Chapter VII

AN ANALYSIS OF THE LEGAL IMPLICATIONS OF THE VALUATION ACTUARY CONCEPT

Section 1: The Current Regulatory System

Before commencing with a detailed evaluation of the concept of the valuation actuary, it is first necessary to attempt to fashion a definition. In brief, a valuation actuary would be an individual employed by a life insurance company who would be responsible for the selection of assumptions and the establishment of reserves for financial reporting purposes. Said assumptions and reserves would be utilized to ensure the financial solvency of the company. In setting assumptions and reserves, the valuation actuary would be guided initially by statutory solvency requirements; eventually, it is anticipated that principles and standards of practice would be articulated by the profession and would, in time, replace the statutory reserve requirements of the Standard Valuation Law.

It is clear that one focus for the implementation of the valuation actuary concept lies with the National Association of Insurance Commissioners (NAIC), inasmuch as that body is where the regulation of the life insurance industry in the United States has its center. Although it is true that the model regulations and statutes proposed by the NAIC meet with varied levels of acceptance (through adoption by the state legislatures or state insurance departments), it is also clear that any major sea change in regulation of the industry must begin with the NAIC. Hence, some discussion about the NAIC and the legal parameters of its pronouncements is relevant here.

As was indicated, the interrelation between the NAIC and the state departments of insurance is ad hoc, which is natural given the fact that the NAIC is purely an advisory body, without any inherent ability to enact regulatory or statutory requirements, modifications, or regulatory pronouncements. In order for NAIC models to be given legal effect, they must be adopted by the individual states, either through legislative action or, when appropriate, through formal or informal rule making by the various departments of insurance.

Historically, the regulatory practices in effect today grew out of a 1906 meeting of the then-named National Convention of Insurance Commissioners, the predecessor of the NAIC. This meeting followed closely on the heels of the widely publicized Armstrong Investigation into insurance practices in New York. Seventeen major requirements for insurance company financial reporting were adopted at that time and eventually served as a basis for the Standard Valuation Law, adopted by the NAIC in 1942 (and repeatedly amended since that time). That law provides each commissioner of insurance with authority to require an annual report from life insurance companies doing business in that state, to certify to the reserves of those companies and to 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.

Virtually all states use the NAIC model life blank for reporting purposes (in no small part due to the fact that the Standard Valuation Law provides that states can accept the report of a company that is filed in another state). Hence, with the support of the life insurance industry, a degree of uniformity in reporting has resulted through the use of the annual statement blank.

Nevertheless, states rarely officially adopt the blank itself. This lack of a clearly established regulatory basis for the use of the blank leaves the blank (and its critical instructions) in something of a legal twilight zone, where the parameters of what can be accomplished or required through the blank and its attendant instructions are unclear, at best, from a legal perspective.

The annual statement blank is, on its face, a relatively simple document. The instructions, which are attached to the blank, are of critical importance in and of themselves, because they serve to define how, when, and where various complex requirements are to be reported. Of particular concern here is the requirement for an actuarial statement of opinion to be part of the blank submission. It is the changes to the statement of opinion, its uses, and its authority that lie at the legal heart of the valuation actuary concept.

The current language for the actuarial statement of opinion includes an introductory paragraph identifying the individual, his relationship to the company, and his qualifications. A second paragraph follows, which deals with the scope of the actuarial review. A third paragraph, as applicable, covers the actuary's review. The final paragraph constitutes the heart of the opinion and includes the following suggested language:

> In my opinion the amounts carried in the balance sheet on account of the actuarial items identified above
>
> (1) are computed in accordance with commonly accepted actuarial standards consistently applied and are fairly stated in accordance with sound actuarial principles,

(2) are based on actuarial assumptions which are in accordance or stronger than those called for in policy provisions,

(3) meet the requirements of the insurance laws of (state of domicile),

(4) make a good and sufficient provision for all unmatured obligations of the company guaranteed under the terms of its policies,

(5) are computed on the basis of assumptions consistent with those used in computing the corresponding items in the annual statement of the preceding year end, and

(6) include provision for all actuarial reserves and related statement items which ought to be established.

The annual statement blank is thus used primarily for state insurance regulators to assess the solvency of the companies within their jurisdictions. In so doing, it is clear that the actuarial opinion is an important part of this oversight and enforcement process. Others use the information contained in the annual statement blank from time to time, including policyholders, investors, or others concerned with the financial condition of a life company. However, those users are, for now, outside the scope of this chapter.

Current qualification requirements for signing the actuarial opinion appearing in the annual statement blank are relatively simple. An individual signing the opinion must indicate that he or she is a qualified actuary, which is defined as "a member in good standing of the American Academy of Actuaries, or a person who has otherwise demonstrated his or her actuarial competence to the satisfaction of the insurance regulatory official of the domiciliary state."

In summation, the profession has embarked upon a broad-scale reconsideration of the actuary's role in financial reporting and regulation of life insurance companies. The goal of the valuation actuary is to enhance the role of the actuary in this process, as well as to create a system that ultimately will replace the specific requirements of the Standard Valuation Law and substitute that law's requirements with a careful exercise of professional actuarial judgment. Proponents of the valuation actuary concept feel that discretion is necessary in times of complex policy forms and financial swings and changes. They also believe that the Standard Valuation Law is too inflexible and limited to deal with a rapidly changing environment. The current NAIC reporting mechanism, through the annual statement blank, has been reviewed here to highlight the current requirements of law and to pinpoint whence significant change will take place as the concept is effected.

Section 2: The Valuation Actuary Concept

2.1 Procedural and Substantive Components

Throughout the foregoing section, it has been assumed that the reader is familiar with the valuation actuary concept. It should be noted that to date, due in part to the "seamless web" of activities involved, no one clear statement of the duties of the valuation actuary has emerged in a single document. The purpose of this section is to highlight the various components of the valuation actuary concept proposal as it exists today.

The first area of concern lies in what can be termed procedural/mechanical aspects of the valuation actuary position. It has been suggested that the valuation actuary will be an individual appointed to that position by the directors of a life insurance company, and that the state regulatory body will be notified of this appointment (as well as of any subsequent changes in the position). At the present time, the actuary who prepares the opinion for the annual statement is considered to be part of the management structure; the change contemplated would certainly elevate the valuation actuary and make him directly accountable to the directors of the company. It should be noted, however, that many within the insurance industry believe that the valuation actuary must report directly to management and continue to be a part of the management of the company, as opposed to reporting directly to the board of directors. This issue remains unresolved at the present time.

Related activity contemplated within this procedural context would be the adoption of model laws and/or regulations by the NAIC, with their subsequent adoption by the various states, to create the new role and position of the valuation actuary.

In what might be called the substantive area, two major projects are now under way within the Academy that will have a direct impact on the valuation actuary concept: determining the qualifications of an individual to serve as a valuation actuary and setting standards of practice under which the valuation actuary will operate. (See the Discussion Draft issued in July 1985.) The articulation of principles is a third major subject of importance in the substantive area.

The differences in opinion as to where the valuation actuary will wind up depend, in part, on the perspective of the individual making the prognostication. Some actuaries, who believe that actuaries have taken a backseat to "market types" or investment decision makers see the valuation actuary concept as a means to restore the traditional importance and significance of the actuarial role in insurance company management. Regulators see in the valuation actuary a potential solution to long-standing regulatory problems of inadequate resources within the state department; the valuation actuary can be turned into an early warning system of company failure—a whistle-blower, if you will. Others may perceive the valuation actuary concept as a threat to the management prerogatives of insurance companies—a power grab by the profession to control an industry. These different views are conflicting and can cause conflict between the actuaries, the companies, and the regulators.

Timetables for the implementation of the valuation actuary proposal are pure guesswork at this stage, given the fact that the outlines of the concept are not securely in place at the present time, as the foregoing discussion amply illustrates. Nevertheless, there has been sufficient discussion to begin to address some of the legal difficulties that may arise with regard to the concept of a valuation actuary in the United States.

2.2 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 (principles and standards). Qualification standards would provide regulators with necessary confidence.

However, it is clearly recognized that existing legal solvency standards must continue to be observed, pursuant to the Standard Valuation Law and one appropriate rules and regulations issued by relevant insurance regulators. The proposed statement of actuarial opinion would, on the other hand, continue to include a legal solvency requirement and, on the other hand, would also include the newer statement of opinion on cash flows.

The revised opinion would be as follows:

In my opinion as of December 31, 19XX:

1. The policy reserves and other actuarial items listed in the schedule attached hereto:

   i) are computed in accordance with commonly accepted actuarial standards consistently applied and are fairly stated in accordance with sound actuarial principles.

ii) are based on actuarial assumptions which produce reserves at least as great as those called for in any policy or contract provision as to reserves basis and method and are in accordance with all other policy or contract provisions.

iii) meet the requirements of the insurance laws of the State of (domicile).

iv) are computed on the basis of assumptions consistent with those used in computing the corresponding items in the Annual Statement of the ______ Life Insurance Company for the year ending December 31, 19XX.

v) include provisions for all actuarial reserves and related actuarial statement items which ought to be established.

2. The anticipated investment cash flows arising from an allocation of assets equal to reserves and other liabilities, plus anticipated considerations to be received from the in-force policies make appropriate provision, according to presently accepted actuarial standards of practice, for the anticipated cash flow regarded by contractual obligations and the related expenses of the Company.

The exposure draft stimulated a great number of comments, many of which were detailed, lengthy, and thoughtful. Major areas of concern raised in the comments include the degree of autonomy of the valuation actuary from company management, the cost involved with the proposals (particularly for small companies), the termination of the current "good and sufficient" language, distinctions between "reasonable" and "plausible" deviations from expected results, and qualification standards for the valuation actuary. These questions are reviewed in the balance of this chapter and are highlighted here for one essential reason: Despite questions about particular features of the proposal, it does appear fairly clear that the profession does not dispute the general direction in which the valuation actuary concept is moving.

In reviewing from a legal perspective the language of this proposed revised statement of opinion, it is useful to underscore the particulars that would be changed if the proposal were adopted. By so doing, the impact on the potential liability of the valuation actuary can be focused.

The current opinion begins with reference to the "amounts carried on the balance sheet," whereas the proposed opinion begins with "policy reserves and other actuarial items." This change, which stresses increased review of the reserves, underscores the actuary's heightened sensitivity to reserving and responsibilities for establishing assumptions for reserves.

The first subparagraph, stating that actuarial items "are computed in accordance with commonly accepted actuarial standards consistently applied and fairly stated," is unchanged in the proposed opinion. "Commonly accepted actuarial standards" is a reference to standards issued by the IASB of the Academy, other actuarial literature, and general practice among recognized actuaries.

The second subparagraph is expanded somewhat in the proposed statement of opinion. The current opinion subparagraph states that the balance sheet amounts are based on actuarial assumptions "in accordance or stronger than those called for in policy provisions." The revised opinion would require the calculations to produce "reserves at least as great as those called for in any policy," as well as being "in accordance with all other policy or contract provisions." Again, stress is to be placed on the involvement of the actuary in establishing assumptions for appropriate levels of reserves.

The third subparagraph of both the current and proposed opinions, that the amounts listed meet the requirements of the domiciliary state, is essentially unchanged. Significantly, it should be understood that the valuation actuary (and, indeed, the current actuary who signs a statement of opinion) holds himself out as an expert in the domiciliary state's insurance law and regulations. (Although this is not a statement of legal opinion, it does tread close to that status and should be closely monitored to avoid claims of unauthorized practice of law. For example, consideration could be given to a disclaimer indicating that any questions of legal interpretation should be referred to qualified legal counsel.)

The fourth subparagraph of the proposed opinion, with minor word changes, is essentially the same as the fifth subparagraph of the current opinion. Both provide notice of whether any changes have been made in assumptions from year to year.

The final subparagraph is also essentially unchanged, except for the addition of the modifier "actuarial" before the term "statement items" to clarify that the opinion is limited to actuarial statement items.

Of course, the most significant change in the proposed statement of actuarial opinion lies with the deletion of the current fourth subparagraph (including reference to "good and sufficient provision") and the addition in its stead of a new full paragraph in the opinion section that lies at the core of the valuation actuary concept.

Phrases in the new paragraph, 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. More discussion on the assumption by the valuation actuary of this major new duty and responsibility follows.

"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 connection with 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 which adequately and promptly check and slacken the speed of a motor vehicle and bring it to a complete stop." [1] "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 language that most actuaries would not assume to be appropriate synonyms — for example, "sound," "better than average," or "safe." 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."[2] Taken together, the words "good and sufficient" legally mean "suitable and sufficient." 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" here: "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 in using the word "appropriate" in this context. However, this may be little more than legal nit-picking that can be resolved through a clear definition of "appropriate provision" in the recommendation.

[1] Blacks Law Dictionary.

[2] Blacks Law Dictionary.

The switch of phrases from "good and sufficient" to "appropriate provision" is to the casual reader a major shift in emphasis and may be recognized as such by even the most sophisticated reviewer. It can be argued that the shift is a reduction in the level of confidence being expressed by the actuary, inasmuch as "good and sufficient" is more absolute and timeless than "appropriate." This is because "appropriate" is a more comparative word; it implies appropriate-compared-with-something. In this context, the something is presently accepted standards of practice. And 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.

This change also has some legal impact, because it heightens the fact that in providing a qualitative valuation opinion, the key phrase of "appropriate provision" is to be more directly linked to standards of practice. This infers that the statement of opinion is more firmly rooted in standards of practice than the less clearly grounded expression of "good and sufficient." Hence, it means that adherence to standards would provide a clearer basis for the exercise of professional judgment by the actuary.

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.

Some additional consideration of the phrase "presently accepted standards of practice" is next appropriate, together with related matters. "Presently accepted standards of practice" is defined within the actuarial profession quite narrowly, and it is used as a term of art to mean the Recommendations and Interpretations issued by the American Academy of Actuaries. In the wider world, "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. To avoid ambiguity, it is suggested that the recommendation clearly state the definition intended here.

It is interesting to note that the term "generally accepted auditing standards," or GAAS, as used in auditors' reports may soon be changed, according to information received from an AICPA Task Force considering changes in the standard report. The term under consideration as a replacement is "standards established by our profession." The term change has been suggested in large part to indicate the more limited meaning of GAAS that the profession believes appropriate. Consideration might be given to using this language in lieu of the phrase "presently accepted standards of practice."

2.3 The Issue of Reliance

The proposed statement of opinion for the valuation actuary 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, and thereby advertise reliance to all readers of the report. This is particularly important in dealing with management responsibility for the information included in the financial statements. This subject has also been under discussion within the AICPA Task Force, which has noted the absence of any explicit acknowledgement by management of its responsibility in the financial reporting process. One idea under consideration (but not yet agreed upon) is a requirement for a management report to accompany the financial statements, so that readers of the audit report will clearly be on notice that the auditor does not have primary responsibility for the financial statements. This, according to proponents of the recommendation, would help reduce the "expectation gap" through which readers may improperly assume that the auditor had primary responsibility for the information.

Should such a report be required from management, several key questions would need to be addressed, including whether it would be mandatory for all entities, whether it must be interrelated with the auditor's report, and what the requirements for inclusion in the report might be. Consideration might be given to a requirement for such a letter from management for the valuation actuary.

2.4 Review for Reasonableness

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 liability 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.

For the actuary, particularly the valuation actuary, the reliance, for example, on the chief investment officer for investment policy, is essential. A valuation actuary is simply not in a position to undertake these tasks personally. 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 therefore be a source of added liability for the valuation actuary because of the implication that by review for reasonableness of 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 that explain the nature of a "review for reasonableness." Such disclaimers might list the specific steps undertaken in the review.

Alternatively, consideration can be given to the development of an interpretation that clearly sets forth appropriate guidance for the review for reasonableness. If that were to take place, the statement of opinion could make explicit reference to that interpretation, or it might more generally indicate that a review for reasonableness has been undertaken pursuant to presently accepted actuarial standards.

2.5 Enhanced Potential Liability

The foregoing discussion highlights the proposed changes in the statement of actuarial opinion and in so doing highlights the major changes that would be brought about by the introduction of the valuation actuary concept itself.

It must be understood that as a result of these changes, the potential liability for individuals acting as valuation actuaries would expand. Whereas discussion of the nature of liability will be discussed more in the next section, the changes already discussed would increase such liability in the following areas:

1. The valuation actuary would have increased responsibility for the establishment of reserve assumptions. Four adverse contingencies have been identified by the actuarial profession (by the Society of Actuaries Committee on Valuation and Related Matters) that provide the conceptual framework for the

valuation of liabilities. They have been designated as C-1, C-2, C-3, and C-4. The C-1 risk concerns the loss of assets from defaults, destruction, or other decline (excluding changes in market value resulting from interest rate fluctuations). The C-2 risk relates to loss resulting from inadequate pricing. The C-3 risk relates solely to losses that result from changes in interest rates. C-4 is general business risk not encompassed by the others.

These risks, especially the C-3 risk, are already under consideration by actuaries, especially with regard to opinions for various interest-sensitive products. Clearly, all these risks would need to be carefully considered by an actuary serving as valuation actuary for an insurance company.

In this context, the question is whether it is within the actuary's professional ambit to undertake estimates with regard to each of these risks. This is particularly troublesome because, as yet, there has emerged no clear concensus from the profession on the question, and the methodology is incomplete, particularly in regard to the quality of assets for the determination of reserve adequacy.

In terms of reliance, it should be stressed that for the valuation actuary's statement of opinion, the valuation actuary will have to rely extensively on others for information regarding the C-1, C-2, and C-4 risks; the C-3 risk, dealing with changes in interest rates, is probably more within the ambit of the actuary's direct estimation. Therefore, the reliance made by the valuation actuary for each of the risks considered must be explicitly stated.

This reliance is itself a source for expanded potential liability. As was noted, there is a potential danger that readers of the valuation actuary's statement of opinion will assume that the valuation actuary is to some extent an insurer of data relied upon, through the "review for reasonableness."

2. Most significantly, the very fact that the scope of duties will extend to the asset side of the balance sheet will enhance potential liability for the valuation actuary. When an individual undertakes new duties in an area that has previously not been within the sphere of actuarial activity, potential liability must increase.

Section 3: Personal Liability and the Valuation Actuary

3.1 Professional Liability Defined

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

> professional misconduct or unreasonable lack of skill. The term is usually applied to such conduct by doctors, lawyers and accountants. 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. It is any

professional misconduct, unreasonable lack of skill or fidelity in professional or fiduciary duties, evil practice, or illegal or immoral conduct.[3]

When a professional advises his employer, client, or others with whom he is in privity of contract, a contractual duty to exercise due care arises. Although professions differ, professionals are generally held to the same standard of skill. That standard requires that when a professional is rendering service for compensation, he must use reasonable care and competence. A failure to discharge that duty will subject the professional to liability for negligence.[4]

In performing his duties, a professional does not guarantee correct judgment; but only that in formulating his judgment and work product, he exercises reasonable skill and competence in good faith without fraud. This is true for physicians, accountants, attorneys, actuaries, and other professionals. Although not an insurer against damage to his client, a professional may be held liable on grounds of "negligences to one with whom he is in privity or with whom he has a direct contractual relation" for damages that naturally and proximately flow from his failure to use the necessary amount of skill and care.[5]

3 Mathews v. Walker, 396 N.E. 2d 569, #571

4 W. Prosser, Law of Tort 143 (1973).

5 Delmar V. Timmons, 485 S.W. 2d, 920 (1972).

3.2 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.[6]

Most malpractice actions are brought under an expressed or implied contract theory. This is the usual case where a professional is hired to perform a skilled service. If the service is not performed competently, consistent with the related employment agreement, contract law generally allows recovery for all damages proximately caused by the breach.

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 both a client and by a third party who had no contractual relationship with the professional but was nonetheless harmed by relying on the professional's work (see the later discussion concerning "Liability to Third Parties").

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.

[6] 92 ALR 3rd 396, 403.

3.3 Primary and Secondary Liability

In most instances, liability can be primary or secondary in nature. As its name infers, primary liability is legal liability that attaches in the first instance. Thus, an actuary who recklessly established an interest rate assumption of 24 percent for anticipated investment earnings (when all assets are maintained in undiscounted bonds paying 11 percent) is directly, or primarily, liable to his client or employer for damages that arise from the actuary's negligence. And if he relied on another for this figure, he remained primarily liable, because he should have known that 24 percent was unreasonable.

The distinction between primary and secondary liability is significant; only if the individual with primary liability cannot satisfy the judgment will the court turn to the secondarily liable defendant for whatever additional relief has been mandated. This division of liability is, it should be noted, often a matter controlled by state law, and a different division of liability (especially when the action is in tort) is possible under the laws of the individual states. This distinction is also important in the pretrial settlement stage of legal proceedings, because the willingness of a party to settle a claim out of court before trial may well rest on the perception of primary versus secondary liability to the plaintiff.

3.4 Liability to Third Parties

An examination of third party action is also critical to the issues examined here, because third parties (for example, regulators, potential investors, policyholders, or beneficiaries) rely on the work product of the actuary. The general rule of third party professional liability 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.

Due to some similarities, comparison can be made between the valuation actuary and auditors for purposes of personal liability. This is not only because both professions deal with financial matters, but also because there has been a substantial amount of litigation concerning auditors that provides a basis for comparison.

There are many different aspects to the issue of auditors' liability. The major issue today of import (and of specific concern to valuation actuaries) is the issue of standing to sue. Standing is the legal right to initiate a lawsuit. In this context, the issue of standing centers on whether a third party who relies to his detriment on the auditor's report can initiate a lawsuit claiming negligence against the auditor. In other words, does the auditor owe a duty of care to people other than the client, who he knows or should know will rely upon his report?

Until relatively recently, parties not in privity of contract (a direct, contractual relationship) <u>and</u> who were not actually anticipated by the auditor to be users of his report could not sue for "mere" negligence. (Fraud, in contrast, was actionable by these "remote" parties.) The fact that the auditor should have foreseen that the third party would rely on his report was considered insufficient to provide a basis for standing. This rule had its most fully articulated expression in Ultramares Corp. v. Touche, 225 N.Y. 170, 174 N.E. 441 (1931).

For the auditor (or the valuation actuary), this so-called Ultramares Doctrine is very significant, by limiting the class of potential plaintiffs to those who (1) rely detrimentally on the auditor's opinion and (2) were actually anticipated to be users of the report. Hence, for example, a potential buyer of the entity would not enjoy standing to sue the auditors due to their negligence where the report was prepared for strictly in-house use.

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.[7] Other jurisdictions that have adopted this broader scope of potential plaintiffs include New Jersey, Wisconsin, New Hampshire, and Ohio.

In contrast, some state courts have in recent years reaffirmed the Ultramares Doctrine. For example, a recent New York decision indicated that auditors were not liable in negligence to third parties unless (1) they were aware that their report was to be used for a particular purpose, (2) they intended that

7 International Mortgage Co. v. John P. Butler Accounting Corp. (Cal. Ct. App., February 20, 1986) No. 6001099.

the plaintiff rely on the report for that purpose, and (3) the auditors engaged in conduct with respect to the plaintiff that evidenced their awareness of the plaintiff's intended reliance.[8]

What then, should the valuation actuary do to limit potential liability to third parties, assuming that this analysis would be applied to the valuation actuary by the courts as it has been applied to auditors? First, 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. Second, the valuation actuary should state affirmatively that the client or entity is to rely on the product for specific articulated purposes. Finally, 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.

3.5 Comparative Negligence

For auditors, the theory of comparative negligence has afforded a great deal of protection at times. The theory holds that a party is responsible for only that proportion of damages that is attributable to his fault, and that on a comparative basis, other parties must bear a share of the ultimate damages. For

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[8] Credit Alliance v. Arthur Andersen & Co., 493 N.Y.S. 2d 435, 65 N.Y. 2d 536 (1985).

auditors, much of their success in the use of this line of defense centers on the fact that management bears primary responsibility for the report, inasmuch as the numbers supplied to the auditors are "management's" numbers. Further, in cases of fraud, the auditors can point out that management was at least as responsible for failing to uncover the fraud within its house.

In contrast, the growth in the use of joint and several liability can be a major problem for auditors. This may be particularly true in the case of insurance company insolvencies, where any existing company assets must first be used to pay policy claims. This is an area of rapidly changing law, where many states have placed new restrictions on the operation of the principle. These changes include the elimination of joint and several liability, or major modification that otherwise limits the ability of a plaintiff to pin an entire judgment on an individual who may have had a relatively minor share in the fault that led to damages.

3.6 Appropriate Professional Techniques

Often professionals will disagree on the proper technique to apply in a given instance. In such cases, the law generally requires that the professional use the technique he deems fairly applicable to the situation presented.

A court judges a professional's acts based on the degree of knowledge, skill, and judgment usually possessed by members of that profession in the community where the action arose. Recently, as professional literature has become much more readily available to all practitioners, courts have looked less to local standards of care and geographical limitation. Those who hold themselves out to the public as experts in a specific area of a field are usually held to even higher standards than professionals who have only a general knowledge of the subject. The higher standard to which such experts are held is equally applicable to the actuarial profession. For example, Opinion A-7 of the Academy requires that an actuary working in a specialized field take into consideration the Recommendations and Interpretations of the relevant practice committees of the Academy.

3.7 Professional Liability and the Actuary

Having discussed "generic" professional liability principles, the discussion now focuses on how the 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.

Historically, the recognized professions (and hence, those that have been subject to malpractice litigation) have been law, medicine (including its various branches and dentistry), and the ministry. More recently, principles of malpractice have been applied to, among others, the professions of accounting, architecture, and engineering.

It is certain as well that actuarial science qualifies as a profession. Indeed, state courts have so held in defining actuarial work. One case defined an actuary as "a person skilled in mathematical calculations whose profession is the calculation of insurance risks and premiums."[9] In another case, an actuary is defined as "one whose profession it is to calculate insurance risks and premiums."[10]

Furthermore, actuarial work meets the traditional professional criterion of a calling involving a "special knowledge of a branch of science or learning." And as will be noted, the courts have not only declared the practice of actuarial science to be a profession, but have applied malpractice principles directly to the actuary, leaving the matter unambiguous.

Generally Accepted Actuarial Principles: Allegations of actuarial malpractice are evaluated by the courts with reference to the "generic" rules of malpractice procedure. Thus, courts will measure a defendant's actions against "generally accepted" actuarial principles. These are standards and practices that have been recognized by either the law or by the profession as appropriate for application in specific actuarial contests.

Indeed, the concept of generally accepted actuarial principles has been recognized by the courts. In United States v. Consumer Life Insurance Company,

[9] King County Employee Assn. v. State Retirement Bd., 54 Wash. 2d 1 (1959).

[10] Champagne v. Unity Indus. Life, 161 So. 52 (La. App. 1935).

430 U.S. 725 (1977), the U.S. Supreme Court, in a case involving the determination of an insurance company's reserves for federal tax purposes, concluded that the proper calculation of reserves should be carried out "under accepted . . . actuarial standards" (p.739).

In United States v. Zazove, 334 U.S. 602 (1948), a case involving insurance reserves and benefits, the Supreme Court determined that the appropriate level of reserves should be determined "under accepted actuarial principles" (p. 620). State courts have similarly recognized the existence of generally accepted actuarial principles.

Liability Controls: A major reason why auditors (and valuation actuaries) would face increasingly high risks of personal liability may be found in the fact that many publics expect auditors or actuaries to deliver more than the standards of practice may actually promise. That is, the publics may not bother to read the fine limitations or disclaimers contained in GAAP or GAAS (or IASB pronouncements), but nevertheless expect that the auditor or actuary will tell them whatever they need to know to avoid economic distress.

Some internal procedures currently being discussed within the accounting community may have application to the valuation actuary to limit potential liability. These may include the following:

1. A requirement that the auditor actively search for management fraud that may be material to the financial statement through the application of professional auditing standards designed to reduce the risk that such fraud

will go undetected. This would include a review and evaluation of management controls, as well as an identification of potential systems that might indicate a higher degree of risk than the financial statement, standing alone, might indicate.

2. Lengthy consideration of a variety of proposals for in-house training of all personnel, technical support, work paper documentation, and peer review of work products.

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

4. Limitations in the statement of actuarial opinion. As has been noted, the proposed Recommendations and Interpretation 7-B make ample reference to the need for limitations when the actuary does not feel able to express an unqualified opinion. In this regard, the experience of auditors may also be of useful consideration.

Auditors often strive to issue "clean," or unqualified, reports. Such a report is an indication that within the scope of the examination, "the financial statements taken as a whole fairly present the company's position" as of the date of the report, in accordance with generally accepted accounting standards. Such a statement does not, of course, necessarily mean that the shareholder's investment is safe or that the company's financial position is sound or secure.

There are four basic types of qualifications that auditors customarily use in their reports. 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.

The first limitation is called the "except for" limitation. An example of such a limitation could be as follows:

> GAPP requires that vacation pay be recorded on an accrual basis. As reported in Note 7, no accrual has been made, with an effect being that income for the year is overstated by $350,000, net of related tax. In our opinion, except for the matter referred to in the preceding sentence, the financial statements present fairly . . .

Such an "except for" limitation indicates that the scope of the examination has been restricted by management or by circumstances, that the financial statements have not been totally presented in accord with GAAP, that disclosures are inadequate, or that accounting principles have been altered.

A second limitation used by auditors is the "subject to" limitation. Such a qualification is often used where a significant uncertainty exists that may have a material impact on the statement itself (for example, pending litigation where the outcome cannot be predicted). In such an instance, a report might state,

> As discussed in Note 8, the company is defendant in a lawsuit that, if successful, will require payment of $1,000,000. It is not possible to predict

> the outcome of the litigation. Subject to the effect of such an adjustment, if any, the financial statements fairly present . . .

A third, albeit more rarely utilized, limitation is the "adverse" qualification, used when deviations from GAAP are so material and pervasive that the "except for" opinion is insufficient. Such an opinion might state the following:

> GAAP requires that vacation pay be recorded on an accrual basis. As reported in Note 7, no accrual has been made, with an effect being that income for the year is overstated by $350,000, net of related taxes. In our opinion, because of the effect of not accruing vacation pay as discussed above, the financial statements do not present fairly . . .

The fourth limitation is the disclaimer, which is used when the potential significance of the scope of limitation is so material and pervasive that a qualified opinion is not appropriate. Such an opinion would state the following:

> Because of the significance of pending litigation discussed above, we are unable to express an opinion on the financial statements referred to above.

Use of Notes as Disclaimers: Frequently, auditors use notes to financial statements in order to explain in detail transactions reported in the financial statements. Similarly, one might expect that valuation actuaries could utilize a note process to modify or explain statements made in the valuation report itself.

Several rules related to auditor statements should be considered in this context. First, a financial statement must be accurate in and of itself; it may not be modified by outside material to attain necessary accuracy. However, it is clear that a note to a financial statement may modify, but not change, the financial statement itself; the statement must, however, remain accurate in and of itself. Courts have held that no amount of note disclosure can prevent an otherwise erroneous set of financial statements from being materially misleading--(for example, Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F. 2d 27 (2nd Cir., 1976).

It is already possible for the actuary to minimize liability flowing from the blank requirement by qualifying his opinions. The NAIC blank has provisions that permit the actuary to qualify the opinion. If the actuary relies on underlying information that cannot be readily verified, he may create a successful defense by explicitly stating such reliance, which serves as a legal disclaimer. Research has failed to locate any reported cases of an actuary's being sued for an inaccurate opinion because the underlying material he used was inaccurate, where his defense was that he had disclaimed knowledge of the underlying material's accuracy.

In a closely parallel situation in the accounting profession, C.I.T. Financial Corporation v. Glover, 224 E2d 44 (2nd Cir., 1955), accountants were sued over an audit they had performed that listed the value of a company's collateral substantially higher than it was actually worth. Other parties relied on the overvaluation and suffered damages as a result. The accountants, however, had asserted in their audit report appropriate disclaimers qualifying their general assertions about the company's collateral and its financial stability. The U.S. Court of Appeals for the Second Circuit held that disclaimers were sufficient warnings to exculpate the accountants of any liability (p. 46). This discussion, of course, presupposes no fraud on the part of the actuary and an absence of suspicious circumstances that would put him on "inquiry notice," meaning that the circumstances would lead a reasonable prudent professional to further investigate the matters being relied upon.[11]

Liability and Employment Status: It is anticipated that the valuation actuary will work either as an employee of a life insurance company or as a consultant to the company. The nature of potential liability exposure for the actuary is not significantly distinct in these two situations.

As an employee, the valuation actuary will either be responsible to management or directly to the board of directors of the company. If he is part of management, potential liability exposure may be somewhat less, inasmuch as the visibility of the valuation actuary will be less than it would be if the valuation actuary were specifically appointed by the board of directors. In contrast, a direct board appointment could be accompanied by a pledge to indemnify the valuation actuary for losses incurred (other than for fraud or intentional malfeasance, of course). The in-house valuation actuary may be held more responsible for errors that arise through reliance on fellow employees, as he will be expected to be more familiar with individuals and work product relied upon than a consulting valuation actuary.

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[11] In re Equity Funding, 416 F. Supp. 161 (C.D.CA, 1976).

An employee valuation actuary (whether part of management or appointed by the board of directors) could be sued by a broad array of third parties who rely on his work product. In addition, the employee valuation actuary could be sued by his employer, either on an implied contract theory or on a variety of tort theories.

On the one hand, the consultant valuation actuary's exposure may be greater in some respects, due to the perception of independence inherent in a consultant's role. On the other hand, reliance expressed by the consultant may be deemed more reasonable by outside observers, thereby reducing once source of potential exposure. However, the consultant's image of independence, together with a perception that a consulting firm has special expertise in the area, may combine to hold the consultant to a somewhat higher standard of care than the in-house valuation actuary.

The distinctions between potential liability for the in-house valuation actuary and the consulting valuation actuary 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.

On the bottom line, the distinctions are probably insignificant in most cases. 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.

Section 4: Conclusions

This chapter has reviewed the background of the valuation actuary concept, the major components of the concept and how the changes would be effected, the nature of professional liability, and how the valuation actuary would be affected by new duties and responsibilities in terms of potential liability.

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 define precisely the extent of this liability increase potential than the actuarial profession can exactly define the words "reasonable" or "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 or reasonable is a judgment to be made in the first instance by the profession and, ultimately, by the industry and its regulators.