Professional indemnity insurance: dealing with the 'run-off' risk

In this second 'back to basics' article, Graeme Tinney of professional indemnity brokers Griffiths & Armour looks at the implications of the 'claims made' nature of PI insurance, the importance of run-off cover and the impact of market conditions.

A question we are frequently asked is how long professional indemnity (PI) insurance cover should be maintained for. To some extent, there is no 'right answer', particularly after the recent extension of limitation periods under the Defective Premises Act[1]. To make an informed decision, it is important to understand how PI insurance operates and what happens when cover is not maintained.

'Claims made' basis of PI insurance

A particular feature of PI insurance is the 'claims made' nature of cover. It means that the insurance cover provided for any claim is determined by the policy in force when a claim is first notified to insurers and *not* by:

- the cover in force when the alleged act of negligence occurred
- when the contract was entered into
- when the work was being performed.

Difficulties can therefore arise where the scope of cover has changed over time and is no longer sufficient to respond to specific risk exposures that have been formed previously. In a worst-case scenario, where cover is no longer available or is not maintained (for whatever reason), the firm will have no protection for future claims that may arise from work undertaken in the past.

This has particular implications for firms that cease trading or for sole practitioners who are considering retirement. While a firm may no longer be accepting any new commissions, there are residual or run-off liabilities associated with the projects it has undertaken. To protect against such liabilities, the firm will typically need to maintain run-off cover, which is often a significant, and sometimes unbudgeted, cost.

As mentioned, it is also difficult to advise firms on the period for which run-off cover should be maintained, but decisions tend to be based around factors such as the type of contracts entered into, and it is obviously best to err on the side of caution.

As time passes, the prospect of a claim will appear (and might well be) far less likely, but the cost of maintaining PI insurance for run-off liability must be viewed against the potential cost of an uninsured claim; the impact of which could prove catastrophic, particularly in retirement.

In terms of the cost of the insurance, the premium in the first year of run-off could be expected to be similar to the premium on the expiring arrangements. Although it should reduce over time, the cost and availability of cover will be dependent on several factors, including the firm's claims experience and wider conditions within the PI insurance market.

Impact of conditions within PI insurance market

Most firms in the UK will be only too aware of the challenging conditions that exist within the current PI insurance market. The last few years have been defined by a severe reduction in market capacity and underwriting appetite, significant increases in premium, and restrictions in the scope of cover insurers are prepared to offer.

It has been difficult for all firms to navigate their way through those challenges, but perhaps even more so for firms or individuals who are attempting to source run-off cover; particularly if the insurer on their arrangements has chosen to withdraw from the market.

Where that happens or where firms have ceased trading due to financial hardship, there is a clear risk that cover will not be maintained and it is important to appreciate that the absence of cover will have implications for parties other than the firm itself. The principals and indeed employees of the now defunct firm may have personal exposure in respect of both civil and potentially criminal liability (e.g. actions brought under health and safety legislation); and clients and other claimants will inevitably feel more exposed.

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Through the application of the principle of joint and several liability, there is also a very real risk to other consultants and contractors engaged on projects in which the defunct firm was involved.

Legislation governing civil liability provides that where two or more parties are responsible (even to a small degree) for the same damage, the plaintiff may pursue recovery against any of those parties as if each were liable for the entire damage.

While the paying 'defendant' is entitled to seek contribution from other parties who have contributed to the loss, in practice, they may be left to carry 100% of the loss where other parties are no longer around or have insufficient assets (e.g. where PI insurance is not being maintained). The risk of this occurring is eminently greater during a period of economic uncertainty.

Making good choices

There are measures that firms can take to protect themselves and, as is so often the case when it comes to effective risk management, this starts with making good choices.

- Consider your options well before you cease trading and engage with your PI insurance broker to understand what the implications might be.
- Give some thought to how you perceive and procure PI insurance. If firms have learned anything from the last few years and the demise of certain insurers, it must be the need to make wiser decisions that are centred on achieving greater sustainability and financial certainty.
- Understand the importance of contractual risk management. Firms that have looked to manage their liability under contract are undoubtedly better placed in terms of their residual exposure and their ability to source adequate and effective PI insurance into the future.
- Agree reasonable limitation periods on liability to achieve greater clarity on residual exposure and the period for which cover should be maintained.
- For other parties, the existence of net contribution clauses within contracts and collateral warranties will offer some protection to firms that might otherwise become exposed due to the failure or inability of other parties to maintain PI insurance cover.

CONSIDER YOUR OPTIONS WELL BEFORE YOU CEASE TRADING AND ENGAGE WITH YOUR PI INSURANCE BROKER

While PI insurance is annually renewable, professional liability is long-tail. Claims can arise long after a project has achieved completion and there is no guarantee that insurance cover will be available at that point, or at least available on the same specification. This means that gaps can emerge between liability assumed and the protection afforded by PI insurance. It underlines the importance of making good decisions when it comes to risk management and the placement of cover. This applies at all times, but could possibly be seen as particularly important when thinking about retirement.

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1) *Defective Premises Act 1972*, c. 35 [Online] Available at: www.legislation.gov.uk/ukpga/1972/35/contents (Accessed: October 2022)