Does an Unsatisfied Self-insured Retention Negate an Insurer's Duty to Defend?

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During the past several years, insurance coverage disputes arising in the context of construction defect litigation have trended away from the typical "covered loss" or "work product exclusion" arguments. The increased use of insurance policies containing high Self Insured Retentions ("SIR") in the construction industry, combined with the recent collapse of the residential building industry, resulted in a new wave of third-party coverage disputes. More and more, plaintiff attorneys are faced with a primary insurer's contention that they have no obligation to indemnify or defend its insured homebuilder against claims for construction defects on the basis of the insured's unsatisfied SIR. This argument is particularly common in circumstances in which the insured homebuilder either temporarily ceased operations or went entirely out of business because of the insured's inability to satisfy the SIR. The issue is further compounded when plaintiff's attorney is confronted with an Owner Controlled Insurance Program ("OCIP") or "wrap" insurance policy which is intended to provide coverage not only to the general contractor homebuilder, but also for the subcontractors on the homebuilding project. This leaves plaintiff's attorney in a perilous position: either proceed with a potentially uninsured construction defect claim against an insolvent or judgment-proof defendant, or walk away from the action and forfeit any investment made investigating the potential construction defect claim. Fortunately, however, recent Court of Appeal decisions in *Executive Risk Indemnity, Inc. v. Jones* (2009) 171 Cal.App.4th 319 and *Legacy Vulcan Corp. v. Sup. Ct. (Transport Ins. Co.)* (2010) 185 Cal.App.4th 677, provide plaintiff's attorney with helpful tools to nudge the reluctant insurer into providing coverage in such situations. [For a detailed discussion of OCIP or "wrap" insurance policies, see Robert J. Olson, *The OCIP or Wrap Policy*, Insurance Journal West Region, Vol. 84, No. 13 (July 3, 2006)].

Self-Insured Retention

First, it is helpful to gain a basic understanding of the SIR. "Self-insurance is analogous to the more common types of direct insurance such as automobile collision coverage or major medical coverage, wherein there is usually a stated deductible amount, the effect of which is, in simplest terms, to make the insured 'self-insured' for any loss up to the amount of the deductible." *Bordeaux, Inc., v. American Safety Ins., Co.* (2008) 145 Wash.App. 687, 695, 186 P.3d. 1118, 1192 (citations omitted). Generally, an SIR refers to the amount of loss or liability that the insured agrees to bear before coverage is triggered under the policy. *Legacy Vulcan Corp., supra*, 185 Cal.App.4th at 694. The problem arises when, regardless of the reason, the insured is unable to satisfy the SIR and tenders the claim directly to its insurer. When this occurs, insurers typically deny coverage on the basis that their duty to defend or indemnify has yet to be triggered because of the unsatisfied SIR.

The *Executive Risk* Case

Executive Risk deals with an insurer's ability to re-litigate a previous arbitration award and judgment against its insured after the insurer refused to defend its insured in the underlying arbitration. Executive Risk Indemnity Insurance, Inc. ("Executive") issued a $10 million insurance policy to STARS Holding

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Company, Inc., ("STARS"), providing STARS with coverage for claims arising from investment advice and its financial planning services. *Executive Risk Indemnity, Inc., supra*, 171 Cal.App.4th at 321-322. Reese Jones ("Jones"), a former STARS client, filed for arbitration against STARS for faulty investment advice. *Id*. at 322. STARS, insolvent at the time, and unable to mount its own defense, tendered the claim to Executive. *Id.* Executive accepted the tender subject to a reservation of rights, but denied that it had a duty to defend STARS on the basis that the policy only provided STARS with reimbursement of defense costs subject to a $250,000 SIR. *Id.* at 323-324. Executive contended that, until STARS exhausted the $250,000 SIR, it had no obligation to contribute to STARS defense. *Id*. at 324. Thereafter, Executive refused STARS's repeated request for a defense against Jones's claim despite the fact that STARS lacked funds to defend itself. Consequently, Jones obtained a $22 million arbitration award against STARS following an uncontested hearing. Jones then judicially confirmed the arbitration award and sought to enforce the judgment against Executive. Executive refused to pay any portion of the judgment. Instead, it brought a coverage action against STARS claiming that it had no obligations under the policy. *Id*. at 322.

In the ensuring coverage action, Executive persuaded the trial court that it was not bound by Jones's arbitration award and subsequent judgment because Executive did not participate in the arbitration. *Id*. at 325-326. Accordingly, the trial court ordered a new trial on the issues of STARS's liability to Jones, causation and damages. *Id*. at 326. STARS, now with Executive defending, prevailed against Jones's claim in the new trial and the trial court entered final judgment in favor of Executive. *Id*. at 327. Jones appealed.

The issue before the Court of Appeal was whether the trial court erred in ruling that Jones's arbitration award and judgment against STARS had no binding effect upon Executive. The Court of Appeal held that:

> ***when an insurer (1) is duly notified of the underlying claim against its insured; and (2) is given a full opportunity to protect its interests, the resulting judgment - if obtained without fraud or collusion - is binding against the insurer in any later coverage litigation on the claim involving the insured. This rule applies regardless of whether the insurer has a contractual duty to defend, or whether or not its refusal to participate in the underlying proceedings is legally justified.***

Id. at 333.

The Court of Appeal reasoned that although the policy issued to STARS was an indemnity-only policy, Executive's interests were clearly at risk in the arbitration filed by Jones against STARS. *Id*. at 332. Despite this fact, the Court of Appeal believed that Executive made the calculated decision not to protect its interests by intervening in the arbitration despite numerous opportunities to do so. *Id.* Under these circumstances, it was "not unfair to preclude [Executive] from relitigating the court approved judgment" because a contrary holding would encourage insurers to take a wait and see approach while not being bound by an adverse judgment. *Id.* at 333-334. Accordingly, the Court of Appeal reversed.

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The *Legacy Vulcan Corp.* Case

Legacy Vulcan Corp. deals directly with a primary insurer's duty to defend its insured prior to the exhaustion of a SIR. Legacy Vulcan Corp. ("Vulcan") manufactured and sold chemicals used in the dry cleaning industry. *Legacy Vulcan Corp., supra,* 185 Cal.App.4th at 685. In January 1982, Transport Insurance Company ("Transport") issued one of several liability insurance policies providing Vulcan with both primary umbrella coverage subject to a $100,000 SIR and excess liability coverage. *Id.* at 682-683. Subsequently, several California municipalities sued Vulcan alleging that the use of Vulcan's chemicals by the dry cleaning industry resulted in environmental contamination. *Id.* at 685. Vulcan ultimately paid for its own defense and settled the lawsuits after Transport and its other insurers refused to provide it with a defense. *Id*. Thereafter, Transport filed a declaratory relief action against Vulcan to determine the parties' rights and obligations under the policy, notably, Transport's duty to defend pursuant to the primary umbrella policy provision. The trial court later consolidated Transport's declaratory relief action with similar actions filed by Vulcan's other insurers. *Id*. at 685.

In the declaratory relief action, the trial court correctly stated that the Transport policy issued to Vulcan provided both umbrella and excess coverage. *Id.* at 687. However, in a pretrial order, the trial court determined that for the purposes of Transport's duty to defend, Transport's obligations were limited to those of an excess insurer. *Id.* at 681. Specifically, Transport's duty to defend pursuant to the umbrella provision only arose upon the exhaustion of all underlying insurance. *Id.* at 686-687. After analyzing the policy issued by Transport, the trial court concluded that the SIR was intended to provide "underlying insurance." *Id*. at 686. Thus, Transport's duty to defend under the umbrella provision was only triggered upon exhaustion of the SIR. *Id*. at 687. Vulcan petitioned for a writ of mandate challenging the trial court order.

On writ, the Court of Appeal reviewed, *inter alia*, the scope and extent of an insurer's duty to defend in spite of a SIR. *Id.* at 681. The Court of Appeal disagreed with the trial court's analysis of the policy issued by Transport. Specifically, the Court of Appeal took issue with the trial court's determination that the term "underlying insurance" encompassed the SIR absent clear language to that effect. *Id*. at 696. The Court of Appeal held that when a primary umbrella policy obligates the insurer to defend claims not covered by "underlying insurance," an SIR does not constitute "underlying insurance." Unless the policy clearly provides otherwise, requiring exhaustion of a SIR "would be contrary to the reasonable expectations of the insured to be provided an immediate defense in connection with its primary coverage." *Id*. at 696. Moreover, unless the policy expressly provided otherwise, a SIR did not affect an insurer's duty to provide a "first dollar" defense. *Id*. at 694. Accordingly, the Court of Appeal's granted Vulcan's writ of mandate and directed the trial court to vacate its pretrial order.

CONCLUSION

The decisions in *Executive Risk* and *Legacy Vulcan* were predicated on the specific language of the policies at issue. As such, it is important to compare the language in the policies from those cases with the policy language being analyzed for coverage in any particular matter. Nevertheless, the decisions in *Executive Risk* and *Legacy Vulcan* provide plaintiff's attorney with helpful tools when dealing with a homebuilder's primary liability insurer which is refusing to defend on the basis of an unsatisfied SIR. If confronted with this situation, plaintiff's attorney should consider a carefully drafted demand letter clearly notifying the insurer of (1) the underlying claim against its insured, (2) the insurer's ability to protect its interests in the underlying action, and (3) the insurer's obligation to provide a "first dollar" defense despite the unsatisfied SIR. At a minimum, such a demand letter should illicit further information on the insurer's coverage position for continued analysis. Alternatively, such a demand letter may just nudge the reluctant insurer into providing a defense. **TBN**

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