BEHIND THE SCENES IN THE INSURANCE CLAIMS INDUSTRY: HOW INSURANCE COMPANIES HAVE REVOLUTIONZIED INSURANCE CLAIMS HANDLING©

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I. INTRODUCTION

Over the past twenty years there has been a revolution in insurance industry claims handling. Over that period major insurers, working closely with a few consulting firms, have redesigned how claims are handled. It is the conclusion of this article that the programs and policies put into use to achieve this revolution have adversely affected the relationship between the insured and insurer. Insurers, through these programs and policies, have sought to reduce their claims payments to enhance their corporate profits to the ultimate detriment of their policyholders. In other words, the insurance industry has sought to turn their claims departments into profit centers.

To demonstrate this revolutionary change in insurance claims handling this article focuses on the following insurers: State Farm, Farmers, Travelers, Fireman's Fund and Safeco. These insurers have retained the same consultants, most often McKinsey or Accenture, to evaluate their claims operations and provide recommendations on how the insurers can improve the profitability of their claim operations. These same insurers have also instituted very similar programs to achieve their goal of increased profitability, such as programs aimed at measuring and reducing so-called leakage. In other words, over the past twenty years, this country's leading insurance companies have led the way in re-engineering their claims operations.

Several other insurance companies have adopted similar programs. [ii] Unfortunately, due to the space limitations of this article the claims handling policies and procedures of these other companies cannot be reviewed here. Nonetheless, it is hoped that this limited discussion of the revolution in insurance claims handling will give the practitioner a working knowledge of contemporary claims handling policies and procedures. The practitioner should seriously consider, in any case involving these or other insurers, initiating discovery regarding the types of programs and policies discussed herein

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II. THE REVOLUTION IN INSURANCE CLAIMS HANDLING

A. STATE FARM

State Farm's goal is to be the "most profitable claim service in the industry."[iii] To achieve this objective, State Farm put into effect various programs in its claims operation aimed at improving company profitability. These programs included State Farm's employee evaluations or PP&Rs, Achieving Claims Excellence ("ACE"), and bonus programs directed at providing financial incentives to claims department employees to increase State Farm's profits.[iv]

1. State Farm's ACE Program

In 1994 State Farm inaugurated its Achieving Claims Excellence ("ACE") program. The purpose of the program was to improve State Farm's profitability by artificially reducing claim payments. Indeed, in the January 1996 State Farm publication Action (Vol. 27. No. 1), under the heading: "A Stitch in Time: Cost Saving Solutions for the '90s," it was reported that "ACE has the potential of taking a billion dollars of cost out of our system every year." The goals of ACE

were set out in several other publications, which were distributed company wide. In the November 1996 State Farm publication, "Operation Understanding," it was reported that a State Farm goal is "future proofing" State Farm by "cutting $2 billion dollars from operating costs." A State Farm ACE presentation outline contained the following:

> Considerable opportunity exists in the area of loss pay out. 69 cents of each premium dollar is used to pay losses. Better management of payouts will improve the rates we charge and make us more efficient. A goal of State Farm 2000 is to achieve a $2 billion savings in expenses by the year 2000. If ACE determines that there is a 12% claims payment shortfall nationwide…and we are able to reduce the shortfall to 10%, we have recovered the $2 billion savings in expenses.

In another State Farm publication it was reported that the "objective of the ACE program is to identify opportunities to build on the existing strengths of the Northeastern Region, to improve auto claims performance, and to lead to sustained profitability."[v] State Farm's goal of increasing its profitability through ACE was to be achieved by reducing claims payments. As one State Farm publication noted: "Indemnity payout represents the single largest opportunity for improvement." In a State Farm document entitled, "Discussion Document-` Region," it was noted that an objective of the "ACE Assessment October '96 to January '97," was to "[d]etermine the impact of ACE to date on both behavior and bottom-line results," and that the quantitative review of six State Farm regions would include "[p]rofitability." This document goes on to describe State Farm's achievement in reducing paid loss per policy as compared to the insurance

industry. This, in effect, is but another way to measure claims performance based on reducing average paid claim payouts.

ACE was initially instituted in State Farm's auto claims operation with the assistance of McKinsey & Co., a private consulting firm. Subsequently, it was expanded to property claims, and called Fire ACE. Fire ACE begun with a review of claims files by State Farm employees, and not independent file examiners, to determine where the company was overpaying or underpaying claims. As a result of State Farm's internal claim file review of property claims, not surprisingly State Farm found it had overpaid many claims but had only underpaid a few isolated claims.[vi]

Fire ACE initially included the review of closed claim files. This review included the measurement of three key factors: (1) Shortfall, or "the quantifiable difference between what was paid and what should have been paid to conclude the file," (2) Frequency, or "the percent of files having a specific characteristic," and (3) Opportunity, which "is the specific annual dollar improvement available to each region." In other words, State Farm identified how much each claims region could reduce their claims payments. In one region alone, the annual opportunity was estimated to be $75.8 million. Once the opportunity was determined, claim files in individual claim offices would then be periodically reviewed to determine whether the offices were meeting their goals of reducing shortfall, which in effect meant the reduction of what State Farm itself had defined as overpayments.

Francis Comella, who was State Farm's Director of Quality Assurance, Fire-Auto Claims, was deposed in *Plateros v. State Farm*, (NV) Case No. CV98-07605. Comella stated that he first became involved in the ACE program in 1993. According to Comella, quality assurance claim file audits were used in the

ACE program to track claim overpayments.[vii] Comella agreed that it was possible that communicating overpayments to claims representatives might encourage underpayment of claims.[viii] State Farm's ACE program also involved tracking average payments for a variety of claim payment categories.

Although ACE was instituted in the 1990's it has remained an important part of State Farm's claims handling philosophy this day. As pointed out by Brad Partington, State Farm's Divisional Claim Superintendent on the ACE team, "ACE is not a one time project. Rather, it presents a fundamental change in the way we conduct our business and the way we define success in claim handling and service to our customers." In 2005, Todd Osborne, a State Farm claims manager, testified that, "while the name and [ACE] program has come and gone, the initiatives designed to improve the claim handling and reduce shortfall are still in existence to some degree here in the region today."[ix]

2. State Farm's PP&R Program

Another program used by State Farm to improve its profitability was the PP&R program. The PP&R program provided for periodic performance reviews and evaluations of all State Farm claims employees based on a number of criteria. One important criterion was the achievement of corporate objectives. According to a 1991 State Farm PP&R signed by a State Farm employee and his superintendent, "the goals and action plans agreed to in this Performance, Planning and Review document are set out to assist the employee and supervisor to achieve corporate and regional objectives." In order to achieve such corporate objectives, such as profitability, the PP&Rs often included a requirement that the claims adjuster reduce his/her average paid claims. The practitioner should consider focusing on such programs in his/her discovery

because it may be improper for an insurer to require its claims representatives to reduce their average paid claims. An average paid claim goal may impose on the claims representative an artificial financial goal that has no relationship to the actual value of the claim and result in claims payments that are below the full claim value.

3. State Farm Bonus Programs

State Farm has also instituted various bonus programs which link financial awards to performance. In 1998, State Farm introduced "Performance Cash," which provides an annual cash payment to employees, including claims department employees, based on "an individual's merit rating." According to State Farm's own publication describing the program, its aim is to "reward employees for their contribution to State Farm's success." The Performance Cash program is part of State Farm's Rewards for Work Initiative. One goal of this initiative was and is to improve the "financial performance of State Farm." In addition, State Farm has a Senior Management Incentive Plan which uses several factors to measure executive performance, including corporate growth. Through these programs State Farm provides financial incentives to all its employees to achieve corporate goals, which include improving corporate profitability. It is clearly improper for an insurance company to provide such financial incentives to its claims employees.[x]

B. FARMERS INSURANCE COMPANY[xi]

1. Farmers' Performance Management Program

In 1992 Farmers inaugurated its Partners in Progress program, which put into place Farmers' performance management program for the evaluation of employee performance. Pursuant to this program, supervisors would set

"specific performance expectations" for each employee, including claims employees, which would be "tied to results that help meet the company's business needs." In the Partners in Progress manual it was also noted that, "[o]ur success as a company depends on everyone's attention to…critical performance factors," and that the employee would "be compensated according to how well you perform in critical performance areas."[xii] On the other hand, if the employee's "performance fails to match expectations, your compensation will reflect that." Farmers' employee's could "expect that [their] individual performance ratings will play a key role in determining your pay level each year." Farmers also noted that, "[b]y rewarding achievers, we put ourselves in a position to develop future leadership and to accomplish critical company business goals." In other words, performance management was aimed not only at impacting current performance, but future performance as well.

According to a January 22, 1993 memorandum from Farmers' Human Resources department to All Regions, performance management consisted of performance planning during which the employee and the supervisor would "develop a specific [performance] plan from which performance can be measured."[xiii] The performance plan includes three elements: "performance factors, expected results and priority weightings." Expected results described the "specific expectations for individual jobs and individual employees." A list of sources for the expected results were provided, which included Farmers' Focus Goals. Farmers' Focus Goals included such objectives as improving agency size, customer service, and life policy sales results. The Focus Goals also

included improvement of Farmers' surplus. Surplus, which is a measure of the insurance company's net worth, is the amount left over to an insurance company after all of its legal obligations have been paid.[xiv] It is a critical factor in determining how much insurance an insurance company can write. In other words, Farmers, through its performance planning program, was integrating its financial goals---improvement of surplus—into its review of employee performance, including its claims department employees.

In addition, the employee's performance in his/her job elements would be weighted. The weighting included four categories: "critical," which would be the "must do" elements of the job; "important," which would be "priority areas of the job;" "expected," and a final category designated "risk opportunity." The individual employee's performance plan, along with the weighting of the expected results, would be recorded in the employees' Performance Planning and Review ("PP&R") form, which the employee's supervisor would complete on an annual basis.[xv]

Based on several Farmers' PP&Rs, which were reviewed for the purposes of this article, claims employees have been required to reduce their average paid claim for certain types of claims. For example, in one 1999 PP&R for one Farmers' claims employee, under the heading "Expected Results," appears the category headed "Surplus Enhancement." This category was weighted "critical." Here, the employee's average claim payments for bodily injury, collision, property damage and other categories are noted, as well as whether those average payments were more or less than the previous years'

average. The supervisor who prepared this PP&R concluded the results were "excellent," apparently because the employee had been able to reduce their average paid claim in many categories. The employee's goals for the upcoming year included maintaining "indemnity costs at or below 1997 levels," or the average paid claim levels two years earlier.

More recent Farmers' PP&Rs specifically set out the Company's financial goals. In one such PP&R, Farmers' Focus goals were set out. Focus goal number one is "Exchange Profitability," which includes a 32% surplus ratio goal, and a 99% combined ratio goal.[xvi] One of the principal measures of an insurance company's profitability is its combined ratio. This is the ratio of earned premium to claims payments plus operational and claims handling costs. If the ratio is 100 then the insurance company is breaking even; however, if the ratio exceeds one hundred the insurance company incurs an underwriting loss. The largest portion of the cost side of the combined ratio is claims payments. Indeed, for a claims department to meaningfully impact combined ratio it must focus on reducing claims payments.[xvii] By setting forth this financial goal in its claims department PP&Rs Farmers is communicating to its claims employees that they are expected to contribute toward the company's profitability.[xviii] For a claims department that must include a reduction of claims payments.

Average paid claims were not only traced in the individual claims employee's PP&Rs, but they were also tracked in the Farmers' claims office's quarterly management reports.[xix] Quarterly management reports are prepared

by each Farmers' office. Farmers' claims management monitors average paid claims with the objective of reducing claim payments.

2. Farmers' ACME Program

Beginning in 2000 to 2001 Farmers started to evaluate their claims employees on claim overpayment. [xx] This was part of Farmers' new ACME program, which was the product of Farmers consultation with Accenture Consulting, a former consulting arm of Arthur Anderson.[xxi] This program is similar to those adopted by State Farm and Safeco. This program is a claims quality evaluation program which requires claims personnel to "calibrate" their handling of claims files so that all claims personnel are handling claims similarly. The focus of this program is to adopt outcome oriented results for Farmers. The purpose of the program is to "improve Farmers' profitability." Therefore, in one PP&R, under the category of "Expected Results" for "Financial," which is a "critical" category, with a weight of 25%, it is noted that the Farmers' employee overpayments for a variety of claims categories was 2.05%. There is no similar evaluation for underpayments.

3. Farmers' Bonus Programs

Farmers also instituted a series of bonus programs aimed at awarding claims personnel for contributing to the company's profits.[xxii] For example, in 1998, Farmers began its Quest for Gold bonus program. All Farmers offices and employees, including claims department employees, participated in this bonus program. Pursuant to the program, employees of individual claims offices would receive bonuses (a percentage of their salaries). The amount of the

bonus would depend on the individual office's success in achieving five goals. Bonuses were granted, in ascending amounts, for offices that achieved three, four and five out of five of the goals. The goals included growth in net premiums, net gain in full time agents, reduction in management company expense ratio, growth in earnings, a goal to be chosen by the individual office, and reduction of the combined ratio to a specific amount. The only Quest for Gold goal that could be impacted by the claims department was the reduction in the combined ratio. As previously noted, the claims department can only effectively reduce the combined ratio if it reduces claims payments.[xxiii]

4. Farmers and "Bring Back A Billion"

In addition to its compensation and bonus programs, Farmers has made several other efforts to turn its claims department into a profit center. For example, in 1994, following the Northridge earthquake in California, Farmers initiated the Bring Back a Billion Program.[xxiv] Bring Back a Billion was a program in which each Farmers' employees were asked to do their part "to help restore" the company's surplus. The goal was clear: "Immediately strengthen our actions so as to quickly rebuild surplus to a ratio of surplus to premiums of at least 33 percent, to attain a 40 percent ratio by 1997, and to reach a 50 percent ratio by the year 2000." Employees, including claims employees were asked to sign individual commitment forms that they would work to restore the company's surplus. Farmers' publications concerning the Bring Back a Billion program focused on the need for Farmers' employees to lower or maintain a low combined loss ratio in order to contribute to surplus.[xxv] Between at least

1994 and 2000, Farmers' Bring Back a Billion program was aimed at encouraging its employees, including its claims employees, to contribute to Farmers' profitability.

5. Farmers' Strategic Management Conferences

Through executive presentations at Farmers' annual Strategic Management Conferences, Farmers has continued its efforts to exhort its employees to contribute to corporate profits. At the 2001 Strategic Management Conference, John Lynch, Farmers' Vice-President of Market Management, reported that Farmers "number one goal, the number one objective for the year 2001 was to fix our combined ratio."[xxvi] Lynch pointed out that achieving this goal "would take the hard work of absolutely every member of the Farmers' organization [including] claims." Lynch then pointed out that the projected combined loss ratio for 2001 was 115.7, which was six and a half points higher than the goal of 108. Translated into dollars these six and half points meant $900,000,000. Lynch stated: "The impact on the exchanges of just our failure to hit our goal of 108, just missing that goal by six points, six points cost us $900,000,000 in surplus." Lynch concluded his presentation by stating that Farmers number one Focus Goal for 2002 would be to restore profitability. This goal was to be tied to management performance plans for 2002, and with compensation.

Farmers' programs to reduce its combined ratio were highly successful. The combined ratio was reduced from 116.6 in 2001 to 101.0 in 2003, a decrease of 15.6 points in just two years.[xxvii] During the same period the pure

loss ratio (ratio of paid losses to earned premium) was reduced from 74.7 to 59.0, which is below the industry lost ratio average.[xxviii] Also, during the same period Farmers' expenses increased, while net investment income and net underwriting income declined.[xxix] Based on the available information it appears that Farmers improved its combined ratio between 2001 and 2003 primarily by reducing its loss ratio, or its claim indemnity payments.[xxx]

C. SAFECO

1. Safeco's Financial Turnaround

In 2001 Safeco suffered a net income loss of twenty two million dollars. At the same time its combined ratio was 120.2, which was higher than the insurance industry average combined ratio in 2001.[xxxi] It is apparent that Safeco sustained a significant underwriting loss in 2001. Similarly, Safeco's loss ratio, which is the ratio of claims payments to earned premium (not including expenses), was 73.8 in 2001. Following 2001 Safeco significantly reduced both its combined and loss ratios so that by 2005 they were 90.9 and 49.7 respectively. Safeco's 2005 loss ratio is well below the insurance industry average, which is above 60 cents for each dollar spent. In response to a significant underwriting loss and high combined loss and combined ratios Safeco made several efforts to substantially improve its profitability between 2001 and 2005.[xxxii] Based on the available information it appears that Safeco introduced several new claims programs during this period. Those programs had the goal of contributing to Safeco's significant turn around in its profitability.

2. Safeco's Quantum Leap Program

In approximately 2002, Safeco also retained Accenture Consulting to assist in its redesign of its claims operation.[xxxiii] It appears that Safeco retained Accenture for a purpose similar to Farmers—interjecting a profit motive into its claims operation.[xxxiv]

Accenture assisted Safeco in instituting Safeco's Quantum Leap Initiative wherein Safeco began measuring Lost Economic Opportunities ("LEO") in its handling of claims.[xxxv] Safeco's program to track LEO's appears to be a similar program as that adopted by State Farm and, therefore, it would also have the potential effect of encouraging the underpayment of claims. For example, Safeco's program involved the tracking of LEOs, or what is also called leakage, to determine if there were lost economic opportunities.[xxxvi] Indeed, the purpose of this program is to look for "lost dollars."[xxxvii] Safeco's leakage tracking is biased toward looking only at overpayments, which even Safeco admits may be subjective.[xxxviii] Similar to State Farm's ACE program, Safeco only tracks what it considers overpayments and does not track underpayments.[xxxix] This builds into the claims evaluation system a bias toward overpayments, which in turn motivates claims employees to be constantly alert to overpayments of any type—meritorious and unmeritorious. In other words, claims employees are provided an incentive to underpay claims and not criticized for overpaying claims.[xl]

.3. Safeco's Performance Evaulations

It appears that Safeco also uses severity guidelines to measure claims employees' performance. Safeco states: "Severity may be considered in the performance evaluation of an adjuster, unit manager and/or product line manager." In the insurance industry severity is a term of art referring to average

paid claim. As previously discussed, this is an improper measure of performance because it may impose on the claims handler artificial goals for the handling of claims.

Similar to Farmers and State Farm's use of PP&Rs, Safeco has used a form called the Performance Development Feedback Reviews ("PDFRs") to evaluate claims employees' claims handling performance in individual claim files.[xli] The results of the PDFRs for an individual claims handler are then used in preparing the employee's Performance Management Review, which is the annual review of the employee's performance.[xlii] PDFRs are used to track the employee's success in reducing claims leakage. According to a Safeco computer link to information regarding Safeco's claim department's Audit/PDFR programs, the program's purpose is to "monitor and evaluate all claims-related functions by providing evaluations of critical processes to assure certain operational quality, regulatory compliance, best claims practices and **superior regional performance in profitability**, expense management and customer service."[xliii](emphasis added) Although many of these goals may be laudable, it is improper for Safeco to use profitability goals in evaluating the performance of its claims personnel. As previously discussed, such goals may distort the claims handling function by placing the insurer's interests above those of the insured.

D. FIREMAN'S FUND

1. Fireman's Financial Turnaround

According to A.M. Best, in 2001 Fireman's sustained a pretax operating income loss $432,717,000.[xliv] This loss doubled in 2002, when it reached $966,674,000. Indeed, Fireman's sustained significant underwriting losses from 1996 to 2000 and 2001.[xlv] Fireman's cumulative underwriting loss from 2000 to 2002 alone was $3.1 billion.[xlvi] Fireman's combined ratio in 2001 was 122.3 and in 2002 it was 157.2.[xlvii] In 2001, Allianz, Fireman's parent company, gave Fireman's three years to turn its underwriting losses around. By 2004, Fireman's pre-tax operating income had changed from a loss to a gain of $241,305,000, and by 2005 that figure rose to $421,148,000. Also, in 2004 Fireman's reduced its combined ratio to 97.6 and to 96.2 in 2005.[xlviii] Significantly, Fireman's was also able to substantially reduce its loss ratio. In 2002, Fireman's loss ratio measured 91.5%. By 2005, Fireman's reduced its loss ratio to 54.8 %.[xlix] In the span of three years Fireman's reduced the amount of its claims payments by approximately 36%. It is apparent that Fireman's success in reducing its loss ratio contributed significantly to its improved profitability.

2. Fireman's 8-5-5 Program

Fireman's remarkable change to profitability was explained by Jeff Post, then Fireman's CEO, in a 2004 article addressed to Fireman's employees.[l] Post observed that Fireman's had been losing one billion dollars a year in its core business. In response to these losses Fireman's instituted the "8-8-5 Program." The goal of the 8-5-5 Program was to reach "the annual reduction targets for our

combined ratio over the course of three years."[li] The targets were a reduction of the combined ratio by eight points in the first year, and five points in each of the following two years. Post observed that, "8-5-5 was a simple slogan everyone could embrace." As a result of this program, according to Post, Fireman's "managed to take 34 points out of our combined ratio." In order to achieve this dramatic change, according to Post, "the staff must be aligned to a common goal," and "[w]e expressed our goal as 8-5-5."[lii]

The over all purpose of the 8-5-5 program was further discussed by Timothy J. McWatt,[liii] in his deposition in the matter of *Thornell v. Fireman's Fund Insurance Company*, Dist. Ct., El Paso, Cty., CO., Case No. 2002CV145:

> Q Was this part of that -- I was reading about where you had some sort of mantra called 855 or 588. Do you know what I'm talking about?
>
> A Yes, I do.
>
> Q What was it called?
>
> A It was called 855. And what that refers to is the reduction of the combined ratio. Because our combined ratio was, let's say, 120. And over three years, we reduced our combined ratio. So the 8 refers to an 8 point reduction; 5, another 5 point reduction; 5, another 5 point reduction. So that was the plan, a business plan.
>
> Q I see. And when you talk about a combined ratio, what is that?
>
> A It is the underwriting expenses and loss expenses -- I guess the best way to put it is if you had combined ratio over 1 --
>
> Q Right.
>
> A -- that would mean technically you're spending

more than you're making.

Q Okay. You're spending more on claims and claims expense than you're bringing in?

A Than you're bringing in. Now, that does not include the investment income side, but generally, from a pure underwriting and claims side expense, for every point over 1 -- technically, if you were 107, let's say, from an investment standpoint, you'd have to make 7 percent to --

Q I see. To break even?

A -- to break even.

Q Got it. So there was this three-year plan to reduce the combined ratio?

A Correct.

Q Running from when to when?

A I believe it ended in 2003. So it would have been, you know, 2000, 2001, 2002, 2003, basically.

Q Okay. And was this plan something that everybody in the company was aware of in endeavoring to perform?

A I believe it was -- yeah. Pretty much, Fireman's Fund employees would know about it, know that that was the company's goal.

Q And you guys had buttons and stuff that said 855?

A Yes.

Q. And somebody like Charlotte Mathis and the people that worked on the Thornell claim would have known about this?

A I believe they would have, yes.

Q. Do you know what the 8.5.5., what areas they refer to?

A I can't give you that detail of breakdown. That's just the overall plan. I mean, when you say

areas –

Q Well, one was underwriting.

A Right.

Q One was claims expense.

A Right.

Q And one was claims payment.

A Right.

All Fireman's personnel, including claims personnel, were involved in achieving Fireman's profit goals.[liv] It is apparent that Fireman's claims department employees were constantly kept up to date on Fireman's achievement of its 8-5-5 program, and other financial goals.[lv] It appears that Fireman's set about to create a corporate culture that included using the claims department to support its financial turnaround. Indeed, according to Barbara Whitfield, Fireman's Assistant Vice President of Complex Claims in 2001, a component of the 8-5-5 program was to reduce losses in order to improve Fireman's loss ratio.[lvi]

3. Fireman's Performance Reviews

In apparent furtherance of Fireman's goal to improve its corporate profitability, Fireman's used an employee Performance Review form, which contained financial goals.[lvii] The Performance Review form contained a section entitled "Financial Performance," in which the claims department employee is directed to "[p]articipate as a member of the regional leadership team to achieve regional financial objectives. This includes loss, LAE and combined ratio goals." The loss ratio goal was to hold the "increase in average paid [claims] to 5% or

less for all lines combined." The performance review also included year's end results for the loss ratio, and average paid claims, as well as a section entitled "Financial Responsibilities." Under this section the claims employee was to manage average paid trends and leakage (see discussion above concerning leakage programs). It appears that Fireman's was interjecting profit goals into its claims department operation through its use of employee Performance Reviews.

4. Fireman's Bonus Programs

Fireman's also instituted the Employee Savings Bonus Plan ("ESBP"). Eligible employees included non-management employees.[lviii] The ESBP was "a one-year plan established to help [Fireman's] ensure achievement of [its] turnaround in expense management." Prior to 2002, non-management employees were not eligible for bonuses.[lix] Fireman's bonus programs appeared to be aimed at providing an incentive to employees to achieve Fireman's financial goals, including the reduction of its combined ratio.

F. TRAVELERS

1. Travelers Total Compensation Program

Beginning in at least 2000, Travelers put into place its Claim Total Compensation Program ("Compensation Program").[lx] A major theme of the Compensation Program was to pay Travelers' claims employees for achieving "critical operating results." Included within this Compensation Program were two variable incentive programs: the Claim Professional Incentive Plan ("CP Plan") and the Property Casualty Claim Incentive Plan (P&C Plan").[lxi] All regular claims employees above salary grade 65 were eligible for the P&C Plan,

and “[r]egular employees in certain claim professional positions” were also eligible for the CP Plan.[lxii] In other words, most if not all of Travelers’ claims employees were eligible for either the CP Plan or the P&C Plan. Funding for both the P&C Program and the CP Plan was based, in part, on the success of the claims department in reducing the “previous year’s Claim payout.”[lxiii] Travelers’ Compensation Program may have continued through at least 2005, with some changes. As pointed out, however, in *Linda Leonard v. The Travelers Indemnity Company,* Dist., Ct., Galveston Cty., TX, 405 Judicial District, Cause No. 05CV0149 (hereinafter, “Leonard Action”) the Compensation Program continued to contain improper claims goals. According to Plaintiff’s Motion to Compel Compliance with Court Order Requiring Knowledgeable Corporate Representatives, filed in *Leonard*, Travelers continued to provide its claims employees with incentive bonuses through 2005.[lxiv] These bonuses were based upon a group of measurements, which are included on what is called the “scorecard.”[lxv] One of these measurements includes “average paid value on claims.”[lxvi] This performance measurement applies to “everybody,” and to “all” of Travelers’ claims.[lxvii] Indeed, profit goals also apply to Travelers’ underwriters. According to Kevin Cahill,[lxviii] who was deposed in *Leonard*, the underwriter’s bonuses would be based, at least in part, on the profitability of his book of business, which would be determined, in part, by the claims paid under the coverages the underwriter written.[lxix]

III. CONCLUSION

It is now apparent that several large insurance companies have revolutionized insurance claims handling. Either on their own or through the retention of consulting firms, such as Mckinsey and Accenture, several insurance companies have adopted programs which have the effect of influencing claims payments. Although, historically, insurance companies have always been concerned about paying the least amount on claims, never before has there been such a concerted effort to effect the amount of claims payments.

In prosecuting a bad faith claim it now becomes necessary for the practitioner to explore the insurer's programs and policies that may have an impact on reducing claim payments. Such efforts may have a significant impact on the trier of fact. Jurors and judges can be very concerned that the playing field be even for both parties. Insurer programs, such as those discussed here, may significantly tip the balance in the favor of the insurer resulting in a skeptical if not condemning view of the insurer's conduct.

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[ii] Allstate consulted with McKinsey & Co. in its revamping of its claims operation, which is called Claims Core Process Redesign. Documents and information concerning Allstate's consultation with McKinsey & Co. have now been produced and made widely available. (See "In Tough Hands At Allstate," Business Week, May 1, 2006, and From "Good Hands" to Boxing Gloves, Berardinell, David J., et al. (Trial Guides LLL, 2006))

[iii] See *Olson v. State Farm Mut. Auto. Ins. Co.* (Az. App. March 16, 2000. Cause No. CV 96-06105, p. 8. All documents cited in this article are in the author's possession.

[iv] These programs have also been described and criticized by other courts. The Arizona Supreme Court in Zilisch v. State Farm 196 Ariz. 234, 995 P.2d 276 (Ariz. 03/03/2000) called attention to these practices when it wrote: "There was sufficient evidence in this case from which a jury could find that State Farm acted unreasonably and knew it. There was evidence that State Farm set arbitrary goals for the reduction of claims paid. The salaries and bonuses paid to claims representatives were influenced by how much the representatives paid out on claims." (Id.) Similarly, the Utah Supreme Court observed: ""State Farm repeatedly and deliberately deceived and cheated its customers via the PP&R scheme. (See Court's Findings, Conclusions and Order Regarding Punitive Damages and Evidentiary Rulings, Campbell, at 17-27). For over two decades, State Farm set monthly payment caps and individually rewarded those insurance adjusters who paid less than the market value for claims. (Id. at 18-19) In particular, State Farm's conduct corrupted its employees by forcing them to engage in deceptive practices or lose their jobs." (Campbell v. State Farm 65 P.3d 1134, 2001 UT 89 (Utah 10/19/2001) rev. in part, State Farm Mutual Automobile Insurance Co. v. Campbell, 123 S.Ct. 1513, 538 U.S. 408, 155 L.Ed.2d 585 (U.S. 2003)) The Idaho Supreme Court also called attention to these same State Farm's claims practices. "Evidence was also presented indicating that State Farm's claims handling policies were designed to increase profits by reducing costs using biased paper reviews, and by inducing lower settlements through denial or delay of claims. Refusing to pay, or delaying payment on a claim that a reasonable person would say was due rises high on the scale of reprehensibility. Compare Walston at 222, 923 P.2d at 47. Such conduct is particularly egregious in a first-party insurance relationship, where the insured has purchased insurance for his or her own protection and peace of mind." (Robinson v. State Farm Mutual Automobile Insurance Co., No. 24952 (Idaho 12/28/2000), rev. Robinson v. State Farm Mutual Automobile Insurance Company, 137 Idaho 173, 45 P.3d 829 (Idaho 04/10/2002))

[v] ACE was initially introduced in State Farm's northeastern region in 1993 and then expanded nationwide. (See State Farm publication "Advancing Claims Excellence, October 1996)

[vi] See Deposition of Todd Osborne, in the matter of *David L. Watkins, Jr. et al. v. State Farm Fire & Casualty Company,* Dist. Ct. of Grady Cty., State of Oklahoma, Case No. CJ-2000-303p. 151, ll. 5-8 (whether there are overpayments are determined solely by State Farm), and p. 221, ll. 4-6 ("the great majority of shortfall was positive," and "[i]t was just a very small part was negative.") (hereinafter "Osborne Deposition"). Mr. Osborne has been employed with State Farm since 1985, and was State Farms team manager on the Fire ACE program from 1996 to 1997

[vii] Id., pp.32-34.

[viii] Id., pp. 37-38.

[ix] Osborne Deposition, 171, ll. 10-14.

[x] For a further discussion of adverse implications of providing bonuses or other compensation to claims as a reward for their claims handling see "Prevent Bad Faith Risks from Adjuster Incentive Compensation Schemes," by Kevin M. Quinley, CPCU, ARM AIC, AIM, ARe, Claims Magazine, Oct. 2004.

[xi] In this article, the term Farmers Insurance Company refers to the over twenty companies that comprise the Farmers Property and Casualty Group ("Group"). These include the three reciprocal insurance exchanges—Farmers Insurance Exchange ("FIE"), Fire Insurance Exchange and Truck Insurance Exchange. Only two companies in the Group have employees-FIE and Farmers Group Inc. ("FGI"). The claims arising out of policies sold by Farmers' entities are administered, under FGI's control and direction, by FIE employees; whereas FGI employees handle other aspects of Farmers' insurance operation, including developing insurance products, marketing insurance policies, underwriting insurance operations, accounting, investments, regulatory compliance and human resources.

[xii] The Partners in Progress Manual is in the author's possession. Further, it should be noted that none of the documents cited herein are subject to any protective or confidentiality order.

[xiii] A copy of the memorandum is in the author's possession.

[xiv] Fundamental of Risk and Insurance, Vaughn, Emmett J. & Vaughn, Therese (Wiley & Sons, 9th ed., 2003), p. 138. (hereinafter "Vaughn")

[xv] This information is drawn from several Farmers' PP&Rs, which are in the author's possession.

[xvi] The combined ratio is the ratio of earned premium to claims payments plus operational and claims handling costs. If the ratio is 100 then the insurance company is breaking even; however, if the ratio exceeds one hundred the insurance company incurs an underwriting loss. (See Vaughn, p. 145 ("the ratio is widely used as indication of the trade profit of an insurer."). As pointed out in Insurance Operations, Regulation and Statutory Accounting, Myhr, Ann E. & Markham, James J. (IIA 2d ed., 2004) §1.20, between 1995 and 2001 the percentage of each dollar spent in the insurance industry for pure claims [other than expenses] ranged from 65.8% in 1995 to 75.4% in 2001. Accordingly, for a claims department to meaningfully impact combined ratio it must focus on reducing claims payments.

[xvii] See Fn. xvi.

[xviii] In an apparent attempt to circumvent the obvious implications of asking claims department employees to contribute to company profits by reducing claims payments, Farmers added the following statements to its PP&Rs beginning in 2003: "Because our overall goal in Claims handling is to pay what we owe—no more, no less, Farmers Insurance Exchange employees should not establish an individual goal in support of Overall Company Goal #1 [surplus ratio and combined ratio goals]." Regardless of this statement, if Farmers had truly wanted its claims employees to adjust claims without the influence of company financial goals then it would have deleted in its entirety any reference in the PP&Rs to such goals. There currently is no evidence that Farmers has done this. Further, there is no evidence that Farmers advised its claims employees that prior PP&R evaluations that related claims payments to company financial performance were in any way improper and should no longer be considered in the handling of claims.

[xix] Farmers' Impact Runs are detailed statistical reports, which provide the claims operation with such information as average paid claims in various categories of claims, such as homeowners' claims, how many claims are being reported in various categories to each office, and so forth.

[xx] Beginning around 2000 to 2001 Farmers begun to evaluate their claims employees on claim overpayment or leakage. According to Farmers' documents, which described this program, the evaluation of overpayments was done by a "subjective" process, whereby claims management would review a file and determine if, in management's opinion, the handling adjuster paid too much to settle the claim. Because this process is subjective, the program is potentially fraught with error and misjudgment. More importantly, such a measurement tool may tend to motivate claims employees to pay less on claims in order to reduce their artificial claim overpayment goals.

[xxi] Documents concerning this program are in the author's possession.

[xxii] Documents concerning these programs are in the author's possession.

[xxiii] It is well recognized in the insurance industry that such financial rewards are a powerful incentive. In the text, Organizational Behavior in Insurance, Vol. I, the authors, some of whom are employed in insurance industry, point out:

> [C]hanging the reward system is a powerful way to introduce change into the organization culture because the reward system is one of the most important aspects of that culture. Developing a reward system is a type of behavioral modification, which represents one way of changing underlying beliefs. Reinforcement is a key aspect of socialization. If someone is consistently rewarded for doing something, human

nature being what it is, that person will continue to do it….Effective reward systems include many levels of rewards, including not only financial bonuses but also career-and stature-related rewards.

Organizational Behavior in Insurance, Vol. 1 White, George A. ed., et al (Ins. Inst. of Am. 1st ed. 1992), pg. 47

[xxiv] The information concerning Farmers' Bring Back a Billion comes from Farmers' documents which are in the author's possession.

[xxv] The loss ratio is the "ratio of incurred losses to earned premiums," and is a measure of "how well an insurer controls the amount of insured losses." (Insurance Operations, Regulation and Statutory Accounting, Myhr, Ann E. & Markham, James J. (IIA 2d ed., 2004)t §119)

[xxvi] A copy of John Lynch's presentation at the 2001 Strategic Management Conference is in the author's possession.

[xxvii] June 24, 2004 A.M. Best Report on Farmers Insurance Exchange

[xxviii] Id.

[xxix] Id.

[xxx] A.M. Best observed that during 2001 to 2003 Farmers gave "[s]significant attention… to introducing more disciplined claims settling practices for the group's homeowners business." (Id.)

[xxxi] A. M. Best's Company Report as of June 23, 2004 for Safeco Insurance Company of America

[xxxii] According to Michael Burton, Safeco's Large Loss Claims Property Unit Manager in his deposition in the matter of *Price v. Safeco*, AZ St., Cty. of Maricopa, Case No.: No. CV2004-006947 (hereinafter, "Burton Deposition") Safeco continues to track its combined ratio at a regional level. (Burton Deposition, p. 148)

[xxxiii] Burton Deposition, p. 122

[xxxiv] Id.

[xxxv] Id.

[xxxvi] Burton Deposition, pp. 125 & 132

[xxxvii] Information regarding this program is taken from Plaintiff's Motion for reconsideration of Court's June 23, 2006 Order Granting Defendant Safeco Insurance Company of America's Motion for Protective Order in the matter of *LeMasters v. Safeco Insurance Co. of America*, CA. Sup. Ct., Cty. Of Los Angeles, Case No.: No. BC32415 (hereinafter "LeMasters Motion for Reconsideration").

[xxxviii] Burton Deposition, pp. 135, 138 & 141

[xxxix] Id.

[xl] This bias is further aggravated by the fact that the leakage amount is only determined by a review of the claim file and not by an actual reinspection of the damage or repaired property. In a first party context where there is damage to a structure the amount of any overpayment often cannot be determined without an actual inspection of the damaged structure.

[xli] Burton Deposition, p. 130

[xlii] Burton Deposition, p. 145

[xliii] LeMasters Motion for Reconsideration.

[xliv] See A.M. Best July 22, 2005 Report on Fireman's Fund Insurance Company.

[xlv] Deposition of Barbara Whitfield, p. 29, in the matter of *B&L Properties, et al. v. Central Garden & Pet Co., et al.*, Sup. Ct., AZ., Cty. of Maricopa, Case No. CV2002-018169 (hereinafter "Whitfield Deposition))

[xlvi] Expert Report of Steven L. Ramsey produced in the matter of *B&L Properties, et al. v. Central Garden & Pet Co., et al.*, Sup. Ct., AZ., Cty. of Maricopa, Case No. CV2002-018169 ("Ramsey Report"), p. 3.

[xlvii] Ramsey Report, p. 7.

[xlviii] See A.M. Best Report.

[xlix] Ramsey Report, p. 7.

[l] A copy of this publication is in the author's possession.

[li] The "8-5-5 Program" was approved by Allianz of America Corporation, Fireman's Parent, in August 2001.

[lii] According to A.M. Best, the reduction was closer to 60 points.

[liii] McWatt was a Claims Technical Director at Fireman's Fund when his deposition was taken on September 4, 2004.

[liv] Whitfield Deposition, p. 39-40) ("[E]ach and every person at Fireman's Fund was specifically instructed they were to do everything they could to reduce costs.")

[lv] See Whitfield Deposition, p. 45.

[lvi] Whitfield deposition, p. 23.

[lvii] Fireman's employee Performance Review form for a claims department employee in Arizona, which covered the period of January 1, 2000 to September 30, 2000 and January 1, 2001 to December 31, 2001. This document is in the author's possession.

[lviii] Whitfield testifies that this was limited to professional employees because they were in a position to have a greater impact on cost reduction. (Whitefield deposition, p. 43)

[lix] Whitfield deposition, p. 41.

[lx] A copy of Travelers' 2000 Claim Total Compensation Document is in the author's possession.

[lxi] Id. at p. 7

[lxii] Id.

[lxiii] Id., Appendix I & Appendix II.

[lxiv] Plaintiff's Motion to Compel Compliance with Court Order Requiring Knowledgeable Corporate Representatives, p. 4, in Leonard v. Travelers.

[lxv] Id.

[lxvi] Id.

[lxvii] Id., pp. 4 &10.

[lxviii] Mr. Cahill is a Travelers' underwriter..

[lxix] Cahill deposition, p. 140.