PROFESSIONAL INDEMNITY INSURANCE, PERFORMANCE AND PRE-EMPTIVE NEGLIGENCE: THE IMPACT OF 'NON-CLAIMS'

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ABSTRACT

As part of Australian licensing requirements professional valuers are required to maintain a level of professional indemnity insurance. A core feature of any insurance cover is that the insured has an obligation to notify their insurer of both actual and potential claims. An actual claim clearly will impact upon future policies and premiums paid. Notification of a potential claim, whether or not the notification crystallises into an actual claim, also can have an impact upon the insured's claims history and premiums. The Global Financial Crisis continues to impact upon business practices and land transactions both directly and indirectly. The Australian valuation profession is not exempt from this impact. One example of this ongoing impact is reflected in a worrying practice engaged in by some financial institutions in respect of their loan portfolios. That is, even though the mortgagor is not in default, some institutions are pre-emptively issuing notices of demand regarding potential losses. Further, in some instances such demands are based only on mass appraisal valuations without specific consideration being given to the individual lot in question. The author examines the impact of this practice for the valuation profession and seeks to provide guidance for the appropriate handling of such demands.

Keywords: professional indemnity insurance, negligence, valuation practices

INTRODUCTION

While Australian valuers are subject to Stated-based, as opposed to a national, licensing regimes, consistently these require professional valuers to maintain a level of professional indemnity insurance in order to practise. This requirement is in addition to those relevant to the acquisition and maintenance of core skills and competency as evidenced by the separate obligations regarding continuing professional development. Maintaining the requisite level of insurance covers imposes a level of obligation that is separate to that enforced by the State-based regulators and professional bodies. A core feature of any insurance cover is that the insured has an obligation to notify their insurance provider of both actual and potential claims. This obligation, as the paper discusses, also is a feature of professional indemnity insurance policies. An actual claim clearly will impact upon future policy acceptance and, if the prospective insured is accepted for ongoing coverage, the premiums paid. Notification of a potential claim, whether or not the notification crystallises into an actual claim, also can have an impact upon the insured's claims history and premiums.

As Blake and Eves (2012) identified over a number of years financier and investor clients often have 'knee jerk' reactions to fluctuating property markets and property prices. This is one issue requiring attention by the professional valuer as many of the identified reactions resulted in litigation against a valuer. Recent reactions by financiers have moved in a slightly different direction. Financiers appear not to be content to wait for losses to crystallise, acting instead pre-emptively. What this paper considers is this more recent and it is suggested more worrying practice as it removes the consideration of issues of liability from the Courts, transferring it instead to insurance companies.

One example of this ongoing impact is reflected in a worrying practice engaged in by some financial institutions in respect of their commercial loan portfolios. That is, even though the mortgagor is not in default, some institutions are pre-emptively issuing letters of demand regarding potential losses. This action is based, seemingly, on purely paper values when no mortgagee is in default. Further, in some instances advised to the author (X, 2014); demands are based only on mass appraisal valuations without specific consideration being given to the individual properties.

The author examines the impact of this practice for the valuation profession and seeks to provide guidance for the appropriate handling of such demands. A detailed consideration of the law of torts in Australia as it relates to valuers, however, is outside the scope of this paper and the reader is directed to other authors[1]. Further, the issue this paper considers cannot be addressed by capping liability under, for example, the legislatively approved API State schemes.

While this paper considers the GFC's ongoing affect from an Australian perspective, other jurisdictions' valuation professions are not immune. The paper commences by providing context for valuer liability by reference to examples. It then identifies an insured valuer's insurance disclosure obligations by reference to specific professional indemnity insurance policies. After identifying issues of concern it concludes by providing suggestions for future practice.

[1] For example see – Blake and Eves, 2012; Boyd and Irons, 2002; Murdoch and Kincaid, 2002.

CONTEXT

It is a well establish principle of Australian law that valuers owe a duty of care to parties who seek to rely upon the valuations prepared by them and as such valuers are required *"to exercise due skill and diligence"* in performing their role (*NAB v Hann Nominees Pty Limited* [1999] at [137]). Part of a valuer's professional duty requires the valuer to consider and account for both positive and negative property factors (*Spencer v Cth* [1907]). This will require the valuer to inspect the property as part of the valuation process. As such mass appraisals by means of utilisation of on line data only is, it is suggested, only appropriate for valuations used for limited purposes such as land tax or rating calculations. Use for other purposes, particularly when the client is seeking to hold a professional valuer liable for a loss arising from an alleged diminished value, is questionable.

The extent of the duty owed by the valuer is *"largely* [to] *be determined from the terms of the instructions given to them by their client"* (*Provident Capital Limited v John Virtue Pty Ltd* (No 2) [2012] at [87]) but may extend to third parties depending on the particular circumstances. More recently, in disciplinary proceedings, the Valuers Registration Board of Queensland observed:

> It is settled law that a person such as Mr Conroy owed a duty of care to the person who had requested the valuation. The duty is to take reasonable care as a trained professional valuer to give a reliable informed opinion on the open market value of the land in question at the date of valuation. It is also now settled that a valuer may owe a duty of care to a third party receiving a valuation containing a negligent misstatement which causes economic loss. For example, in this case, the finance company or companies which Mr Conroy acknowledges on the face of the valuations are entitled to rely on the valuations. (internal references omitted) (*Valuers Registration Board of Queensland v Conroy t/as Bevan Conroy & Associates Valuers* [2013] at [27]).

The Australian position is consistent with that articulated by courts internationally (*Webb Resolutions Ltd v E.Surv Ltd* [2012] at [5]). Simply - valuers will be held accountable for inaccuracies in their reports (Boyd and Irons, 2002). In some instances this translates into involvement in litigation when an affected party, more commonly but not always the party who commissioned the valuation, sues to recover an alleged loss in property value. While history shows that there is a greater propensity for litigation for declined values as a consequence of falling markets (Blake and Eves, 2012), this by itself should not give cause for concern. Valuers, generally, are not liable for subsequently declining property valuers, unless agreed to at the time of accepting the instructions. As McHugh J observed in the High Court's judgement in *Kenny & Good Pty Ltd v MGICA* [1999]:

> Whether a valuer is liable for a subsequent decline in the market will depend on the terms of the valuation arrangement. Ordinarily, however, the valuer will not be liable for the monetary difference between true value of the property and any lesser price obtained because of a market decline, notwithstanding that declines in market values are reasonably foreseeable in a general way. The reason for this conclusion is that, in so far as a decline in the market was reasonably foreseeable, it will already be factored into the assessment of the true value of property as at the date of valuation. In so far as the market decline was not reasonably foreseeable, any loss arising from the decline must be regarded as outside the contemplation of the parties to the valuation arrangement and not recoverable in an action for negligence or breach of contract. (at [48])

A certain degree of valuation error is permissible. However, while a degree of error *per se* has been held not to be a breach of the required duty owed (*Flemington Properties Pty Limited v Raine & Horne Commercial Pty Limited and Anor* [1997]), whether there was in fact a breach would depend, it is suggested, upon the exact circumstances of the relevant valuation process. A step that would be central to this consideration was whether a physical inspection was undertaken, as well as the advised purpose for the valuation report.

Valuers are acting as professionals when providing valuation reports (Blake and Eves, 2012). This recognition, while imposing obligations, is significant. If a valuer has acted in a professional manner (as described in the relevant Act) then most Australian States and Territories' civil liabilities legislation provide they will not be held negligent for subsequent.[2] However, a judicial finding of negligence is not necessary before issues arise. The nature of insurance contracts, particularly those for professional indemnity insurance, are that absent any finding of liability, or any likelihood of such a finding, the insured valuer has enforceable contractual obligations triggered by the actions of their financier client. A failure to fulfil those obligations places the valuer at an unacceptable risk regarding potential loss.

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[2] Protection is provided by Ss. 5O and 5P *Civil Liability Act 2002* (NSW); S. 22. *Civil Liability Act 2003* (Qld); S. 41*Civil Liability Act 1936* (SA); S. 22 *Civil Liability Act 2002* (Tas); and Ss. 59 and 60 *Wrongs Act 1958* (Vic). However, S.5PB *Civil Liability Act 2002* (WA) applies similar provisions only for 'health professionals'; and the *Civil Law (Wrongs) Act 2002* (ACT) and *Personal Injuries (Liability and Damages) Act 2003* (NT) are silent on this issue.

INSURANCE OBLIGATIONS

Samples of commonly available professional indemnity insurance policy documents were reviewed in order to better understand the obligations imposed upon professional valuers as the insured party. Two policies will be examined for the purpose of this discussion; however, the policy providers will not be identified. These policies are a general professional indemnity insurance policy (Policy A) and a valuation industry specific policy (Policy B). It is important to note that these policies are indicative only of general practice and it is necessary to specifically review any policy wording carefully to identify the actual notification obligations of the insured under that policy.

Policy A is a general professional indemnity insurance policy that provides similar cover for *loss* incurred by the insured party subject to stated exceptions and limitations. *Loss* is defined to mean payment made pursuant to any legal obligation regarding a claim, as well as the costs of any defence (as defined). Policy A defines *claim* by reference both to formal legal process and as *"the receipt … of any written demand for civil compensation or civil damages or non-monetary civil relief"*. The insured has an obligation to provide *"written notice"* of any claim *"as soon as practicable"*. Relevant documentation must be provided to the insurance company as soon as possible and in any event not later than 90 days after the end of the period of cover.

Policy B is a policy that is targeted to property valuers and is stated to provide cover (to an agreed maximum) for claims made arising out of conduct by the valuer in breach of their professional duty to their client. The amount covered extends to cover the reasonable costs of investigation and defence of any *claim*. This policy is subject to a number of limitations and exclusion provisions as well as requiring the use of specifically worded disclaimer clauses in certain types of valuations.

Of relevance here is that Policy B obligates the insured valuer to give to the insurance company *"as soon as practicable*", and in any event before the end date of the policy of insurance, written notification of any *claim* <u>and</u> to send to the insurance company all relevant legal documents. The issue for this paper arises in respect of what is meant by the term *claim.* Similarly to Policy A, Policy B defines a *claim* to be both a legal document served as part of legal proceedings, whether in relation to litigation or arbitral process, which contains *"a demand for compensation"* <u>and</u> *"*[t]*he receipt … of any demand for compensation…".* The policy later clarifies that it covers the insured, subject to stated exceptions, in respect of claims made against them *"and notified"* to the insurance company.

This brief analysis of just two policies reinforces the difficulties valuers face in dealing with spurious claims. While both policies are broader than mere liability policies, as they protect the insured for loss arising both from litigation and mere demand (*Pioneer Road Service Pty Ltd v QBE Insurance Ltd* (2002)), this imposes other obligations on the valuers as the insured party regarding the requirement for notification of *any* demands received. This obligation is not limited to notification of formal court issued documentation. Although the insured valuer may not have breached any obligation owed to their client, in order for a valuer to have cover against any future liability arising from that transaction, they must notify the insurance company of *any* demand received by them. This includes notify any disputed or specious demands.

Separately from contractual obligations contained within specific insurance policies, insured valuers are also *obligated* to disclosure information by law. *Obligated* that is in the context of needing to comply with stated disclosure requirements if they wish to be able to rely on the cover provided by their professional indemnity insurance policy. The relevant legislation is the *Insurance Contracts Act 1984* ('ICA'). Section 21(1) of which provides:

> *an insured has a duty to disclose to the insurer, before the relevant contract of insurance is entered into, every matter that is known to the insured, being a matter that:*
>
> *(a) the insured knows to be a matter relevant to the decision of the insurer whether to accept the risk and, if so, on what terms; or*
>
> *(b) a reasonable person in the circumstances could be expected to know to be a matter so relevant.*

This means that even if the valuer disputes the allegation, or does not intend to claim as the amount is below their excess (deductible), or the claim is never pursued, they need to advise their current insurer on renewal, or if looking to change insurers their proposed new insurer. Commonly renewal notices and applications forms specifically advise the (prospective) insured party of this obligation, and for a new application provides an area in which relevant information may be included. If the insured does not provide details of all demands received they risk their policy (if the failure to disclose is held to be fraudulent) being avoided (Section 28(2) ICA); *or*, more commonly, the insurer's level or liability being reduced to put the insurer in the position they would have been in but for the failure (Section 28(3) ICA).

While a claim for damages may be a matter that can be defended, the requirement for notification of potential claims cannot. Without notification now, or in the future advice of any demand received before renewal or granting of new cover, the insurance company will be within their rights to reduce a claim or avoid the policy or decline coverage. Without appropriate insurance cover, the valuer then will not be in compliance with their licencing obligations.

BEHAVIOUR OF FINANCIERS

There is a difficulty in discussing current financier behaviour in that, without a reported decision, reliance must be placed on anecdotal evidence found through examination of news stories, and drawn from personal conversations. That the practice has occurred, and continues to do so, is clear as recounted to the author by a senior industry representative (X, 2014). Changes to property prices stemming from changed development plans in the area in which the property is located (i.e. the proposed shopping centre being postponed; or construction of the next stage of the master planned community, which includes the swimming pool or gym, being slowed due to lack of demand), however, are beyond the crystal ball of even the most experienced valuer. What is also impossible to factor in is the potentially high risk lending practices that were, and arguably still are, engaged in by some financiers (Gaynor and Walsh, 2011).

Each valuation report is provided for a specific property and is based upon the property classification, existing (or proposed) uses unique to that property, and geographic location (Wyatt, 2013). It is also targeted to the client's specific instructions and may draw upon documents provided by them. As the case law reflects, however, it is essential that the valuer verify the source of any such documents (*Kestrel Holdings Pty Ltd v APF Properties Pty Ltd* [2009]). Irrespective of the instructions given, it is not uncommon for financiers to send notification letters to valuers when a borrower defaults to advise that the financiers will look to the valuer for any shortfall arising from the valuer's negligence (TPM, 2014; CPR Insurance Services, 2014; Blake and Eves, 2012; Gaynor and Walsh, 2011). As noted above, some of these matters ultimately end up in court but not all. This recovery behaviour appears now to be taken one step further in that notifications have been received in circumstances where there is not as yet a default, merely a re-valuation of property, undertaken on a mass appraisal basis (X, 2014).

Issues facing valuers are not confined to the larger commercial transaction. Residential property valuers face similar concerns, which are arguably exacerbated due to the emotional attachment many buyers have for their home. One younger valuer who was interviewed for this paper had observed, and been subjected to themselves, both subtle and not-so-subtle pressure from brokers, and lenders' in-house staff, to make sure that the valuation "was up to scratch" (Y, 2014). In a less supportive and professional environment Y may have succumbed as peers of Y were reported to have done. This behaviour by itself makes a mockery of the independency of the valuation profession but is merely indicative of the tough post-GFC market in which all industries must operate. If the borrower defaulted and the valuation was in fact incorrect no doubt the financier would seek to recover any losses from the valuation provider. It is not surprising then that other sources report on the growing conservatism within the valuation profession (Kelly, 2013; Herde, 2012).

Importantly, as noted the majority of financiers have both a significant input into the contents of the valuation reports provided, as well, ultimately, in making the determination based upon their lending practices as to whether or not to proceed with the loan. In some cases this has resulted in a finding of contributory negligence against the financier (*Webb Resolutions Ltd v E.Surv Ltd* [2012] at [162] – [167]) thus reducing the amount the valuer was required to pay by way of damages. However, while this is a consideration for matters that in fact proceed to litigation and consideration by the Courts, such possible defences have no relevance if no litigation is instigated.

DISCUSSION

Risk management is a necessary component of any professional practice. Professional valuation firms on the whole tend to be very mindful of this particularly regarding the need to quality assure for report accuracy (TPM, 2014). However, managing for fluctuating property prices due to matters beyond any valuers' control would appear to be an impossibility. Despite this, banks are clearly continuing to reduce their losses by seeking recovery against valuers when properties in default are sold. This is also reflected in overseas markets such as the United Kingdom (CPR Insurance Services, 2014).

Where negligence has occurred then clearly the client should be able to recover their loss. The issue for concern here, as articulated above, is one that is arising without first a default by the borrower. That is, in respect of large commercial matters, the financiers have allegedly sent letters putting the valuer on notice of potential inaccuracies in their original valuation even though no loss has crystallised under the terms of the loan documentation (X, 2014). Admittedly large commercial transactions are more risky than a house purchase; however, this is something that should be considered by the financier when determining their risk profile. To issue such demands when there is no default, and based apparently on a 'desk' not physical valuation, is a worrying practice. For the valuers concerned, it is not one that can be ignored however as they need to notify their insurer.

Where a professional indemnity insurance policy covers for loss arising from both negligence *and* mere demand, the insured does not need to prove a breach of duty in order to have recourse to the policy cover. However, as noted above, the notification of mere demands, irrespective of whether the third party pursues their demand, will be taken into account by the insurance company in calculating the following years' premiums *and* whether or not to accept the valuer as a future risk. Changing insurance companies will not assist as the insured has a duty of disclosure with which they must comply if they wish to be able to rely upon their new policy in the future. Although such notification may impact future insurance risk and premiums, disclosure of potential claims does provide a level of benefit (comfort) to the valuer.

Section 40(3) ICA reinforces the benefit to the valuer of advising of all potential claims as it provides:

> Where the insured gave notice in writing to the insurer of facts that might give rise to a claim against the insured as soon as was reasonably practicable after the insured became aware of those facts but before the insurance cover provided by the contract expired, the insurer is not relieved of liability under the contract in respect of the claim, when made, by reason only that it was made after the expiration of the period of the insurance cover provided by the contract.

As can been seen, irrespective of the disclosure obligation in Section 28 ICA, Section 40(3) ICA makes it imperative for all potential claims to be notified. However, such notification comes at a cost. That is, each claim or potential claim notified will be factored into the insurance company's consideration of the valuer as a potential risk <u>and</u> the premium to be charged if the insurer determines to accept that risk. In some instances this also is reflected in significant, and arguably disproportionate, increases in policy excesses (deductibles) (Martin, 2014). Not notifying your professional indemnity insurer when a letter of demand, or a warning letter of potential future demand, is received, however, is not a viable risk management option.

CONCLUSION

As the cases clearly reflect, a valuer is not usually held liable for falling market unless other factors also are involved (*Kenny & Good v MGICA).* It is difficult therefore to find a justification for financiers' current reactions. In the context that mass appraisal valuations are only appropriate for ratings purposes, the validity of their use as a mechanism to trigger service of a warning of future possible demands, or even actual demand subsequent to loss, is questionable. Absent a full re-valuation, involving property inspection and full comparison it is suggested that these valuations are likely to hold little weight in Court. The issue of course, is that these matters are unlikely to proceed to litigation or further action. The impact on professional practice, however, can be as significant as full litigation and one that the professional valuer can only attempt to manage by being appropriately proactively. That is, by ensuring all valuers follow proper practices and guidelines and that quality assurance is maintained.

The overarching concern for the valuation profession is that they are *damned if they do, and damned if they do not*. A lower, or apparently conservative, valuation is likely to bring pressure from a broker (or the borrower) client as it may prevent a transaction from proceeding. To raise the valuation amount, however, may result in the valuation being inaccurate and outside acceptable tolerances leaving the valuer at risk of claims of negligence. The answer may be as simple as to have appropriate procedures (and support) in place and to ensure these are followed.

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