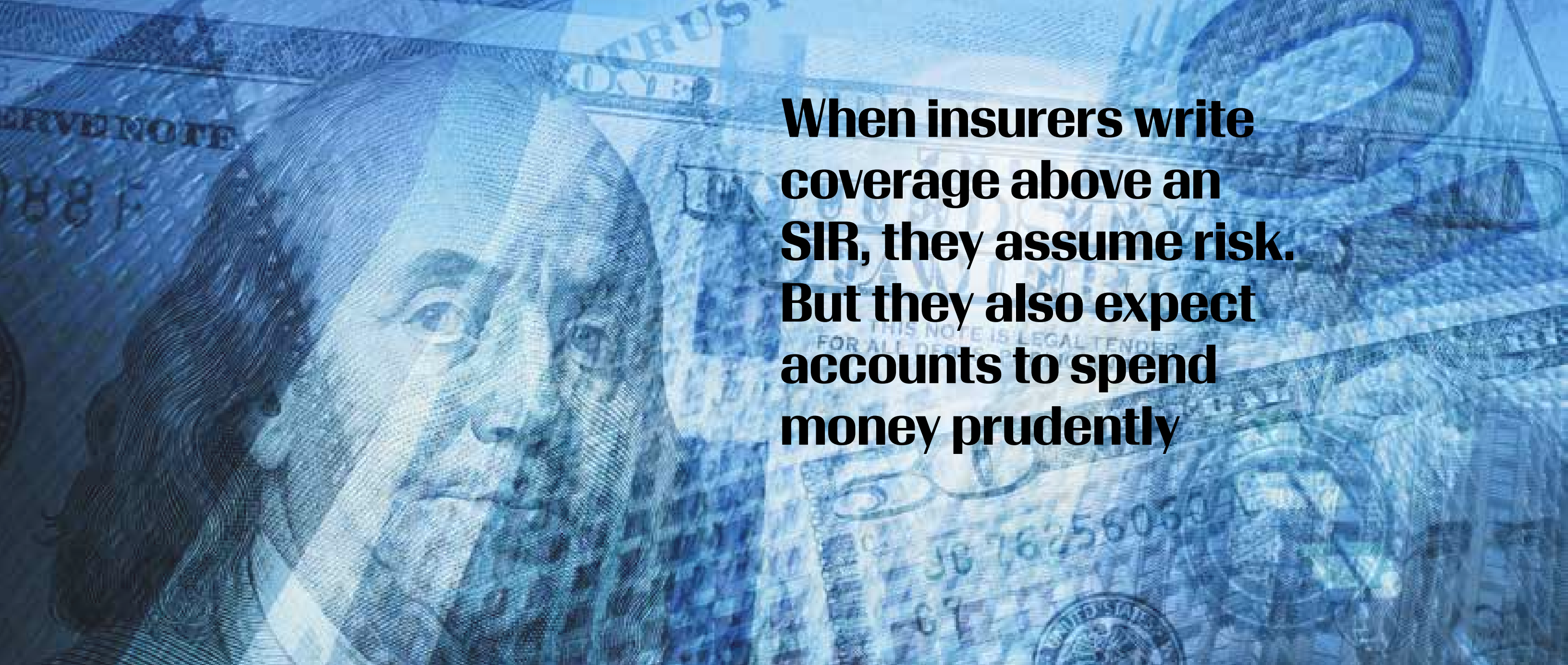
NAVIGATING TROUBLED WATERS:

Insurance Claim Challenges of Self-Insured Retentions

By Kevin Quinley

Policyholders and insurers navigate a delicate balance between risk and coverage. An increasingly frequent practice is writing liability coverage using self-insured retentions (SIRs), which let policyholders retain some control over risks and claims. While SIRs are attractive for many businesses, they pose unique claims handling challenges. This article highlights key considerations for policyholders and insurers and offers accompanying conflict-mitigation strategies.



When insurers write coverage above an SIR, they assume risk. But they also expect accounts to spend money prudently

Self-insured retentions, or SIRs, have gained significant traction as a tool for managing risk and dampening premium costs.

When tailoring coverages to suit their needs, policyholders can assume some monetary responsibility for potential losses through SIRs, which empower them to control minor claims, leaving insurers to handle more substantial losses. But SIRs invite friction, creating a complex landscape that demands the attention of industry professionals.

As policyholders increasingly use SIRs, insurers grapple with issues of proper claims reporting, erosion calculations (providing the status of SIR depletion levels, which affect the insurer's likelihood of having its coverage layer invaded), choice of counsel, and defend-versus-settle tussles.

Let's expand on SIRs, including these issues.

Differentiating SIRs From Deductibles

Many people confuse SIRs with deductibles, but they are not synonymous.

A self-insured retention is the portion of each loss an account retains by setting aside funds or using alternative financing. It's much like a deductible but requires greater self-funding. Also, unlike deductibles, SIRs grant insureds autonomy to handle claims within the self-insured layer.[1]

A deductible is the amount an insurer subtracts from the total damage incurred before determining its payment responsibility. It can be expressed in dollars or as a percentage of the loss. Deductibles are more common in property (versus liability/casualty) policies.[2]

SIRs confer some claims handling discretion on policyholders. But with deductibles, the insurer handles claims from dollar one, even with a $10,000 deductible.

Insureds like SIRs for many reasons. Premium savings can be alluring, for one—and generally, the higher the SIR, the lower the premium.

SIRs also provide accounts with more control over claims. The insured decides to pay or defend claims within the SIR. Clients can customize claims processes to organizational needs.

However, SIRs pose specific perils. Let's examine those next.

Claims Pitfalls

Among the most notable disadvantages of SIRs are:

- Inadequate insurer due diligence

Insurance marketers may agree to an account's large SIR without vetting a policyholder's expertise, systems, and infrastructure to handle claims competently.

- Weak self-administration infrastructure

This weakness includes having no in-house claims manager, few trained, professional in-house claims staff, no written claims handling policies and procedures, no "panel counsel" for lawsuits valued within the SIR, litigation guidelines for outside counsel, or escalation procedures assuring prompt reporting to insurers.

- Lax financial accounting and reporting

Preoccupied clients, busy running their operations, may make payments within an SIR without regularly toting up or reporting cumulative sums to insurers. Clients may belatedly discover that they have paid over their SIR and present insurers with eye-popping reimbursement bills.

Example: A pacemaker manufacturer had a $1 million product liability SIR. It faced repetitive patient claims alleging defective implants, malfunctions, and damages from surgeries for device replacements. In response, it self-handled these claims. But after years of doing so, it discovered payments exceeding $3 million in claims and legal costs. So, it sent the insurer a $2 million bill to reimburse expenses paid over the SIR.

The gob-smacked claims manager, blissfully ignorant of the rising defense and indemnity price tag, reported this development to her CEO and CFO. Had the insured tracked cumulative expenses quarterly and communicated the growing numbers to the insurer, however, the insurer could have reserved for the liability and helped manage the claims.

- Settling contestable claims based on customer relations or goodwill considerations

Common SIR Claims Handling Issues and Suggested Remedies

Issue	Recommendation/Comments
Defense counsel selection within the SIR. (Who hires defense counsel in this layer?)	This decision can be highly material to the speed of SIR depletion, both in terms of defense costs and receptivity to exploring settlement. Suggestion: Encourage the account to use the insurer's panel counsel. Alternatively, reach an understanding with the insured or assess the insured's preferred counsel as an underwriting factor.
Counsel retention on prelitigated claims (hiring lawyers on cases not yet in suit).	Insurers don't want to pay for lawyers doing glorified adjusting work. Include wording stating that "defense costs" apply only to litigated matters unless the insurer approves them.
Insurers' access to insured-appointed counsel on cases within the SIR. (Account complains that an insurer's claim-related queries to defense counsel are "running up our bills.")	Tip: Get the insured's agreement that any third-party administrator or counsel must cooperate with the insurer in answering queries, requests, case evaluations, litigation plans/ budgets, etc.
Delayed reporting and documentation of payments made within the SIR.	Recommendation: Make explicit that SIR or policy erosion credit requires insureds to provide notice and documentation of any expenditures within XX days (e.g., 90). Otherwise, the insurer risks nasty surprises from accounts with tardy or lax financial recordkeeping.
Risk of an insured delaying reporting trial date(s) to the carrier.	Trial dates are sentinel events, often portending huge expense increases and potential awards that invade the excess attachment point. Requiring advance notices of trials are tripwires to flag the insurer's attention to case severity, the need to reassess strategy, etc.
Insureds' SIR or policy erosion credit for claim settlements versus claim payments sans releases.	Recommendation: Include language that settlements require a signed release or court dismissal. This stipulation prevents insureds from making ex gratia payments, not foreclosing future claims, and submitting the tab for SIR or policy erosion.
What payments within the SIR are eligible for credit in eroding the retention?	Consider language mandating that expenses credited to the SIR or policy erosion must meet this standard to avoid accelerated SIR depletion due to gold-plated lawyer billing practices, vendor retention, etc.

Despite sound liability defenses, some insureds are tempted to pay claims ex gratia to preserve customer goodwill.

Example: An insured demands credit for reducing the SIR through payments made from its own funds. Upon reviewing and conducting an audit, the insurer contests payments, saying the insured paid losses for which it was not legally liable. Or the insured overpaid claims, given the debatable nature of the claims, the dubious damages claimed, and causation defenses. In this way, seeking credit to deplete the SIR creates friction between clients and carriers.

- Paying claims without settling/by forgoing signed releases

A claim is not settled without an insured/defendant getting a release or dismissal. But to appease customers, a company might reimburse a consumer for medical expenses, forgoing signed releases. In time, that insured will add up the cumulative payments and submit the sum as either diminishing or exceeding the SIR.

However, if the insured fails to obtain releases, the insurer may balk at applying a credit. No settlement existed. Compensated customers/ claimants consider their claims as still open. Word spreads to other aggrieved consumers (or lawyers) wanting medical bill reimbursement. Customers believe that since they received payment for medical expenses, it's now time to talk about their lost wages, pain, and suffering.

- Regulatory risk

Some states view self-insurance as conventional insurance and hold self-insureds to the same good faith claim regulations they apply to other insurers. If you act like an insurance claim department, you may have to follow the same regulations applied to standard insurance claim departments.

In states viewing SIRs as insurance, an account may breach state claims handling regulations regarding timely communication, deadlines for completing investigations, time limits for paying or denying claims, etc. Companies handling claims within SIRs may be unaware of state regulations. So while these regulatory headaches typically concern conventional insurers, they can also become problems for SIR accounts.

- Contesting legitimate claims

Commercial policyholders can be unobjective and unrealistic in objectively assessing their liability exposures. There's an enormous difference between conference table reality and courtroom reality. Wishful thinking and groupthink can distort corporate self-assessments of claims' financial exposure and defensibility.

Giant trees grow from little acorns. Sometimes, what an account sees as an 'incident' is a significant claim about to happen

As a vice president of claims, for years, I periodically clashed with policyholders (or brokers) who objected to the insurer's (and defense counsel's) settlement recommendations based on reasons such as:

"We've never had a claim like this before."

"We've never paid this much on a claim before."

"None of our competitors have these safeguards!"

These themes are porous liability defenses. Rather than settling claims early, seemingly minor cases metastasize into losses that enter an insurer's excess layer.

Unlike fine wines, claims do not improve with age!

- Gambling by rolling the dice at trial

A policyholder with a $1 million SIR may put a dangerous case before a jury, thinking an excess insurer above them will cover further downside risk. In other words, "If we guess wrong, our max exposure is $1 million. Anything above that is the insurer's problem. Moreover, if the insured's case assessment is correct, we'll win a defense verdict below our self-insured retention or a judgment lower than the plaintiff's demand. We have capped our exposure in all these outcomes, so let's roll the dice!"

I once attended an informative bad faith conference from the Defense Research Institute. A presenter cited an account with a $2 million SIR. The account insisted on taking to trial a lawsuit in Dallas, opposed by plaintiff's attorney and "King of Torts" Joe Jamail—who, by winning a $10.5 billion award, once held the record for a jury trial result.[3]

The trial produced a $26 million judgment against the defendant, who had rolled the dice. Perhaps predictably, litigation ensued between the account and insurer regarding the insured's alleged bad faith failure to settle.[4]

- Expense (mis)management

When insurers write coverage above an SIR, they assume risk. But they also expect accounts to spend money prudently.

How each self-insured spends money within the SIR affects the likelihood of reaching (or torching) the excess insurance layer. The more prudent the self-insured, the less likely an excess insurer will need to be involved. In contrast, mismanaged spending hastens SIR depletion and increases the odds of excess layer penetration.

- "Gold-plated," off-panel defense counsel

Most liability insurers have panels of approved defense counsel. Law firms become eligible for inclusion on one of these panels by a willingness to offer favorable hourly rates and follow case-handling guidelines on status reporting, billing formats, budgeting, and expense preauthorization.

Some insurers prefer to be represented by so-called Big Law firms.[5] However, big firms charge big rates and have aggressive annual hourly billing quotas (e.g., 2,000-2,400 billable hours), resulting in cultures that may reward overstaffing, deter early settlement, and encourage high-volume billable hours.

Counsel selection is a massive driver of an SIR burn rate, or the pace at which an insured spends money before telling an insurer, "It's your case (and money) now!"

Further, some corporate legal departments believe that an $800-an-hour lawyer must be doubly good as a $400-an-hour lawyer. They may also think that hiring a big-name defense firm sends a message of stiff resolve to plaintiffs, perhaps deterring or intimidating them into folding their tent, waving a white flag, abandoning their claims, or settling at huge discounts. (However, I have never seen this occur in over four decades of claims handling.)

Claims professionals counter that the message sent is, "This claim is a Big Deal, or else we wouldn't have gone to the expense of hiring a big-name law firm!" The latter is likely an unwise litigation message to send to the plaintiffs' bar.

- Lack of financial reporting systems to alert insurers of SIR erosion and depletion

Some excess insurers find themselves like kids on Christmas morning who get coal instead of chocolate in their stockings. A similar unwelcome surprise can occur with self-insured accounts unaware of the importance of regularly reporting to insurers the dollars spent on self-handled claims, the extent of SIR erosion, and the imminence of SIR exhaustion. Such reporting is essential for insurers, allowing them to avoid surprises and smoothly transition case management from a self-insured's lawyer to the insurer's panel counsel.

Do-it-yourself (DIY) claims handling is as wise as DIY root canals or DIY appendectomies. While claims handling isn't rocket science, it is more challenging than some may imagine.

Commercial accounts wanting to shoulder a claims handling role should think long and hard, ask soul-searching questions, and realize that the function is complex. As venture capitalist and financial columnist Morgan Housel notes, "Every job looks easy when you're not the one doing it because the challenges faced by someone in the arena are often invisible to those in the crowd."[6]

Insurers contemplating writing coverage and surrendering control must analyze an account's claim and litigation management systems, assessing whether the insured has the infrastructure and subject matter expertise to handle claims competently. Otherwise, self-handling claims can morph into a form of self-abuse: The blowback can scald the insurer if an account botches a claim within an SIR.

Assessing an Account's Fitness

So, how can an insurer determine whether an account is an SIR-quality candidate? Start by applying my top five diagnostics:

1. Have insurance claims specialists verify that the account's in-house staff is qualified to handle and manage claims.
2. Draft agreed-upon claims procedures, including reporting tripwires from the account to the insurer. Link the tripwires to injury severity, reserve size, potential financial exposure, or a combination.
3. Ensure that the account has a defense attorney network for handling lawsuits and written guidelines for outside counsel. If not, view the account as a servicing opportunity for the insurer's Claims Department.
4. Establish incident-handling guidelines from the account to the insurer's Claims Department. Giant trees grow from little acorns. Sometimes, what an account sees as an "incident" is a significant claim about to happen. Opportunities may arise to prevent occurrences from becoming expensive claims or suits.
5. Clarify the account's corporate claim philosophy or overall approach to claims. Does the account have one? For example, does it take an aggressive approach and endorse the maxim, "Millions for defense, but not a penny for tribute"? That can get expensive if the "millions for defense" exhaust the SIR and hasten penetration of the excess layer.

Does the account want to set precedents, determined to have its day in court if it perceives liability defenses, even on catastrophic claims with substantial jury appeal? (The deterrence theory presumes trial victory; the account may set a precedent, but not the one it envisioned!)

Does the self-insured view settlements as a cost of doing business? Will it spend two dollars to save one? These are differing claim philosophies; the insurer should know which one the account embraces before writing coverage.

Risk-Mitigation Strategies

Weighing all this information, let's consider several risk-mitigation strategies.

First, conduct due diligence beyond the account's financial health. Ensure that the self-insured entity has an infrastructure to self-handle claims.

Next, foster collaboration between underwriting and claims when writing coverage above SIRs. Unfortunately, these functional areas are too often siloed and sometimes at odds.

For example, in the zeal to add business, the Underwriting Department might bind or renew accounts with large SIRs. The Claims Department, in turn, must ensure vigilant oversight while working within the Underwriting Department's fait accompli of granting claims handling autonomy to accounts. This balancing-act conundrum is a recipe for friction between the insurer and the account.

Moral: Gain Claims Department buy-in and verify an account's capability to self-handle claims before writing coverage.

Also important is establishing written, agreed-to claims protocols. Draft a blueprint and division of labor, articulating an account's claims handling responsibilities within the SIR.

Disagreements between the insurer's Claims Department and the self-insured entity may also arise about whether a given claim threatens the excess layer. If a self-insured posts an unrealistically low reserve based on a superficial analysis of liability, causation, or damages, the insurer invites unexpected adverse outcomes.

Along these lines, another essential action is to create early warning systems to avoid surprises. Establish threshold triggers obligating the account to notify the insurer of claims meeting either a severity threshold (such as a fatality, paralysis, loss of limb, blindness, permanent disability, disfigurement, etc.) or reserve threshold (for example, claims reserved at, say, $50,000).

Embed in any protocol the insurer's right to periodically audit claims within the SIR to forestall adverse developments and to verify account compliance with sound claims practices.

Further, draft endorsements with time limits for submitting payments creditable toward SIR erosion. Require, for example, that "for any sums paid by account to apply toward eroding or exceeding the SIR, the insurer must receive payment documentation within XX days of such payment."

Time-limit clauses deter insureds from belatedly doing the math and demanding from the insurer reimbursement for significant payments made long ago.

Finally, consider hammer clauses, which modify consent-to-settle provisions or an account's claims handling autonomy. Suppose an insurer wants to settle and has a chance to do so within the SIR, but the insured withholds consent. A typical hammer clause will cap an insurer's liability to the amount of the settlement opportunity or end the insurer's obligation to continue defending a lawsuit.

Claims professionals may alternatively view a hammer clause as a responsibility clause because it requires the account to put its money where its mouth is. Hammer clauses avert many situations where policyholders might gamble and take cases to a jury trial because they feel the SIR is their maximum risk. Financial accountability through such clauses can instead spur sober, realistic case assessments.

The Need for Vigilance

Insurers ignore at their peril the many challenges lurking when granting accounts large SIRs. The complexity and scale of claims handling issues arising from SIRs require careful, proactive strategies. Insurers must prioritize practical risk assessment, comprehensive underwriting, and disciplined claims management to avert pitfalls.

To navigate the complexities of large SIR accounts, insurers can establish solid partnerships with clients, forge collaboration between their claims and underwriting departments, and leverage thorough preunderwriting due diligence.

By embracing essential mitigation strategies, insurers can successfully address claims handling problems and deliver optimal outcomes for all stakeholders. ■

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1. *Insurance Words & Their Meanings*, The Rough Notes Company, Bruce Hicks, Editor, 2015, p. 199.

2. Ibid., p. 69.

3. Mary Schlangenstein, "Jury awards Pennzoil record $10.5 billion," UPI, November 20, 1985.

4. Unfortunately, the presenter offered no legal case citation, but the anecdote underscores the potential friction point.

5. Joshua Holt, "What Is Biglaw and Is It Worth It?" Biglaw Investor, October 8, 2022.

6. Morgan Housel, *The Psychology of Money*, United Kingdom (Harriman House, 2020), p. 158.