SESSION 6

ACTUARIAL MALPRACTICE: AN ANALYSIS OF THE LEGAL IMPLICATIONS OF THE VALUATION ACTUARY CONCEPT (U.S. SESSION)

MR. GARY D. SIMMS: I will offer a brief review of the development of the valuation actuary concept, various aspects of current regulation, and major features of the valuation actuary concept as proposed to date. Following that extended introduction, I plan on discussing the nature of professional liability and the specific legal liability of the valuation actuary. I will attempt to point out some methods of limiting that liability. The remarks and views I express today, while thoroughly accurate, are not necessarily those of the American Academy of Actuaries or of any other organization.

The concept of a valuation actuary in the United States is, in a word, revolutionary. As with almost any revolutionary concept, the implications of its implementation cannot be accurately gauged a priori. While those who undertake careers in actuarial science are accustomed to making projections based on existing data, attorneys are far less comfortable voicing opinions about future events. This limitation on the value of legal forcasting is a critical disclaimer for purposes of this analysis.

DEVELOPMENT OF THE VALUATION ACTUARY CONCEPT

After several years of preliminary discussion, the Joint Committee on the Role of the Valuation Actuary in the United States was established by the American Academy of Actuaries and the Society of Actuaries in December 1983. The Joint Committee was charged to define the appropriate role for the valuation

actuary in the United States, as well as to determine what steps and mechanisms would be required to effect the implementation of the role.

The evolution and eventual implementation of the valuation actuary concept in the United States is a project that transcends all internal actuarial divisions and includes the input and participation of the insurance industry and its regulators as well. One actuarial pundit has described the process as a "seamless web," an apt smile for the myriad activities so inherently interrelated.

It is clear that one focus for the implementation of the valuation actuary concept lies with the National Association of Insurance Commissioners (NAIC). The interrelation between the NAIC and the state departments of insurance is ad hoc in nature. In order for NAIC models to be given legal effect, they must be adopted by the individual states. The Standard Valuation Law, adopted by the NAIC in 1942 (and repeatedly amended since that time), provides each commissioner of insurance with authority to do the following:

- Require an annual report from life insurance companies doing business in that state.
- Certify to the reserves of those companies.
- Specify mortality tables, rates of interest, and methods used to calculate reserves.

The act itself is silent with regard to any certification of the reserves by an actuary. This lack of a clearly established regulatory basis for the use of the annual statement blank leaves the blank (and its critical instructions) in something of a legal twilight zone. And that is critical here, because it is a change to the actuarial statement of opinion that lies at the legal heart of the valuation actuary concept.

PROPOSED STATEMENT OF ACTUARIAL OPINION

The heart of the valuation actuary concept is the new revised statement of actuarial opinion. Ultimately, the valuation actuary is to be responsible for the setting of assumptions and the establishment of reserves that, in his professional judgment, are appropriate. Guidelines for the selection of assumptions would be provided through the actuarial literature (that is, articulated principles and standards). The proposed statement of actuarial opinion would, on the one hand, continue to include a legal solvency requirement and, on the other hand, would also include the newer statement of opinion on cash flows.

In reviewing from a legal perspective the language of the proposed revised statement of opinion, the most significant change is the deletion of the current reference to "good and sufficient provision" and the addition in its stead of a new paragraph in the opinion section that lies at the core of the valuation actuary concept. Phrases such as "anticipated investment cash flows," "appropriate provision," and "presently accepted standards of practice" introduce new terms into the literature and should be carefully considered.

The phrase "anticipated investment cash flows" underscores the fact that the valuation actuary will be looking at the asset side of the balance sheet, with all it implies.

"Good and sufficient" language, which has appeared for some time in the NAIC standard opinion, implies, at least to many actuaries, a degree of conservatism beyond minimum legal requirements. Others do not share this point of view. From a legal perspective, the phrase "good and sufficient" has not been defined

specifically in the insurance financial reporting context. In other legal contexts, the words have not been defined standing alone, but only in connection with other phrases (for example, "good and sufficient brakes" were defined as brakes that "adequately and promptly check and slacken the speed of a motor vehicle and bring it to a complete stop").

"Good" in the context of the valuation opinion probably is best defined as "serving the desired end, or suitable." Interestingly, some definitions of the word "good" include words that most actuaries would not assume to be appropriate synonyms, such as "sound," "better than average," or "safe." On the other hand, the word "sufficient" means at law "adequate, enough, as much as may be necessary, equal or fit for the end proposed, or of such quality, number, force, or value to serve a need or purpose." Taken together, the words "good and sufficient" legally mean "suitable and enough." There is at least an intimation that the phrase "good and sufficient" makes a claim vis-a-vis the quality ("good") and quantity ("sufficient") of the matters under review.

With that as background, we can look at the phrase under consideration as a replacement for the phrase "good and sufficient": "appropriate provision." "Appropriate" generally means "suitable or well-fitting." However, in a legal context (and in its verb form), the word also means "to set apart for a specific use," as when government appropriates private property. When used in the context of financial reporting (and, most specifically, with respect to reserves), if the meaning of "suitable" is what has been intended (as I believe is the intent of the drafters), then there is a risk of using the word "appropriate" in this context.

The switch of phrases from "good and sufficient" to "appropriate provision" is arguably a reduction in the level of confidence being expressed by the actuary, inasmuch as "good and sufficient" is more absolute and timeless than "appropriate." "Appropriate" is a more comparative word; "appropriate" implies appropriate-compared-with-something. In this context, the something is "presently accepted standards of practice." Because "presently accepted standards of practice" are indeed only presently accepted (and might not be accepted next year), the overall tenor of the proposed replacement language may somehow appear to be less certain than the phrase currently in use.

Having said all of this, on the bottom line, the legal distinctions between the two phrases are not significant. What is more important in this context is the perception of what the word change implies to regulators, the insurance industry, and the actuarial community.

"Presently accepted standards of practice" are defined, within the actuarial profession, quite narrowly, and the term is used as a term of art to mean the Recommendations and Interpretations issued by the American Academy of Actuaries. In the wider world, the phrase "presently accepted standards of practice" (or "generally accepted standards") has a broader meaning. At law, generally accepted standards imply not only the formal pronouncements of the profession, but also those practices that, although not articulated, nevertheless are utilized by reasonable practitioners.

THE ISSUE OF RELIANCE

The proposed statement of opinion would contain a separate section dealing with the valuation actuary's reliance on other individuals for information that is used as a basis for the statement of opinion. Reliance obviously needs to be specifically declared and noted. This is particularly important in dealing with management responsibility for the information included in the financial statements.

The statement of opinion would indicate that the valuation actuary has "**reviewed these results for reasonableness.**" This phrase is pregnant with potential adverse consequences for the valuation actuary.

Auditors who are sued are most often sued because, in retrospect, they missed something that a "reasonable" auditor should have seen. In fact, courts frequently will impose liabilty on an auditor not merely because he failed to detect fraud or abuse, but because a "reasonable" review should have put the auditor on "inquiry notice" that something was wrong and that additional review was required. The failure to pursue such an "inquiry notice" can be the basis for liability.

What, then, should the valuation actuary do who must rely on these individuals? First, such reliance must be clearly and unambiguously articulated. Second, the "review for reasonableness" must be limited explicitly and directly.

The proposed language calling for a "review for reasonableness" can be a source of potential liability for the valuation actuary because of the implication that by

reviewing for reasonableness the information provided by others, the valuation actuary is a de facto insurer of the data. Therefore, explicit disclaimers within the opinion are in order to explain the nature of a review for reasonableness.

PROPOSED CHANGES TO INTERPRETATION 7-B

The proposed changes to Recommendation 7 would implement the changes in the statement of opinion we have just been discussing. In addition, the Academy has circulated for comment amendments to Interpretation 7-B (Adequacy of Reserves) which would be significantly expanded to take into account cash flow analysis and would be retitled "Adequacy of Reserves and Cash Flows." The major matter for review here is the language contained in Paragraph 7 of the proposed revision.

The proposed valuation opinion would be to the effect that the reserves make appropriate provision for all future obligations on a basis sufficient to cover future "reasonable" deviations from expected assumptions. It would also indicate that the reserves, plus additional internally designated surplus, make appropriate provision for all future obligations on a basis that is sufficient to cover future "plausible" deviations. It appears to be the intent that "plausible" deviations are assumed to be less likely to occur than "reasonable" deviations.

"Reasonable" is best defined as "fit and appropriate to the end in view." In other words, one cannot define the word "reasonable" in a vacuum; rather, the definition of the word "reasonable" is linked directly to the purpose undertaken. In the context here, "reasonable" must be viewed as "fit and appropriate" to such a valuation. Significantly, this implies that all disclaimers and limitations must

be understood to be part of the word "reasonable," and most important, "reasonable" implies the exercise of professional judgment.

The word "plausible" is generally defined as "superficially fair, reasonable, or valuable but often specious." The difficulty with this word is that in retrospect, almost any outcome or deviation can be considered "plausible."

A level of discomfort appears to exist regarding the use of words "reasonable" and "plausible" because of the inherent difficulty in defining these terms in context. A more concrete methodology (such as a specific declaration of confidence levels) might be more satisfying and defensible. However, should this approach be deemed unfeasible (from a technical perspective), we may have to acknowledge that some terms simply cannot be defined a priori.

PERSONAL LIABILITY AND THE VALUATION ACTUARY

At this point some consideration of the general principles of professional liability is appropriate.

Professional Liability Defined

The accepted definition of "professional liability," more specifically referred to as "malpractice" (the terms are used interchangeably,) follows:

> Professional misconduct or unreasonable lack of skill. Failure of one rendering professional services to exercise that degree of skill and learning commonly applied under all the circumstances in the community by the average prudent, reputable member of the profession with the result of injury, loss, or damage to the recipient of those services to those entitled to rely upon them.

When a professional advises his employer or client, a duty to exercise due care arises. In performing his duties, a professional does not guarantee correct

judgement, but only that in formulation his judgment and work product he exercises reasonable skill and competence in good faith without fraud.

Legal Theories of Liability

Professional liability actions are generally based on one of two (or sometimes both) legal theories: (1) breach of the employment contract between the professional and his client and (2) damages as a result of negligence creating an action in tort. Tort law holds that one is responsible for the consequences of his action, and where his act causes damages to another, he is liable. A tort action could be brought by a client or by a third party who was harmed by relying on the professional's work.

The difference between applicable legal theories is important because, in addition to procedural matters (such as the applicability of statutes of limitations), the theory pursued is of consequence with respect to proof, measure of damages, and other important substantive issues.

Third-party action is also critical, because third parties (for example, regulators, potential investors, policyholders, or beneficiaries) rely on the work product of the actuary. The general rule is that where the professional knew, or should have known, of impending third-party reliance, the potential for third-party liability arises. Generally, only gross negligence or fraud by the professional is a sufficient foundation for a third party to bring a successful tort action.

Until relatively recently, parties who were not in a direct, contractual relationship and who were not actually anticipated by the auditor to be users of

his report could not sue for "mere" negligence. This limitation, however, has been eliminated in some jurisdictions. For example, a recent California case held that the auditor's duty extends to all reasonable foreseeable plaintiffs, and not just those he knows will rely on his report.

What, then, should the valuation actuary do to limit potential liability to third parties?

1. The valuation actuary should seek to limit the use of his report. Such restrictions on reliance should probably appear in large type in a conspicuous place in the written report. Indeed, it may be appropriate for the valuation actuary to explicitly state that reliance is restricted to the client or entity for which the report has been prepared.
2. The valuation actuary should state affirmatively that the client or entity is to rely on the product for specific articulated purposes.
3. In any communication with third parties, the valuation actuary should make sure that the third parties are aware that reliance on their part is inappropriate.

The Law Applied to Actuaries.

Having discussed generic professional liability principles, the discussion now focuses on how tahe law has been applied to the actuary.

Actuaries Are Professionals. Any discussion of actuarial malpractice assumes that the law considers an actuary to be professional and hence subject to

standards required of all professionals. The case law clearly supports this conclusion.

Generally Accepted Actuarial Principles and Practices. Courts will measure a defendant's actions against "generally accepted" actuarial principles and practices. Generally accepted actuarial principles and practices are standards that have been recognized by either the law or by the profession as appropriate for application in specific actuarial contexts. They include, in order of legal importance, (1) statutes or regulations, (2) principles or standards articulated by the profession, (3) professional literature, and (4) testimony from expert witnesses.

LIABILITY CONTROLS

Some internal procedures have application to the valuation actuary to limit potential liability. First, a variety of proposals might be considered at length for in-house training of all personnel, technical support, work paper documentation, and peer review of work products.

A second area for avoidance of personal liability is incorporation. Although the state laws vary considerably on whether actuaries may form professional corporations, and the extent of personal protection from liability that such states offer varies widely, incorporation is a measure that should be investigated by potential valuation actuaries.

Another major area for limiting liability for the valuation actuary is limitations in the statement of actuarial opinion. As I said before, the proposed

Recommendation 7 and Interpretation 7-B make ample reference to the need for limitations when the actuary does not feel able to express an unqualified opinion.

Finally, there are four basic types of qualifications that auditors customarily use in their reports, and these qualifications might be considered by valuation actuaries. Because they have been utilized for some time within the accounting profession, they have attained a degree of acceptance and understanding within financial communities as words of art with very specific meanings. These are the "except for" limitation, the "subject to" limitation," the "adverse" qualification, and the disclaimer. Time does not allow discussion, but you are now placed on your own inquiry notice to investigate whether these phrases can be used in your work as a valuation actuary.

LIABILITY AND EMPLOYMENT STATUS

The distinctions between the in-house valuation actuary and the consulting valuation actuary in terms of potential liability are essentially minor. Both can be sued by the company, by the stockholders or policyholders, or by outside parties who rely on their opinions. Both can be sued in contract or in tort. The in-house valuation actuary can attempt to limit potential liability by receiving a promise of indemnification from the board of directors; the consulting valuation actuary can attempt to limit potential liability through a carefully prepared and executed engagement letter.

What is of much greater significance is that both the in-house actuary and the consulting valuation actuary face greater potential liability exposure under the valuation actuary concept than that faced by actuaries now engaged in life insurance financial reporting.

CONCLUSIONS

There is much here for consideration and digestion. Perhaps most significant is the fact that by increasing the scope of the valuation actuary's duties, the nature and scope of potential professional liability also increase. Many steps can be taken to limit the extent of this increase in potential liability. Nevertheless, this potential professional liability will increase.

Some would argue that this inevitable increase in potential professional liability needs to be quantified prior to proceeding. Unfortunately, as an attorney I am no more able to precisely define the extent of this increased liability potential than the actuarial profession can precisely define the words, "reasonable" and "plausible."

The increased potential for professional liability may be considered to be the price to pay for an expanded professional actuarial role in the financial reporting of insurance companies. Whether that price is excessive, reasonable, or a real bargain is a judgment to be made in the first instance by the profession, and ultimately by the industry and its regulators.