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PERSPECTIVE

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SIRs and the duty to defend: their impact may be less than you think

By Robert M. Waxman

A. The Separate Duties to Defend and Indemnify

The separate duties to defend and indemnify have long been cornerstones in third party liability insurance policies. The California Supreme Court explained both in the landmark case of *Buss v. Sup. Ct.* (1997) 16 Cal 4th 45-49. The Court noted that the "duty to indemnify runs [only] to claims that are actually covered [and] entails the payment of money in order to resolve liability. *Id.*, at 45-46. Buss also stated that the "duty to defend runs to claims that are merely potentially covered [and] entails the rendering of a service, viz., the mounting and [immediate] funding of a defense in order to avoid or at least minimize liability." *Id.*, at 46, 49, emphasis added. Subsequent California decisions confirm the importance of immediate insurer funding on the duty to defend. E.g., *The Housing Group v. PMA Capital Ins. Co.* (2011) 193 Cal. App. 4th 1150, 1156.

B. Deductible and Self-Insured Retentions

Third party liability insurance policies also customarily contain either deductibles or self-insured retentions ("SIR") requiring the insured to bear a portion of a covered loss. Croskey, et. al., California Practice Guide: Insurance Litigation, [7:378.] (Aug. 2022 Update.) A deductible generally "relates only to damages for which the insured is indemnified, not to defense costs." *Forecast Homes, Inc. v. Steadfast Ins. Co.* (2010) 181 Cal. App. 4th 1466, 1474. (emphasis supplied.) While "an SIR…generally refers to the amount of a loss or liability that the insured agrees to bear before coverage can arise under the policy." *Legacy Vulcan Corp., v. Sup. Ct.* (2010) 185 Cal. App. 4th 677, 694 (Croskey, J.).

The difference between SIRs and deductibles is that "the policy limits apply on top of the SIR," but a deductible "reduces the policy limits." Croskey, et. al., California Practice Guide: Insurance Litigation, supra, [7:384.] Nevertheless, an SIR "can reasonably connote to the insured no more than what is expressly stated in the policy;" and as a limitation on coverage, "must be stated precisely and understandably." Legacy, supra, 185 Cal. App. 4th at 694. Thus, to be "a true SIR," the duty to indemnify must be specifically "limited to liability in excess of a specified amount and expressly preclude any duty to defend until the insured has actually paid the specified amount." *Id.*, at 694, n. 12, emphasis supplied. This means that the modern rule "under California law [is that] the duty to defend [and provide a first dollar defense] is not impacted by [the] SIR" unless the policy expressly conditions "commencement" of that duty upon exhaustion of the retention. *TriPacific Capital Advisors, LLC v. Federal Ins. Co.*, 2021 WL 5316407 *7 (C.D. Cal., Selna, J.).

C. The Modern California Rule

This modern rule exists for two reasons. First, "to require exhaustion of an SIR before an insurer will have a duty to defend would not ensure that the defense obligation rests on the insurer receiving premiums for that risk, but instead, would result in no insurer providing a defense prior to exhaustion." Legacy, supra, 185 Cal. App. 4th at 696. Second, "in the absence of clear policy language so providing, to require the exhaustion of an SIR before an insurer will have a duty to defend would be contrary to the reasonable expectations of the insured to be provided an immediate defense in connection with the primary coverage." *Id.*

The fact that an insurance policy with a duty to defend has an SIR as well as policy provisions stating that the insurer will be liable for only that part of a 'Loss' [i.e., indemnity] in excess of that retention and which define 'Loss' as amounts which an insured is legally obligated to pay, including damages and defense costs, does not change this modern rule. The *Crosby Estate at Rancho Santa Fe Master Assn. v. Ironshore Specialty Ins. Co.* (2020) 498 F. Supp. 3d 1242, 1259, 1261 (S.D. Cal., Hayes, J.) (insurer breached duty to defend by refraining from paying defense costs until exhaustion of the SIR even though defense costs were included in the policy's definition of 'Loss,' the policy provided for a duty to defend, while making the insurer liable to pay 'Loss' in excess of the applicable retention, and the policy stated that "the insurer shall advance Costs of Defense …on condition that the appropriate retention has been satisfied.") Accord (2000) *Montgomery Ward & Co., Inc. v. Imperial Cas. & Indem. Co,* 81 Cal. App. 4th 356, 367, n. 11, 374. Instead, "the cases that have required the satisfaction of a retained limit as a condition of [the] duty to defend were…not primary policies but excess policies or involved express

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policy language that made both the duty to indemnify and the duty to defend subject to an SIR." *American Safety Indem. Co. v. Admiral Ins. Co.* (2013) 220 Cal. App. 4th 1, 13 (citing Montgomery Ward.).

D. If an SIR Must Be Exhausted, Profound Consequences Arise

Profound consequences arise when insurers with a duty to defend insist that an SIR be exhausted before funding the defense without express policy language limiting commencement of that duty. An insurer's failure to provide an insured with a first dollar defense until an SIR has been exhausted where the underlying policy provides for a duty to defend but does not expressly state that duty arises only after exhaustion of the retention, carries important consequences. Such conduct breaches the policy, permitting the insured to take control of the litigation and to recover damages for actual attorney fees and costs incurred in defending the underlying action, i.e., not at lower carrier "approved" rates and notwithstanding any agreement between the insured and the insurer that the insured would be responsible for the payment of rates above those to which the insurer had previously consented. *L.A. Terminals, Inc. v. United Nat'l Ins. Co.* (2022) 608 F. Supp. 3d 968, 982-983 (C.D. Cal., Wright, J.) ("United's refusal to reimburse… defense costs, even after… acknowledging its duty to defend… constitutes a breach of United's defense obligations," with "the measure of damages for breach [being] the full amount of any obligation the insured reasonably incurs in mounting and conducting its defense.") Tri- Pacific, supra, 2021 WL 5316407 *9 (carrier lost right to control defense and to limit billing rates); Crosby Estate, supra, 498 F. Supp. 3d at 1261 (insurer breached policy by agreeing to provide a defense under a reservation of rights, but then requiring the insured to first satisfy the SIR and failing to pay defense costs for about a year after the reservation of rights letter, where the insurer had also refused to pay the actual rates of defense counsel and notwithstanding that the insured had agreed to the carrier's demand.) Additionally, if the insured can show that the carrier's delay or denial in paying defense benefits was unreasonable, then the insured can also recover tort damages. *Wilson v. 21st Century Ins. Co.* (2007) 42 Cal. 4th 713, 723.