

# STATE OF THE INSURANCE MARKET

## LAWYERS' PROFESSIONAL LIABILITY

### REPORT

By The Lemme Law Firm Practice Team

The following is our year-end 2019 review and 2020 forecast of the Lawyers' Professional Liability ("LPL") marketplace. As is our practice, we have included a brief discussion of the overall Property & Casualty (P&C) market, as changing conditions in the macro P&C market have an influence on the direction of the LPL market, which is a subset of the P&C market.

#### EXECUTIVE SUMMARY

The U.S. property & casualty industry is in good financial condition. Cumulative policyholders' surplus in the U.S. was more than \$800b at the end of the 3rd quarter, 2019, with loss reserves of \$556b.<sup>i</sup> The ALIRT Composite surplus rose 8.9%, during that period, to approximately \$443b, on operating earnings of \$18.3b and capital gains of \$27.2b.<sup>ii</sup> Underwriting profitability improved compared to the prior year period and operating earnings were stable, reflecting improved pricing. Insurers also appear to have maintained focus on underperforming lines of business (including professional liability) seeking higher rates and exercising limit and risk selection discipline.<sup>iii</sup> Although 2019 Year End statutory financial statement filings of March 1, 2020, have yet to be analyzed, anecdotal evidence supports the conclusion that 2019 finished strong. Year-end financial data are unlikely to provide significant insight into what might be anticipated in 2020.

In mid-March the COVID-19 pandemic shut down the U.S. economy to an extent never experienced before. As of this writing it is not clear how long this period of economic interruption will last. However, resulting volatility in the capital markets, low interest rates and the threat of recession will have an impact on P&C market conditions in 2020. Approximately 20% of the U.S. P&C industry's invested assets are held in stocks, which comprise a significant percentage of surplus base.<sup>iv</sup> Industry operating earnings are dependent on investment income largely from investments in bonds. Current economic conditions will likely result in increased loss activity in certain lines of business while simultaneously dampening P&C industry revenue growth. The current situation makes forecasting P&C market conditions extremely difficult and, likely, changes trajectories that might have been gleaned from the 2019 P&C industry financial performance. The extent of the impact of the COVID 19 pandemic on the industry will depend on duration of the related economic disruption and we will need to revisit the state of the greater P&C industry during the summer.

Despite uncertainty within the greater P&C market, a few projections for 2020 are clear: i) the industry is well positioned to endure the pandemic, but, the financial condition of individual insurance companies following the economic shutdown may vary significantly; and, ii) pricing, rate initiatives and underwriting discipline observed through 2019 will continue through 2020, with particular focus on underperforming lines of business.

#### STATE OF THE LAWYERS' PROFESSIONAL LIABILITY (LPL) MARKET

In 2019 law firms faced a concerted effort by insurers to achieve rate increases, ostensibly necessitated by years of historically low rates and increased frequency of severe losses. Self-insured retentions (SIR) and deductibles

were also subject to increases for many firms, as insurers sought to avoid paying loss on “nuisance” claims and to increase law firm’s “skin-in-the-game”. Through the end of 2019 underwriters strategically reduced limit offerings and executed more restrictive and disciplined appetite guidelines, to manage future exposure to severe claims. Capacity restriction enhanced upward rate pressure on primary and excess layers.

July, 2019, renewals marked a tipping point where insurer’s rate initiatives gained some momentum. Through the last quarter, 2019, SIR’s were under upward pressure and rate increases in the range of 10% to 15% were realized among large law firms (200 lawyers and up) and, regardless of size, for firms with difficult claims histories or practice areas perceived to be a potential source of severe losses. More abundant capacity, willing to compete for mid-size law firm (50 - 199 lawyers) business, allowed such firms to manage proposed rate increases. Nevertheless, underwriters contend to have realized increases of 2% to 5% rate increases in this segment, with most of that success coming in the last quarter.

Through the first quarter, 2020, LPL insurers did not change course but continued to execute rate initiatives and exercise underwriting discipline. Law firms renewing later in 2020 should anticipate another cycle of rate increases as underwriters contend that severe losses in the segment demand even higher rates than achieved in 2019. Insurers’ 2020 pricing may also anticipate legal malpractice claims related to the COVID 19 pandemic and economic shutdown. Underwriting discipline focused on avoiding and insulating insurers from risk profiles likely to generate severe loss and to reduce defense cost will also be evident.

## **RATE ADEQUACY**

Our annual survey of select lawyer’s professional liability underwriters revealed continued general concern over frequency of severe LPL claims in the large, mid-size and small law firm segments and resulting certain conviction that current rates are not adequate. The current frequency of new claims remains in line with historic benchmarks. Underwriters consistently noted the increasing cost of defending LPL claims as a contributing factor in the severity levels of losses. In addition to higher legal fees and investigation costs, more than one underwriter noted higher instances of, and costs related to, outside review of claims, particularly review of coverage issues.

Reinsurance loss and policy data representing \$5.2b in gross written LPL premiums, from 2006 to 2018, indicate severe losses, valued at \$5M or more, totaled \$7.8b.<sup>v</sup> Severe losses from the years following the recession are winding down, but recent accident years are generating significant severe losses.<sup>vi</sup> 2014 is the only recent year with an acceptable loss ratio.<sup>vii</sup> The 2015 accident year is showing significant deterioration with \$690M in losses (up greater than 50% from last year’s report).<sup>viii</sup> 2017 has \$172M of large losses, with \$91M from claims over \$25M.<sup>ix</sup> The most recent years are not without severe claims, 2018 includes one claim over \$100M and many claims larger than \$10M.<sup>x</sup> Another direct insurer of approximately 80% of Top 100 US law firms compiled similar loss data for the period 1999 to 2015 and reported an increase of total incurred loss for that period from \$7.5b to \$8.3b.<sup>xi</sup> Notwithstanding the reinsurer’s perception, noted above, that claims from this period are slowing down, the direct insurer’s data set indicates that losses impacting 2008 to 2013 accident years have continued to deteriorate since 2016.<sup>xii</sup> Their analysis also indicates that the period between 2014 and 2018 has been very active, with accident year 2015 accounting for 48% of deterioration.<sup>xiii</sup>

Factors contributing to current severity levels among large and mid-size law firms have evolved a bit since last year, according to underwriters who contributed to our survey this year: i) the lifecycle of claims with questionable defenses to liability allegations and significant, provable damages, are being resolved much earlier than in the past; ii) settlement demands and indemnity payments are generally higher than in the past; iii) an influx of large law firm litigators, experienced at leveraging insurer’s obligation to negotiate settlement in good faith, have joined the plaintiff’s bar to prosecute legal malpractice claims; and, iv) as noted above, insurers are incurring costs for independent evaluation of coverage more frequently than in the past.

Loss data supports the proposition that large law firms are experiencing frequent severe losses that indirectly impact the entire LPL segment. Although underwriters contend mid-size law firms are exposed to more frequent

severe losses in the range of \$5M to \$15M, they struggle to identify data demonstrating more frequent severe losses. Small firm underwriters are cognizant of higher initial settlement demands and indemnity values, but, their primary struggle remains keeping pace with the rising cost of defending legal malpractice actions. Additionally, all three segments of the law firm market support their contentions that current rates are not adequate noting a prolonged period of rates much lower than pre-economic crisis rates.

## CLAIM SOURCES

Corporate, Securities, Tax, Commercial Transactions and Litigation practice areas continue as leading generators of severe losses for large and mid-size firms, according to underwriters surveyed. Underwriters noted a recent resurgence of transactional and real estate Ponzi scheme cases, which tend to draw a number of law firms into a single, complex malpractice claim. Trusts & Estates practices also generated an expectedly frequent level of claims. These claims are often times costly to defend and have potential to be severe. T&E claims have been more troublesome among small and mid-size firms. While underwriters noted the above practice areas as leading generators of frequent severe claims, there was consensus that the broad range of alleged errors seen over the last few years could arise out of most any area of practice.

The root cause of claims vary widely and most frequently involve simple mistakes by lawyers. According to the underwriters surveyed, claim causes are similar to last year and include:

- a. Client acceptance issues – unworthy clients, conflicts of interest, poor or incomplete documentation of scope the engagement;
- b. Simple drafting errors;
- c. Failure to accurately document advice given;
- d. Technology related errors – court generated notices caught in spam filters, errors in information input, IP maintenance payment notice caught in spam filter;
- e. Errors calculating deadlines – unaware of jurisdictional differences of key dates, failure to discover the correct date of final decision;
- f. Suing clients to collect fees;
- g. Failure to supervise – young associates preparing and filing documents without requirement of quality review by a partner;
- h. Miscommunication – communication from the firm to the client and with the firm service team;
- i. Failure to properly counsel a litigation client about the risk of going to trial, in writing;
- j. Defense errors – trial strategy error, failure to call an expert, failure to make appropriate argument regarding damages, failure to settle case.

According to several underwriters elements of Failure to Supervise and Miscommunication errors are frequently apparent in an emerging claim scenario. Clients create a team of lawyers from several outside law firms working with designated in-house lawyers and with other non-law firm service providers (sometimes including project managers, accountants, legal process outsourcers, legal staffing firms) to provide legal services for particular projects. Claims arising out of these arrangements lack centralized and documented supervision, management of deadlines and overall accountability, which results in the implication of most law firms involved. Claims seek to hold the law firms responsible for all key decisions impacting legal representation.

Underwriters continue to attribute these “causes” to an erosion of disciplined execution of basic risk management practices due to the pressure on lawyers to generate new clients and more revenue and service expectations of clients. Consequently, the underwriting community is suggesting that law firms adopt a “back to basics” approach

to risk management. Additionally, law firms must create culture that fosters a stable environment for lawyers to grow their practices and establish a sustainable career.

Although the COVID-19 related economic interruption is like no other downturn in our history, the economy has certainly slowed significantly. Accordingly, during the remainder of 2020, underwriters will likely brace for an increase of professional liability claims historically experienced during economic downturns. Their focus in this regard will be tempered by the unknown duration of the COVID 19 shutdown and will likely include the following areas:

*Transactions:* The claim risk at this juncture is interrupted transactions in M&A, Real Estate and other complex commercial transactions. The shutdown has caused business to re-evaluate liquidity and financial resilience that will, undoubtedly, result in decisions to withdraw from deals in progress. The longer the duration of the downturn, the more transactions that will be effected. Failed deals often result in related legal malpractice claims;

*Fee Disputes:* Downturns frequently result in fee disputes. During such conditions law firms struggle to maintain cash flow and clients fall behind paying fees. Fee disputes are widely accepted as precursors of malpractice claims;

*Volume Increase Stress:* Bankruptcy, Foreclosure, Labor & Employment and Intellectual Property practice areas typically ramp up quickly upon sudden economic downturns. Rapid increase in volume of work also results in off-cycle claims;

*Trust & Estates:* Recent stock market volatility will negatively impact the value of many trusts. Historically, significant fluctuations in the value of trust assets has resulted in legal malpractice claims against lawyers who have done work for the trustee or has served as the trustee.

## **INSURERS' STRATEGIC RESPONSE**

In 2020 LPL Insurers with mature books of business will seek to build on the momentum achieved in the last quarter 2019. Insurers with new or maturing books will continue to compete for primary and excess business, but at higher rates than expiring. Underwriting strategies will again be fashioned to achieve more sustainable rates given the losses experienced and loss severity trends identified. Consequently, there is consistency in proposed underwriting renewal strategies:

- a. Increase primary layer rates from 5% to 10% depending on individual firm risk profile;
- b. Reduce exposure to, and spread among abundant capacity, risk of severe losses by judicious management of limits deployed on both primary and excess placements
- c. Excess rates will be evaluated based on individual firm risk profile, attachment point, limits exposed and comparison of underlying pricing to excess insurer's rate per million pricing requirements;
- d. Reduce exposure to initial defense cost losses and nuisance claims by seeking higher self-insured retentions;
- e. Avoiding dilution of headcount;
- f. Not supporting rate decreases on quota share arrangements;
- g. Reduce cost loss by accounting for certain coverage features such as choice of counsel.

Primary rate increase strategies will vary from one insurer to the next and depend on individual firm risk profile. More attention will be dedicated to factors such as current rate per attorney, loss history, recent growth and size of firm, exposure to higher risk practice areas and risk management practices. Due to the limited number of insurers willing and able to compete for large firm primary placements, and the more abundant number of

competitors for mid-size law firm business, what law firms should anticipate at renewal will depend largely on the size of firm.

## CONCLUSION

Overall, the U.S. P&C industry is financially strong and well positioned to endure the economic turmoil caused by the COVID 19 pandemic and pay claims that might arise as a result. However, without a clear understanding of how long the U.S. economy will be shut down, it is difficult to assess what impact the shutdown will have on the P&C Industry. However, U.S. insurers have learned how to operate in an environment of artificially low interest rates, volatile capital markets and abundant capacity. Therefore, there is no reason to believe that current underwriting strategies will change dramatically as a result of fallout from the pandemic.

Consequently, law firms renewing in 2020 will experience another cycle of rate increases, the extent of which will depend, in large part, on the size of firm.

Large Law Firm Segment: Large firms should once again prepare for rate increases in the 7% to 10% range on primary layers. Since fewer insurers are willing to deploy capital on large firm primary layers, less competition for such positions has emboldened insurers in this space to push rate. Insurers in this segment will likely seek to increase self-insured retentions perceived to be inadequate. Firms in this segment with adverse claims experience will struggle to avoid rate increases above the range noted above.

Broad policy wording and customizable coverage is available in this segment.

Insurers will likely continue to deploy capacity more conservatively which will likely increase the cost of excess insurance and may challenge large towers of insurance to meet limit objectives.

Mid-size Law Firms: Law firms in this segment should anticipate rate increases in the 2% to 5% range and prepare to challenge any increase by leveraging more abundant capacity willing to compete for primary and excess layers. Despite abundant capacity, firms in this segment with adverse claims development will also face difficulty avoiding significant rate increases, as insurers seek to minimize exposure to severe losses. Coverage in this segment remains broad and competitive. However, features that negatively impact loss costs will be harder to come by and could increase rate or retentions. Excess capacity is abundant, but, firms can no longer expect flat renewals on excess layers.

Strategic and creative use of existing capacity, and new entrants to the space, must be exercised to offset insurers' efforts. Firms should be prepared to show insurers how they avoid the claims like those noted earlier in this report. In the period following the pandemic shutdown underwriters will seek to understand firms' business operations. In particular, law firms should demonstrate to insurers, steps taken during the shutdown to conduct business under unfamiliar circumstance such as:

- a. Review of firm's business continuity measures, financial strength and liquidity and steps taken to prepare for the shutdown;
- b. How will the current Covid-19 situation and resulting negative economic development impact your firm's staffing, legal services demand, revenues, and work process over the next year;
- c. Which practice areas does the firm anticipate decrease/increase in demand and what measures/preparations have been taking to manage shift in demand;
- d. Review of files and engagements in the context of temporary rules, regulations, court orders, critical deadlines etc.
- e. Steps taken to ensure proper supervision of associates and staff and of service redundancy in the event of illness of key personnel;
- f. Steps taken to ensure communications with clients are secure and to discuss how circumstances might impact an engagement;

- g. Steps taken to ensure implementation of risk management policies and procedures via remote operations;
- h. Steps taken to assess security issues related to technology utilized to meet demands of remote practice of law;
- i. Steps taken to preserve confidentiality and privilege under remote working conditions.

Taking advantage of current market conditions will require planning and knowledge of the market conditions and its many insurers and underwriters.

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<sup>i</sup> "P/C Insurers Boosted Underwriting Profit, Surplus in 2019's First 9 Months." *www.insurancejournal.com/Insurance Journal*. Insurance Journal, January 17, 2020. <https://www.insurancejournal.com/news/national/2020/01/17/555206.htm>.

<sup>ii</sup> U.S. P&C Insurance Industry Review 9 Months 2019." *U.S. P&C Insurance Industry Review 9 Months 2019*, November 22, 2019. <https://portal.alirtresearch.com>.

<sup>iii</sup> Id.

<sup>iv</sup> Potential Impacts of Capital Market Upheaval On Property & Casualty Insurers." *Potential Impacts of Capital Market Upheaval On Property & Casualty Insurers*, March 17, 2020. <https://portal.alirtresearch.com>

<sup>v</sup> TransRe. *TransRe View Large Law Firms Errors & Omissions Liability Insurance Market Analysis*. November, 2019.

<sup>vi</sup> Id.

<sup>vii</sup> Id.

<sup>viii</sup> Id.

<sup>ix</sup> Id.

<sup>x</sup> Id.

<sup>xi</sup> Swiss Re Corporate Solutions. *Large US Law Firms – Claims Analysis*, December, 2019.

<sup>xii</sup> Id.

<sup>xiii</sup> Id.