Mercer's Little Alaska Problem

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ALTHOUGH it has received little coverage lately, a bombshell of a lawsuit inching its way through the superior court of Alaska has revealed the financial strain visited on state workers there and promises to have ramifications for public pensions across the country.

The Alaska Retirement Management Board, a state agency, filed the suit in 2007 against Mercer, the human resources consulting firm. The lawsuit says that Mercer's mistakes hindered the ability of Alaska's retirement system to meet its obligations to former public employees.

Mercer, the agency contends, made multiple errors as the state's actuarial consultant when it estimated the amounts that two of the state's retirement plans needed to set aside for health care and pension benefits. The agency seeks damages of $2.8 billion.

Earlier this year, Mercer, a unit of Marsh & McLennan, had asked Patricia A. Collins, the superior court judge overseeing the matter, to dismiss the case. Mercer's lawyers argued that it did no "compensable harm" or damage to Alaska's retirement systems.

On Dec. 4, Judge Collins denied the motion and ordered a trial to be held in Juneau next July to determine whether Mercer had harmed the system.

That Mercer erred in its calculations is bad enough getting such details right, after all, is what the firm advertises as its stock in trade.

But an even bigger grenade dropped earlier this year when the Alaska board, citing depositions of Mercer employees, contended that company executives had known about the actuaries' errors and covered them up.

If Alaska prevails in court, it could entitle the retirement system to punitive as well as treble damages.

Mercer, with 4,000 employees in 150 offices around the world, concedes that the Alaska case is a threat. In its usual corporate filings, a brief discussion of the case heads a list of risks facing Marsh. It also notes that it has "limited" insurance to cover the costs of an adverse outcome.

And according to Marsh's most recent quarterly filing, the company has not recorded a liability related to the Alaska case because it cannot determine "that a loss is both probable and reasonably estimable."

In a statement, Mercer conceded that its error and its failure to disclose it was “a mistake in judgment that Mercer regrets and it is not consistent with the company’s corporate culture.”

MERCER had worked for Alaska since the 1970s. From June 1999 to April 2006, it got $2.5 million for its work on behalf of the Alaska funds. The suit said it billed the plans as much as $430 an hour.

Unlike most public pensions that promise to pay future benefits out of money they hope to earn, the Alaska systems funded health care costs in advance.

As actuary for retirement plans that serve both teachers and other public employees, Mercer had the duty to calculate the plans’ liabilities and determine the employer contribution rates to fund those promises.

But, according to the lawsuit, when Mercer prepared the plans’ 2002 report, it understated their liabilities by as much as $1 billion.

Then, rather than own up to the mistake, Mercer executives covered it up, the documents say. “Following standard Mercer policies designed to prevent clients from discovering Mercer’s errors,” Alaska’s lawyers contend, “Mercer’s actuaries carefully avoided creating a written record of their discussions and calculations, in order, one of them testified, to avoid creating a ‘trace.’ ”

The error that Mercer covered up, according to the lawsuit, occurred in 2002 and involved a “per capita claims cost,” which represented the estimated expenses of providing health care to a retiree. Mercer used one assumption for retirees under age 65 and another, lower estimate for those over 65 because they could tap into Medicare benefits.

But the amount entered into Mercer’s computers for employees of pre-retirement age was $213 less than it should have been. The error understated the amount of liabilities owed by one of the Alaska funds by 10 percent.

A Mercer actuary found the error before the 2002 valuations were to be presented to the Alaska plans and reported it, along with a colleague, to a supervisor. But after several discussions, the lawsuit says, the Mercer executives decided not to tell their client about the error.

One of the Mercer actuaries on the account testified he was “concerned about the ethics of what Mercer was doing by not telling the State of Alaska,” the lawsuit shows. He said that Mercer did not disclose the error because the firm was fearful of being fired. (This happened anyway, in 2006.)

The error was compounded in 2003 because Mercer continued to use an artificially low number for pre-retirement-aged beneficiaries. If the firm had corrected the earlier mistake, an actuary said in a deposition, “It would have been difficult to explain.”

Because of the errors and cover-up, the lawsuit said, Mercer underreported by more than $2.8 billion the contributions required to fund the plans.

Of course, estimating future health care costs is not easy. But the lawsuit details what look like obvious failures by Mercer. For example, Mercer consulted “real-world data” on health care expenses only every five years, a problematic practice given the volatility of these costs.

Mercer also made significant “coding errors” when entering information about the plans into its computer models, the complaint says. It ignored some salary increases for employees as well as survivor benefits, thereby underestimating plans’ liabilities.

The errors emerged in October 2002, when an outside auditor hired by the Alaska funds to examine Mercer’s work delivered a highly critical report on its findings. The lawsuit states that Mercer actuaries attended the meeting where the report was presented and accepted the outside firm’s criticisms.

But a company spokesman said last week that Mercer believed that its error wouldn’t have an impact on contributions to be made by the plans because an Alaska regulation imposed a 5 percent cap on annual contribution rate increases, and Mercer’s recommended rate was already much higher. “Accordingly, Mercer believes that the error had no impact on the plans and that the plans have not, in fact, been damaged,” the spokesman said.

Mercer has had similar problems with other pension clients. Last May, the company paid $45 million to settle a negligence lawsuit filed by Milwaukee’s pension board. Mercer did not acknowledge it was at fault in the matter.

Nevertheless, all eyes are on the Alaska case, because of its size. Indeed, while the suit is pending, actuarial firms are finding it impossible to buy liability insurance against such claims.

“This is the largest case out there in the industry and it could have enormous ramifications if the plaintiff were to succeed,” said Gene Kalwarski, founder of Cheiron Inc., an actuarial consulting firm serving large pension and health insurance funds. “It’s unfortunate that one firm’s behavior, if they are found to be liable, is going to result in other firms being unable to obtain insurance coverage.”

Lewis R. Clayton, a partner at Paul, Weiss, Rifkind, Wharton & Garrison, who represents the Alaska board, said the case illustrates the role an actuarial firm plays in workers’ lives, “and how important it is that actuaries do honest and high-quality work.”

Indeed, about 80,000 workers rely on payments from the retirement systems that have sued Mercer. And the errors made by the firm were a big reason why the Alaska system changed its pension structure, according to people briefed on the discussions.

For all employees hired after 2006, the funds no longer offer a classic pension fund, where retirees receive a specified amount each year. Now those workers receive a defined-contribution plan, similar to a 401(k) account.

Mercer, meanwhile, is learning that age-old lesson: To err is human. To cover up, plain dumb.