primary level.

The SRA should also bear in mind that Outcome 1.8 of the SRA Code of Conduct currently prohibits firms from limiting liability below the minimum level of insurance required in the MTC. Any changes to the minimum insurance level, should dovetail with the restrictions for limiting liability to avoid an increase in the incidence of uninsured claims, and taking care regarding the lag of claims arising from past years.

There is one group of City law firms who might welcome changes to the MTC. Overseas headquartered law firms with a London branch[28] (perhaps headquartered in the US, but not necessarily) do not necessarily structure their insurance program around the MTC. These firms have significant global insurance programs written on an entirely different basis (including aggregate limits) which have been considered carefully and which otherwise comply with O(7.13) (see below). For these reasons such firms may well buy only the minimum MTC policy

[25] Conveyancing accounted for 50% by number of claims in indemnity year 2007/08 at para 2.4.5 Figure 9 of the CRA 2010 Report, now in need of updated claims data.
[26] Five years of more recent data would now be available.
[27] And non-individuals listed at para 6.1 of the CRA 2010 Report.
[28] It may strictly be a separate LLP.

of £3m for the sole reason of complying with the SRA Handbook, duplicating insurance costs for no perceivable benefit to the firm or its clients.

Deciding on the appropriate level of PI insurance is an art. Reducing the minimum permitted level will require a greater number of small firms, for whom £3m (or £2m) may be adequate, to make an assessment in the circumstance where a regulatory change has facilitated a saving (though possibly only a small saving) on premium. It is instructive to look at available guidance from the SRA.

With effect from 1 April 2015 a new Outcome was introduced in to the SRA Code of Conduct 2011 as follows:

"O (7.13) you assess and purchase the level of professional indemnity insurance cover that is appropriate for your current and past practice, taking into account potential levels of claim by your clients and others and any alternative arrangements you or your client may make."

The SRA's Guidance issued on 15 July 2015[29] lists 10 factors for firms to take into account. However, the position is somewhat more complicated (even under existing MTC) as additionally account should be taken of:

the retrospective, claims made, nature of PI cover - the level of cover needs to take account of work done in past years, as most claims arise from work done before the period of insurance;[30]

claimants' (as opposed currently to defence) costs, which are included in the limit of cover, and may be substantial and can eclipse the claim itself;

aggregation, under which multiple claims may be treated as one, so four £1m purchases of the flats for different buyers in the same block, which are found to have inadequate landlord repairing obligations, may be treated as one claim with one policy limit;[31] and

the risk of third party claims, such as a beneficiary claiming over a defective will drafted by a solicitor, where the size of the estate may have increased significantly between drafting of the will and death of the testator, perhaps through inheritance, a success in business, or increase in property values.

Run-off cover

Question 8:

What further issues should we consider in relation to run off cover?

This is a most difficult issue. Where there is no successor practice of a failed firm, then the run off premium is a huge burden on the partners, who will already have suffered loss of capital and loss of profits in respect of the final year or two.[32]

Law firm engagement terms do not typically impose a six year limitation, but rely on the statutory limitation periods.[33] Claims beyond six years from the cause are rare in England,

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[29] See http://sra.org.uk/solicitors/code-of-conduct/guidance/guidance/Professional-Indemnity-Insurance-cover.page

[30] 90% do, per CRA 2010 Report para 2.4.1 figure 6. So, if unlucky, in a single indemnity year a bunch of claims (or circumstances) can be notified arising from the previous six years.

[31] This is particularly relevant to Case Study 1: http://sra.org.uk/solicitors/code-of-conduct/guidance/case-study/professional-indemnity-insurance-cover.page

[32] This was an issue in the case of at least one failed US firm, with a UK LLP, several years ago.

according to CRA data, so pragmatically six years is a fair cut off.[34] However, the same data suggests that 40% of claims arise more than three years after the cause. Whilst not impossible to argue for a change, it has to be an argument that justifies leaving potentially 40% of claims un-remedied and/or expose individual partners to bankruptcy to the extent of personal liability. Of course, unless there is a material diminution in number of claims to be satisfied there would be no material reduction in premium.

It should be noted that the compulsory run off applies only at the minimum cover level and, following a cessation, clients, partners and staff remain unprotected above that level. Partners are most unlikely to be able to fund also a higher cover limit, even if available.

Question 9:

Do you have any views on whether the post six-year run-off cover provided by SIF should be extended beyond 30 September 2020, and if so, whether the extension should be for one or two years?

We do not have sufficient knowledge or expertise in this area to offer any comments.

Defence costs

Question 10:

What further issues and evidence should we consider in relation to the payment of defence costs?

We are not clear what the SRA may be considering here. Defence costs can be considerable, so it would weaken protections for clients, partners and staff if they had to be borne, without limit, by the insured firms themselves in cases where the value of the claim was dangerously near the limit of cover. Including defence costs in the limit of indemnity would erode the cover level, which would diminish the real value of a £3m, £2m, £500k policy. It could impact the delicate discussions between firms and their insurers and among partners on the merits of fighting or settling. Pursuant to O(7.13) firms would necessarily need to have regard to likely defence costs when deciding on the level of cover to buy and while possible it would add a further complicating factor into the mix.

Arrangements for firms to handle relatively small claims themselves and not reclaim costs from insurers would not seem to create difficulties, although such claims may be handled in-house, avoiding payment of any external indemnified defence costs.

Funding of the excess

Question 11:

What further issues and evidence should we consider in relation to funding of the excess?

We agree with what the SRA says.

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[33] For an international firm statutory limitation outside the UK are also relevant.
[34] See CRA 2010 Report para 2.4.1 Figure 6, though form 2008/09 indemnity year.

If the current requirement were to be changed then, as the SRA says, uninsured excess levels would have to be reviewed, but to be precise the SRA would need to set a level above which the insurer would be required to meet the claim, even if for other purposes the excess is greater.

Firms and insurers should be free to set excess payable levels. Currently it is the insurers, not clients, who are at risk, subject to the insurer's right of recovery from the insured firm.

Unpaid premium

Question 12:

What further issues and evidence should we consider in relation to the provision which prevents policies being repudiated for non-payment?

We agree with what the SRA says.

The aspect that perhaps gives insurers greatest concern is in relation to run off cover. This causes insurers to review the financial stability of firms, as well as claims history, which is no bad thing.

At present the risk of non-payment of premiums falls on insurers who are experienced and well able to assess the credit worthiness of firms at each renewal. If renewal is not possible by decisions or potential insurers then that is the market working, not any failure of the market. Clients, the vast majority of whom are ignorant of the point anyway, are protected from the date of renewal and do not need to be concerned.

Of course, it is not only current clients at renewal who are affected (plus new clients arising during the year) but also past clients who have not yet made a claim or triggered a notifiable circumstance. Given that the insurance works on the claims made basis, any change would be unfair on past clients who have relied on the current position under the MTC.

Question 13:

Do you have any evidence on the option of a hardship fund for run off cover premiums?

We have heard anecdotal accounts of there being sole practitioners who wish to retire, but cannot afford to do so. We do encourage the SRA to investigate what may be done to assist orderly retirement for such individuals.

Otherwise, we have nothing to add.

Avoidance, repudiation, adjustment and denial

Question 14:

What further issues or evidence should we take into account when considering the current provisions in MTC 4.1 and 4.2 restricting repudiation, avoidance, denial or reduction of liability?

The compulsory requirements and MTC are a package which has been developed in the market over a number of years, both in the open market and before that under SIF and Master Policy. The various provisions make the whole excellent cover for clients, while protecting partners and staff. MTC 4.1 and 4.2 are key parts of the whole. Unpick these somewhat technical seeming provisions, and the whole becomes less valuable.

These provisions should be retained in the MTC for all clients. They give everyone confidence that there will be insurance available to meet their claims. The MTC also give confidence that an insurer will conduct the defence of a claim, even where there is a coverage dispute, for example, as to which policy year, and there is provision for the first insurer notified to conduct the defence pending resolution. If these provisions were not compulsory, it is possible insurers would cease to offer them.

The MTC as a whole currently provide an excellent basis of cover that, in practice, can be extended to excess layers of insurance. This means cover disputes with insurers about properly notified claims are rare. For this reason, we urge caution on the SRA about making changes - and only recommend change when there is good evidence it will bring substantial financial or other regulatory benefits.

The MTC already exist and are working effectively, so any change is potentially detrimental, so protections of value should not be given away lightly.

Cover for partner fraud

Question 15:

What other factors should we take into account in considering the issue of cover for partner fraud?

The SRA's paper says that removal of this protection for innocent partners might provide better incentive for risk management, which presumably means on promotion or recruitment and on effective supervision. Even without that further incentive, the potential damage to reputation of a partner found to be fraudulent, or even accused of being fraudulent, is horrendous, so a real incentive exists already.

In any event there are limits to risk management; no procedures can guarantee that no frauds will be perpetrated.

A problem with PI claims is not only when liability is established, or a settlement is made, but at the earlier stage when it is threatened. A claim which, if proven, may bankrupt the firm can have serious consequences; this arises now principally if the claim as made is for above the cover limit. If the matters at present under discussion were to be implemented, difficulty would arise (even if there were a single claim alleging fraud) if the existing fraud rule were changed, with the result that fraud of even one partner vitiates the insurance. This could, in a worst case scenario, lead to business failure or forced rescue take-over even long before the claim, and alleged fraud, if made out. We cannot see how that benefits clients, partners or staff.

These provisions should be retained in the MTC for all consumers. They give everyone confidence that there will be insurance available to meet their claims subject to the minimum limits and the terms available for additional cover. If these provisions were not compulsory, it is possible insurers would cease to offer them including at higher levels.

Awards by the Legal Ombudsman

Question 16:

Are there any other arguments for or against the retention of cover for Ombudsman awards in the MTC?

Given the client profile of most CLLS firms, this is not an issue that is likely to impact their clients or the firms in any material respect. However, in terms of maintaining the solicitor brand, it is important that there should be some financial protection for vulnerable consumers who have pursued their complaint as far as the Ombudsman. Failure to make payment in respect of such an award would damage the solicitors profession as a whole. The MTC should continue to cover Ombudsman awards.

Removal of the extended policy period

Question 17:

Do you have any further evidence or comments in relation to the continuation of the extended policy period in particular its impact on the cost of insurance and of removing it from the MTC?

Given the client profile of most CLLS firms, this is not an issue that is likely impact their clients or the firms. However, in terms of maintaining the solicitor brand, it is understood that firms may not know what cover is available until the last day of the renewal period.[35] This is not a consequence of delay and lack of diligence on the part of firms or brokers, but is just a consequence of the way that the market plays out. We would therefore query whether putting the application in earlier would reduce the risks that a firm will find itself without insurance at the last minute. The SRA should obtain very clear evidence that this is the case before it removes the safety net of the EIP and CP.

Consumer information

Question 18:

Is there a case for a requirement to provide better information to clients about insurance cover and CF arrangements?

Large sophisticated clients already ask questions about our insurance cover and know what they want to know. We do not have any information/evidence on whether vulnerable clients require additional information in this area, how they might assess it if they did, and how they would weigh it if talking possible alternative firms.[36] The present minimum arguably provides a reasonable level of protection for basic high street work, so that vulnerable clients do not need to be concerned.

Question 19:

Do you have any evidence or examples from other professions or jurisdictions where providing this information is a requirement?

We have nothing to add.

Question 20:

[35] Though City firm's brokers would usually be able to confirm the position early in September.

[36] Too much information for vulnerable clients is unhelpful, and clients already have far too much to digest in client care letters, CFAs etc. If the claim is made after the end of the policy year in which the work is done, as will be the case in about 90% of cases, then the information is meaningless.

Are there any other changes to the insurance arrangements that we should consider for consultation?

See para 6.14 above regarding aggregation of claims, as any one claim covers a series of connected acts, though the interpretation is not entirely clear.[37] The desirability for clarification arises irrespective of possible introduction of a cap on insurer's liability.

MTC could usefully clarify that liabilities of COLP, COFA, MLRO, anti-bribery officer, complaints officer, data protection officer, insurance mediation officer, SRA organisation contact etc arising in performance of their duties, together with any fines and penalties imposed by disciplinary action, are covered by the insurance.

Options for changes to the Compensation Fund arrangements

Question 21:

Do you think there is evidence to support the introduction of a lower limit for the maximum award made from the Fund or to limit the types of payment made out of the Fund?

This clearly has the potential to affect vulnerable clients and so we would ask the SRA to carefully evaluate the evidence from others before determining where the appropriate balance lies as this could be detrimental to the solicitor brand.

Calculation of contributions to the Fund

Question 22:

Do you think there are fairer ways of calculation for firms and individuals contributions to the CF and what do you think are the pros and cons of the alternatives we have set out?

We very strongly object to a prohibition on solicitors holding client money, as previously represented to the SRA, though, as discussed above, authorisation that a firm will not hold client money could be a possibility and could permit them to making savings on the costs of PI insurance.

We agree that there is unlikely to be a viable methodology for predicting high and low risk firms for the purposes of determining contributions, other than where a firm does not hold client money, as above.

Charging contributions by reference to average client account balances may not otherwise give a fair or reasonable result. If contributions were by reference to overall average balances, CLLS firms might end up meeting a significantly higher proportion of the cost notwithstanding that the clients for whom the money is held have no recourse to the Fund. If contributions were determined by reference to average balances held only for clients who are eligible to make a claim, many CLLS firms may cease to be obliged to make any contribution at all. Assuming we agree with the principle that the entire profession should make some contribution to the Compensation Fund arrangements for the benefit of the solicitors brand, this would not be fair or reasonable.

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[37] This was consulted on in the first 2014 SRA Consultation.

The system of flat fees therefore appears to remain the most objectively justifiable and effective way to obtain the necessary funds.

Other models

Question 23:

Do you think there are areas where the Compensation Fund arrangements should be reformed in order to provide a better balance between the overall level of client financial protection for regulated legal services and the costs on firms and individuals?

The current arrangements appear to work reasonably well and we would not advocate changing them without good evidence that improvements would be obtained for either the profession or consumers.

Concluding remarks

We have read the response of The Law Society to the Discussion Paper; we agree with the substance of their remarks.

Finally, we make a plea that future consultations, or the like, should not run over the summer vacation period (unless extended on account of the timing), and most particularly any connected with PI should avoid the period June – September when those with most PI knowledge tend to be occupied with insurance renewal.

Yours faithfully

THE CITY OF LONDON LAW SOCIETY

Professional Rules and Regulation Committee

Individuals and firms represented on this Committee are as follows:

Sarah de Gay (Slaughter and May, Chair)

Roger Butterworth (Bird & Bird LLP)

Jonathan Kembery (Freshfields Bruckhaus Deringer LLP)

Clare Wilson (Herbert Smith LLP)

Chris Vigrass (Ashurst LLP)

Antoinette Jucker (Pinsent Masons LLP)

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