

Malpractice Claims – What You Can Do to Protect Yourself

Actuaries have a liability problem common to many professionals: the dollar impact of the work product is disproportionate to the fees. As a result, a single malpractice claim could easily wipe out the typical actuarial firm. Even firms with significant Errors and Omissions coverage could be ruined by claims exceeding the insurance limit, claims that the insurer refuses to cover, loss of key clients, and loss of income as the key consultants spend their time defending themselves.

What should you do to protect your firm from financial ruin? Here are a few suggestions.

1. **Engagement Letters.** More and more, actuarial firms insist on engagement letters with all clients. The letter should include:

- An explanation of the work to be performed,
- the basis on which fees will be charged and paid,
- whether the work product may be withheld if fees are not paid,
- limitations such as work that will not be performed (for example notification of amendments required by new legislation or review of existing plan documents to ensure compliance with ERISA),
- dispute resolution procedures, and
- limitations on liability (both quantitative and qualitative).

In numerous presentations on this topic at Enrolled Actuaries Meetings and other actuarial conferences over the last several years, I have heard many practitioners protest that they can not, or should not, insist on engagement letters. Here are the most common concerns I have heard expressed.

I can't ask for an engagement letter from my existing clients. Most clients don't object to engagement letters. Well written letters help the client as much as the actuary, as they spell out billing procedures and dispute resolution procedures, as well as clarify the work to be performed. Clients are accustomed to having contracts or engagement letters with their lawyers, trustees and accountants. The terms of the letter may be negotiated. Many actuaries have a hard time explaining why they need a letter this year when they didn't last year. The answer is simple: that was then and this is now. We're improving our business practices, and need to do this.

Clients will object to limitations on liability. Not if the limitations are reasonable. If you attempt to disclaim all liability entirely, many clients will object or negotiate. If you limit liability so as to eliminate various forms of spurious "damages" (such as consequential damages, punitive damages, contributions that the employer would have had to put into the plan anyway, the effect of changes in the law due to new legislation or new interpretations from Court decisions) you will be protecting yourself from 90% of all financial risk. And the clients, viewing it objectively before there is a conflict, will most likely agree the limitations are reasonable. You may also include quantitative limitations, such as two times annual revenue. Clients may negotiate as to the amount but rarely

object in concept to the idea of limitations in amount of liability. As a practical matter, they know there is only so much they can squeeze out of you anyway. (There is a significant exception for some multiemployer plans. This category of clients involves issues that can't be discussed here due to space limitations.)

Limiting liability is unprofessional. Many malpractice claims are spurious. Even where the actuary made a legitimate mistake, litigation has often ensued after the plaintiffs refused a reasonable settlement offer and asked for damage amounts that were unreasonable. Limitations on liability, both qualitative and quantitative, are a reasonable response to protect you, your family, your partners, your employees, your other creditors, and your other clients who rely on you to be there next year.

The client needs the work right away. There's no time to negotiate an engagement letter. I submit to you that this is the best possible time to insist on an engagement letter. Most mistakes and disagreements occur when the client needs something right away. Further, this is when you are in the best bargaining position.

2. The Arbitration Clause.

This is part of the engagement letter, but it is so important it deserves special mention. Most of my clients are plan sponsors. When they hire an actuary, the last thing they want to do is get into a lawsuit. In general, clients like the idea of resolving conflicts through arbitration. I've handled several arbitrations with actuaries as the arbitrators, and found them to be very fair to both parties. Arbitration is much less expensive than litigation, and the awards bear a reasonable relationship to the real damages to the client.

3. Know your insurance coverage.

Many liability insurance policies will not cover the claim if you admit liability to the client. You need to understand the procedure, and explain it to your client. It is possible to say to a client, in a professional way, "we can't discuss with you directly whether we are liable to you for this claim, because it would void our insurance coverage." Not only will the client understand your predicament – it is to the client's advantage not to void your insurance coverage.

4. Talk to your lawyer as soon as you are aware of a potential claim.

Your lawyer can obtain peer review and damage assessment for you, from another actuary, under the cloak of attorney – client privilege. The last thing you need is to get peer review from someone who will later be forced to testify that you did indeed make a mistake and caused serious damages.

Your lawyer can also help you understand the ramifications of the error. For example, suppose you incorrectly calculated pension benefits giving the pensioners more than they were entitled to. It may well be possible to reduce their benefits to the correct level, or even retrieve a portion of a lump sum. Many errors are a result of incorrect or incomplete

data. In my experience, actuaries tend to take responsibility for these errors thinking they should have noticed the data was incorrect or incomplete. However, that may not be the legal standard to which they will be held.

Remember, if you really think professionalism requires you to pay the client, you can always do that later, after obtaining professional advice.

5. Before you discuss one mistake with a client, find out if you made any other mistakes on the same project.

You may be surprised to find out how often an actuary's "mistake" is offset by some other mistake, or turns out not to be a mistake at all.

6. Solve the problem.

When you discover a mistake, deal with the consequences to the client. Counsel the client on practical ways to minimize the impact of the error. This can be done without admitting liability, by focusing on the problem and the solution rather than blame.

7. Have a realistic quality control process.

Failure to follow your own process can prove negligence. Make sure your quality control process – worksheets, checklists, etc. – are not only helpful but realistic in your day to day practice.

8. Plan to make mistakes.

Humans make mistakes. Assume that sometime, somewhere, you will make a mistake and it will be a whopper. Now make sure your business is run so that mistake doesn't ruin you.

9. Quality control should be proportional to the dollar amount involved.

This recommendation has generated more controversy than any other, but when I have spoken at actuarial conferences, the audiences have always agreed in the end. I've heard many actuaries say that every client deserves a quality product. True, but do you have mechanics examine your vehicle every time you drive your car? The airlines do, every time they take off. Why? Because the consequences of error are more severe. I've heard actuaries say that the complexity of the task should determine the quality control and peer review required. Not so. If you were to invest \$500,000 of your own money in one stock, how carefully would you read the prospectus? Now suppose the investment is \$5,000. The complexity of the task – determining the value of one share – is exactly the same. But you would do more due diligence for the \$500,000 investment. It's the same thing with your clients. A \$1 million lump sum calculation requires more peer review than a \$1,000 lump sum calculation, even if the complexity is exactly the same. I'm not saying you should be careless with small clients – but the amount of quality control and peer

review needs to be greater with the bigger clients, bigger matters, and bigger dollar amounts.

Also pay attention to the dollar amount of the potential loss. If you get the annual contribution amount wrong, it can generally be corrected by increasing or decreasing future contributions. However, if you are costing a proposed benefit increase, the loss may accrue as soon as the benefit increase is adopted. Corporate transactions where plan funds are spun off or the purchase price depends on actuarial calculations also involve greater financial risk, and so deserve more peer review or quality control.

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