

# A Client's Guide to Professional Indemnity Insurance

## Introduction



PI insurance is in place primarily to protect the interests of the insured and not those of his client.

In order for any PI policy to be triggered the claimant (usually the client) has to establish the advisor's legal liability for the losses that he has incurred but the legal process can be lengthy, uncertain and expensive. Although many potential clients believe otherwise, it is not an insurance policy that can be called upon directly to cover the client's 'first party' losses.

A client has only effectively transferred a risk when he has been properly reimbursed for any financial loss that flows from that risk. A risk transferred through a contract of appointment where the financial consequences cannot be borne by the recipient is not a managed risk.

As advisors and designers, the majority of AGS Members have few liquid assets and are, in the main, dependent on their PI policy to pay out on liabilities for their advice or design. If they breach their policy conditions or if the settlement is greater than the amount insured then it is the client as claimant that suffers.

This guide aims to assist clients to better understand PI insurance issues and the need for agreement with their advisors and designers on the most sensible allocation of financial risk.

## Professional Indemnity Insurance: *some basic principles*

There are a number of important aspects of PI insurance which can act against the recovery of loss under a PI policy.

- The claimant needs to prove the insured's legal liability for the loss suffered. Losses can occur even when no liability attaches to the advisor.
- PI insurance is generally only available for periods of twelve months so the advisors need to renew their cover arrangements on an annual basis. A failure to do so would leave the advisor uninsured.
- In common law countries, PI policies generally operate on what is known as a "claims made" basis. This means that it is the policy in force when the insured party first notifies a claim (or a circumstance that might give rise to a claim) to his insurers which applies. The policy, if any, that may have been in place when the appointment was made, or when the alleged breach of contract or negligence arose, is irrelevant.
- Policies will either be on a 'costs inclusive' or on a 'costs in addition' basis. The former means that the legal costs have to be paid out of the insured sum before paying the claimant, while in the latter the full amount of the insured sum is available to the claimant with all legal costs being paid by the insurer 'in addition' to the sum insured. This latter basis is therefore of greater potential benefit to clients who could be inadequately reimbursed for their losses if the insured had his PI on the former 'costs inclusive' basis.
- Advisor appointments may involve periods of potential liability over a number of years. Therefore, should an advisor fail to renew its annual cover, it is effectively uninsured for any work undertaken at any time in the past, leaving the potential claimant unable to recover their loss through PI Insurance.
- PI policies in the future may not be available at commercially acceptable premiums or may not be available at all to cover the type of work originally carried out by the advisor.
- An insurance company may not be able to pay a settled claim if it goes into liquidation prior to the date of settlement despite the claim having been properly notified within the policy conditions. It would then fall to the insured to settle the claim from their assets.

Clients need to be aware that there can be no guarantee that a PI policy will be in place when a claim is made or that the insurance company itself will be able to pay out on the settlement in the future.

The excess (or deductible) is the part of any claim that is paid by the insured as opposed to the insurer. It is not unusual for these to be set at significant levels, perhaps as much as 1% of the insured's annual fee income. The insured will need to be able to fund this excess themselves otherwise the insurer may be able to avoid the whole claim.

The limit of indemnity, as chosen by every insured party, is the maximum amount that insurers will pay. The limit can operate either on an "each and every" claim basis, meaning that the full limit of indemnity under the policy applies separately to each claim which might arise during the period of insurance or on an "aggregate" basis, meaning that the limit of indemnity applies as a maximum total payment irrespective of the number of claims notified during the period of insurance.

It is in the interest of the client that the advisor maintains cover on an "each and every" basis except where the insurance market can only provide "aggregate" cover such as for pollution and contamination or where aggregate cover is the only cover available at commercially viable premiums.

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As with all insurance products, exclusions are incorporated into PI policies. The most notable exclusions, of which clients should be aware, are:-

- claims involving responsibility for strict liabilities such as fitness for purpose and other similar contractual guarantees that are not subject to the test of negligence.
- fines, penalties and liquidated damages (including contractual penalty clauses).
- liability to pay under any bonding arrangements
- claims within 'each and every' cover which are limited in the aggregate

## Agreeing Limits of PI Indemnity

An important aspect of many AGS Members' advisor appointments is the extent to which the client requires them to carry PI insurance and, if so, for what period of time.

The requirement should reflect the actual loss that might arise which in turn will depend upon a number of inter-related factors such as:-

- the nature of the advisory services to be provided and the size and complexity of the project.
- the method of procurement adopted and the extent to which financial losses may be incurred if, for example, the project is delivered late.
- the extent of any high risk activities such as work on contaminated land and the level of fees being earned by the engineering consultancy on the project.
- the extent to which any design work might be used on a repeat basis.

Clients are advised to require their advisors to carry a reasonable limit of indemnity to meet their potential financial liabilities subject to its availability at commercially reasonable rates.

## Agreeing Limits of Financial Liability

As advisors are generally only able to fund risk to the extent that it can be insured, clients should accept that caps on financial liability agreed in the appointment contract must in some way relate to the PI available to the advisor. In this way, both clients and their advisors achieve a degree of certainty as to the liabilities of each to the other.

This strategy offers better protection to the client than imposing onerous liabilities for which there is no possibility of protection by insurance. Unlimited liability only exists in theory.

## Recommendations

The continued availability of adequate Professional Indemnity Insurance is clearly in the interest of all clients. To achieve this, their advisors and designers need to be able to present a risk profile that is reasonable as to amount, certain as to time and based on the discharge of their own responsibilities rather than those of others.

As a result clients are advised to incorporate the following provisions into their appointment documents:-

- a provision that limits the advisor's liability to an amount no greater than the amount recoverable under his PI arrangements.
- a "net contribution" clause such that the advisor will only be liable for that proportion of any loss which is directly related to their own actions.
- a clear point in time, from completion of the services, after which the advisor will be freed from liability and any requirement to maintain PII on the appointment.

It is important for clients to satisfy themselves that the PI arrangements put in place by the advisors they retain are in accordance with the requirements of the conditions of engagement. As PI claims can take a considerable period of time to settle, clients should also seek reassurance that the advisors and designers they employ only place cover with reputable insurers having a long term commitment to the class of business - even if this means higher premiums and higher fees.

If in any particular circumstance, a client feels that the level of his advisor's PI is inadequate, the client can either make arrangements for the consultant to increase the level of cover - in return for payment of any additional premium that is required or make his own alternative arrangements to ensure that additional finance will be available if required.