

Actuarial E&O Liability Risk Management

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In recent years, actuarial firms have been a more frequent target of lawsuits based on negligence and wrongdoing of the actuarial consultants. Pension actuaries, those actuarial consultants with concentration in medical malpractice, and those employed by an insurance brokerage operation for rate development have been the main targets. Past lawsuits have reached the billions of dollars. Being proactive in managing risk of professional liability, therefore, is in the firm's and the individual actuary's best interest. Some of the risk management options available to actuarial firms in managing their Errors & Omissions (E&O) exposure are presented here.

Background

“Actuaries, who for years had a low profile that avoided the kind of malpractice actions routinely bombarding accountants, are now increasingly bigger targets for such lawsuits, according to attorneys and others familiar with the industry” (Hays, 2002). For example, in March 2006, Mercer Human Resource Consulting, a global subsidiary of the \$12 billion in annual revenue conglomerate Marsh & McLennan Cos., was sued by Milwaukee county claiming malpractice. In the federal lawsuit, Milwaukee County contends that the actuarial firm failed to act as an objective consultant and "made repeated, serious actuarial mistakes, grossly underestimated costs and totally failed to assess the actuarial effect" of the new benefits. At least \$100 million is being sought by the suit (Umhoefer, 2006). This type of litigation against actuarial firms has become common and requires attention by management of those firms.

Available risk management practices to address E&O exposure

Actuarial firms have available the same basic forms of risk management as do other firms facing variability in outcomes: risk control as well as insurance and non-insurance risk transfer. Below we discuss specifics of each of these mechanisms. A combination of these options likely will be the most effective way to manage its liability risk.

1) Risk Control. While it may seem obvious, too often litigation arises because of poor communication. In this vein, it is important to establish a clear understanding between the actuarial firm and the client as to the scope of the project, clearly defining the client's expectations of process and outcome. An engagement letter, outlining specifics of the project, a timeline of anticipated deliverables, and mechanisms to deal with any dispute between the parties associated with the specific project is an effective tool to limit litigation and, therefore, should always be used. Successful early communication limits problems later in the relationship. Additionally, if the actuary is pressed for time and believes it has been given too short a period to complete project, the actuary ought to qualify their audit in writing. (NASRA, 2008)

In addition, before accepting a new client/project, the actuary is well advised to assess its associated risk and benefit. According to the SOA, items to keep in mind when considering a new client/project are:

- “Beware of clients who are changing consultants.
- Beware of clients who have unreasonable expectations.
- Think twice if the client tries to negotiate or is difficult about the cost of services.
- Trust your first instinct if your impression of the client or the case is unfavorable.
- If you must decline an account, always decline in writing. Avoid giving any recommendations or opinions on the account” (Whisenand, 2007).

Actuaries must accept some risk in undertaking projects, but can manage that risk through careful balancing of perceived return relative to risk. Those that present potentially devastating financial risk should be declined.

2) **Non-Insurance Risk Transfer.** Inevitably, however, losses will occur even with the best loss control mechanism in place. When it does, those losses can be financed internally through retention or transferred through either insurance or non-insurance mechanisms. Non-insurance transfer such as “indemnification” agreements and “limitations of liability” clauses tend to be wise, given that their presence is likely to decrease insurance premiums and increase insurance availability. Increasingly, actuarial firms are using this type of contractual agreement, limiting the recovery amount against the firms and asking clients to indemnify the firms for damages beyond that amount when lawsuits are filed by participants or others involved with the plan. Two prominent actuarial consulting firms, Watson Wyatt Worldwide and Towers Perrin, insisted that their pension plan clients limit the firms' liability to one year's fees or no more than \$250,000 (Anand, 2002).

It is best to seek legal advice in drafting this clause. A general language such as “The liability of Consultant to Client for work performed under this Agreement shall not exceed \$50,000 or the amount of Consultant’s fee, whichever is greater” (Ashcraft, Terra Insurance Company) and “Client will indemnify and hold harmless XXX from all claims, actions and judgments, including costs of defense and attorneys’ fees incurred in defending against same, arising from and related to any claims from any party other than XXX or Customer, that any musical score, composition, ore related material infringes on any copyright, trademark, trade secret, or similar

right of such third party to such musical score composition or related material” (CDPrintExpress) obviously do not fit our context.

- 3) **Insurance Risk Transfer.** Errors and Omissions (E&O) insurance is also available to finance resulting professional liability on the part of actuarial firms. Generally, such insurance is required for an actuary to be hired for any significant job. The requirement is good for the actuary, however, in that it also offers defense costs and an effective mechanism to transfer large significant risk from the actuarial firm to the insurer.

Actuarial science, despite its name, is something of an art. Each actuarial firm may yield distinct results on the same question, given the relevance of assumptions in deriving those results.

Furthermore, actuaries work in prediction of the future, which is always highly uncertain. When the actual results differ significantly from actuarial estimates, it may well be due to factors outside the actuaries’ skill, such as incorrect data, time constraints, or other reasons; however, the client could think to the contrary. The expense of defending a lawsuit could be substantial, even when the actuary prevails. E&O insurance provides protection for defense costs as well as financing for resulting damages assessed against the firm. A consulting firm without E&O insurance is essentially risking the entire assets of the firm.

However, insurer insolvencies and under-funded pension plans have yielded a difficult E&O insurance market for actuaries right now. Premiums are high and rising, and availability is becoming an issue. Most professional liability insurers do not cover actuaries. If they do, the coverage tends to be restrictive. Many exclude coverage for actuarial opinions or reserve

certifications, or exclude any claim from insolvency, which is the coverage most actuaries need. Actuaries, therefore, often rely on the surplus lines market rather than the traditional insurance market.

Through the surplus lines market, coverage is typically provided on a claims-made basis with defense costs included within the limits and deductibles, which vary with the size and type of insured. The limits available are often well below what is needed. Standard limits for most small to medium sized organizations start at \$1.0 million (Tennant Risk Services Insurance Agency, 2008), far below what most actuarial consultants need to protect against possible litigation. Furthermore, coverage provisions can differ significantly from one insurer to another. Actuarial firms need to review the policy carefully to determine the extent of coverage available, and request of the insurer or broker who is servicing them to clarify how their policy responds to the particular needs of the firm.

- 4) **Risk Retention.** For the portion of risk that the firm does not transfer to others, the actuarial firm should have a risk financing plan in place. Generally, the firm will want to set aside a fund in advance to pay for these future losses so that it is not caught in need of a “fire sale.” A risk-adjusted cost-benefit analysis of holding funds in readily accessible forms versus more productive forms will aid the firm in using its cash flow effectively.

Insurance premiums include a risk charge. They also incorporate fees for administrative expenses and profit. In return, the policyholder (in this case the actuarial firm) gets the risk transfer and receives other insurer services such as legal defense. If the services are valuable to

the actuarial firm, and/or if the risk charge is below the cost to bear the risk internally, these additional charges look acceptable to a policyholder. Furthermore, setting aside funds to retain losses involve costs. The firm loses an opportunity to invest and earn investment returns on the fund, and also incurs its own administrative costs to manage the fund and adjust claims. The extent to which the actuarial firm can provide those services to itself more cheaply, including managing risk, will determine the degree to which retention is economically appropriate. Often those factors relate to firm size, with economies of scale an important consideration.

Risk appetite as an overall risk management tool

The firm's risk appetite is another consideration. Risk appetite relates to the question: How much variability in its cash flows is the firm willing to accept? The greater the appetite, the higher level of retention is appropriate for the firm. A serious analysis of risk appetite will further improve the actuarial firms overall risk management, assisting in serious understanding of the firm's exposures, concerns, and strengths. It is a challenging, malleable process to determine a firm's risk appetite. The rewards of a well executed and communicated process for assessing risk appetite, however, can be significant, and will yield answers to many of the questions raised in this article. By applying these risk management options to proactively prepare itself against potential professional liability lawsuits, an actuarial firm will minimize the adverse consequences of these legal actions. With risk appetite well defined and administered, the firm will increase value and operate more effectively.

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