Docket No. 07-2794-cv(L), 07-2818-cv(CON)

UNITED STATES COURT OF APPEALS
For the Second Circuit

BERNARD L. SCHWARTZ
Plaintiff-Counter-Defendant-Appellee,

TWIN CITY FIRE INSURANCE COMPANY,
Defendant-Cross-Defendant-Counter-Claimant-Appellee,

ROYAL INDEMNITY CO.,
Defendant-Cross-Defendant,

-v-

LIBERTY MUTUAL INSURANCE COMPANY,
Defendant-Cross-Claimant-Appellant,

NORTH AMERICAN SPECIALTY INSURANCE COMPANY,
Defendant-Counter-Claimant-Cross-Claimant-Appellant.

On Appeal From the District Court
For the Southern District of New York

Brief of United Policyholders as *Amicus Curiae* on Behalf of Bernard L. Schwartz, Plaintiff-Counter-Defendant-Appellee Supporting Affirmation

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STATEMENT OF INTEREST OF AMICUS CURIAE

United Policyholders, ("UP") is a non-profit charitable organization founded in 1991 as a resource for buyers of all types of insurance products. The financial security insurance policies provide is an integral part of the fabric of our society and economy. Our organization exists to help enforce coverage promises that are made at the point of sale. Donations, grants and volunteer labor support UP's work.

UP provides pre and post loss claim education, files *amicus* briefs in cases involving coverage and claim disputes and is an information clearinghouse on consumer issues related to commercial and personal lines insurance products. www.unitedpolicyholders.org UP provides disaster aid to homeowners in the states of Texas, Florida, California, and Arizona.

In this brief, United Policyholders seeks to fulfill the "classic role of *amicus curiae* by assisting in a case of general public interest, supplementing the efforts of counsel, and drawing the court's attention to law that escaped consideration." Miller-Wohl Co., Inc. v. Commissioner of Labor & Indus., 694 F.2d 203, 204 (9th Cir. 1982). This is an appropriate role for *amicus curiae*. As commentators have often stressed, an *amicus* is often in a superior position to "focus the court's attention on the broad implications of various possible rulings." R. Stern, E. Greggman & S. Shapiro, Supreme Court Practice, 570-71 (1986) (quoting Ennis, Effective Amicus Briefs, 33 Cath. U.L. Rev. 603, 608 (1984)).

United Policyholders has filed over one hundred and thirty five *amicus* briefs since it was founded. UP's *amicus* brief was cited in the U.S. Supreme Court's opinion in Humana Inc. v. Forsyth, 525 U.S. 299 (1999). UP was the only national consumer organization to submit an amicus brief in the landmark case of State Farm Mutual Auto Insurance Co. v. Campbell, 538 U.S. 408 (2003). We have been invited by several divisions of the California Court of Appeal, to participate in oral argument as *amicus curiae.* Arguments from our *amicus curiae* brief were cited with approval by the California Supreme Court in Vandenburg v. Superior Court, 982 P.2d 229 (Cal. 1999), and contributed to Watts Industries, Inc. v. Zurich American Insurance Co., 18 Cal.Rptr.3d 61 (Ct. App. 2004).

I. QUESTION PRESENTED

Whether a policyholder forfeits coverage by settling a claim without the insurance company's authority, after the insurance company intentionally placed its interests adverse to those of the policyholder by issuing a reservation of rights and without any showing that the insurance company was prejudiced by the settlement.

II. STATEMENT OF THE CASE, JURISDICTION, AND FACTUAL AND PROCEDURAL BACKGROUND

United Policyholders adopts the statements of the case, jurisdiction and factual and procedural background as presented within the Brief of Bernard L. Schwartz, Plaintiff-Counter-Defendant-Appellee.

III. ARGUMENT

A. The Special Public Nature of Insurance

The insurance industry has long acknowledged its special public nature. A text used nationwide to train insurance industry professionals states:

> Insurance contracts are different from other commercial contracts because insurance is more a necessity than a matter of choice.

> Therefore, insurance is a *business affected with a public interest*, as reflected in legislative and judicial decisions.[1]

The special public nature of insurance places insurance companies in a unique position of trust with respect to their policyholders, and the public. As such, both Insurance companies and policyholders stand to suffer from loss of certainty in the insurance market. The insurance market should not become a race to the bottom based on the lowest common denominator.

B. LOSS MITIGATION EXPENSES ARE COVERED

When a policyholder settles a claim on his own, as Mr. Schwartz did here, because all of his insurance companies refused to agree to the settlement, he is essentially limiting the risk, and mitigating the total potential loss, on behalf of himself and the insurance companies. The insurance companies should not be allowed, therefore, to avoid their obligations, when the settlement was done as much for their benefit as for the policyholder himself.

As a matter of law, costs incurred by a policyholder that minimize later damage or cost are covered under insurance policies as loss mitigation costs. Indeed, many liability insurance policies require that the policyholder take steps to mitigate or minimize loss. Generally, a recipient of a government directive will hire a lawyer or investigator to negotiate with the government to mitigate or avoid liability losses. In the environmental liability context, courts have recognized an insurance company's obligation to pay for loss mitigation expenses, even where the policy did not specifically provide for coverage of loss mitigation expenses. *See e.g.* AIU Ins. Co. v. Superior

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1 James J. Lorimer, et al., The Legal Environment of Insurance 179 (4th ed. Insurance Institute of America 1993) (emphasis in original).

Court, 799 P.2d 1253, 1270 (Cal. 1990) ("As long as some 'property damage', as defined below, has already taken place, the agencies' expenses for responding constitutes loss or detriment, whether or not the expenses are attributable to actual cleanup, mitigation of damage, or investigation and monitoring."); Metex Corp. v. Federal Ins. Co., 675 A.2d 220, 228 (N.J. Super. Ct. App. Div. 1996) ("liability insurance policies provide coverage for loss mitigation costs where, as here, off-site environmental property damage has occurred...").

Several courts have stated the strong policy reasons supporting the coverage of loss mitigation costs. *See, e.g.*, Leebov v. U.S. Fid. & Guar. Co., 165 A.2d 82, 84 (Pa. 1960):

> It is a folly to argue that if a policy owner does nothing and thereby permits the piling up of mountainous claims at the eventual expense of the insurance carrier, he will be held harmless of all liability, but if he makes reasonable expenditures to prevent a catastrophe he must do so at his own cost and expense...the [insurance company] ignores the fact that the plaintiff was absolutely liable for damage to the nearby lands...;

Globe Indem. Co. v. State, 118 Cal. Rptr. 75, 79 (Ct. App. 1974), review granted sub nom. AIU Ins. Co. v. Superior Ct., 782 P.2d 595 (Cal. 1990):

> When [a policyholder] takes out an indemnity policy, as in this case, it is more reasonable to suppose that he expects to be protected by his insurance in any situation wherein he becomes liable for damage to tangible property. It would seem strangely incongruous to him, as it does to us, that his policy would cover him for damages to tangible property destroyed through his negligence in allowing a fire to escape but not for the sums incurred in mitigating such damage by suppressing the fire;

The point these decisions and the many courts that follow their rationale emphasize is that an insurance policy should not be construed to reach ridiculous results. Indeed, as held Employers Health Insurance v. General Casualty Company of

Wisconsin, 469 N.W.2d 172, (Wis.1991), in interpreting insurance policy language, courts should construe the policy in light of the apparent object or purpose of the insurance, the subject matter of the insurance, the situation of the parties and the circumstances surrounding the making of the policy. Employers Health Ins., 469 N.W.2d at 175 (citing Swart v. Rural Mut. Ins. Co., 344 N.W.2d 719, 720 (Ct. App.1984)); *See also* Chemtec Midwest Servs., Inc., v. Ins. Co. of N. Am., 290 F. Supp. 106, (W.D. Wis. 1968).

Since standard-form insurance policy language has been held to cover loss mitigation costs, it is especially appropriate to recognize coverage for settlements that benefit the insurance company as much as the policyholder. United Policyholders respectfully suggests that this Court recognize, and clarify in this case, that the settlement costs incurred by a policyholder in response the outright refusal of his insurance companies to provide any coverage, are loss mitigation expenses and should be covered.

C. The Law Disfavors Punitive Forfeitures

Modern contractual jurisprudence disfavors forfeitures based on mere technical violations that result in windfalls to the insurer. *See* Friedland v. Travelers Indem. Co., 105 P.3d 639, 646 (Colo. 2005); Clementi v. Nationwide Mut. Fire Ins. Co., 16 P.3d 223, 230 (Colo. 2001); Coop. Fire Ins. Ass'n of Vt. v. White Caps, Inc., 694 A.2d 34, 37-38 (Vt. 1997); Brakeman v. Potomac Ins. Co., 371 A.2d 193, 198 (Pa. 1977); *see also* Restatement (Second) of Contracts § 229 (1981) ("To the extent that the non-occurrence of a condition would cause disproportionate forfeiture, a court may excuse the non-occurrence of that condition unless its occurrence was a material part of the agreed exchange"). In other words, courts now hold that the penalty for failing to comply with a condition precedent should not overreach the purpose of the condition and the effect of the failure on the other party. *See* Cooper v. Government Employees Ins. Co., 237 A.2d 870, 873-74 (N.J. 1968).

Moreover, to the extent Mr. Schwartz did fail to satisfy a condition precedent, he did so in the face of unanimous intransigence among all of his insurance companies. These companies should not be allowed to profit when their behavior prompted the supposed failure to cooperate.

D. The Insurance Hoax

The magazine Bloomberg Market recently published an article titled "The Insurance Hoax."[2] The article focuses on homeowners insurance, but the picture it paints is a devastating indictment of "secret tactics" used by insurance companies to cheat their policyholders. The article notes that these tactics have resulted in a substantial decrease in payments by the entire property-casualty insurance industry:

> In 2006, carriers paid out 55 percent of the $435.8 billion in premiums collected, according to the Insurance Information Institute, a trade group in New York. That compares to a 64 percent payout ratio on $267 billion in premium revenue in 1996.

Id. at 38. Allowing the industry to further enrich itself through draconian forfeiture rules is not in the interest of justice.

IV. CONCLUSION

For the foregoing reasons, United Policyholders respectfully asks that the underlying decision be upheld.

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2 *See* Dietz and Preston, "The Insurance Hoax", Bloomberg Markets, Vol. 16:9, p. 34-52 at p. 36 (September 2007), which was offered as an exhibit in Bi-Economy Market, Inc. v. Harleysville Insurance Company of New York, CA 06-00847, Ct. App. NY (Sept. 2007) A copy is attached to this *amicus* brief as Appendix A.

November 16, 2007

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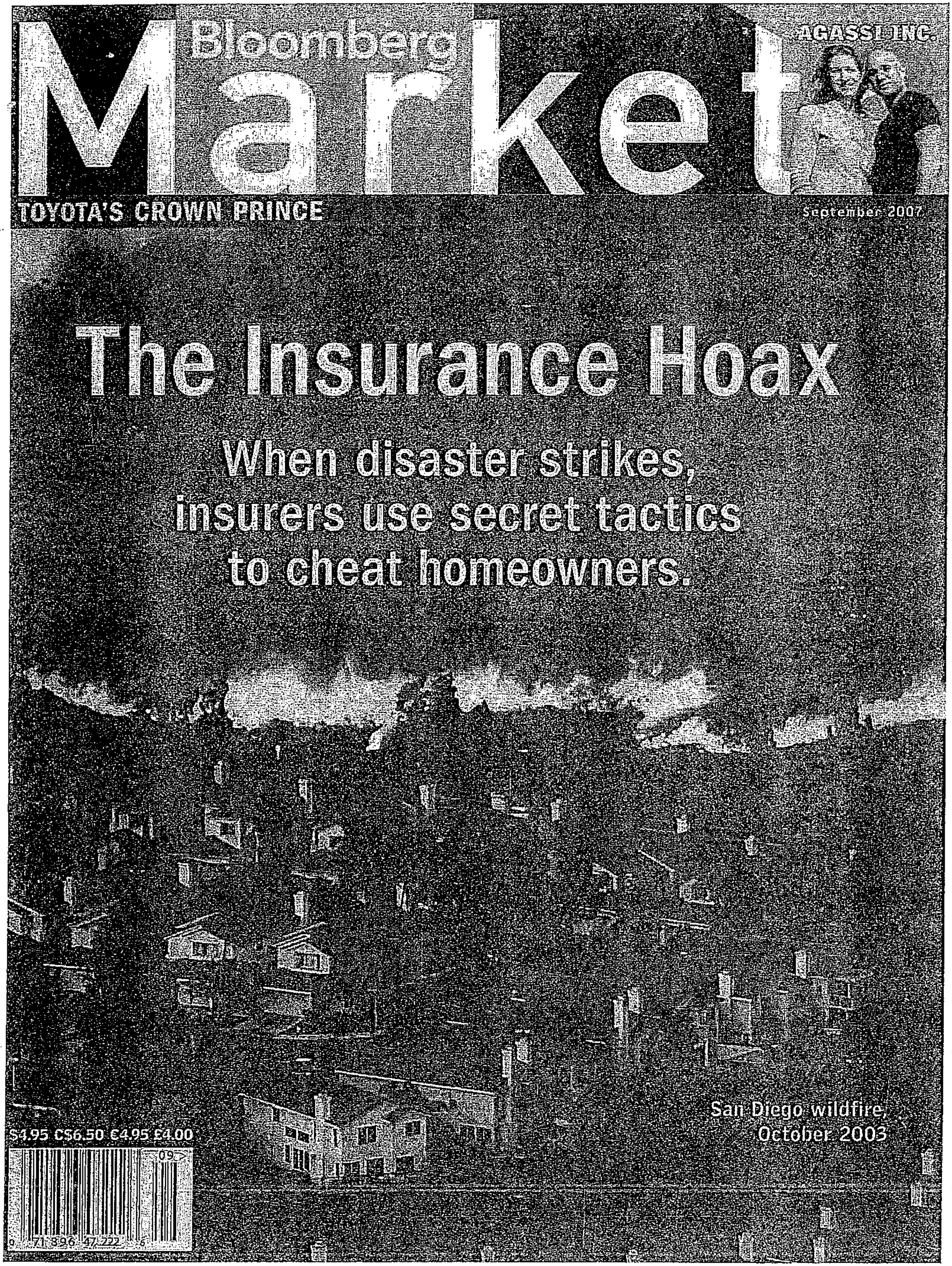
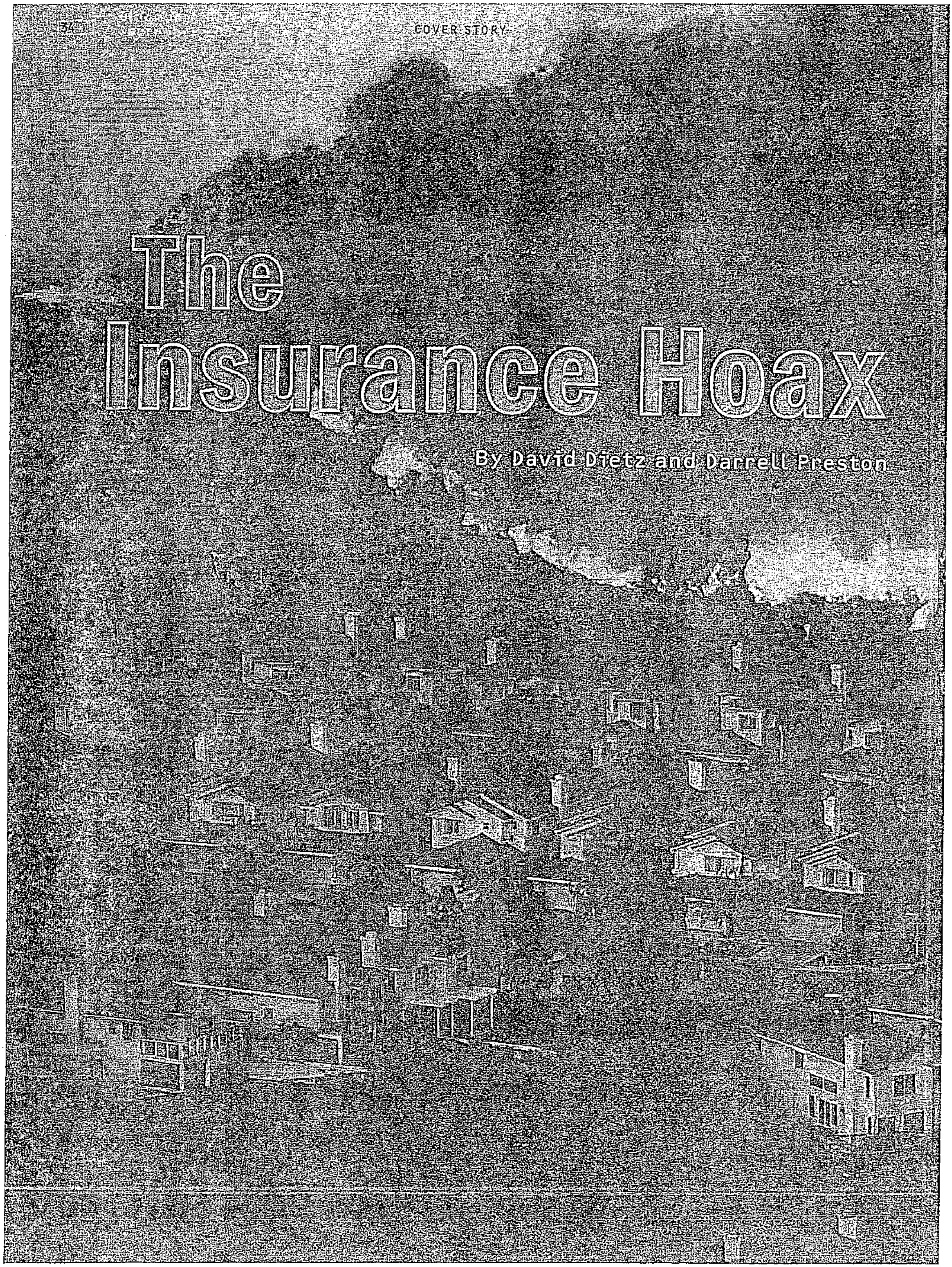

Bloomberg
Market
AGASSI INC.
TOYOTA'S CROWN PRINCE
September 2007
The Insurance Hoax
When disaster strikes, insurers use secret tactics to cheat homeowners.
San Diego wildfire, October 2003
$4.95 C$6.50 €4.95 £4.00

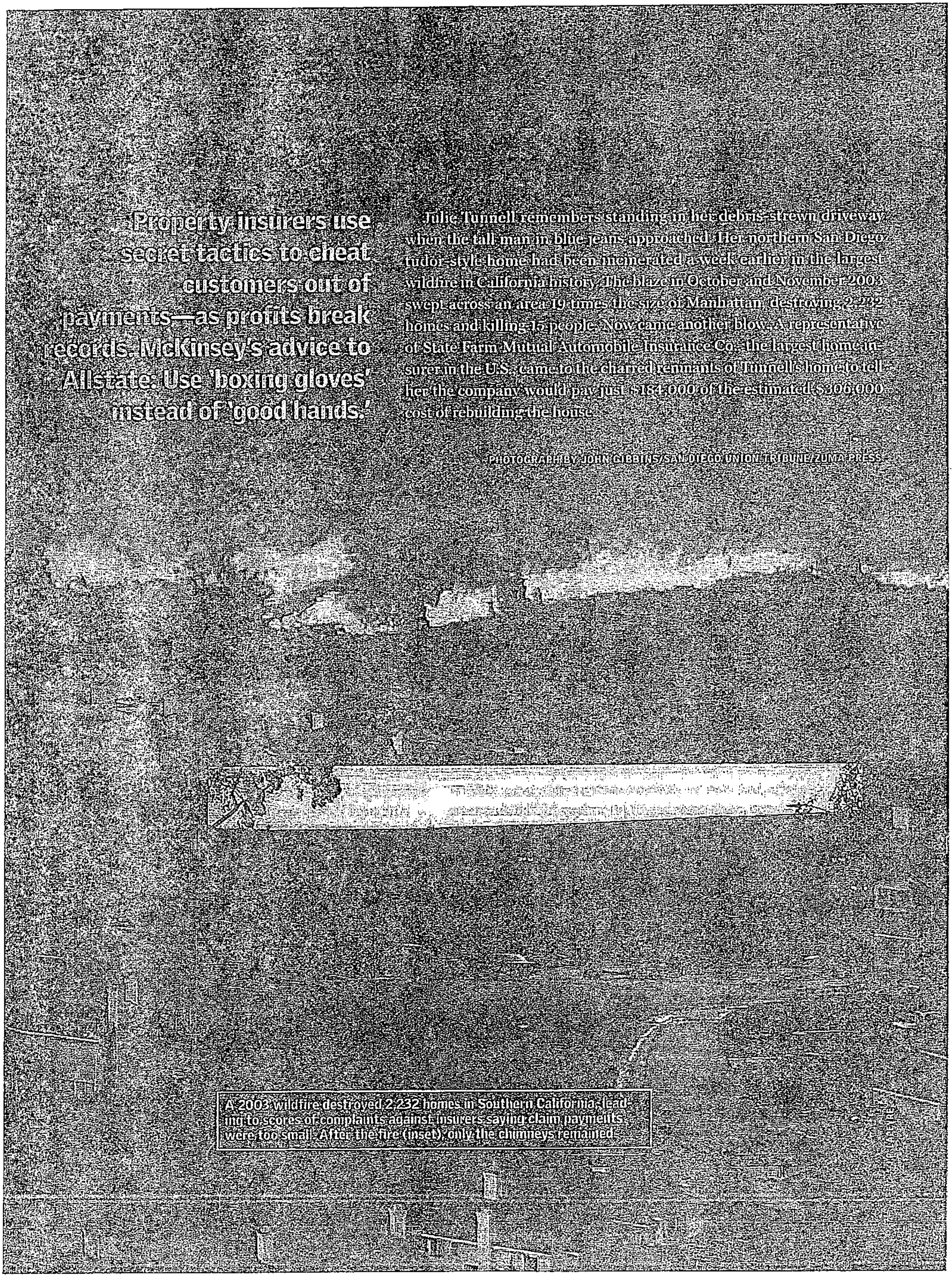
The Insurance Hoax

By David Dietz and Darrell Preston



Property insurers use secret tactics to cheat customers out of payments—as profits break records. McKinsey's advice to Allstate: Use 'boxing gloves' instead of 'good hands.'

Julie Tunnell remembers standing in her debris-strewn driveway when the tall man in blue jeans approached. Her northern San Diego tudor-style home had been incinerated a week earlier in the largest wildfire in California history. The blaze in October and November 2003 swept across an area 19 times the size of Manhattan, destroying 2,232 homes and killing 15 people. Now came another blow. A representative of State Farm Mutual Automobile Insurance Co., the largest home insurer in the U.S., came to the charred remnants of Tunnell's home to tell her the company would pay just $184,000 of the estimated $306,000 cost of rebuilding the house.



PHOTOGRAPH BY JOHN GIBBINS/SAN DIEGO UNION-TRIBUNE/ZUMA PRESS

A 2003 wildfire destroyed 2,232 homes in Southern California, leading to scores of complaints against insurers saying claim payments were too small. After the fire (inset), only the chimneys remained.

"It was devastating; I stood there and cried," says Tunnell, 42, who teaches accounting at San Diego City College. "I felt absolutely abandoned."

Tunnell joined thousands of people in the U.S. who already knew a secret about the insurance industry: When there's a disaster, the companies homeowners count on to protect them from financial ruin routinely pay less than what policies promise. Insurers often pay 30–60 percent of the cost of rebuilding a damaged home—even when carriers assure homeowners they're fully covered, thousands of complaints with state insurance departments and civil court cases show.

Paying out less to victims of catastrophes has helped produce record profits. In the past 12 years, insurance company net income has soared—even in the wake of Hurricane Katrina, the worst natural disaster in U.S. history. Property-casualty insurers, which cover damage to homes and cars, reported their highest-ever profit of $73 billion last year, up 49 percent from $49 billion in 2005, according to Highline Data LLC, a Cambridge, Massachusetts–based firm that compiles insurance industry data.

The 60 million U.S. homeowners who pay more than $50 billion a year in insurance premiums are often disappointed when they discover insurers won't pay the full cost of rebuilding their damaged or destroyed homes. Property insurers systematically deny and reduce their policyholders' claims, according to court records in California, Florida, Illinois, Mississippi, New Hampshire and Tennessee. The insurance companies routinely refuse to pay market prices for homes and replacement contents, they use computer programs to cut payouts, they change policy coverage with no clear explanation, they ignore or alter engineering reports, and they sometimes ask their adjusters to lie to customers, court records and interviews with former employees and state regulators show. As Mississippi Republican U.S. Senator Trent Lott and thousands of other

'It's despicable not to make a good-faith offer to everybody,' a former insurance regulator says.

homeowners have found, insurers make low offers—or refuse to pay at all—and then dare people to fight back.

"It's despicable not to make good-faith offers to everybody," says Robert Hunter, who was Texas insurance commissioner from 1993 to '95 and is now insurance director at the Washington-based Consumer Federation of America. "Money managers have taken over this whole industry. Their eyes are not on people who are hurt but on the bottom line for the next quarter."

J.P. Lapeyre, Karen Reimus and **Julie Tunnell** say they fought their insurers because the firms offered far too little money to rebuild the families' northern San Diego homes.

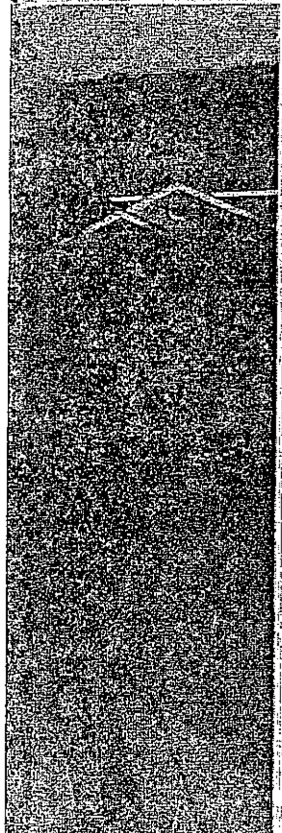
MOJGAN AZIMI

The industry's drive for profit has overwhelmed its obligation to policyholders, says California Lieutenant Governor John Garamendi, a Democrat. As California's insurance commissioner from 2002 to '06, Garamendi imposed $18.4 million in fines against carriers for mistreating customers. "There's a fundamental economic conflict between the customer and the company," he says. "That is, the company doesn't want to pay. The first commandment of insurance is, 'Thou shalt pay as little and as late as possible.'"

Although the tension between insurers and their customers has long existed, it was in the 1990s that the industry began systematically looking for ways to increase profits by streamlining claims handling. Hurricane Hugo was a major catalyst. The 1989 storm, which battered North and South Carolina, left the industry reeling from $4.2 billion in claims. In September 1992, Allstate Corp., the second-largest U.S. home insurer, sought advice on improved efficiency from McKinsey & Co., a New York–based consulting firm that has advised many of the world's biggest corporations, according to records in at least six civil court cases.

State Farm, based in Bloomington, Illinois, and Los Angeles–based Farmers Group Inc., the third-largest home insurer in the U.S., also hired McKinsey as a consultant, court records show.

McKinsey produced about 13,000 pages of documents, including PowerPoint slides, in the 1990s, for Northbrook, Illinois–based Allstate. The consulting firm developed methods for the company to become more



profitable by paying out less in claims, according to videotaped evidence presented in Fayette Circuit Court in Lexington, Kentucky, in a civil case involving a 1997 car accident.

One slide McKinsey prepared for Allstate was entitled "Good Hands or Boxing Gloves," the tape of the Kentucky court hearing shows. For 57 years, Allstate has advertised its employees as the "Good Hands People," telling customers they will be well cared for in times of need. The McKinsey slides had a new twist on that slogan. When a policyholder files a claim, first make a low offer, McKinsey advised Allstate. If a client accepts the low amount, Allstate should treat the person with good hands, McKinsey said. If the customer protests or hires a lawyer, Allstate should fight back.

"If you don't take the pittance they offer, they're going to put on the boxing gloves and they're going to batter injured victims," plaintiffs attorney J. Dale Golden told Judge Thomas Clark at the May 12, 2005, hearing in which the lawyer introduced the McKinsey slides.

One McKinsey slide displayed at the Kentucky hearing featured an alligator with the caption "Sit and Wait." The slide says Allstate can discourage claimants by delaying settlements and stalling court proceedings. By postponing payments, insurance companies can hold money longer and make more on their investments—and often wear down clients to the point of dropping a challenge. "An alligator sits and waits," Golden told the judge, as they looked at the slide describing a reptile.

McKinsey's advice helped spark a turnaround in Allstate's finances. The company's profit rose 140 percent to $4.99 billion in 2006, up from $2.08 billion in 1996. Allstate lifted its income partly by paying less to its policyholders. Allstate spent 58 percent of its premium income in 2006 for claim payouts and the costs of the process compared with 79 percent in 1996, according to filings with the U.S. Securities and Exchange Commission. The payout expense, called a loss ratio, changes each year based on events such as natural disasters; overall, it's been decreasing since Allstate hired McKinsey.

Investors have noticed. Allstate's stock price jumped fourfold to $60.95 on July 11 from its closing price on June 3, 1993, the day of its initial public offering. During the same period, the Standard & Poor's 500 Index rose threefold. State Farm's profits have doubled since 1996 to $4.8 billion in 2006. Because State Farm is a mutual company, meaning it's owned by its policyholders, it doesn't have shares that trade publicly.

"This is about as good a stretch as I've seen," says Michael Chren, who manages $1.5 billion at Allegiant Asset Management Co. in Palm Beach Gardens, Florida, and has followed the property-casualty industry for 20 years. The industry's performance during the past five years has been superb, even with payouts for Katrina, he says. "All the stars have been in alignment. There has been decent pricing of products and an extremely attractive and very low loss ratio."

Reducing payouts is just one way the industry has improved profits. Carriers have also raised premiums and withdrawn from storm-plagued areas such as the Gulf Coast of the U.S. and parts of Long Island, New York—to lower costs and increase income, says Amy Bach, executive director of United Policyholders, a San Francisco-based group that advises consumers on insurance claims. "What this says is that the industry has been raking in spectacular profits while they're getting more and more audacious in their tactics," she says.

Allstate spokesman Michael Siemienas says the company won't comment on what role McKinsey played in lowering the insurer's loss ratio and boosting its profits. Allstate did change the way it handles homeowners' insurance claims, he says. "In the early 1990s, Allstate redesigned its claims practices to more efficiently and effectively handle claims and better serve our customers," he says.

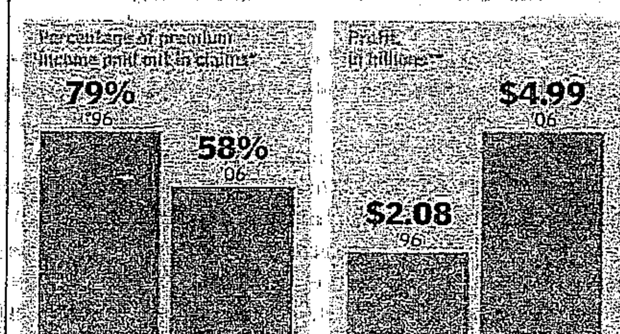
"Allstate's goal remains the same: to investigate, evaluate and promptly resolve each claim based on its merits," Siemienas says. "Allstate believes its claim processes support this goal and are absolutely sound."

McKinsey doesn't discuss any of its work for clients, spokesman Mark Garrett says.

Jerry Choate, Allstate's chief executive officer from 1995 to '98, said at a news conference in New York in 1997 that the company's new claims-handling process had reduced payments and increased profit, according to a report in a March 1997 edition of *National Underwriter* magazine. Insurers can't make significantly more money just from cutting sales costs, he told reporters. "The leverage is really on

Insuring profits

Allstate raised net income by 140 percent from 1996 to 2006 as it paid out less in claims to customers.



*Includes only property-casualty insurance. **For the entire company. Sources: Company, SEC filings the claims side," Choate said. "If you don't win there, I don't care what you do on the front end. You're not going to win."

The more cash insurers can keep from premiums, the more they can invest. This pool of assets—most of which the companies invest in government and corporate bonds—is known as float.

"Simply put, float is money we hold that is not ours but which we get to invest," billionaire Warren Buffett, CEO of Berkshire Hathaway Inc., wrote in his annual letter to shareholders this year. "When an insurer earns an underwriting profit, float is better than free," he wrote in 2006.

'The insurance industry can be justifiably proud of its performance,' a trade group economist says.

Omaha, Nebraska–based Berkshire Hathaway generated 51 percent of its $11 billion profit in 2006 from insurance.

Claims payouts for the entire property-casualty industry have decreased in the past decade. In 2006, carriers paid out 55 percent of the $435.8 billion in premiums collected, according to the Insurance Information Institute, a trade group in New York. That compares with a 64 percent payout ratio on $267.6 billion in premium revenue in 1996. As companies pay less to policyholders, their investment gains are growing, according to the trade group and research firm A.M. Best Co. in Oldwick, New Jersey. The industry has increased profits by an annual average of 46 percent since 1994, Institute data show. In 2006, carriers invested $1.2 trillion and recorded a net gain of $52.3 billion, up from $713.5 billion invested for a gain of $39.1 billion in 1994.

Insurance companies are no longer following their mandate to take care of policyholders' money and then pay it out when needed, says Douglas Heller, executive director of the nonprofit Foundation for Taxpayer and Consumer Rights in Santa Monica, California. "The whole purpose of insurance is evaporating before our eyes as we continue to send checks to the companies," Heller says. "Insurers are looking to shed their purpose as a risk bearer and become financial institutions."

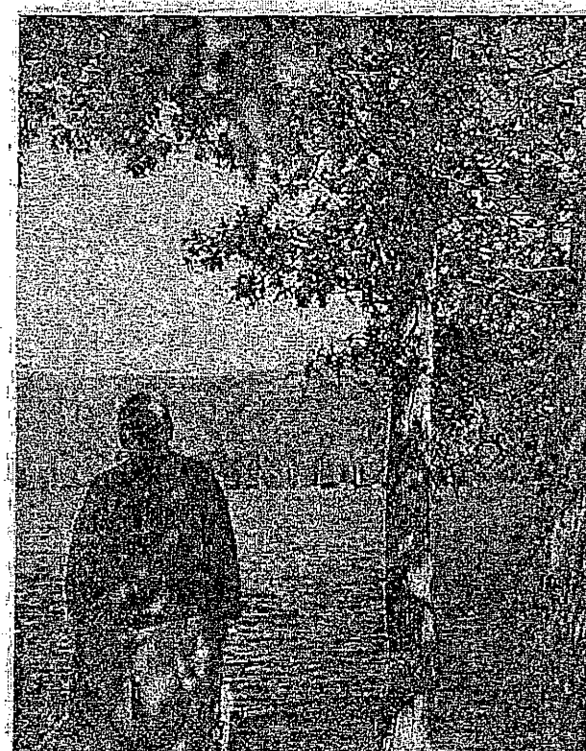
That kind of criticism is unwarranted, says Robert Hartwig, chief economist at the Insurance Information Institute. He says about 1 percent of policyholders contest what they're offered. "The insurance industry can be justifiably proud of its performance," Hartwig says. "It's in the insurance industry's best interests to settle claims as fairly and as rapidly as possible."

Companies have sharpened the use of technology in the past 20 years to help tighten claims payouts. Insurers following McKinsey's advice on claims processing have adopted computer programs with names such as Colossus and Xactimate. Colossus, made by El Segundo, California–based Computer Sciences Corp., calculates the cost of treating people injured in auto accidents, including the degree of pain and suffering they'll endure and any permanent impairment they may have, according to Computer Sciences' Web site. Xactimate, made by Xactware Solutions Inc. of Orem, Utah, is a program that estimates the cost of rebuilding a home.

Insurers sometimes manipulate these programs to pay out as little as possible, lawsuits have asserted. "Programs like Colossus are designed to systematically underpay policyholders without adequately examining the validity of each individual claim," former Texas insurance commissioner Hunter told the U.S. Senate Committee on Commerce, Science and Transportation on April 11. He also criticized Xactimate. "If you don't accept their offer, which is a low ball, you end up in court," Hunter said. "And that was the recommendation of McKinsey." Computer Sciences and Xactware declined to comment.

Farmers Group, a subsidiary of Zurich Financial Services AG, agreed in 2005 to stop using Colossus to evaluate claims filed by policyholders who have accidents with uninsured or underinsured drivers. The move was part of a $40 million settlement in a class-action lawsuit in Pottawatomie County District Court in Oklahoma in which the plaintiffs claimed the company had repeatedly and wrongly failed to pay enough for crash injuries.

An internal e-mail introduced in the Farmers lawsuit



Robert Hunter, a former Texas insurance commissioner, says the industry cares about finding ways to increase profits and not about helping homeowners in need.

ASIA KEPKA

Twisting in the Wind

Michele Ray says she felt secure with her State Farm Mutual Automobile Insurance Co. homeowner's insurance. She had been a clerk in a State Farm agency for 12 years and says the company served its customers well. Then a tornado struck her brick ranch house just outside Hendersonville, Tennessee, on April 7, 2006.

Eleven months later, Ray, 53, and her husband Tim, 57, were still living in their house under tarps, the living room floor covered with boxes once stored in their attic. That's because State Farm refused to pay what it would cost to rebuild, saying the damage wasn't caused by the tornado. The Rays would have to start from scratch to restore the house; two engineering firms and a contractor told them, because the foundation was ruined.

In March, the Rays were waiting to be paid so they could repair the 1,800-square-foot (167-square-meter) home where they've lived for 23 years. State Farm had offered $97,000 toward the $254,000 the engineers and contractor said it would cost. State Farm's engineer, Robert Warren, owner of Warren Engineering in Murfreesboro, Tennessee, concluded that the tornado couldn't have damaged the house enough to need rebuilding. The Rays' State Farm agent, Ken Flatt, who saw the damage, had recommended the company pay the full amount, Ray says. Flatt declined to comment.

JUST BEFORE THE tornado struck at about 2:30 p.m., Tim called Michele at work at the Jason Foundation Inc., a nonprofit company that works to prevent teen suicide. He wanted to warn her that the storm was heading for their neighborhood. Michele ran to her car for the five-minute drive home, where her mother was staying.

She remembers seeing the tornado as she drove. It was 200 yards (183 meters) wide, according to a National Oceanic & Atmospheric Administration report. Winds gusted as high as 206 miles (332 kilometers) per hour. That's strong enough to rip roofs and walls off houses, uproot trees and overturn trains, according to the Fujita scale of tornado intensity.

When Ray got to within six blocks of her house, the road was blocked. She got out of her car and ran, jumping over power lines and around downed trees and passing the roof of a house. "It looked like a war zone," she says. She found her mother alive in a corner of the basement.

HER HOME WAS devastated. The tornado's wind caused drywall to split and floors to buckle. Some bricks in the walls were so loose they could be pulled out and pushed back again.

"I was brainwashed by State Farm. I thought they were a good company," Ray says. "When it comes down to it, you can't count on what they have told you."

At the center of the dispute with State Farm were cracks in the wall of the basement. The Rays say the cracks were caused by the storm. Two engineering firms, Lamb Engineering of Hendersonville and Anthony Locke of Goodlettsville, Tennessee; a contractor, Joe Pope; and Hendersonville's chief building and codes inspector, D. Scott Morrissey, also reached that conclusion. State Farm's engineers say the cracks existed before the tornado.

After the storm, State Farm sent a succession of adjusters. The first two didn't assess damage to the house. On May 15, a representative who came to the house told the Rays that basement cracks weren't caused by the tornado, Michele says. As a result, State Farm sent the Rays a check for $36,000, which Michele returned to her agent, Flatt.

"They completely denied that the tornado had done any damage to the basement," Ray says.

Warren never inspected the house, Ray says. "He never set foot on my property," she says. Warren says he sent an engineer, Michael Nocton, to visit. Warren says water pressure in the soil had damaged the foundation over the years. "The displacement of the foundation wall is inconsistent with how the tornado damaged the house," Warren says he determined after seeing photos taken by Nocton, who didn't return calls for comment.

The cracks in the basement walls weren't there before the storm, Ray says. Lamb Engineering's Aug. 4, 2006, report says the tornado was extreme enough to break and split rafters. The cracks in the foundation were on a wall that was being pushed inward by the action of the tornado, the report says. The Lamb report says Warren incorrectly concluded it was impossible for the tornado to cause foundation cracks.

Locke's engineering study found that the cracks weren't caused by soil or water pressure. "The concentration of the crack is most likely the result of the wind force and slight twisting revealed on the structure due to the trauma force of the storm," the report says.

Morrissey, the building inspector, says in a July 17, 2006, letter to Ray that the cracks in the foundation and nail pops are recent and were probably caused by the tornado.

"Everyone but State Farm and Warren agreed that it was tornado damage," Ray says.

Tim and **Michele Ray** say State Farm had offered just 15 percent of rebuilding costs after a tornado.

JOHN CHIASSON

THE RAYS WERE prepared to sue State Farm in March. In April, after Bloomberg News had submitted questions to State Farm about the Ray case, State Farm said it would pay them enough money to rebuild. It paid the Rays $302,000, Michele says.

State Farm spokesman Shawn Johnson says the company changed its mind after reviewing the Rays' engineering reports and reinspecting the house. "We agreed it was related to the storm," Johnson says.

DARRELL PRESTON

ROBYN TWOMEY

Amy Bach, who heads a consumer group, says most people don't realize they're being deceived and accept too little.

shows the company had pressured its adjusters, whom it calls claims representatives, or CRs, to pay out smaller amounts—and rewarded them when they did.

"As you know, we have been creeping up in settlements," David Harding, a Farmers claims manager, wrote in an e-mail to employees on Nov. 20, 2001. "Our CRs must resist the temptation of paying more just to move this type file. Teach them to say, 'Sorry, no more,' with a toothy grin and mean it." Harding praised a worker for making low settlements. "It can be done as Darren consistently does," he wrote. "If he keeps this up during 2002, we will pay him accordingly."

Farmers said in court papers that it didn't seek to pay less than customers were due. "The e-mail speaks for itself," Farmers wrote. "Plaintiff's characterization of it is denied."

Edward Rust Jr., CEO of State Farm, testified in a 2006 civil case that his company revamped its claims handling through a project called ACE, or Advanced Claims Excellence. McKinsey suggested the use of ACE, according to evidence presented in the district court of Grady County, Oklahoma.

"Technology has allowed us to really streamline our claim organization to be more efficient and responsive," Rust testified. He said the company wanted to cut expenses for claims. In the Oklahoma case, Bridget and Donald Watkins, whose Grady County house was destroyed during a tornado in 1999, accused State Farm of misrepresenting the damage from the storm and won a $12.9 million judgment in May 2006. Watkins and State Farm agreed to an undisclosed settlement after the judgment.

Hunter, who also headed the federal flood insurance program under Presidents Gerald Ford and Jimmy Carter, told Congress that Allstate, with McKinsey's guidance, gave the name Claim Core Process Redesign to its strategy to change payout practices.

As pervasive as computers have become in insurance, the key actor in settling claims is still the adjuster, the person who talks to policyholders and decides how much they should be paid. Allstate has asked adjusters to deceive customers, says Jo Ann Katzman, who worked as a claims adjuster for Allstate in 2002 and '03. She says managers regularly came to her office in Farmington Hills, Michigan, to give pep talks on keeping claim payments down. They awarded prizes such as portable refrigerators to adjusters who tried to deny claims by blaming fires on arson without justification, she says. "We were told to lie by our supervisors," says Katzman, 49, who quit by taking a company buyout in 2003. "It's tough to look at people and know you're lying."

Katzman says an adjuster at Allstate, on orders from a supervisor, told an 89-year-old Detroit fire victim that Allstate wouldn't replace cabinets in her home even though the insurance policy said they were covered. In another case, Katzman says Allstate wouldn't replace a fire-damaged refrigerator—an appliance she says was

McKinsey's advice

"SIT AND WAIT"

McKinsey told Allstate it could wear down customers by delaying settlements and stalling court proceedings.

"ZERO-SUM ECONOMIC GAME"

The consulting firm said there are winners and losers. Allstate can win by paying out no more than it has to, so it can keep more of its premium income.

"GOOD HANDS OR BOXING GLOVES"

McKinsey suggested Allstate politely make a low offer on a claim. If a policyholder protests or hires a lawyer, the insurer should fight back.

Source: A videotape of a hearing in Fayette Circuit Court in Lexington, Kentucky

BLOOMBERG ILLUSTRATION

Duping the Doctor

When fire swept through Terry Bennett's house in Hampton Falls, New Hampshire, on Aug. 2, 1993, the Harvard-educated doctor lost his four-story, custom-built dream home. It had been filled with artwork, antiques and classic cars collected over a lifetime.

For more than a decade, Bennett, now 69, a general practitioner, fought Twin City Fire Insurance Co., a unit of Hartford Financial Services Group, to recover $20 million of losses not paid by his insurer. Years into his legal battle, Rockingham County Attorney James Reams investigated in 2003 and found that the insurance company had secretly deleted a section promising replacement coverage in Bennett's policy after the fire.

"This changing of the contract after a loss has been uncovered only because Dr. Bennett has the personal resources and determination to fight this injustice," Reams wrote in an April 21, 2003, letter to New Hampshire Attorney General Peter Heed. "It may well be that this is not an isolated instance and may affect many policies and claims." The local office lacked the resources to fully investigate, he wrote.

Both the New Hampshire Attorney General and the New Hampshire Insurance Department have so far declined to hear Bennett's case.

WHEN BENNETT APPLIED for coverage, his independent insurance agent, Mark Rowley, valued the doctor's house at $1 million pending an inspection, Rowley said in an Aug. 7, 1998, deposition. Rowley said Bennett had also applied for replacement coverage, so he would be fully protected regardless of the initial estimate. Individual works of art and jewelry were to be separately insured, according to the sworn testimony.

Twin City did no inspection before a fire destroyed Bennett's house six weeks after the policy was written, court records show. The Hartford, Connecticut-based insurance company paid Bennett $1 million for the house and another $700,000 for contents based on a formula that provided 70 percent of the house's value, according to a Sept. 10, 2002, filing with the Strafford Superior Court by Bennett's attorneys. By eliminating the replacement cost coverage, Hartford reduced its payout to Bennett by $1.02 million, according to the filing.

Bennett oversees one of the last independent medical practices in New Hampshire. He says he can't talk about Twin City or Hartford, the sixth-largest U.S. insurer by market value, because he signed a secrecy agreement when he settled with the company in 2004. Papers filed in his court case detail his dispute. "I relied on Hartford and got burned in the process," Bennett said in a July 3, 2001, deposition.

GARY TURK, A former Hartford employee, said in an Aug. 28, 2002, deposition that he deleted the replacement coverage request before the fire because Hartford didn't offer it on homes valued at more than $750,000 and that he requested a letter be sent to Bennett's agent notifying him of the change. Both Bennett, in a May 30, 2003, petition with the state insurance department, and Rowley, in an Aug. 4, 2002, deposition, said they hadn't seen the letter or consented to the change.

Debora Raymond, a spokeswoman for Hartford, says the company met all of its obligations to Bennett and that the New Hampshire Insurance Department examined the case and found Bennett's arguments had no merit.

The insurance department agreed to a hearing on June 10, 2003, and then canceled it under the supervision of newly appointed Insurance Commissioner Roger Sevigny, who had worked at Travelers Insurance Cos. for 30 years. Leslie Ludtke, the hearing officer for the department, says officials needed to gather more information and that the cancellation was not related to the change of commissioners.

On July 7, 2004, without having conducted a hearing, the department issued a report saying Hartford appropriately deleted Bennett's replacement coverage because it violated company guidelines on file with the department.

Bennett produced sworn testimony to the contrary. "I diligently searched in excess of 10,000 pages of microfilm and could find no Hartford filing related to a homeowner's policy replacement cost endorsement that limited the applicability of such endorsements to properties valued under

Dr. Terry Bennett in New Hampshire found his insurer changed his policy after fire ruined his home.

ASIA KEPKA

$750,000," Jason Major, an attorney with Douglas, Monzione, Leonard & Garvey, PC of Concord, New Hampshire, said in a Sept. 10, 2002, deposition.

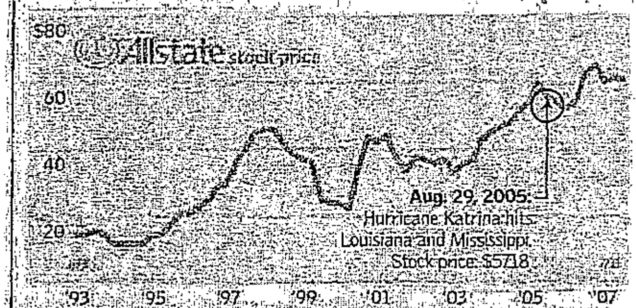
NEW HAMPSHIRE DEPUTY Insurance Commissioner Alex Feldvebel says his office reviewed the case and found it did nothing wrong. "The insurance commission investigated his complaint very fully," he says. "I have a drawer full of information."

Bennett says if he'd altered an insurance document to obtain an extra $1 million, he would have been charged with a crime and jailed. "There was an agenda, and paying me was not on it," he says. "This kind of inadequate government allows insurance companies to get away with this."

CHRISTINE RICHARD

In 'good hands' with McKinsey

Since McKinsey began consulting with Allstate in the early 1990s, the value of the insurer's stock has risen more than fourfold.



Source: Bloomberg

covered. Katzman now runs Accurate Estimating Services, an independent adjusting company in Bloomfield Hills, Michigan. Allstate's Siemienas declined to comment on Katzman's statements.

Insurers sometimes order employees to offer replacement cost settlements that have no connection to actual prices of home contents, according to testimony in a civil trial. A jury in November 2005 awarded Larry Stone and Linda Della Pelle $5.2 million in punitive damages and $616,000 to construct a new house after finding that Fidelity National Insurance Co. of Jacksonville, Florida, had underpaid the couple by $183,000 when it offered them $433,000 to rebuild their two-story Claremont, California, residence.

During the trial in Los Angeles Superior Court, Ricardo Echeverria, the couple's attorney, questioned Kenneth Drake, president of Canyon Country, California–based RJG Construction Inc., who had been hired by Fidelity's lawyers to evaluate damage estimates.

"Are you telling us that sometimes, because the insurance carriers dictate what amounts they are willing to allow for unit costs, estimators then have to comply with that?" asked Echeverria, according to the court transcript.

"That's absolutely true," Drake said.

"Do you think that's fair?" Echeverria asked.

"Fair or not, it's the name of our business," Drake said.

Drake declined to comment on his testimony. Fidelity is appealing the award.

A New Hampshire case involving a home destroyed in a fire exposed another insurance company tactic: changing a policy retroactively. In April 2003, the Rockingham county attorney in Kingston, New Hampshire, found that a unit of Hartford Financial Services Group Inc. had deleted the replacement cost portion of the homeowner's policy of Terry Bennett after his five-bedroom house burned to the ground in 1993. Bennett, a physician, sued Twin City Fire Insurance Co.,

Hidden Policies

Katherine Merritt suffered a fractured skull and crushed face after the car she was riding in was hit head-on by a sport utility vehicle. Merritt, a 29-year-old graphic designer and waitress from Marietta, Georgia, says she didn't find out until two years after the 1996 accident that State Farm Mutual Automobile Insurance Co. was holding out on her as she sought payment for her hospital bills.

The company had not told her about a $1 million "umbrella policy" it sold the driver of the SUV, her lawyers later discovered. An umbrella policy provides extra liability coverage for both home and auto accidents.

Merritt's attorneys collected files of 53 State Farm cases in which drivers had umbrella coverage. In 37 of the cases, State Farm didn't disclose the policies until lawyers appealed through numerous letters or sued, according to the lawsuit.

State Farm has tried to avoid paying millions of dollars in umbrella policy payments to auto accident victims making claims against company customers, lawsuits show. State Farm changed its approach to settling claims after McKinsey & Co., a New York–based consulting firm, told the insurer it could increase profits by paying out less in auto accident claims and home disasters, according to evidence presented in civil court cases.

"THIS IS PART of a system in the industry to squeeze an extra dime out of the claimant," says Robert Altman, an Atlanta attorney who represented Merritt in a 1998 suit in Georgia's Cobb County Superior Court that accused State Farm of fraud for hiding the SUV driver's umbrella policy. Merritt settled the case out of court in 2002 for an undisclosed sum.

State Farm said incomplete computer files and miscommunication among company representatives were at fault for failing to disclose the extra policies, company letters in Merritt's lawsuit say. "I assure you this was strictly an oversight on our part, and we apologize for any inconvenience this has caused your client," Tom Ellerbee, a State Farm claims superintendent, wrote to Athens, Georgia, attorney John Kardos in 1995.

Kardos represented Richard Sims, a Georgia truck driver, who was incapacitated for months by an accident in February 1995 with a car whose driver was insured by State Farm. State Farm had at first offered Sims $100,000 while not disclosing that the other carried extra liability coverage of $1.1 million, court records show. Sims settled in 1996 for a $288,000 payment that included a 15-year State Farm annuity.

State Farm spokesman Phil Supple says the company has changed procedures to prevent disclosure errors. "We are human, claiming his home and its contents—including antiques and fine art—were worth $20 million, not the $1.7 million the insurer paid him. After an 11-year battle, he settled with Hartford in 2004 for an undisclosed amount. "Fighting an insurance company is like staring down the wrong end of a cannon," Bennett says. (For more on the Bennett case, see "Duping the Doctor," page 41.)

An unprecedented number of people stared down that cannon after Hurricane Katrina. The August 2005 storm killed more than 16,000 people in Louisiana and Mississippi, left 500,000 people homeless and cost insurers $41.1 billion. More than 1,000 homeowners sued their insurers in the wake of the storm—the largest-ever number of insurance lawsuits stemming from a U.S. natural disaster.

For insurers, the multibillion-dollar question regarding Katrina was how much of the destruction was caused by wind and how much by water. Property insurance policies don't cover damage caused by flooding; homeowners have to purchase separate insurance administered by the U.S. government. The wind/water issue has spurred allegations that insurers manipulated the findings of adjusters and engineers.

Ken Overstreet, an engineer based in Diamondhead, Mississippi, who examined destroyed Gulf Coast residences, says someone altered his findings on the cause of the damage to at least four homes. "We were working for insurance companies, and they wanted certain results," says Overstreet, who has been a licensed civil engineer since 1981. "They wanted to get a desired outcome, and that's what they did."

Overstreet, who was working for Houston-based Rimkus Consulting Group Inc., prepared a report on the Gulfport, Mississippi, home of Hubert and Joyce Smith for Meritplan Insurance Co. The engineer found that both wind and water

A North Carolina engineering firm says State Farm asked it to change findings to lower payouts.

had damaged the house. "The winds out of the east would have racked the entire structure to the west and simply lifted the footings up," he wrote.

Meritplan declined to pay anything to the Smiths, telling them that all of the damage was caused by water. The company sent the Smiths what it said was Overstreet's engineering report. "Due to the extent of the structural damage to the residence, the storm surge accounted for the damage," the report they got said. The Smiths called Overstreet and asked him to look at what Meritplan had sent them. Overstreet says he looked at both reports side by side and then told the couple that

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and mistakes can happen," he says. "When they do, we correct them."

Merritt, a student at Georgia Southern University at the time of the 1996 accident, was hospitalized for eight days. Doctors cut through her fractured skull to relieve pressure on her brain. She needed months of dental work to rebuild an injured mouth. "It was over two years before I could bite into an apple," she says.

Merritt first asked State Farm in January 1997 for details on the other driver's coverage through Atlanta attorney Kathie McClure, who was later joined on the case by Altman. McClure says she wasn't convinced when the company repeatedly told her in 1997 and '98 that the State Farm–insured driver had only traditional auto coverage and no umbrella policy.

In September 1998, she phoned the SUV driver, Robert Morris, also of Marietta, who told her that he had umbrella coverage. He said he had reminded his agent about the policy after the accident. The agent told him not to tell anyone, documents quoted Morris as saying.

MERRITT SAYS SHE has memory lapses and hasn't been the same since the accident. "It's been an emotional thing," she says. "I'll do drink orders and not remember where the drinks went. I've lost my wallet five times and my car keys three times. I'd get lost at school going to class. I'd take notes in class and start a sentence and then couldn't remember the rest of what the instructor said."

She says she's outraged that State Farm put her through a legal ordeal at a time when she was going through long and painful medical treatments. "There were a lot of medical bills coming in, and it was very frustrating," she says. "I had to deal with enough stress trying to recover."

DAVID DIETZ

Katherine Merritt *sued State Farm in Georgia, saying she was deceived and underpaid on medical costs.*

DAVID STUART

someone had changed his conclusion after his inspection.

"If they defrauded me, how many more did they defraud?" asks Hubert Smith, 88, a retired chiropractor. "There's a lot of crap going on."

Six lawsuits against Rimkus allege the company altered engineering reports. "Those allegations are absolutely false," says Arch Currid, a Rimkus spokesman. "There's no fact to those claims. We're going to vigorously defend ourselves in court, and we're confident we will prevail."

Ed Essa, a spokesman for Calabasas, California–based Countrywide Financial Corp., the parent of Meritplan, says the company confidentially settled a lawsuit with the Smiths in March.

Another engineer involved in Katrina, Bob Kochan, CEO of Forensic Analysis & Engineering Corp., says State Farm asked him to redo his reports because the insurer disagreed with the engineers' conclusions. Kochan sent an Oct. 17, 2005, e-mail to his staff saying State Farm executive Alexis "Lecky" King asked for the changes. "Lecky told me that she is experiencing this same concern with other engineering companies," Kochan wrote. "In her words, 'They are all too emotionally involved and working too hard to find justifications to call it wind damage.'"

Kochan says he complied so State Farm didn't cut its contract with his company. "They didn't like our conclusions," he says. "We agreed to re-evaluate each of our assignments."

Randy Down, an engineer at Raleigh, North Carolina–based Forensic, wrote this Oct. 18, 2005, e-mail response to Kochan: "I have a serious concern about the ethics of this whole matter. I really question the ethics of someone who wants to fire us simply because our conclusions don't match theirs." The e-mails were made public in a civil case against State Farm in Jackson, Mississippi.

State Farm spokesman Phil Supple says Kochan's e-mail comments are out of context. He says sometimes information in engineering reports doesn't support the conclusions.

One State Farm policyholder in Mississippi was Senator Lott, who lost his home in Katrina. He sued State Farm for fraud in U.S. District Court in Jackson, after the insurer ruled that his home had been damaged by water and refused to pay him anything. "It's long overdue for this industry to be held accountable," Lott, 65, says. Lott and State Farm agreed to a confidential settlement in April.

Lott has introduced legislation to have insurers regulated by the federal government. That would supplant a patchwork system of regulation by states. Insurance has no body analogous to the SEC, which can refer cases to the Justice Department for criminal prosecution. That doesn't happen with insurers. The most that state insurance departments typically do is impose civil fines when companies mistreat customers. Such sanctions are weak and infrequent, says Hunter, the former Texas insurance commissioner. Before Katrina, no state or federal prosecutor had ever investigated a nationally known property-casualty company for criminal mistreatment of policyholders. Mississippi Attorney General Jim Hood says a federal grand jury is probing insurance company claims handling after the hurricane.

There was no criminal investigation after State Farm offered just 15 percent of replacement costs to Michele and Tim Ray, whose house was wrecked by a tornado in April 2006. A contractor estimated the cost to rebuild the Hendersonville, Tennessee, home at $254,000. State

The long fight

Michele and Tim Ray fought with State Farm for almost a year before getting reimbursed enough to rebuild their Tennessee home.

APRIL 7, 2006 A tornado strikes the Rays' home near Hendersonville. The basement and the foundation are damaged.

MAY 15 The third of three adjusters comes to the house. He has State Farm send a check for $36,000, which the Rays reject.

MAY 20 An engineer from Warren Engineering, hired by State Farm, examines the house. Concluding the storm didn't cause the damage, State Farm offers $68,000.

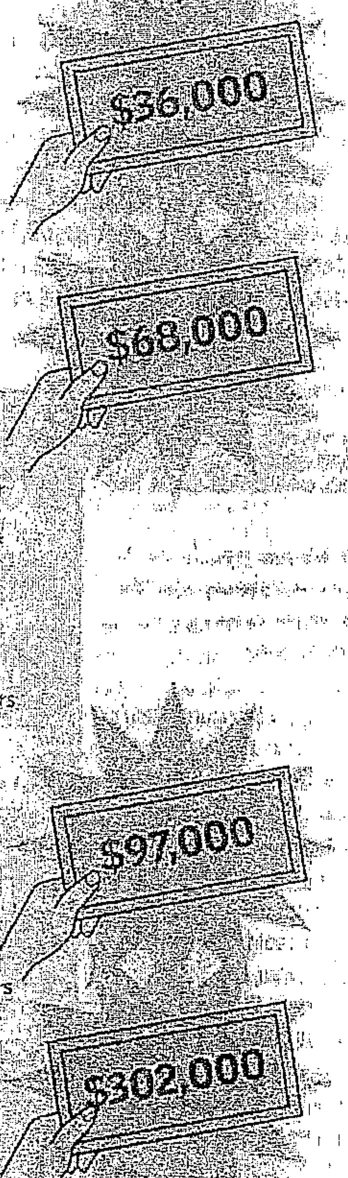
JULY 17 A report by the city of Hendersonville's building inspector says that damage to the Rays' basement was likely caused by the tornado.

AUG. 4 A report by Lamb Engineering (hired by the Rays) says the storm caused damage to the basement and foundation. Contractors later estimated it would cost $254,000 to rebuild the house.

FEB. 28, 2007 Anthony Locke, a second engineer hired by the Rays, also blames the storm for damage to the basement.

MARCH The Rays are still in the house, living under blue tarpaulins that cover the roof. State Farm offers $97,000 toward the cost to rebuild.

APRIL 2 State Farm says it's sending someone out to look at the house again and review engineering reports. The next day, State Farm tells the Rays it would settle the claim for $302,000.



Source: Michele and Tim Ray

Farm made three inspections of the property, Ray says, and sent the Rays a check for $36,000, which the couple returned. A year after the twister, the couple remained in the damaged home, with their tattered roof covered by tarpaulins. In April, after Bloomberg News submitted questions to State Farm about the Ray case, the company inspected the house again. This time, it gave the Rays $302,000. "We decided to call it a total loss and agreed to pay the policy limits after deciding the damage was caused by the storm," State Farm spokesman Shawn Johnson says. (For more on the Ray case, see "Twisting in the Wind," page 39.)

State Farm won't discuss what role McKinsey played in helping the insurer shape its approach toward customers. Similarly, no official at any insurer that hired McKinsey is willing to talk about the consulting firm.

Privately held McKinsey, which has 14,000 employees in 40 countries, has worked for many of the largest companies in the world, according to its Web site. "We take pride in doing what is right rather than what is right for the profitability of our firm," Managing Director Ian Davis says in a quote posted on the site.

'All they were concerned about was the bottom line,' former Allstate adjuster Shannon Kmatz says.

McKinsey pioneered the overhaul of the property-casualty industry at Allstate. The company hired McKinsey in 1992 after the insurer was spun off from what's now Sears Holdings Corp. of Hoffman Estates, Illinois, says David Berardinelli, a Santa Fe, New Mexico, lawyer who won access to view the McKinsey documents for a limited time during a lawsuit involving an auto accident. McKinsey advised the insurer to pay claims quickly at low amounts while delaying payments for as long as possible for those who wanted large settlements, Berardinelli says. "They're capitalizing on the vulnerability of people," he says.

Berardinelli says McKinsey suggested that Allstate hold so-called town hall meetings with claims adjusters to urge them to pay less to customers.

Shannon Kmatz, a former Allstate claims adjuster, says she attended some of those sessions. She says managers told employees to keep claim payouts as low as possible. "The leaders of those town hall meetings were always concerned that we were doing our part to help the stock price by keeping claims down," says Kmatz, 34, who worked for Allstate for three years in New Mexico in the late 1990s and is now a police officer. "It was obvious from the get-go that all they were concerned about was the bottom line."

Just once, at the May 2005 hearing in Lexington, Kentucky, the PowerPoint slides McKinsey prepared for Allstate were made public. William Hager and his wife, Geneva, who suffered neck and back injuries after the family's car was rear-ended in a 1997 accident in Lexington, sued the insurer, claiming the company failed to cover her medical expenses. The case is scheduled to go to trial in October. (For more on auto accident claims, see "Hidden Policies," page 42.)

One McKinsey slide prepared for Allstate was called "Zero-Sum Economic Game," a videotape of the court hearing shows. The slide explains that there are winners and losers, and the insurance company can win by paying out small amounts. "There is a finite pool of money," Golden, the plaintiffs attorney, told the judge at the hearing. "Either it goes to the injured victim or it goes to Allstate's pocket as surplus."

Allstate's attorney at the hearing, Mindy Barfield of Lexington, didn't say anything about the McKinsey slides. She didn't return phone calls seeking her comments.

Former federal flood insurance commissioner Hunter says the McKinsey approach exploits policyholders. "McKinsey presented it as a zero-sum game in which the winners would be Allstate and the losers would be the claimants," Hunter says. "I don't think a claims system should be viewed in that light. It's against any principles on how you should settle insurance claims. They should be settled on their merits."

Allstate convinced the judge to seal the McKinsey slides before and after the Lexington hearing. The insurer has resisted attempts to make the consulting firm's work public in courts across the U.S., arguing it contains trade secrets. In 2004, the company was sanctioned by the Bartholomew Circuit Court in Indiana and fined $10,000 for refusing to turn over the records to attorney Richard Enyon, representing an auto accident victim. Allstate held on to the documents and appealed the punishment. The 7th Circuit Court of Appeals upheld the sanction. Allstate then appealed to the Indiana Supreme Court, which hasn't yet made a decision.

Lawsuits in California, Florida and Texas have asserted that McKinsey's work for Allstate helped the insurer cheat claimants. Records show that through the company's Claim Core Process Redesign project, Allstate encouraged policyholders to accept small settlements on the spot.

The redesign also became a blueprint for fighting more claims in court as Allstate increased its legal staff, according to a 1997 company newsletter obtained by David Poore, a Petaluma, California, attorney who has represented homeowners in lawsuits against carriers. "The bottom line is that Allstate is trying more cases than ever before," the newsletter said. "If the offer is not accepted, Allstate will go to court, if necessary, to prove the evaluation process is sound."

McKinsey-style tactics have spread to insurers large and small—as homeowners discovered after three wildfires ravaged Southern California in 2003, including the one that hit northern San Diego. While Katrina struck thousands of low-income families in New Orleans, the San Diego fire affected mostly affluent homeowners, who fared no better with their insurance companies.

The fire obliterated large sections of Scripps Ranch, a community of 30,000 that sits atop a sagebrush and eucalyptus mesa, where homes can cost more than $1 million. After flames swept through the area on winds of up to 50 miles per hour, residents say they expected their insurance companies to live up to coverage promises and pay the full cost to rebuild. The Southern California fires led to 676 formal complaints to the state saying insurers offered payouts that fell far short of actual costs and delayed on paying claims.

Ken Overstreet, a Mississippi engineer, says his findings on hurricane damage were changed, allowing insurers to make little or no payments.

One of the Scripps Ranch houses that went up in flames, a four-bedroom, gray-stucco home on a sloping cul-de-sac, belonged to J.P. Lapeyre, a division director at JDS Uniphase Corp., a Milpitas, California, maker of telecommunications equipment.

Lapeyre, 41, who is married and has two children, says he had no inkling as he viewed the remains of his house that his insurance would leave him $280,000 short of what he would need to rebuild. Representatives of Pacific Specialty Insurance Co. of Menlo Park, California, told him the most the firm would pay out was $168,075, not even half of the estimated reconstruction cost of $448,000.

The Pacific Specialty representative told Lapeyre in November 2003 that the insurer would pay $75 a square foot (0.09 square meter) to rebuild his 2,241-square-foot house. "What frustration," Lapeyre says. "I had to try to prove to them that it would cost $200 a square foot." That figure came separately from two builders, Norton Construction and TLC Contractors, both of San Diego.

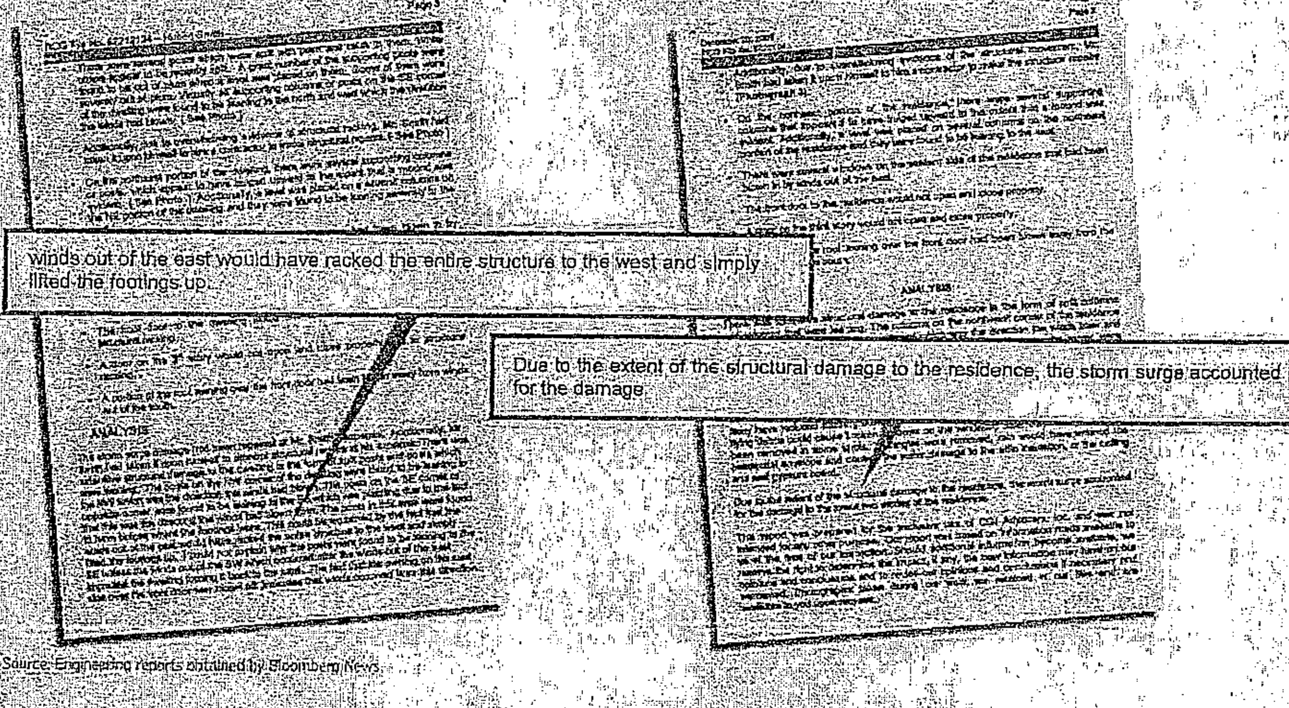
In February 2005, Lapeyre filed suit in San Diego County Superior Court against his insurer and the independent broker who sold him the policy, alleging negligence, breach of contract and fraud for leading him to believe that he was properly covered. After a fight of 19 months, Lapeyre dropped the suit when Pacific Specialty told a mediator assigned to the case it wouldn't raise its offer, he says. "We

Blame it on the rain

Hubert and Joyce Smith found that the engineeering report on damage to their Mississippi home had been altered to say that water, not wind, was the cause—which Meritplan Insurance used as the reason to reject their claim.

ORIGINAL REPORT

ALTERED REPORT



COURTESY KEN OVERSTREET

Source: Engineering reports obtained by Bloomberg News decided it was time to get on with our lives and move forward," says Lapeyre, who borrowed money to build a new house.

Karen and Bill Reimus, both lawyers, fought their carrier, Liberty Mutual Insurance Co., when it told them it wouldn't pay the couple enough to rebuild their burned Scripps Ranch house. Karen, 40, says an agent for Boston-based Liberty Mutual assured her and her husband when they bought their house four months before the 2003 fire that their insurance would replace the home if it were destroyed.

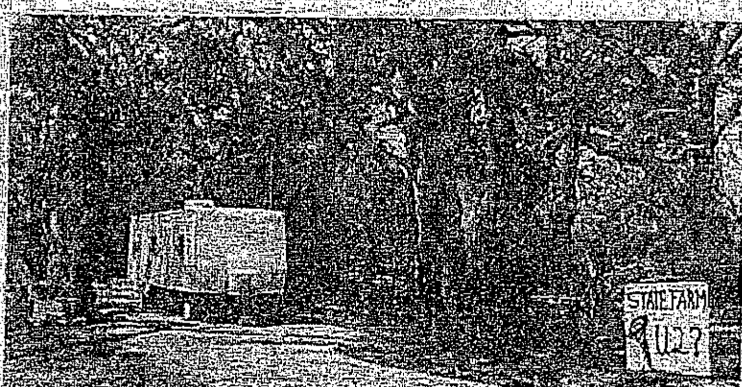
'The system is set up to take advantage of people when they're at their weakest,' a fire victim says.

In a December 2003 letter, two months after the fire, Liberty Mutual offered to pay $40,000 less than the limit of the couple's policy, Karen says. In early 2004, San Diego–based Gafcon Construction Consultants determined the cost to rebuild was well above the limits of the couple's policy.

The Reimuses began a phone and letter campaign to convince the company its offer was too low, Karen says. "It has now been almost seven months since the loss and we are still not agreed as to the numbers," Karen wrote in a May 13, 2004, letter to Liberty Mutual.

Two weeks later, Liberty Mutual agreed to raise the couple's limits by $100,000, Karen says. "This is clear evidence that the original estimate was a low ball," she says. Liberty Mutual spokesman Glenn Greenberg says the company won't discuss the case because its dealings with policyholders are private.

"The system is set up to take advantage of people when they're at their weakest," Karen says. "We went to one of the most-expensive companies in the country because we wanted to be ready for a rainy day. We asked for coverage that would replace the house. We thought *replacement* meant *replacement*."



After Hurricane Katrina, one fed-up homeowner put this sign on his lawn.

CINDY GADY

Scripps Ranch couple Leslie Mukau and Robin Seaberg sued Allstate for alleged fraud and negligence for failing to pay the $900,000 that contractors estimate it would cost to replace their two-story home. Allstate offered the Seabergs $311,000, according to the 2004 San Diego County Superior Court suit. Allstate says in court papers the couple hasn't shown the company was negligent and asked for dismissal of the suit, which is pending.

The California Department of Insurance examined the practices of Allied Property & Casualty Insurance Co., AMCO Insurance Co. and Allstate in connection with the California fires. It fined Allied and AMCO, both based in Des Moines, Iowa, a total of $20,000 for misleading nine policyholders into believing they were insured for full value. The regulators cited Allstate for six rule violations, including that it ignored complaints that it underinsured homeowners. The state didn't fine Allstate, which told the department it had done nothing wrong.

"Fines by state regulatory agencies have been far too small and infrequent to deter unfair business practices," United Policyholders' Bach says. "It's clear that cheating by insurers is a big, profitable business and regulators can't muster the will or political strength to stop them."

Most homeowners take what insurers offer because they don't realize they're being deceived or conclude that fighting is too costly and difficult, Bach says. "Virtually everyone who settles for what the insurer offers is taking less than they're owed," she says.

Homeowners across the U.S. have found themselves in the same situation. Kevin Hazlett, a lawyer, sued Farmers Group after an April 2006 tornado struck his home in O'Fallon, Illinois. Farmers had offered to pay him $470,000 to rebuild the house. Royal Construction Inc., based in Collinsville, Illinois, estimated the cost at $1.1 million. Hazlett, 52, accepted a settlement for an undisclosed amount.

Hazlett says Illinois Farmers, a subsidiary of Farmers, used the Xactimate software program to first determine what it would pay out. "They're just pulling numbers out of thin air," he says. "There's no rhyme or reason." Farmers spokesman Jerry Davies didn't respond to requests for an interview.

Bo Chessor, owner of Royal Construction, says he sees insurers refusing to pay coverage limits all the time. "Most people just roll over and take it because they don't have the money to fight it," Chessor says. "What the insurance companies are doing is purely robbery."

It may be robbery, but it's rarely a crime. State insurance departments don't prosecute insurance companies, and the federal government has no oversight.

The insurance industry wants to keep it that way. To make their voice heard on federal regulation and other government decisions, insurers spent $98 million on lobbying in Washington in 2006, according to PoliticalMoneyLine, a unit of Congressional Quarterly. That's the second-largest amount spent on lobbying by any group, behind $114.4 million by pharmaceutical companies.

Property-casualty companies do want something from the government: bailouts. Insurers beseech states and the federal government to foot more of the bill for rebuilding private homes after natural disasters. Florida has a catastrophe fund that insures some homes to reduce payouts by carriers. The fund paid out about $8.45 billion for storm damage in 2004 and '05, according to its annual report. The federal flood insurance program covers $800 billion of property nationally, which helped the industry increase profits by 25 percent in 2005, the year of Katrina.

'It's clear that cheating by insurers is a big, profitable business,' an adviser to homeowners says.

Homeowners whose properties have been destroyed by catastrophes contend with low payouts, higher premiums, software programs that underestimate rebuilding costs and sudden changes in policy values—all of which have been calculated methods for insurers to increase profits.

Tunnell, the San Diego accounting teacher whose home burned to the ground, says she thought State Farm had adequately insured her family when they bought their three-bedroom house in 1992. She says the policy, destroyed in the fire, provided for "full replacement coverage." It guaranteed to rebuild the house, no matter the cost, she says. The company offered to pay $184,400—which was $121,600 less than a $306,000 figure her family got from State Farm's own estimator, Hersum Construction Inc. of San Diego, for rebuilding the 1,700-square-foot house.

State Farm spokesman Supple says the company sent letters in 1997 to the Tunnells and other policyholders saying that it would no longer offer full replacement coverage. "Policyholders, by regulatory order, were sent prominent notices of the coverage change at that time," he says. Tunnell says she doesn't recall being notified. She says her family debated hiring a lawyer and suing, and eventually decided the battle would be too stressful. The Tunnells took the $184,400 and borrowed money to build a new house.

"Why is this happening to people over and over again?" Tunnell asks. "State Farm keeps underinsuring people, and they get away with it. This is unthinkable."

As long as insurers make the rules and control the game, Tunnell and homeowners across the U.S. won't know whether their homes are fully insured, no matter what their policies say. $

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