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THE SURETY'S RESERVATION OF RIGHTS

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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, pro-forma 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 above, and sometimes it is short and pithy, "the Surety fully reserves all of its rights." Still other times the reservation of rights can be down right over-kill:

> This letter is sent to you for purposes of investigation only and should not be construed as: an admission of liability; a promise to pay a claim in whole or in part; an admission that the documents forwarded are in compliance with the bond or any applicable statute; or a waiver, amplification or extension of any of the terms, provisions, or limitations set forth in the bond or any applicable statute. The Surety demands that the Claimant strictly comply with all the terms of the bond, the contract and all applicable statutes. This letter and the Surety's subsequent activities are undertaken under a full reservation of all of the Surety's rights, remedies and defenses in equity or at law under the terms of its bond, the contract and all applicable statutes. This reservation of rights shall remain in full force and effect unless expressly revoked by the Surety in writing.

Is the archaic practice of reserving one's rights a left over vestige from some formalistic by-gone era when demurrers and writs roamed the land,[1] or does it serve a legitimate risk management function in today's world of claims handling? This paper will explore the surety's reservation of rights and perhaps put a new perspective on that reflexive action we all take for granted.

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[1] It is easy to picture the scene where an old-time "*bond claims man"* with a knotted tie and tie clasp, and shirt pocket protector, is sitting *at his desk* in a haze of smoke from chain smoking cigarettes and inserting the phrase for the surety's reservation of rights in the company's policy and procedures manual, long before computer form letters came into existence.

I. ORIGINS

Reserving one's rights or interests is a long-standing practice that has been employed in all manner of contexts.[2] 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 i.e.: to advise the party with whom one is dealing that some part of the rights and obligations between the parties is being separated out or reserved. Such a concept cuts across the various contexts because it is rooted in the broader and more general law of waiver and estoppel. Thus, while the distinction between suretyship and insurance is clear, to some extent the law regarding reservation of rights in the liability insurance context can be drawn upon in the surety context to help provide a clearer understanding of what the surety should do to effectively protect its rights.[3]

As will be discussed herein, the concept of reserving one's rights springs in part from the doctrines of waiver and estoppel.[4] Essentially, the reservation serves the function of

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[2] Indeed, Article IX of the United States Constitution provides that all rights not delegated to the United States are reserved to the States or the people. The practice of reserving some interest in a matter can be seen in real property transfers (reserving an interest in land), estates and trusts (reserving an interest in the corpus) and even in commercial law (§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").

[3] The blurring of the distinction between insurance and surety is generally illustrated in *A/C Elec. Co. v. Aetna Ins. Co.*, 251 Md. 410, 419, 247 A.2d 708 (1968), wherein Maryland's highest court observed that, "[a] paid surety which is a surety or bonding company is usually considered to be in the same class as an insurance company, its contract being held to be in the nature of insurance and to be construed according to the rules applicable to insurance contracts." *Id*. at 418, *quoting Berry v. USF&G*, 249 Md. 150, 156, 238 A.2d 907, 910 (1968). Similarly, the United States Court of Appeals for the Fourth Circuit in *Maryland Casualty Co. v. Fowler*, 31 F.2d 881, 884 (4th Cir. 1929), has also noted that, "[T]he rule is well settled in this circuit that a compensated surety is in effect an insurer, that its contract will be construed as an insurance contract most strongly in favor of the party or parties protected thereby, that forfeiture on technical grounds will not be favored, and that the strictissimi juris rule of the law of suretyship will not be applied for its protection."

[4] The concept of a reservation of rights also appears in the contractual context where the parties mutually agree that certain rights will be retained. For example, in a Takeover Agreement, a surety may reserve the right to verify or dispute the accuracy of various pieces of information provided by the obligee, such as payments made, the remaining contract balance, and the status of any change orders or back charges, for which time or other circumstances have not permitted sufficient investigation by the surety. Similarly, the Takeover Agreement may

putting the recipient on notice that the surety is not intending its actions 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. Thus, the reservation of rights is designed to preclude any notion of "reasonable reliance" by the obligee, claimant or indemnitor, and plainly contradicts any claim they may make of intentional waiver by the surety. Accordingly, as a beginning point, to understand the function and purpose of the reservation of rights, one must first understand the doctrines of waiver and estoppel.

II. NATURE OF ESTOPPEL

Estoppel is deeply rooted in our jurisprudence. It arises from the maxim that no person may take advantage of their own wrong.[5] At its core, estoppel looks to the effect of the conduct of one party on the position of the other party.[6] One commentator has observed that estoppel, "refers to an abatement raised by law of rights and privileges of the insurer where it would be inequitable to permit their assertion. It necessarily implies prejudicial reliance of the insured upon some act, conduct, or nonaction of the insurer."[7] Thus, a party asserting the benefit of an estoppel must have been misled to his/her injury and have changed his/her position for the worse, having believed and relied on the representations of the party sought to be estopped.[8] While wrongful or unconscionable conduct is generally an element of estoppel,

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also allow the parties to reserve any rights or claims that the principal may have against the obligee and reserve any defenses that the obligee may have against such claims. By agreeing to reserve the right to revisit the issue or issues, the parties can move forward with the Takeover Agreement and keep the project moving. Reservation of rights may also appear in agreements between the surety and the completion contractor, financing agreements with the principal or other agreements with the indemnitors. In these contexts, the reservation of rights is essentially a matter of mutual contractual agreement between the parties to the agreement and it is subject to the same rules of construction and enforceability as any contract term.

[5] *Glus v. Brooklyn Eastern District Terminal*, 359 U.S. 231, 232-233, 79 S. Ct. 760, 762, 3 L. Ed. (2d) 770 (1959); *United States V. Ellis Construction Company*, 78 F.R.D. 317, 318 (E.D.Tenn. 1978).

[6] See *Travelers v. Nationwide*, 244 Md. 401, 414, 224 A.2d 285, 293 (1966).

[7] 16B Appleman, supra, § 9081, at 491-92.

[8] *Rubinstein v. Jefferson Nat'l Life*, 268 Md. 388, 393, 302 A.2d 49, 52 (1973); *American States Insurance Company v. National Cycle, Inc.*, 260 Ill. App. 3d 299; 631 N.E.2d 1292 (1994) *citing Western Casualty*, 105 Ill. 2d at 499-500, 475 N.E.2d at 879; *Metro. Life Ins. Co. v. Childs Co.*, 230 N.Y. 285, 292, 130 N.E. 295 (1921); *Lynn v. Lynn*, 302 N.Y. 193, 205, 97 N.E.2d 748 (1951); *FDIC v. Harrison*, 735 F.2d 408, 410 (11th Cir.1984); *Aurora*

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.[9]

Accordingly, it is generally recognized that estoppel is comprised of three basic elements: (1) voluntary conduct or representation; (2) reliance; and (3) detriment.[10] The party arguing for an estoppel bears the burden of proving the facts that create it.[11] Further, most courts hold that whether an estoppel exists is a question of fact to be determined in each case.[12] When estoppel is found, the estopped party is "absolutely precluded both at law and in equity, from asserting rights which might perhaps have otherwise existed ... against another person, who has in good faith relied upon such conduct, and has been led thereby to change his position for the worse . . ."[13]

Estoppel can arise in a variety of circumstances in the surety context,[14] but by far the most frequently occurring situation involves the statute of limitations. Claimants frequently

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Painting, Inc. v. Fireman's Fund Ins. Co., 832 F.2d 1150, 1154 (9th Cir.1987) and *McWaters and Bartlett v. United States*, 272 F.2d 291, 296 (10th Cir. 1959).

[9] *Food Fair v. Blumberg*, 234 Md. 521, 532, 200 A.2d 166, 172 (1964), *Bean v. Steuart Petroleum*, 244 Md. 459, 469, 224 A.2d 295, 301 (1966); *Waynesboro Village, L.L.C. v. BMC Properties*, 255 Va. 75, 82, 496 S.E.2d 64, 68 (1998), *citing American Sec. & Trust Co. v. Juliano, Inc.*, 203 Va. 827, 834, 127 S.E.2d 348, 352 (1962) and *Khoury v. Community Memorial Hospital*, 203 Va. 236, 243, 123 S.E.2d 533, 538 (1962); *E. C. Ernst, Inc. v. Baltimore Contractors, Inc.*, 1982 U.S. Dist. LEXIS 10086 (E.D.Pa. 1982); *United States for Use and Benefit of Noland Co. v. Wood*, 99 F.2d 80, 82 (4th Cir. 1938)("To establish equitable estoppel it is not necessary that actual fraud be shown. It is only necessary to show that the person estopped, by his statements or conduct, misled another to his prejudice.") and *Bergeron v. Mansour*, 152 F.2d 27, 30 (1st Cir. 1945).

[10] *Cunninghame v. Cunninghame*, 364 Md. 266, 289-290, 772 A.2d 1188, 1202 (2001); *T. v. T.*, 216 Va. 867, 872-73, 224 S.E.2d 148, 152 (1976); *Dews v. Dews*, 632 A.2d 1160, 1167 (D.C. 1993), *citing Parker v. Sager*, 85 U.S.App.D.C. 174 F.2d 657, 661 (1949).

[11] *Creveling v. Government Employees Ins. Co.*, 376 Md. 72, 101-102, 828 A.2d 229 (2003); *Rose v. Red's Hitch and Trailer Service*, 11 Va.App. 55, 59-60, 396 S.E.2d 392, 395 (1990)("Where a party seeks to invoke the doctrine of estoppel he has the burden of proving it by clear, precise and unequivocal evidence."); *Cassidy v. Owen*, 533 A.2d 253, 255 (D.C.1987); *Old Mutual Casualty Co. v. Clark*, 53 Ill. App. 3d 274, 279, 368 N.E.2d 702, 705 (1977)("by clear, concise, and unequivocal evidence.").

[12] *Markov v. Markov*, 360 Md. 296, 307, 758 A.2d 75, 81 (2000), *quoting Travelers*, 244 Md. at 414, 224 A.2d at 292; *see also Allstate v. Reliance*, 141 Md.App. 506, 515, 786 A.2d 27, 33 (2001), *cert. denied,* 368 Md. 526, 796 A.2d 695 (2002).

[13] *Heartwood 88, Inc. v. Montgomery County*, 156 Md.App. 333, 368-369, 846 A.2d 1096 (2004), *citing Cunninghame*, *supra. at* p. 289.

[14] It is not too difficult to imagine prejudice being alleged by a performance bond obligee who held off hiring a completion contractor to allow the surety the time to investigate after receiving assurances from the surety or its consultants only to have the surety then deny liability after significant and costly delays to the project, or by a payment bond claimant after the surety denies a claim because the surety delayed its investigation, thereby causing the claimant to lose its mechanics lien rights when assurances were made that the claim would be investigated and settled promptly.

argue 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.[15] One example of this 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*, 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 even though the key representations pointed to by the court were actually made by the principal.[16] *Humble Oil* involved a supplier who provided asphalt and petroleum products under a subcontract on a highway construction project. Six months after the last delivery made by Humble Oil, the principal (general contractor) failed to make final payment. Thereafter, Humble Oil sought payment directly from the surety. In response to the claim, the surety asked the principal to communicate directly with Humble Oil and make arrangements to settle the claim; the surety advised Humble Oil that it had taken this action. The principal failed to communicate with Humble Oil and the surety was again contacted. The surety advised Humble Oil that it was investigating the financial status of its principal. 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 properly proven, including the claim of Humble Oil, and to fund the 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 indemnitors also agreed to assign all of their assets to the surety. The principal conveyed the substance of its arrangement with the surety to the

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[15] *See United States f/b/o Nelson v. Reliance Insurance Company,* 436 F.2d 1366 (10th Cir. 1971); *United States f/b/o Humble Oil & Refining Company v. Fidelity and Casualty Company of New York,* 402 F.2d 893 (4th Cir. 1968); *United States f/b/o East Coast Contracting, Inc. v. USF&G,* 2004 U.S. Dist. LEXIS 14441 (D.Md. 2004); *United States f/b/o J. Bobby Currin & Sons v. J. W. Builders, Inc.,* 17 F. Supp.2d 462 (M.D.N.C. 1996); *United States f/b/o B&B Welding, Inc. v. Reliance Insurance Company of New York,* 743 F. Supp. 129 (E.D.N.Y. 1990); *United States f/b/o Bagnal Builders Supply Company v. USF&G,* 411 F. Supp. 1333 (D.S.C. 1976); *United States f/b/o Atlas Erection Company, Inc. v. Continental Casualty Company,* 357 F. Supp. 795 (E.D.La. 1973); *Triple Cities Constr. Co. v. Md. Casualty Co*., 4 N.Y.2d 443, 151 N.E.2d 856 (1953).

subcontractors and suppliers, including Humble Oil. Humble Oil prepared the necessary invoices and advised the surety that Humble Oil would, "withhold action against [the principal] for a reasonable time to permit [the surety] to respond." The surety requested that Humble Oil complete certain forms to substantiate its claim, which Humble Oil eventually did. Subsequently, the surety advised Humble Oil 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 its 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 held 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.

There was no mention in the *Humble Oil* decision regarding whether the surety ever attempted to reserve its rights. As discussed herein, while not without its exceptions, the proper and timely assertion of a reservation of rights by the surety may avoid or eliminate the

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[16] 402 F.2d 893 (4th Cir. 1968).

operation of estoppel by precluding the establishment of the necessary element of reasonable reliance.[17]

III. NATURE OF WAIVER

The doctrine of waiver works much like estoppel to deprive a party of a right it would otherwise possess.[18] While waiver and estoppel are often referred to together and courts have from time to time obscured the lines between the two doctrines, the fundamental distinction between waiver and estoppel remains that waiver rests upon the intention of a party alleged to have waived its rights, while estoppel rests upon a detrimental change of position by one party induced by the acts or conduct of the other estopped party.[19] 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, and may result from an express agreement or be inferred from circumstances."[20] When waiver is implied from conduct, the acts, conduct, or circumstances relied upon to show waiver must make out a clear case. Indeed, some courts hold that, "there is an implied waiver of a defense or a right only where a party's conduct is so consistent with and indicative of an intention to relinquish the right and so clear and unequivocal that no other reasonable explanation of the conduct is possible."[21]

The question of whether there has been a waiver in any particular case depends upon the peculiar facts and circumstances of that case.[22] Accordingly, whether waiver exists in a given case "is normally a question for the trier of fact, because the determination of its existence *vel non* turns on the intent of the party ostensibly waiving the right; a state of mind which is to be derived from the facts and circumstances surrounding the purported

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[17] *See e.g. E. C. Ernst, Inc. v. Baltimore Contractors, Inc.*, 1982 U.S. Dist. LEXIS 10086 (E.D.Pa. 1982), *citing Rosen, supra*, 637 F.2d at 597.
[18] *See GEICO v. Medical Services*, 322 Md. 645, 650, 589 A.2d 464, 466 (1991).
[19] *Watson v. U.S. Fidelity & Guaranty Co.*, 231 Md. 266, 276, 189 A.2d 625 (1963).
[20] *Food Fair, supra.*, 234 Md. at 531; *American States Insurance Company v. National Cycle, Inc.*, 260 Ill. App. 3d 299; 631 N.E.2d 1292 (1994); *see also* 16B Appleman, Insurance Law and Practice § 9085 (1981).
[21] *Garfield v. J.C. Nichols Real Estate*, 57 F.3d 662, 667 (8th Cir. 1995).
[22] *Royal Ins. Co. v. Drury*, 150 Md. 211, 132 A. 635 (1926).

relinquishment."[23] It is significant to note that waiver may occur by acts and conduct of the surety or of its agent, having real or apparent authority, provided such acts or conduct occur after the surety or its agent have full knowledge of the facts giving rise to the right or defense.[24]

While a party may waive any condition or provision inserted in a document for its benefit,[25] it is generally recognized that the doctrine of waiver cannot operate to expand or establish coverage where none exists.[26] The Maryland Court of Special Appeals discussed the issue in the context of insurance coverage and noted,

> [T]he Court of Appeals sees a distinction between defenses founded upon lack of basic coverage and those arising from the failure of the claimant to satisfy some 'technical' condition subsequent. The former, it is apparent, may not be waived merely by the company's failure to specify them in its initial response to the claim, for the effect of that would be to expand the policy to create a risk not intended to be undertaken by the company.[27]

Thus, in determining whether the doctrine of waiver may apply, one issue to address is whether the applicable clause or condition proffered as a defense pertains to coverage or whether it arises from the failure of the claimant to satisfy some "technical" condition.[28] Conditions going to the coverage or scope of a bond or policy as distinguished from those furnishing a ground for forfeiture may not be waived by implication from conduct or action.[29]

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[23] *St. Paul Fire & Mar. Ins. v. Molloy*, 291 Md. 139, 145, 433 A.2d 1135, 1138 (1981).
[24] *Royal Ins. Co., supra.*
[25] 26 C. J. 281.
[26] *Neuman v. Travelers Indemnity Co.*, 271 Md. 636, 654, 319 A.2d 522, 531 (1974); *Aetna Cas. & Sur. Co. v. Urner*, 264 Md. 660, 668, 287 A.2d 764, 768 (1972); *Brown Mach. Works & Supply Co. v. Ins. Co. of N. Am.*, 659 So.2d 51, 53 (Ala.1995); *Am. States Ins. Co. v. McGuire*, 510 So.2d 1227, 1229 (Fla.Dist.Ct.App.1987); *W. Food Prod. Co. v. United States Fire Ins. Co.*, 10 Kan.App.2d 375, 699 P.2d 579, 584 (1985); *Palumbo v. Metro. Life Ins. Co.*, 293 Mass. 35, 199 N.E. 335, 336 (1935); *Albert J. Schiff Assoc., Inc. v. Flack*, 51 N.Y.2d 692, 435 N.Y.S.2d 972, 417 N.E.2d 84, 87 (1980); *Currie v. Occidental Life Ins. Co.*, 17 N.C.App. 458, 194 S.E.2d 642, 643 (1973); *Turner Liquidating Co. v. St. Paul Surplus Lines Ins. Co.*, 93 Ohio App.3d 292, 638 N.E.2d 174, 178 (1994); *Texas Farmers Ins. Co. v. McGuire*, 744 S.W.2d 601, 603 (Tex.1988); *Estate of Hall v. HAPO Fed. Credit Union*, 73 Wash.App. 359, 869 P.2d 116, 118 (1994); *Potesta v. United States Fid. & Guar. Co.*, 202 W.Va. 308, 504 S.E.2d 135, 146-47 (1998); *Utica Mut. Ins. Co. v. Klein & Son, Inc.*, 157 Wis.2d 552, 460 N.W.2d 763, 767 (1990); 16B Appleman, supra, § 9083, 9090.
[27] *Insurance Company Of North America V. Coffman*, 52 Md.App. 732, 742-43, 451 A.2d 952, 957 (1982).
[28] *See also Wright v. Newman*, 598 F.Supp. 1178, 1198 (W.D.Mo.1984).
[29] 16B Appleman, supra, § 9083, at 518.

IV. 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.[30] Second, the reservation must clearly and unambiguously inform the recipient of the surety's position.[31] 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.[32] Finally, the reservation must be asserted in a timely fashion.[33]

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.[34] 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.

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[30] *Bell Lavalin, Inc. v. Simcoe and Erie General Ins. Co.*, 61 F.3d 742 (9th Cir. 1995); *Farmers Ins. Co. of Arizona v. Vagnozzi*, 138 Ariz. 443, 675 P.2d 703 (1983); *Foremost Insurance Co. v. Eanes*, 134 Cal. App. 3d 566, 184 Cal. Rptr. 635 (4th Dist. 1982); *Richards Mfg. Co. v. Great American Ins. Co.*, 773 S.W.2d 916 (Tenn. Ct. App. 1988).

[31] *Val's Painting & Drywall, Inc. v. Allstate Ins. Co.*, 53 Cal. App. 3d 576, 588, 126 Cal. Rptr. 267 (1975); *Miller v. Elite Ins. Co.*, 100 Cal. App. 3d 739, 754, 161 Cal. Rptr. 322 (1980); *St. Katherine Ins. Co. v. Shay*, 1996 U.S. App. LEXIS 21821 (9th Cir. 1996); *Transamerica Ins. Group v. Beem*, 652 F.2d 663 (6th Cir. 1981); *Henry v Johnson*, 191 Kan 369, 381 P2d 538 (1963).

[32] *Cozzens v. Bazzani Bldg. Co.*, 456 F. Supp. 192 (E.D. Mich. 1978); *Proudfoot v. Cotton States Mut. Ins. Co.*, 230 Ga. 169, 196 S.E.2d 131 (1973); *Nationwide Mut. Ins. Co. v. Gentry*, 202 Va. 338, 117 S.E.2d 76 (1960).

[33] *Cozzens*, *supra.*; *St. Leger v. American Fire and Cas. Ins. Co.*, 870 F. Supp. 641 (E.D. Pa. 1994), *aff'd*, 61 F.3d 896 (3d Cir. 1995); *Shelby Steel Fabricators, Inc. v. U.S. Fidelity and Guar. Ins. Co.*, 569 So. 2d 309 (Ala. 1990) and *Western Cas. & Sur. Co. v. Newell Mfg. Co.*, 566 S.W.2d 74 (1978).

[34] *See United States f/b/o Frederick Precast Concrete v. Sigal Construction Corp.*, 2003 U.S. Dist. LEXIS 23628 (D.Md. 2003); *Basta v. United States Fidelity & Guar. Co.*, 107 Conn. 446, 140 A. 816 (1928); *Shelby Mut. Cas. Co. v. Richmond*, 185 F.2d 803 (2d Cir. 1950); *Fellows v Mauser,* 302 F Supp 929 (D.Vt. 1969).

In *J. Caiazzo Plumbing and Heating Corp. v. United States Fidelity and Guaranty Company*, the surety acknowledged receipt of the claim and investigated the claim with a reservation of rights, but it did not deny the claim until after the statute of limitations expired. In addressing the estoppel argument raised by the claimant, the United States District Court for the Southern District of New York 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.[35] 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.

Similarly, in *United States f/b/o East Coast Contracting, Inc. v. United States Fidelity and Guarantee Company*,[36] the surety received and acknowledged the claimant's claim and conducted an investigation, but did not deny the claim until after the limitations period had expired. In denying the claims of waiver and estoppel, the United States District Court for the District of Maryland considered the fact that while the surety never promised to pay the claimant's claim and simply counseled patience during the ongoing investigation of the claim, there were no representations that the surety intended to waive the limitations period. Indeed, there were no representations or promises upon which the claimant might have reasonably relied that induced the claimant to forbear timely filing suit. In *East Coast Contracting,* all of the correspondence from the surety contained the following reservation of rights:

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[35] *Supra., citing Krugman and Fox Constr. Corp. v. Elite Assoc., Inc.*, 167 A.D.2d 514, 562 N.Y.S.2d 188 (2d Dep't 1990); *Afsco Specialties Inc. v. Md. Casualty Co.*, 37 Misc. 2d 641, 235 N.Y.S.2d 147 (1962).
[36] 2004 U.S. Dist. LEXIS 14441 (D.Md. 2004), aff'd, 2005 U.S. App. LEXIS 9683 (4th Cir. 2005).

> This correspondence, our delivery of the Affidavit of Claim and all prior or subsequent communications and/or investigative efforts are made with the express reservation of all rights and defenses that may be available to the surety or its principal, whether at law, in equity or under the terms and provisions of the bond and the contract documents. This reservation includes, without limitation, defenses available pursuant to any notice and suit limitation provisions.

In light of the express reservation of rights and the absence of any other factors in favor of estoppel or waiver, the *East Coast Contracting* Court held that it was simply not reasonable to expect payment on untimely claims from the surety.[37]

In contrast to *Caiazzo* and *East Coast Contracting*, several courts have found estoppel and/or waiver to exist *even if the surety asserted a reservation of rights* when the courts have found acts/omissions, representations or promises that were inconsistent with the reservation of rights.[38]

In *United States f/b/o Nelson v. Reliance Insurance Company*, [39] 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 he [principal] doesn't and that they [surety] would even pay the interest if he [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

[37] The *East Coast Contracting* Court also cited as factors in reaching its decision the fact that the claimant was represented by counsel at the time and the fact that the claimant waited nearly three months to seek legal redress after the surety denied its claim.

[38] *See United States f/b/o Nelson v. Reliance Insurance Company*, 436 F.2d 1366 (10th Cir. 1971); *USF&G v. Braspetro Oil Services Company,* 369 F.3d 34 (2nd Cir. 2004); *Western Casualty & Surety Co. v. Brochu*, 105 Ill. 2d 486, 475 N.E.2d 872, 879 (1985); *Employers Insurance of Wausau v. Ehlco Liquidating Trust*, 186 Ill. 2d 127, 708 N.E.2d 1122, 1136 (1999); *Willis Corroon Corporation v. The Home Insurance Company*, 203 F.3d 449 (7th Cir. 2000).

[39] 436 F.2d 1366 (10th Cir. 1971).

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 acknowledged that it 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 trial court found that 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 Reliance 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 Reliance would pay [Nelson Brothers'] claim if [the principal] did not.[40]

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."[41] 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.[42] 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*,[43] 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

[40] *Id*. at 1371.
[41] *Id.*
[42] In *Willis Corroon Corporation v. The Home Insurance Company*, 203 F.3d 449 (7th Cir. 2000), the United States Court of Appeals for the Seventh Circuit discussing Illinois law stated, "[i]t is inconceivable that Illinois would allow a reservation of rights to give an insurer license to prejudice its insured however it wanted. And in fact it does not.

policy behind surety bonds is not to protect a surety from its own laziness or poorly considered decision. (citations omitted)." The trial court concluded that the sureties, in not objecting to the direct and advance payments, "thus waived any objections to the [direct and advance payments] of which they had been informed." The Second Circuit did not expressly decide whether a waiver had occurred, instead holding that the sureties' failure to object constituted *consent*, notwithstanding the sureties' attempts to reserve their rights, and further noted that the sureties did not directly challenge the trial court's ruling on waiver. 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.,*[44] the asbestos and lead paint abatement subcontractor on a federal project performed additional and extra work on the project, the costs of which were submitted for the subcontractor to the government by the principal in a request for equitable adjustment. The subcontractor also asserted a claim against the payment bond. 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

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Illinois courts have found estoppel even when there has been a reservation of rights. See *Western Casualty & Surety Co. v. Brochu,* 105 Ill. 2d 486, 475 N.E.2d 872 (1985).
[43] 369 F.3d 34 (2nd Cir. 2004).

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.

In response to the surety's motion for summary judgment, 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.

V. 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 reconsider 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 replaced with a concerted effort to include a specifically tailored reservation of rights in all communications with obligees, claimants and indemnitors. Form language simply cannot 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

[44] 2000 U.S. Dist. LEXIS 18835 (S.D.Ala. 2000).

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 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.

Sometimes there is a fine line between lulling a party into inaction and avoiding communication that might actually spark the party into action. Often the thought may be to try and couch the language of the reservation of rights in such a way to have just enough to preserve the rights without "waking up" the claimant to the fact that it may be losing its rights. Such "gamesmanship" has a small chance of success given the nature of estoppel and waiver and should be abandoned in favor of being diligent and forthright. Courts have no difficulty in ferreting out situations where the *game* has been played, and, in close calls, will tend to lean in favor of the claimants.

VI. 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.

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