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Illinois Coverage Basics

Really? Seventh Circuit Holds Insurer Has First-Dollar Defense Obligation under Policy with $100,000 Self-Insured Retention

Everything that you think you know about self-insured retentions may be wrong. That is the message delivered by a recent, surprising opinion from the federal appeals court in Chicago. This is another opinion from the Seventh Circuit Court of Appeals to remember: American Safety Insurance Company v. City of Waukegan (filed March 16, 2012).

District Court Rulings in the *American Safety* Case

In American Safety, the plaintiff insurer denied a tender of defense from its insured because it determined that the loss did not fall within the policy period. Another reason for the denial of the tender was that the policy carried a self-insured retention, which had not been satisfied. The self-insured retention provision of the policy specifically required that $100,000 in claims expense and/or indemnity must "be paid by the Insured prior to any obligation on the part of this Company." (*See* district court opinion, 776 F.Supp.2d 670, 685 (N.D. Ill. 2011).

The federal district court disagreed with the insurer's determination on the timing of the loss, finding that the claim fell squarely within the period of the policy. The district court also found that the insurer breached its duty to defend, although it was undisputed that the insured had not paid $100,000 to satisfy its self-insured retention obligation. The district court went on to find that the insurer's declination of the tender on the basis of the unexhausted self-insured retention was "unreasonable and vexatious," and it awarded monetary sanctions against the insurer pursuant to 215 ILCS 5/155.

To summarize: although the insurer issued a policy that required the insured to pay $100,000 in claims expense and/or indemnity before the insurer's obligations were triggered, the district court in American Safety held that the insurer had a first-dollar defense obligation. The insurer's declination of the insured's tender based on the self-insured retention provision was not only held to be a breach of the insurer's duty to defend, but also "unreasonable and vexatious" misconduct on the part of the insurer warranting sanctions.

The Court of Appeals Opinion in the *American Safety* Case

The Seventh Circuit Court of Appeals affirmed the district court's American Safety rulings in all respects. Following the district court findings, the Court of Appeals agreed that even though the insured had not satisfied the self-insured retention, the insurer had a duty to defend, which it breached by declining the tender of defense, and that the insurer's reliance on the self-insured retention provisions of the policy constituted sanctionable misconduct.

The Seventh Circuit's method in reaching these conclusions is as disturbing as the conclusions themselves. First, the Court of Appeals candidly acknowledged that it did not intend to follow state law on this issue. The Seventh Circuit's opinion warned: "If [the plaintiff insurer] genuinely wanted the views of the state judiciary, it should have brought this declaratory-judgment action in state court."

Second, the Court of Appeals undertook its analysis of the self-insured retention issue without ever citing the language of the policy. The appellate opinion did not acknowledge that the policy specifically required that the $100,000 self-insured retention must "be paid by the Insured prior to any obligation on the part of this Company." The Court of Appeals also inexplicably described the self-insured retention in the policy as a "deductible" throughout its opinion, although the policy described the requirement as a "self-insured retention."

Third, without reference to the self-insured retention language of the policy, the Seventh Circuit decided the applicability of the self-insured retention based on its own view of what would best serve the interests of the insured and the insurer. The Court of Appeals declared that a defense clause in an insurance policy has two functions: (1) "to give the [insured] access to counsel without the need to pay in advance;" and (2) "to give the insurer the right to control the defense."

The Court of Appeals made no effort in its opinion to square those functions with the self-insured retention provisions contained in the insurance policy. Instead, the Court utilized those assumptions as its basis for concluding that an insurer has a first-dollar defense obligation, even if a policy contains a self-insured retention requiring the insured's payment of claims expense and/or indemnity up to a specified dollar threshold.

Looking at the self-insured retention issue from the insured's perspective, the Seventh Circuit found that giving self-insured retention policy language a literal interpretation would effectively "nullify" the defense provisions of the policy and would be "unsound." In order to give effect to both the defense provisions and the self-insured retention provisions, the Court of Appeals concluded that a self-insured retention requirement must have no effect on an insurer's duty to defend, but impact only to its duty to indemnify.

From the insurer's perspective, the Court of Appeals found that "by insisting that an insured manage and pay for the defense in a suit such as this, an insurer disserves its own interests." The Court questioned whether an insured would have the requisite experience or interest in selecting qualified defense counsel. In short, the Court concluded that enforcement of a self-insured retention would interfere with an insurer's right to control the defense.

The Seventh Circuit's opinion in American Safety may require insurers to re-evaluate their defense obligations under policies containing self-insured retentions or deductibles. The sanctions awarded against the insurer in American Safety serve as a sober reminder of the possible consequences of failing to provide a first-dollar defense under such policies.

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