

News flash

Above the Law?

The FOS and IFG Financial Advisors

A recent decision by the High Court¹ has made a system that was already arguably tilted against IFAs, even more unfair and unpredictable. John Wasty and Faye Hankin discuss the decision and analyse the impact on Insurers and Professional Indemnity policies.

The compensatory framework

The Financial Ombudsman Service (“FOS”) is governed by the Financial Services and Markets Act 2000. The purpose of the FOS is to help resolve individual disputes between consumers and financial firms, but not to discipline/punish those firms (which is the remit of the FSA).

The Ombudsman is supposed to consider each complaint that it receives on its own merits and base any decision on the individual facts and circumstances of each case. An adjudicator will initially deal with a complaint, but if either the firm or the complainant disagrees with the adjudicator’s decision it will be passed on to the Ombudsman for review. Once the Ombudsman has reviewed the complaint he will issue a Final Decision. If the complainant decides to accept the Final Decision then it binds both the complainant and the firm.

If a complaint is determined in favour of the complainant, the determination can include either:

- a monetary award against the firm of such amount as the Ombudsman considers fair compensation for financial loss, or
- a direction that the firm take such steps in relation to the complainant as the Ombudsman considers just and appropriate, or
- both of these.

The aim of a monetary award is to return the complainant to the position he or she would have been in if the firm had dealt with

the matter properly. The maximum monetary award that the Ombudsman may make is £100,000.

Challenging the FOS – the IFG Financial Advisors case

In this case, a firm of Independent Financial Advisors sought a Judicial Review in respect of a decision made against them by the FOS. Two clients of IFG Financial Services (“IFG”) reported IFG to the FOS, arguing that IFG had wrongly invested their money in a high-risk investment fund despite the fact that the clients had advised IFG that they had a medium risk profile. The clients subsequently suffered large losses. These losses did **not** result from the investment but rather from a fraud perpetrated by one of the fund managers in a fund recommended by IFG.

IFG argued that its clients were not entitled to damages because English law did not allow recovery of losses for unforeseen consequences of fraud. The FOS accepted that IFG’s position was correct in law, but nevertheless ruled that IFG should pay compensation to its clients because the result was not fair and reasonable.

There is, under the legislation, no intrinsic appeals procedure. Accordingly, the cumbersome process of seeking a Judicial Review is the only way to challenge such a decision. In practice, this means that very few IFAs actually challenge the Ombudsman’s final decision, as Judicial Review is an expensive and time consuming process with uncertain prospects of success. Moreover, if unsuccessful the IFA may have to cover the FOS’ legal costs, as well as its own. Indeed, even if an IFA’s application for Judicial Review is granted, the Courts will not actually interfere with the decision of the FOS itself, but rather the process by which it was made. A challenge



will only be successful:

- if the Ombudsman did not comply with the rules, or
- if the final decision was so unreasonable as to be perverse, or
- if the Ombudsman did not give the parties a fair hearing.

Even if a challenge is successful, the Court will not substitute its own decision but will refer the matter back to the Ombudsman to consider the matter again. The Ombudsman may reach the same conclusion, or reach a different conclusion - perhaps worse, as far as the IFA is concerned.

IFG sought a Judicial Review, arguing that the FOS had failed to take account of the relevant law, and in particular the principle that one can only be liable for those losses arising out of negligence that are foreseeable. IFG argued that had English law been applied, the losses resulting from this (unrelated) fraud were irrecoverable. The Court, however, upheld the Ombudsman's decision, "...if the Ombudsman considers that what is fair and reasonable differs from English law, he is free to make an award in accordance with that view assuming it to be fair and reasonable in all the circumstances of the case and provided he has taken into account the matters identified in Rule 3.8.1 paragraph 2 [of the FOS compensation scheme]". Rule 3.8.1(2) states that in considering what is fair and reasonable, the Ombudsman should take into account the relevant law, regulations, regulators' rules, relevant codes of practice, and, if appropriate, good industry practice at the relevant time. Consequently, the Ombudsman is entitled to make an award which does not strictly follow English law, as long as he has:

- taken the relevant law into account; and
- determined that, in his view, his award provides a fairer and more reasonable outcome than would be reached by a strict application of the relevant law.

Implications for IFAs and their Insurers

The Court's ruling that the Ombudsman does not have to follow the law, coupled with the fact that the costly process of Judicial Review is the only way to challenge an Ombudsman's decision, means that IFAs could be forgiven for thinking that they are at the mercy of the Ombudsman. There is some fear that the ruling has set a precedent, which may cost IFAs and their insurers millions of pounds in compensation payments. This is because rather than considering cases on an individual basis as originally envisaged, the Ombudsman tends to make the same award when considering identical complaints against an IFA. Where, therefore, multiple and identical complaints are brought against an IFA, there is a real danger that if the Ombudsman decides that one complainant should be awarded in excess of the £100,000 maximum amount, that award will simply be applied to all other similarly situated complainants.

Even in smaller cases IFAs and their insurers may end up paying more than £100,000 as a result of the Ombudsman's decision. The Ombudsman is only entitled to award a sum up to a

maximum of £100,000. Should the client's loss exceed £100,000, the Ombudsman can *recommend* to both the client and the IFA that the IFA pay the difference. It is also open to the Ombudsman to advise the client that should they wish to pursue the IFA for the balance they can do so through the Courts. Although the Ombudsman cannot give the client any advice as to the merits of his or her possible claim, the suggestion that he may be entitled to more money is often all the encouragement a client needs to pursue the matter further.

It follows that even if a client makes a complaint to the FOS and is awarded the maximum amount of £100,000, the IFA and its Insurers should be aware that this might not be the end of the matter. The IFA could find itself open to a further claim via the Courts, with Insurers having to fund the additional legal costs in defending the claim.

This raises the question of how the IFA's professional indemnity policy is likely to respond. The discussion above raises two separate scenarios:

- 1 An award which (as here) flies in the face of established legal precedent for damages for breach of duty; and
- 2 An award as in 1. above, followed by a civil claim (following a recommendation by the Ombudsman) over and above the £100,000 limit.

A full civil liability wording is likely to catch scenario 1 because an award constitutes an obligation to pay a financial sum arising out of the conduct of the insured professional activity. If the indemnity was limited to the consequences of negligence, the matter might be more difficult. In respect of scenario 2 the result is more clear cut, because the civil claim will have been decided by a court of law (irrespective of whether there had been a recommendation by the Ombudsman).

In a number of cases in which we have been involved, IFAs have been ordered to pay £100,000 on the Claimant accepting the Ombudsman's award, only to be then faced with a further claim on the basis that the Ombudsman had suggested that redress in excess of the £100,000 limit was justified. It is important in these cases to make it clear to the Claimant at a very early stage that although the Ombudsman may have recommended that they receive a higher level of compensation, an analysis of the legal principles (which the Ombudsman may have felt entitled to ignore) makes it highly unlikely that a Court would go down the same route and award additional damages simply because it was "fair and reasonable" to do so.

1. R (on the application of IFG Financial Services Ltd) (Claimant) v Financial Ombudsman Service Ltd (Defendant) & (1) Mr Jenkins (2) Mrs Jenkins (Interested Parties) [2005] EWHC 1153 (Admin)

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