INSURANCE COUNCIL OF AUSTRALIA

Submission to the Inquiry into the Treasury Legislation Amendment (Professional Standards) Bill 2003

Senate Economics Legislation Committee

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1 Introduction

The Insurance Council of Australia (ICA) is the representative body of the general insurance industry in Australia. ICA members account for over 90 per cent of total premium income written by private sector general insurers.

ICA members, both insurance and reinsurance companies, are a significant part of the financial services system. Recently published statistics from the Australian Prudential Regulation Authority (APRA) show that the private sector insurance industry generates direct premium revenue of $19.8 billion per annum and has assets of $66.6 billion. The industry employs about 25,000 people.

ICA members issue some 37.8 million insurance policies annually and deal with 3.5 million claims each year.

2 This submission

ICA makes this submission to the Senate Economics Legislation Committee Inquiry into the Treasury Legislation Amendment (Professional Standards) Bill 2003 (Bill). This submission has four parts:

- Professional Indemnity Insurance and Professional Standards Schemes (Part 4)
- Professional Indemnity Insurance Crisis (Part 5)
- Four pillars of Reform to improve Professional Indemnity (Part 6)
- Submissions on Treasury Legislation Amendment (Professional Standards) Bill 2003 (Part 7)

3 Executive Summary

ICA welcomes the introduction of this Bill as Commonwealth legislation which supports State and Territory professional standards legislative initiatives. ICA believes the enactment of the Commonwealth legislation will give insurers greater confidence that the State and Territory professional standards reforms will have a true impact on the quality of services delivered to consumers of professional services in Australia, leading to lower overall cost of professional indemnity insurance claims.

ICA believes, however, that the legislation could be more effective in supporting professional standards reforms if it applied to a broader range of remedies that are available under Commonwealth law. There may also be unintended outcomes depending on the ability of a particular litigant to access remedies that will not be subject to the reforms proposed by the Bill.

The impact of professional standards legislation on the cost of professional indemnity insurance will depend upon the extent to which the imposition of mandatory professional standards, more effective risk management and better professional practice management leads to an overall lowering of the cost of professional indemnity insurance claims in Australia.

4 PI Insurance and Professional Standards Schemes

Professional Indemnity (PI) is a form of liability insurance. It indemnifies professional persons – accountants, architects, engineers, lawyers, physicians and others – for their legal liability to their clients and others relying on their advice. This liability principally arises from negligent breach of contract, but may also arise in simple negligence and by means of breach of statutory obligations (for example, statutory obligations imposed by the *Trade Practices Act 1974*).

Professional Indemnity insurance classes are underwritten by a small number of Australian insurers, locally based branches and subsidiaries of major overseas insurers, and through underwriting agencies which place the cover into the Lloyds market, primary underwriters in Australia and to reinsurers. Some of the hard to place risks can only insured on the international market through large international insurance brokers.

The nature of PI claims differs according to the profession being indemnified. Accountants, lawyers, investment advisers and valuers, for example, are sued usually for economic (financial) loss occurring as a result of advice provided. These claims can have a volatility related to the economic cycle, with more claims for higher amounts tending to be generated when an economy is in recession.

Claims against architects and engineers often relate to some physical (or property) damage leading to economic loss. Personal injury may also be involved.

Professionals require insurance in order to cover the risk that they are successfully sued in contract, negligence or under a statutory provision for a loss caused by them. Insurance enables professionals to secure their personal and business assets without using complex structures to divorce themselves from those assets. Insurance is also required under some laws, such as the *Financial Sector Reform Act 2001*, under which most professionals providing financial professional services are required to hold indemnity insurance. Insurance also operates to ensure consumers of professional services can quickly gain the benefit of any award of damages they obtain against a professional.

Professional Standards Legislation (PSL) was first enacted in New South Wales in 1994, and was introduced in Western Australia in 1997. New legislation was enacted in Victoria on 2 December 2003 (*Professional Standards Act (Vic) 2003*).

In the Explanatory Memorandum to the current Bill, PSL is accurately described as follows:

"In essence, PSL seeks to minimise damages claims against professionals through improved professional standards – by requiring risk management strategies, compulsory insurance cover, professional education and appropriate complaints and disciplinary mechanisms – in return for caps on the liability of professionals who are covered by PSL."

The model of PSL, first established in NSW and duplicated in WA has the following key features:

- A professional association may apply to the Professional Standards Council to register a scheme
- A scheme usually applies to everyone in that profession, or to classes of practitioners specified in the scheme. In NSW, a person may, on application by a person, be exempted from the scheme.
- Contracting out of the scheme on a contract-by-contract basis is prohibited

- Each scheme has a life of 5 years

- The scheme caps the professional liability of the professional covered at a figure not less than the minimum figure fixed by the Act (presently $500,000 under all PSL). Under both NSW and WA PSL, the minimum cap is $500,000 but, as the following examples demonstrate, the cap is frequently set above this minimum:

    - Example 1: The Law Society of NSW. A Law Society member may have limited liability of between $1.5 million and $50 million. For solicitors who practice in a firm having more than 3 principals, it may be calculated by multiplying $500,000 by the number of principals in the firm, up to $10 million, but a member can select a higher liability amount up to $50 million.

    - Example 2: The Institute of Consulting Valuers Co-operative Limited (ICV) of NSW administers a professional standards scheme for all of its members with a Public Practice Certificate issued by the Institute, and residing in NSW. Under the current scheme, an Institute member may have limited liability of $5 million. In the case of residential valuations, liability is limited to $500,000.

- Liability caps DO NOT apply to any liability for damages for personal injury

- The scheme cap only affects the liability for damages arising from a single cause of action to the extent to which the liability results in damages exceeding such amount as is determined for the purposes of the scheme

- The scheme requires members to protect the interests of consumers by:

    - maintaining insurance cover or business assets or both up to the level of the cap

    - undertaking risk management procedures such as ongoing professional education

    - subjecting to the supervision and, where necessary, disciplinary powers of their professional association.

Because PSL has been a feature of the laws of two States only, exposure of professionals to claims under Commonwealth laws, such as the *Trade Practices Act*, has remained in place. The availability of alternative remedies under Commonwealth law has meant that the existing schemes in New South Wales and Western Australia have had little if any impact on the insurance market.

It should also be noted that where PSL does not operate, PI insurance will always have clear limits in relation to the maximum amount of cover provided by the insurance policy. Unrestricted legal liability will not necessarily be matched by unlimited insurance cover.

5 The PI Insurance Crisis

Professional Indemnity insurance has been a difficult line of cover for insurers for a number of years. The following figures for Professional Indemnity insurance are extracted from the most recent industry statistics, which were published by APRA in June 2002.[1]

Year	Premium Income ($m)	Claims Incurred ($m)	Underwriting expenses ($m)	Underwriting result ($m)	Loss Ratio %
Dec 1999	594	783	93	-282	147
Jun 2000	582	914	87	-419	172
Dec 2000	610	818	93	-301	149
Jun 2001	363	309	73	-19	105
Dec 2001	521	567	93	-139	127
Jun 2002	556	619	96	-159	129

The apparent reduction in premium and claims for 2001 is misleading, because of the absence of information regarding business written by HIH prior to its collapse in March 2001. Overall, the figures demonstrate the very significant underwriting losses reported to APRA.

The ACCC's Second Monitoring Report into Public Liability and Professional Indemnity insurance[2] confirmed the difficult nature of the PI market in Australia. The ACCC reported that the average size of PI claims increased in real terms from $5,915 in 1997 to $19,492 in 2002, an increase of 230 per cent. This upward trend was also observed in the first six months of 2003, when there was a further 19 per cent increase in average claim size to $23,248.

The ACCC also reported that the average premium had increased by 128% between 1999 and 2002, to $8,282. A further increase in premiums occurred in the first six months of 2003, when the average premium increased to $8,698, a rise of 5 per cent.

The ACCC also found that the net combined ratio for professional indemnity insurance had fallen from 117% in 2001 to 92% in 2002, but increased again to 98% for the first six months of 2003.

It is important to note that for professional indemnity insurance, claims costs are predominantly driven by damages awards for economic and property losses. The liability law reforms introduced to date by the Commonwealth, States and Territories have targeted damages for pain and suffering for minor injuries, and hence are likely to have only limited impact on the cost of PI claims.

ICA has strongly supported ongoing monitoring of PI insurance by the ACCC, and is also working with APRA for the creation of a comprehensive industry database for public liability and professional indemnity insurance policies and claims.

[1] Please note that the Underwriting Results shown above are gross figures and do not allow for payment of reinsurance premiums or claims recoveries. Also, the APRA statistics include Directors' and Officers' insurance but do not include Medical Malpractice because the mutual arrangements under which doctors are covered have not been regulated by APRA.
[2] ACCC Public liability and professional indemnity insurance – second monitoring report (January 2004). In July 2002, the Ministerial Meeting on Insurance Issues asked the Australian Competition and Consumer Commission (ACCC) to monitor costs and premiums in public liability and professional indemnity on a six monthly basis over two years to assess the market in these areas.

6 Four pillars of Reform to improve PI Insurance

There are four pillars to a reform package that can assist in improving the availability and affordability of professional indemnity insurance:

1. nationally consistent Professional Standards legislation;

2. amendment of section 54 of the *Insurance Contracts Act 1984* (IC Act);

3. proportionate liability; and

4. amendment of the *Trade Practices Act 1974* (TPA).

In the Joint Communiqué of the Ministerial Meeting on Insurance Issues of 27 February 2004, the Meeting made the following statement on these pillars:

"All jurisdictions have progressed legislation to improve the affordability and availability of professional indemnity insurance. Ministers reaffirmed their commitment to implement reforms including the introduction of professional standards legislation, proportionate liability, amendments to the *Trade Practices Act 1974*, and reforms to section 54 the *Insurance Contracts Act 1984*."

These pillars of reform are important long-term conditions for a stable and sustainable Professional Indemnity insurance market in Australia. However, it is important to note that the benefits of these reforms will not necessarily be felt immediately.

PI insurance is usually (virtually always) provided under "claims made" policies. These policies provide cover to the policyholder in respect of claims made against the professional during the period of the policy, regardless of when the actual loss occurred. Claims may arise out of any negligent act, error or omission that took place many years before the claim is made. Changes to the law under the proposed reforms are rarely, if ever, retrospective, and are unlikely to reduce the cost of claims arising from incidents that occurred before the legislation takes effect. It is inevitable that the reforms package, if fully implemented, will take some time to have a major impact on the cost of claims.

Nationally Consistent Professional Standards Legislation

A coherent and consistent regulatory matrix for professional standards requires:

- States and Territories to enact consistent PSL

  There should be few if any discrepancies between jurisdictions unless there is a clear policy reason for such a discrepancy. Consistent professional standards legislation minimises the costs of complying with discordant legislation.

  The need for and benefits of consistent PSL has been recognized by the Commonwealth, States and Territories. The Joint Communiqué of the Ministerial Meeting on Insurance Issues of 27 February 2004 states that "Ministers confirmed unanimous support for professional standards legislation reforms." In addition to the legislation already in place in New South Wales and Western Australia, Victoria has also enacted PSL.

ICA commends the Ministers' support for PSL reforms and has encouraged them to pass such legislation quickly and consistently.

- The Commonwealth to support State and Territory schemes by closing the gap between liability caps under State and Territory schemes and liability caps under Commonwealth law.

  ICA considers the Bill as pivotal in assisting to remove the possibility of remedies under Commonwealth laws being used to circumvent liability caps imposed under State and Territory PSL schemes. Without comprehensive and consistent Commonwealth, State and Territory legislation, litigants will be tempted to forum shop (between jurisdictions, if the cause of action is available in more than one State or Territory) and cause of action shop (between remedies available under differing Commonwealth, State or Territory laws).

  ICA commends the principle underlying the Bill, but would have preferred the Bill to operate more broadly than is currently the case. The available of alternative remedies will continue the exposure of professionals to liability under those remedies, and hence may limit the extent of any beneficial impact of reform on PI insurance.

Amendment of s54 of the *Insurance Contracts Act 1984*

As previously noted, PI insurance is usually written on a 'Claims Made' or a 'Claims Made and Notified' form of insurance contract. This means that an insurer indemnifies the insured against claims made during a policy year (or, in relation to a 'claims made and notified' policy, for circumstances notified to an insurer which ultimately become a claim against the insured), notwithstanding that the negligent act, error or omission may have occurred prior to the inception of the policy. This form of contractual arrangement is intended to control the uncertainties associated with "incurred but not reported" claims so that insurers can have greater confidence in the number of claims arising out of any policy period, and thereby be in a position to offer PI insurance on more affordable terms.

However, the judicial interpretation of s54[3] of the IC Act in Australia has fundamentally altered the essential nature of 'claims made' and 'claims made and notified' policies. Courts have required insurers to provide cover and indemnify insureds in cases where facts and circumstances that might give rise to a claim are notified to the insurer after the policy period has expired.[4]

The Commonwealth Government has commissioned a review of the IC Act, and the review has published an interim report recommending changes to the Act. Draft amendments to section40 and new section 54A have been released for comment. ICA sought legal advice and comment from its members on the implications of the draft amendments at the time of making this submission.

[3] Section 54 of the IC Act prevents an insurer from relying on a term of a contract of insurance that would allow the insurer to refuse a claim for the sole reason of an act, error or omission of the insured. Instead of refusing the claim, the insurer may reduce the claim to the extent of the prejudice it has suffered from the act, error or omission of the insured.
[4] For a more detailed discussion of ICA's concerns on the judicial interpretation of s54, refer to ICA's October 2003 submission to the Review of the IC Act at http://icareview.treasury.gov.au/content/submissions.asp?NavID=3

Proportionate liability

Under the law as it currently stands, where a number of wrongdoers contributed to a loss, each of those wrongdoers is jointly and severally liable for the full extent of the loss. This means that each wrongdoer can be held liable for the full amount of any damages awarded to a claimant. The claimant may recover the full amount from any one of the multiple wrongdoers.

The system of joint and several liability creates a significant problems for insurers that provide professional indemnity cover: they must price and underwrite insurance policies having regard to the fact that the policyholder may be liable to pay the full loss of a claimant, even if another wrongdoer is responsible for part (even a substantial part) of that loss. Joint and several liability enables a claimant to pursue the wrongdoer with the deepest pockets, the one with insurance. The insured wrongdoer who pays the damages can seek contributions for the loss from other wrongdoers, but this is usually of little assistance of those other wrongdoers are not covered by insurance.

At the Ministerial Meeting on Insurance Issues in Adelaide on 6 August 2003, Commonwealth, State and Territory Ministers endorsed a national model for proportionate liability. Proportionate liability means that a wrongdoer is liable for damages to the extent to which they contributed to the loss in the first place. ICA supports the broad application of this model to claims economic loss and property damage. In order to be fully effective, proportionate liability must apply to all causes of action unless there are clear public policy reasons for exclusion. For example, ICA accepts the recommendation of the Ipp Report that proportionate liability should not apply to personal injury claims.

Amendment of the *Trade Practices Act 1974*

The TPA provides a number of alternative actions to claimants who may find that their claims are unable to be brought or will be restricted by State and Territory liability reform,[5] such as:

- provisions such as section 52 of the TPA prohibiting misleading and deceptive conduct;
- various provisions regulating disclosure of information such as those found in the *Corporations Act;* and
- provisions imposing warranties in respect of the supply of goods or the supply of services found in provisions such as sections 71 and 74 of the TPA.

These provisions of the TPA are replicated in other areas of Commonwealth law, namely the *Australian Securities & Investments Commission Act 2001* and *Corporations Act*.

PSL and proportionate liability reforms will not be fully effective, and will have only limited impact on the PI insurance market, if the TPA is not amended to complement the reforms introduced by the States and Territories.

[5] Refer to Part 4 of this submission

7 Treasury Legislation Amendment (Professional Standards) Bill

The Bill implements the first part of the Commonwealth's response to the professional indemnity insurance liability law reform agenda.

The purpose of the Bill, as described by the Hon Ross Cameron MP, Parliamentary Secretary to the Treasurer, in his Second Reading Speech to the House of Representatives on 4 December 2003 is:

"to amend the Trade Practices Act 1974 and other relevant Commonwealth legislation to support professional standards laws which are currently in force in New South Wales and Western Australia, and which other jurisdictions are expected to adopt in due course."[6]

ICA strongly supports the stated purpose of this Bill. ICA views this purpose as a significant part of the Government's reform package designed to improve the availability and affordability of professional indemnity insurance in Australia.

In ICA's view, if the Bill is to fulfil its purpose, it should:

- Completely close the gap between liability caps under State and Territory professional standards schemes and any remedies available under Commonwealth law
- Support nationally consistent State and Territory Professional Standards Legislation
- Support the four pillars of reform set out in Part 5 of this submission.

ICA has several concerns about the Bill as presently drafted, which are set out below.

Impact

The development and enactment of PSL legislation in Australia is designed to assist consumers of professional services by –

- Mandating the application and use of improved professional standards, including effective risk management and proper avenues for claims and disputes regarding the services provided by professionals;
- Mandating the carriage of PI insurance by professionals, up to limits prescribed by the independent Professional Standards Council;
- Easing the overhead cost of PI insurance (which would otherwise have to be passed on to the consumer) by providing liability caps to professionals operating within an approved professional standards scheme.

The primary impact of the reforms will be the obligation on professionals to provide a higher quality of service to their customers. This should, over time, reduce the number and cost of claims made

[6] at 23772

against professionals under their PI policies. The extent to which this occurs will determine the extent to which the insurance market is able to offer more affordable PI cover to professionals.

As noted above, in the meantime insurers will be providing cover in respect of past losses, under the typical 'claims made' and 'claims made and notified' policies. This means that it is inevitable that savings in claims costs will take some time to flow through to PI insurance premiums.

While professionals may currently have virtually unlimited liability (except in NSW and WA), inevitably their existing PI insurance cover would have policy limits. If the liability caps are similar to the current policy limits, the mere introduction of liability caps will not reduce the exposure of insurers. Where the liability cap under a PSL scheme is lower than typical policy limits for that profession, any reduction of exposure would of course be likely to lead to a reduction in premiums.

If the Bill is not passed

Failure to enact the Bill will mean professionals will be exposed to unlimited liability for breach of Commonwealth laws, thereby negating the beneficial impact of liability caps that would otherwise be available under PSL schemes introduced under State and Territory laws.

Application

The Bill seeks to establish a structure under which the Commonwealth, by prescribing schemes under State and Territory PSL, can support those laws by capping liability under three Commonwealth acts: the TPA, ASIC Act and Corporations Act.

Specifically, the proposed legislation caps liability for misleading and deceptive conduct, which is found to be in contravention of:

(a) section 52 of the TPA;

(b) section 12DA of the ASIC Act; and

(c) section 1041H of the Corporations Act,

by reference to the caps imposed by State and Territory schemes.

It will not apply to many other provisions of the TPA, ASIC Act and Corporations Act which may be available to claimants. A good example of this is s74 of the TPA. Section 74, contained in Division 2 of Part V of the TPA, implies into contracts for the supply of services to consumers implied warranties that the services will be supplied with due care and skill and that, if a particular desired purpose is conveyed by the consumer to the supplier, the services will be reasonably fit for that purpose. A person may acquire professional services at a cost of up to $40,000 as a "consumer" for the purposes of the TPA. Related warranties are implied in relation to the supply of materials in connection with the services.

Section 74 provides an alternative cause of action to a claimant who essentially seeks to recover damages against a professional for negligence. If the liability of that professional is capped under a State or Territory professional standards scheme, it is likely that the claimant will seek to recover

damages for a breach of s74 under the TPA, if the professional's liability is not capped if an action is brought under that Commonwealth provision.

The enactment of this Bill will not affect a s74 cause of action or any other cause of action based on a provision other than a prohibition on misleading or deceptive conduct under the TPA, ASIC Act or Corporations Act. This could have serious ramifications for an individual professional and its insurer.

ICA is concerned that if passed with its current narrow application, the Bill will have the following implications:

- Inappropriate recourse for claimants. The ability of a particular claimant to access remedies that have not been subject to reform will depend largely on chance as to whether the loss or injury suffered happens to fall within the particular provision that has not been addressed by the Bill.

- Uncertainty for insurers as to their exposure. Insurers are best able to offer affordable insurance when they are able to fully understand their exposure to risk. Only a consistent and comprehensive liability cap can significantly improve an insurer's understanding of exposure to risk.

Choice of law

With respect to each of relevant misleading and deceptive conduct provisions of the TPA, ASIC Act or Corporations Act, the Bill provides that the:

"choice of law rules operate in relation to the contravention [of the relevant misleading and deceptive conduct provision] in the same was as they operate in relation to a tort."

The Explanatory Memorandum states that this provision is intended to apply "where uncertainty might otherwise exist as to which State or Territory law was determining the occupational liability arising out of misleading and deceptive conduct".[7]

Following *Pfeiffer v Rogerson,*[8]the general rule in relation to torts committed within Australia is that liability is determined according to the law of the place of the wrong. As a consequence, ICA considers that several problems arise from the current drafting of the Bill, which are demonstrated by the following examples:

- Example 1:If a claimant proves loss arising from the breach by a professional of s52 of the TPA but does not also establish liability in tort (since that is not necessary to found a cause of action under the TPA), the Bill as presently drafted does not assist the choice of which State or Territory's professional standards law apply to limit the professional's liability.

- Example 2: If a professional provides services negligently in more than one State or Territory, the relevant tort may have been committed in each State or Territory and the Bill does not resolve the issue of which professional standards scheme applies or, alternatively, whether any scheme applies if there is not a prescribed scheme in each State or Territory.

[7] Explanatory Memorandum to the Treasury Legislation Amendment (Professional Standards) Bill 2003, para 12 in commentary on Item 3 of the Bill

[8] John Pfeiffer Pty Ltd v Rogerson John Pfeiffer Pty (2000) 203 CLR 503; (2000) 172 ALR 625

- Example 3: If a professional provides services to a claimant within the same State but for valid reasons the law of the contract governing those services is the law of another State, the professional's liability under s 52 of the TPA will nevertheless be determined by reference to the professional standards scheme of the State where the tort was committed. This may not always produce an undesirable result but the location of the parties, the location of the services and the law of the contract may produce difficulties where multiple jurisdictions are involved.

8 Conclusion

ICA strongly supports the introduction of legislation that supports State and Territory PSL.

The recent commitment of State and Territory ministers to PSL is a commendable step towards improving the PI market in Australia. However, Commonwealth legislation that supports their commitment is necessary to improve insurers' confidence in the quality of professional services provided to consumers.

The quality of professional services is central to the overall cost of PI insurance claims, and as such, the impact of PSL on the cost of PI insurance will depend upon the extent to which the imposition of mandatory professional standards, more effective risk management and better professional practice management has an overall impact on the cost of PI insurance claims in Australia.