

Indemnity under the Professional Indemnity Scheme

Introduction

1. The Hong Kong Solicitors Professional Indemnity Scheme (“**PIS**”) is a statutory scheme which is managed and administered by the Hong Kong Solicitors Indemnity Fund Limited (the “**Company**”). Generally speaking, the PIS provides indemnity to solicitors, registered foreign lawyers and employees of Hong Kong law firms in respect of civil liability incurred in connection with their practice.
2. The terms and conditions of the PIS are set out in the Solicitors (Professional Indemnity Rules (Cap.159M) (the “**Rules**”). This article sets out how indemnity position is usually considered under the PIS.
3. PIS operates on a claims-made basis which means that a Hong Kong law firm/ solicitor/ registered foreign lawyer/ employee of a Hong Kong law firm may seek indemnity under the PIS if a third-party civil claim is made against them.

Key Questions to Consider

4. Rule 10 of the Rules is often referred to as the “insuring provision”:-

“Upon issue of the receipt referred to in rule 9, the indemnified shall be entitled to be provided severally with Indemnity out of the fund in the manner set out in rule 11 and to the extent, and subject to conditions and exclusions, set out in Schedule 3 against all losses to the indemnified whensoever occurring arising from any claim first made against the indemnified during the period of indemnity in respect of any description of civil liability whatsoever incurred in connection with the Practice...” (emphasis added)

5. When a claim for indemnity under the PIS is made, the following indemnity issues will be considered:-
 - (a) whether the firm/ person (against whom the third-party civil claim is made) seeking indemnity under the PIS falls within the definition of “indemnified”.
 - (b) whether the relevant work which gives rise to the third-party civil claim (the “**Relevant Work**”) falls within the definition of “Practice”.
 - (c) whether any exclusion provided in the Rules applies.

If the answers to (a) and (b) above are “yes” and that to (c) above is “no”, the relevant claim should prima facie be covered under the PIS.

“Indemnified”

6. The 1st question – Does the firm/ person seeking indemnity under the PIS fall within the definition of “indemnified”?
7. “Indemnified” is defined in Rule 2 of the Rules. It generally covers:-

- (a) the Hong Kong law firms.
 - (b) their principals.
 - (c) their employees and persons who work in connection with their "Practice" (including their associate solicitors, consultants, registered foreign lawyers and trainee solicitors). It does not only cover employees of the Hong Kong law firms, but also covers persons who work in connection with their practice, for example, locums.
 - (d) any solicitors who have ceased to practise as principals by reason of death, retirement or otherwise.
 - (e) the estate and legal representatives of any of the persons per sub-paragraphs (b) to (d) above.
 - (f) any service, administrative or nominee companies or trusts in so far as their activities are carried out in connection with the "Practice". One commonly seen example is companies set up and wholly owned by Hong Kong law firms to provide company secretarial services to their clients.
8. This issue is usually straight forward. However, complications may arise if the third-party civil claim is made against a service, administrative or nominee company or an individual indemnified who has "dual" roles (for example, they are a partner of the Hong Kong law firm as well as a partner of its overseas head office). In such a case, the background circumstances giving rise to the third-party civil claim will be closely examined, including the ownership of the relevant company, the nature of their activities, the way their fees are billed and the capacity in which the individual indemnified was involved in the Relevant Work.

"Practice"

- 9. The 2nd question – Does the Relevant Work fall within the definition of "Practice"?
- 10. The definition of "Practice" is relevant both to this 2nd question and to the 1st question for person/ company/ trust falling within the categories outlined in points 7(c) and (f) above.
- 11. "Practice" is defined in Rule 2 of the Rules as follows:-

"the business of practising as a solicitor, including the acceptance of obligations connected with and incidental to such practice as-

- (a) *trustee;*
- (b) *executor;*
- (c) *attorney acting under a power of attorney;*
- (d) *tax agent;*
- (e) *patent agent;*
- (f) *trade mark agent;*
- (g) *company secretary;*

- (h) *company director;*
- (i) *notary public, provided the solicitor is so qualified;*
- (j) *the neutral in any form of alternative dispute resolution procedure;*
- (k) *China-Appointed Attesting Officer; or*
- (l) *civil celebrant of marriages appointed under the Marriage Ordinance (Cap. 181),*

undertaken by the indemnified or his predecessor in business alone or with others, provided always that wherever any fees or other income accrue therefrom they inure to the benefit of that business;”

12. Whilst various activities are listed, the focus of the above definition will be on the following elements:-
 - (a) The Relevant Work must be undertaken within “the business of practising as solicitor”.
 - (b) The fees or other income accrued from the Relevant Work (if any) must inure to the benefit of the above business.
13. The nature of the Relevant Work will be relevant in assessing the issue in point 12(a) above:-
 - (a) If the Relevant Work is providing legal advice, the answer very likely will be “yes”.
 - (b) If the Relevant Work is something other than providing legal advice, the position may be less straight forward (even if the Relevant Work is one of the activities listed in the definition), for example:-
 - (i) The third-party civil claim arises from an individual indemnified acting as a company director.
 - (ii) It involves them doing or omitting to do something as part of the governing body of that company, i.e. the board and does not involve them giving legal advice.
 - (iii) In such a case, the Relevant Work likely falls outside the definition of “Practice”, and therefore, this claim will not be covered under the PIS.
14. The issue raised in point 12(b) above is a factual question – where did the fees go? For example:-
 - (a) Where an individual indemnified acts as a mediator in a dispute and they keep the mediator’s fees without paying them to their Hong Kong law firm.
 - (b) A third-party civil claim is then made against them in relation to the above.
 - (c) As the fees accrued did not inure to the benefit of their Hong Kong law firm, the Relevant Work (i.e. acting as a mediator) falls outside the definition of “Practice”, and therefore, this claim will not be covered under the PIS.

Exclusions

15. The 3rd question – Does any exclusion apply?
16. The exclusions are set out in paragraph 1(2) of Schedule 3 to the Rules, which include the following exclusions:-
 - (a) the “principal fraud” exclusion.
 - (b) the “employee fraud” exclusion.
 - (c) the “substantial prejudice” exclusion.
 - (d) the “profit costs” exclusion.

The “principal fraud” exclusion

17. The “principal fraud” exclusion is stipulated in paragraph 1(2)(c)(iii) of Schedule 3 to the Rules:-

“The Company will not provide Indemnity to the indemnified ... in respect of losses arising out of any claim brought about by the dishonesty, fraudulent act or fraudulent omission of any person who was a principal at the relevant time;”
18. The words “brought about” make clear that there must be a causal connection between the loss in respect of which indemnity under the PIS is sought and the dishonesty.
19. Case authorities suggest that “dishonesty” has both a subjective and objective element – (a) what did the individual concerned subjectively understand the relevant circumstances to be; and (b) was that individual’s conduct objectively dishonest having regard to that understanding.
20. As provided in paragraph 1(2A) of Schedule 3 to the Rules, a person will be a principal at the relevant time if that person was a principal:-
 - (a) at the time of the event which was alleged to give rise to the claim;
 - (b) at the time when the claim was first made against the indemnified; or
 - (c) in the case of a claim arising out of circumstances previously notified to the Company, at the time when such notification was given to the Company.
21. For example, if a principal of a Hong Kong law firm stole monies from its client’s account and a client then claimed against the principal or the firm for the lost sum, the claim will not be covered under the PIS as the “principal fraud” exclusion is triggered.

The “employee fraud” exclusion

22. Paragraph 1(2)(c)(iiia) of Schedule 3 to the Rules says:-

“The Company will not provide Indemnity to the indemnified... in respect of losses arising out of any claim brought about by the dishonesty, fraudulent act or fraudulent omission of an employee of the firm or the indemnified unless the indemnified can prove or show to the satisfaction of the Company that such dishonesty, fraudulent act or fraudulent

omission of the employee did not occur as a result of recklessness or dishonesty or a fraudulent act or fraudulent omission on the part of any person who was a principal at the relevant time in the conduct or management of the Practice;”

23. The “employee fraud” exclusion as set out above can broadly be divided into 2 parts:-
 - (a) the “dishonesty” element - “any claim brought about by the dishonesty, fraudulent act or fraudulent omission of an employee of the firm”; and
 - (b) the “reckless management” element – “unless the indemnified can prove or show to the satisfaction of the Company that such dishonesty, fraudulent act or fraudulent omission of the employee did not occur as a result of recklessness or dishonesty or a fraudulent act or fraudulent omission on the part of any person who was a principal at the relevant time in the conduct or management of the Practice”.
24. Points 18 and 19 above are also applicable to the “dishonesty” element.
25. After the “dishonesty” element is established, the burden of proof then shifts to the relevant indemnified in respect of the “reckless management” element.
26. For the “reckless management” element:-
 - (a) The phrase “as a result of” requires there be a causal connection between the employee’s relevant dishonesty and the dishonesty or recklessness in the conduct or management of the firm.
 - (b) To establish “recklessness”, according to the case authorities, requires that the person in question is aware of a risk (which includes the person deliberately turning a blind eye to its existence) and deliberately chooses to run that risk in circumstances where it is unreasonable to do so.
27. An example where the “employee fraud” exclusion applies is set out below.
 - (a) A sole proprietor of a firm left signed blank cheques drawn on the firm’s client account with their staff.
 - (b) The staff then misappropriated monies in the client account using the signed blank cheques.
 - (c) The client whose monies were stolen subsequently made a civil claim against the firm.
 - (d) In such a case, both the “dishonesty” and “reckless management” elements are present, and therefore, the “employee fraud” exclusion is triggered. As such, the claim will not be covered under the PIS.

The “substantial prejudice” exclusion

28. The “substantial prejudice” exclusion is set out in paragraph 1(2)(c)(vii) of Schedule 3 to the Rules:-

“The Company will not provide Indemnity to the indemnified ... in respect of losses arising out of any claim ... where non-compliance by the indemnified with a condition of these rules has involved or led to a substantial prejudice, whether or not capable of measurement in monetary terms, to the handling or settlement of the claim;”

29. There are two required elements to trigger this exclusion – (a) non-compliance with a condition in the Rules; and (b) such non-compliance has involved or led to a substantial prejudice to the handling or settlement of the claim.
30. Various obligations under the PIS are set out in the Rules. Please refer to the article “Obligations Under the PIS” published in 2022 for more information. One of the important obligations is not to admit liability without the Company’s prior consent. If an indemnified admits liability for a claim without the Company’s prior consent where there is in fact a good defence, the “substantial prejudice” exclusion will apply and such claim will not be covered under the PIS.

The “profit costs” exclusion

31. Paragraph 1(2)(d) of Schedule 3 to the Rules provides that:-

“The Company will not provide Indemnity to the indemnified... in respect of a direct or indirect loss by the indemnified of the amount of his fees or profit costs;”

32. Very often claimants who are former clients may seek refund of legal fees previously paid for the alleged defective work as a head of damages when they make a civil claim against their solicitors. The effect of the “profit costs” exclusion is that the PIS will not cover such head of damages (save for disbursements such as Counsel’s fees or expert fees).

Conclusion

33. This article is intended to give general guidance on the key issues that will be considered when indemnity of a claim under the PIS is investigated. Please note, however, that issues regarding coverage are highly fact dependent.

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