I INTRODUCTION

This article is part of a broader inquiry into the nature of the professions and professionalism in the 21st century. The inquiry explores whether the structures, practices, beliefs and expectations of professions could act as a regulatory strategy to improve the conduct of, and hence trust in, the institutions of finance.\(^1\)

Members of established professions who provide advice to their clients typically hold professional indemnity insurance (‘PI insurance’), either because it is mandatory or because they choose to do so (including to protect their assets against potential claims or to take advantage of statutory schemes for the limitation of liability). PI insurance indemnifies the adviser against certain liabilities arising out of the practice of his or her profession, including liability to compensate clients for professional failures. The development of PI insurance has mirrored the expansion, over the last 60 years, of legal liability for pure economic loss arising from defective advice.\(^2\)

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\(^2\) Two critical developments in Australia contributed to this expansion. The first is the decision of the High Court of Australia in Mutual Life & Citizens’ Assurance Co Ltd v Evatt (1968) 122 CLR 556 following the House of Lords in Hedley Byrne & Co Ltd v Heller & Partners Ltd [1964] AC 465, which made it clear that pure economic loss was recoverable in an action for negligence where there was no contract. The second is the enactment of statutory prohibitions against misleading or deceptive conduct with remedies including damages for economic loss, commencing with s 52 of the Trade Practices Act 1974 (Cth) and now found in s 18 of the Australian Consumer Law contained in sch 2 of the Competition and...
PI insurance is potentially relevant to the professionalism of the advisers who hold it in two ways. First, the terms on which PI insurance is offered and administered may operate as a form of private regulation of advisers’ conduct that is consistent with professional norms. Secondly, PI insurance may provide a level of protection for clients in the form of compensation for losses resulting from professional failures that is not wholly dependent on the financial resources of the individual adviser. This article tests those two propositions, by reference to the PI insurance held by lawyers and accountants in Australia.

For professional advisers, a requirement to hold PI insurance can arise under statute, as a requirement of membership of a professional body, or through a combination of both. The reasons for mandating PI insurance have public interest elements, encompassing both the protection of individual clients in the event of professional failure that results in a loss, and the creation and support of trust in the general body of professionals. 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.

Despite its ubiquity in the advice professions, the regulatory role of PI insurance ‘is a remarkably underexplored topic’. Similarly, the way in which it operates as a compensation mechanism is not always well understood. Our purpose is to advance the literature by considering how PI insurance works as a regulatory mechanism, and as a basis for providing access to compensation for clients in the event of professional failure, in the context of the advice professions in Australia. This is done through an examination of both the source and nature of the requirement for Australian lawyers and accountants to take out PI insurance, and of the kinds of cover typically provided. The purpose is to determine whether there is a relationship between PI insurance and the attributes of professionalism.

This article is structured as follows. Part II outlines the various requirements and incentives for professional advisers to hold PI insurance and highlights the

3 The courts have observed in many cases that requiring solicitors to hold PI insurance is primarily intended to protect the public who used solicitors’ services, rather than the interests of the profession itself: see Mark Cannon and Brendan McGurk, Professional Indemnity Insurance (Oxford University Press, 2nd ed, 2016) 2–3, and the cases cited therein.

4 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. The rationale for and operation of the professional standards legislation is discussed in Part II below.

relationship between government, the professional associations and the insurance industry in developing the scope of cover. Part III explains the distinctive nature of PI insurance, and describes some of the key features of the PI insurance arrangements currently in place for lawyers and accountants in Australia. Based on this discussion, Part IV offers some observations about the operation of PI insurance viewed as a mechanism for regulation and for compensation. Part V concludes that PI insurance does perform a regulatory function in Australia, but that function largely depends on the involvement of the professional associations and the roles they play, including under the professional standards schemes. As to compensation, PI insurance is not intended to ensure that clients will always receive compensation when their interaction with their professional adviser ends up in a loss. Instead, it reduces the risk that a compensable claim will not be met because of the adviser’s lack of financial resources.

II THE REQUIREMENT TO HOLD PI INSURANCE

All barristers and solicitors in private practice in Australia are required by law to hold appropriate PI insurance.\(^6\) While not required by legislation, most accountants must hold PI insurance under the rules of their professional associations.\(^7\)

In the case of both lawyers and accountants, the relevant professional associations are involved in determining the scope of cover, and the PI insurance is part of the broader framework of the professional standards schemes created under applicable legislation.\(^8\) 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’.\(^9\) 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’.\(^10\)

The involvement of the professional associations distinguishes PI insurance from other categories of occupational liability insurance for non-professionals, such as the insurance that is held by financial services licensees.\(^11\)

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6  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. It is interesting to compare the position of lawyers in the US where only a few states require legal professionals to hold PI insurance but others require disclosure of the insurance held. See also Baker and Swedloff, ‘Regulation by Liability Insurance’, above n 5.
7  See below n 16.
8  See above n 4.
10  Ibid.
It is worth observing at the outset that imposing a requirement on a profession or occupation to hold PI insurance is only possible if the insurance market is willing and able to provide cover on terms that are affordable and meet the cover specification. This involves a negotiation between the body imposing the requirement and insurers to shape the cover, unless that body is willing (and able) to provide part or all of the cover itself. In that negotiation the insurer’s own commercial judgment and interest is in play. In practice, professional associations or regulators may not be able to prescribe the cover they wish. Further, as market conditions change over time the specification may need to change – there is little point in specifying a cover that is not available and there is likely to be significant resistance if the premium is considered to be unaffordable.

The requirement for lawyers (other than in-house and government lawyers) to hold PI insurance in order to practise their profession is contained in relevant legislation regulating the legal profession in each state and territory. Tax practitioners (including tax agents, business activity statement (‘BAS’) agents and tax (financial) advisers) who apply for registration with the Tax Practitioners Board must by law maintain or be able to maintain PI insurance that meets the Board’s requirements. In contrast, the requirement for accountants to hold PI insurance is imposed contractually by the relevant professional association as a condition of membership of that association, typically when the member holds a public practice certificate issued by the relevant body.
In practice, the amount of cover required is linked to the monetary limits on liability created by the professional standards schemes. Where they are available, the schemes provide an additional incentive for members of associations covered by those schemes to hold PI insurance. This is because members must have enough insurance cover (or, in some cases, business assets) to cover their liability up to the monetary ceiling specified under the relevant scheme, in order to satisfy the requirements for limited liability under that legislation.

The monetary ceiling is set by the terms of each relevant scheme, and varies both between the different schemes, and within schemes by reference to factors such as the type of work undertaken, or the size of the practice by reference either to fees or practitioner numbers.

Each professional standards scheme relates to the members’ ‘occupational liability’, which is defined (with minor drafting variations) in the professional standards legislation as ‘civil liability arising (in tort, contract or otherwise) directly or vicariously from anything done or omitted by a member of an occupational association acting in the performance of his or her occupation’. However, the professional standards legislation is expressed not to apply to liability for damages arising from the death or personal injury to a person, a breach of trust, fraud, dishonesty, or to certain claims relating to defects in land titles.

The monetary ceilings specified in each scheme cap the members’ potential liability for damages arising out of a single claim. For this purpose, damages means:

- damages awarded in respect of a claim or counter-claim or by way of set-off;
- costs in or in relation to the proceedings ordered to be paid in connection with such an award (other than costs incurred in enforcing a judgment or incurred on an appeal made by a defendant); and

17Civil Law (Wrongs) Act 2002 (ACT) sch 4 s 4.2; Professional Standards Act 1994 (NSW) s 4; Professional Standards Act 2004 (NT) s 4; Professional Standards Act 2004 (Qld) sch 2; Professional Standards Act 2004 (SA) s 4; Professional Standards Act 2005 (Tas) s 4; Professional Standards Act 2003 (Vic) s 4; Professional Standards Act 1997 (WA) s 4.

18It is worth noting that the schemes may not provide comprehensive protection from liability in all cases for a range of reasons. They do not extend to some important areas of civil liability under Commonwealth law and there are potentially difficult issues in relation to claims involving multiple Australian jurisdictions. There are also questions as to whether courts outside Australia would give effect to the limitations created by the schemes.
any interest payable on the amount of those damages or costs.

The schemes covering the bar associations specify monetary ceilings of between $1.5 million and $2 million.\(^\text{19}\) The schemes for solicitors set different monetary ceilings by reference to firm size, ranging between $1.5 million and $10 million.\(^\text{20}\) These caps for lawyers are to be compared to the minimum levels of cover required by the legal profession statutes which range from $1.5 million to $2 million. As a consequence, membership of a scheme may require higher levels of cover for larger firms.

For accountants, the arrangements are different. For ATMA and IPA members, the monetary ceiling is $1 million;\(^\text{21}\) the schemes for CPA Australia and CA ANZ use much more complex and granular measures to determine the relevant monetary ceilings. In all cases, carve-outs exist with respect to the provision of services that require an Australian financial services licence – these do not receive the benefit of the scheme.

The scheme for CPA Australia differentiates between types of work (divided into Categories 1, 2 and 3) and between firm size.\(^\text{22}\) Category 1 work, which

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19 The limit is $1.5 million in some states: Bar Association of Queensland, *A Scheme under the Professional Standards Act 2004 (Qld)* (at 1 July 2013) cls 3.1, 3.8; South Australian Bar Association, *The South Australian Bar Association Inc Scheme* (at 1 January 2012) cls 1, 6.5; New South Wales Bar Association, *Third Bar Association Professional Standards Scheme* (at 1 July 2015) cl 3.1. In other states, the limit is $2 million: Victorian Bar, *The Victorian Bar Professional Standards Scheme* (at 1 July 2014) cl 4.1; Western Australian Bar Association, *The Western Australian Bar Association Scheme* (at 1 July 2014) cls 3.2–3.3.

20 In practices with 20 or fewer principals and total annual fee income of up to $10 million, the ceiling in Victoria, South Australia, Queensland and New South Wales is $1.5 million, and in these states for practices above either of these thresholds the ceiling is $10 million: Law Institute of Victoria, *Law Institute of Victoria Limited Scheme* (at 1 July 2016) cls 3.1, 3.3; Law Society of South Australia, *The Law Society of South Australia Professional Standards Scheme* (at 1 January 2012) cls 1, 6.1; Queensland Law Society, *The Queensland Law Society Professional Standards Scheme* (at 1 July 2016) cls 3.1, 3.3; Law Society of New South Wales, *The Law Society of New South Wales Scheme* (at 22 November 2012) cls 3.1, 3.4. Western Australia divides the profession into three tiers by reference to total annual fee income: up to $5 million in fees the ceiling is $1.5 million; between $5 million and $10 million it is $5 million, and above $10 million in fees the ceiling is $10 million: Law Society of Western Australia, *The Law Society of Western Australia Scheme* (at 1 July 2014) cls 3.1, 3.3.

21 Association of Taxation and Management Accountants, *The ATMA Scheme* (at 1 January 2013) cl 3.3; Institute of Public Accountants, *The Institute of Public Accountants Professional Standards Scheme* (at 1 January 2013) cl 3.3.

22 CPA Australia divides firms into three tiers: those with fewer than 20 principals and total annual fee income of less than $10 million, those between 20 and 60 principals or between $10 million and $20 million in fees, and those above either of those thresholds: CPA Australia, *The CPA Australia Limited Professional Standards Scheme* (at 9 January 2014) cls 3.3, 3.5, 3.7 (`CPA Professional Standards Scheme`). It also divides the work done into three categories. Category 1 comprises:

(a) all services required by Australian law to be provided only by a registered company auditor;
(b) all other services provided by a registered company auditor in his or her capacity as auditor; and
(c) all services the deliverables from which:
(i) will be used in determining the nature, timing and extent of audit procedures in the context of an audit of a financial report; or
(ii) will be incorporated into the financial report of an entity; or
(iii) are required by law or regulation to be filed with a regulator (excluding returns signed by a registered tax agent): at cl 4.1.
includes audit and audit-type work, attracts limits of between $2 million and $75 million depending on firm size; limits for Category 2 and 3 work are between $2 million and $20 million. The scheme for CA ANZ also differentiates between services but fixes the monetary ceiling by reference to the fee payable for the particular service rather than the firm’s total annual fee income. Category 1 services may attract a monetary ceiling of between $2 million and $75 million.23 For Category 2 and 3 work, there are four separate ceilings, ranging between $2 million and $20 million.24

23 See Chartered Accountants Australia and New Zealand, Professional Standards Scheme (NSW) (at 4 January 2016) cl 4.1 (‘CA ANZ Professional Standards Scheme’). This category includes:

(i) all Corporations Act audits or reviews performed under auditing or assurance standards issued by the Auditing and Assurance Standards Board (including financial statement audits and reviews, Australian financial services licence audits, credit licence audits, and compliance plan audits);
(ii) all audits or reviews performed by a registered company auditor for the purposes of prudential reporting to the Australian Prudential Regulation Authority;
(iii) all audits of self-managed superannuation funds under s 35C of the Superannuation Industry (Supervision) Act 1993 (Cth); and
(iv) all other audits of financial statements which are filed with a regulator, and audit procedures performed on financial information which forms part of a financial statement filed with a regulator.

The monetary ceilings for Category 1 work range from $2 million where the claim arises from a service in respect of which the fee is less than $100 000, to $75 million for a service with a fee exceeding $2.5 million, with six different monetary ceilings in that range. The six levels are: up to $100 000 fee ($2 million ceiling); up to $300 000 fee ($5 million ceiling); up to $500 000 fee ($10 million ceiling); up to $1 million fee ($20 million ceiling); up to $2.5 million fee ($50 million ceiling); and above $2.5 million fee ($75 million ceiling): at cl 3.3.

24 Under the CA ANZ Professional Standards Scheme cl 4.1, Category 2 services include:

(i) services to which Chapter 5 or Chapter 5A of the Corporations Act applies;
(ii) services provided pursuant to s 233(2) of the Corporations Act;
(iii) services to which the Bankruptcy Act 1966 (Cth) applies; and
(iv) services arising out of any court appointed liquidation or receivership.

Category 3 services are: ‘any services provided by a Participant in the performance of his, her or its occupation, which are not Category 1 services or Category 2 services’. The monetary ceilings for Category 2 and 3 work range from $2 million when the relevant fee is less than $100 000 to $20 million where the relevant fee is $500 000 or more: at cls 3.5, 3.7. The four levels are: up to $100 000 fee ($2 million ceiling); up to $300 000 fee ($5 million ceiling); up to $500 000 fee ($10 million ceiling); and above $500 000 fee ($20 million ceiling).
III THE DISTINCTIVE NATURE OF PI INSURANCE

From an insurer’s perspective, there are clear differences in the type of risk associated with first party insurance (insurance of the insured’s own property), and liability insurance and more particularly liability insurance of a professional adviser. This will influence the insurer in the decision to offer these products, the terms of cover and the price.

In the first type of cover, many of the insured losses arise from events that are not within the control of the insured, such as weather events and losses arising from the acts of others. In contrast, liability insurance insures the insured in respect of legal liability to another person arising from the act or omission of the insured itself (or its employees and agents). This exacerbates the moral hazard associated with the insurance, because the risk insured is largely related to the policyholder’s own skill, business systems and behaviour and not the behaviour of others or external events.

Another important difference between the types of insurance and the nature of the risks insured is the nature of the claims. For example, a cause of action for economic loss caused by defective advice may not arise until the claimant actually suffers damage. This has the consequence that there may be a long lead time between the wrongful act (advice) and a third party claim. Also, the claims may take a considerable time to resolve – in insurance parlance this is known as a ‘long tail’. Thirdly, the complexity of the claims may make estimation of the outcome and recoverable loss very uncertain. These characteristics will be uppermost in the mind of the insurer and underpin the design of cover, including its boundaries and policy features.

25 Although there may be incentives for insureds to cause a loss (for example, through arson) there are well-established methods to mitigate this risk, such as the indemnity principle under which the insured can only recover its loss and cannot achieve windfall gains.

26 Moral hazard describes the risk to insurers that insureds will change their behaviour once they have insurance, either by taking less care or incurring larger losses than they would have if they were uninsured. There seems to be no comprehensive study of the behaviour of advisers who hold or do not hold liability insurance although some authors have circled this issue without directly dealing with it: Richard V Ericson, Aaron Doyle and Dean Barry, *Insurance as Governance* (University of Toronto Press, 2003). Recent American literature seems to be asserting that steps to reduce moral hazard result in positive changes of behaviour but the underlying evidence is not that clear: see Omri Ben-Shahar and Kyle D Logue, ‘Outsourcing Regulation: How Insurance Reduces Moral Hazard’ (2012) 111 *Michigan Law Review* 197.

27 Carol Heimer describes these different risks as fixed risks and reactive risks in her ground-breaking study of how insurers deal with reactive risks: see Carol A Heimer, *Reactive Risk and Rational Action: Managing Moral Hazard in Insurance Contracts* (University of California Press, 1985). See especially at 11, where she identifies four key principles that inform insurers’ strategies for the management of reactive risk. These are then explored by reference to fire, marine and fidelity insurances. These ideas have been taken up and further explored by Baker and his colleagues in more recent times: see generally Tom Baker and Kyle D Logue, *Insurance Law and Policy: Cases, Materials and Problems* (Walters Kluwer Law & Business, 3rd ed, 2013).
**A Boundaries of the Cover**

PI insurance indemnifies the insured for legal liability to a third party (client or non-client) who suffers loss or damage arising from the provision of professional services.\(^{28}\) In this sense it is described as a third party cover but typically it also provides cover to the insured for the costs of investigation and defence of claims. This aspect may be described as a first party cover but it is directly related to the principal cover and usually only triggered by a covered claim.\(^{29}\) In the advice professions, the focus of the cover is on economic loss arising from defective advice or other errors in the provision of the particular professional services specified in the policy.\(^{30}\) Other forms of PI insurance will be tailored to the risks of the professional group covered.\(^{31}\)

Typical PI insurance may include optional extensions of cover for a range of matters including:\(^{32}\)

- regulatory investigations*;
- defamation;
- loss of documents (usually where it gives rise to a claim);
- liability determined by a self-regulatory dispute settlement body;
- public relations cover*;
- run-off cover (often on payment of an additional premium);
- fidelity cover (fraud or embezzlement).

Those asterisked are also first party covers.

There can be boundary issues in determining what activities are covered by a policy. For example the current Lawcover Insurance Pty Ltd (‘Lawcover’) PI Policy\(^{33}\) covers civil liability arising from the provision of ‘legal services’ and so the scope of cover will be defined by what constitutes a legal service. The term is defined to mean work done or business transacted ‘in the ordinary course of carrying on the business of a lawyer in private practice in Australia’.\(^{34}\) The focus

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\(^{29}\) Some sophisticated policies may provide cover for responding to regulatory investigations in circumstances where there is no claim for a loss against the insured.

\(^{30}\) PI insurance for advisers typically excludes any liability for loss or damage to property, personal injury or death. This distinguishes it from a general or public liability insurance, which covers these losses. These general liability policies usually exclude claims for economic loss arising from professional or advisory activities. PI insurance may also exclude liability of an insured arising directly or indirectly from or in respect of the insured’s functions and duties as a director or officer of a corporation: see, eg, Vero Insurance, ‘Civil Liability Professional Indemnity Insurance Policy’ (Policy No V9902, 1 October 2015) cl 9.2.3.

\(^{31}\) Medical malpractice insurance will cover death and personal injury whether from advice or treatment by the medical practitioner. PI insurances for engineers, architects and the like may also extend the cover to loss or damage to property or death and personal injury.


\(^{34}\) Ibid cl 43(j).
on ‘work and business’ in modern policies avoids some of the difficulties created by earlier approaches to determining what was covered, which depended on whether the activity giving rise to the claim was strictly ‘professional’.35

B Claims Made Insurance

In order to alleviate the uncertainty of the ultimate liability, 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.

For insurers, the claims made technique assists in resolving uncertainty about which in a series of annual policies, responds to a particular claim. This is especially relevant in relation to advisory services where it can be difficult to identify the occurrence that is the proximate cause of the claim (it is often a series of missteps over a period of time). It also manages the insurance risk for the insurer. As originally conceived, this approach allowed the insurer to know at the end of a policy period what claims had in fact been incurred. It reduces the problems of estimating claims or prospective claims by third parties which may have occurred (been incurred in fact) but which are not known to the insured or insurer.

These strategies are affected by 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: first, rights to notify facts and circumstances that may give rise to a claim in the policy period so to engage the cover in respect of a future claim;36 and secondly, the capacity to notify claims after the end of the policy period.37

Although there are strong incentives for insureds to notify facts and circumstances that may give rise to an insurance claim to lock in cover, there is still a view within the business community that early notification is to be avoided. This may be prompted by a concern that this will lead to adverse action by the insurer, for example, by increasing the premium or refusing to renew the cover. From a compensation perspective, early notification locking in the cover is obviously advantageous but it requires action by the insured and the claimant has no control over this.

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35 This alternate approach can lead to difficult questions. An example of the difficulty raised by the alternative approach is that faced by a US court, which held that billing activities involving overcharging were outside the scope of the policy, as they did not involve the application of professional skill: Medical Records Associates v American Empire Surplus Lines Insurance Co, 142 F 3d 512 (1st Cir, 1998). There are many other cases that have struggled with what is included in professional activities in the context of the scope of cover: see Ian Enright and Robert Merkin, Sutton on Insurance Law (Thomson Reuters, 4th ed, 2015) vol 2, 954–60 [23.1490]–[23.1530].
36 Insurance Contracts Act 1984 (Cth) s 40 (‘IC Act’) provides for this.
37 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.
The fact that PI insurance is structured this way impacts the compensation objective. The capacity of PI insurance to operate effectively as a compensation mechanism is also undermined if the PI insurance is not maintained and is not in place when a third party brings a claim (assuming no prior notification of facts and circumstances has been made). This demonstrates the need for cover to be maintained even if the insured ceases business. This is why, under many of the arrangements organised by professional associations discussed below, there is automatic run-off cover at least for the compulsory component of the cover.

The ‘claims made and notified’ design of PI insurance policies is a relevant consideration for an insured and ultimately for the third party with a claim against an insured arising from defective advice. Reluctance on the part of an insured to notify facts and circumstances may impact on the effectiveness of the cover and its efficacy as a compensation mechanism. There is potential for better education around this process and even perhaps requirements that the insurer will not act in a manner adverse to the insured on the basis of a mere notification (as opposed to an actual claim) on a future renewal (or at least clarity as to the range of things an insurer may do if there is a notification). All of this adds uncertainty for a third party claimant against the insured in knowing whether insurance may cover the claim.38

C Terms of Cover in the Australian Market

This section discusses the terms of cover for PI insurance currently available to lawyers and accountants in Australia who are members of the various lawyers’ and accountants’ professional associations in Australia that have in place a professional standards scheme.39

In addition to prescribing minimum levels of cover, the requirements in the various statutes, rules and by-laws applying to these professions typically specify at least some of the features of the cover by reference to the scope of the cover; the identity of the insurer; the maximum excess; a minimum of automatic reinstatements for each policy period; and run-off cover. Here the tension between the choices of the insurer (directed at managing their risk), the insured (often concerned to minimise their premium) and the broader goals of those imposing the requirement to hold PI insurance (directed at the twin and sometimes conflicting goals of regulation and compensation) are readily apparent. As noted above, this requires a negotiation between the parties directed at achieving cover that meets their respective goals.40

38 Compare the certainty of a motor accident victim injured by a car on a public road – the personal injury motor scheme or policy will provide cover except in most unusual circumstances. This is discussed further below.
39 These are: for accountants, CA ANZ, CPA Australia, ATMA and the IPA; and for lawyers, the BAQ, the NSW Bar, the SA Bar, the Vic Bar, the WABA, the Law Institute of Victoria, the Law Society of New South Wales, the Queensland Law Society, the Law Society of South Australia, the Law Society of Western Australia. This is not the case for Tasmania or the ACT.
40 Even if the cover is being provided by a captive insurer (that is, an insurer owned or operated by a professional group that only provides insurance to that group), that insurer must manage its business to meet applicable prudential and other standards.
Under the professional standards legislation, the adequacy of PI insurance available to members of a scheme is a matter for the Professional Standards Councils (‘PSC’) to consider in deciding whether to approve a scheme. The required policy features are determined by the professional association, not the PSC itself, but the PSC pays special attention to three particular areas in deciding whether the proposed PI insurance arrangements are adequate for its purposes in approving a scheme:

The first is the ability of the insurer to financially respond to and meet a claim under the policy of insurance … The second is the terms on which the cover is to be granted … The third is the question whether the standards require the policy of insurance to be defence costs-inclusive of, or defence costs in addition to, the limit of cover.\(^{41}\)

These matters all go to the efficacy of the PI insurance cover in addressing regulatory and compensatory concerns in the public interest.

In specifying the required policy features, the professional associations take a range of approaches. Detailed terms and conditions of the policy or a standard policy wording may be prescribed. The terms and conditions may need to meet certain minimum criteria, for example, minimum level of cover, maximum deductible, and that the policy cover contains or does not contain certain provisions. There may be a requirement that the policy is issued by one or more specified insurers,\(^ {42}\) or an insurer who is regulated in a particular way (eg, authorised or regulated by the Australian Prudential Regulation Authority), or which holds a minimum rating from a rating agency. In each case there may be arrangements for exemptions or variations of the specified cover.

In its comprehensive annual review of PI insurance available to accountants in Australia, CA ANZ notes that ‘there is no “standard” accountants [sic] PI insurance policy form, but they do have a similar structure. Within that structure, there is significant variation in the individual provisions from one policy to another’.\(^ {43}\) Important differences can relate to: firstly, compulsion, adverse selection and price; and secondly, deductibles, limits and claim definitions.\(^ {44}\)

1 Compulsion, Adverse Selection and Price

None of the arrangements for lawyers and accountants include any specific requirement that insurers must provide cover when it is sought. However, this seems to be the practice or expectation in a number of arrangements, especially


\(^{42}\) This tends to only occur in statutory requirements (eg, in motor accidents or workers compensation legislation where the insurance may only be held with a separately licensed insurer) as otherwise there may be a contravention of the exclusive dealing provisions of the CC Act s 47.


where a professional association is closely related to the insurer or where it
arranges cover for the members of the association (in the latter case the
arrangement may only be for the period of the arrangement between the body and
the selected insurer or insurers). These arrangements between the professional
body and the insurer may also encompass the pricing and scope of cover. The
expectation or arrangement also often operates so that the insurer will not decline
cover and must provide it at the standard price or some explicit variation from the
standard price. There may a limited ability to vary the terms of cover for different
risks.

There are important consequences arising from compulsion for the insurer
and the insured particularly where a single insurer or a limited group of insurers
is specified. The first is that it removes or reduces the potential for adverse
selection, that is, those with little risk (or who believe they have little risk of a
claim) are not able to choose to go bare, reducing the premium pool and driving
up the cost of the cover for those who insure and may have higher risks. The
second is that it permits pricing that involves some cross-subsidy between
insureds and reduces the need to carefully price the individual risk associated
with each insured.

This is reflected in several of the arrangements discussed above, where there
is a common pricing model based on gross fee income or the number of
principals with little variation for individual risk. In fact in a number of cases, no
duty of disclosure notice is given in respect of the compulsory cover with the
effect that the insurer is unable to refuse or reduce a claim due to misleading
information from the insured unless there is fraud.45

The denial of cover by an insurer is obviously a very important part of their
ability to manage risk. However if an insurer could deny cover to riskier
professionals this would run counter to the public interest reasons for mandating
PI insurance, identified above. In those cases, such as with the law societies,
where arrangements are in place between a professional association and a
particular insurer or insurers, it seems that insurers are more willing to provide
cover to all those professionals who qualify for membership of the relevant
professional association. In other words, the ‘gatekeeper’ function sometimes
ascribed to an insurer’s decision to refuse cover is in fact being performed by the
professional association and not the insurer.

2 Deductibles, Limits and Claim Definition

The deductible (or excess) is the first part of a claim that remains the
responsibility of the insured. Ensuring that at least some of the loss sits with the
insured is one of the means by which insurers address the moral hazard created
by the policy. As we have already observed it also affects the compensation
objective, if the deductible is more than the insured has the capacity to pay.46

45 For example, the Lawcover and Legal Practitioners’ Liability Committee compulsory policies: Lawcover
Insurance, above n 33; Legal Practitioners’ Liability Committee, ‘Contract of Professional Indemnity

46 Most of the accounting associations specify a maximum excess. For example, the ATMA By-Laws
required a maximum excess for each and every claim that is no more than 3 per cent of the gross fee
Most policies define a claim widely to include any threat or intimation of a claim against the insured for loss or damage as well as include more formal action such as a letter of demand or the service of process. This wide definition provides an early trigger for notification to the insurer and sets the date as to which policy will respond.

A key question for the operation of the policy is what amounts to a single claim. This is because classifying a particular matter as a single claim has important consequences for how many deductibles are payable and how the limit of cover will operate. In 2003, the Judicial Committee of the House of Lords was confronted with the question in relation to a series of identical claims by clients against a bank for advice in connection with the sale of financial products. The defective advice was based on a system of selling that had been used to train the individual advisers and in that sense there was a common underlying cause of the loss. However the court looked at what constituted the cause of action available to each third party and so concluded that there was a separate claim under the policy each time the advice was given. As a result the financial institution was required to pay the deductible in respect of each individual claim, and because the value of many of the claims were under the deductible they were not covered at all. This was so despite the fact that in aggregate the claims below the deductible involved a very large amount of money.

The ‘claims aggregation’ clause in these policies is critical in determining how much cover an insured may require and depends on the nature of the advisory business. A wide aggregation clause may appear to assist the insured in limiting the number of deductibles but it may operate as a device to limit the maximum exposure of an insurer.

In lawyers’ PI insurance with ‘each and every claim’ cover (and with an aggregate limit on each claim but no aggregate limit on the accumulation of all claims), the claims aggregation clauses are usually very wide so that although the number of deductibles is reduced there is only one limit for all the separate

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An unlimited number of limits are available in an each and every claim policy, that is, one that provides a limit applicable to each single claim whether or not there is an aggregate limit in respect of the total amount available under the policy in a policy period. Lawyers’ PI insurance policies typically operate on the basis that there is a separate limit, say $2 million, for each claim under the policy so if there are five claims, each will have the full $2 million available with no aggregate by reference to the number of claims. In other professional policies an aggregate limit regardless of the number of claims is the usual practice.

Lloyds TSB General Insurance Holdings Ltd v Lloyds Bank Group Insurance Co Ltd [2003] 4 All ER 43.

Ibid 51 [29] (Lord Hoffmann).

causes of action aggregated as a single claim under the policy. In the accountants’ policies providing an aggregate limit there are narrow claims aggregation clauses. This part of the structure of the policy can have wideranging consequences if PI insurance is intended to operate as a compensation tool. In some cases it is possible to acquire cover under which a maximum number of deductibles will apply.

In the policies providing an aggregate limit there is another relevant factor: these policies provide for one reinstatement of the limit where the original limit is exceeded. However, a reinstatement does not equate to each and every claim cover. This is because the claim that goes over the initial aggregate is not covered by the reinstatement – it is only the next claim that is so covered.51

From a regulatory and compensatory perspective these structural issues can significantly affect the cost of cover and the effect of the cover as a compensation mechanism. If the professional is potentially exposed to a series of claims arising from some common error and the policy aggregates those claims there is likely to be a significant adverse impact on the availability of funds for compensation. Where the cover is on an aggregate basis with a narrow claims aggregation provision the insured may need to meet a number of deductibles out of their own resources and there is a fairly uncontrolled and uncontrollable risk52 that the claim that breaks through the aggregate limit may impose a high cost on the insured. Using top-up insurance (that is, additional layers of insurance that sit above the base cover) is unlikely to resolve the issue as top-up insurance typically follows the form of the underlying cover with the consequence that this aggregation of claims will also impact on it.

51 Association of Taxation and Management Accountants, ‘ATMA Limitation of Liability Scheme’ (Information Sheet, 22 November 2012) 5. The issue is explained by ATMA in the following terms:

Clause 1.1 of the ATMA [professional standards] Scheme limits the occupational liability of a Scheme Member for damages arising from a ‘single cause of action’ to $1 million. Most professional indemnity policies have a broad aggregation provision which means that a series of related acts or omissions or a series of related matters or transactions will be regarded as ‘one loss’ under the Policy. This means that the policy limit of $1 million applies to ‘one loss’ which could include a number of different causes of action and be based on a number of different acts or omissions. Scheme Members should note that:

- Claims by a number of persons who have a joint interest in a cause of action are treated as a ‘single claim’ for the purposes of the Act, despite the fact that they may also have several interests; and
- Two or more claims by the same person arising out of a single event against Scheme Members and who are associated persons (that is partners or employees of the same employer or are employer and employee) are to be treated as a single claim for the purposes of the Act.
- While we are not aware of any decided case in which an occupational liability scheme has been tested in court, there is an incongruity between the Scheme and most professional indemnity policies, so a policy may treat multiple causes of action differently from the Scheme and aggregate more than one claim as ‘one loss’. While the Scheme might limit liability to $1 000 000 for each cause of action, the policy might only cover one such loss and not all. Fortunately, most insurance policies … provide for at least one reinstatement of the sum insured (this means that once the cover of $1 000 000 has been exhausted, at least one further cover of $1 000 000 is available during the policy year) (emphasis in original).

52 It may simply depend on the order in which the claims are settled and paid. Third party claimants may not realise the effect of a ‘first-in first-served principle’ and the consequences of being the claimant with the claim that actually goes through the aggregate limit.
D Risk Management and the Feedback Loop

An important feature of PI insurance held by professional advisers in Australia is the existence of formal and informal feedback loops between insurers and insureds about risk and risk management in the insureds’ professional and businesses practices.

One of the key ways in which PI insurance is said to operate as a form of regulation is through insurers adjusting the terms on which they offer cover in order to reduce their risk. This can be done in a number of ways; for example the insurer may decline to provide cover in particular situations (such as the decision by US insurers not to provide cover to lawyers providing advice in situations of conflict, discussed below) or by adjusting the premium to reward steps taken by insureds to reduce their risk. Baker and Logue argue that insurers are better placed to do this than government, because of the unique access they have to claims information over time. This allows insurers to identify risks in practice that are associated with a higher frequency of claims.

In Australia, the lawyers’ and accountants’ professional associations and (in the case of lawyers) affiliated insurers play an important part in creating this feedback loop. Information about risks is collected on a profession-wide basis and used to create risk management strategies and programs for the benefit of members. The intention is to improve professional practice and reduce the risk that clients will suffer loss. The feedback loop is a central feature of the professional standards schemes created under the professional standards legislation discussed above. Under each scheme, the relevant professional association is required to collect comprehensive data about the claims experience of its members and report that information annually to the PSC. This report takes the form of an ‘Annual Report on Professional Standards Improvement Program’ (formerly known as ‘Annual Risk Management Reports’).

A reporting template is provided by the PSC; typically it requires the association to report on actions, policies and decisions in each of the following areas:

- continuing professional development programs
- complaints handling and disciplinary systems
- use of the disclosure statement
- risk management reporting
- insurance cover, claims and business assets monitoring
- annual audit of members.

The fact that associations are required to collect and report information on claims experience within the profession provides an important means for associations (either alone or with the relevant insurers) to improve risk

53 Baker and Logue, above n 27, 7–8.
56 Ibid.
management in the profession. Associations are required to monitor whether members have adequate insurance cover on an ongoing basis and to collect and report on insurance claims data and business assets. The PSC’s guidance to associations includes that they should report on:

- the number, amount and nature of claims made against your members
- the costs and availability of professional indemnity insurance
- the anticipated cost and availability of insurance to your members in future.57

One observation of a number of the PI insurance arrangements is that where there is a close connection between the relevant professional body and the insurer or insurers there is more active feedback to the professional groups on risk management and the causes of claims. For example, Lawcover provides premium discounts for meeting certain risk management requirements.58 These risk management requirements are informed by their claims analysis and the publication of information on a regular basis – this alerts members to take particular care in certain areas. The other legal professional associations take a similar approach. In 2015, Lawcover commented on the underlying causes of claims:

Of the claims made against solicitors in the last financial year, 45% were due to failure in communication between the solicitor and client. In a further 32% of claims, documentation errors and failure in the law practice’s systems were identified as the causes. More than three in four claims were therefore attributable to communication, documentation and systems problems.59

This accords with information from other insurers on the underlying causes of claims and provides extremely important feedback for the individual professional and for the formulation of risk management programs.

It appears that the discounts given for risk management are clearly related to the actual claims experience of the professional group.60

IV OBSERVATIONS

A Insurance as Regulation

Requirements imposed by statute or by professional associations to hold PI insurance as a condition of practising a particular profession are clearly regulatory in character, because a person who is refused cover is thereby precluded from practising that profession or joining the professional body.

57 Ibid.
59 Malcolm Heath, ‘Claims: Understanding the Cause of the Cause’ [2015] (December) Lawcovernotes 6, 7. This also is aligned with the practice assistance the insurer provides to legal practices who have poor claims records: Ray Ward, ‘Lawcovers’ Practice Support in Action’ [2015] (December) Lawcovernotes 10, 11. The Legal Practitioners’ Liability Committee and other like insurers undertake similar information programs and conduct regular feedback sessions and seminars on risk issues.
The related, more interesting question about PI insurance is whether the insurance itself, as distinct from the requirement to hold it, has a regulatory character. The American literature on insurance often describes PI insurance (which in most parts of the US is optional for lawyers) as a form of regulation. For example, Baker and Logue summarise the position by observing that when insurers take steps to reduce their risk, ‘they are in effect acting as private risk regulators’.

They suggest that insurers may be better at this than government, as insurers have significant advantages in the information available to them.

Like all forms of insurance, PI insurance has the potential, if not the effect, of altering behaviour. It may change incentives. How it does this and whether it operates to shift the behaviour of an insured towards greater care or towards riskier behaviour is a central conundrum. A prevailing economic view is that holding insurance may cause the insured to act more carelessly and in disregard of the insurer’s interests (and so against the client interest), giving rise to the moral hazard problem. Hence the insurer’s focus on the moral hazard posed by the policy and the development of strategies to reduce it. These responses by the insurer do not look like traditional regulation; they are just as likely to be driven by self-interest and the influence of the insurance market.

Baker and Logue identify several strategies by which insurers seek to manage this moral hazard. These are:

1. Premium differentials (particularly pricing that seeks to more accurately reflect perceived risk based on more intensive information gathering and underwriting);
2. Deductibles and co-payments (the payment of the first part of a loss or a proportion of the total loss);
3. Exclusions, cancellations, and decisions not to renew;
4. Information production and the teaching of safe conduct (requirements to meet external risk management codes or undertake risk management training); and
5. Insurers as gatekeepers (that is, the use of insurance is a prerequisite for other activities such as the registering of a motor vehicle).

There are clear differences in character between these strategies and how they operate. The fourth strategy depends very much on whether the insurer itself

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61 Baker and Logue, above n 27, 6–8.
64 The insurance market does not merely refer to the market for insurance where competition between insurers offering similar products will influence the approach of a particular insurer. Individual frontline insurers are also very dependent on the reinsurance market and the availability of reinsurance for the policies they wish to write. Reinsurance provides a very important offset to the capital that an insurer may require to support a portfolio and so greatly influences the capacity of an insurer to write particular risks. Therefore reinsurers may have a very substantial influence over the pricing and terms and conditions of policies and the ability of insurers to enter a particular market. The role of reinsurance is not discussed in this article but it is clearly an important factor.
65 Baker and Logue, above n 27, 8–11.
chooses to do this or whether another body, such as a professional association, performs the function.66

These strategies used by insurers to address the moral hazard potentially created by PI insurance are often identified in discussions of how insurance performs a regulatory function.67 For example, in Richard St John’s report for the Australian Government on compensation arrangements for consumers of financial services, delivered in 2012, the potential regulatory effect of these strategies in relation to financial advice licensees is described as follows:

The use of a commercial insurance product as the basis for compensation may have an indirect benefit so far as insurers play a role in assessing the risk profile of licensees. Insurers typically have regard to a range of criteria in determining their underwriting risk, including a licensee’s risk management processes and controls, the professional training of staff and audit processes, and the licensee’s compliance record. Weaknesses may be identified through this process. Cover for high risk products may be declined, thereby encouraging the licensee to avoid such products.68

That said, it is not clear that insurers undertake this type of granular analysis in respect of firm-specific rather than industry-wide practices.

Of course, whether or not these strategies are a form of regulation depends what we mean by ‘regulation’. Black’s definition is that ‘regulation is a process involving the sustained and focused attempt to alter the behaviour of others according to defined standards or purposes with the intention of producing a broadly defined outcome or outcomes’.69 The strategies adopted by insurers to manage moral hazard would appear to have this character. However this ignores a broader consideration – that regulation involves the purposeful intervention by an actor with authority to influence conduct through various means (ranging from prohibition to incentive) towards outcomes that have regard to a purpose or interest broader than that of the parties directly involved.

The self-interested acts of an insurer within the constraint of an insurance market and for its own business reasons need to be carefully distinguished from the acts of external parties (including governments or professional associations) who require and specify the form of PI insurance that is to be held. The latter will to varying degrees be influenced by both public and private interest

66 As Part III(D) explains this varies depending on the nature of the insurer and insurance relationship within each profession. The PI insurance arrangements examined often do not enrol the insurer as gatekeeper because cover must be offered to everyone who holds the requisite professional qualification. In fact in several instances the gatekeeper function is inverted, with the insurer relying on the grant of the qualification by a professional body as a condition of the grant of the insurance. This is discussed further below.


68 Richard St John, ‘Compensation Arrangements for Consumers of Financial Services – Future of Financial Advice’ (Report, Australian Government, April 2012) 37 [2.130]. But as we observe in Part II, where PI insurance is required by law or a professional body, there may be common cover terms and pricing so the underwriting function is diminished and is offset by the benefits of pooling similar risks.

considerations. In contrast the decision by an insurer to enter the market and offer PI insurance (and the terms on which it is offered from time to time) is driven by the self-interest of the insurer influenced by market demands and conditions. That said, in situations where PI insurance is required by an external body, if professional associations arrange the insurance for their members then their bargaining power or their relationship with the insurer may constrain the insurer.

Baker and Logue's concept of insurance as regulation does not seem to take adequate account of the distinction between this private and public effect.

Private action by insurers may be able to react more quickly to changing circumstances of a particular insured or group of like insureds but it may be just as influenced by market conditions or the risk appetite of the insurer. As economic conditions (including the availability of reinsurance) change and the profitability of the product varies over time, the insurer is likely to adjust the availability of the cover, its terms and price with the consequence that this private regulatory effect may also change. It is well known that insurance availability and its terms fluctuate over time in what are referred to as soft and hard markets. In a soft market, where there is an abundance of capital and competitive forces, insurers are likely to lower prices and controls in policies. This may not fit well with longer-term objectives involving the public interest as a central part of the regulatory design. A soft market may deter an insurer from taking action to constrain risky behaviour and a hard market may result in severe curtailment of the cover or increase in price.

If the requirement to hold PI insurance comes from a state or self-regulatory body, there is an increased likelihood that considerations other than insurer self-interest and insurance market conditions will be taken into account in shaping the cover, including the public interest. However, insurer self-interest will not be wholly set aside as insurer co-operation may be a necessary component of the requirements if private sector insurers are being requested to underwrite the risk.

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70 Even in the case of the state requiring PI insurance there may be a private interest consideration. As Ericson, Doyle and Barry observe, ‘[m]ost significantly, private insurance relieves the state of having to compensate losses it might otherwise be politically compelled to cover’: Ericson, Doyle and Barry, above n 26, 7.

71 This may not be the case if the insurer is a government entity or is owned by a professional association where it may have been established for the purpose of offering PI insurance. Two examples are the Legal Practitioners’ Liability Committee, a statutory insurer established by Victoria, and Lawcover, a wholly owned but independent subsidiary of the Law Society of New South Wales.


73 One solution sometimes resort to is a self-insurance scheme operated by the professional body itself. For example, the Law Society of New South Wales operated the Solicitors Mutual Indemnity Fund (‘SMIF’) until 2003, when the New South Wales government required the establishment of a federally regulated insurer to carry on this activity following the collapse of the HIH Insurance Group in Australia (which the SMIF had used to back its insurance arrangements). There is a tortured history in the United Kingdom of swings between mutual funds operated by the profession and the use of private insurers: see Mark Davies, ‘Wither Mutuality? A Recent History of Solicitors’ Professional Indemnity Insurance’ (1998) 5 International Journal of the Legal Profession 29.
This is demonstrated by strategies involving exclusions. In the 1990s, insurers in the US removed cover from lawyers for claims arising out of situations where the lawyer had a conflict, either because they had a personal interest in a matter involving a client or because they were acting for multiple clients with conflicting interests. This led to a spirited exchange in articles by Anthony Davis and Charles Silver. Davis asserted that in the case of US lawyers the removal of cover for claims arising from conflicts of interest or duty did more than the bar association rules to stop firms engaging in activity involving conflicts. So the exclusion directly impacted the behaviour of the insured and had a regulatory effect. But as Silver points out it was the insurers who made this decision by reference to their self-interest. That self-interest may arise from increasing costs of claims arising out of conflicts.

Consider the possibility that an external body such as a professional association determined that the insurance should not cover claims arising from conflicts – that decision may come from a desire to reinforce the professional rules regarding conflicts of interest. It introduces consequence for a breach of professional duty in that the professional will not have insurance available to meet claims and has to meet the cost of any third party claim in these circumstances. In other words, the level of protection provided to clients by requiring PI insurance is reduced because it no longer protects them in the circumstances covered by the exclusion. This is not the concern of the insurer but may be an issue for the professional body or state regulator. As both Davis and Silver acknowledge, the provisions of the insurance do in fact affect the behaviour of the insured but potentially very different interests are involved depending on the source of the decision whether to allow or require cover in respect of particular conduct.

As noted above, even if a professional association or regulator wishes the insurance to contain or omit particular areas of cover then some negotiation between that body and the insurer will be required. Ultimately the insurer’s decision will depend upon whether or not and at what price it is prepared to issue the designated cover.

Other interested parties are also involved. The prospective insured will look to its self-interest if there is only limited or no external control on the terms of the cover that is required to be held. The decision of the prospective insured seems to be driven by the competing objectives of maximising cover and achieving the lowest price. In one sense those objectives may be compatible – the prospective insured may wish the maximum cover and go to the market to find the lowest price for that maximum. In another sense, it may be a search for a policy that can be properly described as PI insurance that meets a regulatory obligation but which is the cheapest available and so likely to provide minimum cover.

75 Davis, above n 75, 212–14.
76 Silver, above n 76, 234.
Another relevant party is the client of the professional or a person who will rely on the advice given. Often professionals will seek to limit their exposure through explicit limitations of liability contained in their engagement terms, or through qualifications to any advice given. If the client or the person relying on the advice has sufficient bargaining power, then they may be able to bargain these limits away or insist on the professional holding specified insurance. Only relatively sophisticated clients with significant resources will seek to do this and insist on insurance coverage. Again these requirements to hold insurance are driven by the client’s self-interest and not from any public interest concern.

To varying degrees regulators and professional associations, where they are involved in determining the type of cover required, provide the public interest perspective in relation to lawyers and accountants. Part II above indicates that in the legal profession there is strong underpinning state legislation whereas for accountants this is weaker and more is done by professional associations and professional standards schemes.

**B Insurance as Risk Transfer**

The insurance literature also describes insurance in terms of risk transfer. Understanding the nature of the risk transferred is important in determining how, and to what extent, insurance might work as a form of regulation.

In all forms of PI insurance, a significant part of the risk is left with the professional and not shifted to the insurer, even if there is broad cover with no significant exclusions. The residual risk of defective advice left with an insured should play an important part in the moderating the insured’s behaviour if it is recognised and understood. To the extent that holding insurance is an incentive to act carelessly, the risk not transferred should operate to offset this. In fact one of the main methods used by insurers to protect themselves is by limiting the cover and leaving part of the risk with the insured.

The substance of what is transferred under PI insurance in law and accounting is the insured’s monetary liability for the loss that arises from legal liability for defective advice as determined by judgment, arbitral award or settlement to the extent it is actually covered by the policy.

The moral hazard which does or may emerge in a covered claim is assumed by the insurer but the only consequence accepted by the insurer is the recoverable loss to the extent it is covered by the policy and the insurer’s own costs in dealing with and administering the claim. Where the loss is covered then the insured’s reasonable out-of-pocket expenses for defence and investigation costs and the claimant’s recoverable legal costs will be included in the covered loss.

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77 See, eg, Heimer, above n 27; Arrow, above n 63.

78 There may be additional covers and extensions but these usually relate to the core liability cover. Usually the insured’s own investigation and defence costs will also be covered either within the limit of cover or less frequently today as an additional cover over and above the limit on the policy.

79 It is very unusual for PI insurance to have no deductible. The exception is in directors and officers’ liability (‘D&O’) insurance in respect of the cover for the directors and officers personally, where there is no indemnity available from the company or such an indemnity is not permitted.
The uninsured loss that remains with the insured also includes the loss of reputation and consequent impact on the insured’s business arising from the third party claim. This may be increased by the notoriety of the claim and more particularly the knowledge of the claim by other customers or users of the advice of the insured.

The loss to the adviser will also include the potentially significant time that it and its employees may need to set aside to deal with the claim, which normally will not be compensated by the policy. There is no business interruption or loss of business cover associated with these policies that may compensate for consequential loss of business arising from claims.

An insured’s response to the fact that part of the risk of defective advice remains with it will depend on a number of factors including:

- whether the insured correctly identifies the risks left behind;
- whether the insured can properly assess the potential size of those risks; and
- the availability of other assets, resources and systems to meet or mitigate those risks.

Logically this process of assessment by the insured of its own risk, what it may be able to insure or not insure and the degree to which it is able or willing to absorb the residual risk should be undertaken in relation to the decision as to what insurance is ideally required. This assessment in part depends on an assessment of the likely size and number of claims that may emerge in the policy period and when they might come to fruition and require payment.

This type of exercise is at the heart of the actuarial assessment that an insurer may undertake but critically an insurer will largely assess and price its risk across a portfolio of business of pooled risks. The task for the individual insured to assess its risk, its requirements for insurance or adopting other risk management strategies is much more difficult and does not have the benefit of the law of large numbers to assist. Insureds will lack the information and actuarial tools available to the insurer and do not have the pooling effect to dissipate the risk. An individual professional may only experience an occasional claim or even none at all and so may not understand or even recognise the risks that may emerge and at best will have an imperfect understanding of them. The discussion of feedback and risk management above suggests it is important to have good information available to insured on claims, their causes and consequences to reduce this information gap.

This perception of the residual risk is potentially important in assessing the degree to which and the manner in which the insured’s behaviour is influenced by the insurance. The example given by Davis of the response of US lawyers to the exclusion from cover of claims arising out of conflicts indicates that if the residual exposure is well and clearly understood there may be evidence that the

81 Davis, above n 75, 223–4.
insured will take care and avoid excluded activities.\textsuperscript{82} There seem to be no behavioural studies that look closely and comprehensively at this issue. However, it may suggest that good education of insureds as to what is covered and what is not covered could be an important factor in changing behaviour.

It is likely that only the most sophisticated or well-advised insured has a good understanding of the risks covered by the policy and those that remain and as a consequence the regulatory effect in the sense identified by the American commentators is seriously diluted. This leads us to consider some other important aspects of this insurance that determine its scope and so its potential to affect insurer behaviour and to operate as a compensation mechanism.

\section*{C Insurance and Compensation}

If PI insurance responds to a claim there is still a range of factors that influence how and the extent to which the insurance compensates an affected person. These include not only what part of the recoverable loss is covered by the insurance (and what is not), but also how claimants, and in some cases the community, are likely to respond to loss, and how claims are handled.

\subsection*{1 Recoverable Loss}

While a detailed discussion of the principles relating to loss recovery is beyond the scope of this article, the important point to note is that PI insurance only indemnifies the insured for civil legal liability to a third party (client or non-client) who suffers loss or damage that results from the provision of professional services or covered services of the insured's professional business.\textsuperscript{83} As already observed the legally recoverable loss of the third party claimant may exceed the loss recoverable under the PI insurance.

Other issues also impact on the compensation outcome for the third party that relate to community behaviour and expectations.

First, there are issues of coverage under insurance when there is political or social pressure on insureds to pay compensation and to set up remediation schemes using processes that depart from the strict legal bases on which courts would determine liability.\textsuperscript{84} This may result in claims not being met by the insurer.

Secondly, there is the so-called bushfire or flood effect. Often politicians, regulators or the media will exert significant pressure on potential defendants and their insurers where an event occurs that leads to widespread losses to provide

\footnotesize{\textsuperscript{82} But the insured may not be able to control the issue. In response to recent steps by the Legal Practitioners' Liability Committee, which insures legal practitioners in Victoria (including many of the large legal firms that operate nationally in Australia) to exclude losses arising from agreements with clients that displace statutory rules of proportionate liability, legal firms have been unable to resist the insistence by large clients, including governments themselves, to retain the displacement: see cl 20.6 of the current solicitors policy: Legal Practitioners' Liability Committee, ‘Contract of Professional Indemnity Insurance’, above n 45.}

\footnotesize{\textsuperscript{83} Derrington and Ashton, above n 28, 2406–519.}

\footnotesize{\textsuperscript{84} See CGU Insurance Ltd v AMP Financial Planning Pty Ltd (2007) 235 CLR 1.}
compensation and to overlook technicalities (such as exclusions in policies). A person who suffers a single or isolated loss rarely gets this type of support and so is left to their own resources. The large loss dynamic may bring about future change for the isolated claimant but that is often a long-term effect that does little to assist a third party claimant now. There are deep issues of fairness in this dynamic – these are beyond the scope of this article.

Similar issues may arise in mass tort or class action claims, where problems can arise in determining the nature of the claim under the policy in respect of each class member. This can raise complex issues as to whether the PI insurance will respond and whether there is a covered claim, and points to the need for the specifications for policy design to keep abreast of these developments. Otherwise the compensation effect of the cover can be further eroded.

2 Claims Handling

Once a risk has emerged the immediate consequences may be more dependent on the behaviour of others and external factors rather than the insured. Whether an actual claim against the insured emerges depends on the propensity of the person who suffers a loss to identify the loss and its cause, and to make and pursue claims. The risk of a ‘real’ claim will also depend on a number of overlapping and interdependent factors which include the costs of recovery and the financial strength of the claimant.

In recent times, regulatory action, the emergence of class claims, third party funding of litigation and complaint and remediation schemes have perhaps changed the propensity for claims.
Once the third party claim actually emerges the insurer will in most cases assert more control and take over the claims handling which may allow the insurer’s interests to be reasserted more directly. This means that the interest of the insurer is likely to influence the manner in which the claim is dealt with and resolved. By reason of the operation of the duty of good faith the insurer is required to have regard to the interests of the insured but unless some further step is taken by an external regulator, it is unlikely that the insurer will give priority to the compensation objectives that may have led to the requirement to hold the cover.

Accordingly, under most current arrangements the actual delivery of compensation to a third party will be largely in the hands of the insurer who will act in its interests within the constraint of the principles of legal liability and procedure. Insurers are typically very skilled litigators (it is a significant part of the liability insurer’s business) with long experience. It is notable that in the major personal injuries compensation schemes for workers and motor accident victims a lot of the regulation is focused on the claims handling and resolution process to bring about early resolution of claims. A good example is the emphasis in New South Wales and other states in workers’ compensation on speedy back-to-work objectives as opposed to forcing victims through the courts system or other dispute resolution processes.

There are no particular rules of this type affecting PI insurance. So even where the liability is relatively clear there may be long delays in compensating the claimant.

### D Lessons from Other Insurance-Based Compensation Schemes

Across liability compensation schemes there is a spectrum along which at one end are highly developed and integrated schemes and at the other is cover available under a policy voluntarily acquired, the scope of which will be set by the insured and insurer. An examination of these schemes and comparison to the surrounding regulation of PI insurance for professional advisers can deliver important insights into the regulatory and compensatory effect of particular arrangements.

Where access to compensation is most highly preferred, schemes typically specify wide comprehensive cover and change both the substantive rights of parties to recover, and the recovery procedure. A good example of a scheme at this end of the spectrum is the compulsory liability cover found in the privately underwritten motor accident personal injury liability schemes in New South

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93 Though there are many instances where the insurer has stood back, told the insured to act as a prudent uninsured and delayed the decision on indemnity until judgment or settlement. This places significant pressure on the insured to resolve the claim and shifts the claims outcome risk in part back to the insured. It also denies the insured access to the resources and skill often held by insurers in claims handling. As already noted, this seems to be more difficult to achieve in Australia, and in the various PI insurance arrangements for law and accounting in Australia the insurers seem to take over the claims and even insist on it.

Wales and Queensland. These types of schemes are designed to regulate when an injured person or the personal representatives of a deceased person may recover and what damages are recoverable as a result of motor vehicle accidents in the relevant state. The relevant statutes then license certain insurers to provide cover for the liability, which is co-extensive with the rights of recovery and with no deductible or policy limit. The insurers must provide the cover at a specified price or within a specified price range to any vehicle owner. The policies are occurrence-based and so there is no run-off problem associated with claims after the expiry of the policy. There are fallback provisions to cover uninsured motor vehicles and the insolvency of any liable insurer. Within the scope of the cover the compensation effect is maximised and is unlimited. But the cover is then constrained by legislative constraints on the damages recoverable.

Such schemes are designed to have the following features:

- it is compulsory to insure; it is compulsory for the licensed insurer to provide the cover; the state underwrites any insurer failure;
- the scheme gives cover if a person who is required to be insured is not insured; the terms of the cover are exhaustively prescribed in standard form;
- the price is regulated, and usually approved in some manner by the regulator; the cover is only limited by the type of event that may give rise to the claim, for example death or injury due to a motor accident;
- damages recoverable are limited as to category and amount but otherwise unlimited; the method of claims handling and dispute resolution of the claim are prescribed and court proceedings a last resort process; and
- confirmation of cover by the insurer is required at an early stage and the method of resolution of any dispute is prescribed but may ultimately go to a court.

The scheme and its benefits are fully transparent to insureds and potential claimants.

Leaving aside issues relating to fault (which are not directly relevant for our purpose here in describing a scheme’s regulatory structure and its components), the main risk that remains with the claimant (but in this case not the insured) is the inadequacy of the prescribed damages to fully compensate the loss actually suffered. Under this type of scheme, the insured’s assets are not exposed to the shortfall.

At the other end of the spectrum is a purely voluntary choice to hold or not hold insurance. The right of recovery is under the generally applicable law and it

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95 See Motor Accidents Compensation Act 1999 (NSW) (‘MAC Act’); Motor Accident Insurance Act 1994 (Qld) (‘MIA Act’).
96 MAC Act pt 7.1; MIA Act pt 5 div 1.
97 MAC Act s 24; MIA Act s 13-13A.
98 MAC Act ss 33, 189; MIA Act ss 33, 60, 61.
99 These schemes are fault-based schemes but in reality they are no-fault in most situations. At fault drivers and contributory negligence may affect the right to damages or reduce damages but not for the care of the very seriously injured or for children: see, eg, MAC Act p1.2.
is not varied for the particular situation. As outlined above, the requirements for
PI insurance for lawyers and accountants seem to fall towards the middle of this
spectrum and depend on the particular elements of each set of requirements and
the effectiveness of the monetary limits under the applicable professional
standards scheme.

PI insurance arrangements for professional advisers, and the allocation of
risks under it, can be located along the spectrum of the highly regulated
compensation scheme to the voluntary insurance model. The examples at the
extreme end of the spectrum help to identify what techniques could be adopted to
expand a compensation objective. But as the scope of cover is expanded to
maximise compensation, the highly regulated schemes remove any personal
liability of the insured and so other regulatory mechanisms become critical in
improving behaviour. Sitting beside the motor schemes are detailed traffic laws,
significant monitoring and enforcement and wideranging education programs to
support care on the roads. This extensive and very detailed regulation supported
by constant enforcement and monitoring systems is not found in respect of
professional activity.

Professional misbehaviour is usually only sanctioned after it has occurred and
has been detected. Active monitoring of behaviour is limited. But the
professional standard schemes have a noticeable similarity with these motor
schemes in that they limit the amounts recoverable by claimant and so potentially
reduce the need for higher levels of insurance cover.

In comparison to the highly regulated schemes (where the full details of
cover are in legislation and transparent), the claimant has little information about
the terms and level of insurance cover (other than in the case of well-specified
levels of minimum cover)\textsuperscript{100} in a context where the assets and revenues of
professionals are closely guarded and not usually available to a user of the
advice. Additionally, the claimant is still exposed to insureds who may jeopardise
the cover they do have.

\section*{E \ PI Insurance as a Protective Scheme}

The foregoing discussion suggests the following about PI insurance as a
protective scheme for clients of professional advisers:

1. The use of exclusions or other similar devices by insurers in PI insurance
may affect the behaviour of insureds but they are most likely to arise
from insurer self-interest rather than public interest;

2. If PI insurance is required to provide compensation for those who suffer
loss from defective advice, then the cover provided should be the most
extensive available from the insurance market constrained only by
affordability (which itself may be difficult to assess);

\textsuperscript{100} This is more the case in the legal profession than in the accountancy profession for in the legal profession,
there is often a compulsory standard policy with a minimum level of cover.
3. The limits of liability in professional standards schemes may shift the compensation burden from insured to claimant in relation to losses in excess of the limit;

4. There should be a rigorous assessment of the limits of cover required by a professional so that there is a reasonably high expectation that the cover will be adequate to meet likely claims and these limits should not be exposed to significant erosion by additional first party covers added into the policy for the benefit of the insured;

5. The deductible or excess borne by the insured in respect of claims should not be set at a level that may result in significant financial difficulties for an insured and so undermining the compensation objectives;

6. There is a need to better ensure that where cover is in place it is able to be triggered for the benefit of claimants and not be wholly dependent on acts of notification by the insured;

7. Where an insured ceases business for whatever reason there needs to be provisions for the continuity of cover if only because claims for defective advice may not emerge until some considerable time after the defective advice;

8. Regulatory or other action to force insureds to compensate where there is uncertainty as to legal liability needs to be carefully considered and, perhaps in a constrained way, covered under PI insurance; and

9. Consideration needs to be given as to how compensation (or at least part of it) may be more speedily delivered without undermining the fundamental nature of the cover that is based on legal liability.

These observations point to the tension between any compensation objective and regulatory function of the insurance itself which is ultimately bounded by the willingness and capacity of the insurance market to provide the insurance.

PI insurance will not always fully compensate the user for a loss or compensate the adviser fully for the effect of the claim. This leaves scope for compensation arrangements for users of advice beyond insurance, for:

- recoverable losses within the scope of the insurance cover not met by the insurer (the deductible or losses in excess of the limit) and not met by the insured or some other form of insurance;
- recoverable losses not within the scope of the PI insurance and not met or not able to be met by the insured (claims arising from fraud or dishonesty); and
- other losses not classically recoverable by action in the courts.

So although insurance will provide compensation that falls within its boundaries, outside of this compensation is only provided by the insured out of its own assets or other mechanisms that may apply (such as through fidelity insurance or schemes). There also may be a range of circumstances that result in the policy not responding to a claim because the particular policyholder does
something or fails to do something with the result that the insurer can refuse or reduce the claim.\textsuperscript{101}

Leaving aside individual insured behaviour that undermines the cover without some rules requiring and specifying the cover, the individual differences in the cover held by different insureds will make the compensation effect of the PI insurance uncertain across a professional group and leave clients adversely affected by defective advice unclear about their position. This is a justification for a common requirement for minimum insurance meeting specified criteria for a group of professionals. But confusion for users of the professional groups can also emerge if there are a number of competing groups with significantly different requirements or a range of insurance options with different coverage designs (variations in scope of cover, extensions of cover and exclusions).\textsuperscript{102}

V CONCLUSIONS

This article investigates the role of PI insurance in professional relationships by considering: first, how the requirement to hold PI insurance, and PI insurance itself, operates as regulation; and secondly, the part PI insurance plays or may play in ensuring that clients who suffer loss or damage as a result of defective professional advisory services can be meaningfully compensated.

For advice professionals, the requirement to hold PI insurance can arise under statute, as a requirement of membership of a professional body, or through a combination of both. We proposed that in each case the underlying rationale for requiring PI insurance had an important public interest element, encompassing both the protection of clients, and the creation and support of trust in a profession that provides a valuable and necessary service to clients they cannot (because of the specialist expertise required) perform for themselves.

PI insurance potentially protects clients in two ways. First, to the extent that it operates as a form of regulation, it reduces the likelihood of the adviser engaging in conduct that results in loss. Secondly, it reduces the likelihood that,

\textsuperscript{101} See St John, above n 68, 31–2 [2.96]–[2.98], where the author, considering indemnity insurance held by financial advisers, points out various reasons why cover might not assist a client of an adviser:

Some of the limitations of professional indemnity insurance flow from the ‘long tail’ nature of liabilities associated with providing financial services, combined with the ‘claims made’ basis of professional indemnity insurance policies … There are other reasons why a professional indemnity policy may not respond to a claim… these include circumstances where:

- a licensee is in breach of its contractual obligations under the policy;
- the claim falls within an exclusion in the policy;
- a licensee faces claims that fall within the level of excess it has to bear;
- the claim exceeds a cap on the cover provided by the policy;
- the claim is made after the cancellation of an insolvent licensee’s policy.


\textsuperscript{102} See Chartered Accountants Australia and New Zealand, ‘Australian Professional Indemnity Insurance Policies for Accountants’, above n 32, cls 2.2, 2.5, 2.6. The specific cover offered to individual practices by the different insurers is often very different.
if a client does suffer a compensable loss, that the client’s claim will not be met by the adviser due to lack of financial resources.

Our examination of PI insurance arrangements in place for lawyers and accountants in Australia suggests some important conclusions.

PI insurance does perform a regulatory function in Australia, but that function largely depends on the involvement of the professional associations and the roles they play (including under the professional standards schemes) in understanding and reporting on both the type of cover held by their members and the claims history of the relevant profession. Indemnity insurance arrangements wholly negotiated bilaterally between an insurer and an insured do not, we think, have a regulatory character because the necessary public interest considerations are not typically present in that negotiation. It is the involvement of the professional associations, through the schemes, that give the PI insurance its regulatory character through the creation of the feedback loop. While governmental requirements to hold PI insurance are often directed at the public interest in providing compensation to clients, the professional associations’ involvement is often directed at the public interest in maintaining trust and confidence in the profession.

The closer the relationship between the professional association and the insurers, the more effectively the PI insurance itself (as distinct from the requirement to hold it) appears to work as regulation. This is because of the professional association’s purchasing power and its ability to assume the gatekeeping and feedback functions. The apogee of this is perhaps the risk management work undertaken with practitioners and firms by the insurers affiliated with the various law societies. In all cases though the professional associations had an important role to play in educating their members as to how PI insurance works and the kinds of policy features that are necessary or desirable for members and their clients.

As for compensation, PI insurance does not and is not intended to ensure that clients will always receive compensation when their interaction with their professional adviser ends up in a loss. Instead, it reduces the risk that a compensable claim will not be met because of the adviser’s lack of financial resources. However the inherent limitations of PI insurance as a compensation mechanism are well known; and while it reduces that risk it by no means eliminates it. Depending on the particular policy features discussed above, the extent to which it reduces that risk varies.

Where there is less uniformity in the features of different PI insurance policies offered by different insurers to members of the same professional group, the extent to which requiring PI insurance achieves the public interest purposes of both access to compensation and warranted trust is diminished. Widely differing boundaries of cover make it difficult for insureds to understand the uninsured part of their risk and to identify appropriate policies. They also present the users of advice with significant difficulties in understanding the scope of any insurance ‘security’ that may be available in the event that the advice is defective. Arrangements that favour standardised terms or minimum forms of cover, such as those for the lawyers’ policies, are more easily accessible to and
understood by advisers and clients. However even then we suspect a degree of naive misunderstanding persists about what the adviser’s insurance actually means for the client and the public interest.

These findings have implications for the professionalisation of other types of advice relationships, including in the financial sector. ASIC’s recent review of the PI insurance market for Australian financial services licensees providing financial advice points to a lack of consistency in product features in this market, which diminishes even further the extent to which PI insurance provides clients of those advisers with access to meaningful compensation. This is despite the fact that ASIC’s Regulatory Guide No 126 indicates its view that the policies held by licensees should have certain features in order to be considered ‘adequate’ under regulation 7.6.02AAA of the Corporations Regulations 2001 (Cth). It may be that cover with the features proposed by ASIC is not available in the market for all advisers. While various professional associations exist for financial advisers, their membership does not cover the whole of that industry and there is (at the time of writing) no professional standards scheme in place for financial advisers. It may be that the absence of the schemes architecture and the place in it for professional associations is a further factor to be examined in the context of ongoing attempts to increase the emphasis on professional standards in that industry.

104 Regulatory Guide No 126, 13–15 [RG 126.41]–[RG 126.49].