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To SIR with Love or Maybe Not So Much
An Exploration of the SIR and its Impact on Claims and Insurance

I. Self-Insured Retentions and Their Impact on the Traditional Roles of Carrier, Client, Counsel and Brokers: How Have These Roles Changed and the Impact on Claims Handling:

An insurer's duties under a general liability policy with an SIR generally do not arise until the insured pays the SIR. Courts will look to policy language to determine whether and when the insured or insurer has a duty to defend. A majority of courts do not view an SIR as insurance. In those jurisdictions, an insured owes no duty of good faith to its insurer because of the SIR. However, courts seem willing to review the policy language to determine whether the SIR is considered insurance and whether an insurer owes a duty of good faith to its insured as contracted between the parties. Courts have declined to extend an implied, reciprocal duty of good faith upon an insured to its insurer under an SIR.

II. How Counsel, Carrier, Broker and Client Work Together in this New Environment:

We will have a general discussion as to how these relationships have changed, particularly in reference to the SIR. As many clients have gone to larger SIR’s in varying degrees including essentially supplanting or replacing the traditional primary layer of insurance the changes have come in various and un predictable ways. These clients have considerable say over all aspects of the defense and indemnification of the matter and act in the traditional role of the primary insurance carrier with choice of counsel, direction of the defense and settlements within its layer. The carrier often times is relegated to the role of a TPA and/or excess carrier with little or no role in the day to day handling of the claim and/or litigation. It varies from client to client depending upon the amount of “skin in the game” and/or the clients’ level of sophistication. Which as one can imagine generally goes hand in hand with the amount of its self-insured retention. Over the years

we have all seen the transition and the shift of the balance of power from carrier to insured as the economic realities have forced the insured/client to migrate from first dollar coverage to the SIR.

III. SIR vs. Deductible – What is the Difference and What are the Benefits of Each?

The definition of true "self-insurance" is a pure risk retention approach wherein a company assumes full responsibility for any losses that may arise and insures none of its potential liability with a third party. As such, a corporation that meets the true definition of a self-insurer must pay all judgments and settlements for any claims asserted against it, as well as the related loss adjustment expenses including defense costs within the retention. All other forms of self-insurance, including the strategic use of deductibles and SIRs as part of an overall risk management strategy, do not meet the definition of actual self-insurance.

SIRs and deductibles are similar in that both require the insured to bear financial responsibility for a portion of a loss and, in this regard, represent an exposure that is not covered by insurance. However, there are important differences in the way they operate.

Insurance policies written with deductibles provide that the insurer will pay the defense and indemnity costs in connection with a covered claim, and then charge or bill back the deductible amount to the insured. In other words, the "deductible" is a sum that is subtracted from the insurer's indemnity and/or defense obligation under the policy. Essential is that traditional responsibility for the defense and settlement of each claim does not change and continues to rest solely with the insurer, as does it's control over the entire claim process.

Policies written with large self-insured retentions, in contrast, may place responsibility for claims handling, including the investigation, settlement and payment of claims, in the hands of the insured. Under a policy with a SIR, the insured is typically required to pay the defense and other allocated expense costs as well as indemnity payments until the amount of the retention has been exhausted. Once the SIR has been exhausted, the insurer responds to the loss and assumes control of the claim. That is why it is imperative for clients to fully review their insurance contracts to see what their rights and duties are in the event of a claim.

An important distinction, as noted above, of the self-insured retentions are that the claims-handling generally is controlled by the insured, an independent adjusting company, or a primary insurer's claim department retained by the insured to assist it in claim management. In essence, a self-insured is the primary insurer. It follows that many

insureds that go the route of self-insurance retention are major companies or commercial entities, sophisticated in matters of insurance, risk management, and loss control.

Another difference between a deductible and a SIR is that the SIR does not reduce available policy limits, whereas a deductible may reduce policy limits. Thus, an excess insurance contract with limits of $750,000 sitting above a $250,000 SIR will provide the insured with $750,000 in coverage once the SIR is satisfied. A $250,000 deductible, in contrast, may reduce the $750,000 insurance policy limits, leaving $500,000 in limits after the deductible is satisfied.

In a standard GL policy, expenses are considered supplemental payments and do not erode the policy limits. In policies with a deductible, the "deductible" is a portion of an insured loss for which the insured is responsible and is generally not a specific sum that the insured must pay before the insurer owes its duty to indemnify the insured for a loss. The deductible can be on a pro-rata basis, making the amount owed by the carrier and the insured a variable until final resolution of a claim. This will be spelled out in the deductible endorsement. A deductible usually relates only to the damages sustained by the insured, not to defense costs. The insurer is usually responsible for defense costs as long as the loss is covered under the policy.

A SIR, on the other hand, is generally a specific amount of loss that is not covered by the policy but instead must be borne by the insured. A SIR endorsement may provide that the insurer shall have the right, but not the duty, to assume charge of the defense and settlement of any claim, including those below the level of the SIR. We will talk about some of the friction that can occur resulting from the "right but not duty during our panel discussion.

There is no dispositive case law differentiating deductibles from SIRs. However, one of the key characteristics of a SIR is that the insurer has no obligation to indemnify or defend a loss until the insured has paid the amount of the SIR. For purposes of analyzing the effect of "other insurance" clauses, this characteristic is the most significant characteristic of a SIR because it is this characteristic that transforms what would otherwise be a primary policy into an "excess" policy.

The magnitude of the difference between SIRs and deductibles depends upon the precise policy terms. Most significantly, the insured with a SIR generally assumes responsibility for claims handling and will report to the insurer only those claims that it considers likely to exceed the amount of its retained limit. By contrast, in the case of liability policies with a deductible, claims are tendered to the insurer for handling; the insurer provides for the defense of its insured and, to the extent of its limit of liability, the insurer pays on behalf

of the insured the amount of any judgment or settlement of a covered claim. The insurer then bills the insured for the amount of the deductible. Should the insured go into bankruptcy, the carrier is still responsible from dollar one.

IV. Who Handles SIR vs. Excess SIR – the TPA or Carrier?:

This is an ongoing discussion and can be handled in several ways. In typical situations, most insureds will retain a carrier-approved TPA to administer the SIR claims and they will continue to handle excess of the SIR with carrier oversight. This avoids licensing issues around self-administration. In some cases, the carrier will assume handling of claims with the SIR, but only in catastrophic cases.

In cases where it appears the SIR will not be breached, the TPA will handle.
Where the value is not determined or is above 50% of the SIR, the carrier may monitor the TPA.

Should a claim be near the retention limit, the carrier may opt to allow the TPA to continue handling.

In high value cases where the excess layer will be impacted, not only might the carrier assume handling, but may change defense attorneys, too. Often the carrier will look to the insured to tender its SIR and assume handling.

V. Friend or Foe? Partnership for Resolution:

Developing a positive working relationship and strategy early on will help ease a potentially stressful situations as the claim develops. The best results occur when all parties are rowing in the same direction. And also that the parties' needs and desires are aligned. Under circumstances involving SIR's and a generally more sophisticated client, is it more likely that the stars will align or that the client will insist that it's their way or the highway? Or is it more likely that those choosing the path of the deductible and accordingly one less involved in claim's handling will present a bigger obstacle to be resolved?

VI. Claim Reporting Expectations:

Under a deductible plan the excess insurer is responsible for paying and defending all claims whereas with a SIR the insured assumes responsibility at a primary level. Because the liability of an excess insurer which is sitting above a SIR can be impacted by decisions taken by the insured, it is common for reporting requirements to be imposed by the

excess insurer that requires the insured to report any claims that have the potential to breach a certain threshold. These can not only be financial thresholds (such as 50% of the SIR) but also the types of claim such as types of bodily injury, which have the potential for significant claims to the excess insurer. The insurance carrier will impose reporting requirements on the insured in order to monitor the development of claims that may impact the liability limit to which the company is exposed. For example, the insured, typically, must report claims that involve fatalities, amputations, third-degree burns, brain injuries, and any other claim for which the insured sets a reserve of 25% or more of the SIR amount. This is a good area for both the insurer and insured to collaborate and create mutually agreed upon protocols.
Should the insurer take over the claims management of a specific claim, then it is usual for the defense costs to be borne by the carrier and not by the SIR.

VII. Concurrence Between Parties Prior to Deciding on a SIR or Deductible:

A self-insured retention means that the insured carries a fixed amount of risk, including adjusting and legal expenses. The insurance policy, whether a primary or umbrella contract, is excess coverage above the SIR. The carrier will require that adequate, proven risk management staff be in place, whether native or contracted. SIRs are rarely smaller than $100K, and can be $1M, $3M or higher for large companies with good controls and substantial liquid assets. Some states have legislation in place to regulate such "attachment point" business.

A deductible, on the other hand, is a portion of an insured loss borne by the insured. The carrier will typically pay the entire claim, and then be reimbursed by the insured. Unlike an SIR, a deductible erodes the limit of liability in the insurance policy. A policy with a $1M limit of liability and a $25K deductible, then, exposes the carrier to $975K. Loss adjusting and legal expenses typically further erode the limit.

Deductibles are commonly used with risks that have a frequency of smaller claims. Daily auto rental or taxicab fleets (lots of minor fender benders), contractors with multiple job sites, supermarket chains (lots of slip-and-fall activity)-are typical of the kinds of risks that can benefit from deductible treatments. Deductibles almost always include loss adjusting and defense expenses. All claims are reported per the policy's terms, and the carrier is involved in the adjusting process immediately.

Collateral instruments for these management tools include escrow accounts, by which the insured maintains a cash reserve with the insurance company (which may or may not pay interest on it), and evergreen letters of credit. Escrow accounts are more frequently

used with frequency-prone risks (think deductible), while a letter of credit is typically more suitable to an insured that carries a substantial SIR.

While the fine points these mechanisms provide differ in practice, their common goal is to reduce loss ratios and premiums for quality insureds who pay attention to their own risk/reward postures, and who share the character and values of the carriers that provide their coverages. An insured that has the ability to manage claims, and to therefore manage risk, should be very attractive whatever the condition of the insurance market.

VIII. Selection and Direction of Counsel – Who has the Say, Client or Insurer?

Policy terms dealing with provision of a defense or reimbursement of defense costs should be similar to those in conventional policies and should be similarly interpreted. One area of potential difference relates to the existence of a conflict of interest that might divest the insurer of the right to control the defense, even though that right is reserved in the policy.

What creates a conflict is an incentive for counsel retained by the insurer to defend in a way that serves the insurer's interests at the expense of those of the insured—for instance, by having any liability found only on non-covered grounds. The fact that the insured will be liable for payments below a certain level should not create a conflict any more than the fact that the insured will be liable for payments in excess of the policy limit. In neither case does the insurer have an incentive to direct the defense in a manner designed to do anything other than minimize liability.

A problem can arise when the claim appears to be solely within the insured's deductible or other self-insured amount. If the contract so provides, the insurer may select and retain counsel to defend the claim. But the insurer's right to control counsel's actions to the exclusion of the insured depends on the fact that, in the usual situation without self-insurance as to the initial portion of the claim, counsel is defending the interests of both the insurer and the insured, so that both may be regarded as counsel's clients in the traditional "tripartite relationship."

A similar problem or potential conflict may exist if the complaint by the third party contains counts that are covered and counts that are not covered. Generally the insurer has a duty to defend the entire claim. With a significant SIR, the insured can control the defense which may cause concern by the insurer who potentially will owe indemnity and can only reserve their rights as to uncovered counts.

If counsel is directed by the insured, but the insurer is liable for counsel's fees, then the insurer may challenge the amount of such fees in a fashion analogous to that applicable when a conflict of interest creates that situation. If the insured will be paying for counsel of its own selection but the insurer fears that the case will be mishandled in a way that will implicate the covered exposure, its remedy would seem to be to associate its own counsel to monitor the defense and question what appears to be improvident decisions. But control would appear to remain with the insured, and it is not clear that the insurer would be permitted to challenge those decisions as a defense to its duty to indemnify, even if they appeared wrong or unreasonable in retrospect, so long as they were made honestly and in good faith.

The insurer may have interests in choosing counsel to control expense and to realize efficiency or other economies. In addition, the insurer may have an interest in making sure assigned counsel is experienced in the particular area of law involved in the litigation. In many cases, however, the insurer has no ultimate involvement because many of the claims will fall within the SIR. Regardless of who selects counsel, however, the attorney providing the defense must always place the interests of the insured first. As a practical matter, however, the issue of who chooses counsel can have implications, both real and perceived, for both the insured and the insurer.

IX When/how do expenses erode SIR?

This is part of the negotiation between the underwriter, broker and insured during the quote process. Premiums will be greater if the SIR is eroded by expenses as the claim will reach the excess layer more quickly.

X. Collateral and Accruals:

Under a large deductible insurance policy, the insurer contractually agrees to pay all claims as they occur, while the policyholder is obligated to reimburse the insurer for all claims that fall under the deductible amount.

To secure the policyholder’s liability, the insurer requires the insured to post collateral. This collateral requirement is intended to safeguard the insurer against risk by:

- Protecting against credit losses — carriers are liable through the statutory obligation of the deductible portion of the policy.
- Fulfilling statutory requirements levied upon the insurers by the states.

- Meeting financial rating agencies' insurer surplus requirements, which is the ratio of total policyholders' surplus to written premiums.
- Preserving their financial rating.

Recent changes have resulted in more stringent underwriting, increased collateral requirements, and higher costs of collateral. Much of this evolution is due to greater scrutiny of insurers' financial accountability by rating agencies and regulators.

Insurers' collateral requirements are also affected by the shrinking amount of available bank credit, client balance sheet strength or weakness, and insurers' return on capital. Posting collateral has become an increasingly burdensome and expensive requirement for clients with loss-sensitive programs.

Availability of Letters of Credit

Clients can obtain LOCs through their bank/financial institution or, in some cases, through a third-party trust arrangement. The availability, as well as the cost of a LOC, greatly depends on the financial strength of the borrower and its relationship with its bank.

Banks

As a result of the current state of the US and worldwide economies — combined with the new regulatory oversight — banks are becoming more restrictive on the total amount of LOCs they extend to their customers, and LOCs can be quite costly. In addition, insurance carriers have limitations or aggregates that restrict the total amount of LOCs they will accept from any one bank or financial institution over multiple insureds, thereby causing additional concerns for those posting collateral.

Third-Party Trust Arrangements

Third-party trust arrangements are viable alternatives to LOCs and are more prevalent than they have been in the past. They are usually only for clients that are experiencing a restriction of credit from their bank or investors and can provide LOC capacity for clients unable to secure their own LOCs. Under this arrangement, the client must provide cash as security to the third party, which in turn will provide the needed LOC to the insurance carrier.

Alternatives to Customary Letters of Credit

Sine Carriers have become more flexible in accepting alternative forms of collateral to secure deductible responsibilities. Not all forms are universally accepted, and each needs to be negotiated based upon the carrier's guidelines and the specific financial merits of each client.

The most common alternative forms of collateral are:

- **Trust**, or **pledge of security**.
- **Cash**.
- **Surety bond**.
- **Credit buydown**

XI. What Happens When an Insured Files for Bankruptcy?

When the insured who files for bankruptcy maintains a SIR, many issues arise with regard to the payment and defense of claims that fall within the SIR and what constitutes satisfaction of the SIR. Even when the insured has filed for bankruptcy, an excess insurer will only be liable for any amount that exceeds the SIR. A SIR is not an amount that the debtor owes the excess insurer, but rather is the "threshold" of the excess insurer's liability to the debtor.

What constitutes satisfaction of the SIR is altered when the insured files bankruptcy. A typical policy provision provides that it shall be a condition precedent to the insurer's liability that the insured make "actual payment, by way of settlement or judgment of damages," of the SIR. Not surprisingly, insurers maintain that obligation to fund the initial losses is an absolute precondition to coverage. Some insurance policies require "actual payment," which includes the notion that the self-insurance constitutes primary insurance for purposes of the "other insurance" clause. On the other hand, policyholders argue that the bankruptcy provision should be construed as excising the deductible and SIR provisions from the policy altogether, which compels the carrier to "drop down."

The majority view treats SIRs and deductibles similarly. Under this view, an insurer must provide coverage above the SIR/deductible amount and up to policy limits even if the policyholder cannot pay the initial amount. Some courts require the insurer to provide coverage in excess of the SIR/deductible, up to the policy limit and sometimes even require the insurer to pay proceeds into the bankruptcy estate for distribution to creditors. The insurer may also be treated as an unsecured creditor in the bankruptcy action with respect to unpaid SIRs or deductibles.

The minority view requires the carrier to drop down and cover the costs, then seek reimbursement of the SIR/deductible from the insured, making the carrier a creditor in the bankruptcy proceeding for the amount of self-insurance.

Courts also have wrestled with disputes over who must satisfy the SIR/deductible. Carriers often point to policy definitions of “you” and “your” to support the argument that the named insured must be the one to pay the SIR/deductible amount, contending that it cannot be paid by others. When the question is whether payment by additional insureds, as opposed to named insureds, will obligate the insurer, at least one court has adopted the carrier view--based on the policy definitions--and found that satisfaction of the SIR/deductible by an additional insured is insufficient to trigger the carrier's obligation to pay.

XII. When is a SIR the Wrong Decision?

The pressure to contain insurance costs by increasing the portion of the risk retained by the insured continues to grow, larger SIRs and deductibles offer the commercial insured a series of advantages and disadvantages. Affirmatively, SIRs allow the policyholder to control the defense and settlement of smaller claims and, depending on the reporting requirement in the specific policy at issue, may allow the insured to keep smaller claims out of its experience rating. On the negative side, administering claims within the SIR may involve more staff and resources than planned or may require the insured to hire a third-party administrator (“TPA”) at its own expense to handle claims within the retention amount.

Deductible policies, allow the insured to avoid the indemnity obligations under a SIR, as well as the loss adjustment expenses associated with the SIR. In addition to lower premium costs, one of the major benefits identified by many commercial insureds whose policies have larger SIRs and deductibles is that they provide the company with an entirely new awareness of loss control which, hopefully, translates into an improved loss experience in the long run.

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