DEDUCTING BENEFITS FROM DEMUTUALISATION - THE HIGH COURT'S DECISION IN NEEDLER AND ALL THAT

by Adam Samuel

I: INTRODUCTION

The question of demutualisation benefits comes up in every context where a client has been advised in a non-compliant or negligent way, or led by a misrepresentation or non-disclosure, to take out a policy with a company that later demutualises. It comes up also where non-compliant advice has led a client to lapse, encash or transfer a with profits policy of a company that has gone through the same process. The judgement of the Vice-Chancellor Sir Andrew Morritt in the Needler v. Taber[1] and the regulatory work done afterwards has tried to answer some if not all of the questions that arise in these different areas. This, though, is really a story of the PI industry and their lawyers engaging in a gamble by going to court which has cost the former dearly, not for the first time.

II: THE ORIGINS OF THE PROBLEM

PIA first turned its attention to the effects of demutualisation in 1997 in the context of the pension review.

> ".. We regard the share value purely as the price paid by the demutualising entity for the exchange of membership rights in favour of shareholder rights. The actual value in the hands of the investor is entirely collateral to the value of whatever investment contract he or she may have. It follows, therefore, that the financial impact of demutualisation should be ignored in calculation of loss or redress."[2]

This was curious since the original pension review guidance concluded that policies taken out to replace occupational pension scheme benefits were not collateral and the benefits paid out under them could be deducted from compensation.[3] So, we were expected to believe that replacement contracts are not collateral but shares and cash paid out under the policy in question are.

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[1][2002] 3 All ER 501.

[2]PIA RU33 at p. 6

[3] The PIA's view was effectively rejected by the judge in the Needler case in his analysis of the House of Lords's decision of Parry v. Cleaver.

The PIA's solution was not that difficult to justify on policy grounds regardless of the legal merits of the case. Firms were struggling to finish the review punctually. The Guidance gave them a serious of short-cuts and concessions on replacement policies, under- and over-contribution, replacement policies and change of employment. In the interests of completing the review promptly, firms could be asked to pay this bill, even assuming that the regulator thought that legally this was not sound. Otherwise, companies were going to be faced with the horrors of another Bowden exercise[4] in opt-out and non-joiner cases. That would allow deduction only of demutualisation benefits to the extent that they could be traced to assets of the policyholder. Even then, only the re-sale value of that asset could be deducted.

In December 1999[5], the then PIA Ombudsman decided to part company with PIA's view at least as regards endowments. He said that the value of any shares if not yet sold should be deducted at the date of the Provisional Assessment or Decision of the Ombudsman Bureau. If already sold, the sale price could be deducted with interest. He said that otherwise the customer would clearly be over-compensated.

The weakness in the Ombudsman's argument was that he treated the claim as being purely one for rescission or avoidance of the endowment contract. In that situation, the client has to return all property or benefits passed to him under the contract. He missed the point that the client also has a claim for damages under the ordinary law of negligence and section 62 of the Financial Services Act. There, the argument about deductions is not as straightforward. In a claim for damages, the client has to be put in the position in which he would have been had the adviser acted in a compliant, careful way and honoured any contract he had with the client. There is then some difficult law on how one handles gains which would not have been received but for the defective advice.

There are two connected arguments here. First, the victim of negligence may subsequently benefit from it in ways which could not be foreseen at the time of the relevant incident. This may involve some enterprise on the part of the complainant or just luck. Secondly, there is the argument based on the Court of Appeal's decision in the Bowden case. There, income received under an investment bond was dissipated on day-to-day living expenses. The Court in that case decided that the income could not be deducted since the client no longer had it. This second argument was going to be particularly relevant with respect to small demutualisations and opt-outs and non-joiner cases. Perhaps, intentionally, the case chosen by the PI industry to fight on involved a transfer and a fairly large amount of money. This by-passed the Bowden argument.

The Needler case reached the High Court by a strange route. It involved a pension transfer and so was covered by Regulatory Update's treatment of the Norwich Union shares allocated to the client. Any firm affected by Regulatory Update 33's treatment of demutualisation could have applied to the High Court at the time it was issued (May 1997) for judicial review of the PIA's actions on the basis that they were unlawful or

[4] R v ICS ex p Bowden [1995] 1 WLR 157

[5] 3 News from the Ombudsman Bureau 4, 2 (1999)

wholly unreasonable and so exceeded the regulator's powers. No such action was brought within the strict time-limits for such applications.

Anyway, Mr Taber brought a complaint against Needler to the PIA Ombudsman about advice he had received to transfer his preserved occupational pension benefits to a with profits personal pension with Norwich Union. There was a curious provision in the paragraph 7 of the PIAOB's Terms of Reference that allows a firm complained against to give notice to the Ombudsman that the complaint may involve an issue with important consequences for the business of firms generally or an important or novel point of law. The notice invites the Ombudsman to stop dealing with the case. The PIA member had to agree that if either it or the client starts a court action within six months, it will pay the costs of the complainant. The Ombudsman then has a discretion as to whether to stop looking at the complaint. There have only been two cases brought to court under this procedure, the Needler case and Equitable Life v. Hyman.[6]

Needler assisted by its PI insurers, gave the relevant notice with respect to the question of whether the Norwich Union demutualisation benefits could be deducted from the compensation.

What is curious about this whole process is that the Ombudsman could never have found in favour of the IFA on the demutualisation point assuming that she applied her own Terms of Reference properly. Paragraph 5.2 of that document required the Ombudsman to apply the PIA's Standards of Redress if they favoured the customer over the law. Regulatory Update 33 must, therefore, be applied in preference to the legal position if it is more favourable to the complainant. Needler was bound to lose on the demutualisation issue; the Guidance was very clear on this. In effect, the complaint did not raise a point of law at all. This became a point of discussion in the case even though eventually the judge did not express an opinion on it.

III: THE HIGH COURT'S DECISION IN THE NEEDLER CASE

When the case went to the High Court, Needler's PI insurers had one simple argument. The IFA's advice may have resulted in a loss to Mr Taber but it had also caused him to benefit from the shares that he received from the demutualisation. They saw no reason why the client should come away better off through the bad advice he had received at their expense.

The policyholder, Mr Taber, had three arguments. First, he said that the windfall gain was unconnected to the non-compliant advice. Secondly, he argued that windfalls should be treated like the proceeds of insurance. Finally, he argued that under the pension review process, the client was entitled to redress calculated in a way prescribed by the relevant regulator and not the law.

Mr Taber won on his first point and the judge declined to express an opinion on the

[6] [2000] 3 All ER 961. The procedure has now been abolished except that FOS can conclude that a case should be resolved in another forum which it presumably would only do if the complainant had a reasonable case on similar terms: DISP 3.3.1(10).

other two. He made it clear that it made no difference as to the form any demutualisation benefit took.[7] The key part of the judgement begins:

> "24. The relevant question is whether the negligence which caused the loss also caused the profit in the sense that the latter was part of a continuous transaction of which the former was the inception..."

This, though, rather begs the question: what is part of a continuous transaction that occurs after the original transaction is completed?

What is really going on here is that the judge is making a value or policy judgement as to what events are sufficiently closely connected to the negligence that he will take them into account. The judge goes on.

> "26. It is true that but for the negligence of Needler Mr Taber would not have taken out the PPP. It is also true that but for the PPP Mr Taber would not have received any demutualisation benefit. Even allowing for these factors the demutualisation benefit was not caused by and did not flow, as part of a continuous transaction, from the negligence. In causation terms, the breach of duty gave rise to the opportunity to receive the benefit but did not cause it...The link between the negligence and the benefit was broken by all those events in the mid 1990s and later which led to the directors of the Society formulating and the court approving... the transfer of the long term insurance business of the Society to LP."

Curiously, the first sentence of this paragraph re-states the standard redress position under the Guidance. The judge then seeks to put a limit on it by restricting recovery as a matter of law to those losses caused by and flowing as part of a continuous transaction from the bad advice to transfer. In other words, firms should not use this judgement as an excuse for not offering compensation. It seeks to restrict redress in a way that the PIA Redress Guidance does not. Insurers and IFAs are regulated by regulators, not the courts.

To return to the strict facts of the case, the court does not explain coherently why the payment of benefits arising from the demutualisation did not flow from the advice to take out a policy with a mutual assurer. Maybe, the case hinges on a factually debatable proposition in the next paragraph:

> 27. The matter may be tested in this way. Would Mr Taber have received comparable benefits from his PPP if there had been no demutualisation? The answer is plainly in the negative. Mr Taber was contractually entitled to share in the profits of the society by way of bonus. Such bonus was likely to provide him with a reasonable return on his asset share in accordance with the PRE. But in the absence of the transfer of the long term business.. or the winding up or closure of the Society to new business it was most unlikely that he would ever share in a distribution of the inherited estate. But by virtue of the demutualisation

[7] Paragraph 25.

he did...”

This presupposes that de-mutualisation was not considered likely when the pension sale took place. It was clearly an option then. Was it most unlikely? I do not know. Perhaps, more significantly, it is not clear what evidence was presented on this fairly debatable point.

Perhaps a better way of looking at this is that the law puts a cut-off point on the benefits received by a claimant from the defendant’s negligence. However, it usually cuts out only events that were unforeseeable when the wrong occurred.

For example, in one case, cited by the High Court, Hussey v. Eels[8], the clients were misled into buying a house which suffered from subsidence. Later, they demolished the house and obtained planning permission to build two new homes on the site. They then sold the property at a considerable profit. The Court of Appeal declined to permit the defendant to take reduce his damages by the profit. It felt that the decision to sell the land for development when they had originally bought it to live on was nothing to do with the original transaction. The idea is that people who give bad advice should not benefit from events which were not foreseeable at the time of the advice. This is particularly the case where the claimant or a third party did something that it could easily not have done.

It all comes down to judicial feel. Strictly speaking, one could run an argument in a case where demutualisation was more likely that a deduction was required. However, the PIA/FSA has indicated that it will not create a string of exceptions in this area for different fact situations. Reasonably, it takes the view that if the court approves of RU33's analysis, that will be enough. In regulation, one can create too many exceptions to make things work.

Anyway, the judge concluded:

> “28. For these reasons I conclude that the demutualisation benefit received by Mr Taber was not caused by the mis-selling by Needler of which he complained. Thus, the common law principles for the assessment of damages do not require the value of the benefit of the demutualisation shares issued to Mr Taber to be brought into account in diminution of the compensation to be awarded to him for Needler’s breach of duty. It follows that the questions whether if the general rule had applied the demutualisation benefits should be excepted by analogy with the exceptions.. in Parry v. Cleaver.. and whether the Pension Review procedure conferred on Mr Taber an entitlement to compensation in excess of what would have been recoverable at law do not arise.”

It is a shame that the judge failed to deal with the other two arguments. Since an appeal is not being pursued, we will never know how meritorious they were.

The final argument is particularly interesting and important. Regulators in designing reviews cannot allow each case to be treated like a High Court trial. The job would never

[8] [1990] 2 QB 227.

be finished if they did. So, they build short-cuts into the process. In doing so, sometimes they appear to favour the industry (under- and over-contribution, replacement policies, change of employment and previously closed no loss cases) as compared with the legal position and sometimes it may be the other way around (reinstatement is not required in a court of law). There is a balance involved.

What the test case sought to do was to disturb this equilibrium. The PI insurers wanted to force the regulators to apply the law when it favoured them without being prepared to accept the application of legal principles when it did not assist their cause. The point that the judge did not reach is whether the court should be prepared to decide a case in a way which contradicts the Ombudsman's Terms of Reference and reasonably drafted guidance. The last thing that PI insurers really want is a pension review based purely on legal principles. That would be seriously expensive. Against that background, the regulator has to be allowed to regulate without interference from the courts unless its conclusions are wholly unreasonable. Where this is the case, an application for judicial review brought promptly is the correct remedy.

The judgement of the High Court is not particularly well argued. It seems to be based on a policy decision that financial advisers who acted in a non-compliant way should not benefit from fortuitous gains received by customers subsequently as a result of their recommendations. It may be based on an unassailable finding of fact that demutualisation was not foreseeable at the point of sale.

Now that the High Court's decision is not going to be appealed, the regulators and the Financial Ombudsman Service seem set to ignore all demutualisation benefits received by policyholders. There is no reason not to apply this to bonuses added to the value of policies. These will have to be deducted for the purposes of loss assessment. As the judge says at paragraph 25:

> "The profit in this case is the holding of demutualisation shares issued to Mr Taber, but it might just as easily have taken the form of a cash payment or an additional bonus. I can see no reason for drawing any distinction based on the form in which the benefit was received."

It is less clear whether the regulators will take the same attitude to cases where a client has given up a policy that would otherwise have generated similar benefits as a result of non-compliance. There, the legal and policy considerations are very different. In such a case, the non-compliant party would be seeking to rely on the Needler case to reduce its liability. Somehow, I doubt that the Vice-Chancellor would agree with that.

IV: AFTER THE JUDICIAL BALL

(i) The Suspension of Cases

Following the abandonment of any possible appeal, the PIA issued Regulatory Update 94 in October 2001. On the pension review, clearly any windfall benefits in the form of cash and shares would not be deductible from any future compensation. It announced that the Financial Services Authority would conduct a consultation exercise as to

whether windfall policy augmentations on demutualisation or similar events should be taken into account. It refers to "technical and practical issues". It continues:

> "In the meantime, where an investor has received a windfall benefit in the form of a policy augmentation, firms should continue to progress the case up to the point where the windfall benefit becomes a relevant consideration (i.e. in the calculation of loss). **Beyond this stage firms should suspend progress pending the issue of guidance and keep the investor informed as to the reason for the delay.** Where an offer has been made for an affected case which has not been accepted firms should withdraw the offer, explaining to the investor that this has been done pending further guidance from the regulator about the treatment of windfall benefits.
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> .. The Regulatory Update does not require firms to reopen cases where an offer of redress has already been accepted by the investor or no redress is due in accordance with pre-existing guidance."

This last point contained a small potential trap. No offer including a deduction for demutualisation was permitted under Regulatory Update 33 anyway. All that happened was that the regulator failed to mention explicitly benefits other than cash and shares. In its subsequent guidance, the FSA has assumed that the silence in RU33 meant that firms did not have to take out of account bonuses added to policies.

RU94 also indicated that the FSA was about to publish a consultation paper on mortgage endowment cases, suggesting that firms be prevented from making any deductions from compensation to take into account demutualisation benefits or windfalls from "other corporate events" in whatever form they take. Any resulting guidance would not, though, come into force until May 2002. It goes on:

> "In the meantime firms should not make offers that take into account the value of any windfall benefits (whether shares, cash, additional bonuses or other policy augmentations). Where an offer which takes windfall benefits into account has been made but has not been accepted, firms should withdraw the offer explaining to the investor that this has been done pending further guidance from the regulator about the treatment of windfall benefits.
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> All cases should be progressed as far as possible. For cases where the windfall benefit took the form only of shares or cash firms can make offers on the basis that their value is not taken into account. Where cases are delayed pending the issue of formal guidance firms should take pains to ensure that complainants are kept informed as to the status of their case and the reasons for delay."[9]

The scope, though, of the problem generated by all this should not be exaggerated. The Financial Services Authority's FSAVC Bulletin 5 points out that in that review, the problem only arises in a limited number of cases. That review only requires firms in the main to compensate clients for greater charges and lost employer matched

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[9] At p. 3.

contributions as enhanced by the relevant CAPS index of fund growth. It follows that in those cases, bonuses added to policies on demutualisation are only relevant in the way in which they may push a policy into the next tier of charges for those policies which have such arrangements. The FSA allows firms in such cases to use the tier below for the charges comparison as a rough and ready way of avoiding reducing compensation by reference to the demutualisation benefits.
Firms, though, have had to wait until the end of the consultation period to cope with cases where clients would have opted for defined or received subsidised benefits. There, a policy augmentation on demutualisation will impact on the compensation payable. A further effect of all this is to render pure loss calculations where augmentation to the fund was offered on demutualisation very unattractive. These cases could not be closed off until August 2002 at the earliest. Any offers made on the pension and FSAVC reviews which are affected by demutualisation must not only be withdrawn if already made but must be pulled from the list of offers issued on the return (FSA Bulletin 17).

Where a firm can identify a windfall added to a policy that is relevant, it had to (according to FSA Pension Review Bulletin 17) apply for a rules waiver if it wished to complete the case. This created an intriguing problem. In some cases, firms failed to withdraw offers when RU94 was issued but which were then subsequently accepted. So long as the firm did not count the case as closed, there seems to be no reason why these offers could not be implemented with the caveat that further compensation might have to be paid. In reinstatement cases, any other approach would put the member in breach of contract with the client. The one pro-industry feature of the original challenge to the SIB Pension Review Guidance was the court's ruling that a regulator was not entitled to put a firm in breach of a contract with a third party. In the one case I know about, the FSA required the firm to apply for a waiver, rejected the application and then granted it after seeing an opinion from me that said that the company did not need the waiver in the first place!

(ii) The Consultation Itself

Consultation Paper 126 was not particularly remarkable. It was the response of the ABI which caught the eye. The Association of British Insurers argued that Needler should not be extended beyond the pensions review. It sought a restricted interpretation of windfalls to limit it to demutualisation benefits. It attacked the restrictive approach in the Consultation Paper which tried to reduce the chances of firms arguing that a demutualisation event was so foreseeable that resulting benefits could be deducted. It went further and attacked the FSA for using the concept of foreseeability for this purpose. Finally, it criticised the regulator's view that re-work should take into account the need to ignore demutualisation bonuses. The regulator resisted all but the last suggestion.

The Association of Independent Financial Advisers wanted one thing for their members. They wanted them to be able to rely on the firm's actuary in calculating the size of the windfall benefit. Essentially, they received what they wanted here with a slight reservation.

(iii) The new rules

(a) Defining a windfall

"Where there has been a demutualisation, distribution or reattribution of the inherited estate, or other extraordinary corporate event in a life office; and the event gave rise to .. benefits that fall outside what is required in order that policyholders' reasonable expectations at the point of sale can be fulfilled...
The issue of free shares or cash on a demutualisation, and additional bonuses and policy enhancements given by way of incentive to approve a reattribution or distribution of an inherited estate, should be treated as relevant benefits for the purposes of paragraph 4 above, unless there is evidence to the contrary."[10]

(b) Taking windfall's into account to reduce compensation

"A 'relevant benefit' derived from a corporate event may only be brought to account if the firm is able to demonstrate, with written records created at the time of the advice, that:
· the firm foresaw the prospect of the event and the benefit;
· the firm's advice included a statement recommending the particular policy
because of the possibility of the benefit in question; and
· the statement was a material factor in the context of the advice and the decision to invest."

I have never seen a file that complied with this test and I do not expect anyone to in the future. It is far stricter than any court would apply. This, though, reflects historical concerns about firms' ability to apply causation tests in the pension review generally (as seen in PIA RU33).

(c) Remedial work

FSA Pension Review Bulletin 5 contains an outrageous rule. It permits firms whose calculations have been found to be wrong to re-do them using the figures applicable at the date of calculation even if a current review would produce a result more favourable to the investor. The idea that a defective calculation can be used to protect a firm financially would be regarded as laughable in a court.

The original consultation paper described it as disingenuous (para C20) to ignore the Needler case when doing remedial calculations. This, though, is exactly what the regulator has come up with. It does not seem to understand that there is no element of retrospection about treating a non-compliant calculation as invalid. Nevertheless, the moment that one accepts the logic of FSA Bulletin 5, the solution now adopted becomes inevitable. It does, though, smack of two wrongs making a right.

(d) Valuation of the benefit

Cash payments can be deducted from policy values without interest. Share values are

[10] Annex C3-5.

calculated at the issue price. Most of the time, these valuations are irrelevant. The customer has the money or shares and the policy value is unaffected. The produce provider's appointed actuary has to certify the value of any bonuses paind into policies.

In actual loss Pensions and FSAVC defined benefits review cases, the firm must calculate the proportion of the fund attributed to the windfall. You then deduct that proportion from the benefits actually paid to the investor. This will give you the amount to be deducted from what the investor would have received had compliant advice been given. Once that deduction has been made, you have the essentials of the loss for redress calculation purposes.

In other Pensions and FSAVC cases affected, you treat the bonuses added as if they were extra contributions made by the investor. These may create or increase an over-contribution or reduce or eliminate an under-contribution.

V: A JUDICIAL POST-SCRIPT

In the aftermath of the Needler case, there was no shortage of lawyers queuing up to condemn it as wrongly decided. I did not think that. The court's view was that demutualisation was not foreseeable when the policy was sold six years before the event. It should not, therefore, be regarded as part of the transaction. That seemed fairly reasonable and in line with existing cases.

Now, the Court of Appeal has applied the Needler decision with apparent approval in Primavera v. Allied Dunbar.[11] This involved a fairly horrific pre-A day missale. In essence, in 1995, the client should have received a large tax free cash amount from his pension to pay off a loan. This, though, would only have happened if Allied Dunbar had advised him to take his profits as earned income from the business. His fund would have been worth £101,000 had he received that advice. The client left the pension in place repaying the loan from other sources. The Court of Appeal decided that he was entitled to £101,000 plus interest from 1995 and lawyer's fees incurred in unscrambling Allied Dunbar's misinformation while disregarding the subsequent growth on his fund. Needler is alive and well and will probably need an appeal to the House of Lords to undo.

VI: CONCLUSION

The Equitable Life and Needler cases send two unpleasant messages to the financial services industry. It is often assumed by it that the courts would be more favourable to the industry than the regulators and the Ombudsman. This assumption has suffered yet another blow.

The demutualisation test case has increased the amount of compensation that will be required of the industry. Before it, the Ombudsman Bureau was minded to deduct such benefits from compensation. That will not happen. No thought seemed to have been given to policy augmentations on demutualisation. The Vice-Chancellor was clearly of

[11] [2002] EWCA Civ 1327

the opinion that they must be treated like cash and shares. The FSA has taken the same view.

The financial services industry must be tempted to repeat, in the direction of the PI insurers who brought the case, Collegiate, and its lawyers, Reynold Porter Chamberlain, the words of the great Oliver Hardy: “that’s another fine mess you’ve gotten me into”.