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Unmanageable Risk – An Unintended Consequence Of Self-Insured Retentions

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insurancepolicyimageSmallA Self-Insured Retention, or SIR, as it is commonly known as, represents the amount of risk that a company is prepared to retain for its own account. It denotes the point at which the risk passes from the company, as self-insurer, to a professional insurer. Typically, retention layer losses – those losses that remain with the company - are not catastrophic so as to impact the company's ability to remain a going concern. As such SIRs have been used by companies for decades as effective risk management tools. A recent decision out of the Eastern District of California potentially turns this risk management principle on its ear. In *Evanston Ins. Co.* (Evanston) *v. North American Capacity Ins. Co*. (NAC), the court required a contractor (Berry & Berry) accused of defectively constructing over 400 homes to pay a $10,000 SIR for each home allegedly damaged, rather than for each suit filed against it, before triggering NAC's duty to defend under its policies. See *1:13-cv-01365; Order Regarding Defendant's Motion for Partial Summary Judgment* (July 8, 2014). While there were only five lawsuits filed against Berry & Berry, those five suits contained defect claims related to 444 homes. The court's ruling required Berry & Berry to pay nearly $4.5 million - as opposed to $10,000 for each of the five suits filed - in order to exhaust its SIR before NAC is required to provide a defense under its policies. The Court concluded that the only reasonable interpretation of the policies' SIR endorsements was that the SIR applies on a per-home basis. The SIR endorsements provide in relevant part:

> The self-insured retention (retained limit) applies to each and every claim made against you, *regardless of how many claims arise from a single occurrence or are combined in a single suit*, and the company (NAC) has no duty to defend you unless and until the amount of the retained limit has been exhausted. **** The retained limit for each and every claim arising as a result of an occurrence . . . shall be$10,000 regardless of the number of claims from a single occurrence, suits brought or the number of claims incorporated into one such suit.

In addition, both policies define "claim" or "claims" as "a request or demand received by an insured or the Company for money or services, including the service of suit or institution of arbitration proceedings against any insured. Evanston, Berry & Berry's other insurer which was defending the suits, and seeking contribution of defense costs from NAC, argued that that NAC's requirement that Berry & Berry pay $10,000 per claim was satisfied by Berry & Berry paying that amount for each suit. Because five suits were brought, Evanston argued that Berry & Berry had exhausted its SIR by paying $50,000. Any other interpretation, Evanston argued would effectively render NAC's duty to defend illusory, in violation of public policy. The court rejected this argument and held that the SIR unambiguously applies on a per-home basis. Specifically, the Court cited the SIR endorsement which required that

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the retained limit of $10,000 be applied to each and every claim “regardless of how many claims arise from a single occurrence or are combined in a single suit.” The court further concluded that Barry & Barry could not have reasonably believed that a single SIR would apply to any suit filed, even if filed by multiple homeowners. Such an interpretation would render the SIR endorsement meaningless, as claims that could have been brought separately, and therefore be subject to separate SIRs, were subject to a only a single SIR when brought together. While the court acknowledged the language “may be onerous,” it found that it was similarly unambiguous, holding that the SIR applies on a per-home basis. Although not addressed in the *Evanston* decision, the SIR language at issue raises another area of concern for policyholders. The NAC policies are occurrence based policies, which require NAC to pay those sums that Berry & Berry becomes legally obligated to pay as damages for bodily injury or property damage to which the insurance applies. The insurance only applies to bodily injury and property damage if caused by an occurrence. NAC’s policies define occurrence as “an accident, including continuous or repeated exposure to substantially the same general harm.” Accordingly, for purposes of limiting its coverage obligations, NAC would argue that the damage to the 444 homes constitutes a single occurrence, because each home has been exposed to substantially the same general harm. Despite the fact that there are over 400 claims, NAC would only be required to pay its limits based on a single occurrence. Conversely, the NAC policy requires Berry & Berry to exhaust its SIR on a per-home, or claim-by-claim, basis. The effect is to cap NAC’s assumption of the risk at its coverage limits for a single occurrence, while exposing Berry & Berry to exponentially greater risk than Berry & Berry thought it was assuming under its SIR. This effectively transforms the retention layer of risk from one the insured deems manageable to a potentially catastrophic risk that impacts the policyholder’s ability to remain a going concern. Such a result is inconsistent with the risk transfer principles giving rise to the use of SIRs by policyholders to mitigate risk. Accordingly, the *Evanston* holding underscores the importance for policyholders to carefully review the language of proposed SIR endorsements, so as to fully understand and effectively manage the potential risk assumed under a SIR.