

## Deductibles and Self-Insured Retentions: Not Interchangeable Concepts

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### **Deductibles and Self-Insured Retentions: Not Interchangeable Concepts**

By Christopher P. Ferragamo

Whether representing insurers or insureds, attorneys practicing in the insurance coverage arena have inevitably been faced with insurance policies that contain self-insured retentions ( SIRs ) or deductibles. Unsophisticated insureds and inexperienced insurance practitioners often conflate and confuse these two concepts and/or use the terms interchangeably. Even experienced attorneys can be left scratching their heads when faced with applying SIRs or deductibles to actual coverage situations. Deductibles and SIRs, however, are separate and distinct and their application can dramatically affect the defense and/or coverage obligations of both insureds and insurers.

In addition, incorrect application of these two ideas can result in an insured paying part or all of a defense or settlement when, in fact, correct application would obligate an insurer to shoulder all of the defense and settlement costs. Moreover, correct application of these two concepts is particularly important when the underlying claimants and/or the insured demand that the insurer tender its full policy limits in an attempt to effectuate settlement. Although their proper application is governed by the terms and conditions of the insurance policy, insurance practitioners, nevertheless, must understand SIRs and deductibles so as to ensure their proper application. This article will address the primary differences between SIRs and deductibles, examine standard SIR and deductible provisions and provide examples that highlight how application of these two distinct risk retention devices can lead to very different results.

Many businesses choose to manage a portion of their risk of liability through deductibles and SIRs which, in effect, place responsibility for losses up to a specific amount on the insured. This self-assumption of a portion of the risk is often utilized by companies to reduce insurance costs. Although the concepts differ, deductibles and SIRs represent the insured's obligation to contribute toward covered claims.

Deductibles differ from SIRs in several important respects. The key distinguishing feature of a deductible is that it is payable by the insured at the end of the claim rather than at the beginning. Consequently, an insured who has obtained a policy with a deductible, as opposed to an SIR, has first dollar coverage. That is, the insurer is obligated to pay defense costs of a potentially covered claim from the beginning and the amount of the deductible will be assessed only after the claim is resolved. By contrast, SIRs generally obligate the insured to pay the first dollars expended in a claim. Many SIR provisions provide that the SIR can be satisfied through payment of claims (settlement or judgment) or defense costs. Thus, in a typical situation where defense costs are included within the SIR, the insured is obligated to satisfy the SIR through the payment of the earliest attorney fees and

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expert costs and, once the SIR has been satisfied, the insurer will assume the defense of the case and pay defense costs above the SIR. See e.g. *Hormel Foods Corp. v. Northbrook Prop. & Gas. Ins. Co.*, 938 F. Supp. 555, 560 (D. Minn. 1996); *Aerojet-General Corp v. Transport Indemnity*

*Co.*, 50 Cal. App. 4th 354 (Cal. Ct. App. 1996) (recognizing that when an entity makes a business decision to retain a portion of the risk, no duty to defend exists until retention limits have been exhausted). In addition, in policies containing SIRs, insureds may assume responsibility and control of claims handling until the claim exceeds the retained limit. By contrast, insurers assume the responsibility and control of claims handling for policies containing deductibles.

Another important distinction between deductibles and SIRs involves the effect upon policy limits. When an insured has purchased a policy containing a deductible, the amount of the deductible is frequently subtracted from the policy limits, thereby reducing the amount of available insurance. Ostrager & Newman, *Handbook on Insurance Coverage Disputes* § 13.13 [a] (12th ed. 2004). By contrast, in a policy subject to an SIR, the insurer's full policy limits will likely be available to respond to a loss after the SIR has been satisfied. *Id.* The distinction between these two concepts is particularly important in situations where the insured is unable to pay the deductible or SIR due to lack of resources or bankruptcy. In situations involving deductibles, the insurer is liable to pay the entire covered loss up to its full policy limit and is then left in the unenviable position of having to seek reimbursement of the deductible amount from the insured. In situations involving SIRs, however, the insurer is only obligated to pay the amount in excess of the SIR. The insurer is not obligated to pay the amount retained by the insured.

Deductibles and SIRs are commonly addressed in specially drafted endorsements. The Insurance Services Office, Inc.

(ISO) has promulgated the only countrywide endorsement for use with the commercial general liability coverage form-CG 03 00. The ISO form allows insurers or insureds to choose a deductible applicable to bodily injury claims, to property damage claims or to both; and also offers the option of deductibles that apply on a per claim or per occurrence basis. Although the general principle is that a deductible is generally subtracted from the policy limits, the effect of the deductible on the policy limits is governed by the terms of the endorsement. For example, prior to the introduction of ISO's 1993 multi-state revisions to its deductible form, liability deductibles imposed via the standard endorsement (CG 03 00) applied the deductible amount to both the amount of the insured loss and to the policy's occurrence limits. In other words, barring an insolvency, a policy with a

\$50,000 per occurrence deductible and a \$500,000 peroccurrence limit would never pay more than \$450,000 for loss arising out of a single occurrence. As a result, an insured having accepted responsibility for the first \$50,000 of the loss did not have \$500,000 of insurance above that deductible amount. By way of illustration, ISO form CG 03 00 11 85 contains the following provision:

Our obligation under the Bodily Injury Liability and Property Damage Liability Coverages to pay damages on your behalf applies only to the amount of damages in excess of any deductible amounts stated in the Schedule above as applicable to such coverages, and the limits of insurance applicable to

each occurrence for such coverages will be reduced by the amount of such deductible. Aggregate limits for such coverages shall not be reduced by the application of such deductible amount.

Application of liability deductibles changed with the 1993 edition of CG 03 00. With this change, the deductible now reduces only the amount payable by the insurer for a covered loss, not the per occurrence limits of the

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policy. Thus, a policy with a \$50,000 per occurrence deductible and a \$500,000 per occurrence limit would pay the full \$500,000 policy limits for losses arising out of a single occurrence. Consider the following hypothetical involving a demand for the full policy limits of a policy with a

\$500,000 per occurrence limit and \$50,000 deductible that incorporates the 1993 ISO form. Although the insurer would be obligated to pay the full \$500,000 policy limits at settlement, once the insurer has been reimbursed by the insured for the

\$50,000 deductible, the policy would have \$50,000 in remaining limits available to the insured for that occurrence since the insurer would only have paid \$450,000 towards the settlement. The remaining policy limits are valuable because the insurer's duty to defend claims arising out of the same occurrence would continue until the per occurrence limits have been exhausted. The change is reflected in ISO form CG 03 00 10 93 which now provides as follows:

Our obligation under the Bodily Injury Liability and Property Damage Liability Coverages to pay damages on your behalf applies only to the amount of damages in excess of any deductible amounts stated in the Schedule above as applicable to such coverages

The ISO deductible forms, however, are consistent in that they both clearly provide that the insurer's duty to defend is not affected by the inclusion of a liability deductible. In this regard, the forms expressly state that:

The terms of this insurance, including those with respect to:

1. Our right and duty to defend the insured against any suit seeking those damages; and
2. Your duties in the event of an occurrence, claim or suit apply irrespective of the application of the deductible amount.

As such, assuming that the standard deductible forms have been included in a policy containing an ISO CGL policy form

(which generally provides that defense costs constitute

Supplementary Payments paid in addition to the policy limits), the insurer will be obligated to pay a first-dollar defense and such defense costs will not erode the limits of the policy. In addition, both ISO deductible forms expressly state that the insurer may pay part or all of the deductible amount in order to effect settlement but the insured must promptly reimburse [the insurer] for such part of the deductible amount as has been paid by [the insurer].

Unlike with respect to deductibles, ISO has not issued a standard country-wide endorsement for self-insured retentions. SIRs are generally addressed in insurer-specific manuscript forms. By way of example, following is an excerpt of an SIR endorsement, a variation of which can be found in many CGL policies:

Our obligation to pay those sums that you become legally obligated to pay as damages applies only to

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the amount of damages in excess of any Self-Insured Retention stated in the Schedule above which the Policy would otherwise apply, subject to the limits of Insurance set forth in the Declarations of the policy to which this Endorsement applies and the occurrence to which the Policy applies.

You shall be responsible for the investigation, defense and settlement of any claim or suit for damages within the Self-Insured Retention, and for the payment of all Allocated Loss Adjustment Expenses. You shall exercise the utmost good faith, diligence and prudence to settle all claims and suits within the Self-Insured Retention.

We shall have the right but not the duty to participate with you at our own expense in the defense or settlement of any claim or suit seeking damages covered under the Policy. In the event of a claim or suit which in our reasonable judgment may result in payments, including Allocated Loss Adjustment Expenses, in an amount in excess of the Self-Insured Retention, we may, at our sole discretion, assume control of the defense or settlement of such claim or suit. You will continue to be responsible for the payment of the Self-Insured Retention.

We shall only be liable for losses covered under the Policy up to the Limits of Insurance in excess of the Self-Insured Retention listed in the Schedule hereof, whether or not such Self-Insured Retention is recoverable or collectible.

See *Liberty Mut. Ins. Co. v. Wheelwright Trucking Co.*, 851 So. 2d 466, 487 (Ala. 2002).

The SIR endorsement cited above affects coverage under the policy in four important ways: (1) the insured is responsible for paying the first dollars in defense costs of the claim and is obligated to pay such costs until the SIR has been exhausted;

(2) the insured's payment of defense costs will erode the SIR;

(3) the insured is entitled to full policy limits under the policy once the SIR has been exhausted, and; (4) the insurer is not responsible for paying amounts within the SIR in instances where the insured is insolvent.

Attorneys practicing in the insurance coverage arena must be cognizant of the distinctions between deductibles and SIRs, the proper application of these two concepts and the effects they have on the rights and obligations of insureds and insurers. As demonstrated above, the two concepts are separate and distinct and their applications can and do affect both the defense and coverage obligations owed by the parties to an insurance policy both in the short term and in the long term. In considering the proper application of deductibles and SIRs, insurance practitioners should be mindful of the following three questions: (1) what amounts are the insured and/or insurer obligated to pay; (2) when are the payments due (i.e., at settlement or later), and; (3) are there remaining policy limits after settlement has been completed? Insurance practitioners are advised to carefully examine deductible and SIR provisions in answering these questions as the terms and conditions of such provisions will ultimately govern their proper application.

The opinions expressed in this article are not necessarily those of the author's firm or clients.

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