AUSTRALIAN **B**ANKERS' **A**SSOCIATION

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19 March 2004

The Secretary
Senate Economics Legislation Committee
Room SG.64
Parliament House
CANBERRA ACT 2600

Dear Dr Bachelard,

The Australian Bankers' Association (ABA) welcomes the opportunity to make a submission to the Senate Economics Committee Inquiry into the Treasury Legislation Amendment (Professional Standards) Bill 2003.

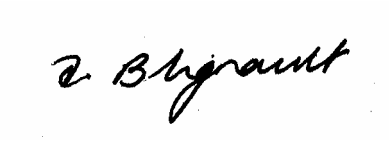
The ABA submission comments on the general provisions of the Bill, as well as the impact it and the introduction of a cap on liability and damages is likely to have on professionals and consumers.

Wherever possible the ABA has provided a possible solution; a way to work through the difficulties associated with the Bill.

The ABA looks forward to an opportunity to appear in front of the Senate Economics Legislation Committee.

Should you require any additional information please contact Ardele Blignault, Director Government and Stakeholder Relations, Australian Bankers' Association on 02 8298 0410 or by email ardeleb@bankers.asn.au

Yours sincerely,



Ardele Blignault

AUSTRALIAN BANKERS' ASSOCIATION

ABA submission to the

Senate Economics Committee Inquiry into the Treasury Legislation Amendment (Professional Standards) Bill 2003

March 2004

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ABA Submission

The Australian Bankers' Association (ABA) welcomes the opportunity to make a submission to the Senate Economics Committee Inquiry into the Treasury Legislation Amendment (Professional Standards) Bill 2003.

The ABA is pleased to see that the Joint Communiqué, Ministerial Meeting on Insurance Issues, Hobart, 27 February 2004, states that the "Ministers agreed that any legislation or schemes being developed should be flexible enough to meet the concerns of large purchasers of professional services."

This flexibility is vital for any successful scheme. The introduction of flexibility and the other measures suggested in this submission will considerably improve the legislation for the benefit of all consumers.

The necessary improvements to the Treasury Legislation Amendment (Professional Standards) Bill 2003 could be easily achieved by a relatively straight forward amendment.

All that would be required is a new sub-section to be added to each of those proposed new sections - 12GNA Australian Securities & Investments Commission Act, 1044B Corporations Act and 87AB Trade Practices Act. A suggested form of words for this amendment appears on page four of this submission. The ABA is happy to provide any further comment about the form of words that may be of assistance to the Parliamentary drafters.

The ABA understands that the sixth Ministerial meeting on Insurance Issues on 6 August 2003 endorsed a national scheme for professional standards legislation for economic loss. In a joint press release by Senator Coonan and Senator Campbell on 4 August 2003, Senator Coonan suggested such a national scheme should be based on the New South Wales model. This submission is prepared on the basis that the New South Wales model will serve as the basis for the national model.

From the perspective of banks as consumers of professional services, the current New South Wales model is flawed in critical respects, and any model adopted by the Commonwealth and/or other States and Territories which is based on that New South Wales model will be similarly flawed.

The concern expressed in this submission, is that a number of schemes for limiting professionals' liability under the Professional Standards Act, 1994, New South Wales (eg. the schemes applicable to accountants and solicitors) cap liability in an inappropriate manner. Two features of those schemes which illustrate the concerns are:

- that cap is inflexible – i.e. individual firms effectively cannot "contract out" of the upper cap on liability (unless they are prepared to revert to completely unlimited liability); and
- the cap on liability is set by the relevant professional bodies with the consent of a statutory body, the Professional Standards Council, not by individual firms or by the market generally.

These undesirable features of the NSW schemes should not be duplicated in other States and Territories, or under Commonwealth law.

Further, liability capping schemes shift the consequences of risk above the cap from one section of the economy (the professions) to others (consumers, be they individuals, small businesses or financial institutions). In other words the consequences of risk are shifted from those best able to mitigate the risk in the first place to those least able to mitigate the risk in the first place.

The Victorian Professional Standards Act 2003 partly addresses this inflexibility, but for the reasons set out below, not satisfactorily. An inflexible capping mechanism, set and maintained by industry bodies, is anti-competitive, inefficient, and inequitable and may well lead to poorer quality risk management practices, rather than better quality risk management practices. Further, by effecting a systemic transfer of risk from professional service providers to their clients, it creates prudential issues in some industries such as banking and financial services which have not been properly considered or addressed.

The Commonwealth legislation giving effect, for the purposes of Commonwealth law, to schemes which limit the liability of professional services firms allows the Commonwealth to prescribe, by regulation, which schemes will benefit from capping liability under Commonwealth law.

We would therefore submit that the Commonwealth should use the power thereby given to it to ensure that schemes for capping liability conform to certain minimum standards. Those minimum standards should:

(a) Permit contracting out

Permit individual firms to contract out of the maximum cap on a case-by-case or client-by-client basis or indeed generally. Liability limitation statutes should prohibit schemes which prevent professionals from voluntarily accepting limits higher than scheme limits (as noted, the Victorian Professional Standards Act 2003 partly, but unsatisfactorily, addresses this – see below).

(b) Relate the liability cap to a firm's ability to get insurance

Determine the cap by reference to the maximum amount of insurance for which individual firms can, from time to time, reasonably obtain for an affordable price.

(c) Require firms to devote minimum amounts of profits/revenues to insurance

Mandate a minimum percentage of a firm's profits or revenues be devoted to the purchase of acceptable insurance.

(d) Prohibiting caps based on a multiple of fees

Require that caps be set as a fixed dollar amount, not as a multiple of fees.

(e) Allow professionals to use limited liability companies

Allow professionals, if they wish, to limit their risk by conducting their business through limited liability companies rather than by relying on capping. Limited liability companies can, of course, increase their assets exposed to suit by raising or retaining shareholder capital.

(f) Introduce proportionate liability

Implement proportionate liability. This will reduce professionals' risk levels and thus should reduce, indeed perhaps abolish, the need for capping. It is noteworthy that the Treasury Discussion Paper on CLERP 9 provides that auditors be allowed to incorporate, and that proportionate liability be adopted, instead of capping auditors' liability.

(g) Protect competition

Insert a role for the ACCC to balance the current role conferred on industry associations by the New South Wales Act and the Victorian Professional Standards Act 2003. Thus, it would be desirable for no scheme to be approved unless the ACCC had confirmed that it had no greater anti-competitive effect than was necessary to implement the goals of the scheme, namely to ensure insurance remains available on reasonable terms.

(h) Scrutiny of prudential implications

Require liability capping schemes to be referred to, and approved by, appropriate prudential regulators, eg. APRA should have a role in approving liability capping schemes which shift risk to financial institutions. APRA should ensure liability caps do not transfer risk any more than is necessary to ensure insurance is affordable.

(i) Require strict proof of problems with affordability of insurance and permit protection only while the problem persists

A significant push for liability capping has come from the medical profession where it is said that insurance is now unaffordable unless caps on liability for medical negligence are set.

There is however no widespread evidence that other professions are unable to obtain affordable insurance.

The solution – suggested amendment

The Treasury Legislation Amendment (Professional Standards) Bill 2003 proposes that new sections be inserted into each of the Australian Securities & Investments Commission Act, the Corporations Act and the Trade Practices Act to enable liability under each of those three acts to be limited in accordance with a professional standards law of a State or Territory. The proposed new provisions which would implement that are proposed new section 12GNA Australian Securities & Investments Commission Act, proposed new section 1044B Corporations Act and proposed new section 87AB Trade Practices Act

Each of these proposed new sections is in virtually identical terms. To implement a solution that would provide the flexibility needed to cap schemes in an appropriate manner, all that would be required is for a new sub-section to be added to each of those proposed new sections which would provide broadly as follows:-

"A scheme must not be prescribed by regulations unless the scheme complies with minimum standards set out in the regulations. The regulations must require that those minimum standards include:

- *a requirement that schemes permit members of the scheme to accept voluntarily caps higher than those contained in the scheme;*
  - *for particular kinds of work*
  - *for particular specified transactions or classes of transaction*
  - *for a particular client or clients*
  - *for work of a particular value*
  - *in any other case determined by the scheme member*
- *a requirement that schemes must not contain caps based on a multiple of fees*
- *a requirement that caps be related to the amount of insurance a particular member of a capping scheme can purchase with a specified percentage of the members' revenues or profits, and must not be set as a fixed dollar amount*

- *a requirement that members of a scheme devote a stipulated minimum percentage of their revenue or profits to the purchase of insurance which meets minimum standards prescribed in the regulations*
- *a requirement that schemes not be prescribed unless the law of the State under which the scheme is made adopts proportionate liability and permits members of the scheme to conduct their professional activities through a limited liability company*
- *a requirement that schemes not be prescribed unless the ACCC, and any prudential regulator having jurisdiction in the relevant industry, have approved the scheme*
- *a requirement that all schemes have "sunset provisions" and contain requirements that the occupational associations which propose schemes should satisfy the Professional Standards Council and the ACCC, annually, that insurance conditions in the relevant industries require the continuation of the particular scheme for a further period of twelve months."*

These measures will have no adverse consequences on the expressed goals of the legislation. The goals of the legislation are said to be to ensure that Australian consumers continue to get reasonable recourse from professionals by ensuring that professionals have access to affordable insurance and are therefore not induced to "go bare". Contracting out would be a purely voluntary act by the professional service firm and would be designed solely to allow higher limits of recourse where the professional is able to offer them. The other measures serve to protect the interests of consumers of professional services without prejudicing the aims of the proposed legislation.

The ABA encourages the Committee to consider the submissions contained in this paper about flexible caps.

Appendices

1. A description of the Accountants Scheme in New South Wales and comments on the Victorian Professional Standards Act 2003

In order to illustrate the problems with capping schemes, it is useful to focus on one existing capping scheme and then examine its consequences. The following looks at the NSW scheme applicable to accountants as a useful model.

The Accountants Scheme is a scheme under the NSW Act, established by the relevant occupational associations, CPAA and ICAA. As envisaged by the Act, the CPAA and the ICAA drafted the Accountants Scheme and it has been approved in accordance with the Act by the Professional Standards Council (an eleven person statutory body established under the Act to administer the Act).

The Accountants Scheme applies to limit all civil liability (whether in contract, tort or otherwise), arising under New South Wales law, of the persons to whom the Scheme applies which arises in the performance of their occupation. It does not apply to damages awarded for personal injury or death, or arising from a breach of trust, fraud or dishonesty.

The fact that the Accountants Scheme only limits liability under New South Wales law means it is of no assistance to accountants if they are sued under Federal law (eg. the Trade Practices Act) or other State statutes. Hence, the need for a national scheme in all States and Territories, and at the Commonwealth level.

Under the Accountants Scheme, damages in respect of civil liability covered by the Scheme:

- below $500,000 remain unaffected;
- above $500,000, are limited to the lesser of 10 times a reasonable charge for the relevant service or $20 million.

Twenty million dollars is thus an absolute upper cap on damages for liability covered by the Scheme.

Participants in the Accountants Scheme are required to maintain insurance of not less than the cap and to maintain sufficient business assets to cover any deductible applicable under that insurance.

Provisions in the NSW Act prohibiting "splitting of defendants" effectively have the result that the $20 million cap applies to partnerships, not their individual partners (see Section 29(3) of the NSW Act).

Participants in the Accountants Scheme can apply to be exempted from the Scheme (see paragraph 2.5 of the Scheme) by the CPAA or the ICAA. However, the power thereby conferred on the CPAA or the ICAA under this provision is solely to permit an entire exclusion of a person from the Scheme, i.e. a person exempted is simply not covered by the Scheme at all and thus has unlimited liability. Neither the Scheme nor the Act creates an ability for participants in the Scheme to remain in the Scheme, but opt for a limit on liability higher than $20 million.

For all practical purposes, this precludes participants in the Accountants Scheme from opting for a higher limit of liability than $20 million since voluntarily accepting unlimited liability seems irrational.

Schemes may be amended by the relevant occupational associations (in this case the CPAA or the ICAA) with the consent of the Professional Standards Council. Individual firms cannot alter the limit applicable to them under the Scheme or any other provision applicable to them under the Scheme of their own motion. Nor can individual participants contract out of the Act, including limitations on liability (see Section 50 of the Act).

It should be acknowledged that the problem inherent in the Accountants Scheme, namely the inflexible cap on liability, is a product of the drafting of the Scheme, not necessarily an inherent defect in the Act. It would be possible for Schemes drafted under the Act to permit flexibility and individual tailoring of upper liability caps. However, it is a fact that the Accountants Scheme (and the Solicitors Scheme as well) do contain these inflexible upper limits.

Legislation which permits such inflexible caps should not be permitted. Any new legislation, in New South Wales or in any other Australian jurisdiction, dealing with liability capping should therefore expressly prohibit schemes which make it impossible for participants in the scheme to accept, voluntarily, a limit higher than the prescribed limit contained in the scheme.

Further, the potentially anti-competitive, anti-consumer role of industry associations in establishing capping schemes needs to be tempered by inserting a countervailing review of capping schemes by the ACCC. No capping scheme should be permitted unless the ACCC has vetted it for anti-competitive features, and decided its anti-competitive effects are no larger than are strictly necessary to achieve the goal of capping, namely to ensure that insurance remains affordable.

The Victorian Professional Standards Act 2003 confers in clause 26(b) "a discretionary authority on an occupational association, on application by a person to whom this scheme applies, to specify in relation to the person a higher maximum amount of liability than would otherwise apply under the scheme in relation in relation to the person either in all cases or in any specified case or class of case". Whilst this provision is a significant improvement on the New South Wales model, it is not

totally satisfactory as it continues to vest power in the occupational association which is likely to have a vested interest in opposing flexible caps, or caps which (in its view) are too high. The occupational association will be obliged to act in what it considers to be the best interests of all of its members. Indeed, it will no doubt be placed under considerable pressure by its members to do so. Thus, there will be considerable pressure placed upon it to prevent members from specifying caps which are (in the view of other members of the association) too high since that would require other members to match the exception.

The occupational association will be placed in an invidious position.

The power to approve higher limits should be removed from the occupational association. This is a matter to be considered in whether a scheme should be nationally approved. It should be open to members to unilaterally specify a higher limit of liability, without approval by any person. That would best enable market forces to work both in the provision of professional services as well in the provision of insurance.

Even if, contrary to this submission, it were desired to require contracting out to be approved by some authority, that authority should be a body (such as the ACCC) which acts in the interests of consumers. It should not be an occupational association which is bound to act in the interests of professional firms.

2. Affordability and absolute level of insurance premiums

A significant push for liability capping has come from the medical profession where it is said that insurance is now unaffordable unless caps on liability for medical negligence are set.

There is however no widespread evidence that other professions are unable to get affordable insurance.

Under the Accountants Scheme, for example, the liability for accounting firms for matters covered by that scheme is set at a maximum of 10 times the fees reasonably chargeable on an engagement or $20 million (whichever is the lower). Further, as a practical matter (and subject to the comments below on the Victorian Professional Standards Act 2003), no accounting firm is able to contract out of that upper limit, irrespective of their ability to get insurance or otherwise. The ABA is unaware of any evidence that has been produced to show that accounting firms are unable to afford insurance for more than $20 million. Most large firms carry between $100m and $400m of professional indemnity cover.

The ACCC has recently produced the "Public Liability and Professional Indemnity Insurance Second Monitoring Report". The report follows two earlier reports by the ACCC and confirms that the cost of providing public liability and professional indemnity insurance has increased over the past 5 years and that the major driver behind these increased costs and associated premium hikes is an increase in the cost of claims.

However, these reports only give information about the absolute level of insurance premiums. They give no information about the affordability of those insurance premiums by accountants or other professionals. Those reports could not do so without gathering significant empirical information about all the components of the costs of accounting firms, their revenues and their profits. It is therefore by no means clear that there is a problem to be solved at all. Indeed, if proportionate liability and the ability for professionals to practise in incorporated form are introduced (as was recommended in the CLERP 9 Discussion Paper) it may become even more likely that capping is unnecessary.

However, even if there is a problem to be solved, the response should be proportionate to that problem. It is not clear that the amount of the caps on liabilities has been struck by reference to the level of affordable cover obtainable by accountants or other professionals.

3. The problems with caps

The Accountants Scheme, to return to that Scheme as an illustration of the problem, limits accountants' liability to the lesser of $20 million or 10 times fees, irrespective of:

- an individual firm's ability to obtain insurance, or the cost of that insurance;
- the size and complexity of the work undertaken by the particular firm;
- the size and financial resources of the particular firm.

It is acknowledged that clause 26(a) of the Victorian Professional Standards Act 2003 does authorise a scheme to specify different maximum amounts of liability for different classes of work or for the same class of work but for different purposes. One cannot assess whether that provision will actually be used, or if it is used, whether it is used in a truly flexible way. As schemes are proposed by occupational associations and approved by a Professional Standards Council which may not have adequate consumer representation, that clause is unlikely to be utilised. Occupational associations are most likely to act in the interests of their members, not consumers. It is therefore submitted that even under the Victorian Professional Standards Act 2003, the schemes which are likely to be proposed will be quite inflexible, and will not suit consumers' interests.

The disadvantages of that kind of system are as follows:

3.1 The maximum limit is set by professional bodies in conjunction with a statutory body, not by individual firms or the market

No statutory body or professional association will ever be able to dictate liability caps as effectively or efficiently as the individual firms to whom they apply or the market. However, the Accountants Scheme provides that no matter what changes occur in insurance markets, in accounting firms' size, practices or risk profile, in general economic conditions or other factors, only the professional association and statutory body, acting jointly, can vary the maximum liability limits.

This method of setting caps is slow, inefficient and not responsive to the particular circumstances of individual firms, or to changes in those circumstances.

3.2 An inflexible cap is anti-competitive and prejudices quality of service

Because New South Wales accounting firms are effectively unable to choose a greater liability cap than that permitted by the Accountants Scheme, they cannot compete on the basis that their skill and efficiency, and risk management practices, might enable them to accept a liability limit larger than that permitted by the Scheme.

This rewards poor risk management. It penalises innovation and strong risk management. It chills competition on the basis of quality and will ultimately lead to poorer quality accounting services than would be available if firms were allowed to compete on the basis of liability caps. This harms consumers and the efficient operation of the economy at large.

As noted, the anti-competitive nature of these capping schemes is almost inevitable given the power vested by the enabling legislation in industry associations. There must be some countervailing supervisory power vested in a body which will protect consumers and promote competition to the maximum extent possible as clearly industry bodies are unlikely to do so. We would recommend that the ACCC have a role in vetting schemes to ensure they have no greater anti-competitive effect than is absolutely necessary to ensure that insurance remains affordable.

3.3 Inflexible liability caps – major players and new entrants

Inflexibility liability caps entrenches major players and precludes new entrants from gaining a foothold. Because, as noted above, smaller, skilful competitors cannot compete by using their skills to accept greater liability caps, the existing entrenched market share of accounting services by the Big 4 accounting firms will continue. New and smaller firms with a greater appetite for, and ability to accept, risk are foreclosed from effective competition, at least, from competition based on better risk management practices.

3.4 Inefficient allocation of risk

The Accountants Scheme effectively passes liability risk above the cap to consumers of services who have no ability to manage those risks or to insure against them.

The law should impose risks on those able to manage them/insure against them to the maximum extent reasonable having regard to:

- the responsibility of those parties for the risk maturing;
- the ability of those parties to manage/insure against the risk without imposing undue costs upon them.

To give an illustration, banks which manufacture and distribute financial products rely significantly on accounting and tax advice as to the effects of those products. Banks will retain full liability to their customers for those products, limited only by their own capital and surplus financial resources. If those products prove defective because of the accounting or tax advice given to the banks, the banks will end up assuming virtually the full burden of the liability risk for the accountant/tax adviser without any ability to manage that risk or (subject to the comments in the next

paragraph) insure against it. This is inequitable, as well as being economically inefficient.

Consumers of accounting services, such as banks, will be able to insure against liabilities they incur to their customers (unless in the unlikely application of clause 26(a) of the Victorian Professional Standards Act 2003) which:

- result from negligence by accountants, but
- are not recoverable from accountants due to the cap.

Currently, it is common for professional indemnity insurance policies to contain exclusions for liability which the named insured assumes voluntarily. Thus, presently, if a bank were to agree voluntarily to accept a cap on the liability of its accounting adviser, then the bank's insurance would exclude cover above the cap for any liability the bank might incur to its own customers as a result of an error by the accounting firm. However, it is unlikely that a statutory liability capping scheme would fall within a "voluntary assumption of liability exclusion" of an insurance. More serious would be the possible reaction of the insurance market. Whilst losing the ability to recover from the accounting adviser because of the statutory cap, it is likely that insurers will expand the standard form of their exclusions to capture liability a bank may incur to a customer above the statutory cap of its accounting adviser. This, effectively, would make liability above a statutory cap uninsurable However, even if insurance is available to consumers (such as banks) to cover the risk of loss in excess of the cap, insurers will presumably reprice the insurance to take account of the additional risk. In effect, the statutory capping scheme would thus simply end up shifting the costs of insurance from one sector of the economy to another. Indeed, the burden of insurance costs will thereby be shifted from the sector that can manage the risk to sectors that cannot.

This seems a perverse result. It will neither reduce the total cost of insurance to the community nor encourage sensible management (and thus, reduction) of risk.

3.5 Systemic risk

As noted above, other participants in the Australian economy will end up shouldering the risk of liability arising from the negligence of accounting firms, over and above the caps.

Given the central role that accounting and tax advice plays in many aspects of the economy, this creates a significant new source of prudential risk for many institutions. Financial institutions are especially vulnerable given their reliance on accounting and tax advice. The caps on accountants' liability therefore affect a systemic transfer of risk for accounting/tax advice from accounting firms to banks and financial institutions.

As far as we understand it, no consideration has been given to the prudential implications of this systemic transfer of risk.

This is of concern. Consideration should be given to inserting in relevant enabling legislation a requirement that industry regulators consider the implications of liability capping for their industries. For example, APRA should have a role in approving accountants capping schemes to ensure such schemes do not impose inappropriate prudential burdens on financial institutions.

Indeed, current arrangements between APRA, the banks and their auditors serve to highlight the problem. Under tripartite agreements that APRA has with each of the banks in relation to Prudential Standard APS310, the regulator relies heavily on the bank's auditor to confirm the quality of the information provided by the bank, and to confirm the effectiveness of the bank's risk management processes. Rather than employ people with the skill sets necessary to perform these functions, APRA relies on the bank's auditor. For this work, the auditor charges the bank a fee. The proposed legislation would permit the auditor to limit significantly its liability for that work.

3.6 Capping Schemes Render Professional Firms Immune from Failure

A major problem with capping schemes is that they render it impossible for firms to fail because of their own negligence. No single act of negligence will, in future, be able to lead to the failure of a professional services firm as an ongoing business entity. Any single act of negligence will give rise to liability which is limited, and presumably covered by insurance.

This is undesirable. No firm should be free from the fear of failure. It is the fear of failure which is the most significant incentive to produce high quality work.

This is an important reason why a better solution to the current insurance problems would be to permit professional service firms to conduct business through limited liability companies. If professional firms could incorporate, the assets of individual members of a firm could be protected from seizure if those members were innocent of negligence or default. However, an act of negligence of sufficient size could still cause the company to fail.

This is one reason why the Discussion Paper on CLERP 9 recommended incorporation, instead of capping, as the best solution to the insurance problem. Incorporation protects innocent individual professionals but leaves the business entity exposed.

Capping, by contrast, protects both the assets of individual members of the firm **AND** the ongoing viability of the business entity itself.

The limited liability company has historically been recognised as the best vehicle to enable risky enterprises to be conducted without jeopardising the personal assets of the venturers. There is no reason why this historically proven vehicle cannot and should not be used to solve the current insurance difficulties.

3.7 Moral hazard

It will appear from the comments above, that the inflexible caps on accountants' liability create a significant moral hazard. This is significantly exacerbated under the Scheme by the nature of the cap. A cap of 10 times fees or $20 million (whichever is the lesser) in the context of the large transactions and complex work in which accountants are sometimes involved, may well be trivial.

Whilst it is accepted that it is equally unreasonable (given the magnitude of transactions in which accountants are involved) not to grant accountants some limit on their liability, 10 times fees or $20 million is hardly appropriate in the context of say, the audit of a bank or financial institution. The need to avoid moral hazard requires that accountants accept a level of risk sufficient to mandate prudence. This is particularly so in view of the systemic transfer of risk affected by the Scheme.

3.8 One size fits all

As has been noted, the cap under the Accountants Scheme is inflexible no matter what:

- the size and resources of the accounting firm;
- the kind of work they do;
- the risks the accounting firm undertakes.

Thus, the same maximum cap proposed for services by a suburban accounting firm to a small business is proposed for services by a Big 4 accounting firm to a Big 4 bank. This is clearly inequitable from a client's point of view.

It is also inequitable as between members of the profession. Why should a Big 4 accounting firm, with its vast resources and access to specialist global insurance markets have the same liability cap as a suburban accounting firm, which is dependent for its insurance needs on a restricted local market?

The New South Wales Act, and the Accountants Scheme, would need to be amended if caps are to vary depending on the profession, the size of the firm and the risks, as neither the Act, nor the Scheme, currently does this.

3.9 International competitiveness

Regimes which cap the liability of professionals are likely to render Australia an unattractive destination for foreign investment. If a foreign investor is looking to establish a new business, or invest significant capital, in this region it may well choose a jurisdiction where limitation of liability is not part of the regulatory framework. In this case an international bank, engineering company etc may well choose to use the service providers it already deals with overseas rather than Australian or state-based firms.

The corollary is also that Australian major investors and businesses may themselves look overseas for professional service providers. This is especially so as businesses operate on a global basis and are significant users of resources internationally already. It should be noted that this would certainly be the case where overseas regimes operate without caps (albeit with other liability regimes such as limited liability partnerships with substantial professional indemnity insurance policies as assets of those partnerships).

Additionally there is the question not just of the users of the services but also the international competitiveness of the service providers. Australian accounting and legal firms have, to date, been able to resist competition from foreign providers of professional services because the Australian firms are cost effective and efficient. However, the lack of full recourse to Australian professional service firms may well render them uncompetitive with foreign accounting and law firms. It is quite likely, for example, that significant Australian corporations will choose to use US, UK or New Zealand accounting/tax/legal advisers where possible.

3.10 Access to capital

Australian companies and businesses compete for foreign capital with entities based in jurisdictions which do not set liability caps to protect professional service firms in the way Australia proposes to. Access to foreign capital is frequently dependent upon an issuer's ability to produce an auditor's comfort letter, or legal opinions, to foreign investors which satisfy them about the issuer's financial position and about enforceability of judgments against the issuer. US institutions, in particular, demand auditors' comfort letters and lawyers' opinions from an issuer's accountants and lawyers before they will buy the securities of an Australian issuer.

Foreign investors, especially US institutions, may well decline to invest in securities which do not come with accounting/legal opinions carrying sufficient recourse. They may well choose to invest in securities issued by issuers from jurisdictions which require professional service firms to stand behind their work.

3.11 Whose liability will be capped?

The Victorian Professional Standards Act 2003 allows capping schemes for:

- all persons within an "occupational association"; or
- a specified class of persons within an "occupational association".

"Occupational association" is defined as a body corporate which represents the interests of members of an "occupational group" and whose membership is "limited principally to members of that occupational group".

"Occupational group" is defined to "include" (note: the term is deliberately not exhaustive) a "professional group and a trade group".

Neither "professional group" nor "trade group" are defined.

"Professional group" is a term of wide meaning which could well include, to give but some examples, bankers, tax advisers, politicians and priests, as well as those traditionally considered to be professionals.

"Trade group" is an extremely wide term. It is very likely to include trade unions, as well as most classes of worker.

The Victorian Professional Standards Act 2003 thus makes it likely that virtually all categories of occupation will be able to limit their liability. Which association or organisations require the benefit of the laws should be carefully thought through.

Moreover, what is the relationship between existing regimes for limiting liability (such as the Corporations Act) and this regime? Since companies can take advantage of capping schemes (see for example section 20 of the Victorian Act), companies may well be able to rely, for at least some of their liabilities, on two separate legislative protections from liability.

4. Model capping schemes – minimum standards applicable to schemes limiting liability for professionals

The Commonwealth legislation giving effect, for the purposes of Commonwealth law, to schemes which limit the liability of professional services firms allows the Commonwealth to prescribe, by regulation, which schemes will benefit from capping liability under Commonwealth law.

We would therefore submit that the Commonwealth therefore should use the power thereby given to it to ensure that schemes for capping liability conform to certain minimum standards. Those minimum standards should require that:

- professional service firms should be allowed, if they so choose, to contract out of the scheme all together;
- schemes permit professional service firms to opt for liability caps greater than the caps mandated by any particular scheme. Professionals should, at a minimum, have the right to opt for higher limits for particular clients, for particular jobs, for particular categories of work or for work of a particular value;
- caps determined as a multiple of fees for particular items of work or particular transactions should be prohibited;
- caps for a particular professional services firm should be calculated by reference to the amount of insurance cover that firm could purchase with a specified percentage of its revenues or profits;
- professional service firms should be obliged to devote a minimum percentage of their revenues to the acquisition of acceptable insurance. That insurance should meet certain basic requirements to ensure it is suitable to protect the consumer;
- States must ensure that professionals are able to use incorporation and reliance on proportionate liability as an alternative to capping. The Discussion Paper on CLERP 9 published by the Treasury in September 2002 concluded, in relation to auditors, that incorporation and proportionate liability were sufficient to address insurance problems and were preferable solutions to capping.
- schemes should be approved by the ACCC and by appropriate prudential regulators;
- occupational associations should be required to demonstrate annually that the scheme continues to be necessary.

4.1 Schemes must not prohibit contracting out or opting out

A number of existing schemes, eg. the Accountants Scheme made under the Professional Standards Act, New South Wales, (the Accountants Scheme) prohibit members of the scheme from accepting, by private contract or otherwise, liability limits higher than those prescribed by the scheme. Members of such schemes are obliged to accept the limit of liability imposed by the scheme (eg. in the case of the Accountants Scheme, 10 times the fees for a particular item of work, or $20 million – whichever is lower) no matter how appropriate or inappropriate that limit is for the particular firm or the particular item of work.

Where such prohibitions on contracting out exist, a member who wishes to opt for a higher limit of liability, must opt out of the scheme entirely.

These, and any other, limitations on contracting out or indeed opting out generally should not be permitted. Generally, professional service firms should be allowed to accept voluntarily caps higher than those prescribed by individual schemes:

- for particular kinds of work;
- for a particular specified transaction or class of transactions;
- for a particular client or clients;
- for work of a particular value; or indeed
- in any other way.

Indeed, the competitive effect of permitting contracting out will ensure that whatever available capacity exists in the insurance market will be used for the benefit of consumers. Firms will have an incentive to differentiate themselves by offering higher caps and this competition will drive rival firms to utilise whatever spare insurance capacity exists. Without this mechanism, consumers will lose the ability to obtain the maximum liability protection the insurance market can offer at any particular point in time.

Apart from being strongly pro-competitive, the ability to contract for higher limits may prevent the loss of work that Australian firms will otherwise suffer when they must compete for work with international service providers whose liability is not capped. If Australian firms can accept higher liability caps for work subject to international competition, they will be rendered much more competitive with overseas service providers.

Similarly, permitting contracting out will reduce the problems that liability capping schemes will cause Australian corporates in accessing foreign capital. Because foreign capital markets frequently require provision of opinion letters and comfort letters from an Australian issuer's professional advisers, Australian corporates will

be disadvantaged in accessing foreign capital markets when compared to issuers from jurisdictions where professional service advisers' opinions come with uncapped liability. "Contracting out" would permit Australian professional service firms to give uncapped opinion letters to Australian clients in support of Australian clients' capital raising efforts.

Allowing contracting out will have no adverse consequences on the expressed goals of the legislation. The goals of the legislation are said to be to ensure that Australian consumers continue to get reasonable recourse from professionals by ensuring that professionals have access to affordable insurance and are therefore not induced to "go bare". Contracting out would be a purely voluntary act by the professional service firm and would be designed solely to allow higher limits of recourse where the professional is able to offer them.

If there must, contrary to this submission, be some "approving authority" which consents to contracting out, the approval authority should not be the relevant "occupational association" as in the Victorian Professional Standards Act but should be a body, such as the ACCC, expressly charged with protecting consumers.

4.2 Caps based on a multiple of fees should be prohibited

A number of existing schemes, eg. the Accountants Scheme, provide for liability to be capped to a multiple of the fees charged for a particular item of work. Such caps should not be permitted for a number of reasons including:

- caps based on a multiple of fees will almost inevitably mean that a significant number of claims will fall outside the caps; and
- there is no necessary link between the fees charged for a particular professional service, and the loss to which that service may give rise. This lack of any link arises for many reasons, including the fact that the size of a loss resulting from an act of professional negligence will often depend on attributes of the victim of the loss which vary from consumer to consumer and are not dependant in any way upon the fees charged for a professional service.

Requiring some proportional link between the professional fees applicable to a particular job, and the loss caused by that job, is not required to ensure the availability of insurance. Insurance, almost by definition, pools risk and allocates premiums, and payouts, on an aggregate basis. To permit professionals to limit liability to a multiple of fees on a particular job is to deprive consumers of the benefit of this pooling of risks. The fact that insurers can pool risks means that the "eggshell skull" victim should be able to recover more than a fixed multiple of fees because there will be a number of robust victims whose loss will be less than the fixed multiple of fees.

It should be noted that there does not appear to be any publicly available empirical data concerning the impact that caps based on a multiple of fees would have on claims. The Explanatory Memorandum states that "available data supports statements that the overwhelming majority of claims are settled within the established caps". In support of that proposition the Explanatory Memorandum quoted data supplied by LawCover. However, LawCover gave data about the number of claims above $1.5M. It provided no evidence as to whether claims would frequently be settled within a cap based on a multiple of fees.

4.3 Caps should be related to the amount of insurance a professional can purchase with a given percentage of the professional's revenue or profits

Just as caps based on a multiple of fees are inappropriate and inequitable, mandating a fixed dollar cap on liability for a particular profession is also inequitable and inflexible. It is a "one size fits all" solution which applies equally (for example) to giant multi-national accounting firms as it does to suburban accounting practices.

Caps should be determined in a way that fluctuates according to:

- the state of the insurance market and the availability of insurance;
- the profitability of a particular profession generally;
- the risks applicable to a particular industry.

If this is not done, a particular firm's liability cap could be fixed at a fixed dollar amount for the life of a capping scheme despite the fact that during the life of the scheme:

- insurance had become significantly easier to get, and/or significantly cheaper;
- the particular firm (or indeed all firms in the particular industry) was experiencing boom times and could easily afford more insurance; and/or
- the risks of a particular industry have changed.

Further, a cap which varied in accordance with changes in the state of the market and the risks of a particular industry would seem to be the only way to ensure that consumers receive the maximum possible protection available through the insurance market at any given time. Static, fixed caps will almost certainly provide a windfall benefit to professionals as the cost and availability of insurance changes.

Thus, it seems much more sensible to have caps which are determined as the amount of insurance cover which a professional could purchase with a particular percentage of the professional's revenues or profits.

This is a similar approach to that which the Commonwealth Government followed in relation to doctors. It tied an individual doctor's obligation to pay premiums to that

doctor's income from Medicare. Thus, each doctor was obliged to pay 100% of all premiums up to 7.5% of his/her Medicare income but only 20% of the premium above 7.5% of his/her income from Medicare (with the Government paying the balance of the premium). The formula for doctors related their obligation to pay premiums to a percentage of their revenue from a particular source.

4.4 Professional service firms should be required to devote a stipulated minimum percentage of their revenues or profits to the purchase of insurance which met minimum acceptance standards

It is recognised that a quid pro quo for liability capping would be an obligation to purchase a certain minimum level of insurance. For reasons set out above, the amount of insurance a firm would be required to purchase should vary according to its revenue or profit. It should neither be expressed as a dollar amount nor be static.

Thus, it might be possible to:

- set liability caps as an amount equal to the amount of insurance coverage which could be purchased with, say, 7.5% of a firm's prior year profits (or an appropriate percentage of revenues); but
- a firm might only be required to spend 5% of its prior year profit (or an appropriate percentage of revenues) on purchasing insurance.

Insurance qualifying for the purposes of this requirement should have certain minimum characteristics. It should be:

- purchased from a reputable insurer;
- have appropriate deductibles;
- cover appropriate liabilities;
- not have unacceptable exclusions;
- otherwise generally conform to acceptable standards

4.5 Mandating proportionate liability and use of limited liability companies

For reasons set out above, allowing professionals to conduct business through incorporated entities, and introducing proportionate liability, may well be better methods of protecting professionals than capping schemes.

Liability capping schemes should therefore not be mandated as the sole way of avoiding unlimited liability for professionals. Thus, State capping schemes should only confer protection from liability under Commonwealth law if the relevant State has also implemented proportionate liability and permits its professionals to conduct business through companies.

As has been noted above, the Discussion Paper published by the Treasury in September 2002 concluded in relation to auditors (possibly the professional group most exposed in this area) that proportionate liability and allowing incorporation was a better solution to insurance difficulties than capping schemes. However, capping schemes are preferred by professional firms because they offer professional firms immunity from failure by reason of negligence, whilst incorporation does not grant such complete immunity.

It is submitted that the original reasons for preferring proportionate liability and incorporation as a solution are valid, and indeed powerful. Professional firms should therefore be encouraged, and enabled, to rely on incorporation and proportionate liability to solve their insurance difficulties rather than capping.

4.6 Schemes should ensure an appropriate role for the ACCC and prudential regulators

As discussed above State capping schemes should only be given protection under Commonwealth law to the extent that the ACCC is satisfied that the scheme is no more anti-competitive than is necessary to meet the objective of protecting professionals. Similarly, there should be some mechanism for prudential regulators such as APRA to ensure that schemes do not transfer risk any more than is necessary to ensure the availability of insurance.

4.7 Schemes should contain inbuilt mechanisms to ensure they survive only as long as the demands of the insurance market require

Capping legislation is predicated on the argument that it is necessary to overcome difficulties in the insurance markets. It is quite possible that these difficulties are temporary rather than permanent. Indeed, anecdotal evidence suggests that the insurance market has already eased somewhat.

To ensure that capping schemes last only so long as they are necessary to achieve the legislative intention, the "occupational associations" which propose schemes should be obliged to demonstrate, annually, that insurance conditions in their particular markets justify the continuation of capping schemes. Where the occupational association cannot do this the scheme should be terminated immediately.