PROFESSIONAL INDEMNITY MITIGATION PROVISIONS TESTED

- GBP 102 million insurance claim by Standard Life for mitigation costs in relation to miss-selling upheld by High Court
- The High Court held that the correct approach was to identify the expected and intended effect of the mitigation payment
- Highly likely judgment will be appealed
- Increased focus from FSA on treating customers fairly likely to increase number of future mitigation claims

A recent judgment handed down in the high court gave a timely reminder of the importance of mitigation provisions in financial institutions civil liability insurance policies.

Following the onset of the credit crisis in mid 2007 and the subsequent collapse of Lehman Brothers in 2008, a number of institutions were concerned about having marketed funds as ‘cash or near cash’, only to find that the asset backed securities held within the fund were insufficiently liquid or could not accurately be priced. This led to allegations of misselling from disgruntled investors.

In January 2009, Standard Life (SL), which had been monitoring the Standard Life Pension Sterling Fund (‘the Fund’), and mindful of the difficulties in the market, decided to implement a pricing change, which it was aware would lead to an immediate fall in value of the Fund. Concurrently it was investigating whether its marketing literature would give rise to the possibility of allegations of misselling as described above.

The sum required to make good the Fund following the drop in value did not equate to the potential loss which investors might subsequently claim, but as time passed, a strong argument developed within SL that to put this sum back into the Fund was ‘the right thing to do’ and would also stem the loss of customers and funds under management. This plan became known as the ‘brand option’.

The alternative was to run a customer redress project and pay customers compensation on a case by case basis, if they could prove misselling; the so called ‘legal option’. Legal advice suggested that the latter was appropriate and that paying sums into the Fund was not, as matter of law, ‘necessary’, and would result in some investors receiving a ‘windfall’. It appears to have been unclear which was the more expensive option until very close to the actual decision being made, or indeed thereafter. The decision was taken in February 2009 to adopt the so called ‘brand option’.

A claim of GBP 102 million was subsequently advanced under SL's professional indemnity policy, and notwithstanding the apparent motivation to protect the reputation of SL being a key factor (or that argument having been made strongly within the organisation), it was
argued in the insurance claim that the payment into the Fund was ‘Reasonably and necessarily incurred... in taking action to avoid or reduce a third party claim’, that is to say the payment to the fund was a mitigation cost to reduce the misselling claims.

Insurers denied the claim, alleging that the relevant test was to identify the dominant purpose of the payment, which was to protect the brand of Standard Life. This argument was rejected by the court, which identified the overwhelming difficulties in seeking to identify and rely on one purpose for a corporate decision, when quite clearly it is possible to have a number of concurrent purposes. The court held that the correct approach was to identify the expected and intended effect of the payment. On the basis of the detailed evidence it was concluded that SL expected and intended that the payment into the fund would have the effect of reducing misselling claims (and indeed it appeared so to do). It was irrelevant that it would also protect the brand.

In January 2010 SL were also fined by the FSA for the systems and controls failings that resulted in the production of misleading marketing material for the Fund. It is very common in handling financial institutions claims to see the insured managing multiple (and often conflicting) work streams as it seeks to come to terms with potential civil liability, potential regulatory censure, its reputation and the terms and conditions of its insurance policies. In this context the decision against a dominant purpose test, and the reconfirmation that a mitigation payment need not be the same as the liability to third parties, is a welcome one.

But it is also worth putting this case in the wider context. We think it likely that the nature of the range of matters with which financial institutions have to grapple, including the ever increasing focus on treating customers fairly, will give rise to an increase in mitigation claims in the future (irrespective of whether firms adopt the route of making good a fund or approaching potentially disadvantaged customers in relation to redress).

Since the date of the decision made by SL to adopt the brand option (February 2009) the FSA has further increased its focus on retail misselling and how firms should best deal with these issues. In June 2011 the FSA sent a ‘Dear CEO’ letter to the wealth management industry, commenting, that its work indicated that there is a high risk across the industry of historic misselling, particularly in relation to portfolio suitability. In October 2011 the FSA fined Credit Suisse for systems and controls failings in relation to sales by its private bank of structured capital at risk products. In December 2011 the FSA issued its largest ever retail fine (of GBP 10.5 million) to HSBC because of inappropriate investment advice provided by one of its subsidiaries, NHFA Limited to elderly customers.

The FSA’s guidance makes it clear that the expectation is that firms will be obliged to consider their own proactive redress schemes at an early stage, including contacting customers who have not complained. It is worth noting that this expectation kicks in even earlier in a financial institutions’ processes than the operation by the FSA of the amended provisions under section 404 of FSMA, by which firms can be required to operate customer redress schemes.

In both these instances of redress, from an insurance perspective the insured may well be in the position of having ‘circumstances’, but not a ‘Claim’, to notify. As the SL case illustrates, how or if that may then give rise to any obligation on insurers to provide indemnity is dependent on the policy wording.

In the light of these developments, and given that we understand that the judgment is likely to be appealed, we strongly urge financial institutions to review the operation of the mitigation provisions in their professional indemnity policies.