TREATMENT OF SELF-INSURED RETENTIONS IN BANKRUPTCY

Seth D. Lamden
Blank Rome LLP

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When an insured files a bankruptcy case, disputes involving insurers, insureds, and claimants can arise when the insured is unable satisfy the self-insured retention (SIR) on its liability policy. In that situation, insurers often argue that they are relieved of their coverage obligations to judgment creditors because payment of an SIR is a condition precedent to coverage. Whether a debtor's failure to satisfy an SIR relieves the insurer of its coverage obligations often depends on the relevant policy language, state law, and public policy. This article discusses some of the key decisions in which courts have addressed this issue.

What Is a Self-Insured Retention?

An SIR is "a dollar amount specified in a liability insurance policy that must be paid by the insured before the insurance policy will respond to a loss." Self-Insured Retention (SIR), *IRMI Glossary,* https://www.irmi.com/term/insurance-definitions/self-insured-retention (last visited Sept. 25, 2021). *See also Fireman's Fund Ins. Co. v. OneBeacon Ins. Co.,* 495 F. Supp. 3d 293, 297 (S.D.N.Y. 2020) (SIR is "[t]he amount of an otherwise-covered loss that is not covered by an insurance policy and that … must be paid [by the insured] before the insurer will pay benefits.").

SIR provisions can be worded in a variety of ways. Set forth below are examples from directors and officers (D&O) liability insurance policy forms:

> The Insurer shall only be liable for the amount of Loss arising from a Claim which is in excess of the applicable Retention amount stated in Item 3 of the Declarations, such Retention amount to

be borne by the Organization and/or the Insureds and shall remain uninsured ….

The Company's liability under this Coverage Part shall apply only to that part of each Loss which is in excess of the applicable Retention set forth in Item 4 of the D&O Declarations, and such Retention shall be borne by the Insureds uninsured and at their own risk.

When the Bankrupt Insured Cannot Fund the SIR

Not all SIR provisions expressly condition coverage on satisfaction of the SIR. The SIR policy condition in *Phillips v. Noetic Specialty Ins. Co.,* 919 F. Supp. 2d 1089 (S.D. Cal. 2013), for example, stated that the insurer "will pay those sums, in excess of the 'self–insured retention', that the insured becomes legally obligated to pay as 'damages' because of 'bodily injury.'" *Id.* at 1097. The insurer refused to pay a covered judgment against its bankrupt insured because the insured did not satisfy the SIR. Among the reasons for which the court held that the insurer was liable for portions of the judgment in excess of the SIR was that the SIR provision did not specify that satisfaction of the SIR is a condition precedent to coverage. *See id.*

The *Phillips* court also based its holding on a policy provision stating that "the insolvency of the insured will not relieve the insurer of their obligations under the policy." *Id.* at 1098. As was the case in *Phillips,* insurance policies often contain "bankruptcy clauses." By way of example, commercial general liability form CG 00 01 04 13, issued by the Insurance Services Office, Inc., states that the "[b]ankruptcy or insolvency of the insured or of the insured's estate will not relieve us of our obligations under this Coverage Part."

Bankruptcy clauses are required by statute in many states. *See, e.g.,* Ark. Code Ann. § 23–89–102(a); Fla. Stat. § 324.151(c); 215 Ill. Comp. Stat. § 5/388; Md. Code. Ann., Ins. § 19–102(b); Minn. Stat. § 60A.08(6); N.Y. Ins. Law § 3420(a)(1); Va. Code Ann. § 38.2– 2200(1). The Illinois Insurance Code provides that an insurance policy cannot be issued in Illinois "unless it contains in substance a provision that the insolvency or bankruptcy of the insured shall not release the company

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from the payment of damages for injuries sustained or death resulting therefrom or loss occasioned during the term of such policy…." 215 ILCS § 5/388.

Courts considering policies containing bankruptcy clauses subject to such statutes typically will reject the argument that a bankrupt insured's failure to pay its SIR relieves the insurer of its coverage obligations, regardless of how the SIR provision is worded. *See Gulf Underwriters Ins. Co. v. Burris,* 674 F.3d 999, 1005 (8th Cir. 2012) ("Our research revealed that every court to consider the issue in a State that has enacted such statutes has rejected [the insurer's] interpretation of its SIR as a matter either of public policy or of policy interpretation."). In one such case, the court in *Home Ins. Co. v. Hooper,* 294 Ill. App. 3d 626 (1st Dist. 1998), held that section 388 of the Illinois Insurance Code, quoted above, precluded an insurer for denying coverage due to its bankrupt insured's inability to satisfy its SIR. The policy in *Hooper* contained an SIR provision stating that:

> With regard to such insurance as is afforded by this policy, it shall be a condition precedent to the company's liability under this policy that the Named Insured make actual payment, by way of settlement or judgment of damages, of the amount(s) stated in the declarations and in any endorsements thereto as the Named Insured's Self-Insured Retention(s).

Id. at 626. The policy also stated that "[b]ankruptcy or insolvency of the named insured … shall not relieve the company of any of its obligations hereunder." *Id.*

When the insured in *Hooper* became bankrupt and was unable to satisfy its SIR, the insurer argued that payment of the SIR was a condition precedent to its obligation to pay damages in excess of the SIR. *See id.* at 628. The court disagreed, holding that the insurer was liable for amounts in excess of the SIR, up to the policy limit. *See id.* at 633. In support of its holding, the *Hooper* court observed that enforcing the SIR as a condition precedent to coverage would be "directly contrary to the public policy as declared by the legislative enactment of section 388." *Id.* at 632. Even though the SIR provision in the policy was "unambiguous," the court noted that enforcing that language would impermissibly relieve the insurer of its coverage obligations due to the bankruptcy of the insured. As the court continued, "[t]he plain language of section 388 makes clear the legislative intent to prevent insurers from using the insured's bankrupt condition and resulting inability to make actual payment to satisfy a judgment or any portion thereof as grounds to avoid payment on a policy." *Id.*

Other courts also have held that where a policy contains a bankruptcy clause that is required by state statute, as in *Hooper,* a bankrupt insured's failure to satisfy an SIR will not relieve the insurer of its coverage obligations. *See Admiral Ins. Co. v. Grace Indus., Inc.,* 409 B.R. 275 (E.D.N.Y. 2009) (considering New York statute); *In re Vanderveer Estates Holdings, LLC,* 328 B.R. 18 (Bankr. E.D.N.Y. 2005) (consid–

ering Illinois statute); *In re Federal Press Co.,* 104 B.R. 56, 62 (Bankr. N.D. Ind. 1989) (considering Indiana statute)

Courts also have considered statutes permitting a tort claimant to sue a bankrupt insured's liability insurer (often referred to as "direct action" statutes) in holding that a bankrupt insured's failure to satisfy its SIR does not relieve the liability insurer of coverage obligations to the tort claimant. *See, e.g., Rosciti v. Ins. Co. of Penn.,* 659 F.3d 92 (1st Cir. 2011). The policy at issue in *Rosciti* stated that the insurer's coverage obligations arose "only after there has been a complete expenditure of [the insured's] retained limit(s) by means of payments for judgments, settlements, or defense costs." *Id.* at 94. The policy also stated that the insured's "bankruptcy, insolvency or inability to pay … shall not relieve [the insurer] from the payment of any claim covered by this Policy…." *Id.*

The plaintiff in *Rosciti* was a tort claimant who had sued the insured in a product liability action. When the insured filed for bankruptcy, the claimant brought a direct action against the bankrupt insured's insurer pursuant to a Rhode Island statute that permitted "[a]ny person, having a claim because of damages of any kind caused by the tort of any other person" to sue the alleged tortfeasor's liability insurer "whenever the alleged tortfeasor files for bankruptcy…." *Id.* at 94. As a defense to the tort claim, the insurer argued that it had no coverage obligations because the bankrupt insured had not satisfied the self-insured retention. The *Rosciti* court disagreed, holding that to permit the insurer to avoid its coverage obligations in a tort-feasor's direct action would violate Rhode Island public policy as set forth in the direct action statute.

In the absence of a bankruptcy insurance statute or a direct action statute, whether an insured's failure to satisfy its SIR constitutes a coverage defense depends on the specific language of the SIR provision at issue. *See, e.g., Pinnacle Pines Cmty. Ass'n v. Everest Nat. Ins. Co.,* No. CV-12-08202-PCT-DGC, 2014 WL 1875166, at *4 (D. Ariz. May 9, 2014) (finding that policy's SIR and bankruptcy clauses required insurer to cover amount in excess of unpaid SIR but rejecting insured's argument that "it would offend public policy to permit an insurer to avoid its obligations for a judgment in excess of the SIR when an insured cannot satisfy the SIR due to bankruptcy" because the insured "has not identified—and the Court has not found—such a statute or public policy in Arizona."). Where a policy contains a bankruptcy clause, courts often will not permit an insurer to avoid its coverage obligations due to the insured's failure to satisfy its SIR, even in the absence of a controlling statute. *See id.; see also Sturgill v. Beach at Mason Ltd. Partnership,* No. 1:14CV0784 (WOB), 2015 WL 6163787 (S.D. Ohio Oct. 20, 2015) (same).

Courts holding that a bankrupt insured's failure to satisfy its SIR relieved the insurer of its indemnity obligations to a third-party claimant have based their decisions, in part, on policies that were not

subject to bankruptcy insurance statutes. *See, e.g., Pak-Mor Mfg. Co. v. Royal Surplus Lines Ins. Co.,* No. SA-05-CA-135-RF, 2005 WL 3487723 (W.D. Tex. Nov. 3, 2005). The *Pak-Mor* policy's bankruptcy condition stated that:

> Bankruptcy, insolvency, or any other inability of the insured or of the insured's estate or any other insured to pay the "Retained Limit" will not increase or otherwise change our obligations under this Coverage Part and our obligations shall continue to apply only in excess of the "Retained Limit."

2005 WL 3487723 at *17. The *Pak-Mor* court found this language to be enforceable because Texas had not enacted any statutes addressing the impact of an insured's bankruptcy on its insurer's obligations. Accordingly, unless the debtor could satisfy the SIR, the insurer would not be liable to provide coverage. As the *Pak-Mor* court explained, the analysis under Texas law was different than the analysis of the cases discussed above because "[i]n all those cases, the courts' decisions were virtually compelled by applicable statutes in those states that required insurers to assume liability in the bankruptcy context just as they would outside the bankruptcy context, regardless of what the policies themselves said." *Id.* at *25. As the court continued, "[u]nder Texas law, insurers are free to issue policies that relieve them of liability in the bankruptcy context. This Court is thus not constrained by statutory law in interpreting particular policies that claim to so relieve insurers." *Id.* at *25.

Also applying Texas law, the court in *Associated Electric & Gas Ins. Services Ltd. v. Border Steel Rolling Mills, Inc.,* No. EP-04-CV-00389-KC, 2005 WL 3068787 (W.D. Tex. Sept. 27, 2005), held that an insurer was relieved of its coverage obligations when its bankrupt insured could not satisfy the SIR. *See id.* at *11. The *Border Steel* court found significant that the policy states that it "shall be excess over the stated limits of the underlying insurance … whether collectible or not … and regardless of insolvency," and the stated limits included the insured's SIR limits. *Id.* As a result, it concluded that the insurer had no liability absent payment of the SIR, notwithstanding insolvency. *See id.* A court applying Ohio law, which also does not contain a statute addressing an insurer's obligations when a bankrupt insured could not pay the SIR, similarly found that the insurer was not required to provide coverage because the SIR had not been satisfied. *See In re Kismet Prod., Inc.,* No. 04-25167, 2007 WL 6872750, at *7 (Bankr. N.D. Ohio Aug. 28, 2007), report and recommendation adopted sub nom. *Kismet Prod. v. HCC Benefits Corp.,* No. 1:07-MC-66, 2007 WL 4180654 (N.D. Ohio Nov. 20, 2007).

Can Non-Insureds Satisfy the SIR?

Under the wording of some SIR provisions, an SIR can be satisfied by sources other than the insured's own funds. Most courts to consider the issue have held that if an insurance policy is silent as to the required source of funding for an SIR, then the insured need not pay the SIR out of its own funds. *See, e.g., Ins. Co. of the State*

of Penn. v. Acceptance Ins. Co., No. SACV01-0225, 2002 WL 32515066, at *5 (C.D. Cal. Apr. 29, 2002) (citing cases)); *Cont'l Cas. Co. v. N. Am. Capacity Ins. Co.,* 683 F.3d 79, 90 (5th Cir. 2012). In one such case, the court in *Intervest Construction v. General Fidelity Ins. Co.,* 133 So.3d 494 (Fla. 2014), held that settlement payments made to the insured by a third party could satisfy the SIR because the policy stated that the SIR "will only be reduced by payments made by the insured," but did not specify the source of such funds. *Id.* at 497. The court ruled that unless the policy explicitly states that the insured must satisfy the SIR out of its "own account," the insured could use payments from third parties to satisfy the SIR. *See id.*

Courts have found that absent policy language to the contrary, SIRs can be satisfied in a variety of ways. *See, e.g., Lasorte v. Certain Underwriters at Lloyds,* 995 F. Supp. 2d 1134 (D. Mont. 2014) (insured's settlement with the plaintiff satisfied the SIR); *Pak-Mor Manuf. Co.,* 2005 WL 3487723 (holding that debtor can satisfy the SIR by payment in any form, including a non-dischargeable promissory note to the judgment creditor); *In re Keck, Mahin & Cate,* 241 B.R. 583 (Bankr. N.D. Ill 1999) (debtor permitted to satisfy SIR through treatment in the plan of reorganization).