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Construction Law

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A Primer on Self-Insured Retentions

Construction companies and contractors face a myriad of options when selecting the appropriate commercial general liability insurance coverage. One of the many factors in choosing a suitable insurance policy is whether to utilize a form of self-insurance referred to as a self-insured retention ("SIR") rather than a policy with a deductible. At first glance, a SIR and a deductible appear to be similar concepts with respect to insurance policies. However, upon closer inspection, there are significant ramifications in choosing a SIR as opposed to a deductible. Potential concerns for a construction company or contractor in deciding between a SIR or deductible include primary versus excess insurance, horizontal exhaustion, "other insurance" provisions of a policy and indemnification implications.

SIRs and Deductibles

With a SIR, when a claim is made, the insured agrees to pay up to a certain amount, and the insurer pays only after that certain amount has been exceeded. A SIR is a risk that the insured has agreed to retain for itself. *Practical Tools for Handling Insurance Cases* §1:43 Deductibles and Self-Insured Retentions (July 2017). Essentially, with a SIR, no insurance coverage exists until the predetermined amount has been met. The insured must pay its agreed portion of the loss before the insurance policy is activated and the insurer is obligated to pay. *Id.* Importantly, until the amount of the SIR has been reached, the insurer is not compelled to defend the insured and the insured is responsible for all of its own settlement decisions and costs of defense, if any. *Id.*

Illinois courts have cited to decisions from other states, which characterize SIRs as "the antithesis of insurance." *Fellhauer v. Alhorn*, 361 Ill. App. 3d 792, 796 (4th Dist. 2005) quoting *American Nurses Ass'n v. Passaic General Hospital*, 192 N.J. Super. 486, 491 (1984). In doing so, the appellate court explained that unlike insurance, where the risk of loss is shifted from the insured to the insurer, no such shift occurs under a SIR until the agreed certain amount has been met. *Fellhauer*, 361 Ill. App. 3d at 798. Under a policy with a SIR, the insured initially bears the risk of loss that has been levied upon them and must pay all settlements or judgments before the SIR limits are reached. *Id.* at 798.

SIRs and deductibles are distinct entities. While they both represent amounts at which the insurer becomes responsible for the loss, for a deductible, the insurer initially covers the loss, with the insured eventually being obligated to reimburse the insurer for the amount of the deductible. *Practical Tools for Handling Insurance Cases* §1:43 Deductibles and Self-Insured Retentions (July 2017). When a claim is made on an insurance policy with a deductible, the insurer has an immediate responsibility to defend a covered claim. In that instance, as opposed to a policy with a SIR, the insurer controls the settlement of that claim, regardless of whether the amount of the deductible has been met. *Id.* With control of the claim from the outset, the insurer is not required to obtain the insured's consent when negotiating or agreeing to a settlement amount that is within the deductible. For a deductible-based policy, the insurer assesses whether the settlement is appropriate, though the insured pays the settlement amount up to the deductible limit. *Id.* As a result, in considering whether to opt for a SIR or standard deductible policy, construction

companies and contractors need to evaluate whether future claims would be best handled by themselves, their legal counsel, or their insurer.

Of course costs go hand in hand with the responsibility of defending a claim. Who initially pays the cost of defense signifies another difference between SIRs and deductibles. With deductibles, when early settlement negotiations occur at the outset of a claim, the insurer pays all defense costs, with the insured later reimbursing the insurer up to the deductible limit. *Insurance Coverage of Construction Disputes* §4:6 Deductibles and Self-Insured Retentions (November 2017). In contrast, at the outset of a claim with a SIR-based policy, the insured pays the defense costs and the insurer is not involved with the claim until the agreed limit for that SIR has been met. *Id.* Only after that point, the insurer steps in and covers defense costs.

Similarly, if or when payment is made to the claimant, the logistics of that payment, also differ between an insurance policy with a deductible or SIR. For a deductible policy, the insurer first pays the settlement or judgment amount to the claimant, then pursues reimbursement from the insured for the deductible amount, if and when appropriate. *Id.* For a SIR, any payment or payments made to the claimant until the SIR amount has been reached are paid directly by the insured. *Id.* Construction companies and contractors must measure the balance between the pricing of insurance policies with SIRs or deductibles, as well as their ability to pay for defense costs or settlements at the outset of a claim.

SIRs and deductibles also differ with respect to insurance policy limits. For an insurance policy with a deductible, the policy limits reflect the actual amount of insurance coverage afforded by the policy, with the deductible amount included within the relevant policy limits. *Id.* On the other hand, with a SIR-based policy, the certain agreed amount of that SIR is not included in the policy limits, so that the amount of actual insurance coverage is the difference between the policy limits and the SIR amount. *Id.* This difference in policy limits may be applicable with respect to certain construction or service agreements that contain minimum insurance coverage provisions. Likewise, while a SIR must be disclosed on a certificate of insurance, the insurer has no obligation to include the deductible amount on the certificate. *Id.*

SIRs, Primary Insurance Coverage, and Horizontal Exhaustion

A construction company or contractor considering whether to include a SIR as part of its overall liability coverage should also take into account the various interpretations of SIRs as either primary or excess insurance coverage. Primary and excess insurance coverage, in conjunction with SIRs, apply in distinct fashions. Excess insurance coverage provides an additional level of coverage where a judgment or settlement exceeds the SIR or primary insurance policy limits, after the SIR or predetermined amount of primary insurance coverage has been expended. *John Crane, Inc. v. Admiral Ins. Co.*, 2013 IL App (1st) 1093240-B, ¶ 42. Even if an excess insurance policy has been triggered, the limits of the SIR or primary coverage must be exhausted before the excess insurer is compelled to contribute to a settlement or judgment. *John Crane, Inc.*, 2013 IL App (1st) 1093240-B, ¶ 42. Where there are multiple primary insurance policies, the excess insurance policies may not be obligated to contribute to a judgment or settlement until all primary insurance coverage has been expended. *Id.* ¶ 42. This concept is referred to as horizontal, rather than vertical, exhaustion.

For example, under the model of horizontal exhaustion, Illinois courts have held that an insured is "required to exhaust all applicable underlying coverage … before reaching any excess insurance." *Missouri Pac. R. Co. v. Int'l Ins. Co.*, 288 Ill. App. 3d 69, 81 (2d Dist. 1997). The insured in *Missouri Pacific* held a SIR and sought to manipulate its insurance coverage to "avoid absorbing the cost resulting from its position as a self-insurer." *Missouri Pac. R. Co.*, 288 Ill. App. 3d at 81. The insured was prevented from vertically exhausting its insurance coverage to select particular

insurance policies to apply to its loss, in an effort to circumvent the complications encountered by its SIR and the bankruptcy of a portion of its insurers. *Id.* at 81–82. Specifically, the court held that the insured was not allowed to seek insurance coverage from particular excess insurers while disregarding other sources of coverage. *Id.* The court reasoned that if an insured were permitted to do so, the barrier between primary and excess insurance coverage would be effectively eliminated and the holder of the SIR or primary insurer could "escape unscathed when they would otherwise bear the initial burden of providing indemnification." *Id.* at 82.

Rather than the vertical exhaustion of insurance coverage attempted in *Missouri Pacific*, Illinois decisions are clear that an insured's coverage must be horizontally exhausted, so that all primary or underlying polices are used prior to the expenditure of any excess coverage. C*ommonwealth Edison Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA.*, 323 Ill. App. 3d 970, 986 (1st Dist. 2001). Particularly, the insured's primary insurance coverage, including any SIRs, must be exhausted before any excess coverage is triggered. *John Crane, Inc.*, 2013 IL App (1st) ¶ 41. These rulings underscore the assessment of SIRs as primary insurance. In particular, the court in *Missouri Pacific* emphasized that a SIR must be interpreted as primary coverage, and consequently must be exhausted prior to any other insurance coverage. *Missouri Pac. R. Co.*, 288 Ill. App. 3d at 82. "To hold otherwise would allow Missouri Pacific to manipulate the source of its recovery and avoid the consequences of its decision to become self-insured." *Id.*

With respect to cost of coverage, which is often a significant factor in a construction company or contractor's selection of an insurance policy, horizontal exhaustion "is required because excess coverage carries a smaller premium than primary coverage due to the lesser risk insured." *Id.* at 81. Correspondingly, the excess insurer substantially reduces the insured's risk of loss, with that reduced risk being signified in the cost of the excess insurance policy. *Id.*

SIRs and "Other Insurance"

As in *Missouri Pacific*, it is often the plain language of the "other insurance" provisions of the policies that view a SIR as "other insurance," thereby differentiating SIRs and deductibles. *Id.* at 83. While a SIR is interpreted as constituting "other insurance," a deductible is not considered "other insurance" within the plain meaning of a policy. *Id.* The plain language of the insurance policy at issue in *Missouri Pacific*, similar to the language found in other policies, stated that the insured must exhaust all "other insurance" coverage prior to the insurers being required to contribute to a settlement or judgment. *Id.* Importantly, SIRs, as opposed to deductibles, constitute "other insurance" with respect to these insurance policy provisions. The *Missouri Pacific* court found that it was the "other insurance" provision of the insurance policy that required the insured "to exhaust all underlying coverage, including its SIRs, before it [sought] coverage under the policies." *Id.* at 84.

In direct contrast, other courts have held that SIRs do not fall under the "other insurance" provisions of insurance policies, and therefore SIRs do not constitute primary insurance. Those courts have found that when an insured chooses a SIR-based policy rather than one with a deductible, it has opted "to completely retain the risk of a particular loss" up to a certain amount, and that a SIR is not insurance, and therefore does not constitute "other insurance." *Chicago Hosp. Risk Pooling Program v. Illinois State Med. Inter-Ins. Exch.*, 325 Ill. App. 3d 970, 982 (1st Dist. 2001). One court reasoned that "a true self-insured does not share an identity of insurable interests and risks with a traditional insurance carrier because it has chosen to retain its risk rather than shift any of that risk to a commercial carrier." *Chicago Hosp. Risk Pooling Program*, 325 Ill. App. 3d at 982. Similarly, SIRs are not deemed "other insurance" for purposes of assigning liability for contribution. *Caterpillar v. Century Indem. Co.*, 2007 WL 7947740, at *5 (Ill. App. Ct. 3d Dist.

Feb. 2, 2007). Construction companies and contractors must be mindful of any "other insurance" provisions of prospective policies if they are contemplating a SIR rather than a deductible.

In certain instances, courts have also found that horizontal exhaustion may not apply with respect to SIRs. *See*, C*ommonwealth Edison Co.*, 323 Ill. App. 3d 970 at 986. Unlike *Missouri Pacific*, the "other insurance" provision at issue in C*ommonwealth Edison* failed to reference SIRs, or any other form of self-insurance. *Id*. at 987. The court in *Commonwealth Edison* further differentiated its analysis from *Missouri Pacific*, noting that in *Missouri Pacific*, the question posed to the court was whether the insured was obligated to exhaust its SIRs as primary insurance before it could obtain any coverage under any excess insurance policies. *Id.* In *Commonwealth Edison*, a utility company sought coverage for a claim as an additional insured under the primary insurance policy of a tree maintenance company. *Id.* at 973. The court found that the principle of horizontal exhaustion did not apply because, while the utility company did have an excess insurance policy with a SIR, its primary insurance coverage was via its status as an additional insured under the primary insurance policy of the tree maintenance company. *Id.* at 988. This scenario is markedly different from an insured attempting to circumvent its SIR under its primary policy and move directly towards seeking coverage from its excess insurer. In *Commonwealth Edison*, the court noted that the utility company "made no attempt to invoke coverage under its separate excess policy under which it had taken its SIR." *Id.* The utility company never reached its excess insurance, and therefore never invoked its SIR, since it was covered as an additional insured under a separate primary insurance policy. *Id.*

SIRs and the Construction Contract Indemnification for Negligence Act

The Illinois Construction Contract Indemnification for Negligence Act ("Indemnification Act") proscribes any agreement to indemnify an individual from that individual's own negligence as void against public policy. 740 ILCS 35/1. However, the Indemnification Act specifies that it "does not apply to construction bonds or insurance contracts or agreements." 740 ILCS 35/3. In doing so, the Indemnification Act provides that while parties cannot agree to indemnify individuals for those individuals' own negligence, those individuals may agree to procure insurance coverage for their own negligence. In construing the statute's application to SIRs, Illinois courts have held that a subcontractor's promise to include the general contractor under its SIR, and thereby indemnify that contractor, would "invoke the insurance exception" and thus circumvent the Indemnification Act's directive to prevent indemnification of an individual's own negligence. *USX Corp. v. Liberty Mut. Ins. Co.*, 269 Ill. App. 3d 233, 243 (1st Dist. 1994). The Indemnification Act would essentially be rendered useless if "a distinction were to be made between self-insurance and indemnity." *USX Corp.*, 269 Ill. App. 3d at 243. To maintain the efficacy of the Indemnification Act, a contractor must not be permitted to "simply substitute a requirement that the subcontractor 'insure' the contractor against its negligence rather than deploy the term 'indemnify.'" *Id.* "'[S]elf-insurance' is merely a recognition that there is no insurance, a 'mere private promise to indemnify.'" *Beloit Liquidating Tr. v. Century Indem. Co.*, 2002 WL 31870525, at *2 (N.D. Ill. Dec. 20, 2002). This assessment is noteworthy for legal counsel of Illinois construction companies and contractors that are contemplating SIRs as part of their overall liability insurance coverage.

Conclusion

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When evaluating whether to choose a SIR or deductible, a construction company or contractor, as well as their legal counsel, must contemplate a variety of elements, including whether the SIR would be applied to a primary or excess insurance policy, whether that application would have any potential bearing with respect to horizontal exhaustion, whether there are pertinent "other insurance" provisions in the policy at issue, and whether that policy would be affected by the Indemnification Act.

About the Author

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