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Actuaries, Conflicts of Interest and Professional Independence: The Case of James Hardie Industries Limited

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ABSTRACT. Drawing on calls by researchers to examine corporate scandals involving potential conflicts of interest or compromise to professional independence involving the actuarial profession, this article outlines one such case. The consulting actuaries – to a large Australian listed company, James Hardie Industries Limited – found themselves advising two parties in a corporate restructuring where the interests of each were sometimes competing and the interests of the public appeared to be ignored. The James Hardie case is instructive in a number of ways: first, it demonstrates the subtlety with which conflicts of interest or pressures on professional independence can arise; second, it demonstrates how important professional issues can be obfuscated by more obvious and pressing financial and strategic issues; and finally it demonstrates that adherence to professional codes of conduct and the ease with which professional ethics can be compromised when those codes are vague and transgressions are rarely actionable. The James Hardie case highlights structural issues in the employment of consulting actuaries which presents risks to the profession. It demonstrates that the combination of an aggressive corporate management with a strategic agenda reliant on consulting actuaries that have a vested interest in promoting and maintaining valuable relationships, both financially and professionally, results in ethical challenges.

KEY WORDS: conflicts of interest, actuaries, professional independence, virtue ethics, James Hardie Industries Limited

Introduction

One of the overlooked professions in the public debate about business failures is that of the actuary.[1] This is no doubt because of the somewhat esoteric and inaccessible nature of what the actuary does: 'Actuaries apply mathematical, statistical, economic and financial analyses, which involves adding risk assessment to longer term financial contracts, in a wide range of practical business problems' (IAA, 2009a). Further, in numbers, the membership of the actuarial professions is far smaller than that of, say, the accounting professions. The profession has very high barriers to entry through demanding professional standards, and the principal roles of the actuaries continue to be relatively narrowly focussed on the needs of the insurance industry.

The profession, at least in some jurisdictions, has expressed concerns that its relative obscurity might result in potential loss of status and has proposed a resolution through the expansion of its areas of operations: '…an expansionist view of the perimeter of the profession is essential. Failing this, the profession will find itself left behind, with other professions stepping forward to meet actuarial needs as best they can' (CRUSAP Task Force, 2006, p. 6). Significantly, at the same time, whilst it attempts to expand its own fields of operation, it may also find itself subsumed within, for example, the large accounting firms where the argument is made that actuarial services form part of the integrated financial services they provide.

The focus of this article is not on the current state of the actuarial profession. Whatever its status vis-à-vis other professions, it will undoubtedly maintain an exclusive monopoly over its niche services, and these services will continue to be the ones that other professions and business in general will require. The concern here is for its ethical responsibilities and, specifically, the extent to which the public can have trust in the integrity with which actuaries practice their profession. A case has been made elsewhere that the actuarial profession, in certain contexts, faces

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inevitable and potentially troubling conflicts of interest within the context of valuing-defined benefit pension plans (Gunz et al., 2009). Here, a case study of the actuary providing professional services is explored from the perspective of whether the profession faces more fundamental pressures which it may or may not be able to withstand when it expands its services to consulting. In this way, this article extends the study of Gunz et al. (2009) by studying the issues they raised in an applied context and one where the conduct of the actuary demonstrates the inherent conflicts of interest between employment relationships and the 'public interest'.

This article focuses in particular on pressures imposed upon the maintenance of professional independence. The context is the valuation of long-tail tort liabilities in the form of litigation claims arising from asbestos exposure against the various subsidiaries of James Hardie Industries Limited, a large Australian[2] listed corporate group.

The actuarial profession

Professionals are expected to have two levels of obligation, institutionalised and individual (Abbott, 1983). Most research into the professions and their ethical obligations has focussed on the institutional obligations (e.g. Fearnley and Beattie, 2004; Gendron et al., 2006) through the examination of regulated conduct (i.e. professional rules of conduct or legislated rules of conduct). However, in the accounting, audit and actuarial professions, the primary obligation to be independent or free from bias is fundamentally a personal characteristic, a virtue (Francis, 1990).

In relation to the auditing profession, independence has long been considered to be an essential characteristic that is a function of professional integrity:

> Independence is an elusive quality … Basically it is an attitude of mind which does not allow the viewpoints or conclusions of the possessor to become reliant on or subordinate to the influences and pressures of conflicting interests. The auditor must maintain a continual awareness of these influences and pressures in order to maintain his objectiveness and impartiality in all aspects of his work. Thus, independence in this sense is a feature of the professional integrity of the auditor. (Lee, 1972, p. 68)

When focussing on the personal characteristics of professionals, the concept of independence is structured as the means by which conflicts of interest are avoided. Its essence is captured through notions of professional integrity. '[I]ntegrity is an internal state of being' (Killinger, 2007, p. 3), and therefore is best understood within a virtue ethics framework. Virtue ethics encourages what Aristotle calls *phronesis* or the ability to make reasonable judgements when there is no obvious right answer. In doing so, it is concerned with the concrete contexts in which individual judgements are made rather than adherence to a strict methodology for solving ethical problems (Everett et al., 2006; Maguire, 1997). In addition, MacIntyre (1984) argues that virtues are established and exercised in the course of a practice. A practice is said to be a

> … socially established cooperative human activity through which goods internal to that form of activity are realized in the course of trying to achieve those standards of excellence which are appropriate to, and partially definitive of, that form of activity, with the result that human powers to achieve excellence, and human conceptions of the ends and the goods involved, are systematically extended. (p. 187)

The discourse of professional ethics is embedded in and co-opted by practice. Practice is embodied in institutions, whether they are professional service firms or professional association's codes of conduct. This has led to the notions of morality, honesty and integrity being defined in rules – through codes of conduct or policy. 'A *code of conduct* is a *list of rules* that spells out what one should or should not do, and it is usually included in the ethical statement' (Killinger, 2007, p. 48, emphasis in original). These codes or policies both prescribe and proscribe certain behaviours and outline the sanctions for transgressions. However, sanctions only come into play where there is a proven 'actionable conduct'.

In this article, we outline one case study that demonstrates the inability of a member of the actuarial profession to maintain professional integrity and avoid a conflict of interest and thereby compromising a professional commitment to protect the broader public, or serve the public interest. Whilst

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doing so, we highlight what Gunz et al. (2009) discussed from a theoretical perspective: both the shortcomings of a rule-based approach to achieving professional integrity and the manner in which institutional structures, here the employment relationship, have the potential to corrupt or subvert professional ethical conduct.

In an historical context, the actuarial profession is one of the newer professions and has been defined as a 'patronage' profession in that it is derived from the relationship with a strong external entity or patron, in this case the insurance industry (Johnson, 1972). This categorisation may also be applied to the accounting profession (its patron being the general purpose corporation of the mid-nineteenth century) and contrasts with the more ancient professions of law, medicine and the priesthood. While finding precise definitions for the term 'profession' can be problematic, professions in general can be said to be distinguished from non-professions by five major characteristics: a systematic body of theoretical knowledge; authority to practise; community sanction; a formal enforceable code of ethics or conduct; and a recognised culture (Abbott, 1983).

At the heart of the formal code of ethics or conduct for all professions is often said to be a commitment to serve and protect the public interest.[3] This commitment is crucial, as professions are placed in a position of trust by the society that they serve. This commitment is embodied in professional standards which, in most cases, prioritise the personal characteristics of the professional such as technical competence, personal integrity, objectivity and the ability to perform professional duties without bias – that is, independently.[4] In this respect, the actuarial profession is no different.

Gunz et al. (2009) considered the actuarial profession in the North American context. There is, however, considerable commonality in fundamental principles and governance across jurisdictions, largely for historic reasons. In Australia, actuaries are given formal regulatory status under statutory provisions[5] as well as by the prudential regulator (Australian Prudential Regulation Authority – APRA) publishing a series of guidance notes. The prudential standards and guidance notes deal with a number of significant issues, including that of independence of the actuary (Owen, 2003). These standards and guidance along with the pronouncements of the professional body in Australia (The Institute of Actuaries Australia, IAA) outline the professional actuaries' responsibilities in relation to their ethical conduct.

The role of the actuary is akin to that of the auditor as Gunz et al. (2009) observed.[6] The actuary is evaluating documentation – in this case, the records of asbestos litigation claims and associated information – applying professional techniques that will allow her/him to calculate future risk and estimate a value, and providing a professional opinion as to what that risk/value might be. The opinion is subject to the assumptions made, but those assumptions must be informed by and arrived at according to professional practice standards.[7] If it is to be based on anything else, then it would destroy the value of the professional opinion and place it in a category no different than, for example, a routine management announcement. In some cases, a consulting actuary may be advising management for management purposes. However, in the cases where the actuary is providing information that will form the basis of management assertions and subsequent public announcements for publicly listed corporations, the comparison with the audit becomes very close (IAA, 2007a).[8]

There are, however, structural differences in the employment relationships of professional actuaries and auditors. Actuaries are employed directly by management, and while their primarily responsibility is ostensibly to serve the 'public interest', the detailed activities of each engagement are determined on a case-by-case basis. A statutory auditor's primary role is to protect the interests of investors (shareholders or creditors) by acting as a form of 'quality control' over the financial information reported by management (Chambers, 1973/2006, p. 192). Their activities are structured, predetermined and the risks that arise due to conflicts of interest are well understood, documented, and in some cases, regulated with the force of law (e.g. Sarbanes–Oxley Act in the USA). The tasks performed by the actuary, while structured and performed with guidance of professional standards, are diverse in nature and scope. As such, potential conflicts of interest are not so well understood.

However, it remains essential that, for the actuaries to perform tasks effectively, they must clearly have an independent mind; that is, a mind set free of

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any interests other than those the actuary must legitimately consider. In the Australian profession, this is expressed in the following manner:

> **5.3 Impartiality of actuarial advice**
>
> 5.3.1 To ensure the integrity and professional standing of Actuarial Advice, all Actuarial Advice must be impartial. (IAA, 2007a)

Whilst strong similarities might exist with the role of the auditor, interestingly, remarkably little has ever been written about the formal concept of professional independence in relation to the actuary and certainly not outside the literature of the actuarial profession. Yet, even slight adjustments in the assumptions that form the basis of actuarial calculations can result in enormous differences in the evaluations the actuary provides (Gunz et al., 2009). Besides, in the context of commercial decision making and corporate financial reporting, the value to management of being able to influence the actuary (or auditor) in a particular manner may be highly significant. In general, however, we can only infer from circumstances the possibility of such influence having occurred. The extraordinary events of the James Hardie case, and in particular, the extensive documentation made available to and by the subsequent judicial inquiry, have allowed us to deconstruct this relationship in a way we can seldom otherwise do. What follows is a brief account of the circumstances of the case, highlighting the central role of the actuarial estimates and how the actuaries fulfilled their professional responsibilities, especially in relation to the pressures placed on the actuaries' professional independence.

The James Hardie case

James Hardie Industries Limited (JHIL) was the parent company of a series of subsidiaries that were, at key times, the dominant producers of asbestos products in Australia (Prince et al., 2004). The history of asbestos in Australia, from its identification as a mineral with extraordinarily useful commercial properties, through the recognition of the serious harm to health that it caused, the ignoring of those health concerns, the subsequent removal of asbestos from the market and finally the evolution of tort liabilities of vast scope and consequences, mirrors that of the experience in other countries and particularly the United States and the United Kingdom. Indeed the James Hardie group[9] was closely linked to the US market and has since become an integral player in the fibre cement market in that country. In Australia, asbestos and the James Hardie companies in particular, had a unique cultural place. 'Fibro' was a cheap and versatile construction material that was the main-stay of the post-Second World war housing boom. Unfortunately, it also incorporated asbestos at least until 1987 (Pickett, 1997). Insulated sheet containing asbestos was found in most major construction sites, particularly in the post-war period. Many sites were government projects (power plants, shipyards, etc.) and as elsewhere, asbestos was particularly important in ship building. Asbestos was also a key component in the manufacture of other products produced by companies in the James Hardie group, most notably brake linings.

> …every time you walk into an office building, a home, a factory: every time you put your foot on the brake, ride in a train, see a bulldozer at work…the chances are that a product from the James Hardie group of companies has a part in it.
>
> (John B. Reid, Chairman, in 1978 Annual Report in Peacock, 2009)

In addition, James Hardie companies mined asbestos in Australia under conditions that were no doubt as questionable as in many other countries. The processing and manufacturing plants were equally primitive in terms of ventilation and the protection of worker health (Haigh, 2006; Peacock, 2009; Spender, 2003).

The litigation exposure of asbestos producers in Australia became highly significant within a few years of the Johns-Manville Corporation invoking Chapter 11 Bankruptcy protection in the United States (1982). In Australia, there was, however, no equivalent legal protection for corporations. The two primary asbestos producers, James Hardie and CSR, were finally facing successful common law suits by the second half of the 1980s after the barriers that restricted claims to workers' compensation only (brought against a governmental body and with restricted awards) were overcome and the legal obstacles that prevented the parent corporation

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being held responsible for the actions of a subsidiary, in certain circumstances, were also successfully surmounted. The period till the end of the twentieth century saw significant growth in successful claims in Australia. The James Hardie group sought to minimise risk by settling most cases but as the full extent of the potential harm from incidental or environmental exposure to asbestos became apparent, the magnitude of the James Hardie group's exposure to potential claims was also becoming better understood and the continued use of this strategy was questioned.

Arguably, the turning point for James Hardie was the publication of an Exposure Draft 88 (ED88) to revise an Australian Accounting Standard in 1998. This would alter the accounting treatment for certain contingent liabilities and, in particular, the amended Standard required the publication of formal actuarial estimates of liabilities, such as asbestos liabilities (ICAA, 1999). When the proposal proceeded, it would have an immediate impact on the financial reporting of the James Hardie group which at the time was reporting the value of the asbestos liabilities as $AUD45 million,[10] a sum that by this stage was, arguably, vastly under-estimating probable future claims. As an indication of the change the adoption of an appropriate actuarial estimate might yield once the Australian Accounting Standards Board issued the accounting standard derived from ED88, AASB 1044 *Provisions, Contingent Liabilities and Contingent Assets*, in July 2001 CSR Limited (CSR)[11] increased its provisioning for asbestos-related liabilities from $AUD110 million to $AUD300 million. CSR had approximately one-third the exposure to asbestos litigation of the James Hardie group (Haigh, 2006, pp. 216–217).

The response of the James Hardie group to ED88 was the design and subsequent implementation of a strategy that would, effectively spin off and isolate the asbestos exposure from the main operations of the company. There was considerable urgency with this plan since the primary business of the James Hardie group was increasingly in the United States and a proposed stock market listing in that country in 1998 had failed, in good part, because of the uncertainty surrounding asbestos liabilities. The new strategy was named 'Project Green' and it is this project that becomes the primary focus of the present case study.

Project Green involved a complicated corporate restructuring[12] to eliminate asbestos legacy issues which were detracting from 'value creation' (McDonald, 2001, p. 1). The key outcome was that the James Hardie companies would effectively now become domiciled in the Netherlands (for tax reasons) with most operations – and certainly those that involved an element of profitability – in the United States. The two subsidiaries that had been responsible for most of the asbestos claims, James Hardie & Company (Coy) and Jsekarb Pty Ltd (Jsekarb), were to become wholly-owned subsidiaries of the newly formed Medical Research & Compensation Foundation (MRCF). MRCF was an independent Australian entity, the principal purpose of which was to hold assets for the distribution of funds to asbestos claimants (a secondary purpose was to engage in related medical research although this was perhaps to serve more as window dressing than anything of substance – see Moerman and van der Laan, 2007).

Whilst the MRCF was structured to be legally entirely independent of the James Hardie group, it was not only a creation of James Hardie management, but two (out of four) of its initial directors were former directors or officers of companies within the group, and therefore involved at some level in devising the various strategies to 'quarantine' the profitable operations from asbestos liability exposure. Before returning to the role of the actuaries in the establishment of the MRCF, it is worth summarising ensuing events.

The MRCF was established in February 2001, and later in the same year, it was found to have been technically insolvent from its inception because of the under-estimation of the value of liabilities both in the reasonably short- and long terms (long 'tail').[13] MRCF directors quickly came to understand the extent to which MRCF (as well as themselves, personally) had been left adrift by the James Hardie management and board. The latter assumed a consistent position that the assessment of asbestos liabilities at all relevant times was adequate and, in any event, MRCF was an unrelated legal entity for which it had no responsibility.

The under-funded status of the MRCF rapidly became a major public issue with an alliance of victim groups, trade unions, politicians and media personalities pushing for government (specifically, the State of New South Wales where MRCF was

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incorporated) intervention. On 25 February 2002, 1 year after the creation of MRCF, the Premier of New South Wales announced the formation of a special commission of inquiry (the Jackson Inquiry) into the funding issue and the state of knowledge of key players in the James Hardie group at the relevant times.

As a result of the Jackson Inquiry, MRCF was ordered to recover, by civil litigation if necessary, adequate compensation for *all* future asbestos victims of the James Hardie group.[14] The government assigned responsibility for negotiating what this sum should be and how it should be funded to the Australian Council of Trade Unions (the overarching organisation of Australian trade unions) and the public face of asbestos victims groups, Mr Bernie Banton. The subsequent arrangement reached was not unlike that for Johns-Manville in the United States (see Delaney, 1992). This involved setting up a legally separate trust to fund claims, and in this case, the provision of a proportion of future annual 'free cash flows' to be allocated to fund a new entity, to assist in satisfying claims through a 'Final Funding Agreement'.[15] Whilst this arrangement has ensured that funding was made available, the amount, timing and control that the James Hardie management has over this funding has been questioned (see Moerman and van der Laan, 2010). In addition, in late 2009, the Australian Government announced a loan facility to the new trust which again was concerned with its ability to remain solvent in the face of rising claim costs and limits on the funding available from James Hardie under the Final Funding Agreement (Moerman and van der Laan, 2009b).

The role of the actuary

Much of the focus of the Jackson Inquiry was, quite naturally, upon the state of knowledge, and timing of that knowledge of the key executives and board members of both the James Hardie group and MRCF. A critical element of the restructuring and the focus of subsequent civil proceedings against former James Hardie companies and certain former directors and officers,[16] concerned the veracity of claims in a key press release announcing the establishment of MRCF. This has been discussed elsewhere (see Moerman and van der Laan, 2007) but for present purposes the critical statement was: 'The Foundation has sufficient funds to meet all legitimate compensation claims anticipated from people injured by asbestos products that were manufactured in the past by two former subsidiaries of JHIL'(JHIL, 2001). As such, the valuation of outstanding claims was a pivotal issue at all stages of the restructuring of the James Hardie group of companies and the subsequent creation of MRCF. The actuaries were essential for advising the respective managements and boards in this regard.

The IAAis the professional body to which actuaries belong and which establishes professional standards.[17] Actuaries acquire their professional status from their formal or regulated functions in the insurance and associated industries, and this allows most who are in private practice (that is, not directly employed by industry) also to provide consulting services. It is in this capacity that the relevant actuary in the James Hardie case was hired.

The firm of consulting actuaries in this case, Trowbridge Consulting, was one of the larger Australian actuarial firms[18] and one which had considerable experience valuing asbestos claims (Jackson, 2004). The firm had evaluated asbestos liabilities for members of the James Hardie group from at least as early as 1996 when it estimated the future cost of asbestos related claims at $250 million (Haigh, 2006, p. 176).

The actuary in the James Hardie case

Some of the earliest evidence of how, at least some, officers of the James Hardie group viewed the relationship with actuaries hired to value asbestos liabilities can be found in meeting minutes of March 1998 where it was noted that 'there needs to be a strategy for managing Trowbridge' (Board subcommittee in Jackson, 2004).[19] The firm was being asked to provide an evaluation of asbestos liabilities that would form part of the evidence required to inform a complicated proposed restructuring and public listing in the United States. In other words, this evaluation might, at some stage, be publicly disclosed with corporate decisions being based on the credibility of an independent actuarial assessment. The word 'manage' certainly suggests an unwillingness to accept the essential nature of professional

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independence. In the language of the literature of the sociology of the professions, here is clear evidence of client capture; where powerful clients control the behaviour of professional advisors (Coffee, Jr., 2003; Leicht and Fennell, 2001; Macey, 2004; Macey and Sale, 2003; Prakash, 2004).

The particular reorganisation and attempted US listing in 1998 failed, and in no small part, because of the valuations prepared by the actuarial firm, Trowbridge. The numbers clearly concerned analysts and, more importantly, the manner in which James Hardie described the process of evaluation was less than forthcoming. In the context of a US market already well informed about asbestos and tort liability (the latter arguably being potentially more extensive than in Australia because of different litigation climates), this was certainly likely to signal concerns. For example, an information memorandum was released incorporating a valuation by Grant Samuel (an Australasian investment house) that was extraordinarily vague and anything but reassuring to the markets. It included statements such as '…while the directors have taken expert advice, the population of potential claimants is unknown and there is no reliable basis on which to assess…the likely cost of settling potential future claims' (Haigh, 2006, p. 190). Actuaries are charged with the task of dealing with uncertainty, and there was in fact, by that stage, a good deal known about claims in Australia. Another way of interpreting this was that the company was simply obfuscating.[20]

With the background of the above failed venture and the spectre of increased accounting disclosures plaguing the balance sheet, management moved onto what became known as Project Green and the inevitable need for further actuarial estimates. From the late 1990s, the key representative of Trowbridge was one, David Minty, an actuary with approximately 11 years of experience. This was also still a time where email, while recognised to be potentially non-secret, was still widely used in the commercial context, thus providing the subsequent Jackson Inquiry with a wealth of detail about relevant communications.[21]

Throughout this period, successful claims against the James Hardie group were increasing both in number and value. Minty was following these and reporting the changing valuations as he was requested to calculate them. Therefore, in 2000, for example, Minty reported that 'Our "first draft" conclusion is that the discounted present value of the liability lies between $A200 to $350m at 31 March 2000 compared to our estimate of $254m at March 1998' (Haigh, 2006, p. 207).

This communication was alarming from Hardie's perspective and the response gives further insight into the way the relationship between actuary and corporation was viewed from the perspective of management. Certainly, management had every right to approach any valuation with a critical eye and to question assumptions. The valuations were pivotal to the implementation and success of Project Green. What we find, however, in the communications is a combination of two elements that arguably would ultimately prove to place extraordinary pressure on the independent professional advisor: an aggressive management and a constant imposition of tight timelines. It was clear that Hardie management was not pleased with the Trowbridge estimates, and subsequently the estimate was revised down to $294 million. This figure was more acceptable but, still, in the opinion of general counsel, Peter Shafron, a concern.[22] He sought to have the report kept in 'draft' form and made requests for changes that would subtly alter its meaning. For example, the report of the Jackson Inquiry (2004, pp. 212–213) found:

> 15.36 Mr Shafron, through Mr Attrill [litigation counsel], sought to exercise very great influence over the contents of Trowbridge's report. His views are recorded in Mr Attrill's note of the telephone conversation with Mr Shafron on 1 June 2000. These views were then reinforced by Mr Shafron in a facsimile forwarding a copy of the first five sections of the draft report, with manuscript comments and amendments, to Mr Attrill on 1 June 2000.
>
> 15.37 Mr Shafron's manuscript comments indicate that he required that the words "Draft" and "confidential and legally privileged prepared for purposes of litigation" be included in the *footer* on each page of the report. The commentary and heading "Developments Since Our Previous Review" were deleted. Comments which emphasised the uncertainty of estimates were to be softened. A reference to ED88 was deleted, as was a reference to the fact that the estimate had increased by $40m since the last review, and also the fact that the number of mesothelioma cases was higher than the previous review. The word "*considerably*" was deleted from the phrase "*future experience could vary*

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considerably from our estimates''. The sentence ''*Wide variations are normal and are to be expected*'' was deleted.

15.38 Mr Shafron, an obviously intelligent man, was clearly very familiar with the issues raised in the draft report and understood the report's limitations. The amendments sought by him, to a significant extent, were incorporated in the final Trowbridge draft.

The Trowbridge report itself remained as a draft due to other conflicts, and this suited Hardie management which was then able to cherry pick from it and use it as it suited, and suggesting precision or imprecision of estimates according to the need (Haigh, 2006, pp. 209–210). The relationship between the James Hardie group and its actuaries, and Minty in particular, became strained as Hardie wished to extend the use of the report to show potential insurers. Minty responded that this could only happen with an assurance of indemnity. The following email from Shafron to Minty of 16 June 2000 was put before the Jackson Inquiry (2004, p. 231):

I have just finished talking to our CEO and wanted to convey how unhappy we are with the position you have taken in demanding an indemnity in return for us being able to use your report for the purposes that I outlined to you in February. The reason I outlined the possible use of the report (subsidiary and incidental to the main purpose of using it in our litigation strategy) in February was to flush out any special requirements that you may have. I suspect that you didn't raise any issues then because you were still operating as Trowbridge and had not merged with Deloittes. The position you took then was consistent with your general approach to our work – nothing was too much trouble. For that I was very grateful. The position you have now taken is a surprise and likely in breach of your original contract of engagement where no such requirement was discussed or agreed.

An interesting aside was that, at this time, Shafron made some effort to seek out an alternate actuary, although this was ultimately unsuccessful. The Commissioner, Jackson, concluded that '…I think it more likely he was exploring, as he was entitled to do, whether a further actuarial report might be more favourable, in the sense of giving a lower estimate of the asbestos liabilities…' (Jackson, 2004, p. 236).

The role of the actuary became far more critical as James Hardie moved to isolate its liabilities to MRCF. In principle, MRCF was intended to have adequate funds to meet expected liabilities. Incoming MRCF directors were so concerned about this fundamental requirement that they sought assurance that MRCF assets would be supplemented if necessary to meet its liabilities. This in turn called for a further actuarial report to determine liabilities, and once more, Minty was the primary figure involved. Due to the significance of these events, the Jackson Inquiry examined the interactions between actuary and James Hardie executives in minute detail.

The critical factor upon which a good deal of the Jackson Inquiry findings turned was that Minty did not have current claims data at the time he prepared the critical report. Specifically, he did not have access to the 9 months of data from March to December 2000. Without this, he was essentially preparing the new evaluation on the data used in the earlier report.[23] While there seems little doubt that doing so raises concerns about the level of Minty's professional competence,[24] the focus here is upon why he would go ahead with this evaluation in the absence of information he certainly requested. There was conflicting evidence before the Jackson Inquiry as to exactly what was said between Shafron and Minty about the missing data. Certainly, there were once again more time constraints imposed by Shafron and a certain lack of clarity about the purpose of the report itself which allowed the Commissioner, Jackson, to conclude (2004, p. 394) that, at least at this stage of the proceedings, Minty had likely not acted improperly:

Having regard to the clear basis on which Trowbridge had been instructed to do the report, the fact that Trowbridge did not react and did not express a caveat in the February [2001] Report is not particularly surprising. The report was being done for JHIL, which had asked that it be done by reference to the March data, and was on any view aware of its own experience in the interim. It had also asked for the report to be kept brief. Trowbridge had no obligation to point out the obvious to JHIL. Moreover, the task it had been asked to do was not an irrational one, even if there had been a clear deterioration. JHIL may have wanted to see, by direct comparison with the 2000 report's outcomes, just what the effect of Watson and Hurst [a recently developed approach to evaluating asbestos liabilities] was, unclouded by the impact of new data. The position became different of course, on

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> 13 February when Trowbridge became aware of the true use to which the report would be put. But I do not regard its failure to act appropriately as regards the incoming directors in that situation as strong evidence that Mr Minty and Mr Marshall had from the outset regarded the current data as immaterial.

As the above assessment states, circumstances changed dramatically when Minty et al. learned that the report was to be used to satisfy the concerns of incoming directors about funding of the yet to be created MRCF.

The proposed board of MRCF was highly experienced, especially in relation to asbestos and two directors came from companies within the James Hardie group. It was, nonetheless, also seriously lacking in independent advice. Its lawyer was remunerated by the James Hardie group. Its actuary was Trowbridge, the long-standing Hardie actuary. Its interactions were guided by senior management of the James Hardie group and, in particular, Shafron who clearly, by this time, was viewing his mandate to be ensuring Project Green was carried out, whatever documentation and information was required to achieve this end. When the James Hardie lawyer [Attrill] suggested the new Trowbridge report be commissioned by the lawyer for MRCF, Shafron responded 'No, I want the report to be to JHIL. I want to keep Minty on JHIL side of things as far as possible, for tactical reasons and control' (Haigh, 2006, p. 256). He advised Attrill 'My preference is not to include the reference to one or two of the more sensitive documents… because it will likely make things tense with the new board, who will become suspicious.' and insisted on being present when the prospective directors met with Minty '… to provide some context' (Haigh, 2006, pp. 256–257).

Minty delivered. The report of his contribution to this meeting at the Jackson Inquiry was as follows (2004, p. 385):

> 23.29 Secondly, in the course of Minty's own presentation Mr Gill [incoming independent non-executive director of the MRCF] asked, "*How long will $280 million last?*" Minty answered:
>
> If you take our projections and apply discount rates in the order of 7% to 8%, a fund of around $280 million is going to last about 20 years if our medium projection plays out, and obviously it would be insufficient if the high projection is what emerges. In that case you would expect the, a fund of that size to last about 15 years. Obviously, if what we've called the current projection occurs, then $280 million would last you 20 years and maybe a few years longer depending on, among other things, investment returns. So it depends on a number of variables, many of which are quite uncertain.

It is evident that both the question and the answer session proceeded on the footing that there were to be no additions to be made to the fund in the relevant period,[25] apart from earnings on assets.

> 23.30 Finally, at the end of Mr Minty's presentation, Mr Jollie [incoming independent non-executive director of the MRCF] said: "*We intend to rely on this*", and Mr Gill asked that Mr Minty send a copy of the report to the incoming directors through Mr Bancroft [MRCF legal advisor]. (Jackson, 2004, p. 385)

Following further testimony as to what Minty knew about the purpose of the Report he would give the incoming board, the Commissioner, Jackson (2004, p. 387), concluded:

> 23.32 In light of this evidence I conclude that Mr Minty either knew or should have known how his report was being used. At the very least there was sufficient risk that the report would be used to set the level of funding for the Foundation that Mr Minty should have made some inquiry, or volunteered a warning as to the limits of the utility of the report. Further, if there was any room for doubt as to whether the fund would be "*closed*" (i.e., that there would be no right to further contributions by JHIL) that doubt would have been resolved when Mr Minty saw reports of the JHIL media releases on the 16 or 17 February. His failure to warn his old client, JHIL, or his prospective client, the Foundation, that they may have proceeded on a serious misunderstanding of Trowbridge's work, is impossible to justify.
>
> 23.33 In the result, I find that Trowbridge fell below the standards of professional care and engaged in misleading conduct in permitting the incoming directors to rely on the February 2001 report without warning them of its limitations, and in particular, without warning them that it would not be appropriate to rely on its NPV estimates to assess the life of a closed fund such as the MRCF.

It should be added that the incoming board did not rely on the actuarial report alone to satisfy itself

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that MRCF would be adequately funded to meet future claims. Shafron and others produced financial models that confirmed the desired conclusions. But undoubtedly the role of the actuary in providing independent expert estimates of the valuation of future asbestos liabilities was pivotal at this, as in earlier, stages. It is worth noting that the Commissioner concluded that it was unlikely that the key parties would be able to sue Trowbridge for negligence. This was, however, largely because of the complicity of management in some of the companies involved and the inevitable conclusion in the case of the James Hardie group that, if the numbers had been more 'accurate', then it would never have been able to contribute an appropriate amount at the time to establish MRCF on a fully funded basis.

Finally, while the IAA proceeded with a disciplinary action against Minty, in light of the clear contraventions of its Code of Professional Conduct, the Tribunal hearing the complaint against Minty unanimously determined that Minty merely be reprimanded.[26] Minty was charged with two breaches of the Institute's Code of Conduct. The Complaint against Minty outlined that the advice he provided in his February 2001 report was misleading to third parties. This part of the complaint did reference that 'constraints on the actuary's independence were not disclosed' (IAA, 2007b). But this compromise of independence was relegated to a contributory factor. In addition, he was charged with failing to fulfil his obligation to the public interest to provide high quality actuarial advice and service. The relevant section of the professional code is that was breached is summarised below:

> **4.5 Potential misuse of Professional Services**
>
> 4.5.1 A Member must not provide, or continue to provide, Professional Services to a Principal when the Member reasonably believes the result of any Professional Services provided will be used…in a manner that is likely to mislead third parties.

It could be argued that not only were the actions of the actuary potentially misleading to the incoming directors of MRCF, Trowbridge was also complicit in the 'watering down' of the usual disclaimers in relation to the significant uncertainties surrounding actuarial advice. Trowbridge's defence to claims of negligence relied heavily on assertions that the advice provided was limited to that as instructed by Shafron and other members of James Hardie management and the subtleties of information and language used in the reports prepared by the actuaries were not fully appreciated by those relying on their advice. Minty conceded that he failed to exercise independent judgement in relation to the information required for preparing an actuarial report and that the professional advice provided in the February report would have been unsuitable for the purpose for which it was being used (Jackson, 2004).

Given the less than onerous penalty imposed on Minty, it appears that his defence resonated to some extent with the disciplinary body. It may well be that those deciding this case were influenced by the vagueness of the language of the Code itself. However, there would appear to be some overriding reluctance to address ethical concerns in a more forthright manner. Even today, under a new schema, it is rare for the IAA to take disciplinary action against members.[27]

Concluding comments

The next stage in the James Hardie saga has seen the negotiation of a new asbestos funding agreement between the key players for the James Hardie group to provide what appears to be substantial, if not adequate, funds to meet the future claims of those harmed by its products. Due to the funding negotiations, much of the assignment of legal responsibility became moot. However, the concern in this article is for the role of the actuary, and how a highly skilled professional may have been compromised in terms of the ability to deliver independent and reliable advice.

There are undoubtedly structural issues that led to this outcome. Returning to the focus on individual characteristics or virtues, we have here a case where the fundamental concept of professional integrity is challenged to the point where very real harm could have resulted to those in society to whom all professionals ultimately owe an ethical responsibility.

Employing a virtue ethics framework highlighted that the establishment of professional virtues and their exercise occurs in the course of a practice (MacIntyre, 1984). In addition, the virtue of integrity requires a focus on the 'big picture' (or public

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interest) in difficult situations through being socially conscious and other-directed in carrying out professional responsibilities (Killinger, 2007). The actuary was clearly influenced and pressured by Hardie which resulted in the inability to maintain the appropriate attitude of mind and judgement required by his professional status in this specific context.

Evaluating the events from an institutionalised perspective, we can readily identify the shortcomings of 'rules' and their enforcement. It is questionable whether an actuary should be able to advise both parties (the James Hardie group and MRCF) in these circumstances.[28] Certainly the understanding held by the actuary here of what it means to be 'impartial' and thereby maintain professional integrity was suspect. The Actuaries Professional Code of Conduct gave minimal attention to explaining these professional concepts and the soft approach of the IAA in disciplining its members when breaches have occurred undoubtedly did nothing to reinforce the importance of the code.

One response to the Hardie case then would be a call for the enhancement of the language and enforcement of the actuarial codes of professional conduct. Another is the enhanced legal enforcement of the type ultimately taken against others involved in this case. These approaches, however, ignore the critical role of ethics at the 'personal' level or personal virtues. Where notions of 'client capture' are raised, what is essentially being described is the challenge the individual must face to maintain a personal commitment to integrity – here expressed as professional independence – in light of the powerful organisational forces that arise out of an employment relationship. Moreover, it is at this level that the Hardie case provides the most powerful insight. Seldom do we see such explicit language as that used here to describe the management of the actuarial function and the anger when the actuary ventures to deliver autonomous advice (that anger expressed even in terms of a 'breach of contract'). Besides, the subtle manner in which the actuary allowed his opinion to be misused at the critical meeting with MRCF directors was, using the words of Commissioner Jackson, 'impossible to justify' (2004, p. 387).

If we evaluate the behaviour of the actuary solely in terms of institutional values, we can perhaps see how loose language in codes could allow undesirable outcomes. But this ignores the essence of what it means to be an ethical or virtuous professional. Should this actuary have internalised the ethical responsibility not only to the client or employer but, much more importantly, to the broader set of those in society ultimately dependent on his expertise, there would have been no ambiguity in terms of his responsibilities. This advice was to be used to determine whether there were sufficient funds to compensate potential claimants. Under no circumstances, could it be said that the February 2001 estimates could have met these requirements. By allowing ambiguity to surround the words provided, the actuary clearly abandoned his responsibility both to the directors seeking his advice, but more importantly, those in society most dependent on that advice being professionally appropriate.

The James Hardie group was only able to succeed in isolating its asbestos liabilities and creating MRCF due to the efforts of other professionals, including accountants and lawyers, relying on the knowingly flawed information provided by the actuary and a legal regime that gives primacy to the notion of a separate legal entity and as a consequence, allows the limiting of liability. Highlighting the role of the actuary is certainly not meant to imply that members of the other professions did not assume active roles as facilitators of these schemes. Above all else, however, what this case demonstrates is the ease with which 'independent' professionals can subtly, or not so subtly, be drawn into a course of action that by any standards must be viewed as unethical and perhaps illegal. No one ordered the actuaries to do the things they did. However, by taking an existing and no doubt valuable relationship, relying on familiarity and imposing conditions of high stress and tight timelines, well-trained professionals could be just as effectively 'instructed' by management to do what they did.

The value of this case is that we have before us evidence that, in most circumstances, would not be available. In the course of the Special Commission of Inquiry, vast numbers of records and lengthy sworn testimony became publicly available. This article only skims the surface of what could be examined. However, what it aptly demonstrates is how the combination of a less than assertive actuary and a driven and manipulating management can result in

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almost tragic consequences. The outcome could well have been large numbers of victims of asbestos exposure being left without any recourse to seek compensation as the vehicle through which compensation was to be provided was left severely under-funded from its inception due to, in no small part, flawed actuarial advice.

Notes

[1] The exception being in the United Kingdom where the failure of the insurer, Equitable Life, led to the Morris Enquiry and considerable public and regulatory attention being given to the actuary.

[2] Through the complicated restructuring process commenced in 2001, James Hardie Industries Limited is now known as JHI NV, a company domiciled in the Netherlands, but a listed foreign entity in Australia (see Moerman and van der Laan, 2009a, b).

[3] Note that it is beyond the scope of this article to examine the literature relating to whether indeed Codes of Ethics exist for the public or private use of the profession. Clearly, codes will have a mixture of both functions but should the purpose be primarily for the private benefit of the profession only, obvious concerns are raised. See, for example, discussion in Scott Carson et al. (2008) available at EthicsCentre.ca.

[4] Independence here may be seen as parallel to the notions of professional independence that are at the heart of the audit profession.

[5] For example, the *Insurance Act 1973*.

[6] Indeed, under the APRA Guidelines, both auditors and actuaries are covered in the same document.

[7] Note that, in certain cases, assumptions may be, for example, technically those of management. Nonetheless, the actuary should not be associated with assumptions that would be professionally inappropriate. See Gunz et al. (2009) discussion of assumptions in valuation of defined benefit plans.

[8] Indeed, as an input into financial reporting, the actuarial estimates also become subject to audit.

[9] The corporate structure of the James Hardie companies was/remains complex and changed several times during the period described in this article. To avoid unnecessary detail, the companies will generally be referred to as the James Hardie group, although that does not have any formal legal meaning here.

[10] At that time, only 'known' claims were required to be reported.

[11] CSR is another large listed Australian company with asbestos exposure.

[12] Although not within the ambit of this article, it should be noted that corporate structuring or restructuring to avoid liabilities or achieve other strategic ends has been practised since corporations began structuring as corporate groups. The primacy of the doctrine of the separate legal entity in most Western jurisdictions has facilitated many corporate misdemeanours (see e.g. Clarke and Dean, 2007; Delaney, 1992).

[13] The realisation of the inadequate funding of the MRCF was obvious as early as 6 August 2001 when Mr Minty presented a new actuarial report to the board of Coy (renamed Amaca) (which was then a subsidiary of MRCF) where the projected net cost of claims had nearly doubled from the $294 million in February to $574 million in August (Jackson, 2004).

[14] See Second Reading James Hardie (Investigations and Proceedings) Bill 2004 (comments by Premier Mr. Bob Carr at Second Reading) http://www.parliament.nsw.gov.au/Prod/Parlment/HansArt.nsf/V3Key/LA20041019023 last visited 24 Feb 2009.

[15] The Final Funding Agreement has undergone several iterations. The most recent amendments to the agreement dated 31 March, 2009 broadened the scope of the agreement to include previously excluded asbestos claims (i.e. miners from a subsidiary that was sold); however no amendments to funding levels have been negotiated (see Moerman and van der Laan, 2010).

[16] These proceedings were commenced by the Australian Securities and Investments Commission in February 2007. In 2009, a number of former directors and officers were found guilty of breaching certain sections of the *Corporations Law* and were fined large sums of money as well as being banned from managing companies for significant periods of time (5–7 years). At the time of writing, these matters were subject to appeal.

[17] For the purposes of insurance, actuaries (and auditors) are regulated by the APRA which receives its authority from the *LIFE INSURANCE ACT 1995*. APRA may remove the right of actuaries to perform actuarial services in this industry.

[18] Interestingly, the firm merged with Deloittes in 2000, 1 year prior to the critical advice in this case. Following regulatory changes to audit firms in 2005, the insurance work of the then, Trowbridge Deloittes, was split off.

[19] Testimony of treasury executive Stephen Harman to the Inquiry, 6 May 2004, describing notes from the minutes of a meeting dated 31 March 1998. Harman was unable to describe what 'managed' meant beyond ensuring that Trowbridge understood that parts of its report might be made public.

[20] Indeed, it may have simply been misleading the public. The memorandum went onto state that 'Analyst

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estimates of the present value of the liability vary widely but appear to range from $50 million to $120 million'. In fact the Trowbridge evaluation of the net present value of the liabilities was $254 million (Haigh, 2006, p. 189).

[21] The risks associated with email communication were not unrecognised: 'Please excuse the cryptic nature of this email given the non-secure nature of the internet!' (email from David Minty 13 April 2000, in Haigh, 2006, p. 207).

[22] The role of the general counsel in this case – or indeed the Chief Financial Officer – was at least as problematic as that of the actuary. Shafron (and other directors and officers) were in fact convicted by the Supreme Court of New South Wales in 2009 of a number of offences, raising important issues about the responsibilities of general counsel that will, no doubt, be the subject of discussion elsewhere.

[23] At the Jackson Inquiry, the significance of this missing data was explained: 'Trowbridge, with knowledge of the Current Data, would have increased its estimated 20 year NPV from $286 million to $373 million and the total (50 year) NPV from $322 million to $437 million (in each case, with no allowance for super-imposed inflation)…; (ii) KPMG, with knowledge of the Current Data, would have increased its estimated NPV from $694.2 million to $1044.5 million (in each case, with superimposed inflation at 2%)…'.

[24] This was a period in which there had been a major increase in both the incidence and the value of claims settled and a general understanding that the 'tail', or period over which claims might still be expected, was lengthening.

[25] This is referred to as a 'closed fund'.

[26] As at May 2010, David Minty is a consulting actuary at Finity Australia, Australia's largest firm of consulting actuaries (see www.finity.com.au). He has held this position for 5 years. It appears his tenure at Trowbridge Consulting (which merged with Deloitte Actuaries & Consultants in 2000) ceased in 2005. However, his breaches of the Professional Code of Conduct appear not to have overly tarnished his professional reputation. After the reprimand, he has continued to write pieces for professional journals as well as present articles at industry conferences.

[27] In February 2006, a new Disciplinary Scheme was introduced by the IAA. The action against David Minty was prior to the new scheme. Since the new scheme was introduced, only three complaints have been made (from a membership of around 3500) up to the end 2009. Of those complaints, two were dismissed, and the third resulted in a warning (IAA, 2009b).

[28] A comparable argument has been made elsewhere in the case of the auditor acting for parent and subsidiary company. Whilst in many cases, there is no problem, there will be occasions where the minority shareholders of the subsidiary may suffer harm (see Gunz and McCutcheon, 1991).

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