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LEGAL AFFAIRS

In Tough Hands At Allstate

It's fighting accusations that its methods deny policyholders legitimate benefits

David Berardinelli is something of a bon vivant. The Santa Fe (N.M.) plaintiffs' lawyer collects fine wine, has chefs from local restaurants over to cook in his home, and restores classic Porsches. He's also about to become a published author.

His book, *From Good Hands to Boxing Gloves*, won't burn up the best-seller lists. But it's already making waves. It tells the story of the key role played by management consultant McKinsey & Co. in reengineering auto insurance claims operations at Allstate Corp. (ALL) -- and it's a story Allstate doesn't want told.

In February, a New Mexico state court rejected Allstate's efforts to keep Berardinelli from publishing his book, which will be marketed to trial lawyers nationwide later this year. Since 2004, Allstate has been defying an order by the same court to make available public copies of some 12,500 PowerPoint slides McKinsey prepared for the insurer, which form the basis of the book. That's quite unusual -- big companies almost never ignore judicial orders. In a court filing, Allstate has characterized its actions as "respectful civil disobedience."

What is it that Allstate so badly wants to keep under wraps? In a written response to *BusinessWeek*, the insurer says the McKinsey material contains proprietary business secrets. The documents also present a clear risk to the company's reputation. The title of Berardinelli's book is drawn from a McKinsey slide that suggests that Allstate should

treat some of its claimants with "boxing gloves," rather than with its trademark "good hands." Collectively, the documents present a portrait of business strategies that are at odds with the insurer's carefully cultivated public image. Rather than simply rushing to the scene of an accident and doling out cash, Allstate deploys a variety of systems set in place by McKinsey to make sure it pays the minimum necessary -- and it plays hardball with those who seek more.

Berardinelli, 57, has provided *BusinessWeek* an exclusive copy of a draft of the book, as well as more than 200 typed pages of notes he took on the McKinsey slides. His tale illuminates the largely hidden role McKinsey has played as a key architect of claims practices in use across the insurance industry today. In addition to advising Allstate, McKinsey has also done work for Farmers Insurance Group, USAA, State Farm, and Fireman's Fund (AZ). While many of the cost-reduction strategies McKinsey recommended at Allstate remain in place, some have been reined in following legal and regulatory challenges in several states.

EPIC WAR

Berardinelli's book is certainly a partisan one, written to support "bad faith" lawsuits that he and other attorneys have filed against Allstate alleging mistreatment of policyholders. He says that the McKinsey project, which lasted from 1992 until at least 1997, institutionalized aggressive practices aimed at enriching investors at the expense of customers. "When you strip away all the fancy jargon, all this is a plan for switching money from the policyholders' pockets to the shareholders' pockets," he maintains. In the decade after Allstate instituted the McKinsey program in 1995, the amount of money it paid out per premium dollar in car accident cases declined from about 63 cents to 47 cents, according to A.M. Best.

McKinsey declined to comment, citing client confidentiality. But Allstate says Berardinelli's allegations are "unfounded and unproven." Rather than trying to cheat customers, the company says, its claims revamp was just good management: an effort to "become the premier claim organization in the industry." A major goal, it says, was to benefit policyholders by identifying "exaggerated and fraudulent claims." In its written response, Allstate further said its "processes are absolutely sound" and that its goal is "to investigate, evaluate, and promptly resolve each claim fairly, based on the merits."

The battle over the McKinsey documents is just the latest round in an epic, decades-long war between insurers and the plaintiffs' bar over access to one of the biggest treasure troves of cash ever created: the billions of dollars in premiums held by insurers to pay claims. For years, each side has cast the other as evil incarnate. In the early 1990s, when Allstate retained McKinsey, there was a widespread sense among insurers that they were paying too many illegitimate automobile-accident claims and that an

aggressive plaintiffs' bar, fueled by a wave of newly allowed attorney advertising, bore much of the blame. One focus of the program McKinsey introduced at Allstate, called Claim Core Process Redesign (CCPR), was aimed at striking a blow at that trend.

But plaintiffs' attorneys around the country allege that various elements of CCPR go beyond eliminating fraudulent claims and operate in a systematic way to deny policyholders legitimate benefits. Copies of Allstate's massively thick CCPR manuals have been circulating among trial lawyers for years. Although plaintiffs have had piecemeal success in bad-faith cases against Allstate, the insurer points to seven court rulings that have rejected attacks on CCPR. Last December a Montana state court noted that while CCPR practices may be illegal "if misapplied in a particular case, they nevertheless are neutral with no manifestly illegal purpose."

Berardinelli is convinced that the McKinsey material could turn the tide. The documents "explain why McKinsey built CCPR," he says. In his book he compares Allstate to a vendor of canned peas and argues that the documents "show how McKinsey...deliberately designed Allstate's claim factory to arbitrarily 'underfill' every can of Allstate insurance."

He begins his story in 1992, when, Berardinelli believes, McKinsey made its initial presentations on the Allstate project. (Allstate confirms that it retained McKinsey in the early 1990s.) Berardinelli's notes on the McKinsey slides, which he has filed in court, show that the consultants' goals were far-reaching. The objective, according to notes on one slide, was to "radically alter our whole approach to the business of claims." The consultants also advised the insurer on what steps were needed to achieve those ambitious goals.

Just why Allstate brought in McKinsey at that time isn't clear. But Berardinelli notes that in 1993, Allstate's then owner, Sears Roebuck & Co., spun off 20% of the insurer to the public and distributed the rest of the Allstate stock to Sears shareholders two years later. Freed of their ties to the large and struggling retailer, Allstate executives could now connect their personal financial fortunes directly to improvements in the insurer's bottom line. Jerry D. Choate was president of Allstate's personal property and casualty operations when McKinsey was retained, and the notes on several McKinsey slides list him as a participant in the project. Choate went on to serve as Allstate's chairman and chief executive from 1995 through 1998. By the end of 1997 he had accumulated shares worth tens of millions. He could not be reached for comment.

Allstate's "gross opportunity" if McKinsey's plan were fully implemented, according to Berardinelli's notes on one slide, was \$550 million to \$600 million in savings, almost all of which would come from reducing claims payments, not from cutting expenses. The

consultants then targeted several areas as presenting the greatest opportunity for reductions. Fraud was one, with one slide stating that "it may exist in approximately 11 percent of current claim volume," according to Berardinelli's notes.

DRY SPIGOT

Another major focus was on "subjective" injuries, meaning claims for such things as emotional distress and pain and suffering, as opposed to "objective" injuries, such as broken limbs. To get a handle on these claims, the notes on the slides show, McKinsey worked with Allstate to install Colossus, a computerized claim-evaluation system sold by Computer Sciences Corp. (CSC) Colossus compares a claimant's injuries with a database of similar cases and recommends a settlement range. Plaintiffs' attorneys have alleged that insurers can "tune" Colossus to consistently spit out lowball offers.

Berardinelli's notes show one McKinsey slide stating that the system has been "extremely successful in reducing severities with reductions in the range of 20% for Colossus-evaluated claims." ("Severities" is insurance industry jargon referring to the size of claim payments.) In its written response to *BusinessWeek*, Allstate says that "Colossus is merely a tool used to assist in the valuation" of some bodily injury claims and that adjusters use their expertise to come up with appropriate settlements "on each individual claim."

One of the key elements of McKinsey's plan was reducing the number of claimants who turn to attorneys after an accident for help in collecting on their insurance. The consultants even forecast what the potential gains in this area would mean for Allstate's stock. A 25% drop in attorneys appearing in several categories of cases could add \$1.60 to Allstate's share price, one slide states, according to Berardinelli's notes.

The boxing gloves slide was displayed in open court in a case against Allstate in Kentucky last year. It states that by "holding the line" on cases where accident victims hire lawyers, Allstate could achieve "a new distribution of settlement times" on subjective-injury claims. "By increasing the number of early unrepresented settlements," the slide says, Allstate could give 90% of these claims the "good hands" treatment, resolving them within about 200 days. But the slide shows the remaining 10% getting "boxing gloves" treatment, and a graph shows resolution of their claims taking as much as four years or longer.

In Berardinelli's view, this slide reflects what he sees as the current practice at Allstate. Claimants in the "good hands" category may get swift reimbursement, but they will end up with less than they're entitled to, he says. Those who hold out for more -- and retain a lawyer to help them get it -- face battering in the courts and potentially years of delay. "You can get your claims resolved promptly or fairly," he argues, "but not both." Allstate

says some people hired lawyers because they were not familiar with the claims process.

Once the CCPR program was rolled out in 1995, the effect was quickly felt by the trial bar. "We would ordinarily settle one or two cases a month," recalls Whitney Buchanan, a plaintiffs' attorney in Albuquerque. But then, "Allstate simply turned off the taps."

In mounting a counterattack, plaintiffs' attorneys have had some success. Courts and regulators in a number of states, including New York, Pennsylvania, and Washington, have forced Allstate to halt or change its practice of handing out a controversial "Do I Need an Attorney?" form to people involved in accidents. And Colossus, now widely used in the insurance industry, has come under attack on a number of fronts, with attorneys alleging it is being used to lowball claims. Last year, Farmers Insurance Group, a unit of Zurich Financial Services, agreed in a nationwide settlement to stop using it for certain claims.

Loquacious and professorial-looking, Berardinelli began his quest for the McKinsey documents in a routine bad-faith suit he filed against Allstate in December, 2000, in Santa Fe County. In ordering Allstate to turn the McKinsey material over to Berardinelli, the trial judge ruled that the documents were not entitled to confidentiality but said Berardinelli had to treat them as confidential while Allstate pursued an appeal. If Allstate lost its appeal, the judge ruled, the confidentiality order would expire.

During this period, Berardinelli furiously took notes as he worked in the office of his home, perched in the southeast hills overlooking Santa Fe. The 12,500 pages -- a bit more than half of which are duplicates -- were on paper that contained background printing declaring them to be confidential.

It took two years for an interim appellate court, and then the New Mexico Supreme Court, to rule that Allstate's appeal failed because it had filed it one day too late. With the Supreme Court ruling in hand in March, 2004, Berardinelli returned the McKinsey material he had to Allstate and demanded a clean copy, free of the restrictive printing. Allstate refused, prompting the trial court judge to hit it with the most extreme civil sanction a court can order, a default judgment -- finding it liable without trial in the underlying bad-faith case.

Allstate is appealing that ruling. In a court filing, Allstate argues that Berardinelli's aim is not to have the McKinsey documents for use in a particular case but to be able to disseminate their contents to lawyers around the country. As he puts the finishing touches on his book manuscript, Berardinelli would be hard-pressed to disagree.