

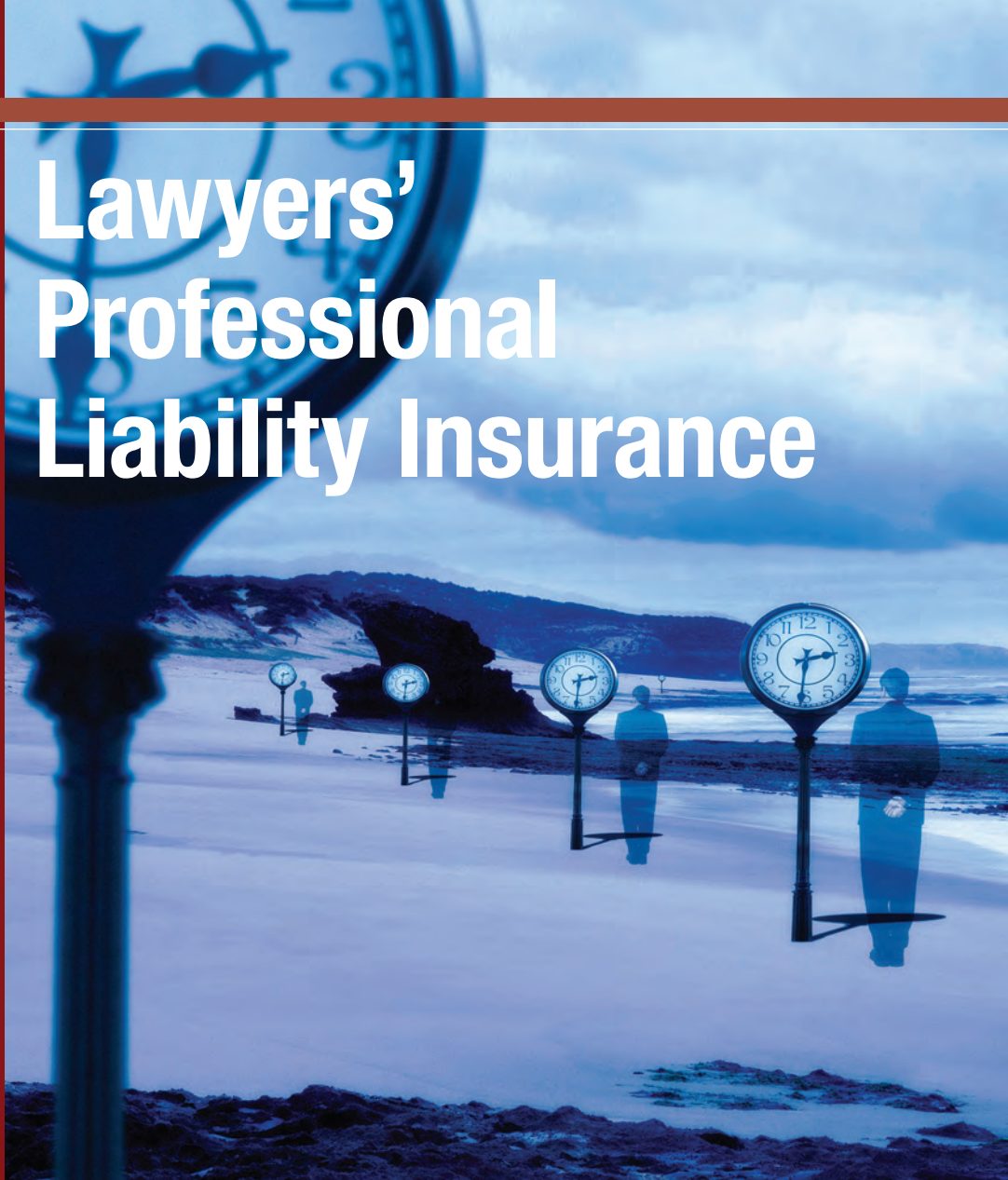


The Times They
Are A-Changin’

By Stephen S. van Wert

If you take a long-term view of the insurance market, you can make good decisions now to position yourself well for the long-term trend.

Lawyers’ Professional Liability Insurance



In 1964, Bob Dylan released his third album, *The Times They Are A-Changin’* (Columbia Records). Now, 47 years later, the title song seems to describe our world today aptly. Already in 2011 we have witnessed an enormous earth-

quake and tsunami in Japan resulting in widespread nuclear contamination, the citizens of several Middle Eastern countries forcefully replaced their governments in the “Arab Spring,” America continued to battle worldwide terrorism, several European countries have teetered on the edge of

bankruptcy, and Standard & Poor’s downgraded the debt of the United States for the first time in history largely due to partisan politics in Washington, D.C.

What, you say, does this have to do with lawyers’ professional liability (LPL) insurance? The answer is “a lot!” But as Bob



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Dylan warned so long ago, you don't want to "get hurt" because you have not positioned your law firm well to navigate these challenging times.

The Current Market for LPL Insurance

In the insurance world, either the market is deemed "hard," meaning that premiums are high and coverage is limited, or "soft," meaning that premiums are low and insurers offer coverage freely. Since 2003, the LPL insurance market has been softening. Over this time, the average cost of LPL insurance has decreased steadily, and sellers have added new coverage enhancements. Many industry commentators have predicted over the past several years that a hard market loomed "just around the corner," but that has not materialized yet. Why?

In general, three variables affect the "hardness" or "softness" of the LPL market.

First and most obviously, claims affect the market's character. If clients assert more claims against lawyers (referred to as frequency), or if insurance carriers have to pay claims of higher amounts on average (referred to as severity), then the cost of LPL insurance will rise. But another often overlooked element contributes to the cost of claims. It is called "claims inflation," which always operates in the background. "Claims inflation" is the increase in the cost of defending a claim asserted against an attorney or law firm.

I would imagine that your law firm has raised hourly rates over the past seven years. The same increase in costs that you have been able to charge your clients also has been felt by your LPL insurance carrier. So even if the frequency and severity of claims had remained constant over time, we would expect premiums to rise each year, at least in the low single digits, simply due to claims inflation.

The second variable affecting the LPL insurance market is interest rates. In insurance jargon, LPL insurance has a "long tail," which means that usually a carrier doesn't actually pay a claim until several years after the carrier collects an insurance premium from a firm. (For comparison, a property insurance policy has a "short tail" because an insurer knows at the end of the policy period whether the building that it has insured has burned down). During this "tail period," sometimes called the "float," an insurance company invests the premium that it has received, primarily in debt investments. If interest rates are low, then the income generated from the float is likewise low. In those circumstances, an insurance carrier has to rely on its underwriting activities to make a profit. In other words, carriers typically make up for poor interest-investment income by raising premium rates, decreasing coverage, or both.

The third variable that affects the LPL insurance market is the amount of surplus capital in the overall insurance market. Surplus capital increases as insurance carriers generate positive income and choose to keep it in their companies as retained earnings instead of paying dividends to their stockholders or policyholders, as the case may be. In general, the more surplus capital that an insurance carrier has, the more the insurer can "put that surplus capital to work" by

writing more policies. Otherwise, the surplus capital just sits in an insurer's investment accounts earning very little interest.

Over the past several years, the first two variables, claims with higher frequency/severity and lower interest rates, have steadily built pressure that has worked to increase rates in the LPL insurance market. The third variable, though, has worked to

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decrease rates because more surplus capital has been chasing a relatively stagnant number of insureds. During the past several years, this pressure from the surplus side of the equation won, as seen in LPL insurance premium levels, which remained low. However, this is no longer the case.

So What Has Changed?

As we have moved into the second half of 2011, I have noticed a definite firming in the LPL insurance market. One LPL insurance carrier is lowering limits in California and pushing rate increases nationwide in the 10 percent range. Another is completely remaking its book of business by not renewing policies with certain firms, lowering limits, and raising rates. I have seen another LPL insurance carrier even decide not to renew with a good law firm, presumably only because it could not raise rates fast enough due to state limitations on the allowable size of annual price increases. Several other LPL insurance carriers are raising rates on most of their law firm clients in the 2 to 10 percent range. One actuary that I spoke with recently said, "If anyone tells you they are making money insuring lawyers, they are either fooling themselves or just lying."

So what has changed? Unfortunately, when the economy goes bad, claims against lawyers rise. Since the last recession that began in 2008, law firms that practiced in real estate and general business transactions have had more claims asserted against them, and the corresponding sever-



ity of those claims has gone up as well. This has exerted more pressure on LPL insurance carriers to raise rates.

The last hard market resulted from similar circumstances. The stock market dropped precipitously in 2001 when the “dot.com” bubble burst. The Federal Reserve lowered interest rates to stimulate the economy. Both events had the effect of

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reducing insurance carriers’ investment income. Economic growth at that time also slowed down, and unsurprisingly, claims against lawyers increased, especially in the securities, corporate, and wills/probate areas of practice. However, it was not until the tragedy of 9/11 that the hard market really kicked into gear. The 9/11 attacks resulted in some of the largest insurance losses in history, and as a consequence, a huge amount of surplus capital was used to pay these claims. The result? In 2002, many law firms saw their premiums rise 10 to 50 percent in a single year, and many law firms even had trouble finding the coverage that they desired.

History Repeats Itself

Could this happen again? Of course, no one can predict future events with perfect certainty, but we can take note that the first half of 2011 generated record property losses from a large earthquake in New Zealand, from a very active tornado season in the midwestern United States, from riots in England, and from significant flooding due to Hurricane Irene hitting the eastern United States. And literally at the moment of writing this paragraph, I received a text message from a colleague saying that an earthquake just hit the eastern United States, fortunately, causing very little damage.

Perhaps now you can see why an apparently irrelevant event such as a large earthquake in Japan can have an effect on LPL insurance rates in the United States. To the extent that such catastrophic losses serve to decrease the worldwide amount of surplus capital, they will decrease the pressure to deploy that capital in the form of underwriting more policies. And as that pressure decreases, the countervailing pressure from increasing claims and decreasing investment income begins to win out. Believe it or not, many of the same carriers that provide your law firm with professional liability insurance also have exposure to earthquakes in Japan, either directly or indirectly through reinsurance agreements. This is very purposeful on the part of insurance companies, to “spread their risk” across many classes of business all around the world. This diversification strategy is encouraged by rating agencies because it helps prevent one catastrophic event from bringing an insurer into bankruptcy.

Is There Any Good News?

Fortunately, there is good news. In some cases, carriers offering LPL insurance seem to be taking a “surgical approach” to their underwriting actions. By that I mean that they seem to have sought rate increases only from those classes of law firms that have generated the most losses recently. For example, one large LPL carrier just filed for a 19 percent overall rate increase in a certain state that it would achieve primarily through price increases targeting law firms in the real estate practice area. This is unsurprising because the real estate sector of the economy most acutely experienced the most recent recession. When times were good, mistakes that lawyers made on real estate deals did not result in claims because “everyone made money” on those deals. But when times are bad, clients may allege that those same mistakes caused the clients to experience losses. Sad to say, but when people are desperate, they look for the closest “deep pocket” to help cover their losses even when no one committed malpractice.

The good news for defense lawyers is that defense firms are still viewed very favorably by the LPL insurance industry. This is not to say that defense firms will not see some carriers attempting to raise

rates in the coming year in the low, single digit range. However, on a relative basis, defense lawyers should fare much better than their colleagues in transactional areas of practice.

The plain truth is that defense lawyers just are not sued as often as lawyers working in other areas of practice. They also are relatively more insulated from claims emanating from poor economic conditions. They should by all counts continue to enjoy premium rates that are sometimes half as much as in other areas of practice. They also should not have much problem securing higher limits and favorable deductible options. All bets would be off, though, even for defense firms, if we experienced another enormous insurance loss such as that experienced after 9/11. Therefore, do not let the fact that your firm is a defense firm lull you into complacency. While some LPL insurance carriers seem to have taken the surgical approach described above, at least as many seem to have raised rates across their entire books of business.

Prepare for the Storm

If we see the storm clouds coming, that means that we have time to prepare for the storm. In LPL insurance, you can take several actions now to weather a potential storm in the best way possible.

Start Easy

The easiest and often most overlooked way to improve your risk profile with LPL underwriters is to prepare a good application. In many ways, applying for LPL insurance is analogous to applying for a job. You would make sure that your resume was perfect and communicated everything that was good about you. Unfortunately, many LPL applications that I read appear as if they have been just “thrown together” by law firms. That generates an unfavorable first impression in the eyes of an LPL underwriter, even if the content of the application is otherwise acceptable. Remember that LPL underwriters have the power to apply discretionary credits to your account. These credits are based on a carrier’s subjective evaluation of the quality of your firm. Therefore, it makes sense to present your law firm in the best light possible. Answer every question on an application. Leaving questions blank indicates

either that (1) you wish to hide something, or (2) you just take a sloppy approach to your work. Also, do not feel limited to the space allotted to you on the application form itself. Feel free to add additional pages to amplify your responses and to put your best foot forward. By doing this you communicate that you care about risk management and wish for an underwriter to evaluate your firm in the most favorable light possible. It should go without saying that anything that you put on an application must be true, as an insurance carrier can use misrepresentations on an insurance application as the basis to deny coverage for a future claim.

Be Honest But Assertive About Past Claims

Be sure to explain any incidents or claims on your application carefully. Resist the temptation just to attach the court documents themselves. First, an LPL underwriter will not wade through all of that paperwork. Second, the court documents themselves allow an LPL underwriter to read a plaintiff's assertions about how negligent, ignorant, incompetent, and sometimes malicious your firm has been in handling a claimant's legal matter. Rather, it is much more preferable to summarize a claim using an insurance carrier's supplemental claims application.

In the minds of LPL underwriters, law firms with prior claims are much more likely to have claims asserted against them in the future. Therefore, it is critical that you supplement your description of a claim with tangible reasons why it should not happen again. LPL underwriters will read a claims summary carefully, and it provides a chance for you to put your best foot forward even when discussing a negative aspect of your law firm's insurance history. Some LPL underwriters even believe that a law firm is a better risk if has suffered a large LPL loss because it has focused the attention of the law firm on risk management issues. However, focusing attention on risk management is one thing. Actually doing something about it is another, and you should document all actions taken in this regard. The foregoing also applies to any prior complaints or disciplinary actions taken against any of the attorneys in your firm.

Your Website Is Read by Everyone—Including the Underwriter

You periodically should review your law firm's website to make sure that it contains the most current information about your firm. Most LPL underwriters now review a firm's website in tandem with its insurance application. If there are discrepancies between the two, then an underwriter will want to know why you portray your firm one way to the general public and another way on your insurance application. Most times when an underwriter spots a discrepancy, it is because a firm simply failed to update the content of its website. Yet, once again, that is not a good message to send to an underwriter.

Law firms often portray themselves as very sophisticated on their websites, stating emphatically that they handle all kinds of areas of practice. Yet, when it comes to those reported on their insurance applications, law firms just report those areas of practice in which they in fact render services.

I recognize that in the same way that insurers have diversified their books of business insuring many different classes of risk around the globe, many law firms have chosen to engage in a broad array of practice areas to better serve their clients and diversify their revenue base. However, to the extent that your law firm has exposure to the following areas of practice or clients, you may experience greater difficulty in obtaining the price and coverage that you desire during your next LPL renewal:

- Banking and financial institution clients, especially if a client is under financial duress
- High value plaintiff personal injury cases
- Collections, especially since there have been many class action claims made against lawyers for violations of Fair Debt Collection Practices Act
- Domestic relations with high values
- Entertainment law with high-profile clients
- Oil and gas
- Probate, wills, and estates with high values
- Real estate law
- Securities law

It would be wise to analyze whether your law firm's exposure to these higher risk

areas of practice or clients are worth it in light of the additional revenue that the firm realizes. Many LPL underwriters bypass quoting the entire law firm simply because one attorney in the firm performs services in a difficult area of practice. The reason is that the limits of an LPL policy apply to all areas of practice, not just those in which the majority of the attorneys perform. For example, if your firm has one attorney practicing securities law, many carriers will simply decline to offer terms, no matter how great your firm is otherwise. And if they do offer terms, they will charge you a much higher price than they would otherwise. Thus, you should at least ask yourself whether certain boutique areas of practice in your firm may be causing problems in your firm finding LPL coverage at the best price possible. Certainly, if the market hardens, this aspect of your firm's risk management profile will cause you difficulties at your next renewal.

Ownership Interest in Clients—Treasure or Trap?

When I was practicing law, I noticed that the richest partners in the firm were not the ones who billed the most hours, but rather they were those who had taken an early ownership stake in clients that eventually went public. Now I admit that this scenario does not happen very often, but attorneys often seem to believe that this could happen to them, too.

You should know that ownership interest in clients among individual lawyers is a "red flag" for LPL insurance underwriters. If a client in which an attorney has a financial interest has asserted a claim against the firm, an underwriter will wonder whether the attorney acted in the capacity of an attorney or as a company shareholder. The extent of this potential conflict of interest increases as the percentage ownership of an attorney increases. When a client asserts this kind of claim, the claimant's attorney will try to make this potential conflict as meaningful as possible to prove that an attorney did not provide his or client with unbiased advice. Although not dispositive, ownership issues tend to make claims more complicated, and thus, more expensive to defend. As a result, the settlement value of a claim goes up.

In addition, almost all LPL insurance



policies exclude coverage for claims asserted by a client of the firm where the insured's attorneys, either individually or collectively, own more than a certain percentage of the client, typically anywhere from 5 to 25 percent. In other words, right now you may not have LPL insurance coverage for a sizable portion of your firm's legal work. If you have not checked your current

If a hard market comes, those firms that do not sue their clients for fees will survive the storm much better than those that do.

policy for this provision, you should do so immediately, after polling all of your attorneys to determine the extent of their ownership in clients of the firm.

Know Your Rights

It seems that everyone nowadays is quick to assert their rights whenever they feel that they have been wronged. Unfortunately, when it comes to insurance, most insureds do not know their rights under the insurance laws of their states. As a result, sometimes law firms find themselves in difficult situations that they could otherwise have avoided. As the market hardens, and as LPL insurance carriers start to charge higher premiums or even decide not to renew firms' policies, having a good working knowledge of these laws will become essential to protecting your firm.

For example, in most states, an insurance carrier must notify you well in advance of price increases for renewal above a certain threshold. If a carrier does not notify you in a timely manner, then it cannot legally enforce the higher pricing until it has satisfied the legally mandated notification period. The purpose of these laws is to allow an insured to have time to shop around for coverage from another insurance carrier before the price increase becomes effective. Although each state is different, many states require at

least 60 days advance written notice before an excessive price increase can take effect.

In addition, if an insurance carrier desires to take away coverage, then typically the carrier can do it only if it provides a "reduction of coverage" notice to you well in advance of your renewal date. Say, for example, that your firm has a "loss only" or "first-dollar defense" deductible under which you do not pay a deductible for the costs of defending a claim, but rather, you pay the costs only if your insurance carrier makes an actual indemnity payment to a claimant. Many times clients assert meritless claims against lawyers, yet the carriers have a duty to defend insureds for such claims even if they are groundless, false, or fraudulent. If an insured has this type of "loss only" deductible, then the insuring carrier has to pay for the cost of the defending the insured against meritless claims from the "first dollar." In hard markets, though, insurance carriers may attempt to remove this type of deductible when next renewing policies. In such a case, an insurance carrier needs to provide your firm with a "reduction in coverage notice," usually sometime before 60 days before your policy expires. Again, these laws are in place to provide you with adequate time to secure the coverage that you desire from another insurance carrier.

If the market becomes very hard, then some law firms may not have their coverage renewed. If an insurance carrier decides not to renew your policy, you should take it very seriously because future carriers will ask you if the firm's insurance history has involved this scenario. If so, an LPL underwriter will want to know the reason why another insurance carrier did not renew your firm's previously held policy. An LPL underwriter knows that in most circumstances an insurance carrier does not decide to non-renew a firm's policy unless the carrier experienced trouble with the firm, such as problems with the firm's claims, difficulty dealing with the firm during the claims adjustment process, or failure by the firm to pay a deductible, among other things. As such, insurance underwriters generally consider a decision by a previous carrier to non-renew a LPL insurance policy as a "black mark" on your firm's insurance history.

In most states, not only does an insurance carrier need to give your firm signif-

icant advance written notice that it does not intend to renew your LPL policy, but usually it must state the reason or reasons why. The wording explaining why a carrier didn't renew a policy is very important as it will provide written proof to future carriers about why your firm did not have its policy renewed. Sometimes a carrier simply withdraws from a state or decides it will no longer insure a certain class of business (real estate attorneys, for instance). If this is the case, then that does not necessarily reflect adversely on the merits of your particular law firm. However, without this explanation, an LPL insurance underwriter justifiably will view an insurance carrier's decision not to renew your firm's LPL policy as suspect because an underwriter knows that a carrier does not rid itself of business purposefully without good reason.

Don't Sue Your Clients

In tough economic times, clients often fail to pay their legal bills. It is tempting for a law firm simply to sue a client in such circumstances. However, it is a well-known fact that law firms that sue their clients often are countersued for legal malpractice. And once a client alleges legal malpractice, the allegation triggers an insurance carrier's defense obligation under your LPL policy.

In general, it is a big "red flag" for any law firm to sue a client. It means that something has gone terribly wrong in the relationship between the law firm and its client. The expectations of either or both of the parties have been so disappointed that they have turned to the court system to resolve their dispute. Just because law firms have easy access to the court system should not mean that they should resort to such means of dispute resolution easily.

To an LPL insurance underwriter, a fee-related lawsuit means that a law firm's client-intake process has failed somehow, or the firm has failed to manage client expectations. In either case, proper risk management means that a law firm will do everything essentially possible to manage clients' expectations. Some law firms understand this dynamic so well that they have instituted a policy of not suing their clients for fees, period! The partner in charge of a matter must write off the entire amount against his or her allocable reve-

nues. That focuses the partner's attention on managing the expectations and collections process with clients, which, in turn, benefits the economic health of the firm overall.

If a hard market comes, those firms that do not sue their clients for fees will survive the storm much better than those that do. Usually, insurance carriers only ask about fee lawsuits that have occurred over the past one to three years, as opposed to those reaching back five to seven years. If you institute better policies now in your firm, then you can report truthfully that you have not sued your clients for fees on future insurance applications during the time period that an insurance carrier will query.

Some Final Thoughts

As we move into 2012, it will be interesting to see how the insurance market reacts to world events. Even though I detect the beginning of a hard market, I am not sure when it will occur. In many ways, predict-

ing the insurance market is akin to trying to predict the stock market: when you think you got it right, you find out that you don't.

However, as with the stock market, if you take a long-term view, you can make good decisions now to position yourself well for the long-term trend. The actions that you can take presented in this article represent just a sample of what you can do to prepare yourself better. Your insurance broker can offer you more in-depth recommendations suited to the particular needs of your firm.

However, if you have considered buying higher limits for your firm, you should seriously consider doing so now instead of waiting another year. Not only is pricing relatively cheap now, but you risk a significant chance that it will cost more or even not be available in the future. You should expect that an underwriter will ask you the reasons why you want higher limits, and the underwriter may also increase the size

of your deductible if you want to increase your limits.

It is important to remember that much of the increase in LPL claims frequency and severity has been tied to the poor economy. Defense firms have been largely immune from an increase in these types of claims. Therefore, a claims-free defense firm should not tolerate an attempt by a carrier to raise its rates significantly simply because the carrier wants to subsidize its losses emanating from other law firms in its book of business that practiced in other areas of law that generated claims from the poor economy. Again, your insurance broker can lead you through this process.

As Bob Dylan sang so long ago, the one who has stalled is the one who will get hurt. By perceiving the long-term trend and being proactive now, you can position yourself in the best way possible because it is dangerous to presume that the favorable conditions of the current soft insurance market will last forever. 