NASRA

Limitations on Liabilities for Actuarial Services

Actuarial firms are requesting that pension plan trustees consider limitations on liabilities, or limiting recovery of damages due to errors in actuarial work. Although this request has the appearance potentially of not being consistent with trustees' fiduciary responsibility to protect participants and their assets, there may be circumstances where a limitation of liability, if legally permissible for a retirement system, may be appropriate.

As this debate continues, the National Association of State Retirement Administrators (NASRA) prepared this paper to provide guidance for administrators renewing or negotiating contracts with actuarial firms. Exploration of limiting actuarial firm liability was prompted by these facts: 1) the services provided by actuarial firms are essential to the administration of a pension plan, and 2) actuarial firm representatives argue that without adequate protection from lawsuits, they face potentially devastating financial risks and may be forced to decline certain assignments. This paper was prepared by a group of NASRA members who accepted an invitation to participate, and representatives of actuarial firms who are NASRA associate members. This paper is not intended to be prescriptive; rather, it is intended to foster discussion of this issue.

Because of the critical role actuaries play in pension administration, it is important that trustees and the firm's representatives have confidence in one another. Actuarial firms also should not be held liable for errors that are the fault of the retirement system or its other vendors, or that are made under time constraints that do not permit adequate attention to accuracy. Actuaries should qualify their results in writing if they believe they have been given inadequate time to conduct their review. At the same time, actuaries should be held accountable for errors that result from their own negligence, fraud, or incompetence.

Background

The issue of limiting recovery of damages due to errors applies to more than actuarial firms; it also has become a significant concern to other groups of consultants and professionals. Doctors, auditing firms, lawyers, investment consultants, and investment managers are among those assessing their potential financial liabilities in case of a lawsuit. One prominent case is that of the auditing firm Arthur Anderson, which was driven into bankruptcy as a result of its relationship with Enron.

In the past, lawsuits against actuarial firms have been rare. In recent years, the actuarial profession has become a more frequent target of lawsuits by pension plans that claimed damages in the billions of dollars due to alleged negligence on the part of their consulting actuaries. For example, one major actuarial consulting firm was required to pay more than $40 million in damages to a union pension fund with $170 million in assets. Another large actuarial firm was sued by a large public retirement system with over $30 billion in assets—for $2 billion in damages. The case was since resolved.

Some predict the number of lawsuits will continue to grow because lower funding ratios, declining markets, and other factors have exposed conditions that may have existed for years. In the future, audits and investigations into the causes of lower funding ratios of the nation's pension plans may expose more errors. Many actuarial firms contend that they are in jeopardy of losing their insurance; opponents of limitations charge that actuarial firms are overstating their potential risk and ask whether actuarial firms are raising the possibility of financial ruin as an excuse to reduce their accountability and their legal exposure.

According to media reports, some actuarial firms undertook a strategy to protect themselves, starting in 2002, by requiring their pension plan clients to agree not to sue them for more than a set amount or for a multiple of one year's fee, for any funding changes the plans might realize as a result of errors made by the actuaries. Some actuarial firms are agreeing with clients to liability amounts far greater than the amount of their annual fees. Some clients have successfully negotiated higher limits, and some have retained the traditional no limit on liability. The legal counsel of one large pension fund said, "Limiting damages to the annual fee amount is absurd. The fee bears no relationship to the damage a sloppy actuary can cause."

Two Sides of the Issue

Fiduciaries' concerns about actuaries limiting liabilities

- Fiduciary standards require trustees to administer and oversee their plan for the exclusive benefit of members and beneficiaries. Pension plan boards, directors, and staff are fiduciaries and must protect the participants in the pension plan. This means that they must receive accurate actuarial information and be able to obtain possible recovery if the fund's actuary makes an error.

- Fiduciaries rely on the advice of actuaries to assure the health and well-being of their funds, and for their ability to continue to pay promised benefits. Fiduciaries must hold service providers accountable for their work, and cannot rely on professional actuaries who do not take responsibility for the quality of their own advice.
- Actuaries should be held accountable for their errors, and limitations serve to reduce that accountability. If pension plans hold actuaries liable for the work they perform, actuaries will have an additional incentive to ensure the accuracy of their work.
- The ability of pension funds to recover damages already is limited: in most cases, funds are able to recover only assets of the actuarial firm plus any Errors and Omissions (E&O) insurance, less legal fees. Fiduciaries need to determine the real value of the insurance and assets of their actuaries to determine the fund's existing liability limitations.
- Pension fund boards and administrators work in a public environment where activities are highly scrutinized. It is critical that trustees fully understand their fund's financial protection with and without expressed liability limitations.
- In some jurisdictions, public pension administrators may be precluded, by constitutional or statutory provision, from limiting a damage claim.
- If fiduciaries insist on unlimited liabilities, some predict that larger firms will stop working for public pension plans, or those actuaries will become sole practitioners, with minimal corporate assets, and simply file for bankruptcy if sued. If this happens, pension funds would lose the breadth of resources available from large firms.
- The U.S. justice system is designed to address and resolve issues like the legal liability of actuarial firms.

Actuarial firms' concerns about limiting liabilities

- Large actuarial firms argue that when trustees hire smaller actuarial firms, they are effectively agreeing to a limitation of liability because a significant error by a smaller, thinly capitalized firm would result in the firm's demise and a small recovery for the fund. Therefore, it is reasonable for large firms to seek to limit their liability to some reasonable level. The situation could force pension plans to choose between smaller, less capitalized firms with no limitations, and larger, well-capitalized firms with limitations (the latter may provide greater recovery potential than the former).
- Before agreeing to a contract, actuarial firms will be more intent to balance the reward of the contract fees against the potential risk of lawsuit from the pension plan which may be based on hindsight, funding shortfalls, or actuarial error. Thus, these firms will be making

a decision of whether or not to bid on contracts on the basis of the associated business risk.

- Actuarial firms are interested in protecting themselves to avoid a situation in which a lawsuit can bankrupt the company. Even a small percentage error in liabilities in a statewide plan can easily exceed the net worth of even the largest consulting firm.
- E&O insurance is expensive and available limits are far below the magnitude of assets and liabilities of most statewide public sector retirement plans. Many other professions—physicians in particular—are finding it difficult to continue practicing because of the cost of liability coverage. Actuaries are finding that they face a similar dilemma..
- Data, typically provided by the pension plan, is critical to the accuracy of the actuarial information produced. Incorrect data can lead to errors that may not be the fault of the actuary. Actuaries should not be responsible for ensuring the accuracy of data provided to them other than testing for general reasonableness.
- Actuaries make reasonable assumptions about contingent future events based on the best information available at the time the assumptions are made. The real fear is that actual results and those predicted based on reasoned judgment will be different, and this will lead to lawsuits.
- Fund administrators and boards frequently ask actuaries to complete complex calculations in a short time frame. These time constraints increase the possibility of errors.
- Politics can influence some decisions about actuarial matters. Boards or administrators may later call these decisions into question, outside the context in which they made the original determination. Should these conclusions turn out to be less than beneficial, pension funds may attribute the decision to the actuarial firm.
- Actuaries do not ultimately decide the cost of benefits. The cost of the plan is equal to the benefits paid plus administrative expenses, less investment return. Actuaries do not decide on the actual benefits to be paid, the actual expenses, or investment decisions. While actuaries may have input into design decisions, many other factors usually are considered.
- The actuarial process is not an exact science; however, some expect it to be. A certain amount of actuarial work involves judgment. Actuarial firms argue that it is not reasonable to hold a firm liable for judgment calls.
- A minor difference between expected experience and actual results, or a minor programming error, can have a significant impact on actuarial results.

- A small percentage error made by one person in an isolated instance in work on a large pension fund could conceivably result in bankruptcy of an entire company and the financial ruin of all of its employees, including those who had no relation to or control over the error.
- When the fund administrator or board identifies a problem, plan sponsor representatives may assign or deflect blame. A possible target may be the actuarial firm.
- Actuaries have much greater risk exposure than most other service providers. For example, money managers typically are responsible for only a portion of the plan's assets, while actuaries are asked to measure all current and future plan liabilities.

Suggestions for fiduciaries and actuarial firms

Retirement systems and actuarial firms both win if there is a positive working relationship with accurate results. NASRA has identified some basic strategies, including those listed below, that may help maximize the benefits of their relationship. NASRA believes it is in the best interests of both parties—pension plans and actuarial firms—to try to mitigate the possibility of errors and disputes.

- Establish a strong line of communication.
- Clearly define the roles and responsibilities of both the retirement system and the consulting firm.
- Clarify the scope of work and the fee structure for the work before beginning the project.
- Determine the true value of recovery amounts when considering a contractual agreement with an actuarial firm.
- Plan sponsors must take responsibility for providing accurate and timely information regarding plan provisions, current assets, and all other data needed by the actuary. The actuary is responsible for testing and reviewing data for reasonableness.
- Actuarial firms need ample time to prepare and review their calculations, especially when potential plan changes are involved. Actuaries should qualify their results in writing if they believe they have been given inadequate time to conduct their review.
- Have an actuarial audit conducted at least every five years by an actuarial firm other than the firm that normally consults with the plan, to identify potential problems before they grow in magnitude.

Requests for Proposals and contractual issues

- The retirement system should make the request for proposal as specific as possible, including a question regarding how the firm proposes to deal with liability.

- Request unlimited recovery in cases of errors regardless of the cause of the error. At a minimum, unlimited liability should be permitted in cases of fraud, willful misconduct, or negligence. In some cases, administrators should consider negotiating a higher cost for the services to cover the assumed risk of claim(s) with regard to the particular system.
- Where applicable, the retirement system should consider a request for cost of services to include limitation of liability under certain circumstances as an alternative to cost for services with unlimited liability. Once proposals are submitted, the system should negotiate based on due diligence and appropriate risk analysis as it relates to the services sought of the actuary.
- Determine the true "value" of unlimited recovery amounts when considering a contractual agreement with an actuarial firm. Request a certification of insurance for a specific amount that meets the contract standards of the retirement systems. Also, retirement systems may want to ascertain the liquidation value of the company.
- Retirement systems may wish to form their own judgments about the amount of liability protection they need to meet their fiduciary obligations. Once that is done, they should ensure that the firms with which they do business have insurance sufficient to provide that coverage.
- Retirement systems may way wish to consider including mediation and arbitration clauses in the contract to help resolve disputes.
- Retirement systems may wish to consider including in the contract an agreement to waive a jury trial where a dispute cannot be resolved through mediation or arbitration.
- Retirement systems may wish to consider specific conditions for inclusion of limitation of liability, such as if the actuary acts on erroneous information from the system or system vendors, or when the actuary is given time constraints.

Final Observations

NASRA believes that mitigating the possibility of errors and disputes should be the first priority of both retirement systems and actuarial firms. Plan fiduciaries need to have a clear understanding of the true limitation of liability provided by an actuarial firm, after accounting for available insurance and the salvage value of the company. NASRA will continue to explore and research the issue of E&O insurance and the possibility of establishing an expert panel to become involved in potential disputes between actuarial firms and plan sponsors.