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LITIGATION RISKS OF THE PENSION ACTUARY

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Recorder: THOMAS K. CUSTIS

- Are actuaries being sued? Why? Over what?
- Malpractice or difference of opinion?
- How not to be a fiduciary
- Actuarial standards – Safe Havens? or Land Mines?
- Case histories

MR. THOMAS K. CUSTIS: I am a pension consultant in the Milwaukee office of Milliman & Robertson and also serve as the chairman of the firm's peer review committee. With me on our panel is Stephen Jacobs, a shareholder in the firm of Reinhart, Boerner, Van Deuren, Norris and Rieselbach, also in Milwaukee. Steve joins us as the general counsel to the Professional Consultants' Insurance Corporation, which is a captive malpractice insurance company writing coverage for five major consulting firms in the U.S. Steve has a lot of direct experience in the litigation activity as it involves actuaries of all types and pension actuaries in particular.

The general format is intended to keep the session as informal as possible and encourage the participation of all of you in the audience. I have prepared a list of questions that will serve to focus the discussion. I will pose them to Steve. In addition, we had a third panel member recruited for this panel. However, Bill Hartman is not able to be here. So, even though he isn't with us, we do have some comments from Bill Hartman that I think will also be useful.

With those preliminary remarks I think we're ready to jump right in. Steve, from your experience what can you tell us about the prevalence of malpractice suits particularly against pension actuaries?

MR. STEPHEN T. JACOBS: It's a growth industry, unfortunately. Let me just make a couple general comments first.

I would like to tell you my general view on the subject of malpractice claims, or errors and omissions (E&O) claims, against the actuarial profession so that you can take my remarks with my own personal bias. It is not only on the increase, but also your profession has not seen anything yet. If you compare some of your risk characteristics to those of either the legal profession or the accounting profession – or some other financial-services-related professional firms – you're on the front side of a slope, I believe, that's going to dramatically increase. If you talk to people involved in other professions who are spending enormous amounts of their time, energy and revenues [illegible] ...alpractice claims, you will find few, if any, even in an honest moment, [illegible] this defense has turned out for the betterment of the profession.

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There's always a good amount of griping about it, but I don't think anybody who has been involved in the increase in malpractice claims involving the medical, legal or accounting profession believes there are very many positive aspects to it.

At the start I would also say that I make no apologies for the legal profession. I think the court system and the litigation system, in general, is here to stay for a long time. We'll talk more about it. It is an enormous economic entity. Whatever you think of lawyers (and I have as many harsh views of them as anybody else), they are not going to change readily or quickly, if at all. The idea of changing the legal system or the laws or getting a more realistic view by the lawyers as a way of defending yourself against malpractice claims isn't going to work. It may be the noble way to go, but it isn't going to work in my opinion. I think what you have to do as a profession is deal with the system the way it exists. Spend whatever time you think appropriate trying to change it, but as far as defending yourself, defend yourself and act within the system as it is, because that's the system you're going to be dealing with for a long time. So that's sort of where my prejudices are. If you don't like lawyers, I agree with you. If you don't like the increase in malpractice claims, I agree with you. But let's talk about where some of the risks are and what you can do individually and as a profession to stay in the relatively low ranges of risk, as far as professional services go.

Your question was whether the incidence of claims is going to increase. I think it is. My observations are that there are both an increasing number of suits and an increasing number of severe suits. There have been some studies done in connection with an insurance company I do some work for. There have been some other actuarial firms that have done their own studies. I don't think you can get a statistical base large enough to draw meaningful, accurate data conclusions, but those of us involved are seeing more claims. Most of the claims we're seeing are smaller claims, and there seems to be a general increase in those. In my view, with a growing number of smaller claims, sooner or later there are going to be large claims. There are several large claims. Considering both small claims and large claims today, there are more in existence than there were five years ago.

I think that as far as pension work goes, compared to other actuarial work, I would have these observations: Most underwriters both in the United States and, I guess, primarily London who underwrite E&O insurance for actuaries, tend to believe that employee benefit/pension work is less risky than other types of actuarial consulting work. They do so to some extent because that's the underwriters' perception. If you ask for numbers, no one can produce them, but pension work is generally rated lower than other types of actuarial work, and I think it's more out of the underwriters' fear of other types of work. It's the casualty work they're always talking about, casualty companies that have gone down, and casualty captives that have gone down, and the risk associated with that. Everyone is worried about life work these days with the sort of spectacular failures of some of the big life companies and what that involves. More of the mergers and acquisitions have been involved, I think, in the life companies than others. So many companies have gotten burned on health work and health-related risk. I think there's just the dollar volatility there that they're concerned about. So it may be more of a jaundiced view of the other major areas of consulting.

Two things I think are going to change that. First, more and more pension/employee benefit consulting work seems to be done with respect to defined-contribution plans as opposed to defined-benefit plans. At least the plans seem to be increasing, and I think the actuarial professional is getting involved in some of the defined-contribution work. We're seeing a lot of claims out of that type of work. We'll discuss those characteristics a little later. A lot of defined-benefit plans are being maintained by governmental entities, whether they're school systems or states or municipalities, and that's making, I believe, and still does, a substantial percentage of the defined-benefit work. Second, there has also been a prevailing wisdom that the government generally does not sue their professionals. Governments don't hire you for the next contract period or the next valuation or whatever, but they generally do not bring malpractice claims, or historically have not. The most famous one several years ago was when the PBGC brought a claim against Buck Consultants which sort of went away – I think the PBGC actually apologized for doing that and went away. But I think that's changing also. If you look at what's happening in the S&L crisis with the FDIC and the Resolution Trust Company, it is becoming more acceptable for government entities to sue their professionals. So, I think that's also changing.

In summary, I think that malpractice claims are increasing against pension actuaries and that while the perceptions have been that you are the least risky of the actuarial fields, I think that is going to be changing.

MR. CUSTIS: Bill Hartman had a couple comments that he mentioned in some of the materials he sent to me. He pointed to a 1990 *Fortune* article that was somewhat of a follow-up to the actuarial profession being ranked first in the *Jobs Rated Almanac*. There seems to be more public disclosure and awareness of what actuaries do and what kind of money they make, giving a public expectation that these are professionals that do good work and, therefore, increasing the level of expectation in terms of the quality of the work product and also the awareness of all the various types of things that actuaries do. Clearly, as more people become aware of the profession, that increases the number of people who may question what we do.

FROM THE FLOOR: Are you referring to suits brought against the actuaries by plan sponsors or suits in which actuaries are named as co-respondents when plan participants sue the plan sponsors? Or both?

MR. JACOBS: Both and more. It's not only plans that are bringing claims (and they're serious) and/or participants, but also what are more third-party claims. In mergers and acquisitions work, an acquiring company or a bank will rely on a valuation to determine the amount of liability or unfunded liability. It will buy the company and find out there's a lot more and look for a source of revenue which will be sometimes an actuary. So, I think that's an increasing trend. May I ask a question?

MR. CUSTIS: Sure. Absolutely.

MR. JACOBS: How many of you are in a consulting type practice? Okay. (Large majority raised hands.) How many of you do work for defined-contribution plans? (About one-half.)

MR. CUSTIS: You touched on defined-contribution plan, Steve, but what general categories of problems and types of work seem to be causing the most litigation activity in general?

MR. JACOBS: Well, by far and away the greatest number of claims or actual lawsuits are from the defined-contribution area. I think the problem or the reason that defined contribution gives rise to claims is that there's no margin of error when you're working on a series of individual accounts. Someone once explained that the standard of care is perfection. I'm not an actuary, but if you're working on a defined-benefit plan, there's always a margin of error. Actual experience always turns out a little different than expected, and you adjust the numbers next year or adjust the contribution rate. With defined-contribution accounts, if there is a miscalculation and someone is paid out more than he should be, that money's gone; whether it's $20 or $2,000 or $200,000, it's simply not there anymore, and you're not going to find it. You can't just adjust things a little later. If, in fact, there were some balances supposed to be put in one type of an investment vehicle, and it is not put in that vehicle but rather put in another vehicle, and the vehicle it's in doesn't quite do as well, the money's gone, and someone's got to make it up. Generally it will be the consultant who's doing the work. So, it is my understanding that the trend in retirement plans is toward more defined-contribution-type plans, and that a number of consultants and actuaries who were working with defined-benefit plans are retooling their practices trying to figure out what type of services they can offer in that area. And, in my view, it is the defined-contribution plans that give rise to a greater number of claims than all other types of actuarial work combined. They are generally small claims. They're generally $1,000 or $5,000, but at times they can be a lot more substantial than that. So, I think that's one of the categories that's creating more work.

The second category that is creating more claim work for me is the general trend that, when there is a financial loss, people look for a source of revenue to fund it. This is prevailing both in society and business. You can blame anybody you want, I'm not sure it helps, but "if there's a loss or there's a problem, someone ought to pay." Someone is at fault, someone ought to pay. And I think when you're seeing shortfalls and underfunding in some of the retirement plans, there is more and more of a tendency for plan sponsors and/or plan participants to try to fund that shortfall through a claim against the professional, whether it's an accounting firm, whether it's an actuarial firm, whether it's a lawyer.

I think a third area is the problem with some of the life companies that were issuing annuities or contracts that were being purchased by some of the pension funds and what responsibility consultants and actuaries ought to have. Consultants are now being sued because they were involved in purchasing annuities from First Executive, even if their role was as small as setting up certain selection parameters. So, I think the thing that drives litigation is losses. To the extent we're in a society where there are more losses, there are just going to be more claims.

MR. CUSTIS: You mentioned earlier that you weren't an actuary. Well, most of us in this room aren't attorneys. Oftentimes our clients look to us to help them interpret laws or regulations, particularly Internal Revenue Code situations. As a natural adjunct

to what we do, we end up either intentionally, or more often inadvertently, offering tax advice. Is that an area that's likely to be growing?

MR. JACOBS: It is. From what I've seen, it's very difficult, if not impossible, to be a good consultant for a plan without both a knowledge of the tax laws and regulations that define the requirements of plans. And I don't think it is possible every time you've got a question about the regulations for you to say, "Go call your lawyer." Some questions are very obvious; and, as a practical matter, there are a number of plans that really can't afford to have a lawyer for every legal question or an actuary for every actuarial question, or an accountant. In the ideal world that would happen. Sometimes the world is less than ideal, and I think you do get into positions where you're asked about tax areas.

I think there are two problems facing you. First of all, if you're wrong, the next question is not whether you pay, but how much you pay. It is an area that is very, very difficult to defend. If you've given some advice about contribution requirements or the maximum contributions or top-heavy rules or rollover ability or all those myriad of complex rules and regulations and requirements and if you suggest or tell someone that he or she can do something, and, in fact, it is not proper and/or the IRS is going to take an opposite view (and sometimes it doesn't have to be improper for the IRS to take an opposite view), you're cooked. The plan sponsors will come back to you, and you mitigate your damages. You can argue that you weren't an expert, and the client should have known that, but once you give that advice in all likelihood you're holding yourself out as an expert.

The second area is that as professional service firms seem to be being squeezed, including the legal profession, lawyers are sort of jealously doing a little turf guarding. There was a lawsuit in Florida recently about what actuaries could do and at what point actuaries or other professionals were practicing law. There's a series of regulations or a series of tests all which bring new meaning to the term "the shades of gray between black and white."

I think I would suggest to you two safeguards: (1) If you're writing something, and particularly when you're talking, it doesn't hurt to tell your client, "I'm not a lawyer. I'm not trying to give you legal advice. This is my view as an actuary of the regulations." Now, that may sound a little bit like covering your posterior, but, in fact, they know it, you know it. Why not say it and put it down in writing? That will protect you in most cases from claims that you're practicing law without a license. It also may give you the benefit of some protection if the advice is sort of on the border. You can also indicate, "If you have more questions, you're certainly free to consult an attorney." (2) Don't be afraid to recommend and/or get some legal advice when it's a tough area. I'm not sure lawyers can interpret regulations and provisions any better than some actuaries who have worked in the area a lot. In fact, I think some of the more knowledgeable individuals on IRS regulations and some of the interpretations and some of the requirements are actuaries who deal with them all the time as opposed to a general practitioner lawyer. There's certainly some comfort in a difficult area to say, this is a judgment call or this is how I read it. Why don't you talk to your lawyer? So, I think that's another area that may be increasing.

FROM THE FLOOR: Steve, from the first two to three comments that you made earlier, it sounds like most of the things actuaries are getting sued over on defined-contribution plans, are things that might be classified as clerical errors?

MR. JACOBS: Yes, by and large they're math errors, clerical errors, allocation errors, and sometimes tax advice. By and large, it's clerical, miscalculation errors, and those are difficult to deal with.

FROM THE FLOOR: What kind of percentages do you have in those nuisance claims? We had a recent plan termination where annuities were continued under the old PBGC. That was before Executive Life, and the people were getting exactly what they deserved. One out of 37 sued and said he should have had new options. Never mind he signed an option that he wants a life annuity 10 years ago. Now he is going to die in two years. He had cancer, and now he wants 100% joint survivor which you should have offered him. Now, that case was settled for the deductible. The guy didn't have a case in the world. Our liability carrier said, "So, let's pay everybody's legal fees and forget it." By the time it would have come to a suit, the guy was dead. But what can you do to avoid being trapped in those nuisance suits where they get settled for the deductible, and everybody knows that you can't afford to fight it?

MR. JACOBS: I think I agree with the way claims are being handled, but whether it's right or not is another issue. Most claims are put into one of three categories. The first is there is no merit at all to it. We're going to either get rid of it or settle it the cheapest we can, but it's going to be done cheaply. It's sort of buying it off. The second category is those claims where there is some question, and there is a plausible claim. There's a question about damages, but they're neither enormous nor inconsequential. Those cases tend to get argued for a while, litigated for a while, and usually resolved. There's a third category in which no quarter is given, that you're not settling, period. These tend to be either (1) perceived very frivolous claims where companies have to take a stand and/or (2) enormous claims where you can't afford to pay them because at eight or nine or ten figures you can't deal with them.

As companies are involved in more and more litigation, I see a decrease in defending to the hilt frivolous claims because of the cost and the inconvenience factor. Often the first or second time through there's no quarter given. We didn't do anything wrong, and we're not paying. And then there's $15,000 or $20,000 worth of legal fees or more. Consultants who want to be out practicing are spending their time in depositions. Management who wants to try to be managing a professional services firm spends more time managing some litigation. At the end there's not a lot of satisfaction in winning when the person goes away. I think after a couple of those experiences, most firms tend to try to realistically assess it and deal with it as cheaply as possible. Now, if "cheaply as possible" means paying them off early, I think that's done. There's a question of whether that encourages future suits. I don't know that it does, but I see the amount of settled claims being increased particularly as firms have more and more exposure to it. I can tell you that it gets less irritating as time goes along, but it doesn't make it any more right.

MR. CUSTIS: That depends on whether you're the attorney or you're the company that's paying off those small claims as to whether it's less irritating or not.

You indicated earlier, Steve, that the actuarial profession may even be riskier than other professions. Do you want to talk about that a little bit? What are some of the characteristics that make that so?

MR. JACOBS: I think these are the characteristics that make your profession more prone to litigation:

1. lots of money involved,
2. predict the future,
3. judgment calls,
4. mathematical calculations,
5. jury system, and
6. third-party liability.

The first and foremost characteristic is there's a lot of money involved, and that's what drives the legal system. It drives contingency fees. It motivates lawyers. It motivates other professionals or experts. It motivates insurance companies. My own personal view is that insurance companies would rather see more premium dollars and bigger claims because they'll get a bigger piece out of it. I have probably insulted some people already, but I think there's some truth to that. It is an enormous financial system, and when you're doing work like a lot of actuaries do, there's a lot of money at risk, where there's five, six, seven figures and more projecting out in the future and trying to determine contribution levels. You can be millions of dollars off and not "wrong." When I say "off," I mean developing experience is different than your projections. Lawyers see a potential loss, and they calculate what their fee will be on that. They'll spend a lot more time on a $5 million loss than on a $5,000 loss and I don't apologize for that. I think there are some very sound characteristics to the legal system. There are some good reasons for contingency fees. But even if you disagree with the system, that's what you're going to be dealing with for the next 20 years; it's not going to change. It is too big of a system in my opinion to change, rightly or wrongly.

Actuaries predict the future. Well, that's not really what you do. I think you make assumptions about what future experience is going to be, based on historical trends and assumptions and try to view things and try to determine what investment returns and what sort of mortality and what sort of retirement rates and things like that will be. But you are looking into the future, and by necessity what actually happens will never be exactly what you predict it to be. There's always going to be a difference, and that's the difference you're going to be fighting about. It's the nature of your work, and if you believe that the actual retirement benefits paid out over the course of the next two years is going to be $27 million and, in fact, they are $32 million, why, you may think that's good given the volatility of the work force or something. The plaintiff's lawyer's going to see you being off by $5 million, and how can you be off by $5 million unless you screwed up royally?

You have to make a number of judgment calls in your work. That's the essence of a professional. You may make 50 judgment decisions over the course of a substantial valuation or a large assignment. You may make 49 very well. The 50th, there's a question about -- that's the one you're going to be talking about.

It's the same with math errors. When you do a lot of work, there's just going to be some margin of error. You're going to get up in front of a jury, and you're going to be lambasted about not being able to divide or multiply or putting people in the wrong age category or doing something like that. When you look back over the whole assignment you say you can't be 100% perfect, but you focus for a week on a math error, and you talk about billing rates and why you're billing $150 or more an hour, and you're in trouble.

I have two views about the jury system. One is that, in my own personal view, it is the best thing that's ever happened to our country, and I know a lot of our freedoms and the better things in life reflect that. My second opinion is, though, it is not the best system for trying to make a decision on whether a complex actuarial project met an appropriate average standard of care of your profession. The jury doesn't know. It never will know. The jury will know you were $5 million off. The jury members will know that, any time they're more than $5 off, they've made a mistake. So, they will know at the start whether they think you've made a mistake.

Another area is third-party liability. There is a very substantial growing trend where third parties, not your clients, have rights to sue professionals. An easy example is a client comes in, I write the client a will, I screw it up horribly, and instead of leaving the estate to the client's son I leave it to the fire department or something -- it just makes no sense. The client dies. The son doesn't get the inheritance that he should have. He has a right to bring a claim against a lawyer for making a mistake like that, even though he was not the client. That's the type of third-party claim that makes sense. It has now gotten so that anybody in most states who foreseeably could look at your work and rely upon it has a right to sue you. That creates all sorts of problems. Your client can understand what you're doing. Your client can be happy with the work. A bank that gets the work and says it relied on the work and made a loan to your client and the client went under will think of all sorts of excuses, of questions it didn't ask. You and your client are privy to discussions at times to expand on your work. A third party will not do that. Your client will recall the 47 times you got the client's work done, and you put in an extra effort, and the 48th time, when the work is less than perfect, the client will not automatically think of bringing a claim. Most third parties will. I can tell you that we've recently looked at a series of five serious claims involving actuaries that are pending, and all of them had the potential of in excess of $1 million, some a lot more. Of the five, four were third-party claims, only one was from a client. So, I think that's an area that's going to be more and more troubling.

MR. CUSTIS: Anybody else have some additions? Bill did, and so I'll share those. He mentioned that oftentimes, particularly in the pension arena, we may be actually operating with a lack of full knowledge of what's going on with the company. Perhaps our client company has been a client for a while, and it may be having some sort of financial trouble or have a lawsuit pending that we know nothing about, that we don't reflect in any of our assumptions. That may have a bearing on the results down the road, and because we don't have that knowledge, some of the assumptions that we make may have been different had we had that knowledge. We've all encountered situations where we don't have complete or accurate data, and how we deal with that may look a lot different in hindsight than it did at the time that you're making some kind of assumption as to missing people or missing ages or whatever.

So, that's another area that increases risk. Steve mentioned a judgment area, and Bill also picked up on that. We are making numerous judgments, oftentimes with regard to technical matters where there really is not clear external guidance either from regulations or professional standards or whatever. We're out there on the fly making a judgment as to how to deal with a particular situation in a particular arena, and we are the professionals expected to make the right judgment in that situation. And, finally, a good one I think is that Steve mentioned the fact that we're dealing with very technical, complex, mathematical concepts, and it is part of our job to communicate that effectively to the client. Oftentimes the nature of the variability or the nature of the technical complexity simply isn't well-communicated, and it's not so much the nature of the work that gets us into potential hot water but the fact that we haven't communicated well the results that we've arrived at. So all those things really add fuel to the fire. I don't know if anybody else has ideas that make it even that much worse.

FROM THE FLOOR: You haven't touched on some of the areas that I think have caused some problems: union bargaining, and not only multi-employer plans but also single-employer plans. An actuarial firm may be doing something where you're making calculations under pressure, and maybe you haven't factored in something or you don't have all the facts. Things are always under the gun, the numbers are there, and the next year if things don't come out according to the actuarial predictions or experience deviates from assumptions, quickly plan sponsors want to turn and tag the insurer.

What about this idea of the protection that we do have with the insurance? Are we going to get to the point where our pockets are too big? I'm aware of a few instances where maybe because the pockets weren't deep there wasn't a lawsuit. The actuarial firm was not a consideration, and it was only because it was such a small amount to be gained there it wasn't worth it, and the plaintiff would go along and pursue other parties. I wonder if you might touch on that.

MR. JACOBS: Sure. There have been two or three claims and I'm not sure any have ripened into a lawsuit yet, but I think there's been at least one settlement. There are cases where you are representing a plan, and it may be corporate-sponsored or a Taft-Hartley plan where there's both a management and a union actuary. You're involved in collective bargaining, and someone calls you up at nine o'clock at night and asks what it will cost to offer an early retirement subsidy going back to age 40 or what it will cost to offer this benefit or what can we save by reconfiguring this type of benefit? And you're sitting there on the back of an envelope trying to do some figuring. You can't really say, wait, I'll get my staff on it in the morning, and we'll Federal Express the next day. You'll be told I don't need it then, I need it in an hour. We're going back in 25 minutes. Everybody's taking a coffee break or something. I think the only thing you can do in those cases are two recommendations: (1) Make certain that you understand what is being asked. That situation is ripe for miscommunication. I didn't really mean all of the early retirement subsidy, I only meant part of it; or I really didn't mean a complete cost of living adjustment (COLA) increase, all I meant was half or something like that. So, make certain you clearly understand what's being asked. (2) You've got to have a comfort feeling with your client. That's a risk. Your client is asking you to take a risk, to give some quick advice in a tough situation. The only way to deal with a client that you

think is likely to come back and look at you the wrong way, if it is less than perfect advice, either don't give it or give it in such a way that it can't be misinterpreted. You can also add statements like, "it's the middle of the night," "this is my best estimate," "I don't know if it's right," and all those type of things, and that doesn't hurt, but you've got to know your client. I think that's really one of the keys, and one of the things you should do in malpractice avoidance is not do some work and not work for some types of clients.

The second question was the amount of malpractice coverage, and can you have too much? That is a question that is asked every time people are deciding how much to buy and how much they can buy and how much is too much. If you ask people from the insurance industry, they'll say "Well, how much do you need? Think of the worst disaster you can have and get that much."

I think in some ways you can be a too attractive target. First Executive had a shortfall of about $800 million or something like that. I'm not suggesting to work in that area you need $800 million worth of insurance. The megasuits are the suits that are going to get all the publicity, everybody's going to read about them. I think the real cost to you is not the $25 million suit. The real costs are the 25 $1 million suits or the 50 $500,000 suits. That is going to be the overall cost. I would certainly never practice as an individual with less than $1 million or more, and if you are in a good size firm, I can't imagine doing it with anything less than $5 million worth of coverage. As you get bigger you can layer up, and the higher layers are the cheap layers. But $1 million won't get you very far. It'll bankrupt you if you're a solo practitioner if you have to pay it yourself, but I would certainly, as an absolute minimum, do that.

MR. CUSTIS: Okay. This is perhaps maybe the most important question of the day. What can we do to lessen these risks?

MR. JACOBS: I've got one more list:

1. engagement letter,
2. report writing,
3. client selection,
4. prerelease peer review, and
5. malpractice awareness.

First, let's discuss engagement letters. One of the most important aspects, I think, of any professional relationship is an understanding of what your client is expecting you to do and what you're doing. That defines the relationship, whether it's in writing or an oral understanding or a handshake. It's a contract that will form the scope of the parameters of what you can be sued about. An engagement letter is nothing more than putting in writing what you're going to do and in some cases what you're not going to do. It does two very important functions. First of all, to the extent there's some potential misunderstanding at the start, you get it cleared up right away. For example, data. There are always data problems. What duty do you have as an actuary to deal with bad data? Are you going to recheck all the data? Are you going to subject data to a "reasonableness" check? I haven't figured out what that means, but everybody seems to say we check data for reasonableness. Are you going to do

nothing? Are you simply going to accept the data the way they are? Whatever you're going to do, put it in a letter so that there's an understanding with your client at the start about what you're going to do. If you're not going to recheck data or you're not going to do some sort of a reasonableness review, put it in a letter. Your client can then say, "Wait a minute, I thought you were going to check the data." You can get back and say we can, but here's the added expense, and then you can decide. You generally include fee arrangements, what sort of work product is to be given, and any sort of limitations. If there's going to be a misunderstanding, find out at the start. The second aspect, and maybe from a litigation management as important, is down the road. The letter will serve as a written record of what the deal was. You would be surprised, five years later in a lawsuit, how people's memories can change, differ, fade, and do other things. If you're not going to check the data, don't leave yourself open to a client five years down the road or 10 years down the road saying in a deposition, "Well, I'm sure he was going to check the data because, in fact, I remember a call, and he asked me about some anomaly with data, so I assumed he was checking the data." Get it down in writing at the start.

Number two is one of the keys when you're putting out a report, whether it's a valuation, whether it's a study, whether it's a one-page letter on your findings, be careful about what you write, and make sure it's well-caveated and limited. When an attorney is deciding whether to bring a claim against you, the first thing he or she will do is read your work product, your report, and that will form generally the initial decision on whether to pursue a claim. It is in that report that you can explain, limit, and do all sorts of things that will survive.

We talked about third-party liability. If you put in your report, "This report is intended only for (the client), it is not to be reviewed by or released to or relied upon by anyone else, only (the client) will understand it," it is unlikely that you will have third-party liability problems. If you don't put that in and the report gets out, then you're going to be arguing in front of a jury about whether it was reasonable for you to foresee that the report would get out. If you have in your report, "we did not verify the data," "we did not check the data," "we assumed the data were correct," "to the extent the data are inaccurate, our results will be inaccurate," you're in a lot better shape than if you're arguing about, down the road, what you should have done or what the standard of care was for data review. What is absent is an actuary's duty with respect to client data on a valuation. What's the standard of care in your profession? My sense is that there is no well-defined standard of care that is generally articulated. Nonetheless, you can limit 80% of your judgmental-type liability by careful report writing. It doesn't take that much more time, and I think it's a professional thing to do.

Regarding client selection, you've got to be careful for whom you do work. What brings lawsuits are financial losses, for the most part. When there's a big loss, people try to figure out how they can recoup it. More and more of those people are going to lawyers, and more and more of those lawyers are looking at professionals. If you're in a situation that it appears likely that it is a troublesome client, that there's a lot of financial risk involved, that's a tough situation. Think about it before you undertake it. If you do undertake it, be particularly cautious.

Some clients are simply more litigation prone. If you've got a client that is constantly suing everybody, you're next on the list.

Regarding internal disputes, at times lawsuits are a way of one group in a business dealing with a problem with another group. If there's a client where the controller's not speaking to the treasurer or the employee benefit manager, be careful about that.

One item I should have added are fee disputes. Nobody likes clients that complain about fees. The legal business is no different than anything else. I think you're always going to have some questions, but some clients complain about every bill or every other bill, and you put up with it. "Why did it take so much time?" and "I thought it was going to be less." Those clients are going to be much, much more prone to sue you. They constantly think they're being overcharged, and the first time you make a mistake, they think they've been gouged for the last seven years, and you're paying for it. I'm not talking about the client that once in a while will have a question about a bill. Everybody does. Chronic complainers are chronic litigators. The other phenomenon is, if you have a client that is continually complaining about its bills, you might say, well, let's take a little shortcut and we'll try to do the work for a little less. We won't do this study or we won't do that. It's worse. Then you're giving that client an excuse. I understand there's business concerns, but that's a problem.

I think Tom's in charge of prerelease peer review for his firm. More and more firms are having a second person review work product before it goes out. Having established standards cuts down on a lot of problems, a lot of errors, particularly when people do a fair amount of prerelease peer review. It's a fresh look. It is a look to see whether not only the work is done properly, but also whether it's written well, with caveats and limitations. At least in my profession, when lawyers are doing work they know are going to be reviewed by another lawyer before it goes out, sometimes it gets done a little more carefully. So, I think that's important.

Your profession has to become more and more aware of malpractice, the problems, and how to avoid it. We used to never talk about malpractice. We didn't want to think about it. It was the guy down the street who didn't do a very good job who had to worry about it. So, we didn't talk about it. If there was a claim, it was sort of hush-hushed and dealt with. That's the worst thing to do.

Malpractice is a problem. It's a business problem. It faces every professional. You'll either deal with it like a business problem, make people aware of it, how to handle it, and reduce your costs, or you'll pretend it isn't there. And, like other business problems that you pretend aren't there, it will only get worse. My own firm went from not mentioning malpractice to not only having a formal program set up, but also we have monthly meetings, and it is a part of every single monthly meeting. I think any professional service firm that doesn't have an active malpractice program is malpracticing, per se. You have to become aware of it. People handle it better, and it's not just the managers -- it's the people down on the firing line who have to be aware of it. They have to catch problems, they have to know how to handle and deal with them, and have to treat them as a problem as opposed to some unmentionable thing.

It is my understanding that some of the medical specialties spend 20% of their gross revenue on malpractice. Some of the big auditing firms spend 4% to 5% to 6%. Law firms spend 2% to 3% to 4%, depending on how you count. The actuarial profession is substantially below that now, but as I look at your risk characteristics -- what makes you attractive targets in a lawsuit -- you're right up there with a lot of medical specialties, certainly accountants, certainly lawyers, and there's no good reason that over time you, too, can't get into that higher category.

I think as a profession you've got to really look at malpractice and start dealing with it effectively. I think if you do, you can substantially reduce the ultimate risk and the ultimate cost. The other professions, for the most part, have been reactive. It's come on, and now they're going to do something. The doctors are marching or the accountants are doing things. I think you have an opportunity beforehand to look at some of the things and deal with them, but you've got to do it before you're up with everyone else. That's not where you want to be. Trying to reduce it is a lot more difficult than keeping it down before it gets up there.

FROM THE FLOOR: Steve, do you find very small firms with three or four or five people incorporating just to limit liability? Or even saying to an employer, put me on your payroll and then take me off the payroll three or four months later?

MR. JACOBS: I don't have as much knowledge of small actuarial firms. As far as incorporating, that is generally a way to avoid the individual partners having liability. It does not shield the individual who has done the work and in some states doesn't make any difference. I'm from Wisconsin. In Wisconsin, even if you're a service corporation as opposed to a partnership, each of the principals is personally liable for malpractice up to the limit. So, I think generally small firms ought to incorporate for a variety of reasons, not just for malpractice. However, incorporating is not a complete bar. I think what you've got to do is get some insurance. I have not often seen people getting on the payroll. It would seem to me that, if you have that type of a relationship, you could either do that or you can reach an agreement with your client that you will not be liable for malpractice. Now, a lot of clients are sometimes loathe to do that, "It's a big assignment. I'm sort of like an employee. You wouldn't sue your employee if he made a mistake. I'd like an agreement where I'm not liable for malpractice." That is only good for your client. It is not protection against third parties. In certain circumstances, a lot of larger firms are using hold-harmless agreements in high risk areas. Investment bankers for years, when they've done merger and acquisition work, have only been liable for fraud, or perhaps for gross negligence, not ordinary negligence, and there's a big step up. So, I think you can do those type of things more and more for high risk areas.

FROM THE FLOOR: To what extent would an actuary have an obligation, as far as malpractice is concerned, and maybe perhaps as a general matter of professional ethics, to walk away from a client who consistently disregards the actuary's advice? For example, if you're providing advice to a municipal plan regarding funding of its plan where the federal standards regarding adequate funding are not applicable, and the municipality consistently disregards your advice, no matter how dire the warnings you make in your report are about the eventual consequences of this, does your continuing to provide professional services to a client like that set the basis for some kind of complicity in the underfunding of that plan?

MR. JACOBS: We've been there. Generally, the answer is legally no, as long as you've documented your advice. You've recommended this, and you understand the client hasn't done it, and it's on record, and you're on record. If there's fraud involved, then you've got to get out of it. But if it's just basically the client doesn't take your advice, as long as your reports are clear and your correspondence is clear, legally you should not have a problem. But I've got to tell you, sooner or later that client's going to be in a big problem, and once there's a problem, the chance of a claim being brought against you greatly increases. Anyone who has been through a malpractice claim, whether the individual wins or loses it, would rather not have taken the assignment. So, I think that at some point those are the type of clients you've got to say, listen, we can't work for you anymore.

FROM THE FLOOR: This is a comment on the disclaimer that we actuaries take on the accuracy of the underlying data. I think that in your client selection it's a good idea to have a smell test as well because you may put in a disclaimer on the accuracy of the data. If the situation is egregious enough and the plaintiff goes after deep pockets, the plaintiff will say you knew or should have known that the data were incorrect. In other words, you should have smelled a rat. The firm I was with 20 years ago was involved in that situation. I recall going through that to determine that, indeed, there were other companies that had the same rate of growth as this company that phonied up its records to show its gross was greater than it really was. Had we gone to court, why, I think State Farm and IDS Life both had for real the same rate of growth, so I didn't even smell a rat in that case. But it's very important to realize that, even though you take a total disclaimer on the data, it's still a good idea to see if they make sense.

MR. CUSTIS: That's an excellent point. In fact, Bill Hartman makes the same comment. He states it even stronger. He says posture that all data supplied to you is suspect, treat it as such, and if you have trouble getting data, there's a good chance that ultimately there's trouble down the road, and walk away from it. So, data obviously are a real concern. I have a couple other interesting points that Bill throws out that I think are worth sharing. Beware of the spot assignment. When you have an ongoing client relationship, in many cases you have the opportunity to perhaps redirect or correct what might have been a misinterpretation or a mis-communication. If you're involved in a spot assignment, and you have no relationship before or after, that can be a situation where maybe what you did in that very narrow context was correct, but situations change after the fact. You have no opportunity to know about that or to correct it or to readvise your client. Clearly make sure that you limit your obligation to advise the client based upon any subsequent changes.

On the flip side Bill said, watch out because sometimes you get too comfortable with client relationships. Remember that even though there may be a long-term relationship that sometimes people, individual people on either side, either within your staff or on the client's staff, change. Therefore, some of the understanding and background may not be the same as it was before, and these can lead to errors of carelessness or miscommunication. And a third point that Bill touched that Steve didn't really go over is, we all use computer systems, and we all try to make things as efficient as possible. We need to be careful that we don't introduce into some circumstance a systematic error that isn't picked up, and we set something up wrong the first time, and we just keep repeating it and not going back and rechecking. If

you make an error once, but you catch it the next time in a valuation or whatever, you can fix it, but if you keep making the same error over and over, the problem is going to tend to grow, and obviously you're going to be in a worse situation.

FROM THE FLOOR: Have there been any judgments, decided cases, jury awards, in the malpractice area against pension actuaries? You haven't said.

MR. JACOBS: There have been, to the best of my knowledge, three actual judgments and over a half-dozen settlements in excess of $1 million, maybe more.

FROM THE FLOOR: Could you tell us something about them? Where? What happened? And so forth.

MR. JACOBS: Let me try to describe them generically; some of it's privileged information. There was a company that had been phonying up its records. There was an enormous amount of money involved. There was a claim that the actuaries should have known in doing their work, as well as everybody else, that the data were phony. Everyone else settled out of the lawsuit. The actuarial firm was faced with a potential of $100 million worth of liability. There was $15 million worth of insurance, and it got settled. There has been a claim in the defined-contribution area, a lawsuit, where there was a misallocation of a stock. The actuaries involved were supposed to allocate a certain amount of contributions into the employer's stock. In fact, it was misallocated into a mutual fund. The employer's stock took off like a rocketship. It quadrupled before the actuaries caught the error. The shares had not been bought. There was a total settlement between the actuaries and the others of less than $1 million. There was a claim in the casualty area recently. It was an acquisition of a business. It was an acquisition of a block of policies dealing with a variety of various losses. It was some old casualty occurrence policies written by managing general agents in the 1980s. There was a valuation put on it by an actuary. One company bought it. Losses were a lot worse. The case is still pending, but I know that one of the firms involved will pay well in excess of several million dollars. It was the same type of a business acquisition, although it involved a small group medical insurance, and there was a question of bad data. There was a valuation put on what the runout on the losses would be, and the runout on the losses was considerably higher because of a lag time, and the settlement involved was exactly $1 million. There's a case involving Petromark that's pending in the courts. It's about a captive insurance company that was established as a risk retention group for insuring underground gasoline tank owners from environmental cleanup cost. That went south. There's now a $10+ million claim against the actuaries there. It's being actively litigated. Those are, I guess, the large ones I can think of at this point. They seem to be increasing.

FROM THE FLOOR: Steve, along these same lines regarding those actuaries or actuarial firms who are wise enough to purchase malpractice insurance, can you tell us anything about any case or the number of cases where a suit has gone and a settlement has been arrived at where the amount of money -- forgetting about the deductibles on the front end -- exceeded the amount of insurance?

MR. JACOBS: Okay. I don't know of any cases where that's occurred. I'm not as familiar with very small firms that might only have $100,000 worth of coverage.

Generally, all of the large awards I've been aware of have been covered by insurance, and that's really for one or two good reasons. First of all, most plaintiff's lawyers will settle for the amount of coverage or less, even if they believe their claims are a lot more. Unless you're talking about very large firms, the net worth of a professional service corporation is some desks and pencil sharpeners. There's not a lot of ongoing asset net worth in most law firms. Trying to chase a service corporation or chase a bunch of individual partners for any large amount of money is not worth it. The flip side, unfortunately, is also true. A lot of professional service firms will settle to keep the potential within their insurance coverage. If a firm had $10 million worth of coverage, and there's an $80 million claim, a lot of times people will get around it and say, we're not liable, but we can't bankrupt the firm. That's the one thing we can't do. So they will accept what they all consider to be an unreasonable settlement simply to avoid an uncovered liability. Then there's fights between the layers of insurance. The upper layers are always trying to cram down the settlements and force the lower layers to pay their limits.

MR. CUSTIS: Steve, one of the issues that comes up, particularly on the pension side, most importantly is the whole concept of, is the consulting actuary a fiduciary for ERISA standards? Is that a big issue? If so, are there things that we should or could do to avoid that situation?

MR. JACOBS: I have a little bit of a minority view on this. I don't think it is a big issue, but there are a lot of lawyers who do. There have been some recent favorable decisions, I think, that helped pension actuaries. By and large the courts have recently been holding that, if you are doing what a consulting actuary will normally do with a pension plan -- determining liabilities, filing the schedules with the government, doing the valuations -- you are not considered a fiduciary. The problems of being a fiduciary are that you can be sued in federal court. There is, in some instances, a slightly higher standard of care. You have fiduciary liability. Your best efforts have to go to the plan participants. The plan participants can sue you in court. And I think there's a general sense that, when you're being sued as a fiduciary, you somehow have a higher standard. Courts view you as more than just a service provider. You have a legal trust for your clients.

Whether or not you're a fiduciary, you can be sued for malpractice. You can be sued for making a mistake. You can be sued for breach of contract so that, whether or not you're a fiduciary, you're still subject to suit. You don't want to be a fiduciary. I don't think it's as harmful as other people feel, but certainly it's not a positive aspect of liability.

I think in your engagement letters you can indicate that you're a service provider. First, you are not going to be a fiduciary, and the plan should not consider you a fiduciary, and I think that will help certain circumstances. Avoid situations of actually being the one to control assets or too much in control or management of the firm. You have to have discretionary authority, discretionary control, or control over assets, and it's a fact test. I think the best way to avoid it is to, at the start of the engagement, indicate that you're not a fiduciary and have your client agree to that. Now, some court at a later point in time can overturn it, but it's a lot more difficult.

MR. CUSTIS: Any comments or questions on the fiduciary issue from the audience?

MR. JAMES E. HOLLAND, JR.: I thought that issue has been settled. The actuary is not a fiduciary.

MR. JACOBS: That's right, but you can get in situations where you will be held to have exercised a certain degree of control and authority. In the recent case, the court said there was no unusual exercise of authority or control, but if you seem to be able to direct plan assets, you seem to be the person who automatically okays payment of assets, you seem to be more involved in asset allocation, there's a possibility. I think by and large it has been settled. Nonetheless, my recommendation is in your engagement letters have a clear statement that you're not a fiduciary, and that ought to protect you as much.

MR. HOLLAND: The other thing that I've observed you might want to mention or comment upon is that the pension advisor (actuary, attorney, or whatever) is actually engaged on behalf of the plan participant and has no privileged communication from the employer. If you look at the Gulf litigation, the internal memos and everything were held not to be privileged because of this relationship.

MR. JACOBS: Who is your client? That's right. Yes, there are some lawyers who are painfully aware of that at this point. There's always a question of who exactly your clients are. You are usually engaged by a plan sponsor. Sometimes if it's a corporate-sponsored plan, it will be the company, the plan sponsor, the financial vice president or the head of the human resources department. In a jointly administered Taft-Hartley plan it's the trustees. Lawyers always thought whatever they said was privileged. They could say anything they wanted, and it never would come back. That has been not the case, particularly in claims brought by plan participants, so that you should also be aware, even when you're dealing with a plan lawyer, there's no more "off the record" statements or "off the record" discussions. They'll be brought out in court.

MR. CUSTIS: The actuarial profession, by means of the Actuarial Standards Board, over the last few years has been and continues to be actively involved in promulgating formal standards for actuarial work. Some are particular to pensions and some are general. Several questions arise with that in light of the litigation risks. Do these tend to help in a manner in which they provide guidance to avoid practices that we consider negligent, or conversely, do they create additional risks?

MR. JACOBS: I don't know if there are any members of the Standards Board here.

MR. CUSTIS: Bill Hartman, by the way, is a member of the Standards Board, and he has a couple of comments. Bill's perception of the feeling of the board members is that the intent of the standards is, in fact, to provide some guidance to assist in the nature of making some of these professional judgments. They encourage the input and review of exposure drafts. He didn't specifically come out and speak for the Board, and, in fact, he said he was not speaking for the Board. The Board recognizes that the standards will limit the range of acceptable practice. The standards are not intended to be a cookbook or to be overly restrictive but, rather, flexible guidelines, and he sees this as an evolving thing. He does not comment specifically on the issue

of additional risks, but from his perspective would hope that the standards would be helpful.

MR. JACOBS: I will risk getting into a disagreement with the Standards Board. By the way, the Standards Board understands the potential relationship between the standards and litigation risks and the problems, and it's a difficult issue. What I would encourage everyone to do is to be actively involved with the Standards Board and actively encourage its members to consider and deal with the litigation risks inherent in the standards. Let me tell you why. The question of negligence is whether you fall below the "standard of care," common or average standard of care, exercised by the profession. If your conduct is above that standard of care, then you're not negligent. If you are below that standard, whatever the common standard is or the average standard or how ever it's defined, then you're negligent. The law says the profession itself will decide what's negligent. So, here you have the profession, and this is zero and a hundred, and let's say here's where the average standard of care is. It's a hard concept in legal theory. I don't know whether it helps or I butcher it even more. The way it stands is, right now if your practice was in this area, you're negligent, which means you pay dollars.

Now, how do you define what the standard of care is? Well, you go out and hire experts, and if you can hire anybody who calls himself an actuary and has some sort of a letter or two behind his name and for $200 an hour will get up on the stand and tell the jury here's the standard of care, he gets you to a jury. Then the jury decides, listening to all these people, what the standard of care is. Professional standards, like those of the Actuarial Standards Board, do not automatically define this line. But they are very strong evidence of what the standard of care is. If there are written standards from a professional body, they go a long way legally to defining the standard of care, and in most jurors' minds it does. If you fall below the written standards, your goose is cooked. If you meet them, sometimes it's safe, and sometimes it's not, but it really does define that line. All the plaintiff's attorney has to say is, do you want to know what the standard of care is? Here's the booklet. This guy didn't meet what the Board said he should, and he's saying it's okay.

You take that, and then you try to define what the Standards Board is trying to do with its standards. Some people believe it's not only to try to define where the appropriate standard is now but also to try to elevate the profession, to try to draft those standards that will bring the profession up to higher levels of practice. I think that's probably a very worthwhile goal. But let me tell you what it does as far as litigation. It raises it up to here, and here's the Actuarial Standards Board, and let's say the Standards Board is at 80. It is trying to get the practice up to where the top 20% are now. The Board members think they can do it and define it. What they have done by doing that, and they may raise the entire practice of the profession, is just defined this whole area below as negligence. That's a problem, and I don't know the answer to it, other than I know that's true. I don't know where they're going, but I know what's below it is certainly fodder for the plaintiff's attorney. I know there is a belief that a lot of the Standards Board members feel that they owe the public an increase in the standards. I don't know whether that has an inevitable cost; I don't know whether you've got to do it because that's what you need for the profession to survive. I don't know whether that's a problem no one thought about and everybody's going to pay down the road. But it's something each member of

the profession ought to be thinking about and asking about. I think the Board is becoming aware of it, also.

MR. CUSTIS: Yes, I again encourage people to review these standards. I've gotten into this in a couple of the more recent proposed standards, and a lot of times you'll give one of these standards your reading over, and you'll say, well, yeah, that sounds good, and those are things that we try to do. You need to read it from a little bit different perspective. You need to read it saying, "If I don't do every single thing that's in that standard, am I going to be prepared to sit in a defense seat and defend my actions if a plaintiff's attorney waves it under my nose?" Like Steve says, you may be doing 99 things out of 100 exactly in accordance with the standard. The plaintiff's attorney isn't going to comment on those 99. It's the one that you didn't follow in the standard that's going to be coming up in front of you. It really does change the perspective of how you need to read and review these standards, and once they're issued, you better be aware that they're out there because if you're not following them, that risk really does exist. So, to the extent that they have been promulgated and they do exist, by all means be aware of them and adjust your policies and procedures so that you're complying with them.