
*Loss Reserving And The Law:
What Every Actuary Needs To Know*

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Introduction

James C. Dugan



- ❖ Partner, Willkie Farr & Gallagher LLP
- ❖ Focuses on complex commercial litigation
- ❖ Represents insurers, reinsurers, actuarial and accounting firms, among others
- ❖ Cornell Law School
- ❖ Member of New York Bar (1994)
- ❖ Court Admissions:
 - ❖ United States Supreme Court
 - ❖ Courts of Appeals for the 2nd, 10th and 11th Circuits
 - ❖ United States District Courts for the Southern and Eastern Districts of New York

Parties

- Plaintiffs
 - Liquidators & Rehabilitators
 - Investors
 - Corporations & Joint Ventures
 - Insurance & Reinsurance Companies
- Defendants
 - Insurance/Reinsurance Companies
 - Officers and Directors
 - Auditors
 - Actuarial Firms
 - *Mostly Not Individual Actuaries*

Types Of Claims

- Common Law Claims
 - Fraud
 - Negligence
 - Breach of Fiduciary Duty
 - Professional Malpractice
 - Breach of Contract
- Federal Statutory Law
 - Securities Act of 1933
 - Securities Exchange Act of 1934

Claims Against Actuaries Are Infrequent

■ Malpractice

- “Because an actuary is not required to be licensed, is not regulated, and is not subject to a State-created disciplinary system, an actuary is not a “professional” for purposes of a malpractice cause of action.”

Health Acquisition Corp. v. Program Risk Management, Inc.
964 N.Y.S.2d 554, 557 (2d Dep’t 2013)

■ Negligent Misrepresentation

- However, a claim for negligent misrepresentation will lie where there is a “special or privity-like relationship” imposing a duty on the actuary to impart correct information to the plaintiff.

Leading Insurance Group v. Friedman LLP,
Index No. 651049-2015 (N.Y. Sup. Ct. Sept. 30, 2015)

Focus On Loss Reserves

- Largest liability of insurance and reinsurance companies is based on an estimate of accrued claim payment obligations
- Stated value of the company depends on the quality of the estimate
- Risk of over-estimation
 - Competitive disadvantage
- Risk of under-estimation
 - Reserve strengthening
- Perceived earnings manipulation leads to litigation

Reserves Are ‘Informed Guesswork’

“[H]istory may be an imperfect guide to the future, particularly with regard to casualty risks. The incidence of claims may increase, and inflation may lead to unexpectedly high losses per claim. Even the conservative B-F method relies on assumptions as to future events and conditions, that, if wrong, will lead to substantial errors in the final estimate.... Consequently, regardless of the actuarial method used, the preparation of, and reliance upon a net worth calculation in a balance sheet for a casualty risk reinsurer is based in large part upon informed guesswork.”

Delta Holdings, Inc. v. National Distillers & Chemical Corp.,
945 F.2d 1226 (2d Cir. 1991)

Reserves Are ‘Only Estimates’

“Thus, loss reserves were ‘only estimates,’ as estimating loss reserves was a difficult and complex process involving many variables and subjective judgments.”

Coronel v. Quanta Capital Holdings Ltd.,

No. 02-Civ-1405, 2009 WL 174656 (S.D.N.Y. Jan. 26, 2009)

Reserves Are ‘Extremely Conjectural’

“Insurance reserves are, by their nature, extremely conjectural, and may need adjustment as time passes and their accuracy can be tested in retrospect.”

In re CRM Holdings, Ltd. Securities Litigation,
No. 10 Civ. 975, 2012 WL 1646888 (S.D.N.Y. May 10, 2012)

Not Actionable: Business Judgment Errors

“Plaintiffs’ repeated assertions that management failed to maintain adequate loss reserves . . . are criticisms of Defendants’ business judgment and management of SCA, not fraudulent misrepresentations.”

In re Security Capital Assurance, Ltd. Securities Litigation,
729 F. Supp. 2d 569 (S.D.N.Y. 2010)

Not Actionable: Opinions

“Reserves are opinions, and the Complaint must allege facts showing ‘that defendants did not truly hold those opinions [either knowingly or recklessly] at the time they were made public.’”

In re CRM Holdings, Ltd. Securities Litigation,
No. 10 Civ. 975, 2012 WL 1646888 (S.D.N.Y. May 10, 2012)

Not Actionable: ‘Puffery’

“Puffery is an optimistic statement that is so vague, broad, and non-specific that a reasonable investor would not rely on it, thereby rendering it immaterial as a matter of law.”

In re General Electric Co. Securities Litigation,
857 F.Supp.2d 367 (S.D.N.Y. 2012)

“Plaintiffs’ allegations that SCA made material misrepresentations when it referred to its underwriting approach as ‘disciplined’ and ‘conservative’ ... are classic examples of puffery.”

In re Security Capital Assurance, Ltd. Securities Litigation,
729 F.Supp.2d 569 (S.D.N.Y. 2010)

Not Actionable: Fraud By Hindsight

“The relevant inquiry . . . is not whether the estimate disclosed in the offering documents later turned out to be correct, but rather whether the facts alleged in the Complaint evince that the Company knew or had reason to believe, at the time the Prospectus and Registration Statement were filed, that the statement was untrue.”

Coronel v. Quanta Capital Holdings Ltd.,

No. 02-Civ-1405, 2009 WL 174656 (S.D.N.Y. Jan. 26, 2009)

Judgments & Settlements - Case Examples

- *Thabault v. Chait and Pricewaterhouse Coopers LLC*
- *PMA Capital Corporation Securities Litigation*
- *Converium Holding AG Securities Litigation*
- *In re Tower Group International Securities Litigation*

Thabault v. PricewaterhouseCoopers

- Claim
 - Professional malpractice
- Parties
 - Plaintiff - Receiver of failed casualty insurer
 - Defendant - Independent auditor of failed insurer
- Wrongdoing Alleged
 - Negligent issuance of clean audit opinion with knowledge that financial statements materially understated reserves
 - But for negligence, insurer would not have continued to write policies which resulted in its ultimate failure
- Result
 - Jury verdict for \$182.9 million

In re PMA Capital Corp. Securities Litigation

- Claim
 - Class action alleging securities fraud
- Parties
 - Plaintiffs – Class of purchasers of PMS stock
 - Defendants – Reinsurance company and its executive officers
- Wrongdoing Alleged
 - Falsely represented that company carried sufficient loss reserves
 - Net loss reserves increased by more than \$300 million after independent review of reserves
- Result
 - Settled for \$15 million after motion to dismiss denied

Converium Securities Litigation

- Claim
 - Class action alleging securities fraud
- Parties
 - Plaintiffs – Class of purchasers of Converium securities
 - Defendants – Reinsurance company and its executive officers
- Wrongdoing Alleged
 - Falsely represented that company carried sufficient loss reserves
 - Duped independent actuarial consultant
 - Artificially inflated securities price
- Result
 - Claims settled for \$84.6 million after extensive discovery

In re Tower Group Int'l Ltd. Securities Litigation

- Claim
 - Class action alleging securities fraud
- Parties
 - Plaintiffs – Class of purchasers of Tower stock
 - Defendants – Reinsurance company, its executive officers and outside auditor
- Wrongdoing Alleged
 - Intentionally and/or recklessly underrepresented its loss reserves by \$570 million
 - Bullied auditors into providing clean audit reports despite auditors' knowledge of serious reserve deficiencies and lack of sufficient reserving controls
 - Artificially inflated securities price
- Result
 - Claims against reinsurance defendants settled for \$20.5 million
 - Claims against auditor dismissed

Polling Question

– Oops!

Have you ever used your BUSINESS email to communicate about PERSONAL matters

- A. Yes
- B. Yes
- C. Yes
- D. Pleading the fifth

Polling Question

- Oops Too!

Have you ever used your PERSONAL email to communicate about BUSINESS matters

- A. Yes
- B. No

Emails: The Nightmare Scenario (Part 1)

From: [Chief Risk Officer]

Sent: [REDACTED]

To: [Head of Reserving]

Subject:

It wasn't pretty this afternoon. Apparently, [REDACTED] managed to convince the BoD that [reinsurer] is globally the worst company they have come across in terms of documentation of what we decide

Emails: The Nightmare Scenario (Part 2)

From: [Property Underwriter]

Sent: [REDACTED]

To: [Pricing Actuary]

Subject: Re: Quota Share

[REDACTED],

The specific franchise deductibles were established for the sake of expediency as opposed to an analytical or modeled approach.

From [REDACTED]'s perspective, there is only one underwriting result....

Emails: The Nightmare Scenario (Part 3)

From: [Senior executive]

Sent: [REDACTED]

To: [Chief Actuary]

Subject: Re: Pricing LR vs Reserving LR

[REDACTED],

When we did the study, we were out to lunch on our reserves.
Thus, maybe we should do a new study.

Emails: The Nightmare Scenario (Part 4)

From: [CFO of subsidiary]

Sent: [REDACTED]

To: [Senior executive of subsidiary]

Subject: FW: Why our stock price moved up

It worries me that we make too many promises.

Polling Question

– Still Oops!

Have you ever used text messaging to communicate about business matters?

- A. Yes
- B. No

Polling Question

– Good Housekeeping

When your mailbox is full, do you:

- A. Delete old emails?
- B. Save old emails to your desktop?
- C. Download old emails onto portable media (such as a thumb drive)?
- D. Ask your IT department what to do?

Best Practices for Email

- Email lasts forever. Don't commit a thought to email unless you have to.
- If you have to, first assume that the email will be produced in litigation and may also appear in newspapers.
- Don't be funny.
- Don't be angry.
- Don't be clever.
- Assume that the recipients of your email will forward it to others, particularly if you instruct them not to.

Issues For Reserving Actuaries

- Comply With Actuarial Standards
 - Know your ASOPs and follow them
- Document Your Work
 - Actuarial method
 - Actuarial assumptions
 - Actuarial approach
 - Ranges and point estimates
- Be Consistent In Your Approach
 - Deviations documented and explained
- Communications With Management
 - Clarity

Issues For Management

- “Best Estimate”
 - Tie to objective, verifiable criteria
- Ranges
 - Book consistently within the range
- Process
 - Allow independent meetings between actuaries and outside directors
- Systems
 - Develop robust systems that minimize human error and manual adjustment
- Disclosures
 - Consider robust disclosures

Issues For Independent Consultants

- Scope of Work
 - Clearly define
- Information Requirements
 - Understand what information the client has (and does not have)
 - Make clear what information you require and why
 - Make clear what information you do not require and why
- Drafts
 - Mark appropriately and discard when done
- Process
 - Be prepared to defend the normal give and take

Questions?



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