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WHAT PROFESSIONAL INDEMNITY INSURANCE LIMIT IS ADEQUATE?

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What is an adequate Professional Indemnity Insurance limit? This is not an exact science with an applicable formula and the answer can be different for everyone, but there are some key issues that should be considered when determining an adequate indemnity limit.

The Indemnity limit needs to be sufficient to meet the size of a future claim

To determine if an indemnity limit will be sufficient to cover a future claim, consider the following:

- *All potential claims* that might be brought today or in the future arising from your professional services.
- *The likelihood that claims will not be finalised during the current policy period.* Litigants have substantial time to commence proceedings. All jurisdictions have enacted various Limitations of Actions statutes that prescribe the time in which an action can be commenced against an insured. Generally, the time allowed to bring an action is six years and this period begins at the point the damage is discovered. Damage may not be discovered for several years. Asbestosis and concrete cancer are examples of latent defect or damage, where the claims are brought many years after the completion of the initial contract but within six years of discovery of the damage. In certain circumstances the limitation period can be longer, for example in cases of bodily injury, particularly where a person is considered to be a minor, i.e. under 18 years, additional time to bring the action can be allowed.
- *Estimate the worst possible outcome* that could result should the advice given or services rendered prove to be negligent. Whilst the insured's largest contract or estimated future earnings can act as indicator of their exposure to loss, it may be grossly misleading. For example, an insured, a building surveyor, took out a PI policy with a sum insured of \$1 million. The sum insured was based upon his largest contact involving the certification of a building with a value of \$1 million. Unfortunately, a young man fell over the building's handrail, as a consequence of which he was rendered a paraplegic. The building surveyor was sued on the grounds that he had negligently certified that the handrail met the statutory minimum height requirement when, in fact, it did not. The Plaintiff sought damages of \$6 million against the surveyor, therefore the insured was substantially under insured.
- *Contemplate the type of clientele you have or who you are working for.* If you are a consultant or sole contractor a large company won't hesitate to sue you if you are the cause of a claim. You may feel that you are only one 'link in the chain', but your portion of a settlement may indeed be sizeable.
- *Consider how many people may be relying on your advice.* This is particularly important for financial service providers who may be providing advice for one financial product; the product will then have numerous clients. Numerous clients utilising the one product can equate to multiple claims if the advice on that product is repeatedly incorrect. The policy limit needs to be large enough to respond to the total number of claims within a year and have sufficient reinstatements as required;
- *Projecting potential quantum of damages into the future.* Increased court interest rates, inflation fluctuations, increased hourly legal representation costs, decisions of courts relating to how damages are calculated, e.g. compound as against simple interest, etc, and unforeseen Acts of Parliament, all impact on the level of damages.

The Indemnity limit needs to be sufficient to cover claims from past activities

In addition to considering your current and future liability, it is also essential to consider potential claims from past activities that arose from work within the retroactive period stated in the policy. The retroactive date is the date after which acts, errors or omissions of the Insured are covered. If the policy has an unlimited retroactive date, the policy cover will be available for any claim that comes within the terms and conditions of the policy, however far back in the past the event giving rise to the claim may have occurred. If the policy sets the retroactive date, then any claim must arise out of an event which occurs after that retroactive date. The policy limit must be sufficient to cover a claim arising from work completed in the past, as well as in the future. Before reducing your Indemnity in the future it is important to consider the possibility of any potential liabilities arising from past activities.

For example, an insured architect was involved in a multi-storey office construction, valued at \$20 million. For the period of the contract, the insured took out a PI policy with a sum insured of \$30 million with an unlimited retroactive date. On completion of the above project when his practice reverted to domestic and small-to-medium commercial projects, the insured reduced the sum insured on his PI policy to \$2 million. Subsequently, the insured was served with legal proceedings in relation to his work on the \$20 million project, in which the damages claimed were \$10 million for losses allegedly said to have resulted from his negligence. The current \$2 million policy applied to the claim.

The need to determine how the policy treats the payment of legal defence costs

The Professional Indemnity Insurance limit needs to be enough to encompass the dollar value of both the claim and the costs in defending it. Consider whether legal costs are 'inclusive' or 'exclusive' of the indemnity limit in the policy. This affects whether the indemnity limit covers the claim with a separate limit for defence costs or is intended to cover the claim, plus the insured's defence costs.

You may consider requesting a larger indemnity limit where costs are inclusive of the limit to ensure coverage of the claim and costs. Preferably and where possible you will have legal (defence) costs in addition to the indemnity limit, i.e. exclusive of defence costs.

You should be aware that, if the legal costs and award exceed the sum insured, then the insured will have to meet the difference.

Where costs to resolve the claim exceeds the indemnity limit, most policies require that the defence costs incurred be pro-rated between the insured and the insurer in such a ratio as the indemnity limit to the total amount of the claim. It further provides that any "overpayment" of costs be offset against the limit available to settle the claim, e.g. indemnity limit \$1 million, claim settled for \$2 million, defence costs incurred \$600,000. The ratio of sum insured to the claim settlement is 1 to 2 or 50%. Therefore, in the above example, 50% of the defence costs (\$300,000) would be offset against the sum insured. The amount available to

Other requirements to consider

- Are you part of a specific industry group, scheme, association or have an industry standard that requires you maintain a certain indemnity limit?
- Is there Government legislation that impacts the size of the indemnity limit required?
- Do you have specific contracts in place that require a particular indemnity limit and a set period of time in which it needs to be maintained;
- How much can your reasonably afford to pay for your cover? This will determine the indemnity limit you are able to buy.

These considerations will provide a base from which to set an appropriate indemnity limit and whilst the size of a claim is an unknown factor, hopefully you will have a reasonably suitable indemnity limit in place at the time of claim.

This advice and comments are provided in the capacity as your insurance broker and should not be construed as legal advice. Separate legal advice relating to the interpretation and implication of this article for your individual circumstances should be obtained.

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