Mitigation costs cover

Financial Institutions professional liability
This paper considers some of the issues which often arise in relation to mitigation costs cover in the context of Financial Institutions professional liability policies. While still not a standard feature of such policies, cover for the cost of taking steps to mitigate an actual or potential claim is increasingly being offered or requested in this line of business. This is particularly so given the raised profile of this form of cover as a consequence of judicial attention during 2012. As such, this paper is an important read for all those involved in procuring such cover for regulated Financial Institutions.

**Background**

The general position is that, in the absence of express wording, cover cannot be implied into a liability insurance policy for costs which may mitigate an unquantified loss which insurers might have to meet at a future date. As such, if this type of cover is to feature, it must be by express provision in the policy wording.

There are often clear benefits for both insureds and insurers in having professional indemnity cover which incorporates an element of pre-claim response. Dealing quickly and effectively with a matter in its early stages can result in a reduced payment to the potential claimant and a significant saving in overall costs.

Whilst it remains the case that not all Financial Institutions will consider purchasing professional indemnity insurance, most consider it a core part of their insurance needs. This is particularly the case in the UK regulatory environment and when investor returns are under pressure and the risk of customer claims inevitably increases. However, this is not to say that mitigation costs cover is suitable or even necessary for all Financial Institutions whose business models otherwise require professional indemnity insurance.

The variety in the form and the substance of the wordings used for mitigation costs cover in the London insurance market is notable. By way of illustration, the most common form in which mitigation costs cover is provided is by extension or endorsement, albeit it is sometimes incorporated into the primary professional indemnity insuring clause or within relevant definitions. On occasion, the operative mitigation costs insuring provision can be found within the policy conditions. One other noticeable difference is that sometimes mitigation costs cover is sub-limited. Further, some wordings expressly (or are worded in sufficiently broad terms so as to) provide cover for sums paid in settlement of a loss (or in substitution for a claim), whereas other wordings limit the scope of cover to associated legal and other professional costs in taking mitigating steps.

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The Increasing Importance of Mitigation Costs Cover

The increasing importance of mitigation costs cover can largely be attributed to characteristics of the UK financial services regulatory regime which mean that there is an increased regulatory focus on a proactive, pre-claims response to issues which have resulted (or may result) in consumer detriment.

One of the Financial Conduct Authority’s (FCA) statutory objectives (and also of its predecessor the Financial Services Authority) is to secure an appropriate degree of protection for consumers and, while this objective has certainly been pursued over the years in terms of enforcement and other regulatory actions, the credit crisis has undoubtedly led to more aggressive and intrusive regulatory behaviour in the UK, and many other jurisdictions. Some say that this is, in part, in recognition of the regulatory failings which arguably contributed to the credit crisis. The FCA has made clear that it will be even more pro-active and pre-emptive in its approach to consumer protection.

There are a number of aspects of the UK regulatory regime which provide for an increasing emphasis on pro-active identification and remedy of issues before complaint.

This includes the high-level Principle for Business that firms “must pay due regard to the interests of its customers and treat them fairly.” There is a large body of regulatory guidance on how the “treating customers fairly” principle should be applied in practice, including a requirement on firms to carry out root cause analysis of complaints in order to identify systemic problems.

Additionally, there is a growing use by the regulator of “thematic reviews” to ascertain and evaluate particular risks or problems with findings (based on a sample analysis) published and change imposed on all. Past business reviews to assess the extent of customer detriment, may follow thematic reviews or form part of firm-specific supervisory or enforcement action. The regulator is also able to establish compensation schemes where widespread or recurring problems have affected consumers and the regulator anticipates that wide scale compensation is likely.

Adding to these existing powers, 1 April 2013 saw the introduction of product intervention powers. These allow the FCA to limit or prohibit the marketing of products that pose unacceptable risks to consumers without industry consultation if the FCA considers that the delay involved in public consultation would be prejudicial to the interests of consumers. At the same time super complaints and mass detriment references were introduced, and these processes further emphasise the regulator’s focus on early response to wider issues.

Many of the regulatory pressures which exist in the UK can be observed in other jurisdictions. Consequently, mitigation costs cover may in time become equally important to Financial Institutions operating outside the UK.

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2 On 1 April 2013, significant changes were made to the structure of the UK financial services regulatory regime. The Financial Services Authority was replaced by the FCA and the Prudential Regulation Authority (“PRA”). The PRA is now responsible for the authorisation, prudential regulation and supervision of all insurers, deposit-taking institutions and systemically important investment firms. The FCA is responsible for the conduct regulation of all firms, and also the prudential regulation of all firms not regulated by the PRA. The Financial Policy Committee (FPC) was also introduced and has responsibility for the oversight of financial stability in the UK economy as a whole.

3 FCA Handbook, Dispute Resolution Sourcebook, DISP 1.3.3R and Appendix 3.4.

4 Thematic reviews are a supervisory tool and often follow other forms of regulatory market surveillance. Examples of issues which have been the subject of past thematic reviews by the FSA include venture capital trusts, capital secured structured products, insurance comparison websites, over 50’s life cover, spread betting, structured deposits, investment advice and platforms, mortgage fraud against lenders and self invested pension plans.

5 Past business reviews are often conducted by agreement between the firm and regulator. Sometimes, however, they are conducted under section 166 Financial Services and Markets Act 2000 (“FSMA 2000”) skilled persons reports. As explained in the FCA Handbook, Supervision Sourcebook SUP5, skilled persons reports can be used (1) for diagnostic purposes, to identify, assess and measure risks; (2) for monitoring purposes, to track the development of identified risks, wherever these arise; (3) in the context of preventative action, to limit or reduce identified risks and so prevent them from crystallising or increasing; and (4) for remedial action, to respond to risks when they have crystallised. It is the last of these categories which can involve customer redress programmes.

6 Compensation schemes are set up under section 404 FSMA 2000, which has been in force since October 2010. There are, however, examples of where firms have participated in similar schemes on a voluntary basis.

7 Section 137D FSMA 2000. The product intervention powers effectively allow the regulator to intervene before detriment has been suffered, or where some detriment has been suffered but complaints have not necessarily started to flow.

8 Sections 234C to 234G FSMA 2000. Mirroring the process which currently exists under the UK competition law regime, a super complaint will be able to be made to the FCA by designated consumer bodies if they consider that a feature (or combination of features) of the UK financial services market is, or appears to be, significantly damaging to the interests of consumers. A mass detriment reference can be made by either the FOS or by a regulated firm or individual (in other words, a self-report) under one of two bases. These are: (a) if: (i) it appears that there may have been regular failure by one or more regulated persons to comply with requirements which apply to them; or (ii) as a result consumers have suffered, or may suffer, loss or damage; and (iii) a remedy or relief could be obtained in respect of this loss of damage in legal proceedings; or (b) where it appears that one or more regulated persons have on a regular basis acted in such a way that, if a complaint were to be made to the FOS, it is likely that the complaint would be determined in favour of the complainant and an award would be made in their favour.
Mitigation costs cover in the context of Financial Institutions insurance was considered for the first time by the courts during 2012. This has served to highlight some of the more challenging issues which come into play when dealing with pre-claims cover, and the importance of policy language. The policy in that case provided an indemnity to the Insured, Standard Life, for mitigation costs which were defined as:

"...any payments of loss, costs or expenses reasonably and necessarily incurred by the Assured in taking action to avoid a third party claim or to reduce a third party claim (or to avoid or reduce a third party claim which may arise from a fact, circumstance or event) of a type which would have been covered under this Policy (notwithstanding any Deductible amount)."

In summary, Standard Life operated a fund which reduced in value by 4.8% in January 2009 following changes applied to the asset valuation methodology. Complaints from investors and IFAs followed quickly, together with press criticism and regulatory pressure. Standard Life subsequently estimated that the majority of the fund’s investors would have valid claims against it as a result of misleading statements in some versions of the fund’s marketing literature representing that investment in the fund was equivalent in terms of risk to cash on deposit. Influenced by a number of factors, in February 2009, Standard Life made a corrective payment into the fund in excess of £100 million, which restored the value of the fund to its pre-January 2009 value. Standard Life also made other payments to customers who had sold their units since the fund’s drop in value. Standard Life then sought to recover these payments under the mitigation costs clause of its professional indemnity insurance policy.

The main points arising were:

- Reasonableness and necessity of steps taken: the Judge concluded the assessment of whether the insured had acted reasonably was an objective test and, applying previous case law, "necessarily" imported a high threshold for recovery by the Insured although one that must have regard to the realities;
- Purpose and motive: the focus of the language "in taking action to avoid or reduce..." was the intended objective (or expected result) of the payment, and the court determined that the Insured made the cash injection with the intention of avoiding or reducing one or more third party claims. In the absence of express wording, that the insured was equally motivated by a desire to avoid brand damage did not effect its entitlement to cover;
- Apportionment: Insurers sought to imply a principle similar to marine "sue and labour" clauses such that, if there were two genuine and equally efficacious or dominant purposes, one insured and the other uninsured, then an apportionment of the relevant mitigating costs should be made. This argument was rejected at First Instance and by the Court of Appeal, with the Court of Appeal finding that it was not only contrary to the express terms of the policy but that there was no basis on which to imply the principle to liability insurance. As such, if apportionment between insured and uninsured perils is to apply, it must be expressly catered for in the wording;
- Windfall: It was acknowledged that the cash injection in effect provided a "windfall" to those investors who had received adequate marketing literature and, as a consequence, would never have had a valid claim against the Insured. However, the Judge concluded that it did not follow that the cash injection fell outside the definition of Mitigation Costs as the policy did not require the relevant payment to have been made to discharge a particular liability to a particular third party claimant. As the Assured showed, on a balance of probabilities, that the cash injection was reasonably and necessarily incurred in taking action with the stipulated intended objective, recovery could be made for the entirety of the cash injection. The Court of Appeal agreed, noting that the payment was indivisible and could not have been made in a reduced amount if it was to achieve its purpose. The fact that it produced a windfall to some investors was irrelevant to its recoverability.

The aspect of this case which generated the most debate was the conclusion that the policy responded to the windfall aspect of the cash injection. Some commentators have suggested that this case was so fact specific that the same situation is unlikely to arise again. However, the regulatory framework within which Standard Life operated formed part of the factual matrix and this is common to all financial services firms authorised to operate in the UK.

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9 Standard Life Assurance Ltd v ACE European Group & Others. [2012] EWHC 104 (Comm); [2012] Lloyd’s Rep. I.R. 655; [2012] EWCA Civ 1713. The High Court judgment was handed down on 1 February 2012 and the Court of Appeal Judgment was handed down on 16 December 2012.

10 Pabari v Sec of State for Work and Pensions [2005] 1 All ER 287 at 297-8. “necessarily… does not mean reasonably or sensibly or justifiably. It is higher on the spectrum than that. Nor does it mean reasonably necessary... it sets a high threshold”

11 A “sue and labour clause” is a standard clause in a marine insurance policy which allows the insured to recover from the insurer any reasonable expenses incurred by the insured in order to minimise or avert a loss to the insured property, for which loss the insurer would have been liable under the policy.
Contract Certainty & Clarity

In the context of mitigation costs cover there was, at least in the Standard Life claim, an observable mismatch in the understanding of insurers and the insured as to how the cover operated and what the requisite triggers were (or should have been). The findings of the High Court and Court of Appeal in that matter serve as a timely reminder of the importance of the choice of language and clarity in any form of cover but particularly with respect to mitigation costs. The benefits of clarity are broadly twofold: (i) better articulation of insurer's intent and (ii) realistic and reasonable expectations of the insured.

Discussion / Challenges

We have summarised the evolving regulatory environment in which Financial Institutions in the UK are operating. In general terms, regulators worldwide are becoming more active and are seeking to interact more closely with the organisations which they regulate.

As set out in this paper, regulators have increasingly taken steps to intervene where they perceive consumers may have been wronged and the regulator has even gone so far as to establish compensation schemes where they consider groups of potential litigants are owed redress. Organisations regularly advising and selling to retail customers are one segment of the industry facing ever increasing scrutiny as regulators seek to play their part in restoring consumer confidence following the global financial crisis.

Development of Mitigation Costs Cover

The mechanics of the typical “claims made” professional indemnity policy are generally consistent with the business operations of a Financial Institution. Experience tells us though that the requirement for a claim to be made before the policy can be triggered for defence costs and any civil compensation may not fit the business operations and regulations governing all Financial Institutions.

The potential disconnect between regulatory requirements and the function of the “claims made” policy for some Financial Institutions was first recognised in specific industry segments due to best execution regulations and the exposure of their operations to market volatility.

The insurance industry responded to this issue with costs of correction coverage. This cover was developed to address the situation where a stockbroker, for example, discovers an order was processed in error contrary to a client instruction and corrective action is required immediately in accordance with regulation and in order to negate the exposure to market forces. This is often before the affected party even becomes aware that an error has been made, and such action may need to be taken (due to regulatory requirements, for example) whether the affected party is eventually notified of the original error or not. As a recognition of the complexities of covering these types of errors, costs of correction cover may sometimes be sub-limited or subject to co-insurance (where insurers provide cover for a percentage of the costs incurred, leaving the balance for the insured to meet).

Over time, costs of correction expanded into mitigation costs cover. Mitigation costs cover recognises that Financial Institutions in industry sectors with operations outside execution only type transactions may, on occasion, need to access their professional indemnity policies before a claim is made. This is particularly relevant where the regulator may exercise its powers in such a way that the Financial Institution is required to seek out potential claimants in the form of affected customers.

Although mitigation costs cover developed from costs of correction, a clear distinction can be drawn between the two pre-claim extensions. Costs of correction is a very specific cover for certain types of errors requiring urgent correction whereas mitigation cover is for a broader scope of potential claims resolved with less urgency.
The Cover

We now discuss some of the issues which commonly arise in the context of mitigation costs cover. Each carrier may seek to approach these issues in different ways within their own risk appetite and in the context of their insureds’ needs. For illustrative purposes in this paper we identify below how AIG, as one carrier, has sought to address these issues when the cover is provided.

Claim or Pre-Claim

Mitigation costs cover enables the insured, in the preliminary stages of a dispute, to seek an indemnity under the policy for a payment and costs equivalent to a settlement and defence costs. Without mitigation costs cover the matter could be notified only as a circumstance. Any costs or payments flowing from a circumstance normally fall outside the scope of the policy with a potential indemnity only being triggered if a claim later eventuates. A mitigation scenario could therefore be described as treating a circumstance as a virtual claim for the purpose of coverage.

As mitigation costs is a pre-claim cover the insured should easily be able to distinguish how they access the policy in that pre-claim situation versus a claim situation. References to claim and claimant being prefixed with “potential” for mitigation costs may assist in making this distinction. AIG also seek to expressly state in a mitigation clause that it will be triggered only where no claim has been made by the potential claimant.

When distinguishing pre-claim situations from actual claims it is important not to lose sight of the fact that settlements of actual claims are commonly provided for within the scope of the primary insuring clause. Mitigation costs cover is therefore not required to resolve a matter once an actual claim has been made.

Windfall Payments

As mentioned above, one of the most debated aspects of the Standard Life judgment was the determination that the windfall aspect of the payment was covered. This was despite language in the insuring clause which stated “third party claim…of a type which would have been covered under this Policy”.

This reinforces the need to ensure the language of the clause is entirely clear as it is generally the intent that mitigation costs cover is available only for those payments and costs arising from a circumstance that would have resulted in a loss covered under the policy if the mitigation action had not been taken.

The primary insuring clause of a professional indemnity policy it is clearly reliant upon a legally enforceable obligation of the insured to a third party to be triggered. A clear indication of the intent of cover under a mitigation costs clause could therefore be made by expressly referencing this key element of cover. To ensure this aspect of the cover is captured in a mitigation costs clause AIG expressly state that if a claim had been made by the potential claimant the insured would have had a legal liability to that potential claimant.

The actual language used in any mitigation costs clause will of course depend upon the definitions that already exist in the policy and how these can be utilised. For example, a connection to a potential claim that would have given rise to a covered loss or claim under the policy may be effective. However, the relevant definitions of “loss” or “claim” may not always provide the clarity sought if they do not fully encompass the key triggers of the primary insuring clause.

Following on from this and as previously discussed in this paper, it is anticipated that the efforts of the insured to resolve a matter in the early stages may reduce the amount payable to the third party and the related costs. It follows then that insurers would anticipate a reduced overall indemnity under the policy in the event the mitigation costs clause is triggered in advance of the primary insuring clause. AIG have encompassed this concept expressly within the conditions of cover for mitigation costs by stating that the liability of insurers under the policy for mitigation costs and associated fees should be no more than it would have been for civil compensation and costs if the claim had been made. Such a condition also assists in conveying the general intent of the clause that cover extends only to such payments that would have been covered under the ordinary insuring clause of the policy if a claim was made.

AIG have sought to further clarify their underwriting intent by clearly describing the scope of the types of costs and payments they are covering. AIG therefore separate the payments to the potential claimant to resolve the matter from the professional costs incurred to effect the payment. Insureds and insurers are familiar with the distinction in the body of the professional indemnity policy between damages/settlement payments and defence costs, which makes the approach easy to understand.

AIG describes the types of payments as those made to a potential claimant for the purpose of avoiding a claim. Peripheral costs to other parties which may happen to avoid or reduce a potential claim would therefore be restricted, such as payments to “C” described by Eder J in Standard Life as follows: “In my view, as stipulated in the definition, the requirement is simply that the payment is reasonably and necessarily incurred in taking action to avoid or to reduce one or more third party claims of the relevant type.” By way of example the Judge stated “…if A has a legal liability to B, it is my view that a payment by A to C may well fall within the definition of “Mitigation Costs” even if (i) A has no liability to C and (ii) such payment does not in fact discharge the liability to B.”

By also defining professional fees a distinction can more easily be made between the insured’s business costs and those costs and fees which are akin to defence costs that would be covered in a claim scenario.
Co-operation

Co-operation between insureds and insurers is paramount in the handling of any matter notified under the policy. In a pre-claim situation this is amplified as the potential claimant has not yet made a written demand setting out their allegations, insurers are therefore reliant upon effective communication with the insured to assess the claim under the policy. Communication between the insured and the insurers and sharing of information also promotes an effective and efficient claims handling process.

Accordingly, one reason to make it a condition of mitigation costs cover that the insured seeks the consent of insurers before incurring mitigation costs and professional fees is to contractually encourage co-operation. To ensure that such co-operation and early communication with insurers takes place, consent can be written as a condition precedent to cover for mitigation costs.

When the insured communicates its actions in a timely manner, it can take comfort that the insurer will not be surprised by the payments made and a subsequent request for indemnification under the mitigation costs clause. This also provides the insured with the additional benefit of assistance from the insurer’s experienced claims team throughout the mitigation process.

Conclusion

Where the language of a mitigation costs clause clearly reflects the intent, disputes may be avoided. Disputes lead to unresolved claims which leave both insureds and insurers unsatisfied.

We have referred in this paper to the prevailing regulatory environment for Financial Institutions which may force insureds and insurers to act quickly and before a claim is made against the insured. In such situations clarity of cover is essential.

Insureds and insurers need to work together to ensure the mitigation costs clause in the policy clearly represents the intent of cover. The professional indemnity policy will thereby provide meaningful cover for the insured when they seek to access their policy in a pre-claim situation.
Mitigation costs cover

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