Assurances

Professional Indemnity Coverages: Two Different Approaches

Francis Style

Volume 47, Number 1, 1979

URI: https://id.erudit.org/iderudit/1104012ar
DOI: https://doi.org/10.7202/1104012ar

See table of contents

Publisher(s)

HEC Montréal

ISSN

0004-6027 (print)
2817-3465 (digital)

Explore this journal

Cite this document

Style, F. (1979). Professional Indemnity Coverages: Two Different Approaches. *Assurances*, *47*(1), 10–15. https://doi.org/10.7202/1104012ar

Professional Indemnity Coverages: Two Different Approaches

by

FRANCIS STYLE

Liability policies have been issued for several hundred
10 years and until quite recently they were virtually all on an
"occurrence" basis. In effect, they covered liability for occurrences or accidents happening during the policy period irrespective of when the actual claim might first be made. This was a logical extension from property policies, which of course cover accidents (such as fire or collision) occurring during the policy period.

For most liability policies, this "occurrence" basis continues to be satisfactory, because in most cases an accident is followed by a claim either rapidly or not at all. When, for instance, you skid into the rear of a car stopped at traffic lights, you can reasonably expect the claim from the third party to materialize within a matter of days. Consequently, for the vast majority of liability policies, Insurers see no problem in continuing to provide protection for accidents occurring during the policy period, even if it occasionally happens that the claim itself is not made until after the period has expired.

Some forty years ago, however, it became apparent to certain Lloyd's underwriters that, for two rather exotic forms of liability insurance, there was a potential problem. The classes they were worried about were professional liability for accountants, and "directors and officers" liability. The specific problem that concerned them was that an accountant or a director or officer might unwittingly make a mistake which would not come to light for many months or even many years. Therefore, even at the expiry of the policy it would be extremely difficult to estimate Insurer's potential liability for claims which might be made in the future. Since Insurers would be expected to quote meaningful premiums to cover claims which might not be made until years after the policy had expired, intelligent underwriting would be difficult, to say the least.

Forty years ago, this problem was academic rather than practical, since there had been virtually no claims experience in these two classes, and it was far from sure whether there was really much of an exposure to insure in the future.

The solution adopted by these far-sighted underwriters was to apply a radical new principle. Instead of covering events occurring during the policy period, they would insure claims made during this period. The error itself might have been made long before the policy took effect, no matter (provided, of course, the Insured had been unaware at the policy inception of the potential problem).

For many years, the number of "claims made" policies remained very small, as there was little demand for professional liability insurance and even less for directors and officers coverage. It was not until the 1960's that a series of claims in both fields drew attention to the need for protection. Lloyd's policies were already on a "claims made" basis, and other Insurers of professional liability began to swing from "occurrence" to "claims made". More recently, there has been a tendancy to write products' liability also on this basis.

Nevertheless, certain Insurers continued to offer "occurrence" professional liability insurance for several more years (the St. Paul only switched in 1975), while even today this coverage is still available in Canada for certain classes.

What are the advantages and disadvantages of these two policies ?

To an Insured, an "occurrence" policy has one large and obvious advantage: it covers in what most people would consider a straight-forward and logical way in that it provides protection for all services performed during a given period. This is particularly attractive to a professional just entering on his career who has no need to cover any earlier errors he may have made. This man could take out an "occurrence" policy whose period could theoretically correspond exactly to the period of his active career, and when the time came for him eventually to retire he could let his policy lapse, secure in the knowledge that any future claim, yet unknown, would be insured, even if it did not reveal itself for several years.

However, if this professional took the time to consider the history of professional liability claims in the past ten years, he would note that the average size of claims has risen dramatically over a short period. Assuming then that he decided a limit of, say, $100,000.00 was adequate at the present time, what guarantee would there be that this limit would still be adequate in 3 years time when a claim might be made ? Since this claim would attach to the year the error was made, it would be that year's limit which would apply even if the policy limit had been increased in subsequent years. When one considers the rapid rise in the amounts of individual settlements in the past few years, the seriousness of this defect becomes apparent.

For a professional who would have practiced for several years without insurance, there would be another disadvantage in that an "occurrence" policy would provide no protection for errors made prior to its inception. The Insured would have to hope that he had not made any mistakes previously, or if he had, that they would not give rise to claim.

The "claims made" policy, on the other hand, would cover errors made prior to its effective date as well as during the policy period provided the claim first came to light during the policy period. (A small percentage of these policies exclude errors made prior to the effective date, with a corresponding reduction in the premium). Also, its limit can be increased regularly to correspond fairly closely with the maximum probable exposure at the time of the claim. Admittedly, there can still be a lapse between the claim and the final settlement, but this will always be less than that between the actual error and the settlement. The most serious disadvantage of the "claims made" policy is that a professional who retires or a firm which ceases to operate cannot simply allow the policy to lapse. It is necessary to arrange some continuing form of protection to take care of future claims for mistakes already made but not yet known. In partial mitigation of this, if an Insured notifies Insurers during the policy period of an error which may result in a future claim, that claim will be covered even if made after the expiry date. Moreover, "discovery policies" are generally available to retiring professionals to take care of other claims received after retirement.

The foregoing advantages and disadvantages are the ones that will no doubt be most obvious to Insureds, and all in all a reasonable conclusion, based on these arguments alone, might be that the two sides tend to balance themselves out, so that there is really little to choose between the two policies.

However, the crucial point remains that it is extremely difficult for Insurers writing a book of professional liability insurance on an "occurrence" basis to evaluate the experience at any given date. The premiums paid in 1979 will have to meet claims spread over a large number of future years. To make any sort of an estimate of the 1979 experience at the beginning of 1980, a huge "IBNR" factor must be included

(which may well turn out to be completely inaccurate, since there will be no hard information on which to base it). If premiums are increased by, say, 20% in 1980, it will be three or four years before Insurers will know whether the increase has been sufficient, and in the meantime 1981 and 1982 may well be developing further nasty surprises which will not become evident until 1984 or 1985. Consequently, as has happened many times in the past, as soon as the loss experience starts
14 to worsen there is a strong temptation for "occurrence" Insurers either to withdraw completely or at best to switch to a "claims made" basis.

"Claims made" Insurers, on the other hand, suffering a deteriorating claims situation do at least know at the end of 1979 that all potential claims have been declared, and they are then in a position to put up reserves accordingly. From this they can estimate the experience and adjust their premiums to keep step with claims' activity. Were it not for "claims made" policies, it is almost certain that coverage for accountants and lawyers in the U.S.A. would have disappeared in the 1970's if not earlier.

In the event of an improving experience, it will be several years before this becomes evident to "occurrence" Insurers, and in the meantime they are likely to overcharge their Insureds. "Claims made" Insurers will detect this improvement earlier, and be in a position to reduce the premiums accordingly.

Both Insurers and Insureds have a common interest in having the underwriting done as accurately as possible, so that the Insurers may make a reasonable underwriting profit with a fair degree of consistency and avoid either overcharging or undercharging the Insureds. The "claims made" policy is much easier to underwrite accurately and so provide a stable and flexible market which can adjust reasonably quickly to the ups and downs of claims' experience. In times of difficulty, it is the policy which is far more likely to stay the course.

Insureds who have a choice between "occurrence" and "claims made" policies and are concerned with establishing a solid and long-term relationship with their Carriers would be well advised to make their selection accordingly.