

# The Willis Index

Willis

Accountants' and Auditors' Newsletter

The Accountants' and Auditors' PI Insurance and Risk Management Quarterly

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## Advantage Buyers – Q2 2005 Insurance Market Survey Results

Average rate reductions now appear greater on the excess layers whilst the most extreme examples of premium saving are clearly seen in some of the smaller firms switching Insurer for individual savings of up to 40% or 50% on their primary policy. These are generally firms purchasing limits of £1m or £2m, possibly up to £5m. This is certainly not typical but demonstrates the extreme.

The reason for the increased reductions on excess layers is the effect of restructuring programmes as mentioned in the "Willis Prediction" below. However, whilst this is demonstrating an increasingly competitive market, individual underwriters are beginning to express concern at such a rapid softening of the market. Those with the more established and mature accounts are being very selective in their premium reductions whilst some of the new entrants are still seeking to gain market share.

The Willis Index is a quarterly publication reporting on the relevant issues affecting the Professional Indemnity Insurance industry and the impact they have upon auditors and accountants. The main feature is an extensive market survey taken from Approved Professional Indemnity Insurers, providing responses on key indicators including premium, excesses and cover.

Our quarterly analysis will provide buyers with an overview of insurance market conditions and our assessment of the outlook.

In this issue we include case studies, technical analysis of coverage and market conditions together with special features highlighting significant changes in regulation, and insurance market news.

### The Willis Prediction\*

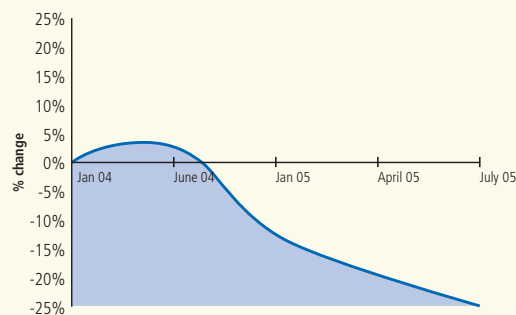
Since our last newsletter we have continued to see rate reductions over last year for claims free renewals particularly at the smaller end of the profession where limits of only £5m and less are purchased; and the split of work is not too heavily weighted on audit nor does it include IFA work.

The underwriting market, whilst generally following these reductions, is increasingly becoming concerned about the effect on their own budgets and premium forecasts. This is leading to the recently unknown situation of underwriters protecting themselves against loss of income through rate reduction by competing for increased market share on individual risks. Where clients are moving Insurers this is readily obtainable by restructuring placements, particularly those that buy excess of £5m.

This is, in turn, increasing the level of competition amongst Insurers for risks with a good claims history by up to a further 15% to 20%. Some underwriters have reported recent cases where the rate charged on fees for a £1m limit of indemnity has been as low as 0.5%.

However, as a word of caution, Jeremy Jones, Willis' PI broking Director added:

### Primary Layer Premium Change



"We have just heard that Underwriters are talking about a new PI development (not one of the Big Four) with a quantum of £77m, but with the Equitable Life litigation still ongoing, just how quickly will any major losses impact on the rating war? It will be interesting to see if the underlying problems behind these negligence actions will become lessons learnt, or will they simply be lost in Insurers eagerness to maintain and grow market share".

Willis will monitor the progress and report any relevant developments in our next edition.

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\* The Willis Prediction is based on multiple criteria and does not relate to the situation for each organisation.

# Going Global

The primary benefit of operating on a global basis is easily identified: the ability to attract higher value work from multi-national companies by providing an apparently seamless service across numerous jurisdictions. So how is this done without creating an international partnership?

In order to attain the kudos of being viewed as an international player and take advantage of reciprocal referral arrangements, many accountancy practices of varying sizes are entering into associations or networks with firms in other countries. This may involve entering into an international association via an umbrella arrangement, whereby member firms practice under a single brand identity whilst remaining autonomous at a national level. Alternatively, and more informally, some firms prefer to continue to practice under their individual name, but advertise the fact that they are associated with a network.

However, what are the implications for an association's or network's members in the event of a breach of duty by a partner of another member firm? Is there a danger that member firms may be found to actually be, or have held themselves out to be, a single partnership? If a local firm has limited Professional Indemnity cover could claimants look toward the association or network to make up any shortfall?

In a dispute, a Court may be asked to consider whether an association's members were actually a partnership carrying on business in common with a view to a profit. To do so it may take into account:

- The terms of the member firms' agreement.
- The registration of a common business name.
- The sharing of client lists.
- The existence of a common Professional Indemnity policy.
- Whether one member firm (or the international association itself) exercises 'control' over members.

The Court may also look at the way member firms represent themselves in order to establish how they 'hold themselves out' to the public. For example, do all members' marketing documents make it clear that the individual

practice is an independent legal entity, liable for its own acts. Post Parmalat, many of the larger firms have been at pains to clarify the true relationships between themselves and the other members of their international associations.

The association as an entity may be drawn into a dispute where an individual member firm signs documents in such a way that 'holds the firm out' as representing the association; for example as in *Cromer Finance Limited and Primval NV et al vs Michael Berger et al* (2002). Whilst a judgment against the international association may be worthless because of the lack of assets and/or Professional Indemnity cover, the differing approach to holding out issues across jurisdictions should be considered. A claimant may use this in order to forum shop, looking for the most sympathetic jurisdiction in which the association is represented to put its case. Whilst that claim may not be particularly meritorious, it will still be expensive to defend and an unnecessary distraction for the firm involved if member firms are joined to the action as well as the association itself.

A standard Professional Indemnity policy would not respond if a firm were dragged into litigation in this way, unless specifically endorsed to respond to claims against the other association members or the association itself. However, as the existence of a 'common' policy may increase the risk of the association being viewed as a single partnership, this would not appear to be an answer to the management of that risk.

The exposure for those firms within a network differs in that the lack of a common brand makes them less likely to be at risk from allegations that they are part of a single partnership or hold themselves out to be so. However, as with any firm, they must be wary of making representations to their clients about the quality and skill of any other firm. Where another member of the network is introduced to a client

but subsequently breaches its duty to that client, the introducing UK practice could be seen as an additional or easier target for a claim. There is a risk that they may face allegations of a conflict of interest, namely that the overseas firm was recommended not because of its appropriateness, but because of the potential for reciprocal business. Any such allegation may have consequences with regard to the availability of coverage under the Professional Indemnity policy for the UK member, and will certainly lead to investigations being made by Insurers before cover is confirmed.

Clearly the commercial benefit of going global brings with it potential risks as well, but recognising these risks from the outset allows practical steps to be taken to avoid or minimise them.

Prepared by **Jayne Goddard**  
With the kind assistance of  
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Tristan Hall, Solicitor  
Reynolds Porter Chamberlain



# Does your LLP mean uninsured LLP?



Ernst & Young were the first firm to adopt the limited liability partnership (LLP) structure and since then we have experienced a steady stream of firms converting to this new status, but has this reduced the partners exposure to Professional Indemnity claims?

The traditional structure of joint and several liability means that individuals who were partners at the time of a negligence loss would remain exposed. This would apply even if they were not directly responsible for the negligent act and, unfortunately, there are many examples where this structure has nearly resulted in the personal bankruptcy of every partner. Likewise, even retirement does not protect partners if the remaining partners cannot afford to meet the claim. Furthermore, new partners who were appointed after the negligence claim can also suffer. This is particularly relevant if the claim results in a loss which needs to be catered for in an accounting year after joining the partnership. Willis decided to review whether the LLP structure has resolved these issues, and consider some of the Professional Indemnity issues which affect the LLP status.

Firstly, becoming an LLP does offer the benefit of limited liability whilst maintaining the internal structure of a partnership. Therefore, the LLP is like a company in so far as it is a corporate body, and when it contracts it is the LLP which is bound, not its members. This is an undisputed benefit. This structure also has the advantage of being recognised in the characteristics of corporations established outside the UK so is also good news for LLP's who may need to consider legal and negligence issues on an international level. Furthermore, we are now starting to see liquidations of LLP's so again this structure has clearly protected its members against losses which the traditional structure would not have. Therefore, where can the problems arise?

Ironically, the answer is that a number of problems have arisen simply because the transition in structure has not been catered for in the firms' Professional Indemnity (PI) insurance arrangements. Many LLP's have assumed automatic liability for previous partners or new

claims arising from the traditional partnership and former business structures but, they have failed to adequately disclose these arrangements to their Insurers. Unfortunately, failure to inform Insurers can result in the PI policy not responding in the event of a claim. This is because the "entity" requiring cover may not be covered under the current policy or the change to the working practices can be deemed so material that Insurers can argue that had they known about them, they may have provided a different basis of policy terms and conditions.

In this regard, all PI policies will require the policyholder to declare all material facts, and this applies to the need for any agreements or arrangements concerning potential PI losses to be disclosed and accepted by Insurers.

Willis would recommend that adequate insurance advice is sought before finalising the LLP status to ensure that consideration is given to:

- The liability of (what will become) the former partnership, and Partners. This generally means that run-off cover will be required on the assumption that this practice will cease trading. The purchase of run-off cover is mandatory under accounting institute rules.
- The liability of the new LLP.
- Any new liabilities assumed under LLP status. For example, many firms consider buying Directors and Officers Insurance or Employment Practice Liability insurance.

The PI insurance needs can be effectively managed, with the policy changes usually negating the need for any additional premium. A fact which is always well received by any accountants or auditors.

The key to ensuring adequate insurance protection is to communicate the changes to your Brokers/Insurers. This will ensure the practicalities of arranging PI is a simple process. It is also important that the approach to PI cover is agreed by the relevant partners. As you would expect there is benefit from economies of scale in the purchase of insurance cover, so there would be advantages to combining any former firm with any new LLP. This does depend on the nature and structure of the agreement. However, many Partners prefer to adopt a separate run-off policy which is ring fenced from any future business activities, and this is maintained in parallel with any new cover required for the LLP. On saying this, it is interesting to consider;

- **The Retroactive/Run-Off Exposure:** the major proportion of the ongoing premium is usually attributable to the run-off element of the policy. This can be particularly relevant for new partners joining or important in considering the apportionment of premium where different liability agreements exist. Your broker can offer advice on ascertaining a breakdown of premium if required.
- **Entity vs Entity:** where both entities i.e. the run-off and the new LLP are insured jointly under the same policy, the claims record of one practice may adversely affect the other.
- **Premium Payment Warranties:** it is common under a combined policy that both entities would be responsible for premium payment. This would mean if the new LLP premium was not paid, it would be the responsibility of the outgoing partners under the run-off to pay it and vice versa.
- **Risk Management/Corporate Governance:** Insurers would need confirmation that the risk management processes and governance procedures would be to an acceptable standard. There needs to be an agreement over the record-keeping of the practice. This is vital in the event of a PI claim for which liability could be up to 12 years after the work was undertaken. The Partners need to ensure that responsibilities are agreed in writing, and that these actions will not prejudice future Insurers in the event of a PI claim. The agreement should cater for the physical storing of files, their safekeeping, and the attendance and full co-operation of past partners or relevant individuals, if required, at any future hearing, tribunal or similar meeting involving liability or claims.
- **Business Activity Changes:** the activities would need to be acceptable to underwriters. This is important as frequently the move to LLP status has meant that firms have had a re-think about their core business activities and these have sometimes changed. All such changes must be agreed and accepted by Insurers.

Hopefully these comments will assist any firm considering dissolving their existing partnership and creating a new LLP. If you require any further information or assistance please contact **Joanne Willmore**, Executive Director on +44 (0)20 7975 2216 or email [willmorej@willis.com](mailto:willmorej@willis.com)

# The Big Four Thank Sarbanes-Oxley

At the start of February 2005, AstraZeneca announced that it would face compliance costs of tens of millions of dollars, in order to meet the requirements of the Sarbanes Oxley Act. Whilst there is little doubt about AstraZeneca's commitment to its US listing, other European corporations are considering their positions in light of the costs of compliance.

However, as has been seen in the financial markets, 'arbitrage' opportunities of any type do not last long. The probability that European legislation will emulate that in the US will remove the competitive advantage that European exchanges presently have.

As regulations converge, Willis anticipates Insurers revising their coverages to reflect the regulatory environment, but in the interim, the Big Four are able to cash in on the cost of regulation. In fact, it was recently reported that the Big Four accounting firms have doubled their audit fees with US clients because of work mandated by the Sarbanes-Oxley legislation.

It is no secret that many companies have complained about soaring costs associated with Section 404 of the Act, and its provisions on internal controls, which are supposed to ensure good accounting and detect fraud. Interestingly, a survey undertaken by the Corporate Executive Board, a consulting firm, involving 43 companies that have to comply with Section 404, found the companies spent on average between \$5m and \$8m to comply with Sarbanes-Oxley in 2004. Whilst they did not

provide the identities of the companies, the Corporate Executive Board said 40 were in the Fortune 500.

Concern is being expressed among the Professional Indemnity market, with underwriters keen to assess if the associated income for accountants is likely to generate an increased exposure to Professional Indemnity claims. It is becoming increasingly important for all firms to allay Insurers' fears, and to actively demonstrate that they are able to keep up with the cost of compliance. Willis would recommend that all firms discuss this issue with their brokers prior to their next renewal as a valid strategy will greatly assist the insurance buying process.

For any further information on this please contact **Steve Bonnington** on [bonningtons@willis.com](mailto:bonningtons@willis.com)

## Breaking News

Willis has been named the "2005 European Commercial Broker of the Year" as voted by more than 3,000 risk and/or insurance managers or directors of multinational companies across 12 European countries (Belgium, Denmark, France, Germany, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the UK).

# Meet the Associates

**Andrew Fryer ACII**  
Executive Director  
Willis Professional Risks



Andrew has 25 years experience in both broking and underwriting Professional Indemnity and Directors and Officers Liability Insurance both at national and international level for major partnerships and multinational organisations. He is an Associate of the Chartered Insurance Institute, and he jointly leads the Professional Risks business practice at Willis where he has been for over 15 years. Andrew has been actively involved in advising accounting and auditing firms on Professional Indemnity exposures and risk management. This work has included research into the area of liability limitation. His experience has helped him as co-editor of "A Worldwide Guide to Directors' & Officers' Liability" and has written articles for publications in a number of journals.

Andrew comments, "Sarbanes-Oxley will create a new rule book which will undoubtedly be broken over time. It will be interesting to see how accounting firms cope with the responsibilities of this new legislation, and how fast Professional Indemnity Insurers will act in adapting coverage to respond".

Places remain on the Willis Accountants Seminar in London on 14 June 2005. For more details on content, and to book your place, please contact Claudia Green on +44 (0)20 7975 2074

Willis is one of the World's leading risk management and insurance intermediaries. We have 15,800 professionals in over 300 offices around the World.

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