NAVIGATING THE LITIGATION MINEFIELD: A GUIDE TO ACTUARIAL MALPRACTICE CLAIMS

By

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By

Joseph P. Dailey and Loren F. Selznick[1]

Beginning with the infamous *Equity Funding* cases of the 1970s,[2] actuaries have been the target of professional malpractice claims by disaffected clients and third parties, including shareholders, buyers, trustees, beneficiaries, guaranty funds, and regulators. While actuarial malpractice claims were relatively rare until recently, they proliferated in the 1990s, exposing actuaries to the same litigation risk as accountants, who had been fending off suits for years. For accountants, economic downturns and collapsing stock prices were responsible for the claims; for actuaries, it was insurance insolvencies, reserve deficiencies, and underfunded pension plans that spawned the suits. Consulting actuaries, like their counterparts in accounting firms, bore the brunt of the claims, but they were not alone--actuaries at insurance companies and corporations have also been subject to suit.

This article will review the scope of liability for actuarial malpractice and the history of claims against the profession. Focusing on one major segment of the profession, casualty actuaries, and one of their most difficult tasks, estimating highly variable casualty risks, the article will review the genesis of most malpractice suits--faulty data, unreasonable assumptions, improper methodologies, careless calculations, and professional ignorance. The article will conclude by recommending steps to avoid or limit liabilities.

I

SCOPE OF LIABILITY

A relatively new tort, actuarial malpractice is based on standards developed for other professionals, particularly accountants.[3] The scope of liability for actuarial malpractice, as with other forms of culpability, involves two distinct but interrelated elements--the class of persons who can sue and the degree of fault they must prove. Potential claimants include clients, persons an actuary knows *will* rely on his work, persons an actuary knows *may* rely on his work, and unknown parties who an actuary should reasonably *foresee* will rely on his work. The degree of fault ranges from ordinary negligence to recklessness and fraud. In general, claimants with the closest relationship to an actuary are entitled to the highest standard of care, while those with an indirect or tenuous relationship are entitled to little, except an honest effort. Since malpractice liability arises under the common law, the scope of liability for actuarial malpractice varies widely from state to state, except for ERISA claims, which are based on federal law and have uniform standards.

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[2] *In re Equity Funding Corp. Of America Securities Litigation*, 416 F.Supp. 161 (C.D.Cal. 1976). See Note 25, *infra* at 7.

[3] *Dill v. Wood Shovel & Tool Co.*, 1972 U.S.Dist. Lexis 14098 at 16 (S.D.Ohio 1972). *See* Section 1(C), *infra* at 9.

A. CLIENTS.

The clearest rules apply when an actuary has agreed to provide advice or services to a client for a fee, where there is what the law calls *privity of contract*. Where privity exists, actuaries owe a duty of care to their clients. There are different formulations of the duty, but each is based on a promise, express or implied, to perform services with the degree of skill and competence reasonably expected of persons in the actuarial community, as delineated by generally accepted actuarial principles.[4] In addition to obligations under the contract, there is an independent duty imposed by law on professionals to exercise reasonable care in performing their specialized skills and services.[5] Depending on the nature of the relationship, actuaries may also owe a fiduciary duty to clients,[6] and, in virtually all relationships, are barred from misusing confidential information for their own profit or gain.

Like other professionals, actuaries who breach their duty of care to clients can be sued in contract or tort.[7] Damages are generally greater in tort, where actuaries are liable for all economic losses proximately caused by their actions, subject to a right of contribution from other culpable parties. In contract actions, damages are limited to what the parties reasonably contemplated at the time of the agreement, without contribution, but with a longer statute of limitations.[8]

Unlike third parties, whose rights are established by law, clients can agree to limit the liability of actuaries for damages, in both contract and tort.[9] By allocating the cost of insurance to clients, who are in the best position to measure the magnitude of loss, limitation of liability provisions result in lower prices and more affordable services. Limitation of liability provisions, however, only insulate professionals from damages for ordinary negligence, not gross negligence or fraud.[10]

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4 *See* Section III, *infra* at 13.

5 Prosser & Keeton, *The Law Of Torts, §* 92 at 655 (5th ed. 1984).

6 In *United Teacher Associate Insurance Co. v. MacKeen & Bailey, Inc.*, 847 F.Supp. 521 (W.D.Tex. 1994), *aff'd in part, rev'd in part*, 99 F.3d 645 (5th Cir. 1996), an actuary who prepared a reserve study for a client breached his fiduciary duty when he disclosed the study to an adverse party, who then withdrew from a potentially profitable transaction with his client.

7 *See Airparts Co. v. Custom Benefit Services Of Austin, Inc.*, 28 F.3d 1062 (10th Cir. 1994); *Steiner Corp. Retirement Plan v. Johnson & Higgins*, 31 F.3d 935 (10th Cir. 1994); Carl *Colteryahn Dairy, Inc. v. Western Pennsylvania Teamsters & Employers Pension Fund*, 847 F.2d 113 (3d Cir. 1988); *Alton Memorial Hospital v. Metropolitan Life Insurance Co.*, 656 F.2d 245 (7th Cir. 1981); *Saffo v. Occidental Life Insurance Co.,* 602 F.2d 1265 (8th Cir. 1979); *Scardelletti v. Bobo*, 1997 U.S.Dist. Lexis 14498 (D.Md. Sep. 8, 1997); *In re Equity Funding Corp. Of America Securities Litigation*, 416 F.Supp. 161 (C.D.Cal. 1976).

8 Prosser & Keeton, *The Law Of Torts, §* 92 at 655 (5th ed. 1984).

9 *See, e.g., Eaves Brooks Costume Co. v. Y.B.H. Realty Co*., 76 N.Y.2d 220, 227, 557 N.Y.S.2d 286, 289 (1990); *Seigneur v. National Fitness Institute, Inc*., 132 Md.App. 271, 752 A.2d 631 (2000); *Rosenstein v. Standard & Poor's Corp*., 636 N.E.2d 665 (Ill.App.Ct. 1993).

10 *Sommer v. Federal Signal Corp*., 79 N.Y.2d 540, 553, 583 N.Y.S.2d 957, 963 (1992).

B. THIRD PARTIES.

While there is a broad agreement on the obligations of professionals to clients, their duties to third parties vary significantly from state to state. There are three common law rules for holding actuaries and other professionals liable to third parties in negligence:

- A minority of states, including New York, strictly limit liability to cases where a professional, by words or deeds, consents to the use of his work by a specific party in a specific transaction.
- An even smaller minority of states follow the products liability rule which expands liability to all members of the general public who professionals should reasonably foresee will rely on their work.
- A growing majority of states follow § 552 of the Restatement of Torts, which limits liability to persons and *groups* for whose benefit and guidance information is supplied in specific *types* of transactions.

(1) New York Rule

The law on professional liability has its genesis in a pair of watershed decisions by Mr. Justice Cardozo when he was a member of the New York Court of Appeals.[11] The first case, *Glanzer v. Shepard,* 233 N.Y. 236, 238-39 (1922), established that persons who hold themselves out to the public as experts owe a duty of care when they know their work will be used for a particular purpose by a specific party.[12] The second case, *Ultramares Corp. v. Touche,* 255 N.Y. 170 (1931), explained the limitations of *Glanzer,* holding that professionals are not liable in negligence to members of the general business community who use their work, without pay, "according to the needs of the occasion...."[13] Concerned that liability for honest blunders would cripple professionals, the court set aside a negligence verdict against an accounting firm, but reinstated a fraud claim. Professionals are only liable to third parties in negligence, Cardozo wrote, if there is a "bond...so close as to approach that of privity, if not completely one with it." *Id.* at 182-83.

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11 A year after *Ultramares,* Cardozo was appointed to the Supreme Court by President Hoover, where he served for six years. In contrast to his service on the New York Court of Appeals, where he authored a series of landmark opinions, his tenure on the Supreme Court is generally dismissed as the relatively unimportant part of his career.

12 In *Glanzer*, a seller of beans engaged a public weigher to certify the weight of 905 bags of beans being sold to plaintiff. The weigher, knowing his services would be used to determine the price of the beans, provided two certificates, one to his client, the seller, the other to the buyer. Though privity was lacking, the court held the weigher liable to the buyer for a defective certificate because its preparation "was...the end and aim of the transaction." *Id.*

13 *Id*. at 174. The accountants in *Ultramares* negligently certified a balance sheet, knowing their client was in need of credit and their certification would be displayed to many interested but unknown parties, including potential lenders. Plaintiff made a series of loans in reliance on the certified balance sheet, which were uncollectible because the company was insolvent.

The ambit of potential claimants was further refined in *Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 551 (1985). Reaffirming the limitations of *Ultramares, Credit Alliance* added a new condition of its own--conduct by a professional that shows that he consented to use of his work by a particular party in a specific transaction. To demonstrate what *Credit Alliance* called "linking" conduct, a third party must generally must show some form of direct contact with the professional, such as face-to-face conversations, sharing of documents, or substantive communications relating to the engagement.[14]

Under *Credit Alliance*, a professional who is aware his work will be relied upon by a known party in a specific transaction, but does not have any "substantive communications" with the party, is not liable in negligence. In *Security Pacific Business Credit v. Peat Marwick Main & Co.*, 79 N.Y.2d 695, 704-08 (1992), for example, an accountant who learned in a phone call that a bank would be relying on its audit report in extending credit was absolved of liability in negligence. Noting that the bank was seeking to place the accountant "in the role of an insurer or guarantor of loans," the court held that "such an extraordinary obligation" could not be created for the price of a single telephone call.[15] Despite widespread criticism,[16] the "linking" requirement of *Credit Alliance* has been repeatedly invoked in New York to dismiss third party claims against a variety of professionals, including accountants, lawyers, engineers, and actuaries.[17] *Credit Alliance* has also been adopted in at least ten other states that adhere to the *Ultramares* rule.[18]

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14 *Securities Investor Protection Corp. v. BDO Seidman, LLP*, No. 99-7719 & 99-7720 (2d Cir. 2000).

15 In *CMNY Capital, L.P. v. Deloitte & Touche*, 821 F. Supp. 152, 161 (S.D.N.Y. 1993), an accountant who was told in a telephone call from his client that a lender would be relying on its audit report was relieved of liability for lack "linking" conduct.

16 California and other states have rejected *Credit Alliance* because "[t]he New York court offers no rationale for the distinct 'linking' element of the rule nor does it specify what conduct is required to satisfy this element...." *Bily v. Arthur Young & Co.*, 3 Cal.4th 370, 388 (1992).

17 A third party claim against an actuary was dismissed under *Credit Alliance* in *Employee Staffing Of America, Inc. v. William M. Mercer, Inc*., 1998 U.S.Dist. Lexis 3104 (S.D.N.Y. Mar. 12, 1998). See *State of California Public Employees' Retirement System v. Sherman & Sterling*, 95 N.Y.2d 427 (2000); *Parrott v. Coopers & Lybrand, L.L.P.*, 95 N.Y.2d 479, 483, 741 N.E.2d 506 (2000); *Westpac Banking Corp. v. Deschamps*, 66 N.Y.2d 16, 19 (1985).

18 Seven states have adopted a variation of the *Credit Alliance* rule by statute, but only for accounting firms. *See* Ill. Rev. Stat., Chap. 111, ¶ 5535.1; N.J. Stat. § 2A: 53A-25; Mich. Comp. Laws § 600.2962; Ark. Code Ann. § 16-114-302; Kan. Stat. Ann. § 1-402(b); Utah Code Ann. § 58-26-12; Wyo. Stat. Ann. § 33-3-201. Two states, Maryland and Idaho, have followed *Credit Alliance* in judicial opinions. *See Walpert, Smullian & Blumenthal, P.A. v. Katz*, 361 Md. 645, 762 A.2d 582 (2000); *Idaho Bank & Trust Co. v. First Bancorp Of Idaho*, 115 Idaho 1082, 772 P.2d 720 (1989). Montana adopted *Credit Alliance* without the "linking" requirement in *Thayer v. Hicks*, 243 Mont. 138, 146, 793 P.2d 784, 791 (1990); while Virginia requires actual privity of contract. *See Ward v. Ernst & Young*, 246 Va. 317, 435 S.E. 2d 628 (1993). Alabama embraced *Credit Alliance*, but found it too confusing and changed to the Restatement rule in *Boykin v. Arthur Andersen & Co*., 639 So.2d 504, 509-10 (Ala. 1994). The *Credit Alliance* rule was certified to the Connecticut Supreme Court in *Gerber Trade Finance, Inc. v. Davis, Sita & Co., P.A.*, 128 F.Supp.2d 86 (D.Conn. 2001).

(2) Foreseeability Rule

At the other end of the spectrum from *Ultramares* is the foreseeability rule, an expansive view of professional liability similar to that imposed on manufacturers of defective products.[19] Under the foreseeability rule, professionals are liable in negligence to investors, lenders, creditors, buyers, and other parties who it is reasonably foreseen will rely on their work. Creating the indeterminate liability that Cardozo feared in *Ultramares,* foreseeability has been rejected as a standard of professional liability in all but three states--Wisconsin, Mississippi, and New Jersey.[20]

(3) Restatement Rule

Dissatisfied with the restrictive approach of New York and the specter of unlimited liability raised by the foreseeability standard, a growing majority of states have adopted the rule of professional liability set forth in § 552 of the Restatement of Torts, entitled *Information Negligently Supplied for the Guidance of Others*. Section 552 establishes a duty of care in favor of persons for whose benefit and guidance information is supplied, as follows:

> "(1) One who in the course of his...profession...supplies false information for the guidance of others in their business transactions is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise care or competence in obtaining or communicating the information.
>
> "(2) [T]he liability stated in Subsection (1) is limited to loss suffered (a) by the person or one of a limited group of persons for whose guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction."

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19 *See* H. B. Weiner, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation,* 20 San Diego L.Rev. 233 (1983). In rejecting a foreseeability test for professionals, Cardozo drew the line between injuries caused by the release of a "physical force" and those caused by "the circulation of a thought or a release of the explosive power resident in words." *Ultramares Corp. v. Touche,* 255 N.Y. at 181.

20 Wisconsin rejected the Restatement rule in favor of a foreseeability standard in *Citizens' State Bank v. Timm, Schmidt & Co*. S.C., 113 Wis.2d 376, 335 N.W.2d 361 (1983). While Mississippi and New Jersey claim to adhere to the Restatement, in practice they follow the foreseeability rule. The Restatement says professionals are liable if they "intend" to supply information to certain users and "intend" to influence certain transactions. Ignoring this language, Mississippi and New Jersey say professionals are liable under § 552 if it was "foreseeable" that a plaintiff would rely their work, regardless of intent. *Strickland v. Rossini*, 589 So.2d 1268, 1277 (Miss. 1991); *Petrillo v. Bachenberg*, 139 N.J. 472, 655 A.2d 1354, 1360-62 (1995). The New Jersey legislature repealed the foreseeability standard for accountants in 1995 (*see* N.J. Stat. § 2A: 53A-25), but *Petrillo* held the enactment "does not affect the application of section 552 to other professionals...." *Id.*

Some variation of § 552 has been adopted in thirty jurisdictions to date, including California, Texas, Pennsylvania, Michigan, Ohio, Missouri, and Massachusetts.[21] Like *Ultramares*, the Restatement recognizes the need to restrict liability when commercial data is widely circulated among parties who have financial dealings with a business. To encourage professionals to supply information in transactions where the magnitude of potential loss is great, the Restatement limits liability to cases where professionals are "manifestly aware" of the use to which their information will be put and intentionally supply it for that purpose.[22]

While the Restatement limits liability to persons professionals expect will rely on their work, it expands their exposure by eliminating the privity rule of *Ultramares* and the "linking" requirement of *Credit Alliance*. Thus, § 522 does not require that a professional have "any particular person in mind as the intended, or even probable, recipient of the information," much less have direct communications with him. It is enough that the professional intends to influence either a particular person or persons, known to him, or a group or class of persons, distinct from the much larger class who might reasonably be expected" to rely on it. *Id*. The rule recognizes that while the identity of a user may not be of particular moment, "the number and character of the persons to be reached and influenced, and the nature and extent of the transaction for which guidance is furnished may be vitally important." *Id.*

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21 *See Boykin v. Arthur Andersen & Co*., 639 So.2d 504 (Ala. 1994); *Selden v. Burnett*, 754 P.2d 256 (Alaska 1988); *Standard Chartered P.L.C. v. Price Waterhouse*, 190 Ariz. 6, 28, 945 P.2d 317, 339 (Ariz. App. 1996); *Bily v. Arthur Young & Co*., 3 Cal. 4th 370, 413-14, 834 P.2d 745, 772-73 (1992); *First Florida Bank, N.A. v. Max Mitchell & Co*., 558 So.2d 9, 14-15 (Fla. 1990); *Badische Corp. v. Caylor*, 257 Ga. 131, 356 S.E.2d 198 (1987); *Kohala Agric. v. Deloitte & Touche*, 86 Haw. 301, 322, 949 P.2d 141, 162 (Hawaii App. 1997); *Eldred v. McGladrey, Hendrickson & Pullen*, 468 N.W.2d 218, 221 (Iowa 1991); *Wilkinson v. Shoney's Inc*., 4 P.3d 1149, 1165 (Kan. 2000); *Nycal Corp. v. KPMG Peat Marwick LLP*, 426 Mass. 491, 500, 688 N.E.2d 1368, 1374 (1998); *Law Offices Of Lawrence J. Stockler, P.C. v. Rose*, 174 Mich. App. 14, 41, 436 N.W.2d 70, 82 (1989); *MidAmerican Bank & Trust Co. v. Harrison*, 851 S.W.2d 563, 564-66 (Mo.App. 1993); *Bonhiver v. Graff*, 311 Minn. 111, 248 N.W.2d 291 (1976); *Gibb v. Citicorp Mortgage, Inc*., 246 Neb. 355, 371, 518 N.W.2d 910, 921 (1994); *Spherex Inc. v. Alexander Grant & Co*., 122 N.H. 898, 451 A.2d 1308 (1982); *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 322 N.C. 200, 367 S.E.2d 609 (1988); *Haddon View Inv. Co. v. Coopers & Lybrand*, 70 Ohio St. 2d 154, 436 N.E.2d 212 (1982); *Rempel v. Nationwide Life Insurance Co*., 471 Pa. 404, 408, 370 A.2d 366, 367 (1977); *ML-Lee Acquisition Fund, L.P. v. Deloitte & Touche*, 320 S.C. 143, 158, 463 S.E.2d 618, 627 (S.C.App. 1995), *aff'd in part and rev'd in part on other grounds*, 327 S.C. 238, 489 S.E.2d 470, 472 (1997); *Land Bank Association v. Sloane*, 825 S.W.2d 439, 442 (Tex. 1991); *Bethlehem Steel Corp. v. Ernst & Whinney*, 822 S.W.2d 592, 595 (Tenn. 1991); *Culp Constr. Co. v. Buildmart Mall*, 795 P.2d 650 (Utah 1990); *TransAmerica Title Insurance Co. v. Johnson*, 103 Wash.2d 409, 693 P.2d 697 (1985); *First National Bank Of Bluefield v. Crawford*, 182 W.Va. 107, 110, 386 S.E.2d 310, 313, 1989 W.Va. 221 (1989); *Verschoor v. Mountain West Farm Bureau Mut. Ins. Co*., 907 P.2d 1293 (Wy. 1995). Federal courts believe that § 522 is the law in five other states. *See First National Bank Of Commerce v. Monco Agency, Inc*., 911 F.2d 1053 (5th Cir. 1990)(Louisiana law); *Ingram Indus., Inc. v. Nowicki*, 527 F.Supp. 683 (E.D.Ky. 1981) (Kentucky law); *Bunge v. Eide*, 372 F.Supp. 1058 (D.R.I. 1968) (Rhode Island law); *Bowers v. Allied Inv. Corp*., 822 F.Supp. 835, 839 (D.Me. 1993) (Maine law); *Bunge Corp. v. Eide*, 372 F.Supp. 1058, 1062-63 (D.N.D. 1974).

22 Restatement of Torts (Second), § 552, Comment, Subsection (2).

Among the universe of potential claimants under § 552 are insurance regulators who rely on professional certifications in performing their duties. In *Arthur Andersen LLP v. Superior Court Of Los Angeles County*, 67 Cal.App. 4th 1481, 79 Cal. Rptr. 2d 879 (Ct.App. 1998), the California Insurance Commissioner was allowed to sue an accounting firm that negligently certified a balance sheet knowing it would influence the Commissioner in discharging his statutory duty to protect policyholders and creditors.[23]

(4) Recklessness and Fraud

Whatever immunity professionals may enjoy from third party suits for negligence does not extend to recklessness and fraud. Even New York, the jurisdiction with the strictest rules for professional liability, has little tolerance for reckless or deceitful conduct. In reinstating a fraud claim by a lender whose negligence claim against an accountant had been dismissed, *Ultramares* held that professionals owe a duty to creditors and investors to make their reports "without fraud." 255 N.Y. at 179. Since the latitude afforded professionals under the Restatement is also premised on honesty and good faith, if they are lacking, the "reason for a narrower scope of liability" disappears.[24] Actuaries who engage in fraud may incur significant civil liabilities and, in egregious cases like *Equity Funding*, criminal penalties and professional censure as well.[25] Outright lies are not the only thing that can result in exposure to third party claims, reckless behavior, such as turning a blind eye to obvious problems or making baseless professions of opinion, is actionable as well.

> "Fraud includes the pretense of knowledge when knowledge there is none....Even an opinion, especially an opinion by an expert, may be found to be fraudulent if the grounds supporting it are so flimsy as to lead to the conclusion that there was no genuine belief back of it." *Ultramares Corp. v. Touche*, 255 N.Y. at 179, 186.

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[23] In an anomalous opinion, the court allowed the Commissioner to sue on behalf of individual policyholders and creditors, even though it acknowledged they could not sue themselves under § 552. This was justified, the court reasoned, because the Commissioner was "simply assembling funds to pay their claims." At least two other states allow regulators to sue under § 522. *Bonhiver v. Graff*, 311 Minn. 111, 248 N.W.2d 291 (1976); *Reider v. Arthur Andersen, LLP*, 47 Conn.Supp. 202, 784 A.2d 464 (Ct.Super.Ct. 2001).

[24] "The liability stated in this Section is likewise more restricted than that for fraudulent misrepresentation stated in § 531. When there is no intent to deceive but only good faith coupled with negligence, the fault of the maker is sufficiently less to justify a narrower responsibility for its consequences." Restatement of Torts (Second), § 552, Comment a.

[25] In *In re Equity Funding Corp. Of America Securities Litigation*, 416 F.Supp. 161 (C.D.Cal. 1976), actuaries paid a $3 million settlement, were expelled from the American Academy of Actuaries, and were sent to jail for participating in a fraudulent scheme to loot a life insurance company. See N.Y. Times, March 19, 1975, at 75, col. 7; American Academy Of Actuaries, Proceedings 28 (1980). See also *Carl Colteryahn Dairy, Inc. v. Western Pennsylvania Teamsters & Employers Pension Fund*, 847 F.2d 113 (3d Cir. 1988); *American Independent Insurance Co. v. Lederman*, 2000 U.S.Dist. Lexis 12351 (E.D.Pa. 2000); *Torchmark Corp. v. Rice*, 945 F.Supp. 172 (D.Ark. 1996).

C. ACTUARIES

(1) Client Suits

To date, at least fifty actions have been filed against actuaries, with over 70% coming in the last decade. Thirty-four of the suits, or 68%, have been filed by clients or their successors. Nineteen of the client actions were brought against pension actuaries by corporate sponsors, pension plans, or liquidators.[26] Ten of the suits were brought against casualty actuaries by client companies, controlling shareholders, liquidators, and a purchaser who retained an actuary in acquisition.[27] Five of the actions were brought against life and health actuaries by client companies and liquidators.[28]

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26 Seven claims were brought by company sponsors: *George Knight & Co. v. Watson Wyatt & Co*., 170 F.3d 210 (1st Cir. 1999); *Alton Memorial Hospital v. Met. Life Ins. Co*., 656 F.2d 245 (7th Cir. 1981); *Steiner Corp. v. Johnson & Higgins*, 118 F.Supp.2d 1174 (D.Utah 2000); *Orthopaedic Clinic Of Monroe v. Ruhl*, 786 So.2d 323 (La.App. 2001); *Castle Oil Corp. v. Thompson Pension Employee Plans, Inc*., 2001 N.Y.Misc. Lexis 1257 (N.Y.Sup.Ct. 2001); *Clinton Mills, Inc. v. Alexander & Alexander, Inc*., 687 F.Supp. 226 (D.S.C. 1988); *British Columbia Auto. Ass'n v. Manufacturers Life Ins. Co*., 14 B.C.L.R. 237 (S.Ct.B.C. 1979). Eleven were brought by pension plans: *Airparts Co. v. Custom Benefit Services Of Austin, Inc*., 28 F.3d 1062 (10th Cir. 1994); *Pappas v. Buck Consultants, Inc*., 923 F.2d 531 (7th Cir. 1991); *Gerosa v. Savasta*, 189 F.Supp.2d. 137 (S.D.N.Y. 2002); *Gallagher Corp. v. Mass. Mut. Life Ins. Co*., 105 F.Supp.2d 889 (N.D.Ill. 2000); *Scardelletti v. Bobo*, 1997 U.S.Dist. Lexis 14498 (D.Md. 1997); *Redall Indus., Inc. v. Wiegand*, 878 F.Supp. 1026 (E.D.Mich. 1995); *Richards v. Union Labor Life Ins. Co*., 804 F.Supp. 1101 (D.Minn. 1992); *Isaacs v. Group Health, Inc*., 668 F.Supp. 306 (S.D.N.Y. 1987); *Louisiana Oilfield Contractors Assoc. v. International Surplus Lines Insurance Co*., 610 So.2d 1036 (La.Ct.App. 1992); *Farnham v. Watson Wyatt & Co*., 3:99-CV-00792 (D.Conn. Feb. 27, 2001); *Los Angeles County Emp. Retirement Ass'n v. Tower, Perrin, Forster & Crosby, Inc*., CV-01-1351-DDP (C.D.Cal. 2001). And one was filed by a liquidator, *Resolution Trust Corp. v. Mass. Mut. Life Ins. Co*., 200 F.R.D. 183 (W.D.N.Y. 2001).

27 Two claims were brought by client companies: *American Independent Insurance Co. v. Lederman*, 2000 U.S.Dist. Lexis 12351 (E.D.Pa. 2000); *Connell Industries, Inc. v. Arthur J. Gallagher & Co*., 1991 U.S.Dist. Lexis 900 (N.D.Ill. Jan. 29, 1991). Two were brought by liquidators: *Webb v. Mason*, Cause No. 99-08253 (Tex.Dist.Ct. 1999); *Gross v. National Ass'n Of Home Builders Of The United States*, No. 96-00472-E (Tex.Dist.Ct. 1996). Five were brought by shareholders: *GFN Corp. v. KPMG Peat Marwick*, 2002 Fla.App. Lexis 3930 (Fla.Ct.App. 2002); *CIE Service Corp. v. Milliman & Robertson, Inc*., 95 4110-CV-C-SOW (W.D.Mo. 1997); *Home State Holdings, Inc. v. PriceWaterhouseCoopers*, No. 98-35720/SAS & 98-35723 (D.N.J.Bktcy. 1998); *National Home Ins. Co. v. Towers, Perrin, Forster & Crosby, Inc*., 94 CV 0705 (Colo.Dist.Ct. 1994); *Lawrence Ins. Group, Inc. v. KPMG Peat Marwick, LLP*, (N.Y.Sup.Ct. 1996) (see "Lawrence Firm To Sue Ex-Auditor," Capital District Business Review, Jan. 20, 1997, at 1). One claim was settled prior to suit after an action against a purchaser was dismissed. *Delta Holdings, Inc. v. National Distillers and Chemical Corp*., 945 F.2d 1226 (2d Cir. 1991); see *supra* at 16 and Note 62.

28 Two claims were brought by client companies, *Michigan Retail Hardware Assoc. v. Zak*, 1993 U.S.Dist. Lexis 5927 (W.D.Mich. Jan. 22, 1993); *United Teacher Associate Ins. Co. v. MacKeen & Bailey, Inc*., 99 F.3d 645 (5th Cir. 1996); and three were brought by liquidators. *Buchanan v. Greene*, 1998 U.S.Dist. Lexis 5505 (D.Kan. 1998); *Greene v. AMS Life Insurance Co*., CV 1992-005232, Minute Entry (Ariz.Super.Ct. Sep. 5, 2001); *Torphy v. Touche Ross*, 82 CV 004033 (Wis.Cir.Ct. Jul. 26, 1982).

(2) Third Party Actions

Relying on principles developed for accountants and other professionals, *see Dill v. Wood Shovel & Tool Co*., 1972 U.S.Dist. Lexis 14098 (S.D.Ohio 1972), sixteen of the fifty actions filed against actuaries, or 32%, were by brought by third parties. The basis of third party suits was explained in *Steiner Corp. v. Johnson & Higgins*, 135 F.3d 684, 689-90 (10th Cir. 1998).[29]

> "The actuary holds himself out to the public as a specialized expert, and he undertakes employment to perform his professional services in the same manner as the other professionals--lawyers, physicians and accountants, for example."

Seven of the sixteen third party suits were brought by parties with a personal or financial stake in pension plans who did not retain the actuary but met the requirements of privity or its equivalent.[30] Four of the actions involved fraud, another recognized basis for third party liability.[31] The remaining claims sounded in negligence: One was settled, three were dismissed because the relationship with the actuary was too tenuous,[32] and the last allowed a shareholder who was assured by an actuary that a plan was adequately funded to sue under § 552.[33]

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29 The Actuarial Standards Board cautions members that "[i]nformation prepared by an actuary may be used by another person in a way which may influence the actions of a third party. If someone other than an actuary might convey such information...the actuary should recognize the risk of misquotation, misinterpretation, or other misuse...." Actuarial *Standard of Practice No. 9*, § 5.3 at 3.

30 Four cases were brought by beneficiaries: *Saffo v. Occidental Life Insurance Co.*, 602 F.2d 1265 (8th Cir. 1979); *Mertens v. Hewitt Assoc's*, 948 F.2d 607 (9th Cir. 1991); *Cunha v. Ward Foods, Inc*., 501 F.Supp. 830 (D. Hawaii 1980); *Dellefield v. TPF&C*, 1993 U.S.Dist. Lexis 4673 (N.D.Ill Apr. 13, 1993). A fifth case was brought by a pension plan, *Gallagher Corp. v. Russ*, 721 N.E.2d 605 (Ill.App.Ct. 1999), a sixth by a sponsor, *Horton v. CIGNA*, 825 F.Supp. 852 (N.D.Ill. 1993), and the last by the insurer of a fund and its trustees. *Aetna Casualty & Surety Co. v. William M. Mercer, Inc.*, 173 F.R.D. 235 (N.D.Ill. 1997).

31 *Equity Funding*, 416 F.Supp. 161 (C.D.Cal. 1976); *Carl Colteryahn Dairy, Inc. v. Western Penn. Teamsters & Employers Pension Fund*, 847 F.2d 113 (3d Cir. 1988); *Torchmark Corp. v. Rice*, 945 F.Supp. 172 (D.Ark. 1996); *Superior National Insurance Group, Inc. v. Foundation Health Systems, Inc*., (N.D.Calif. Bktcy. 2000).

32 In *Great Central Insurance Co. v. Insurance Services Office*, 74 F.3d 778 (7th Cir. 1996), the ISO was absolved of liability to a supermarket insurer who lost business to competitors that adopted negligently established liability rates, which the ISO admitted were "too low." In *Employee Staffing Of America, Inc. v. William M. Mercer, Inc*., 1998 U.S.Dist. Lexis 3104 (S.D.N.Y. Mar. 16, 1998), a claim by a company denied self-insurer status when an actuary overestimated its potential liabilities on behalf of a state insurance department was dismissed. See also *Dill v. Wood Shovel & Tool Co*., 1972 U.S.Dist. Lexis 14098 (S.D.Ohio 1972).

33 In *Sabey v. Howard Johnson & Co*., 5 P.3d 730 (Wash.App. 2000), the actuary for a seller personally assured a controlling shareholder that a plan his company was acquiring was adequately funded, when it was not. After the acquired firm filed for bankruptcy, the shareholder paid the deficiency to the Pension Benefits Guaranty Corporation and sued the actuary for negligent misrepresentation under § 552.

II

HISTORY OF ACTUARIAL CLAIMS

The actuarial profession, free of malpractice claims until the 1970s, has become an increasingly popular target for litigation. Suits against actuaries were a direct outgrowth of a series of laws and regulations that required companies to submit actuarial valuations to regulators. The filing requirements, which were endorsed by the American Academy of Actuaries, proved to be a mixed blessing for the profession--they created a new found source of business, but a much greater risk of litigation. Claims against pension actuaries were the first to appear, a direct outgrowth of the Employee Retirement Income Security Act ("ERISA"). Suits against life and health actuaries emerged after their clients were required to file annual statements of actuarial opinion in 1975. For casualty actuaries, the claims began to surface after the National Association of Insurance Commissioners ("NAIC") required casualty insurers to file statements of actuarial opinion in 1990.

A. PENSION ACTUARIES.

Malpractice claims against pension actuaries followed on the heels of ERISA, which was enacted in 1974.[34] The principal purpose of this comprehensive statute was to ensure that employees and other beneficiaries would not be deprived of retirement benefits when companies became insolvent.[35] To address this and similar problems, ERISA required actuaries to submit annual reports to the Department of Labor and the Internal Revenue Service, and actuarial valuations at least once every three years.[36] The first post-ERISA case appeared three years after its passage in *Cunha v. Ward Foods, Inc*., 501 F.Supp. 830 (D.Hawaii 1980), where an actuary convinced a client to terminate a pension plan prior to the effective date of ERISA so it could escape ERISA liabilities and qualify for a guarantee from the Pension Benefit Guaranty Corporation When the application for a guaranty was denied for lack of a valid business purpose, the beneficiaries sued the actuary for malpractice and a variety of other claims.

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34 Prior to the enactment of ERISA, the only reported case against an actuary was *Dill v. Wood Shovel & Tool Co*., 1972 U.S.Dist. Lexis 14098 (S.D.Ohio 1972). In *Dill*, former employees sued actuaries retained by their employer for failing to advise the company of the proper amount needed to fund its pension plan. The case was dismissed for lack of privity.

35 *Pension Benefit Guaranty Corp. v. R.A. Gray & Co*., 467 U.S. 717, 720, 104 S.Ct. 2709, 2713 (1984); *Nachman Corp. v. Pension Benefit Guaranty Corp*., 336 U.S. 360, 361-62, 100 S.Ct. 1723, 1726 (1980); *Central States, Southeast & Southwest Areas Pension Fund v. Midwest Motor Express, Inc*., 181 F.3d 799 (7th Cir. 1999). "One of the most shocking incidents of workers losing their retirement benefits occurred in 1963 when Studebaker terminated its employee pension plan, and more than 4,000 auto workers...lost some or all of their promised pension plan benefits." Pension Benefits Guaranty Corporation website (www.pbgc.gov/about/hptext.htm). "The resulting tumult was one of the prime factors leading to the enactment of ERISA." James C. Hickman & Linda Heacox, The Actuarial Role In Financial Reporting, North American Actuarial Journal Vol. 3, No. 4 at 8 (Oct. 1999).

36 29 U.S.C. §§ 1023(a)(1) & 1024(a)(1)(A); 29 U.S.C. § 1023(d).

Subsequent cases against pension actuaries typically alleged that faulty actuarial advice was responsible for underfunded plans or higher than expected financing costs for sponsors.[37] Malpractice actions and breach of contract suits against pension actuaries began to multiply after *Forbes* magazine highlighted a claim by the Pension Benefit Guaranty Corporation in 1985.[38] Although ERISA was the underpinning of the pension suits, claims under the statute itself were rare and almost universally unsuccessful. In a welcome decision for the profession, the Supreme Court in *Mertens v. Hewitt Associates*, 508 U.S. 248 (1993), held that actuaries who only provide actuarial services to a pension plan are not fiduciaries under ERISA, and consequently not subject to ERISA claims.[39] Courts that dismissed ERISA claims against actuaries generally allowed common law claims to proceed.[40]

B. Life And Health Actuaries.

Life and health actuaries were the next targets of malpractice suits. The actions began to appear after the NAIC required life and health companies to file annual statements of opinion in 1975. The first of seven suits was brought by the liquidator of an insolvent life company, who sued a consulting actuary for failing to uncover a reserve deficiency that bankrupted the company. *Torphy v. Touche Ross*, 82 CV 004033 (Wis.Cir.Ct. Jul. 26, 1982). Because life and health companies typically employ their own actuaries, most of the suits in this area involve fraud or deceit, not actuarial malpractice.[41] The paucity of malpractice claims against in-house actuaries is not surprising since they are a much less inviting target than consulting actuaries. As one observer noted:

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37 See, e.g., *Isaacs v. Group Health, Inc*., 668 F.Supp. 306 (S.D.N.Y. 1987); *Airparts Co. v. Custom Benefit Services Of Austin, Inc*., 28 F.3d 1062 (10th Cir. 1994); *Horton v. CIGNA Individual Financial Services Co*., 825 F.Supp. 852 (N.D.Ill. 1993); *Richards v. Union Labor Life Insurance Co*., 804 F.Supp. 1101 (D.Minn. 1992); *Geo. Knight & Co. v. Watson Wyatt & Co*., 170 F.3d 210 (1st Cir. 1999); *Farnham v. Watson Wyatt & Co*., 3:99-CV-00792, Complaint (D.Conn.); *Los Angeles County Employees Retirement Association v. Towers, Perrin, Forster & Crosby, Inc*., CV-01-1351-DDP (C.D.Cal. Feb. 9, 2001).

38 Richard Morais, Faulting The Fortune-Tellers, Forbes at 102 (Oct. 21, 1985).

39 See *Pappas v. Buck Consultants, Inc*., 923 F.2d 531 (7th Cir. 1991). But see *Gerosa v. Savasta*, 189 F.Supp.2d 137 (S.D.N.Y. 2002). When an actuary takes on duties in addition to the traditional actuarial role, however, he may be deemed a fiduciary and, therefore, subject to ERISA suits and state law claims may be preempted. *Louisiana Oilfield Contractors Ass'n v. International Surplus Lines Ins. Co*., 610 So.2d 1036 (La.App. 1992).

40 *See, e.g., Airparts Co. v. Custom Benefit Services Of Austin, Inc*., 28 F.3d 1062 (10th Cir. 1994); *Aetna Casualty & Surety Co. v. William M. Mercer, Inc*., 173 F.R.D. 235 (N.D.Ill. 1997); *Richards v. Union Labor Life Insurance Co*., 804 F.Supp. 1101 (D.Minn. 1992); *Isaacs v. Group Health, Inc*., 668 F.Supp. 306 (S.D.N.Y. 1987).

41 *In re Equity Funding Corp. Of America Sec. Litig*., 416 F.Supp. 161 (C.D.Cal. 1976); *Michigan Retail Hardware Assoc. v. Zak*, 1993 U.S.Dist. Lexis 5927 (W.D.Mich. Jan. 22, 1993); *United Teacher Associate Ins. Co. v. MacKeen & Bailey, Inc*., 99 F.3d 645 (5th Cir. 1996); *Torchmark Corp. v. Rice*, 945 F.Supp. 172 (D.Ark. 1996). But see *Torphy v. Touche Ross & Co*., 82-CV-004033 (Wis.Cir.Ct. 1982); *Greene v. AMS Life Ins. Co*., CV 1992-005232, Minute Entry (Super.Ct.Ariz. Sep. 5, 2001).

> "In-house professionals generally have only personal assets that can be drawn upon. In contrast, a plaintiff can reach the assets of the outside professional, the assets of the outside professional's firm, and the assets of the partners of the outside professional. Consequently, it is outside professionals who are most vulnerable to suit in the case of an insurance insolvency." O'Reilly, *Targeting The Wrong Deep Pocket: Professional Liability Claims In Insurance Company Insolvencies*, 1996 Wis. L. Rev. 123, 126.

C. Casualty Actuaries.

Although casualty risks are among the most difficult to estimate,[42] and the magnitude and variability of loss is great, casualty actuaries were surprisingly able to avoid malpractice suits for years. All this changed in the 1990s, when regulators tried to forestall another round of insolvencies like those that occurred in the 1980s.[43] With the support of the profession, the NAIC required casualty insurers to submit a statement of actuarial opinion on loss reserves in 1990.[44] Certification was not the panacea envisioned by regulators, however, and the 1990s saw another wave of claims on policies written decades earlier. Most of the claims resulted from asbestos and pollution hazards, but unforeseen liabilities for tobacco, breast implants, and lead paint also fanned the flames.[45]

The actuarial opinions required by the NAIC spawned a series of suits against casualty actuaries beginning with *National Home Insurance Co. v. Towers, Perrin, Forster & Crosby, Inc*., 94 CV 0705 (Colo.Dist.Ct. Feb. 10, 1994), where the owners of a defunct insurer claimed that a failure to detect a reserve deficiency caused the company to become insolvent. In another suit, the receiver of the American Eagle Insurance Company claimed that an overly optimistic reserve analysis delayed regulatory action that would have saved policyholders and creditors millions of dollars.[46] All told, sixteen suits were filed against casualty actuaries in the last decade. While late in coming, claims against this segment of the profession have accounted for nearly 50% of all malpractice suits against actuaries since 1996.

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42 *See* C.K. Khury, *The Actuarial Method--How Much Art, How Much Science*, The Actuarial Review, Aug. 1985.

43 According to the *Economist,* over 200 casualty insurers became insolvent in 1985 alone. *The Economist* (Jun. 6, 1987). The NAIC currently lists over 500 active insolvencies, more than 300 of which are property-casualty insurers. See NAIC, Contact List For Insurers In Receivership, Last Update: January, 2002.

44 See Issues Digest, American Academy Of Actuaries, at 23, Sep. 1990. Actuarial opinions became a requirement for property-casualty companies in 41 states that adopt NAIC forms. NAIC, Compendium Of State Laws On Insurance Topics, State Laws Related To Annual Statement Filings (1996).

45 An estimated 200,000 asbestos claims alone had been filed by the early 1990s. Deborah R. Hensler & Mark A. Peterson, *Understanding Mass Personal Injury Litigation: A Socio-Legal Analysis*, 59 Brook.L.Rev. 961, 1004 (1993).

46 *Webb v. Mason*, Cause No. 99-08253, Complaint (Tex.Dist.Ct. Sep. 17, 1999).

III

LIABILITY FOR CARELESS ESTIMATES

Since actuaries are in the business of forecasting future results, it is not surprising when their estimates are wrong. Indeed, for some assignments, such as estimating highly variable casualty risks, "accurate" estimates are more likely the result of happenstance than skill. As one court noted, "[t]o overreserve has been said to be bad practice, to underreserve is said to be worse, to be exactly right is said to be a miracle."[47] Because of the difficulty of the task, actuaries are not liable if their estimates prove to be too high or too low, even by wide margins; they are only liable if they failed to exercise reasonable care in making their estimates. Liability for careless estimates is most likely to arise from some combination of the following--faulty data, unreasonable assumptions, improper methodologies, careless calculations, and professional ignorance. This section will review the problems responsible for careless estimates, focusing on the perennially challenging task of estimating "long-tail" casualty claims.

The standard of liability for actuaries is delineated by generally accepted actuarial principles. Like generally accepted accounting principles ("GAAP") used to assess the conduct of accountants,[48] generally accepted actuarial principles are the measuring rod for actuaries. *See United States v. Consumer Life Insurance Co.*, 430 U.S. 725, 739 (1977); *United States v. Zazove*, 334 U.S. 602, 620. Failure to adhere to these standards may, without more, constitute negligence. *Scardelletti v. Bobo*, 1997 U.S.Dist Lexis 14498 (D.Md. 1997).

Generally accepted actuarial principles include pronouncements of professional societies, textbooks and articles, and practices that have achieved acceptance through common usage.[49] Standards for reserving are set forth in the *Statement Of Principles Regarding Property And Casualty Loss And Loss Adjustment Expense Reserves* of the Casualty Actuarial Society (the "*Statement of Principles*"), which are incorporated in *Actuarial Standard Of Practice* No. 9 of the Actuarial Standards Board ("*Standard No. 9*"). Along with *Actuarial Standard Of Practice* No. 36 dealing with statements of actuarial opinion ("*Standard No. 36*"),[50] these are the main sources of professional standards for reserving. Necessarily general in nature, the meaning and reach of the standards can be seen when applied to specific problems in the reserving process.

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47 *Stewart v. Citizens Casualty Co*., 61 Misc. 2d 809, 810 (N.Y.Sup. Ct. 1969).

48 GAAP defines the duty of "professional care owed by accountants to their clients...." *Vosgerichian v. Commodore Int'l,* 862 F.Supp. 1371, 1373 n.2 (E.D.Pa. 1994). In malpractice cases, "courts often employ the standards as evidence of unacceptable conduct," *Alff v. State Personnel Comm'n*, 1985 Wis.App. Lexis 3880 at 5 (Wis. Ct. App. 1985).

49 *Cf. Checkosky v. Securities & Exchange Commission*, 23 F.3d 452, 472 (D.C. Cir. 1994).

50 *Standard No. 9*, entitled *Documentation and Disclosure In Property and Casualty Insurance Ratemaking, Loss Reserving, and Valuation* took effect on July 14, 1989. *Standard No. 36*, entitled *Statements Of Actuarial Opinion Regarding Property/Casualty Loss and Loss Adjustment Expense Reserves*, became effective on October 15, 2000. *Actuarial Standard of Practice No. 23* on *Data Quality* (1993) is also relevant to reserving issues.

Before reviewing the problem areas, a preliminary note about timing is necessary. As noted, actuarial estimates commonly vary, sometimes significantly, from actual results, especially for many types of casualty risks where there are "substantial delays in the discovery and reporting of claims."[51] The period between the time a claim arises and the time it is paid can be 20 to 25 years, or longer. During this period, actuaries continually revise their reserve estimates as events unfold and new data becomes available. Under GAAP, changes in estimates are recorded in the year the change occurs, called the *valuation date*, not the year the estimate was originally made, called the *financial statement date* or *accounting date*.[52] The disparity among successive estimates can be great,[53] but whatever it is, actuaries like other professionals are judged by circumstances that existed at the time of their work, not subsequently.[54] This principle was firmly established in *National Distillers and Chemical Corp. v. Stephens*, 912 S.W.2d 30, 32-33 (Ky. 1996), where a federal appeals court and a state high court jointly refused to allow the liquidator of an insolvent reinsurer to recover dividends based on a hindsight analysis that showed the original reserve estimates which justified the payment of dividends were too low.[55]

> "At the heart of this matter is an issue of timing: whether the lawfulness of dividend distribution is to be determined at the time of payment or at some time later when additional financial information begins to surface. As we rule for the former, we likewise hold that so long as certain basic...principles and statutory requirements...are followed, retroactive evaluations play no role in ascertaining the legitimacy of any foregone dividend payments. *Hindsight may be twenty-twenty, but the law turns a blind eye towards attempts to restate the financial condition of a corporation once that condition has already been lawfully determined* ....." (Emphasis added).

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51 *Delta Holdings, Inc. v. National Distillers and Chemical Corp.*, 945 F.2d 1226, 1229 (2d Cir. 1991), *cert. denied*, 508 U.S. 985 (1992).

52 The reserve for all claims occurring on or before a certain date, called the *accounting date*, is evaluated as of a *valuation date*. "The *accounting date* may be any date selected for a statistical or financial reporting purpose. The *valuation date*...is the date through which transactions are included...in the evaluation of the liability, regardless of when the analysis is performed. For a defined group of claims as of a given accounting date, reevaluation of the same liability may be made as of successive valuation dates." *Statement of Principles*, § I.

53 "[T]he amount of settlement often varies considerably from the original estimate, since it depends on the interaction of complex variables such as the type and severity of the injury and intricacies of the judicial process." *Statement Of Principles*, § III.

54 Exposing misconduct "after the clues have been confessed and handed to critics, [is] like solving a crossword puzzle after the answer has been published...." *Mishkin v. Peat, Marwick, Mitchell & Co.*, 744 F.Supp. 531, 550-51 (S.D.N.Y. 1990).

55 The rule applies both ways. Thus, in *United States v. Bowler*, 2001 U.S.App. Lexis 10803 (5th Cir. May 25, 2001), a court refused to overturn the conviction of an insurance executive who wilfully understated reserves when it was subsequently discovered that actual losses were indeed lower than projected.

D. DATA PROBLEMS.

Problems relating to the use and application of client-generated data are a common source of malpractice claims.[56] Aside from external data, such as discount rates and mortality tables, which are considered separately,[57] the principal problems relating to client-generated data include failing to reconcile data to financial records, failing to request or use appropriate data, failing to understand the data presented, and failing to adjust the data to optimize its predictive value.

(1) Failing To Reconcile Data

While clients and accountants are primarily responsible for insuring the accuracy of data, actuaries cannot turn a blind eye to information presented for analysis, they must satisfy themselves that it is suitable for reserving.

> "The accuracy and comprehensiveness of data supplied by others are the responsibility of those who supply the data. However, the actuary should, when practicable, review the data for reasonableness and consistency. *Standard No. 23*, § 5.3 (1993).

To ensure the reasonableness and consistency of data, the *Statement of Principles* requires actuaries to reconcile information provided for analysis with the financial records of the company.[58] Failing to reconcile data resulted in a malpractice verdict in *CIE Service Corp. v. Milliman & Robertson*,[59] where actuaries used information that was inconsistent with paid loss data in the annual statements. Using inaccurate data, the actuaries estimated a reserve deficiency that rendered the insurer insolvent by $17 million, causing it to be placed in rehabilitation. The actuaries then accepted an engagement from the receiver, who was seeking to place the insurer in liquidation, and performed another analysis with additional inaccurate data, which added another $10 million to the alleged deficiency. At trial, the receivership court found the reserve estimates developed from the inaccurate data were grossly excessive, and that rather than being insolvent, the insurer was in sound financial condition. In an ensuing case against the actuaries, a jury awarded the insurer and its parent corporation $11.3 million in damages for malpractice.

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56 *See, e. g., CIE Service Corp. v. Milliman & Robertson*, 95-4110-CV-C-SOW, Third Amended Complaint ¶ 6 (W.D.Mo. Jul. 1, 1997)*; National Home Insurance Co. v. Towers, Perrin, Forster & Crosby, Inc*., 94 CV 0705, Complaint at ¶¶ 54-55 (Colo.Dist.Ct. Feb., 10, 1994); *Redall Industries, Inc. v. Wiegand*, 878 F.Supp. 1026 (E.D.Mich. 1995); *British Columbia Automobile Ass'n v. Manufacturers Life Insurance Co*., 14 B.C.L.R. 237 (S.Ct.B.C. 1979). *Cf. Delta Holdings, Inc. v. National Distillers and Chemical Corp*., 945 F.2d 1226, 1237 (2d Cir. 1991), *cert. denied*, 508 U.S. 985 (1992).

57 See *infra* at 20.

58 "Whatever data are used in analysis of reserves, they must reconcile to the insurer's financial records." *Statement Of Principles,* § III.

59 *CIE Service Corp. v. Milliman & Robertson,* 95-4110-CV-C-SOW, Third Amended And Supplemental Complaint ¶¶ 6, 7, 14-16, 23 (W.D.Mo. Jul. 1, 1997). See *Updates*, Business Insurance, Mar. 30, 1998.

(2) Failing To Use Appropriate Data

Another problem that can result in litigation is failing to use appropriate data. While completely accurate and appropriate data are seldom available, *Standard No. 23* requires actuaries to"seek and use appropriate data in their work" and disclose "imperfections in the underlying data...."[60] Implicit in this mandate is a duty to use the most appropriate data "for the intended purpose of the analysis." *Id., § 5.1(b).* When breached, the duty has been the basis of several suits against actuaries. In *National Home Insurance Co. v. Towers, Perrin, Forster & Crosby, Inc*., for example, an actuarial firm was charged with failing to use paid loss data on open claims in its reserve reviews, leading to a reserve deficiency and ultimate insolvency. In its complaint, the company charged that if proper data had been used, it would have been aware of its true reserve requirements sooner, charged higher premiums, and avoided bankruptcy.[61]

In another case, *Delta Holdings, Inc. v. National Distillers and Chemical Corp*., 945 F.2d 1226 (2d Cir. 1991), *cert. denied*, 508 U.S. 985 (1992), a purchaser retained two groups of actuaries to evaluate the adequacy of the reserves of a small property and casualty reinsurer it was planning to acquire. After they made their initial estimates, the actuaries were advised by the auditors that the loss development triangles provided by the company were prepared on what is known as an account-date, rather than a book-date, basis. Recognizing that account-date triangles would tend to understate future claim development, unless adjusted, one group of actuaries made what they believed were appropriate modifications to the data, the other inexplicably did nothing. Neither group, however, followed what in hindsight was the preferred course, namely, asking the company to prepare book-date triangles from the database. After its suit against the seller was dismissed,[62] the purchaser settled a malpractice claim against one of its advisors for $3 million.

(3) Failing To Understand Data

Problems also arise when actuaries fail to understand the nature of the data provided, as well as the underlying business practices and conditions needed for a proper interpretation and analysis of the data. The importance of understanding the data is explained by the *Statement of Principles*:

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60 *Standard No. 23, §§ 3, 5 (1993).*

61 *National Home Ins. Co. v. Towers, Perrin, Forster & Crosby, Inc*., 94 CV 0705, Complaint at ¶ 49 (Colo.Dist.Ct. Feb. 10, 1994). The case was settled before trial for an undisclosed sum. In *British Columbia Automobile Association v. Manufacturers Life Insurance Co*., 14 B.C.L.R. 237 (S.Ct.B.C. 1979), an actuary employed by a trade group used improper data to estimate the level of payments required to fund a pension plan. Finding that the use of faulty data created a funding deficiency, a Canadian court ordered the association who employed the actuary to pay the cost of the additional contributions caused by his negligence.

62 After protracted litigation, the Second Circuit reversed a $42 million judgment against the seller in *Delta Holdings*, finding that its staff acted in good faith in providing account date triangles to the actuaries. 945 F.2d at 1244-46.

> "Understanding the trends and changes affecting the data base is a prerequisite to the application of actuarially sound reserving methods. A knowledge of changes in underwriting, claims handling, data processing and accounting, as well as changes in the legal and social environment, affecting the experience is essential to the accurate interpretation and evaluation of observed data and the choice of reserving methods. A knowledge of the general characteristics of the insurance portfolio for which reserves are to be established also is important. Such knowledge would include familiarity with policy provisions that may have a bearing on reserving, as well as deductibles, salvage and subrogation, policy limits, and reinsurance." *Statement Of Principles*, § III.

Under the *Statement of Principles*, actuaries are required to understand all matters that affect reserves, not only the data used for estimates. The need for an understanding of related issues can be seen from *Delta Holdings*, where actuaries for the buyer were asked to evaluate the adequacy of a $10 million loss portfolio policy purchased by the reinsurer. The company accounted for the policy as a receivable on its GAAP balance sheet, but was told by a state regulator to account for it as ceded reinsurance on its SAP balance sheet. In evaluating the adequacy of the policy for GAAP purposes, the actuaries treated it as ceded reinsurance, which is an offset to claim liabilities. The disparate treatment had the effect of counting the policy twice on the *pro forma* balance sheet prepared by advisors to the buyer. In a less complex transaction, an actuary responsible for calculating pension benefits in *Redall Industries, Inc. v. Wiegand*, 878 F.Supp. 1026 (E.D.Mich. 1995), failed to appreciate the difference between wages, which were to be included in the calculation of benefits, and Subchapter S earnings, which were to be excluded, resulting in an overpayment of benefits.

(4) Failing To Adjust Data

After actuaries are satisfied with the regularity of the data, and understand the basis on which it is presented, they may have to adjust the data to optimize its predictive value,[63] or modify their estimates to correct for a data anomaly. Failing to make an appropriate adjustment was another prong of the malpractice claim in *National Home*.[64] In this instance, the actuary received booked premium data that was mistakenly labeled "written premiums." The actuary discovered the error, changed the description of the data in its report, but failed to create a provision for the unbooked premiums, an oversight that allegedly understated reserves by $7 million. The company claimed that if had been advised of its reserve requirements on a timely basis, it could have recovered the cost through higher premiums.

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63 "Consideration should be given to segregating the experience into more homogeneous groupings" and "subdividing or combining the data so as to minimize the distorting effects of operational or procedural changes should be fully explored." *Statement Of Principles*, § III.

64 See Note 61, *supra* at 16.

Data must also be adjusted when the company does not generate reports in the form expected by the actuary. In *Delta Holdings*, for example, the actuaries who received account-date triangles from the company recognized that if they were not adjusted, they would result in smaller average development factors, and consequently smaller estimates of ultimate loss. The actuaries sought to correct for the understatement by using industry loss ratios for the most recent underwriting year, but failed to appreciate that the understatement caused by the use of account-date triangles affected all underwriting years, not only the most recent year as they assumed.[65]

E. UNREASONABLE ASSUMPTIONS.

Actuarial estimates, like other forecasts, depend on assumptions. For some categories of business, a slightly different assumption can lead to widely different results. The *Statement of Principles* recognizes that an actuarially sound loss reserve requires "reasonable assumptions,"[66] which *Standard No. 36* says "may be implicit or explicit, and may involve interpreting past data or estimating future trends."[67]

The number and significance of assumptions varies with the type of risk. Fast closing lines of business with large numbers of small claims, such as automobile collision policies, require relatively few assumptions since claims are reported and settled quickly, with little litigation. In contrast, slow reporting lines that produce a small number of large, frequently litigated claims, such as general liability and medical malpractice policies, require numerous assumptions, some of which can dramatically affect the estimate. When slow reporting lines are included in excess of loss policies or reinsurance treaties, the estimate of ultimate loss is so heavily dependent on assumptions, it has been described as "informed guesswork." *Delta Holdings, Inc. v. National Distillers and Chemical Corp.*, 945 F.2d at 1249-50.

Because of their importance, *Standard No. 9* requires actuaries to document, explain, and describe the effect of any material change in assumptions.[68] *Standard No. 36* requires actuaries to "consider the sensitivity of the reserve estimates to reasonable, alternative assumptions" and disclose if a change in assumptions materially affected the reserve estimates.[69] Assumptions have been challenged in at least four circumstances--*first*, when they conflict with experience, *second*, when they are unreasonable on their face, *third*, when they ignore economic factors or market conditions, and, *finally*, when they deviate from a predetermined selection.

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65 The data issues faced by the actuaries were described in an unusually thorough opinion by Judge Winter of the Second Circuit. See *Delta Holdings, Inc. v. National Distillers and Chemical Corp.*, 945 F.2d at 1229-33, 1236-39, 1244-46.

66 *Statement of Principles*, § II(1).

67 *Standard No. 36*, § 3.5.5.

68 *Standard No. 9,* § 5.2.

69 See *Standard No. 36* at § 3.5.5, § 3.5.6, and § 4.5.

(1) Assumptions That Conflict With Experience

The most common problem with assumptions arises when they conflict with historical data. Section III of the *Statement Of Principles* requires actuaries to review development patterns "to assure that assumptions regarding the claims process are appropriate." Assumptions that ignore experience have been the basis of several malpractice claims. In *CIE Service Corp. v. Milliman & Robertson*, the assumptions selected by the actuary conflicted with historical loss data in the annual statements;[70] in *Torphy v. Touche Ross,* the assumptions failed to take into account increased losses due to aging and lack of renewals by healthy insureds;[71] and in *National Home*, they were at odds with claim frequency levels calculated by the actuary.[72]

Assumptions that overlook an important practice or condition have also been the subject of malpractice claims. In *Steiner Corp. Retirement Plan v. Johnson & Higgins*, 31 F.3d 935 (10th Cir. 1994),[73] the actuary evaluated a pension plan based on the value of annuities, even though retirees historically opted for more costly lump sum payments. And in *Great Central Insurance Co. v. Insurance Services Office*, 74 F.2d 778 (7th Cir. 1996),[74] the actuaries, in recommending rates, assumed that supermarkets and grocery stores had the same incidence of "slip and fall" claims, when they were markedly different.

(2) Facially Unreasonable Assumptions

Some assumptions are unreasonable on their face. In *Gallagher Corp. v. Massachusetts Mutual Life Insurance Co*., 105 F.Supp.2d 899 (N.D.Ill. 2000),[75] for example, a federal court held that a pension fund actuary who assumed zero increases in salaries in calculating benefits could be sued for malpractice. Similarly, in *Mertens v. Hewitt Assocs*., 948 F.2d 607 (9th Cir. 1991), *aff'd*, 508 U.S. 248 (1993), a negligence claim was reinstated against an actuary who failed to change his assumptions after his client closed a series of plants, rendering his prior assessment of the number of workers entitled to early retirement benefits irrelevant.[76]

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70 *CIE Service Corp. v. Milliman & Robertson,* 95-4110-CV-C-SOW, Third Amended And Supplemental Complaint ¶¶ 6, 7, 14-16, 23 (W.D.Mo. Jul. 1, 1997). See *Updates*, Business Insurance, Mar. 30, 1998.

71 82 CV 004033, Complaint (Wis.Cir.Ct. Jul. 26, 1982).

72 See *Gallagher Corp. v. Massachusetts Mutual Life Insurance Co*., 105 F.Supp. 2d 889, 899 (N.D.Ill. 2000); *Geo. Knight & Co. v. Watson Wyatt & Co*., 170 F.3d 210 (1st Cir. 1999); *Pension Benefit Guarantee Corp. v. Buck*, *cited in* Morais, "Faulting The Fortune-Tellers", Forbes, Oct. 21, 1985.

73 Ultimately this case was dismissed but not until after thirteen years of litigation. See *Steiner Corp. v. Johnson & Higgins*, U.S.App. Lexis 22581 (10th Cir. Oct. 18, 2001).

74 This claim was dismissed after six years of litigation.

75 See also *Gallagher Corp. v. Russ*, 1999 Ill.App. Lexis 705 (Sep. 30, 1999).

76 The actuary in *Mertens* was also charged with improperly delegating the selection of assumptions to the client. 948 F.2d at 609.

(3) Assumptions That Ignore Market Conditions

Assumptions that ignore market conditions are another source of malpractice claims. The *Statement Of Principles* requires actuaries to examine the impact of external influences, including "market mechanisms, and economic variables such as inflation." *Statement Of Principles,* § III. Failing to examine the effect of developing trends in health care costs for an insolvent life and casualty company led to a malpractice claim in *Torphy v. Touche Ross*,[77] while failing to determine the market price of annuities required to close a pension plan prompted suit in *Sabey v. Howard Johnson & Co*., 5 P.3d 730 (Wash.App. 2000).[78]

(4) Assumptions That Ignore Specified Selections

In some cases, assumptions are determined in advance by the client. When they are, actuaries who fail to follow the specified assumption are subject to suit. In *Pappas v. Buck Consultants, Inc*., 923 F.2d 531 (7th Cir. 1991), a consulting actuary used a 7% discount rate to calculate the present value of lump sum distributions, rather than the 5% specified by the pension plan, creating a funding deficiency and charges of malpractice.[79] Failing to use a specified discount rate was also the basis of a malpractice claim in *Orthopaedic Clinic Of Monroe v. Ruhl*, 786 So.2d 323 (La.App. 2001), while in *Gallagher Corp. v. Massachusetts Mutual Life Insurance Co*., 105 F.Supp. 889 (N.D.Ill. 2000), it was failing to use the correct mortality tables.

F. IMPROPER METHODOLOGY.

In addition to adopting reasonable assumptions, actuaries must use an appropriate methodology in estimating reserves.

> "Selection of the most appropriate method of reserve estimation is the responsibility of the actuary. Ordinarily the actuary will examine the indications of more than one method when estimating the loss and loss adjustment expense liability for a specific group of claims." *Statement of Principles,* § III.

While an actuary has considerable leeway in selecting an appropriate methodology, his discretion is not unfettered. In *Scardelletti v. Bobo*, 1997 U.S.Dist. Lexis 14498 (D.Md. Sep. 8, 1997), for instance, a malpractice claim was sustained against an actuary who allegedly based his advice on a five-minute analysis during a breakfast meeting.

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77 82-CV-004033, Complaint (Wis.Cir.Ct. Jul. 26, 1982).

78 When the market price of the annuities proved to be substantially higher than the actuary had assumed in *Sabey*, the company was forced to make lump sum payments to close the plan, leading to its insolvency.

79 The common law claim for actuarial malpractice was dismissed in *Pappas* for lack of pendent jurisdiction after the court concluded the actuary was not a fiduciary under ERISA.

Unexplained changes in methodology can also give rise to claims. *Standard No. 9* requires an actuary to document and explain the reasons for any material changes in methodology and describe the effect of the changes on his work. *Id., § 5.2.* In *American Independent Insurance Co. v. Lederman*, 2000 U.S.Dist. Lexis 12351 (E.D.Pa. 2000), an actuary who had been trained by the outside manager of a company changed his methodology at year-end to conceal a reserve deficiency from regulators. When the manager decided to bid for the company the following spring, the actuary reverted to his prior methodology, producing a $7.5 million deficiency. The changes in methodology were sufficiently suspicious that the court sustained a conspiracy claim against the actuary and the manager for trying to force a fire sale of a company. In a less Machiavellian case, *Lawrence Insurance Group v. KPMG Peat Marwick, LLP*, a change in methodology was accompanied by a $36 million increase in claim liabilities. When the insurer was placed in liquidation, the client sued the actuaries for malpractice, claiming the change in methodologies proved their earlier procedures were "wrong." The owner laid the blame for the insolvency at the feet of the actuaries, claiming the company had based its decisions regarding rates, dividends, and marketing on the faulty estimates.[80]

G. Careless Calculations.

Little need be said about the duty of an actuary to guard against careless calculations, except they are the easiest to prove and hardest to defend. To the extent that a miscalculation leads to an unreasonable or unexpected result, the *Statement Of Principles* requires the actuary to either find the error or explain the reason for the variation.[81] Malpractice claims have arisen from typographical errors,[82] computer programming mistakes,[83] and old fashion mathematical errors.[84]

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80 Summons, (N.Y.Sup.Ct., Albany County, Dec. 30, 1996). New York regulators who seized the company, were not impressed with the charges, telling the press they had been investigating reserve problems at the company for over four years. See Pinckney, "Lawrence Firm To Sue Ex-Auditor", *Capital District Business Review*, Jan. 20, 1997.

81 "The incurred losses implied by the reserves should be measured for reasonableness against relevant indicators, such as premiums, exposures, or numbers of policies, and expressed wherever possible in terms of frequencies, severities, and loss ratios. No material departure from expected results should be accepted without attempting to find an explanation for the variation." *Statement Of Principles*, § III.

82 In *Richards v. Union Labor Life Insurance Co*., 804 F.Supp. 1101, 1102 (D.Minn. 1992), a transposition error allegedly caused a $3 million funding deficiency in a pension plan, which pales in comparison to the $92 million typographical error in *Prudential Insurance Co. Of America v. S.S. American Lancer*, 870 F.2d 867 (2d Cir. 1989).

83 See, e.g., *Isaacs v. Group Health, Inc*., 668 F.Supp. 306 (S.D.N.Y. 1987); *Resolution Trust Corp. v. Massachusetts Mutual Life Insurance Co*., 20 F.R.D. 183 (W.D.N.Y. 2001).

84 See, e.g., *Gerosa v. Savasta*, 189 F.Supp.2d 137 (S.D.N.Y. 2002); *Alton Memorial Hospital v. Metropolitan Life Insurance Co*., 656 F.2d 245 (7th Cir. 1981); *Airparts Co. v. Custom Benefit Servs. Of Austin, Inc*., 28 F.3d 1062 (10th Cir. 1994).

H. Professional Ignorance.

The *Statement Of Principles* requires actuaries to stay abreast of current laws and regulations, including judicial decisions.[85] Over the last two decades, casualty actuaries have had to consider a dizzying array of new torts in evaluating reserves on existing policies, including liabilities for Dalkon shield, asbestos, pollution, breast-implant, and tobacco exposures, none of which existed when the policies were issued years or decades earlier. The reserving problems created by the expanding theories of liability are compounded by a patchwork of inconsistent rulings, which require casualty actuaries to monitor legal developments in virtually every state where their clients do business.[86] To date, no actions have been reported against casualty actuaries for failing to consider the newly recognized torts in their estimates, but it is early.

Pension actuaries have not been so fortunate. If tort rules are vague and inconsistent, pension rules are highly detailed and plentiful, a virtual labyrinth of laws and regulations for actuaries to consider. In *Pappas v. Buck Consultants, Inc.*, 923 F.2d 531, 533 (7th Cir. 1991), an actuary who was retained to advise a new owner of a company on the amount that could be distributed to the former owner upon termination of a pension plan allegedly failed to consider the adverse effects of a termination under the Pension Protection Act of 1987. In *Horton v. CIGNA Individual Financial Services Co*., 825 F.Supp. 852 (N.D.Ill. 1993), an actuary who advised an owner that a change in the law required an amendment to its pension plan was sued for actuarial malpractice when the change, which caused the plan to become underfunded, was alleged to have been unnecessary. And in *Orthopaedic Clinic Of Monroe v. Ruhl*, 786 So.2d 323 (La.App. 2001), a judgment was affirmed against an actuary who failed to give timely advice on the effect of the Tax Reform Act of 1986 on a company pension plan. See *Airparts, Co. v. Custom Benefit Services Of Austin, Inc*., 28 F.3d 1062, 1064 (10th Cir. 1994).

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85 "Due regard should be given to the impact of...the judicial environment, regulatory and legislative changes..." *Statement Of Principles*, § III.

86 See 7A J. A. Appleman, *Appleman's Insurance Law And Practice* (Berdal ed.) § 4520 (Supp. 1997). The difficulty of estimating the effect of the new torts on the reserve requirements of casualty insurers is described in the annual report of American International Group, the largest domestic casualty company:

> "AIG continues to receive claims asserting injuries from toxic waste, hazardous substances, and other environmental pollutants....Estimation of asbestos and environmental claims loss reserves is a difficult process, as these claims, which emanate from policies written in 1984 and prior years, *cannot be estimated by conventional reserving techniques*. Asbestos and environmental claims development is affected by factors such as inconsistent court resolutions, the broadening of the intent of policies and scope of coverage and increasing number of new claims. AIG and other industry members have and will continue to litigate the broadening judicial interpretation of policy coverage and the liability issues. If the courts continue in the future to expand the intent of the policies and the scope of the coverage, as they have in the past, additional liabilities would emerge for amounts in excess of reserves held. *This emergence cannot now be reasonably estimated*...." AIG, Form 10-K, Dec. 31, 2001, Consolidated Financial Statements, Note 12. (Emphasis added).

IV

RECOMMENDATIONS

The appearance of actuarial malpractice claims on the judicial landscape says more about the litigious nature of society than the profession. Even if blameless, actuaries can be drawn into a maelstrom of litigation by circumstances beyond their control, including unexpected losses, insolvencies, and failed acquisitions. If there is little actuaries can do to avoid being sued, there is much they can do to enhance their prospects of success. The most promising ways to avoid or limit liability are engagement agreements, disclaimers in actuarial reports, well documented work papers, and peer reviews.

A. ENGAGEMENT AGREEMENTS.

Engagement agreements, which generally take the form of a letter signed by an actuary and client,[87] confirm the scope of services to be performed and the amount of fee to be paid. They can also be used to limit liability to clients and, in all but three states, avoid liabilities to third parties for negligence. If an engagement agreement is not feasible, an engagement letter that describes the limitations of the actuarial opinions and identifies the parties who are expected to rely on the work can achieve some but not all of the benefits of an engagement agreement. Neither engagement agreements nor engagement letters, however, insulate actuaries from claims of fraud or deceit.

Since most malpractice claims are filed by clients, actuaries like other professionals can reduce their exposure to negligence claims with an engagement agreement that limits liability to a specified amount.[88] Many professionals, understandably, are reluctant to request a limitation of liability agreement from clients, believing it would impair relations and reflect adversely on their skills. In some instances, the concerns are justified and exculpatory provisions are unnecessary and unproductive. In many circumstances, however, limitation of liability clauses are both reasonable and prudent. If a client intends to circulate an actuarial estimate in a transaction where the magnitude and variability of loss is great, the client, not the actuary, should bear the risk of loss and the cost of insurance.

At a minimum, engagement agreements should restrict the circulation of an actuarial work to particular parties in a specific transaction. Provisions of this sort establish the intended beneficiaries of a report and absolve an actuary of liability to unknown parties who use their work, without pay, as § 552 of the Restatement contemplates. Engagement agreements may also require a client to indemnify a professional against the cost of defending third party claims.[89]

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87 Engagement agreements are "Actuarial Communications" with the meaning of the Code of Professional Conduct. As such, they must be "clear and appropriate to the circumstances...." Actuarial Standards Board, *Code of Professional Conduct*, Precept 4.

88 See *supra* at 2.

89 *Cf., Rafferty & Towner, Inc. v. Ball*, 2002 Wash.App. Lexis 132 at 17 (Wash.Ct.App. Jan. 24, 2002).

B. ACTUARIAL REPORTS.

A properly prepared actuarial report can also assist in avoiding or limiting malpractice claims: For client suits, it can reinforce protections provided by an engagement agreement or letter; for third party actions, it can provide an independent basis for a motion to dismiss. A limitations section should specifically identify the persons for whose benefit and guidance the report is being supplied, and disavow responsibility for any other use or purpose. It should also disclaim any inference or suggestion that the estimates will accurately predict actual losses and explain the uncertainties inherent in estimating casualty risks. The limitations section should describe the significance of assumptions in the reserving process and identify any data issues that limit reliability. Since forward-looking statements, such as projections, forecasts, and estimates, are not actionable when accompanied by *meaningful* cautionary statements,[90] the limitations should be described in detail.

(i) Risks And Uncertainties

The most important part of the limitations section is a description of the risks and uncertainties that may result in a material deviation in the reserves. *Standard No. 36*, § 3.6.5. The section should explain that estimates for slow reporting casualty risks are subject to large errors of estimation because they are based on the outcome of events that have not yet occurred and that future results will likely vary, perhaps materially, from the estimates. Judicial, legislative, and regulatory developments that could cause a material deviation should be identified and described, along with other factors that could have a material effect on the estimates, including erratic development data, shifts in reporting patterns, changes in claim frequency or severity, and new underwriting, reinsurance, claims handling, data processing, or accounting policies. *Id.*, § 3.6.1. The report should also note that the uncertainty inherent in the reserving process implies that a range of reserves can be actuarially sound,[91] and that while the estimates are believed to be reasonable, different assumptions could produce materially different results.[92] If an explicit provision has been established for uncertainty, it should be disclosed.[93] Finally, if the risks and uncertainties are such that an actuary cannot develop reasonable estimates for one or more lines of business, a qualified opinion should be issued. See *Standard No. 36*, § 3.3.2(d).

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90 *EP Medsystems, Inc. v. Echocath, Inc.*, 235 F.3d 865 (3d Cir. 2000); *Gasner v. Board of Supervisors*, 103 F.3d 351, 358 (4th Cir. 1996); *Saltzberg v. TM Sterling/Austin Assocs., Ltd.*, 45 F.3d 399, 400 (11th Cir. 1995); *Rubinstein v. Collins*, 20 F.3d 160, 167 (5th Cir. 1994); *Moorhead v. Merrill Lynch*, 949 F.2d 243, 245-46 (8th Cir. 1991); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040 (6th Cir. 1991); *I. Meyer Pincus & Assocs. v. Oppenheimer & Co.*, 936 F.2d 759, 763 (2d Cir. 1991).

91 "The uncertainty inherent in the estimation of required provisions for unpaid losses...implies that a range of reserves can be actuarially sound. The true value of the liability for losses...at any accounting date can be known only when all attendant claims have been settled." *Statement of Principles,* § II (3).

92 The report should avoid using words such as "best" or "most reasonable" to describe the estimates unless there is a statistical analysis to support such descriptions.

93 "[A]n explicit provision for uncertainty may be warranted when the indicated ultimate reserve value is subject to a high degree of variability." *Statement of Principles*, § III.

(ii) Assumptions

The limitations section should also disclose that the estimates are based on assumptions relating to future events which, if wrong, could lead could to a material deviation in the reserves. The section should describe the nature and significance of the assumptions for each methodology used in the report.[94] If a loss ratio method is used, the report should disclose how the target ratios were selected and how they compare with company and industry experience. If a loss development method is used,[95] the report should explain what assumptions were used to select development and "tail" factors for projecting ultimate results; it should also quantify the number of years of future development implied by the selected tail factors.[96] If major lines of business are sensitive to small changes in selected factors, they should be identified and the effect of using reasonable alternative assumptions should be quantified.[97] If there has been a change in assumptions from prior reserve evaluations, and the change is likely to have a material effect on the current estimates, the nature of the change and the significance of the effect should be disclosed. *Standard No. 36*, § 4.5.

(iii) *Data Issues*

Data issues are frequently a source of uncertainty and litigation. Limitations in the data should be identified and discussed, along with any adjustments or modifications by the actuary. The actuary should describe what was done to reconcile the data to the financial records of the company, or, if that was impossible or impracticable, disclose any resulting limitations. *Standard No. 23*, § 5.3. The report should identify imperfections or anomalies in the data and explain what adjustments or modifications have been made to correct for those conditions.[98] If the adjustments or modifications produce material biases or otherwise limit the reliability of the estimates, the biases and limitations should be disclosed and, if possible, quantified. *Id.* at § 5.2.

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94 The three general methods for estimating casualty reserves are the loss development method, the loss ratio method, and the Bornhuetter-Ferguson method, which is a combination of the loss ratio and loss development methods. See *Delta Holdings, Inc. v. National Distillers and Chemical Corp*., 945 F.2d at 1229-30.

95 The loss development method requires an actuary to select individual development factors for each category of business and development period, along with a "tail" factor which reflects the number of years it will take for all claims to be settled and paid. Depending on the number of categories and periods, hundreds or thousands of factors must be selected.

96 Factors are normally selected by calculating various averages from the data and selecting the one the actuary believes is most likely to reoccur. There are no rules or formulae for making a selection; it rests entirely on the experience and judgment of the actuary.

97 "The actuary should consider the sensitivity of the reserve estimates to reasonable, alternative assumptions. When the use of reasonable, alternative assumptions would have a material effect on the results of the actuary's reserve analysis, the actuary should consider the implications regarding the risks and uncertainties associated with such an effect." *Standard No. 36*, § 3.5.5. See Letter From The President, C.K. Khury, The Actuarial Review, Nov. 1985.

98 "Users expect that actuaries" will disclose "any material imperfections in the underlying data of which the actuaries are aware as of the date" of the report. *Standard No. 23*, § 3.

C. WORK PAPERS.

The last line of defense against actuarial malpractice claims is a set of well organized and thoroughly documented workpapers. Limitation of liability provisions and actuarial disclaimers are grounds for motions to dismiss or summary judgment, but if they fail and the case is tried, the workpapers will be the best evidence of the degree of care exercised by the actuary. The general requirements for workpapers are specified in *Standard No. 9*.

> "Appropriate records, worksheets, and other documentation of the actuary's work should be maintained by the actuary and retained for a reasonable period of time. Documentation should be sufficient for another actuary practicing in the same field to evaluate the work. The documentation should describe clearly the sources of data, material assumptions, and methods. Any material changes in sources of data, assumptions, or methods from the last analysis should be documented. The actuary should explain the reason(s) for and describe the impact of the changes." *Standard No. 9*, § 5.2. See *Standard No.* 7 at § 4.5, *Standard No. 23* at § 6.1, and *Standard No. 41* at § 3.6.

A good set of workpapers will demonstrate that generally accepted actuarial principles were followed and provide evidence and support for the conclusions reached. Among other things, the workpapers should:

- Include a table of contents and index, with appropriate cross-references in memoranda and analyses to supporting and related materials.

- Contain all letters, e-mails, and other written communications with the client relating to the engagement. Since most of the information gathered during an engagement is not provided in writing, notes of important telephone conversations and face-to-face meetings should also be maintained in the workpapers. If critical information was imparted during a conversation or a meeting, a file memorandum should be prepared from the notes.

- Indicate where management reliance is the basis of a conclusion and describe the testing done to confirm the reasonableness of the information provided.

- Avoid light-hearted comments, jokes, and similar remarks that appear unprofessional and reflect poorly on the actuary.

- Purge the files of unnecessary materials or drafts that were subsequently revised to correct errors.

For evaluations of casualty reserves, the workpapers should address the following issues:

- *Risks*. The workpapers should include a memorandum identifying and assessing the risks and uncertainties associated with lines of business being evaluated. Materials reviewed by the actuary relating to external risks, such as articles on judicial and legislative developments, should be retained in or referenced by the workpapers. Calculations and analyses relating to risk assessment, such as alternative reserve estimates, should also be kept in the workpapers.

- *Data*. A summary memorandum documenting communications with the client relating to data availability, data imperfections, or data anomalies should be prepared and included in the workpapers. The memorandum should describe the data requested, the data provided, measures taken to reconcile the data to financial records, any modifications or adjustments made to the data, and any biases and limitations produced by the data.

- *Methodologies*. The workpapers should include a memorandum identifying the factors that led to the selection of a particular methodology, such as the presence or absence of homogeneous and stable data. While selection of an appropriate method is within the discretion of the actuary, the actuary has the burden of establishing that the discretion was exercised in good faith. If there have been material changes in methodologies, the reasons for the changes should be explained and their effect on the estimates quantified.

- *Assumptions*. A summary memorandum that describes the nature and significance of the assumptions for each methodology used, with appropriate references to the detailed workpapers that contain the specific assumptions, should be included in the workpapers. The summary should quantify the effect of different assumptions on the estimates for major lines of business and explain why the assumptions selected were chosen. If the client directed the actuary to use certain assumptions, the actuary should describe the instructions and explain what tests were performed to confirm their reasonableness. If there has been a change in assumptions from prior evaluations, and the change is likely to have a material effect on the current estimates, the effect of the change should be quantified.

- *Reasonableness*. The *Statements of Principle* require reserve estimates be tested against internal and external measures of reasonableness.[99] Reasonableness tests may include comparisons of the loss ratios implied by the estimates with historic ratios reported by company and industry, as well as an analysis of the percent of IBNR in the reserves in successive development periods in relation to industry benchmarks. If a line of business is highly variable and there is a wide range of possible outcomes, the estimates may also be compared to the outcomes indicated by appropriate aggregate loss distributions.[100] The results of the reasonableness tests should be set forth in a summary memorandum, with references to other sections of the workpapers that contain the tests. The summary memorandum should also describe any other considerations that support the reasonableness of the estimates.

D. Peer Reviews.

Though not required by generally accepted actuarial principles, peer reviews are a common and constructive practice among consulting actuaries. If diligently performed and documented, they can also be an effective defense against actuarial malpractice claims. Testimony from an actuary who has reviewed the disputed work will generally be more compelling than testimony from an actuary whose work is under fire, and has a personal and professional stake in its propriety and reasonableness. On the other hand, a superficial review will probably do more harm than good, since it will create the impression that the entire firm was careless.

To be effective, the results of a peer review should be set forth in a memorandum that can be used at trial. The memorandum should describe the steps taken in the review and comment on the appropriateness of the data and the reasonableness of the methodologies, assumptions, and estimates. The memorandum should also describe conversations and meetings with the lead actuary, identifying areas covered, questions asked, and responses given. Any external sources consulted by the peer reviewer, such as industry data or actuarial analyses of similar lines of business, should also be noted.

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99 "The incurred losses implied by the reserves should be measured for reasonableness against relevant indicators, such as premiums, exposures, or numbers of policies, and expressed wherever possible in terms of frequencies, severities, and loss ratios. No material departure from expected results should be accepted without attempting to find an explanation for the variation." Statement Of Principles, § III.

100 An aggregate loss distribution is the set of all possible outcomes from the historical data and their associated frequency or probability of occurrence. If the reserve estimates deviate materially from the most probable outcomes, as indicated by the historical data, the reasons for recommending the selected estimates should be explained.

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