Actuarial Perspective on Recent Captive Court Cases

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Three Cases

- Avrahami – August 2017
  - Actuarial support for premiums was not well documented or explained
- Reserve Mechanical – June 2018
  - No actuarial support
- Syzygy – April 2019
  - No actuarial support, advice from actuaries was ignored

Avrahami (August 2017)

<u>Background</u>

- Captive manager hired an outside actuary to price policies
- Captive manager and actuary had worked together on many clients
- Actuary was told what the premium goal was for each year

Avrahami (August 2017)

Background

- Policies issued:
  - Business Income
  - Employee Fidelity
  - Litigation Expense
  - Loss of Key Employee
  - Tax Indemnity
  - Administrative Actions
  - Business Risk Indemnity
  - Terrorism

Avrahami (August 2017)

<u>Actuarial Issues</u>

- The actuary was unable to clearly explain to the court how he developed the premiums
- The opinion includes 17 pages detailing, policy by policy, the judge's best guess of the actuary's methods
  - Includes many direct quotes from the actuary that illustrate how confusing the testimony was
- Approaches taken by the actuary are questionable

Avrahami (August 2017)

Actuarial Issues

- Terrorism pricing was set at 6.5-7% rate-on-line
- Actuary could not think of any event in history that would have triggered a claim on terrorism policy
  - Calls into question the validity of 7% rate-on-line

Reserve Mechanical (June 2018)

Background

- Policies were priced based on a review of all other clients, with adjustments for the insured based on comparisons to everyone else
- Original pricing came from an underwriter at an outside firm
- Actual loss data for the insured was not incorporated

Reserve Mechanical (June 2018)

Background

- Policies issued:
  - Excess Directors & Officers Liability
  - Loss of Major Customer
  - Expense Reimbursement
  - Loss of Services
  - Weather Related Business Interruption
  - Excess Pollution Liability
  - Tax Liability
  - Excess Intellectual Property
  - Regulatory Changes
  - Punitive Wrap Liability
  - Excess Employment Practices
  - Excess Cyber Risk
  - Product Recall
  - Legal Expense Reimbursement

Reserve Mechanical (June 2018)

Actuarial Issues

- Premiums were not determined by an actuary
  - However, two actuaries did testify at trial that the methods used and premiums determined were reasonable
  - Opinion states that while it does appear that actuarial methods were used, the premiums paid were not the result of an arm's length negotiation and no unrelated party would agree to pay the premiums attached to these policies

Reserve Mechanical (June 2018)

Actuarial Issues

- Questionable risk distribution
  - Pool covered 50% of total claims in excess of 35% of total premium, other insureds were similar
    - Pool charged Reserve Mechanical approximately 19-20% of premium for this arrangement
  - Reserve Mechanical also insured vehicle service contract liability
  - In total, approximately 30% of premium was from unrelated parties
  - Court found pool was not a bona-fide insurance company, so risk was not distributed

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Syzygy (April 2019)

Background

- Premiums set by underwriter employed by captive manager
- Actuarial feasibility study stated premiums were adequate (“not too low”)
- Policies had $1M limits:
  - First $250K of each loss was paid by captive – 49% of premium
  - Remaining $750K of each loss was shared by pool – 51% of premium

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Syzygy (April 2019)

Background

- Policies issued:
  - Administrative Actions
  - Bankruptcy Preference
  - Cyber Liability
  - Deductible Reimbursement
  - Legal Expense
  - Intellectual Property Defense
  - Intellectual Property Enforcement
  - Property DIC

Syzygy (April 2019)

Actuarial Issues

- Actuarial methods were not used to determine premiums
- Underwriter did not document how premiums were determined
- Actuary told captive manager that split of premiums between layers should be closer to 70% / 30%, rather than 49% / 51%, but manager ignored this advice

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Syzygy (April 2019)

Actuarial Issues

- No claims filed on Deductible Reimbursement policy, even though claims were filed on commercial policies and deductibles were incurred
- Insured switched captive managers because they were unhappy that premium was decreasing

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Takeaways

- Actuary should be involved with setting premiums
  - If not, actuarial methods should be used
    - Premium quotes from commercial insurance companies
    - Rate filings
    - Comparison pricing to other insureds based on objective characteristics (but only if other insureds are actuarially supported)

Takeaways

- Methods used to determine premiums should be well documented
  - Must be able to clearly explain why methods were used
- Premiums should be determined based on terms of policy

Takeaways

- Pooling methods involving different layers of risk need to be actuarially supported
  - Split of premiums in Syzygy implies average loss will be more than $500K
    - This may be a reasonable assumption, but should be documented why
    - But probably doesn't make sense to use this assumption across many different types of policies

Questions?

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