**SURETY TODAY PRESENTATION**

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## THE SURETY'S RESERVATION OF RIGHTS

We all do it. It's practically instinctive. We don't even give it so-much-as a second thought. Even if all we are doing is something mundane, or routine like transmitting a document, we still do it. We "reserve our rights." No doubt you have written letter after letter which ends with some variation of the following:

> The Surety reserves any and all rights, remedies and defenses under the bonds, other applicable documents, at law and/or in equity as pertain to this matter. Nothing stated herein, or left unsaid, shall constitute an admission of liability, estoppel, prejudice or waiver of any kind, including but not limited to a waiver of the statute of limitations.

Sometimes the reservation of rights is fairly detailed like the statement I just read, and sometimes it is short and pithy, such as - "the Surety fully reserves all of its rights." Still other times the reservation of rights can be fairly lengthy, bordering on over-kill.

So, the question arises, is the practice of reserving one's rights a left-over vestige from some formalistic by-gone era when demurrers and writs roamed the land, or does it serve a legitimate risk management function in today's world of claims handling? In this presentation we will explore the surety's reservation of rights and perhaps put a new perspective on that reflexive action we all take for granted.

## ORIGINS

Reserving one's rights or interests is a long-standing practice that has been employed in a

variety of contexts.[1] Perhaps the most familiar context is that of liability insurance coverage where a reservation of rights is most often discussed in the circumstance of an insurer providing a defense for an insured while at the same time preserving any rights and defenses the insurer may have regarding denial of coverage or liability for indemnity.

Regardless of the context, the concept remains the same, the purpose of the reservation of rights is to advise the party with whom you are dealing that some part of the rights and obligations between the parties is being separated out, protected or reserved. The concept of reserving one's rights arises in part in response to the doctrines of waiver and estoppel. Essentially, the reservation serves the function of putting the recipient on notice that the surety is not intending its acts or omissions to constitute a waiver of rights or an estoppel. By providing the "notice" to the recipient, whether it be an obligee, claimant or indemnitor, the recipient is advised that the surety may yet assert its rights notwithstanding the action it is currently taking or notwithstanding the fact that the surety has not specifically addressed an issue. Thus, the reservation of rights is designed to simultaneously preclude any notion of "reasonable reliance" by the recipient, and plainly contradict any claim they may make of intentional waiver by the surety. Accordingly, as a starting point, to understand the function and purpose of the reservation of rights, one must first understand the doctrines of waiver and estoppel.

## NATURE OF ESTOPPEL

Estoppel arises from the maxim that no person may take advantage of their own wrong. At its core, estoppel looks to the effect of the conduct of one party on the position of the other party. Thus, a party asserting the benefit of an estoppel must have been misled to their detriment

[1] For example §1-207 of the Uniform Commercial Code provides that, "(1) A party who with explicit reservation of rights performs or promises performance or assents to performance in a manner demanded or offered by the other party does not thereby prejudice the rights reserved. Such words as "without prejudice," "under protest" or the like are sufficient".

and have changed their position for the worse, having believed and relied on the representations of the party sought to be estopped. Estoppel may arise even when there is no intent to mislead, if the actions of one party cause a prejudicial change in the conduct of the other.

It is generally recognized that estoppel is comprised of three basic elements: (1) voluntary conduct or representation; (2) reliance; and (3) detriment. Estoppel can arise in a variety of circumstances in the surety context, but by far the most frequently occurring situation involves the statute of limitations. Claimants have frequently argued that the surety has taken some action or failed to take some action which has allegedly "lulled" the claimant into inactivity until the statute of limitations has expired.

One example of an estoppel situation can be found in the case of *United States f/b/o Humble Oil & Refining Company v. Fidelity and Casualty Company of New York*, 402 F.2d 893 (4th Cir. 1968), in which the United States Court of Appeals for the Fourth Circuit held that the surety was estopped from asserting the statute of limitations as a defense to a payment bond claim.

The case involved a supplier who provided asphalt and petroleum products under a subcontract on a highway construction project. The principal failed to pay the supplier and the supplier asserted a claim against the payment bond. The surety advised the supplier that it was investigating the claim. After reviewing the principal's financial situation in an attempt to get several unfinished projects completed, the surety reached an arrangement with the principal and its indemnitors whereby the surety agreed to pay all outstanding bills that were covered by the bond and which were properly proven, including the claim of the supplier, Humble Oil, and to fund the principal's payroll and pay $1,200 per month to one of the indemnitors to continue running the principal in order to complete the unfinished projects.

The principal conveyed the substance of its arrangement with the surety to the subcontractors and suppliers, including the supplier. The supplier prepared the necessary invoices and advised the surety that it would, "withhold action against [the principal] for a reasonable time to permit [the surety] to respond." The surety requested that the supplier complete certain forms to substantiate its claim, which the supplier did. Subsequently, the surety advised the supplier that its claim was denied because the statute of limitations had expired.

In reaching its decision, the *Humble Oil* Court found that at the time the promise to pay Humble Oil's claim was communicated by the principal to Humble Oil, the surety had assumed control of the principal's business and had employed one of the indemnitors to complete the remaining work and stave off creditors. Accordingly, the Court held that the principal was an agent of the surety. The Court found that there was: (1) acknowledgment by the surety of its liability to the supplier; (2) an explicit promise by the surety to the principal that the surety would pay all debts owed to the subcontractors and suppliers; (3) a procedure set up by the surety for the principal to verify subcontractor and supplier claims and to submit such claims directly to the surety; (4) participation by the subcontractors and suppliers in the verification and payment of claims, including lengthy negotiations with the surety before and after the statute of limitations had run; and, lastly, (5) an explicit promise by the supplier to forbear from bringing suit based on the representation that the surety would pay upon submission of proper claims. Thus, the Court found that there was a representation, reliance, change of position and detriment. Accordingly, the surety was estopped from asserting the statute of limitations as a defense to the claim.

## NATURE OF WAIVER

In general, waiver is typically defined as, the intentional relinquishment of a known right, or such conduct as warrants an inference of the relinquishment of such right. Waiver may result from an express agreement or be inferred from circumstances. When waiver is implied from conduct, the acts, conduct, or circumstances relied upon to show the waiver must make out a clear case. Accordingly, whether waiver exists in a given case is a question for the trier of fact, and turns on the intent of the party ostensibly waiving the right. It is significant to note that waiver may occur by acts and conduct of the surety or of its agent. For a waiver to occur the acts or conduct must occur after the surety or its agent have full knowledge of the facts giving rise to the right or defense.

## REQUIREMENTS FOR AN EFFECTIVE RESERVATION OF RIGHTS

In reviewing and distilling the case law regarding reservations of rights, both in the context of suretyship and insurance policies generally, several over-arching, common sense principles can be observed. First, to be effective, the reservation of rights must be adequately communicated to the intended recipient. Second, the reservation must clearly and unambiguously inform the recipient of the surety's position. In this regard, the adequacy of the reservation is determined not by the recipient's subjective intent, but by whether the reservation "fairly informs" the recipient of the rights being preserved. Finally, the reservation must be asserted in a timely fashion.

In addition to the foregoing principles, courts also look to other factors in determining whether a party's rights have been properly reserved. Specifically, courts tend to place a great deal of weight on whether any other subsequent actions have been undertaken that are inconsistent with the reservation of rights. Further, courts also consider whether any

representations or promises have been made to the recipient that are inconsistent with the reservation of rights. Finally, courts will look to whether the underlying claim has remained disputed throughout.

So, let's look at some cases involving the use of reservations of rights. In *J. Caiazzo Plumbing and Heating Corp. v. United States Fidelity and Guaranty Company*, 2004 WL 2848548 (S.D.N.Y. December 9, 2004), the claimant asserted that the surety should be estopped from arguing that the statute of limitations has run because the surety acknowledged the claimant's claim and represented that they were investigating the claim and then waited for the statute of limitations to expire before denying the claim. The court noted that a claimant can prove estoppel by showing that the surety initiated settlement negotiations in order to "lull the claimant into inactivity" until the statute of limitations expired. In addressing the estoppel argument raised by the claimant, the Court observed that New York courts have consistently rejected estoppel claims against a surety when the surety acknowledged receipt of the claim, reserved its rights on numerous occasions, the amount of the claim was always in dispute, and no settlement was ever offered by the surety. The *Caiazzo* Court noted that USF&G never waived its rights under the bond because each letter it sent to the claimant explicitly reserved those rights. Further, USF&G advised the claimant that it was in the process of determining its position with regard to the claim, but never offered a settlement or otherwise claimed to be in the process of resolving the claim. As a result, the Court held that there could be no estoppel or waiver.

The case of *Hutton Construction Co., Inc. v. County of Rockland,* 1993 WL 535012 (S.D.N.Y. Dec. 22, 1993), presents somewhat of an unusual circumstance. In *Hutton*, the principal encountered subsurface rock and water conditions on a project that were materially

different than what was disclosed by the owner in the contract documents. The principal filed suit to obtain payment from the owner for the additional costs caused by the changed conditions. The owner asserted that the Principal failed to timely perform and terminated the principal and made claim against the three surety companies. In response to the claim against the bond, the sureties chose to litigate the issue of the termination of the principal. The litigation dragged on for over 5 years. The principal could not afford to fund the litigation, so the sureties incurred $1.3 million in legal fees, expert fees and payment of some payment bond claims.

Along the way there were several attempts at settlement to no avail. Also, along the way, the sureties made two demands for collateral and indemnity from the principal and its indemnitors, but no collateral was provided and no payments were made. Finally, after a jury was empaneled a settlement was reached between the sureties, the owner and the owner's design engineers. The sureties settled the claims on behalf of the principal and indemnitors under the GIA without their consent or approval. Subsequently, the sureties filed a motion to enforce the settlement.

The principal opposed the motion challenging the sureties' rights to settle and asserting that the sureties had waived any such rights or were estopped from asserting such rights. The principal contended that the sureties' support for the litigation over five years constituted a waiver of any right to settle the claims. The Court rejected this argument and noted that the Sureties continuously reserved their rights under the GIA in four separate letters over the five-year period of the litigation and concluded that in light of the reservation of rights there can be no issue of fact as to whether the sureties intentionally relinquished their rights. The Court also pointed to the reservation of rights in denying the claim of estoppel noting that the principal could not have reasonably relied on the sureties' actions in funding the litigation because the

sureties continuously reserved their rights under the GIA. So, the *Hutton* case stands as a reminder to repeatedly assert and reassert your reservation of rights in order to preserve your rights, particularly when the matter drags on for a long period of time.

In contrast to *Caiazzo* and *Hutton*, several courts have found estoppel and/or waiver to exist *even when the surety asserted a reservation of rights.* In *United States f/b/o Nelson v. Reliance Insurance Company*, 436 F.2d 1366, 1370 (10th Cir.1971), the United States Court of Appeals for the Tenth Circuit held that the surety was estopped from asserting the statute of limitations as a defense. In *Nelson*, the claimant, Nelson Brothers, a subcontractor on a federal project, attempted to obtain payment from the principal for work and materials provided to the project. After receiving no response from the principal, Nelson Brothers contacted the local agent for the surety regarding the claim. In a telephone call, the agent purportedly said, "you don't need to worry about the bonding company not making payment if the principal doesn't and that the surety would even pay the interest if the principal didn't pay it." Following the telephone call, the attorney for Nelson Brothers sent a letter directly to the home office of the surety advising that the claimant was looking to the surety for payment and that it would "hold off" filing suit until a certain date to enable the surety sufficient time to investigate the matter. The surety responded to the claim requesting information and asserted a reservation of rights.

Subsequently, the surety was advised by the principal that it did not dispute the claim and that it did not have sufficient funds to pay the claim. The principal expressly asked for funds to pay Nelson Brothers, but the surety refused. After learning about the financial status of the principal, the local agent wrote a letter to the Nelson Brothers' attorney for the purpose of getting them to hold off filing any litigation. The letter from the agent requested Nelson Brothers' "indulgence" while the matter was referred to the home office for consideration. The agent

assured Nelson Brothers that the bond claims department would investigate and that they would take immediate action.

Some five months later, Nelson Brothers' attorney inquired as to the status of the matter and stated that Nelson Brothers would file suit if the surety did not respond in ten days. The local agent responded to the letter and advised that negotiations between the owner and the principal were on the verge of completion and that once a settlement had been reached with the owner, direct settlement would be negotiated with the creditors. The agent's purpose in responding was to nullify the ten day deadline. Three months later, Nelson Brothers' attorney again inquired as to the status and threatened litigation. The principal responded to Nelson Brothers' inquiry, at the behest of the surety, and advised that as soon as funds were made available from the owner the account would be settled. There were no further communications and the statute of limitations on the claim expired. The *Nelson* Court concluded that:

> In sum, Nelson Brothers contacted the surety on four occasions, manifesting the clear intent to file suit if the claim was not settled forthwith. On every occasion their requests and demands were met with answers which assured them that amicable settlement was just around the corner. When the foregoing representations are viewed in the light of what the surety knew and intended, it is clear that their conduct and representations were calculated to convey the impression that Nelson Brothers should defer action pending the settlement negotiations between the prime contractor and the government and that the Surety would pay [Nelson Brothers'] claim if [the principal] did not.

The *Nelson* Court held that the surety did in fact "lull Nelson Brothers into believing that the claim would be amicably settled within a reasonable time." The *Nelson* case brings into focus the fact that a reservation of rights is not an impenetrable shield or license to do as one pleases. Actions and conduct after the reservation of rights can still lead to such significant prejudice that the court will be more inclined to find estoppel.

In *USF&G v. Braspetro Oil Services Company*, the surety companies argued that they

were not liable under the performance bonds because, among other things, the obligees failed to satisfy certain conditions precedent to asserting claims against the bonds. In *Braspetro,* the principals on the performance bonds informed the obligees that they were experiencing financial difficulties and that if contract funds and other monies were not advanced to them they would not be able to complete the projects. The obligees agreed to a number of financial assistance measures including making direct payments to suppliers, modifying the contract terms, etc. The sureties were eventually informed of these measures but did not object or demand that such measures cease. The *Braspetro* Court found that, "the record discloses that the Sureties, while attempting to effect a 'reservation of rights' in certain communications with the Obligees, simply stood by, took no action, and offered no opinion while the Obligees amended the Contracts and implemented the system of direct and advance payments. The Second Circuit noted that, "[i]t is well settled that 'the law does not favor the indifferent, unseeing surety who fails to help himself.' (citations omitted). And, as we have stated, the policy behind surety bonds is not to protect a surety from its own laziness or poorly considered decision. (citations omitted)." The court concluded that the sureties, in not objecting to the direct and advance payments, "waived any objections to the [direct and advance payments] of which they had been informed." Clearly, in spite of a reservation of rights, there can come a point at which a critical mass of facts and/or actions are reached which over-rides the attempt to reserve one's rights. Again, the reservation of rights is not a license to ignore one's obligations to act reasonably.

In *All Gulf Contractors, Inc. v. Jiminez, Inc.*, a subcontractor on a federal project performed additional and extra work on the project and submitted a claim against the payment bond for recovery of the costs associated with that work. The surety responded to the claim by requesting further information and stating, in part, that the surety was reserving "all rights and

defenses whether by statute, at law, or in equity." The subcontractor provided the additional information requested by the surety.

There was no further communication until after the statute of limitations had expired when the surety sent another letter to the subcontractor requesting additional information. The surety did not refer to the fact that the statute of limitations had run on the claim against the payment bond. The subcontractor responded reasserting its claim and requesting immediate payment "to keep legal matters from escalating." The surety responded indicating that any amounts due for extra work would be determined in accordance with procedures described in the dispute resolution provisions of the general contract and that "the claim presented is premature and cannot be honored at this time." The subcontractor filed suit against the surety.

The surety responded to the suit with a motion for summary judgment asserting that the statute of limitation barred the claim. The subcontractor argued among other things that the surety had waived its right to assert the statute of limitations because the surety continued to deal with the claim after limitations had expired and the surety asserted a belief that the claim was premature pending the resolution of the request for equitable adjustment. The subcontractor contended that such conduct demonstrated the surety's intention to waive the statute of limitations pending the contracting officer's decision. The *Jiminez* Court denied the surety's motion for summary judgment concluding that the surety's conduct after it reserved its rights created a genuine issue of fact as to whether the surety impliedly waived the statute of limitations.

In *Casey Industrial, Inc. v. Seaboard Surety Co.*, 2006 WL 2850652 (E.D. Va. 2006), the surety, Seaboard Surety Company ("Seaboard") issued an A312 Payment Bond to the Owner of the project in connection with the construction of an electrical power station in Virginia by the Principal. The claimant, Casey Industrial, Inc. ("Casey"), entered into a subcontract with the

Principal to perform concrete construction services and underground electrical work. Eventually, the Principal was default terminated by the Owner and through a Takeover Agreement Seaboard hired a completion contractor and Casey continued working for the completion contractor. Casey provided a notice of claim against the A312 Payment Bond on September 20, 2005. Seaboard responded to the claim rejecting it on November 4, 2005 and in its response identified certain defenses upon which it relied. In addition, Seaboard also asserted a reservation of rights in its response letter stating that Seaboard:

> . . . continues to reserve all rights and defenses that it or RBI may have at law, equity, or under the bond. This reservation includes, without limitation, all defenses that may be available under any applicable notice or suit limitation provision, as well as all other defenses that may be identified or which may be developed during Seaboard's further review of [the] claim.

Casey subsequently filed suit and moved for partial summary judgment relying on *Bramble* and argued that any defenses not asserted as a basis for denying the claim within the 45 day period were waived.

The *Casey* Court held that Seaboard was not entitled to rely upon a blanket reservation of rights clause to delay identifying disputes to the claim within the 45 day period. Similar reservation of rights were asserted by the sureties in the *Wadsworth* and *Bramble* cases as well and those reservations were similarly brushed aside. *Casey, Wadsworth* and *Bramble* point out the limit of the ability of a surety to rely on a reservation of rights. A reservation of rights is a unilateral action asserted by one party. As such, it cannot be used to alter or change contractual or statutory requirements in the bond or applicable statute. So, in the *Casey* line of cases the bond language required a response from the surety within 45 days, the surety in a claim response letter cannot modify the bond language by simply inserting a reservation of rights paragraph. Rather, the surety is contractually bound to the language of the bond. Similarly, if a claims

handling statute, rule or regulation required the surety to take action within a certain period or provide certain information, the surety will not be able to change those requirements with a unilateral reservation of rights.

## PRACTICAL OBSERVATIONS

As the foregoing illustrates, far from being a remnant from a by-gone era, the reservation of rights can play a vital role in the claims handling process. Indeed, the surety should renew and reevaluate its approach to the use of the reservation of rights as a risk management tool. The wide-spread practice of using pre-packaged form language, whether it is applicable to the context or not, should be reviewed with a concerted effort to include a specifically tailored reservation of rights in all communications with obligees, claimants and indemnitors. Form language may not address the many nuances and circumstances in which estoppel and/or waiver can arise. Such circumstances vary from case to case and depend on a myriad of factors such as: the sophistication the party; the magnitude of the prejudice to the party; the knowledge and information available to the surety and the timing of obtaining that knowledge; whether the claim is disputed; and whether the claimant is represented by counsel, as well as a host of others. The reservation of rights should clearly and unambiguously describe the rights and defenses being reserved in the particular circumstance and should be timely conveyed. But, as the case law reveals, the most important aspect of an effective reservation of rights once it is asserted is the conduct of the surety *after reserving the rights*.

Every effort should be made to avoid actions or statements that are inconsistent with the reservation of rights. Not only should the surety be aware of and be sensitive to this, but its outside counsel, consultants and agents should also be aware as well. In addition to affirmative actions and statements, silence and inaction can also undermine an effective reservation of rights.

If the claimant communicates its intent to hold-off filing suit based upon its understanding of communications with the surety, the surety should respond informing the claimant that it does so at its own risk.

## CONCLUSION

Several constructive points can be taken away from this article which may appropriately be put into practice by the surety to begin and/or continue the benefits of the reservation of the surety's rights. Starting with the reservation of rights itself, the following general points are important:

1. The reservation of rights should be clear and unambiguous;

2. The reservation of rights should be adequately communicated or delivered to the recipient and repeatedly re-asserted;
3. The reservation of rights should fairly inform the recipient of the surety's position;
4. The reservation of rights should be timely asserted; and
5. The reservation of rights should be updated as facts and events unfold and knowledge and information are obtained.

Once the surety has effectively reserved its rights, it should make every effort to avoid actions which might undermine the reservation of rights. The following general points are important:

1. Avoid actions which are inconsistent with the reservation of rights;
2. Avoid statements or representations which are inconsistent with the reservation of rights;
3. Avoid omissions, silence or failures to act which could be construed as being inconsistent with the reservation of rights;
4. Make outside counsel, consultants and agents aware of the reservation of rights and request that they act in a manner consistent therewith; and
5. Make sure the reservation of rights does not become stale.

Effectively reserving one's rights and then preserving the reservation thereafter can be effective for the surety if proper attention and effort are focused on the subject and the process becomes one of deliberate action instead of repetitious and reflexive action.