

**RECENT DEVELOPMENTS IN ACTUARIAL  
MALPRACTICE LITIGATION**

**By**

**JOSEPH P. DAILEY AND LOREN F. SELZNICK**

**© 2004  
ALL RIGHTS RESERVED**

# RECENT DEVELOPMENTS IN ACTUARIAL MALPRACTICE LITIGATION

BY

JOSEPH P. DAILEY AND LOREN F. SELZNICK<sup>1</sup>

Free of malpractice claims for years, actuaries have become an increasingly popular target for litigation over the last decade, with scores of suits by clients and third parties alleging injury from an actuarial opinion or report.<sup>2</sup> In *Navigating The Litigation Minefield: A Guide To Actuarial Malpractice Claims*,<sup>3</sup> we reviewed the history of malpractice claims against actuaries, focusing on the standards for third-party liability, the types of problems that give rise to claims, and steps that can be taken to enhance the prospects for success in the event of suit.

During the past year, a series of new decisions have confirmed that like accountants and lawyers, who have been defending malpractice suits for years, actuaries are now a primary target for parties injured by the vicissitudes of the insurance business.<sup>4</sup> Their exposure is likely to increase with the publication last month of a highly critical report by Standard & Poor's, which accused actuaries of "naivete or knavery" in certifying reserves for property and casualty insurers. On a positive note, the National Association of Insurance Commissioners has adopted a model law which, if enacted by the states, would limit the liability of actuaries to third parties when they certify reserves to regulators, except in cases of fraud or willful misconduct. Even if the model law is enacted, recent cases have confirmed that actuaries who negligently review reserves or fail to recommend adequate funding levels are liable to clients and regulators for the resulting damages. The only departure from the principles discussed in our earlier article was a dubious but procedurally helpful ruling that actuaries are not "professionals" in New York.

---

1 Mr. Dailey and Ms. Selznick are partners in the New York law firm of Dailey & Selznick.

2 Actuarial malpractice claims proliferated in the 1990s, which saw three times as many cases as the prior two decades combined. If anything, the pace has quickened: more cases have been brought since 2000 than in all the 1990s. As noted in our prior article, the heightened exposure is likely the result of the reserve certification requirements of state regulators.

3 See *Mealey's Litigation Report: Insurance Insolvency* (Aug. 15, 2002) and *Mealy's Litigation Report: Reinsurance* (Sep. 19, 2002).

4 In the past year, at least fourteen additional decisions relating to actuarial malpractice have appeared. See *Burke v. Bodewes*, 250 F.Supp.2d 262, 263 n.1 (W.D.N.Y. 2003); *Castle Oil Corp. v. Thompson Pension Emp. Plans, Inc.*, 750 N.Y.S.2d 629 (N.Y.App.Div. 2002); *Connecticut Education Ass'n, Inc. v. Milliman USA, Inc.*, 2003 Conn. Super. Lexis 2013 (Conn. Super. 2003); *Dudley Supermarket, Inc. v. Transamerica Life Ins. & Annuity Co.*, 302 F.3d 1 (1st Cir. 2002); *Fire & Police Retiree Health Fund v. Towers, Perrin, Forster & Crosby, Inc.*, 2003 U.S. Dist. Lexis 5405 (W.D.Tex. 2003); *Gerosa v. Savasta & Co.*, 329 F.3d 317 (2d Cir. 2003); *Koken v. Steinberg*, 2003 Pa. Commw. Lexis 370 (Pa. Commw. 2003); *Los Angeles County Emp. Ret. Ass'n v. Towers, Perrin, Forster & Crosby, Inc.*, CV 01-1351(C.D.Cal. 2002); *Paulsen v. CNF, Inc.*, 2003 U.S. Dist. Lexis 21700 (N.D.Cal. 2003); *Pineiro v. Pension Benefit Guaranty Corp.*, 2003 U.S. Dist. Lexis 15034 (S.D.N.Y. 2003); *San Luis Obispo County Pension Trust v. William M. Mercer*, 2003 Cal. App. Unpub. Lexis 6236 (Cal. App. 2003); *Toussaint v. James*, 2003 U.S. Dist. Lexis 12940 (S.D.N.Y. 2003); *Vantage Health Plan, Inc. v. ACMG, Inc.*, 830 So.2d 398 (La. App. 2002); *Walton Risk Services, Inc. v. Clarendon America Ins. Co.*, 2002 U.S. Dist. Lexis 20650 (N.D.Ill. 2002).

## STANDARD &amp; POOR'S REPORT

Perhaps the most significant development in the past year was not a judicial decision, but a report by a leading rating agency, Standard & Poor's ("S&P"), that charged actuaries with aiding and abetting insurers in establishing inadequate casualty reserves.<sup>5</sup> The S&P Report, which drew an immediate rebuke from the American Academy of Actuaries (the "Academy"),<sup>6</sup> claimed that actuaries have "an abysmal track record" in "signing off on reserves that turn out to be wildly inaccurate." Noting that casualty companies increased reserves by a "massive" \$22 billion in 2002 and \$11.6 billion in 2001, S&P claimed "'reserve shortfalls don't just happen overnight. What happened to all the reserving opinions signed by actuaries in prior periods?'" *S&P Report* at 1. According to S&P, the problem is not limited to asbestos exposures, which it admits are difficult to estimate, but extends to "normal bread-and-butter business" as well. *Id.*

After describing a series of questionable reserving practices by insurers, the report argued that actuaries should be held accountable when they certify woefully inadequate reserves. "Everyone's paying much more attention to accounting and corporate governance issues these days, but the forgotten issue is the actuaries!..." S&P claimed that while "managements may be the driving force behind these practices. . . actuaries are the ones providing the intellectual varnish. The actuarial profession should therefore be held equally accountable..." *Id.* at 3.

"The accounting profession has come in for a lot of criticism . . . for signing misleading financial statements . . . . Meanwhile, the insurance industry has done something almost as egregious by . . . overstating prior-year earnings by billions of dollars. Somehow, actuaries have avoided the spotlight for abetting this." *Id.*

S&P contends that the complexity and uncertainties of the reserving process allows actuaries to "manipulate the numbers without penalty..." *Id.* According to the report, "reserving [is] a Gordian knot of complexity and controversy. 'One can come up with at least 50 different methodologies for estimating reserves...Even if a methodology is actuarially sound, you can easily compromise on the assumptions, which could lead to a significant understatement of reserve requirements.'" In a similar vein, S&P equates reserve additions with restatements of financial reports, though it acknowledges the stock market has "withheld the kind of punishment for insurer reserve charges that it metes out to other corporations that restate earnings." *Id.* at 2-3.

---

5 *See Insurance Actuaries--A Crisis Of Credibility*, Standard & Poor's, Nov. 19, 2003.

6 In a one-page news release on November 21, 2003, the Academy said the S&P Report was "fundamentally flawed" and "'an obvious attempt to explain away the errors some analysts have made in estimating property/casualty insurers' earnings.'" A spokesman for the Academy commented, "Actuaries have estimated reserves within reasonable ranges...but recent adverse events have caused losses that exceeded reasonable expectations. That alone is not a reason to accuse actuaries or their companies of 'naivete or knavery'....Fraud should not be inferred from misfortune, but that is exactly what the authors are trying to suggest."

To remedy what it calls a "crisis of credibility" in the actuarial profession, S&P makes three recommendations: *First*, consulting actuaries should be retained to review the estimates of internal actuaries; *second*, "ground-up" reserve studies should be done on asbestos exposures, which accounted for half the reserve additions in 2002; and, *third*, reserve certifications should provide "a measure of variability or a confidence level in reserve estimates, either as an explicit range or as a percentage of held reserves by which the final outcome may vary." The latter recommendation, S&P notes, "may have to be mandated by regulatory authority." *Id.* at 3.

#### A. ESTIMATING CASUALTY RISKS.

Whatever its expertise may be in rating bonds or other financial instruments, the S&P Report displays a surprising misunderstanding of the reserving process for casualty insurers. The difficulty of estimating casualty risks was described by Judge Winter in *Delta Holdings, Inc. v. National Distillers and Chemical Corp.*, 945 F.2d 1226 (2d Cir. 1991), *cert. denied*, 508 U.S. 985 (1992), who noted that "regardless of the actuarial method used," actuaries cannot eliminate "conjecture" in estimating casualty losses. *Id.* at 1231.

"The underwriting of third-party liability, known as 'casualty risks,' leads to complex problems of financing and accounting because assumption of third-party liability risks involves substantial delays or 'tails' in the discovery and reporting of claims. These delays, as lengthy as fifteen or twenty years with some policies, such as medical malpractice insurance, inevitably create considerable uncertainty as to the calculation of future claims and of the reserves that must be set aside to pay those claims." *Id.* at 1229.

Estimating casualty reserves for slow-reporting lines of business has been a perennial challenge for insurers, particularly IBNR reserves, the largest component of the reserve for unpaid casualty claims.<sup>7</sup> As a result, investors cannot "expect equivalent certainty in a balance sheet's statement of loss reserves and its statement of more determinable items, such as outstanding principal and interest on debt instruments." 945 F.2d at 1231. If anything, the difficulty of estimating casualty reserves became more pronounced in the 1990s, as courts expanded the scope of policies written decades earlier, imposing liability not only for asbestos and pollution injuries that in many cases were expressly excluded from coverage, but for a litany of new risks, including tobacco, breast implant, and lead paint poisoning, that were never assumed or priced by underwriters. The full extent of losses on the decades-old policies is still unknown and may not be finally determined for another fifty years. *See In re Joint Eastern & Southern Districts Asbestos Litigation*, 878 F.Supp. 473, 490 (E.D.N.Y. & S.D.N.Y. 1995), *aff'd in part, vacated in part*, 78 F.3d 764 (2d Cir. 1996).

---

<sup>7</sup> IBNR means "incurred but not reported" claims. IBNR reserves are estimates of (1) future increases in the cost of reported claims, and (2) the cost of unreported claims that based on experience are believed to exist but have not been reported as of the financial statement date. According to A.M. Best, IBNR represented 58% of the loss reserves reported by domestic property and casualty insurers in 2002. *See Best's Aggregates & Averages, Property & Casualty* at 26, Schedule P, Part 1 (2003). For slow-reporting lines, the IBNR component is much greater, typically 90% or higher at the end of the first accident year.

Given these developments, it is not surprising that actuarial estimates have failed to accurately predict future losses for long-tail casualty risks, and frequently by large amounts.<sup>8</sup> The largest domestic commercial-lines carrier, AIG, reported a \$4.2 billion increase in net reserves in 2001, and a \$4.0 billion increase in 2002. The problem for AIG and other casualty insurers is not the complexity of the methodologies or the competence of the actuaries, as S&P suggests, but the sheer unpredictability of highly volatile casualty risks.<sup>9</sup> In an environment of rapidly changing legal precedents, estimating these risks for many companies is little more than "informed guesswork." *Delta Holdings, Inc. v. National Distillers and Chemical Corp.*, 945 F.2d at 1231.

The suggestion that changes in reserve estimates are similar to restatements of financial results is misplaced. Changes in estimates occur routinely and are a necessary part of the reserving process.<sup>10</sup> Under GAAP, changes in estimates "should not be accounted for by restating amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods."<sup>11</sup> In contrast, restatements of prior-year financial reports are rare and limited to cases of fraud or mistake of existing fact or principle. The distinction between changes in reserve estimates and restatements is well recognized in the law. See *National Distillers and Chemical Corp. v. Stephens*, 912 S.W.2d 30, 32-33 (Ky. 1996). The same distinction is recognized in accounting, where mathematical errors, mistakes of principle, and oversight of existing facts may be corrected retroactively, while changes in estimates arising from new information or subsequent events may not. AICPA, Accounting Principles Board Opinion No. 20, *Accounting Changes*, ¶ 13 (1971). The distinction has not been lost on the stock market which, as S&P acknowledges, punishes restatements but not changes in estimates.

---

<sup>8</sup> Large in absolute terms, the \$22.7 billion in reserve additions cited by S&P is not "massive" when compared to industry reserves (5.5% of \$413 billion) or surplus (7.8% of \$291 billion). See *Best's Aggregates & Averages, Property & Casualty* at 26 & 3 (2003). Moreover, changes in estimates do not always result in reserve additions, as S&P suggests. Reserve increases in 2001 and 2002 broke a string of seven consecutive years of reserve *decreases* for property and casualty insurers. Overall, the industry had favorable loss development between 1993 and 2002--i.e., decreases in prior-year reserves exceeded additions by \$7.3 billion over the ten-year period. *Id.*, Schedule P, Part 2, at 27.

<sup>9</sup> AIG Form 10-K, Dec. 31, 2002, at 7. According to AIG, IBNR estimates for asbestos and environmental claims "cannot be estimated by conventional reserving techniques." If courts continue to expand the scope of coverage, "additional liabilities would emerge for amounts in excess of reserves held. This emergence cannot now be reasonably estimated, but could have a material impact on AIG's future operating results." *Id.* at 102 n.12. Hartford agrees. "Conventional reserving techniques cannot reasonably estimate the ultimate cost of these claims, particularly during periods where theories of law are in flux." Hartford Financial Services Group, Inc., Form 10-K, Dec. 31, 2002, at 42.

<sup>10</sup> "Changes in estimates used in accounting are necessary consequences of periodic presentations of financial statements . . . . [A]ccounting estimates change as new events occur, as more experience is acquired, or as additional information is obtained." AICPA, Accounting Principles Board Opinion No. 20, *Accounting Changes*, ¶ 10 (1971).

<sup>11</sup> AICPA, Accounting Principles Board Opinion No. 20, *Accounting Changes*, ¶ 31 (1971). See FASB, Statement of Financial Accounting Standards No. 60, *Accounting and Reporting By Insurance Enterprises*, ¶ 18 (1982).

## B. S&P RECOMMENDATIONS.

The S&P recommendations, while helpful, are hardly a panacea. Most major property and casualty insurers, who are responsible for the lion's share of the \$22 billion in reserve additions in 2002, already use consulting actuaries to review reserves. Likewise, while ground-up reserve studies would likely improve the reliability of estimates for known claims, they would be of little help in estimating IBNR for slow-reporting casualty claims. AIG, which has been doing ground-up studies of asbestos and environmental claims for years, believes that as a result of inconsistent court resolutions and other factors, IBNR for these claims "cannot be estimated by conventional reserving techniques." AIG, Form 10-K, Dec. 31, 2002, at 30.

The S&P proposal for expressing reserve estimates as an explicit range, or as a percentage of held reserves by which the final outcome may vary, is more useful. Support for such an approach can be found in generally accepted actuarial principles,<sup>12</sup> although at least one large insurer believes it is impractical and would provide little meaningful information to investors, particularly for companies which have hundreds of lines of long-tail casualty risks.<sup>13</sup>

Even if desirable, there has been no generally accepted actuarial method for calculating the variability of a reserve estimate in a meaningful way.<sup>14</sup> Last year a framework for quantifying the variability inherent in reserve estimates was developed by two former presidents of the Casualty Actuarial Society.<sup>15</sup> The methodology uses a new function, called the coefficient of estimation, to place reserve estimates on a continuum of all possible estimates that can be calculated from a universe of data, allowing actuaries to say, for example, that their estimate is in the middle or at the high-end of the range of possible estimates. It also allows actuaries to quantify the variability associated with the boundaries of a selected range of estimates, as the S&P Report recommended. The authors emphasize, however, that while the model is a useful tool, it "does not eliminate the inherent uncertainty of reserve estimates." *Id.* at 26.

---

12 The Casualty Actuarial Society recognizes the "uncertainty inherent in the estimation of required provisions for unpaid losses...implies that a range of reserves can be actuarially sound." *Statement Of Principles Regarding Property & Casualty Loss and Loss Adjustment Expense Reserves* (1988) § II(3). See *Actuarial Standard of Practice No. 36, Statements Of Actuarial Opinion Regarding Property/Casualty Loss and Loss Adjustment Expense Reserves*, § 3.6.4-5 (Oct. 15, 2000). The NAIC requires actuaries to disclose any factors or conditions "that could result in material adverse deviation" from the range in their Statement Of Actuarial Opinion. NAIC, Annual Statement Instructions, Property & Casualty, Actuarial Opinion, ¶ 6(a) (2002).

13 AIG, which insures hundreds of lines of slow-reporting casualty risks, says that "developing a range around loss reserve estimates would not be meaningful" because its "general insurance business is primarily in volatile long tail casualty lines driven almost entirely by severity rather than frequency of claims". AIG, Form 10-K, Dec. 31, 2002, at 29.

14 Lack of a reliable mathematical model, unfortunately, did not prevent many actuaries from using such words as "best" or "most reasonable" to describe their estimates when there was no generally accepted methodology to support their conclusions.

15 See C.K. Khury & Irene K. Bass, *A Probabilistic Framework for Evaluating Materiality and Variability In Loss Reserve Estimates* (2003).

## II

### THIRD PARTY LIABILITY

If the S&P Report increases the exposure of actuaries, a recent action by the National Association of Insurance Commissioners ("NAIC") limits the potential for suit by third parties. On December 7, 2003, the NAIC adopted a model law that provides partial immunity for property and casualty actuaries who certify reserves on an Annual Statement. The provision, apparently a *quid pro quo* for an agreement by the actuarial community to submit workpapers and a confidential summary of their certification reports to regulators, provides:

"The Appointed Actuary shall not be liable for damages to any person (other than the insurance company and the commissioner) for any act, error, omission, decision or conduct with respect to the actuary's opinion, except in cases of fraud or willful misconduct on the part of the Appointed Actuary."  
NAIC, Property And Casualty Actuarial Opinion Model Law § 2(D) (2003).

Scheduled to be submitted to the states for enactment in 2004, the provision is patterned after a law passed by 43 states for life insurance actuaries, also at the behest of the NAIC.<sup>16</sup> In recommending immunity for actuaries, the NAIC said it was concerned that the certification requirements would "expose the actuary's personal assets to the threat of financial liability, particularly since the testing of [reserve] adequacy is not an exact science."<sup>17</sup>

---

16 Statutes immunizing life insurance actuaries from third-party liability typically provide: "Except in cases of fraud or willful misconduct, the...actuary shall not be liable for damages to any person other than the insurance company and the commissioner...with respect to the actuary's opinion." Colo. Rev. Stat. § 10-7-114 (1)(f) (1992). *See* Alaska Stat. § 21.18.110 (q)(1) (1993); Ariz. Rev. Stat. § 20-510 (C)(2)(e) (1994); Ark. Code § 23-84-112 (d)(6) (1995); Conn. Gen. Stat. § 38a-78 (b)(7) (1991); Del. Code tit. 18, § 1111 (c)(4)(f) (1994); D.C. Code § 31-4901 (a)(7) (1993); Ga. Code § 33-10-13 (b)(5)(F) (1993); Haw. Rev. Stat. § 431:5-307 (j)(4)(F) (1995); Idaho Code § 41-612 (12)(d)(vi) (1995); Ill. Rev. Stat. § 215 ILCS 5/223 (1)(A)(7) (1991); Ind. Code § 27-1-12-10.1 (g) (1994); Iowa Code § 508.36 (2)(d)(6) (1995); Kan. Stat. § 40-409 (b)(5)(F) (1994); Ky. Rev. Stat. § 304.6-171 (5)(f) (1996); La. Rev. Stat. § 22:162.1 (D)(6) (1992); Me. Ins. Code § 952-A (4)(F) (1995); Mass. Laws ch. 175, § 9B (A)(6) (1993); Mich. Comp. Laws § 500.830a (5) (1994); Minn. Stat. § 61A.25 (2a)(g) (1991); Miss. Code § 83-7-23 (9)(d)(vi) (1994); Mo. Rev. Stat. § 376.380 (4)(4)(f) (1993); Mont. Code § 33-2-521 (4)(d)(vii) (1995); Neb. Rev. Stat. § 44-424 (5) (1994); Nev. Rev. Stat. § 681B.250 (1) (1995); N.H. Rev. Stat. § 410:2-a (IV)(f) (1995); N.J. Rev. Stat. § 17B:19-10 (d)(6) (1995); N.M. Stat. § 59A-8-7 (E)(6) (1993); N.C. Gen. Stat. § 58-58-50 (j)(8) (1993); N.D. Cent. Code § 26.1-35-01.1 (4)(f) (1993); Ohio Rev. Code § 3903.72 (B)(3)(e) (1996); Okla. Stat. tit. 36, § 4061 (D)(5) (1997); Or. Rev. Stat. § 733.304 (1)(f) (1991); 40 Pa. Cons. Stat. § 71 (g)(5)(E) (1993); R.I. Gen. Laws § 27-4.5-3 (d)(6) (1993); S.C. Code § 38-9-180 (B)(4)(f) (1993); S.D. Cod. Laws § 58-26-53 (1995); Tenn. Code § 56-1-402 (g)(6) (1995); Utah Code § 31A-17-503 (5)(f) (1993); Va. Code § 38.2-3127.1 (A)(7) (1992); Wash. Rev. Code § 48.74.025 (5)(f) (1993); W.Va. Code § 33-7-9 (c)(4)(F) (1995); Wis. Stat. § 623.06 (1m)(d) (1995).

17 NAIC, *Report of Advisory Committee On Standard Valuation Law*, 1989 Proceedings, Vol. 1 at 605 (1988). A recent Texas case sustaining a malpractice claim against two actuaries who were acting in the scope of their employment by an actuarial firm confirms that actuaries have reason to be concerned about their personal assets. *See Fire & Police Retiree Health Fund v. Towers, Perrin, Forster & Crosby*, 2003 U.S. Dist. Lexis 5405 (W.D. Tex. 2003).

While welcome news for property and casualty actuaries, the limitation proposed by the NAIC may not be as helpful as first appears:

- *First*, the limitation does not affect suits by clients and regulators, which accounted for more than 70% of the malpractice claims since 1972, and all but two of the fourteen malpractice decisions reported in the last year.
- *Second*, the limitation does not affect two major segments of the actuarial profession--accident and health actuaries, who are regulated by the NAIC, and pension actuaries who are regulated by the Departments of Treasury and Labor.<sup>18</sup>
- *Third*, there is no assurance that the limitation, which was adopted without comment by the NAIC,<sup>19</sup> will be enacted by the states in the form proposed. Four states, including the two largest, altered the model law dealing with life insurance actuaries--New York expanded the fraud exception to include gross negligence,<sup>20</sup> while California turned the Model Law on its head, providing that an actuary "*shall* be liable for his or her negligence or other tortious conduct." Cal. Insurance Code § 10489.15 (c)(6) (Deering 1992).
- *Fourth*, the limitation does not apply to fraud or willful misconduct, or gross negligence in New York and Maryland. Since it is not difficult to allege willful misconduct or gross negligence in a pleading, actuaries may have to incur the costs and distractions of a trial to vindicate their work.
- *Finally*, the limitation only applies to certifications on Annual Statements. Among other things, it does not cover actuarial reviews relating to pension plans, SEC filings, mergers and acquisitions, reinsurance contracts, and a host of other insurance and reinsurance transactions where actuarial services are commonly provided.

---

<sup>18</sup> A model law limiting third-party liability for actuaries who work for accident and health companies has not been adopted by the NAIC. However, if a life company offers accident and health policies, health actuaries working for the life company would presumably be covered by the limitation of liability provision. There is no indication the Labor and Treasury Departments, which have jurisdiction over ERISA issues, are considering immunity for pension actuaries.

<sup>19</sup> The NAIC press release announcing the adoption of the Actuarial Opinion Model Law was silent on the limitation of liability provision. The release simply said the model law required "every property and casualty insurance company doing business in a state . . . to annually submit a confidential summary of the Actuarial Report and work papers at the time that the Actuarial Opinion, a public document, is submitted." See NAIC, Summary--Property and Casualty Actuarial Opinion Model Law (2003).

<sup>20</sup> See N.Y. Insurance Law § 4217 (e)(4)(F) (1994); Md. Insurance Code Ann. § 5-201 (i) (1995). A fourth state, Wyoming, swallowed the rule by expanding the exceptions to include ordinary negligence. See Wyo. Stat. § 26-6-208 (e)(v) (1994).

For the myriad of transactions unaffected by the limitation of liability provision, common law rules will continue to apply. As noted in our previous article, rules relating to third party liability vary significantly from state to state. A majority of jurisdictions follow § 552 of the Restatement of Torts, which allows suits by third parties for whose benefit and guidance a report is supplied in specific types of transactions. *See, e.g., Arthur Andersen LLP v. Superior Court Of Los Angeles County*, 79 Cal. Rptr. 2d 879 (Cal.App. 1998). A smaller number of states follow New York, which limits liability to cases where actuaries, by words or deeds, consent to the use of their work by a specific party in a specific transaction. *See, e.g., Employee Staffing Of America, Inc. v. William M. Mercer, Inc.*, 1998 U.S. Dist. Lexis 3104 (S.D.N.Y. 1998). Finally, a handful of states follow the products liability rule which expands liability to members of the public who actuaries should reasonably foresee will rely on their work. *See, e.g., Citizens' State Bank v. Timm, Schmidt & Co.* S.C., 335 N.W.2d 361 (Wis. 1983).

Over the past year, courts have continued to adopt widely disparate rules for third party liability. In *Walton Risk Services, Inc. v. Clarendon America Insurance Co.*, 2002 U.S. Dist. Lexis 20650 (N.D.Ill. Oct. 25, 2002), a federal court applying Illinois law adopted a liability standard narrower than the Restatement but broader than New York.<sup>21</sup> In *Walton*, an actuary reviewed the reserves of a reinsurer who was required to maintain a trust fund equal to 102% of its reinsurance obligations. The insurer responsible for 98% of the business assumed by the reinsurer, and for whose benefit the trust fund was established, sued the actuary for malpractice, claiming it had "selected parameters unreasonably and made assumptions that . . . understated" reserves by \$12 million. *Id.* at 5. In finding that the actuary owed a duty of care to the ceding company, even though there was no contract or dealings between the parties, the court held:

"The existence of a duty is a question of law, and the answer depends on whether there is such a relationship between the defendant and the plaintiff that the defendant has an obligation of reasonable conduct for the benefit of the plaintiff . . . .In *Pelham v. Griesheimer*, an attorney malpractice case, the Illinois Supreme Court first stated what has come to be known as the primary intent rule: 'to establish a duty owed by the defendant attorney to the nonclient, the nonclient must allege and prove that the intent of the client to benefit the nonclient third party was the primary or direct purpose of the transaction or relationship.' 440 N.E.2d at 99 . . . .

"[Plaintiff] . . . alleges that a 'direct purpose of the preparation of the Loss Reserve Reports was so that [it] could rely upon the Loss Reserve Reports in determining whether it would continue its relationship with [the reinsurer]'. . . [The actuary] knew that the 1999 Report was going to be shown to [plaintiff and that it] would rely upon the 1999 Report and would use the report to determine whether [the reinsurer] should continue to provide reinsurance." *Id.* at 11-13.

---

<sup>21</sup> See *Credit Alliance Corp. v. Arthur Andersen & Co.*, 483 N.E.2d 110, 118 (N.Y. 1985).

At the other end of the spectrum, *Paulsen v. CNF, Inc.*, 2003 U.S. Dist. Lexis 21700 (N.D. Cal. Nov. 24, 2003), applied the limitations in § 552 of the Restatement of Torts to dismiss an actuarial malpractice claim by a pension plan participant whose benefits were reduced after his company became insolvent. Following the lead of *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992), which dismissed a malpractice claim against an accounting firm under § 522, the court held that the participant who was a beneficiary of the plan lacked standing to sue the actuaries because they "provided services to the plan and thus owed no legal duty to the individual participants."

A significantly broader standard of liability was adopted in *Koken v. Steinberg*, 2003 Pa. Commw. Lexis 370 (Pa. Commw. May 20, 2003), the first major decision in the liquidation of the Reliance Insurance Company. The Pennsylvania court permitted the liquidator of Reliance to sue Deloitte & Touche for allegedly providing negligent actuarial and accounting services that resulted in a "looting" of the insurer by the controlling shareholder. Rejecting the privity standard established by Justice Cardozo in *Ultramares Corp. v. Touche*, 255 N.Y. 170 (1931), the court allowed the liquidator to sue on behalf of policyholders and creditors who do not have any contract or dealings with the actuary:

"...Deloitte simply ignores the fact that it is now settled law in Pennsylvania that an insurance regulator is charged not only with representing the public interest but the interests of the policyholders and creditors as well. Article V of the Insurance Department Act...clearly states, 'The purpose of this article is the protection of the interests of insureds, creditors, and the public generally'...."

"In this jurisdiction, our Court has said that Article V authorizes the rehabilitator to pursue actions on behalf of the insurer and on behalf of the policyholders and other creditors. *Foster v. Peat Marwick Main & Co.*...In that case, we overruled...objections that were grounded on the purported failure of...the rehabilitator . . . to state a cause of action for injuries to policyholders . . . . We noted that there, as here, the Company was a mutual company and that therefore the policyholders were both the insureds and the insurers. We also... found that 'a rehabilitator...may assert injury common to shareholders and general creditors and enjoys the authority to recover estate assets to which they will eventually look for recovery.'" *Id.* at 5-8.

*Koken* is similar to *Arthur Andersen LLP v. Superior Court Of Los Angeles County*, 67 Cal.App. 4th 1481, 79 Cal. Rptr. 2d 879 (Cal.App. 1998), which allowed the California Insurance Commissioner to sue an accounting firm that certified the balance sheet of an insolvent insurer. In both cases, regulators were allowed to sue on behalf of shareholders and creditors, even though they could not sue themselves, except in states that follow the foreseeability rule of third party liability--Wisconsin, New Jersey, and Mississippi. However, unlike direct actions, where third parties can recover consequential damages to their business, liquidators can only recover damages that are "common" to all shareholders and creditors of the defunct entity.

### III

## MALPRACTICE CLAIMS BY CLIENTS

Whatever rules states may adopt for third party claims, they all entertain actuarial malpractice claims by clients. Although it did not break new ground, a recent Second Circuit decision, *Gerosa v. Savasta & Co.*, 329 F.3d 317, 329 (2d Cir. 2003),<sup>22</sup> described the salutary effects of such claims in the ERISA area, namely, ensuring the accurate reporting and disclosure of reliable financial information for participants and beneficiaries. Unlike the NAIC, which recommended immunity for actuaries because it was concerned the certification laws would expose their "personal assets to the threat of financial liability,"<sup>23</sup> the Second Circuit believed that "liability, not immunity" was the way to insure sound actuarial practices, and nothing can "compare to a common law action for damages" for achieving that end:

"[O]ne of ERISA's express purposes is to ensure 'the disclosure and reporting to participants and beneficiaries of financial and other information' pertinent to benefit plans . . . . Actuaries, plainly, play an important role in such disclosures. If ERISA's actuarial provisions are enforceable, though, they guarantee at least a floor of responsible reporting standards. State standards, while possibly inconsistent with one another, could only add to the protections afforded to the plan and its beneficiaries . . . .

"[I]t is liability, not immunity, which ultimately can help ensure that the reporting and disclosures demanded by ERISA are made accurately. As this case graphically illustrates, the 'appropriate equitable relief' authorized by § 1132(a)(3) will rarely have any meaningful deterrent effect on negligent actuaries, since such relief cannot compare to a common-law action for damages as a stimulant to adherence to the appropriate level of professional performance. True, there are other formal and informal sanctions, such as suspension or termination by the Joint Board . . . . or damage to a firm's professional reputation. But such broad disincentives operate with uncertain force in particular instances, especially when highly out of proportion (in either direction) to the negligence or malfeasance. Suspension and termination also rely on the scarce resources of the Department of Labor, which although not inconsiderable, are tiny compared to the huge number of plans now in existence. It is highly implausible that a Congress interested in disseminating precise and meaningful plan information would intentionally minimize the incentives for careful behavior of one of the primary guardians of reliable, objective data . . . ."

---

<sup>22</sup> Following the lead of other courts, *Gerosa* held that common law claims for professional malpractice were not preempted by ERISA. See, e.g., *Airparts Co. v. Custom Benefit Services Of Austin, Inc.*, 28 F.3d 1062 (10th Cir. 1994); *Aetna Casualty & Surety Co. v. William M. Mercer, Inc.*, 173 F.R.D. 235 (N.D.Ill. 1997); *Richards v. Union Labor Life Insurance Co.*, 804 F.Supp. 1101 (D.Minn. 1992).

<sup>23</sup> NAIC, *Report of Advisory Committee On Standard Valuation Law*, 1989 Proceedings, Vol. 1 at 605 (1988).

## IV

### DAMAGES

In the past year, the dimensions of actuarial malpractice claims have been brought into sharp relief by a series of decisions in the pension area. While it has always been clear that actuaries, like other service providers, are liable for direct damages--i.e., fees and expenses paid by the client<sup>24</sup>--until recently their liability for consequential damages has been limited to reasonably manageable amounts. All this changed with a pair of recent California decisions. In the first case, a federal court allowed an actuarial firm to avoid a \$2 billion damage claim by deciding a dispositive question of state law in its favor; in the second case, decided a year later, the California Court of Appeal adopted the opposite view on the same issue.<sup>25</sup> If the order of the cases had been reversed, the actuarial firm would have faced financial ruin.

#### A. DAMAGE THEORIES.

Like other professionals, actuaries who breach their duty of care to clients can be sued in contract and tort.<sup>26</sup> Damages are generally greater in tort, where actuaries are liable for all economic losses proximately caused by their actions.<sup>27</sup> Since actuarial engagements frequently entail hundreds of millions, or even billions, of dollars, a consequential damage award could bankrupt even the largest firms. In contract actions, damages are limited to what the parties reasonably contemplated or foresaw at the time of the agreement.<sup>28</sup> In practice, there is probably little difference between consequential damages in tort and reasonably foreseeable damages in contract, since most types of actuarial injury, such as reserve deficiencies and funding shortfalls, are an obvious and foreseeable result of actuarial error. Whatever the legal theory, when the business under review is substantial, the potential for financial ruin is great.

---

<sup>24</sup> Where "defective performance of services is the breach," direct damages are "fee[s] paid to defendant for the services" promised but not received. *Jones Memorial Trust v. Tsai Investment Services*, 367 F.Supp. 491, 499 (S.D.N.Y. 1973). Direct damages were recently awarded in *Board Of Trustees For San Luis Obispo County Pension Trust v. William M. Mercer*, 2003 Cal.App. Unpub. Lexis 6236 at 7 (Cal. App. Jun. 26, 2003).

<sup>25</sup> See *Los Angeles County Employees Retirement Ass'n v. Towers, Perrin, Forster & Crosby, Inc.*, No. CV 01-1351 (C.D.Cal. Jun. 20, 2002); *Board Of Trustees For San Luis Obispo County Pension Trust v. William M. Mercer*, 2003 Cal.App. Unpub. Lexis 6236 at 7-13 (Cal. App. Jun. 26, 2003).

<sup>26</sup> *Chase Scientific Research, Inc. v. NIA Group, Inc.*, 749 N.E.2d 161, 163-64 (N.Y. 2001).

<sup>27</sup> Tort "damages are awarded to [fully] compensate the victim for [all] injury suffered . . .", *Erlich v. Menezes*, 981 P.2d 978, 982 (Cal. 1999), and include all economic losses proximately caused by the malpractice. See *Hydro Investors, Inc. v. Trafalgar Power Inc.*, 227 F.3d 8, 15 (2d Cir. 2000); *Movitz v. First National Bank Of Chicago*, 148 F.3d 760 (7th Cir. 1998).

<sup>28</sup> In contract cases, damages are those "reasonably foreseen or contemplated by the parties during their negotiations or at the time the contract was executed." *Kenford Co. v. County Of Erie*, 537 N.E.2d 176, 180 (N.Y. 1989); *Rexnord Corp. v. DeWolff Boberg & Associates, Inc.*, 286 F.3d 1001, 1004 (7th Cir. 2002); *AM/PM Franchise Association. v. Atlantic Richfield*, 584 A.2d 915, 920-21 (Pa. 1990). Foreseeability serves to "limit the liability for unassumed risks . . ." *Kenford Co. v. County Of Erie*, 537 N.E.2d at 180.

## B.. DAMAGE ELEMENTS.

1. *Funding Shortfalls.* One of the most common types of injury in pension cases is a shortfall in contributions from a sponsor due to actuarial errors.<sup>29</sup> When the errors span many years, the consequential damages can be enormous. In *Los Angeles County Employees Retirement Ass'n v. Towers, Perrin, Forster & Crosby, Inc.* ("*Los Angeles County*"),<sup>30</sup> a public employees pension trust claimed that an actuarial firm used unreasonable assumptions in calculating the contribution rates of its sponsor, Los Angeles County. Over two decades, the alleged shortfall was \$800 million. The damage claim was eviscerated, however, when the federal court ruled that the county and its pension trust were a single, unified entity, and that any damages to the trust were offset by an equivalent savings to the county.<sup>31</sup> Another funding shortfall claim was made in *Board Of Trustees For San Luis Obispo County Pension Trust v. William M. Mercer*, 2003 Cal.App. Unpub. Lexis 6236 (Cal.App. Jun. 26, 2003) ("*San Luis Obispo County*"), but the sum was smaller, only \$11 million. In *San Luis Obispo County*, the actuary admitted that a computer error was responsible for a funding shortfall of up to \$28 million and recommended the trustees collect it from the county. The trustees, inexplicably, ignored the advice and sued the actuaries instead, claiming the trust was injured when it increased benefits to participants in anticipation of higher funding levels from the county. The court rejected this damage theory, finding that the additional benefits "would have been paid anyway at a later date." *San Luis Obispo*, 2003 Cal. App. Unpub. Lexis 6236 at 3. In another funding shortfall case, a New York court held that a pension plan could recover damages from its actuary by proving the shortfall was caused by unreasonable actuarial assumptions. *Toussaint v. James*, 2003 U.S. Dist. Lexis 12940 (S.D.N.Y. Jul. 25, 2003).

2. *Investment Income.* Actuaries are also liable for lost investment income on the funding shortfalls. In *Los Angeles County*, investment income on the \$800 million funding shortfall amounted to \$1.2 billion, bringing the total malpractice claim to \$2 billion. While the court eliminated most of the investment income claim under the unified creditor doctrine, it allowed the trust to recover interest at its own rate of return, which was higher than the county. *Los Angeles County*, (C.D.Cal. Dec. 6, 2002), Slip Op. at 5. In *San Luis Obispo County*, the trust was allowed to recover \$3 million in lost investment income from the actuary, even though it did not try to recoup the funding shortfall from the county.

---

<sup>29</sup> Funding shortfalls are analogous to reserve deficiencies for casualty insurers. Actuaries have been sued for reserve deficiencies on the theory that, if detected on a timely bases, they could have been eliminated by higher premiums. See, e.g., *National Home Insurance Co. v. Towers, Perrin, Forster & Crosby, Inc.*, 94 CV 0705 (D.Colo. Feb. 10, 1994); *Great Central Insurance Co. v. Insurance Services Office, Inc.*, 74 F.3d 778 (7th Cir. 1996).

<sup>30</sup> No. CV 01-1351, (C.D.Cal.). Two summary judgment decisions were issued in *Los Angeles County*, the first on June 21, 2002, the second on December 6, 2002. The case was apparently settled pursuant to an April 23, 2003 stipulation of dismissal.

<sup>31</sup> In a subsequent decision, the court in *Los Angeles County* held the actuaries were liable for funding shortfalls from other sources, such as private employers, employees, and the federal government. *Los Angeles County* (Dec. 6, 2002), Slip Op. at 4-5. See *Toussaint v. James*, 2003 U.S. Dist. Lexis 12940 at 17 & 22 (S.D.N.Y. Jul. 25, 2003).

3. *Excessive Benefits*. Unlike *San Luis Obispo County*, which denied a claim for excessive benefits, *Gerosa v. Savasta & Co.*, 329 F.3d 317 (2d Cir. 2003), sustained a similar claim, but in far more compelling circumstances. In *Gerosa*, an actuary repeatedly advised trustees that a plan was overfunded and recommended that benefits be increased accordingly. After the trustees accepted the advice, and began paying higher benefits, the actuary reported the plan was underfunded, not overfunded, and that its assets would only cover 71% of the vested benefits. A contractual malpractice claim was reinstated on appeal by the Second Circuit, after having been erroneously dismissed by the trial court on grounds of preemption.

4. *Uncollectible Reinsurance*. In *Walton Risk Services, Inc. v. Clarendon America Insurance Co.*, 2002 U.S. Dist. Lexis 20650 at 16-17 (N.D.Ill. Oct. 25, 2002), a federal court applying Illinois law upheld a third party complaint by a ceding company against an actuarial firm that had negligently certified the reserves of a reinsurer. Rejecting the contention that future losses were "too speculative and uncertain" to support a damage award--a position shamelessly advanced by an actuary that had just certified the reasonableness of the reserves--the court upheld a \$12 million claim for uncollectible reinsurance.

#### C. DAMAGE DEFENSES.

The viability of three commonly asserted damage defenses was also addressed in the funding shortfall cases. *First*, as noted earlier, *Los Angeles County* held that a county and its pension trust were a single, unified entity, allowing the actuary to offset damages to the trust by the savings to the county. In *San Luis Obispo County*, decided a year later, the California Court of Appeal reached the opposite result, holding that California counties and their pension trusts were separate entities, precluding an offset. 2003 Cal.App. Unpub. Lexis 6236 at 7-13. If *San Luis Obispo County* had been decided a year earlier, the *Erie* doctrine would have required the federal court to follow the state court ruling, *Fidelity Union Trust Co. v. Field*, 311 U.S. 169, 178 (1940), and the actuaries in *Los Angeles County* would have been faced with a \$2 billion judgment for actuarial malpractice. *Second*, another defense to funding shortfall claims is that since defined benefit plans are not required to accumulate surpluses, higher contributions would constitute a "windfall" to the trust and its beneficiaries. Rejecting this claim, *Los Angeles County* held the plan "was entitled to accumulate surpluses free of negligence."<sup>32</sup> *Finally*, actuaries frequently claim that future investment income is too speculative in nature to support a money damage award. The courts in *San Luis Obispo County* and *Los Angeles County* disagreed, but said that if it was, the actuary had to bear the risk of uncertainty.<sup>33</sup> A similar defense was raised and rejected in *Walton Risk Services, Inc. v. Clarendon America Insurance Co.*, 2002 U.S. Dist. Lexis 20650 at 16-17.

---

<sup>32</sup> Slip Op. at 3 (C.D.Cal. Dec. 6, 2002). See *San Luis Obispo County*, 2003 Cal.App. Unpub. Lexis 6236 at 6-14; *Toussaint v. James*, 2003 U.S. Dist. Lexis 12940 at 21-22 (S.D.N.Y. Jul. 25, 2003).

<sup>33</sup> *San Luis Obispo County*, 2003 Cal.App. Unpub. Lexis 6236 at 13; *Los Angeles County*, Slip Op. at 5-6 (C.D.Cal. Dec. 6, 2002).

## STATUS AS "PROFESSIONALS"

The most curious development in the last year was an appellate court decision that actuaries were not "professionals" under New York law. *See Castle Oil Corp. v. Thompson Pension Employee Plans, Inc.*, 750 N.Y.S.2d 629 (App.Div. 2002). The issue arose when an actuarial firm moved to dismiss a malpractice complaint as untimely, contending the three-year statute of limitations for negligence was not tolled by the continuous representation doctrine.<sup>34</sup> Since the doctrine only applies to "professionals," the court had to determine whether actuaries satisfied the requirements of *Chase Scientific Research, Inc. v. NIA Group, Inc.*, 749 N.E.2d 161 (N.Y. 2001), which defined "professionals" as follows:

"Professional' is a term in wide usage, commonly understood to have several meanings. For example, it denotes a measure of quality, as in professional dry cleaners; a distinction from trade or businesspeople, and from amateur status, as in professional golfers; a lifework as opposed to pastime, as in professional musicians. Often there are study, licensure and continuing skills requirements, as for barbers, electricians and real estate brokers. Thus, neither common parlance nor licensure can determine the meaning of 'professional,' for surely the Legislature did not have such a vast, amorphous category of service providers in mind when it amended CPLR 214(6) . . . .

"The term 'professional' is also commonly understood to refer to the learned professions, exemplified by law and medicine, which have particular relevance to the history of CPLR 214(6). The...malpractice statutes of limitation, after all, began with doctors, enlarged soon after to encompass attorneys and accountants...'The qualities shared by such groups guide us in defining the term 'professional.' In particular, those qualities include extensive formal learning and training, licensure and regulation indicating a qualification to practice, a code of conduct imposing standards beyond those accepted in the marketplace and a system of discipline for violation of those standards....Additionally, a professional relationship is one of trust and confidence, carrying with it a duty to counsel and advise clients...'This definition...implements the Legislature's intention to benefit a discrete group of persons....[A]ny broader definition would...make it hard to draw meaningful distinctions and groups covered by CPLR 214(6) would quickly proliferate." 749 N.E.2d at 165-66.

---

34 The continuous representation doctrine allows plaintiffs to toll the statute of limitations against professionals during the period when services are being rendered. The doctrine holds that a "person seeking professional assistance has a right to repose confidence in the professional's ability and good faith, and realistically cannot be expected to question and assess the techniques employed or the manner in which the services are rendered" . . . " *Shumsky v. Eisenstein*, 750 N.E.2d 67, 70 (N.Y. 2001). When New York extended its three-year statute of limitations for malpractice to nonmedical professionals in 1996, it "ended one quandary but exposed another: who are the 'professionals' whose misfeasance toward clients is subject to the shortened limitations period?" *Chase Scientific Research, Inc. v. NIA Group, Inc.*, 749 N.E.2d 161, 164 (N.Y. 2001).

Applying these standards to actuaries, the trial court in *Castle Oil* found that while there was "persuasive" evidence that actuaries met most of the requirements established in *Chase Scientific Research*,<sup>35</sup> they did "not fully satisfy the test set forth by the Court of Appeals. Missing from these requirements are any references to licensing and regulation of actuaries by the State." *Castle Oil Corp. v. Thompson Pension Employee Plans Inc.*, 2001 N.Y. Misc. Lexis 1257 at 5 (N.Y. Sup. 2001). On appeal, a five-judge panel affirmed the trial court judgment, but adopted its own findings. Unlike the trial court, the appeals court found that actuaries lacked virtually all of the characteristics of a "professional." Placing actuaries on the same footing as barbers, electricians, and real estate agents, the appeals court ruled:

"A group is considered 'professional' within the ambit of CPLR 214(6) when it shares qualities which include 'extensive formal learning and training, licensure and regulation indicating a qualification to practice, a code of conduct imposing standards beyond those accepted in the marketplace and a system of discipline for violation of those standards' . . . Guided by this definition, we reject the plaintiff's contention that its cause of action alleging negligent performance of actuarial services is governed by CPLR 214(6). Unlike architects, engineers, lawyers, and accountants, who are required to be licensed to practice in their fields . . . , actuaries are not required to be licensed in New York. Moreover, actuaries are not regulated by the State, or subject to a State-created disciplinary system. In addition, although the record indicates that actuaries must usually pass a series of examinations administered by the Casualty Actuarial Society or the Society of Actuaries, there is no formal educational criteria for entry into this field. Furthermore, while individuals are alternatively permitted to become actuaries through work experience, the required duration of this experience is not specified. Considering these factors, we conclude that actuaries are not professionals within the meaning of CPLR 214(6) . . . . Accordingly, the plaintiff may not rely upon the doctrine of continuous representation . . . .*Castle Oil Corp. v. Thompson Pension Employee Plans, Inc.*, 750 N.Y.S.2d 629, 631 (App.Div. 2002).

The findings in *Castle Oil* are flawed in at least three respects. *First*, contrary to the findings of the trial and appellate courts, there is a licensing requirement, or its functional equivalent, for life, health, and casualty actuaries in New York, and other states, and for pension actuaries enrolled with the federal government. *Second*, there is also a code of professional conduct for actuaries and a disciplinary system for violation of those standards. *Third*, the American Academy of Actuaries has education and work experience requirements for members who issue statements of actuarial opinion and the Joint Board has more detailed requirements for actuaries who work on ERISA-related issues, such as the defendant in *Castle Oil*.

---

35 In *Chase Scientific Research*, the court held that insurance brokers were not "professionals" because they lack extensive specialized training, were not bound by a standard of conduct and a related disciplinary system, and did not have "a continuing duty to advise...a client based on a special relationship of trust and confidence." In short, "insurance agents and brokers are held to high standards of education and qualification . . . but these criteria are simply not as rigorous as those embraced by what we conclude are the professionals within" the statute. 749 N.E.2d at 167.

## 1. Licensure.

Both the trial and appellate courts in *Castle Oil* held that actuaries failed to qualify as "professionals" because they were "not required to be licensed in New York..." While New York may not issue a formal certificate to actuaries, as it does barbers, electricians, and real estate agents, there is "licensure and regulation indicating a qualification to practice . . . ." *Chase Scientific Research*, 749 N.E.2d at 166. The New York Insurance Law requires that actuaries who certify property and casualty reserves be members "of the Casualty Actuarial Society, or [have] such other experience as is acceptable to the superintendent to assure a *professional* opinion..." N.Y. Insurance Law, § 4117(g)(2) (McKinney 2000). New York also requires life actuaries to be members "in good standing of the American Academy of Actuaries" and meet "the requirements prescribed by the superintendent" of insurance. *Id.*, § 4217(e)(4)(E). Similar rules apply to health and workers compensation actuaries.<sup>36</sup>

Since permission to practice is the essence of "licensure," actuaries satisfy the licensing requirement of *Chase Scientific Research*. In virtually every state, including New York, permission to practice is conditioned on membership in a professional society that regulates their qualifications, experience, and performance. That a private body, rather than a state, issues the license, or its functional equivalent, is immaterial. The power to "delegate to private parties the authority to formulate...standards and to determine the qualifications of particular applicants" is well-recognized in the law.<sup>37</sup> It is not surprising, given their sparsity of numbers and the complexity of their field,<sup>38</sup> that states rely on "distinguished private professional organizations... to administer licensing examinations" for actuaries. *People v. Lopez*, 484 N.Y.S.2d 974, 981 (N.Y.Sup. 1985). The rationale for this approach to licensure was explained as follows:

"Consistent with this judicial treatment of delegation is the sound legislative and administrative practice...in the field of professional education and training, of relying on distinguished private professional organizations to determine the adequacy of specific programs of training and to administer licensing examinations....Thus, assessment of professional training is an area commonly left to established professional organizations more knowledgeable in that specialized field than the Legislature or administrative agencies." *Id.* at 981.

---

<sup>36</sup> N.Y. Insurance Law, § 4702(i); 12 NYCRR § 317.2(p). Virtually every state has such laws. The NAIC Annual Statement Instructions also defines a Qualified Actuary for property and casualty insurers as "either a member in good standing of the Casualty Actuarial Society, or [a] member in good standing of the American Academy of Actuaries who has been approved as qualified...by the Casualty Practice Council of the American Academy of Actuaries." NAIC, Annual Statement Instructions, Property & Casualty, Actuarial Opinion ¶ 1.A (2003).

<sup>37</sup> *Hoover v. Ronwin*, 466 U.S. 558, 585 (1984) (Stephens, J. dissenting). See, e.g., *United Chiropractors of Wash., Inc. v. Washington*, 578 P.2d 38, 41 (Wash. 1978); *Independent Electricians & Elec. Contractors Ass'n v. New Jersey Board*, 256 A.2d 33, 41-42 (N.J. 1969).

<sup>38</sup> According to the Labor Department, there are 1,463,000 engineers, 681,000 lawyers, and 598,000 physicians, but less than 10,000 insurance actuaries nationwide. Department Of Labor, *Occupational Outlook Handbook* (2003) at 164.

For pension actuaries, such as defendant in *Castle Oil*, permission to practice is granted by the Departments of Labor and Treasury, which were granted exclusive jurisdiction over actuaries who opine on ERISA-related issues.<sup>39</sup> Pursuant to this authority, the Departments required actuaries to "enroll" with the Joint Board, a federal agency with extensive rules on the qualifications, experience, and performance of enrolled actuaries. While it is unclear whether the "supplemental benefit plan" in *Castle Oil* raised ERISA-related issues, the court plainly erred in finding that actuaries did not satisfy the licensure requirements of *Chase Scientific Research*.

## 2. Disciplinary System.

*Castle Oil* also held that actuaries were not "professionals" because they were not "subject to a State-created disciplinary system." 750 N.Y.S.2d at 631. New York, however, has a disciplinary system for life actuaries, as does the Joint Board for pension actuaries.<sup>40</sup> Moreover, *Chase Scientific Research* did not specify a "state-created" disciplinary system, but "a code of conduct imposing standards beyond those accepted in the marketplace and a system of discipline for violation of those standards". 749 N.E.2d at 166. Actuaries clearly satisfy this test. Each of the professional actuarial societies--including the Casualty Actuarial Society and American Academy of Actuaries--have Codes of Professional Conduct providing that an "[a]ctuary who commits a material violation of the...Code shall be subject to...discipline procedures." Casualty Actuarial Society, *Code of Professional Conduct* (2001) at 1. Disciplinary complaints are forwarded to the Actuarial Board For Counseling And Discipline for investigation and, if necessary, a hearing. If a material violation is established, a recommendation for discipline, including suspension and expulsion, is returned to the forwarding body.<sup>41</sup> The NAIC also forwards complaints to the Actuarial Board For Counseling And Discipline.<sup>42</sup>

---

<sup>39</sup> The Joint Board was created by the Departments of Labor and the Treasury pursuant to the Employee Retirement Income Security Act of 1974, which directed the agencies to "establish reasonable standards and qualifications for persons performing actuarial services with respect to plans to which this Act applies..." 29 U.S.C. § 1241-42. To qualify as an enrolled actuary, an applicant must fulfill the experience requirement, as well as basic and pension actuarial knowledge requirements. For qualifying experience, the actuary must have completed either 36 months of responsible pension actuarial experience or 60 months of responsible actuarial experience, including 18 months of responsible pension actuarial experience. The applicant must demonstrate basic actuarial mathematics and methodology, as well as pension actuarial knowledge, by passing examinations prescribed by the Joint Board. 20 C.F.R. § 901.13(a)-(d).

<sup>40</sup> "Disciplinary action by the superintendent against the...qualified actuary shall be defined in regulations by the superintendent." N.Y. Ins. Law, § 4217(e)(4)(G). See 12 NYCRR § 95.5(d)(iv-v). The Joint Board has authority to suspend or terminate enrollment of an actuary for fraud, dishonesty, or breach of trust. 20 C.F.R. §§ 901.30 & 901.31.

<sup>41</sup> Disciplinary procedures were first invoked in 1975 in *In re Equity Funding Corp. Of America Securities Litigation*, 416 F.Supp. 161 (C.D.Cal. 1976), which resulted in a \$3 million fine, expulsion from the American Academy of Actuaries, and incarceration. See N.Y. Times, March 19, 1975, at 75, col. 7; American Academy Of Actuaries, Proceedings 28 (1980).

<sup>42</sup> Section 3(B)(2) of the NAIC *Property And Casualty Actuarial Opinion Model Law* provides that it "shall not be construed to limit the commissioner's authority to release the documents to the Actuarial Board for Counseling and Discipline..."

### 3. Education And Training.

*Castle Oil* finally concluded that actuaries did not qualify as "professionals" because there "is no formal educational criteria" and the work experience alternative does not have a specified duration. 750 N.Y.S.2d at 631. This is the most problematic area for actuaries. Although the Academy has *Qualification Standards For Prescribed Statements Of Actuarial Opinion*, they lack specificity, relying on the completion of between six and ten examinations to demonstrate the requisite knowledge, without any formal educational criteria.<sup>43</sup> The education standard can also be satisfied by a statement from a qualified actuary attesting to the "comprehensive knowledge" of an applicant, a procedure that smacks of cronyism, particularly since the attesting actuary expressly disavows any "responsibility for the accuracy, completeness or quality of any work undertaken by" the applicant. *Qualification Standards* at Appendix 3.

The work experience requirement is also vague. Except for actuaries issuing NAIC opinions, who must have three years of experience, the work requirement is generally defined as "significant responsibility in the actuarial practice area . . . ." *Id.* at 4. The Joint Board is more specific, requiring "either 36 months of responsible pension actuarial experience or 60 months of responsible actuarial experience, including at least 18 months of responsible pension actuarial experience." 20 C.F.R. § 901.13(b). Despite a lack of specificity, the *Qualification Standards* appear to satisfy the requirements of *Chase Scientific Research* for two reasons. *First*, they have the tacit approval of the NAIC and insurance regulators, who rely on the standards to ensure a "professional" actuarial opinion.<sup>44</sup> *Second*, given the rigorous nature of the exams,<sup>45</sup> it is unlikely an applicant could pass the tests without "extensive formal learning."

### 4. Procedural Effect.

Procedurally, *Castle Oil* is a mixed blessing for actuaries. For actuaries with an ongoing relationship, such as firms performing annual reserve reviews for clients, it is preferable *not* to be classified as a "professional" since there is repose when the statute of limitations for contracts expires. On the other hand, if there is a discrete engagement, lack of a "professional" designation means that actuaries do not have the benefit of the generally shorter limitations period for malpractice--three years for negligence versus six years for contract in New York. Since the continuous representation doctrine does not affect discrete engagements, *Kearney v. Firley, Moran, Freer & Eassa*, 651 N.Y.S.2d 781 (App.Div. 1996), loss of a "professional" designation extends the statute of limitations without any corresponding benefit.

---

<sup>43</sup> The education standard for engineers and accountants may also be satisfied with work experience in New York. See N.Y. Education Law §§ 7206(2), 7404(2) (McKinney 2000).

<sup>44</sup> New York requires that property and casualty actuaries be members of the Casualty Actuarial Society or have "such other experience as is acceptable to the superintendent to assure a *professional* opinion...." N.Y. Insurance Law, § 4117(g)(2) (McKinney 2000).

<sup>45</sup> According to the Academy, "[t]he average candidate takes over nine years to complete the examinations, and more than half of the candidates who begin the examination process fail to complete it." Letter from Robert A. Anker, President, American Academy of Actuaries to Securities and Exchange Commission, Nov. 26, 2002, at 2.

## CONCLUSION

The past year has been an eventful one for actuaries. Malpractice claims, which began to mount in the 1990s with the reserve certifications laws, accelerated in the new millennium, and will likely continue to escalate with the publication of the S&P Report, a deeply-flawed analysis that ignores the risks and uncertainties of casualty reserving. The prospect for further litigation is only marginally diminished by a NAIC Model Law which, if enacted by the states, would immunize property and casualty actuaries against third party claims. The high stakes of actuarial malpractice litigation was illustrated by a pair of recent California cases, where an actuarial firm managed to elude a \$2 billion judgment based on a ruling that was rejected a year later by a superior tribunal. Finally, the dubious decision that actuaries are not "professionals" in New York, while a blow to the collective self-esteem of actuaries, is on balance a procedurally helpful development that establishes a date certain for the termination of malpractice claims.

© 2004  
ALL RIGHTS RESERVED