EXPLORING THE SELF-INSURED - INSURER RELATIONSHIP

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I. INTRODUCTION

Self-insurance, in its various forms, has become increasingly common. With the rising costs of insurance, self-insurance has been utilized by many large trucking companies to control rising premiums and also to manage their claims. Self-insurance allows companies with substantial financial resources to assume some or all of their risk. In making the decision to self insure, companies have adopted a variety of methods including true self-insurance or pure risk retention; purchase of insurance with a self-insured retention; fronting policies; and the purchase of policies with retrospective premiums.

Most commonly, businesses choose to manage a portion of their risk through the use of self-insured retention ("SIR"), which places responsibility for losses up to a certain amount upon the insured with an insurance policy covering losses above that amount. An SIR essentially operates as a deductible -- the insured itself pays the first level of loss. Unlike a deductible where the insured is obligated to pay a specific sum of loss, but not the cost of defense, an SIR applies to payments not only for judgments or settlements, but also for defense expenses. The insured must exhaust the amount of the SIR before the insurer will respond to the loss. Thus, an insured whose coverage is subject to an SIR may retain its own defense counsel and control the entire claims handling effort.

SIRs generally are incorporated into an insurance policy, which may be written either as a primary policy or as an excess or umbrella policy. When an SIR is under an excess policy, it is commonly referred to as the "retained limit". An "excess" or secondary insurance policy provides coverage "whereby, under the terms of the policy, liability attaches only after a predetermined amount of primary coverage has been exhausted." *See Whitehead v. Fleet Towing Co.*, 442 N.E.2d 1362; 110 Ill. App. 3d 759 (1982); *Olympic Ins. Co. v. Employers Surplus Lines Ins. Co.*, 178 Cal. Rptr. 908, 910; 126 Cal. App. 3d 593 (1982). Thus, excess insurance is the next "layer" or "level" of coverage above the primary policy or the insured's SIR.

Since the relationship between the excess insurer and its insured is contractual, the rights and obligations of both the insured and the excess carrier must be determined by the policy provisions. Excess policies often contain the same or similar basic provisions as a primary liability policy. The excess carrier and the insured may agree to add particular conditions or endorsements to the form policy either to broaden or to narrow the excess coverage. Generally, an excess insurance policyholder that self-insures instead of purchasing a primary policy must exhaust its SIR before the excess insurer is required to respond to a loss.

A company considering some form of self-insurance needs to be aware of not only the heightened financial exposure in connection with unexpected losses, but also the unpredictable legal ramifications of being a self-insurer. Some courts and legislatures have chosen to treat self-insurers as insurers for purposes of the obligations imposed by insurance laws. Issues frequently arise as to whether self-insured amounts should be considered as insurance in various settings, including questions regarding the effect of the SIR on the obligations of insurers above the SIR.

Generally speaking, these questions are resolved with reference to several factors: (a) applicable statutes, (b) policy implications (e.g., protection of the public versus allocation of a loss among insurers), (c) whether the self-insured entity has made a conscious decision to assume certain risks and has set aside funds for this purpose, and (d) whether the SIR, when examined in the context of the insurance policy it underlies, is in essence a deductible. *See generally* 1 COUCH ON INSURANCE § 10.1 (3d ed. 2000).

The rights and obligations between excess carriers and their insureds are far from clear in cases involving SIRs. Among the most practical concerns are: who has the right to select and control counsel; who has control over the decision to settle and what are the attendant consequences for failure to settle; and what are the practical implications of a reservation of rights in such circumstances. This article will explore some of the most common issues that arise between the excess carriers and their insureds.

II. NOTICE OF CLAIM

Excess insurers frequently have the option to become more involved in the day-to-day handling of claims. This option may be triggered when the insured is facing a claim which may exceed its SIR.

An express condition of most liability policies, including excess policies, is that the insured must give its insurer timely notice of all claims and lawsuit brought against the insured. Generally, the primary insurer is obligated to undertake the investigation and defense of claims against the insured when it receives notice of claims potentially covered under the policy.

An excess carrier can also include a notice provision in its policy in order to allow itself to become involved in the handling of the claim. The notice requirement allows the excess insurer the opportunity on a timely basis to evaluate its coverage position, investigate and evaluate the merits of the lawsuit against the insured, review the files of the insured and its counsel and, if it so chooses, become involved in the handling of the liability lawsuit.

In *Sisters of Divine Providence v. Interstate Fire & Cas. Co.,* 453 N.E.2d 36; 117 Ill. App. 3d 158 (1983), the insured medical center was sued for malpractice by a patient who contracted meningitis. The medical center maintained a $ 100,000 SIR, followed by a $ 100,000 excess policy and a $ 5 million second level excess policy. More than two years after the lawsuit was initiated, defense counsel notified the insured that the minor's injuries were "catastrophic." Nonetheless, the second level excess carrier was not notified of the lawsuit until one month prior to trial.

In subsequent coverage litigation, the excess carrier argued that it received late notice as a matter of law. The policy contained a condition precedent requiring notice of a lawsuit as soon as practicable. The court found that the insured had actual knowledge of the liability and damages, and could offer no excuse for its delay in providing notice. Accordingly, the court held that the excess insurer afforded no coverage.

In *Prince George's County, Maryland v. Local Gov't Ins. Trust*, 879 A.2d 81; 388 Md. 162 (2005), the county was self-insured and possessed excess insurance through an insurance pool. A lawsuit was filed against the county for police brutality. After a judgment was rendered against the county, the county notified the insurance group seeking indemnification. The policy provided that the insurer must be given the opportunity to participate in the investigation, settlement, or defense of the claim. Since the self-insurer breached the terms of the policy, and the excess insurer had been prejudiced, the court held that the excess insurer was not obligated to indemnity.

Clearly, careful consideration must be given to the notice provisions. The failure to promptly notify the excess insurer can jeopardize the insurance and ultimately place the company on risk for the entire loss.

III. DUTY TO DEFEND

Where the insured retains the right to control the defense, the excess insurer does not normally undertake the duty to defend. Generally, the excess insurer has no duty to defend until the insured's SIR is exhausted. However, an excess insurer can have the contractual *right* to participate in an insured's defense where policy limits are implicated. Many excess policies allow the carrier the "option" to defend lawsuits pending against the insured. This provision is intended to allow the excess insurer, if it so chooses, to become involved in actively defending lawsuits which could involve its layer of coverage. The option is generally exercised by carriers in situations where there is significant exposure in excess of the underlying limits. Most courts have held that even though an insurance policy allows the excess insurer the right or option to defend lawsuits, the carrier does not thereby have a duty to defend the insured. If an excess insurer defends a lawsuit, it is obligated to assume the same duties as the insured, and can be held liable for failing to properly defend the insureds' interest.

Even though the excess insurer may exercise the option to defend, the insured is normally still responsible for defense costs. In *Chicago & Eastern Illinois Railroad Co. v. Reserve Ins. Co.,* 425 N.E.2d 429; 99 Ill. App. 3d 433 (1981), the court held that the insurer was not obligated to pay defense costs since the insured was contractually obligated to provide its own defense. Finding that the insurer was not required to defend, the court stated:

> The insurance policies provide that: "The Assured shall be responsible for the defense or settlement of any claim made or suit brought or proceeding instituted against the Assured which no other insurer is obligated to defend." Furthermore, under these policies, the insurers merely had the right to "participate with the Assured" in the defense. . . . We find no basis for disregarding the contract language and imposing upon the insurers a duty to defend the insured which the insurers did not undertake in the insurance policies.

Id. at 438.

Similarly, in *City of Peoria v. Underwriters at Lloyds' London,* 290 F. Supp. 890 (S.D. Ill. 1968), the policy allowed the insurers, "if they so desire," to "take over the conduct . . . of the defense of any claim" covered by the policy. The court held that the insurer was not required to defend suits against the insured. The court noted the policy language created the right, but not the obligation to defend.

City of Oxnard v. Twin City Fire Ins. Co., 44 Cal. Rptr. 2d 177; 37 Cal. App. 4th 1072 (1995) also dealt with the issue of an excess insurer's duty to defend. The self-insurer was covered under an excess policy. In a lawsuit against the self-insurer and other defendants, the total settlement amount of $306,000 exceeded the self-insurer's $100,000 SIR; however, the self-insurer's share of the settlement amount ($98,000) was still within its SIR. The self-insurer argued that 1) the excess insurers were primary insurers and had a duty to defend because there was potential policy coverage; and 2) the "ultimate net loss" amount was the total settlement amount of $306,000 and, therefore, over the SIR of $100,000. The court rejected both of these arguments, finding that the excess insurer had no duty to defend.

The courts have found some instances where the excess insurer can be obligated to pay defense costs once it is determined that there is a potential for liability above the amount of the SIR underlying its policy. *In Builders Transp., Inc. v. Ford Motor Co.*, 25 F. Supp. 2d 739 (E.D. Tex. 1998), the self-insured trucking company was covered by a primary policy issued by Planet Insurance Co. (Planet) and an umbrella policy issued by the Insurance Company of the State of Pennsylvania (ISOP). An accident occurred which implicated all levels of the self-insurer's insurance coverage. The court, in determining liability among the insurers, looked first to the policy language. The ISOP umbrella policy (indistinguishable from an excess policy) stated: "Should applicable underlying insurance(s) become exhausted by payment of covered claims, this insurance will continue in force as underlying insurance and shall defend any suit arising out of a covered occurrence." *Id*. at 742.

The self-insurer argued that the language of the ISOP policy incorporated by reference the terms of the Planet policy, requiring that ISOP contribute a pro rata share of the entire defense cost incurred. ISOP contended that the language did not incorporate by reference, and that it was obligated to pay only defense costs incurred after the exhaustion of the Planet policy. The court held that ISOP was obligated to pay a pro rata share for the defense of the whole underlying case, not merely for the amounts incurred after exhaustion of the policy. The court also noted that had ISOP intended to limit its liability as it argued, it could have included express language to that effect in the policy. The court also states the general law that:

> In Pennsylvania, Texas and New York, the determination of whether an excess or umbrella insurer is liable for a proportionate share of all costs and fees incurred in defending an insured begins with an examination of the various layers of coverage, and the specific language of the policies themselves. Courts require pro-rata sharing of defense costs where, as here, the language of the excess or umbrella policy incorporates by reference a proration of costs and fees provision contained in an underlying policy.

Id. at 744 (internal references omitted). In short, the court found that the policy language imposed a duty upon the excess insurer to defend and, thus, it was responsible for its share of the defense costs.

In *Cooper Laboratories, Inc. v. Int'l Surplus Lines Ins. Co.*, 802 F.2d 667 (3d Cir. 1986), it was held that an insurer has an immediate duty to defend, without limitation or condition, once it is determined that there is a potential for liability above the amount of the SIR underlying its policy. In this case, the insurer provided products liability coverage in excess of one million dollars retention to the insured pharmaceuticals manufacturer. The policy also obligated the insurer to defend any suit against the insured alleging bodily injury within the policy period. The insured settled a personal injury suit and demanded reimbursement, including the cost of defense, from the insurer. Upon the insurer's refusal to reimburse, the insured brought suit under the policy. The insurer contended that the manufacturer was self-insured up to one million dollars and so had a duty to defend "as do primary insurers as a matter of insurance industry custom." *Id.* at 675. The Third Circuit disagreed, stating:

> This contention may be dismissed rather quickly. Cooper is neither a primary insurer nor an insurer at all. A duty to defend is a matter of contract, and the reason why primary insurers provide a defense is that their policies require that they do so. An industry custom allocating responsibility when two carriers both may have a contractual duty is not applicable when one of the parties bears no obligation.

Id. The insured contended that the insurer's obligation to defend arose when plaintiff submitted its first demand in the amount of $3,500,000, a claim within the insurer's policy limits. The insured did not contend that the "right and duty to defend" language imposes an unlimited obligation on the insurer, but restricts its argument to claims "seeking damages in excess of the retention." *Id.*

The court stated if the judgment sought against the insured is one that the carrier would be required to pay, then the duty to defend exists. Thus, the court held that the insurer was obligated to reimburse the insured for part of the cost of defense.

Thus, the general proposition is that an excess insurer is not liable for any portion of defense costs if the insured is potentially liable in the underlying action where the excess insurer has only the right, but not the duty to defend where the SIR is not exhausted. However, when the policy imposes a duty to defend, the excess insurer will be responsible for at least a portion of the defense costs.

IV. INTERVENTION

Generally, the excess insurer relies heavily on the insured's claims handling expertise, including the evaluation and defense of actions against the insured as well as the timely recognition and resolution of coverage issues. On occasion, the insured may not in its claims handling adequately protect the excess insurer's interests. Accordingly, the excess insurer may, in appropriate circumstances, consider seeking leave to intervene either in the underlying litigation against the insured or in coverage litigation involving underlying carriers.

Provided its involvement in the underlying action will not create an impermissible conflict of interest, an insurer may consider intervening in the action pending against the insured in order to protect its subrogation rights, to seek a stay pending resolution of coverage issues in another court or to seek answers to special interrogatories which could clarify or resolve coverage questions.

An excess insurer's petition to intervene, which can in certain circumstances serve as an effective mechanism to control potential exposure in excess of the primary limits, is governed by the same rules of procedure that apply to other litigants. *See, e.g.,* Federal Rule of Civil Procedure 24. In the event an excess insurer's interests are not adequately being protected either in connection with the underlying suit or a declaratory judgment proceeding, it nonetheless must meet each element required either for intervention as a matter of right or for permissive intervention.

V. DUTY TO SETTLE

Where a loss is likely to exceed the amount of an SIR, the issue arises as to whether the insured or its insurer above the SIR should have control over settlement decisions. Faced with a settlement demand at or about the amount of the SIR, the insured may wish to take its chances at trial in a case where there is a possibility of obtaining a defense verdict, since its risk is capped at the amount of the SIR. The excess insurer would want the matter to be settled so as to avoid exposing its layer of coverage. Since both the insured and the insurer have a substantial financial stake in the litigation, each can make compelling arguments as to why it should control settlement decisions.

An excess insurer may contend that the insured SIR has a duty to accept a settlement offer within the amount of the SIR to avoid exposing the insurer to liability. In California, it has been held that the insured neither has a duty, nor can a duty be predicated upon an implied covenant of good faith and fair dealing. *See Commercial Union Assurance Cos. v. Safeway Stores, Inc.*, 610 P.2d 1038; 26 Cal. 3d 912 (1980). The insured, however, may not ignore a reasonable settlement offer within the SIR. Further, the "cooperation" clause in a policy may require the insured to contribute its SIR to settle a third-party action; in other words, the insured cannot "permit" the insurer to settle a claim in excess of its SIR and then refuse to contribute the amount of the SIR.

Some insurers attempt to protect themselves against an insured's unreasonable failure to accept a reasonable settlement offer by including the following language in their defense and/or "cooperation" clauses: "The Insured will use diligence and prudence to settle all claims and suits which reasonably should be settled, provided, however, that the Insured will not make or agree to any settlement for any sum in excess of the Underlying Insurance without the Company's prior written approval."

The other side of this issue is whether an insurer may agree to a settlement without the insured's consent where the insured has a substantial deductible or SIR that must be applied to the settlement. Some policies expressly grant the insured the right to control acceptance or rejection of settlement demands. In such cases, the policy language will be upheld. Other policies give the insurer the right to settle a suit involving a loss that might exceed the SIR. For example, in *New York City Housing Auth. v. Housing Auth. Risk Retention Group, Inc.*, 203 F.3d 145 (2d Cir. 2000) (applying New York law), the court of appeals, construing a liability insurance policy provision authorizing the insurer to settle if there was a reasonable chance that the loss would exceed the SIR, held that a court should employ an objective standard in determining whether there was a reasonable chance and should limit its inquiry to information available at the time that the decision to settle was made. In *Nat'l Cas. v. Green*, 711 So.2d 609; 1998 Fla. App. LEXIS 5303 (1998), the Court upheld a policy provision that excused the insurer from any obligation where the insured refused to accept a reasonable offer within its SIR.

In the absence of controlling contract language, however, the general rule is that standard liability policy language regarding the insurer's right to settle claims outweighs the insured's interest in minimizing its financial obligation. Of course, the terms of the settlement must be reasonable, and the insurer's conduct, including the decision to settle, must be in good faith.

Some jurisdictions do not follow the general rule. For example, in Alabama, the insured has the right to control the acceptance or rejection of settlement offers if it has a "direct financial stake" in the litigation. *See, e.g., St. Paul Fire & Marine Ins. Co. v. Edge Mem'l Hosp.*, 584 So. 2d 1316; 1991 Ala. LEXIS 615 (1991). Similarly, in *Transp. Indem. Co. v. Dahlen Transp. Inc.*, 161 N.W.2d 546; 281 Minn. 253 (1968), the Minnesota Supreme Court held that, where a settlement will affect a policy's retrospective premiums (i.e., premiums calculated annually based upon the insured's past loss history), the insurer bears the burden of proving that the settlement is reasonable because the retrospective premium arrangement gives the insured an interest in the amount of the settlement.

In *Continental Cas. Co. v. Roper Corp.*, 527 N.E.2d 998; 173 Ill. App. 3d 760 (1988), the insured, Roper Corporation ("Roper"), had a primary policy with Columbia Casualty. The Columbia primary policy had limits of $ 950,000 per occurrence with a $ 1,000,000 aggregate in excess of Roper's $ 50,000 per suit SIR. Columbia's liability limits for the 1975-76 policy year were exhausted while fifteen covered suits remained pending. Because Columbia's policy limits had been exhausted, Roper sought indemnification from Continental. Continental indemnified Roper for settlements and verdicts in excess of its SIR in all but two of the cases. One of those cases, Webster, became the subject of this decision.

The Webster plaintiff made a $ 500,000 settlement demand. Continental offered to contribute $ 50,000 toward settlement contingent upon Roper's payment of its $ 50,000 SIR. Roper refused and the case went to trial. A jury returned a $ 76,000 verdict against Roper, which Roper appealed on the issue of liability only. While the appeal was pending the Webster plaintiff offered to settle for $ 70,000, with $ 50,000 coming in the form of Roper's SIR and $ 20,000 being paid by Continental. Roper refused and prevailed on appeal, winning a new trial on liability and damages.

Continental again asked Roper to settle the case within its SIR, or to send the $ 50,000 to Continental and it would settle the case. Roper refused Continental's demand and the plaintiff increased his demand from $ 70,000 to $ 183,000. Roper took the case to trial, and the jury returned a $ 214,000 verdict for the plaintiff.

Roper then offered its $ 50,000 SIR to Continental, while vowing to appeal. The judgment was affirmed on appeal. Roper then demanded that Continental satisfy the $ 214,000 judgment plus post-judgment interest. Continental responded by sending Roper a $ 20,000 check. Continental took the position that Roper had needlessly exposed it to greater risk by trying the case when it could have been settled for $ 70,000. Accordingly, Roper was only entitled to the difference between its SIR and the reasonable settlement that Continental favored.

The Policy, sets forth the following settlement procedures:

> In the event the claimant or plaintiff, as the case might be, shall tender a bona-fide good faith, settlement demand in excess of the insured's retention, the payment of which would result in a full and final disposition of said claim or suit and such settlement demand is acceptable to either (1) the Insured, or (2) the Company (but not both), then in that event,

> with regard to that claim or suit, only:
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> * * *
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> (b) if such settlement demand is not acceptable to the insured and the Company tenders to the insured an amount equal to the difference between the insured's retention and said settlement demand, then the Company's agreement to 'indemnify the insured for the ultimate net loss' hereunder shall be discharged and terminated and the Company shall have no further obligations with respect thereto."

Id. at 1004. The Court held that since Continental made it clear that it would agree to the settlement terms, Roper was only entitled to the difference between its SIR ($50,000) and the reasonable settlement ($70,000).

In *Rocor Int'l, Inc. v. Nat'l Union Fire Ins. Co.*, 995 S.W.2d 804; 1999 Tex. App. LEXIS 4105 (Tex. Ct. App. 1999), an excess insurer, National Union, assumed control of settlement negotiations in a high-exposure case that clearly implicated its policy limits. Although National Union ultimately settled the case within its policy limits, it delayed in doing so. Shortly after National Union took control of settlement negotiations, the case could have been settled for $ 6.3 million. National Union finally settled the case almost a year later for $ 6.4 million. In the meantime, Rocor, which was self-insured up to $ 1 million, had to continue to prepare for trial in the event the case did not settle. Rocor thus sued National Union to recover its defense costs incurred because of National Union's delay in settling the case.

Rocor alleged that National Union violated the Texas Insurance Code by not attempting in good faith to settle on fair terms once Rocor's liability was reasonably clear. The Texas Court of Appeals agreed that Rocor had pleaded a cause of action under the applicable statute, stating that:

> While Rocor had no right to expect that [National Union] would settle blindly, it certainly had a right to expect that, once all parties agreed on liability and damages, settlement would follow with reasonable promptness, and thus Rocor's financial interests would be protected. This is especially true in this case, because National Union took over

> settlement negotiations and negotiated with Rocor's funds and those of Rocor's primary carrier.

Id. at 809.

Rocor also alleged National Union's negligence in handling the settlement. National Union argued in response that it had no duty to defend Rocor, and that absent a duty to defend it owed Rocor no duty to settle within policy limits. The *Rocor* court rejected National Union's arguments. While National Union clearly had no duty to defend Rocor under the express terms of its policy, it "assumed a duty to fairly settle the underlying tort litigation when it took over settlement negotiations, especially negotiations involving funds that it did not control" (Rocor's SIR and its primary policy limits). *Id*. at 812. The court reasoned that National Union could not have it both ways: "it [could not] take exclusive control of the handling of claims against its insured" and then claim that it could not be liable for related missteps because it had no contractual duty to defend. *Id*. National Union's assumption of exclusive control over settlement negotiations gave rise to a special relationship upon which liability could be premised.

The court acknowledged that National Union did settle the case, such that Rocor was not exposed to excess liability. Nevertheless, the fact that this was not a typical third-party bad faith case did not mean that National Union should escape responsibility; National Union owed Rocor a duty to handle claims in such a way as to minimize Rocor's financial hardship. The *Rocor* court reasoned that National Union should not be allowed to drag out settlement free from a duty to defend while Rocor paid what were essentially unnecessary defense costs. If National Union's delay in settlement was the product of hard negotiations required to close a significant gap between the plaintiffs' initial offer and the true value of the case, the Court would not have found that National Union violated unfair business practices or was negligent.

Other cases have held that an excess carrier may not sue a self-insured policyholder for bad faith in failing to settle a lawsuit for an amount within its SIR. *See, e.g.*, *Int'l Ins. Co. v. Dresser Indus., Inc.*, 841 S.W.2d 437, 444-45; 1992 Tex. App. LEXIS 2959 (1992) (holding that insured had no common law duty to accept settlement offer that would avoid exposing excess insurer to liability). As the court observed in *Employers Mut. Cas. Co. v. Key Pharmaceuticals, Inc.*, 871 F. Supp. 657, 663 (S.D.N.Y.) (predicting New Jersey law):

> The simple fact of the matter is that policyholders, even partially self-insured policyholders, are not primary carriers. Policyholders pay premiums to excess carriers in order to have protection against the risk of litigation (which risks include that of guessing wrong in settlement negotiations); primary carriers do not, and therefore must be careful as to how they balance their own interests with the competing interests of the excess carriers in any given claim instance. We have found no basis in the law, nor have we been pointed to any, for concluding that, apart from the premiums it pays, an insured also assumes a fiduciary duty of care toward its insurer in the context of settlements.

Id. at 666. Thus, an excess insurer believing that its insured wrongly refused to settle a case within its SIR must raise policy defenses to coverage for the resulting judgment.

As is the case in other disputes between the insured and its insurer, the courts will look to the policy for guidance. Unlike in other areas it appears that the courts are more apt to look to the reasonableness of the action of the insured and insurer to determine whether each satisfied its obligation to act in a manner that does not jeopardize the other's interest. Where that occurs, the courts have allowed the "wronged" party to seek redress for the unreasonable acts.

VI. CONCLUSION

As more and more trucking companies opt for self-insurance, the relationship between the self-insurer and excess insurer becomes a critical component of any successful risk management system. Since the self-insurer - insurer relationship is governed primarily by the insurance contract, self-insured trucking companies must carefully review the terms and conditions of the excess insurance policy to be aware of the rights and duties that flow to and from each party.

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