ALERT
JULY 11, 2008

GLOBAL INSURANCE GROUP
News Concerning
Recent Insurance Coverage Issues

COZEN O'CONNOR
www.cozen.com

# WASHINGTON APPELLATE COURT CONCLUDES SIR IS NOT "INSURANCE" IN SUBROGATION CONTEXT AND DEFENSE COSTS PAID BY THE INSURED CONCURRENTLY SATISFY SIRS IN SUCCESSIVE PRIMARY POLICIES

William F. Knowles, Esq. • 206.224.1289 • *wknowles@cozen.com*
Laura J. Hawes, Esq. • 206.373.7202 • *lhawes@cozen.com*

## OVERVIEW

The Washington Court of Appeals recently affirmed a trial court ruling that an SIR is not considered primary insurance for purposes of subrogation, and thus the developers were entitled to be made whole from any third-party recoveries prior to the insurer. Moreover, an insurer is not entitled to apportion defense costs between two policies where the insured's duty to defend is triggered under both policies. Thus, the insured satisfied its SIR obligations under both its liability policies by paying its defense costs in excess of a single SIR amount. *Bordeaux, Inc. v. Am. Safety Ins. Co.,* No. 59947-0-I, 2008 WL 2636817 (Wash. Ct. App. July 7, 2008).

## BACKGROUND FACTS

The Bordeaux Condominium Owner's Association (COA) filed a lawsuit against developer Bordeaux alleging construction defects and property damage related to the condominium building envelope, site drainage, and mechanical systems. American Safety Insurance Company ("American Safety") and Steadfast Insurance Company ("Zurich") both insured Bordeaux and agreed to defend Bordeaux in the COA action under a reservation of rights.

The COA and Bordeaux settled for $630,000. American Safety agreed to indemnify Bordeaux for sixty percent of the total after Bordeaux paid its SIR; Zurich would indemnify Bordeaux forty percent after Bordeaux paid its SIR. Bordeaux had paid $105,399 in defense costs; American Safety contended those costs satisfied the Zurich SIR only and that it would withhold benefits under the policy until Bordeaux paid an additional $100,000 to satisfy the American Safety SIR. Bordeaux's position was that the $105,399 paid for defense costs related to the COA action, which satisfied its SIR obligation under both policies.

At the cutoff date for funding the settlement, Bordeaux paid the COA $100,000 to mitigate its damages. American Safety then paid its sixty percent and Zurich its forty percent to complete the settlement. Bordeaux sued and settled with third-party subcontractors, and the funds were held pending a judicial determination of whether Bordeaux or American Safety was entitled to recover first.

In a related action, Cameray, Inc., Bordeaux's sister company, built and sold Cameray Condominiums. The Cameray Condominium Homeowners Association sued Cameray for construction defects. American Safety and Zurich, under the same policies referenced above, defended Cameray under a reservation of rights. Cameray settled with the owner's association, having satisfied its $100,000 SIR on behalf of American Safety and Zurich concurrently. Cameray likewise later sued and settled with third-party subcontractors, and those funds were placed in an account pending a determination of whether American Safety had a right to recover before its insured.

Cameray and Bordeaux filed a complaint for declaratory judgment and breach of contract against American Safety. Bordeaux sought the recovery of the second $100,000 it contributed to the Bordeaux COA settlement. Both insureds asked the court to rule they were entitled to the third-party settlement proceeds to fully reimburse them for the SIR funds they paid for defense and settlement costs before proceeds were paid to their insurers. The trial court granted summary judgment to Bordeaux and Cameray, and American Safety appealed.

## LIABILITY INSURANCE POLICIES

American Safety issued a commercial general liability policy to Bordeaux incepting September 30, 2000 and expiring

September 30, 2001. The Zurich policy incepted September 30, 2001 and expired September 30, 2002. The Zurich policy contained a substantively similar SIR provision as the SIR provision in the American Safety policy. The policy provided coverage for defective construction claims but was subject to a Self-Insured Retention ("SIR") as follows:

> Our obligation under the policy to pay damages or SUPPLEMENTARY PAYMENT — COVERAGES A AND B to you or on your behalf applies only to the amount of damages or SUPPLEMENTARY PAYMENTS — COVERAGES A AND B in excess of any self-insured retention amounts stated in the Schedule above as applicable to such coverages, and the limits of insurance applicable to such coverages will not be reduced by the amount of such self-insured retention.
>
> As a condition precedent to our obligations to provide or continue to provide indemnity, coverage or defense hereunder, the insured, upon receipt of notice of any "suit", incident or "occurrence" that may give rise to a "suit", and at our request, shall pay over and deposit with us all or any part of the self-insured retention amount as specified in the policy, requested by us, to be applied by us as payment toward any damages or SUPPLEMENTARY PAYMENTS — COVERAGES A AND B incurred in the handling or settlement of any such incident, "occurrence" or "suit".
>
> * * *
>
> Per Occurrence Basis - if the self-insured retention is on a "per occurrence" basis, the self-insured retention amount applies to all damages and SUPPLEMENTARY PAYMENTS -- COVERAGES A AND B because of "bodily injury", "property damage" or "personal and advertising injury" as the result of any one "occurrence" regardless of the number of persons or organizations who sustain damages because of that "occurrence" or offense.

Bordeaux had a $100,000 SIR "per occurrence for Condominium, Townhome/Apartment Work." The policy defined occurrence as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions that happen during the term of this insurance." The policy was silent as to fulfilling the SIR requirement in the event an occurrence triggers coverage under more than one policy. Lastly, the American Safety policy contained a "subrogation provision" that provided "[i]f the insured has rights to recover all or part of any payment we [American Safety] have made under this Coverage Part, those rights are transferred to us."

## SELF-INSURED RETENTION PROVISIONS ARE NOT "INSURANCE" IN SUBROGATION CONTEXT

The court's task was to define the "nature and meaning" of the SIR provisions in the American Safety policies. The court rejected American Safety's argument that the SIRs operated as primary insurance, and as a result, the American Safety policy provided "excess insurance" and had superior subrogation rights. The court also rejected the idea that the insureds were "insurers" for two reasons: (1) neither Bordeaux or Cameray operated as "insurers" as defined by the Washington Insurance Code;* and (2) Washington courts have rejected the idea that "self-insurance" constitutes "insurance" in the context of a worker's compensation claim. The idea underlying "self-insurance" is that the insured self-insures for any amount up to a stated deductible amount; the court provided medical insurance or automobile collision coverage as common examples. On the other hand, the insured should not be not considered an "insurer" who has merely "reinsured" the risk above a certain limit.

In addition, the court distinguished prior case law cited by American Safety as characterizing SIRs as "primary insurance" because those cases did not involve the operation of the SIR as insurance in the subrogation context.

Ultimately, the court concluded American Safety's arguments failed because traditional insurance involves risk shifting while self-insurance involves risk retention (i.e., in self-insurance, the insured retains the risk of loss and does not shift the risk to an insurer or other group).

As to American Safety's subrogation rights, the court noted the American Safety policy gave it the right to subrogation for sums **it** paid, not for sums it did not pay, such as the SIRs. The court deferred to the long-standing rule in Washington that favors full compensation of insureds over subrogation rights of insurers. As a result, the court affirmed the trial court's ruling that Bordeaux and Cameray were entitled "to be made whole" prior to fulfilling American Safety's subrogation rights.

## REIMBURSEMENT OF DEFENSE COSTS

American Safety argued the trial court erred in ruling that Bordeaux was entitled to reimbursement for the additional $100,000 it paid toward settlement after it had paid $105,399 in defense costs. American Safety's position was that the payment of defense costs only satisfied the Zurich SIR, and American Safety's duty to defend was not triggered until

* The Washington Insurance Code defines insurer as "every person engaged in the business of making contracts for insurance." WASH. REV. CODE 48.01.050.

Bordeaux paid an additional $100,000, satisfying the American Safety SIR. Additionally, American Safety argued the COA's claims arose from "at least two occurrences" that were covered separately under the two liability policies and required independent satisfaction of the two separate SIRs.

The court disagreed; the American Safety policy stated it was obligated to pay covered damages in excess of $100,000. The American Safety policy contained no language regarding the insured's obligation to pay other policies' SIRs or the interplay between various SIRs. The defense costs incurred by Bordeaux were related to the damages covered by both the American Safety and Zurich policies, and "'no right of allocation exists for the defense of non-covered claims that are 'reasonably related' to the defense of covered claims.' " (Citation omitted). As a result, American Safety had no right to apportion defense costs between the two policies, and Bordeaux was entitled to reimbursement of its second $100,000 payment.

Lastly, the court affirmed the orders granting the insureds' attorneys' fees and costs under *Olympic Steamship*.

## CONCLUSION

The *Bordeaux* opinion may prove critical in cases in which the insured has multiple primary liability policies with SIRs that may be triggered as the result of a single occurrence. The court's holding, based on the American Safety policy language, permits the insured to meet its SIR obligations under different policies through consolidating its expenditures. In addition, the court distinguished on a limited basis Washington case law previously discussing the purpose and nature of an SIR. Though it made a distinction based on context—subrogation rights—it seems unlikely the nature of the SIR will be settled until the Washington Supreme Court weighs in on the issue.

*To discuss any questions you may have regarding the opinion discussed in this Alert, or how it may apply to your particular circumstances, please contact Bill Knowles at 206.224.1289, wknowles@cozen.com, or Laura Hawes at 206.373.7202, lhawes@cozen.com.*