CURRENT PRECEDENT AND ETHICAL ISSUES REGARDING THE 45 DAY PROVISION IN THE AIA A-312 PAYMENT BOND

Michael A. Stover, Esquire*
David Anderstrom, Esquire

A. Introduction

The seemingly simple requirement that a surety answer a claim within 45 days after receipt of such claim (hereinafter referred to as the "45 Day Period") as required under the AIA A312 Payment Bond (1984) has engendered much controversy and concern within the surety industry and has spawned much discussion. The controversy was generated by certain courts that have taken an extremely harsh and myopic view of the surety's obligations under the A312 bond. According to these handful of courts, if a surety fails to respond to a claim within the 45 Day Period as required by the bond *the surety's defenses to the claim can be waived!* Obviously, a loss of defenses can be a serious issue for any surety and surety claims professional and such a circumstance deserves significant scrutiny. However, perhaps equally important is the impact and effect that the "waiver interpretation" of the 45 Day Period may have on the handling of claims under the AIA A312 for surety claims professionals.

Accordingly, as a starting point, this paper will look at the terms and conditions of the A312 Payment Bond and discuss the differences between the A312 and the prior bond form the A311. The paper will next discuss in detail those cases that have interpreted the AIA A312 Payment Bond and their holdings. The paper will then focus on various issues that may arise for the surety claims professional when dealing with the AIA A312 Payment Bond and the 45 Day Period, exploring different scenarios that could confront the claims handling professional from a legal, ethical and statutory claims handling perspective. Practical tips and advice will then be provided on what should be included in the surety's denial of claim letters and calculating when the 45 Day Period runs. In addition, some attention will be given to the potential effect of the 45 Day Period and the "waiver interpretation" on indemnity issues between the surety and its indemnitors. Finally, the paper will discuss the recent developments concerning the redrafting of the AIA A312 Payment Bond to address the industry concerns with the 45 Day Period.

Of course, do to the nature of the issues discussed, the "answers" to the questions and issues raised may differ on a state by state basis depending on the unique interplay between statutory law and common law in the particular jurisdiction and the specific facts of a give situation. It is beyond the scope of this paper to attempt to set forth the status of the law in all 50 states. Further, do to

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* Mr. Stover is a Partner in the law firm of Wright, Constable & Skeen, LLP in Baltimore, Maryland with over 19 years of surety and construction litigation experience. Mr. Anderstrom is a bond claim manager at the Hartford Insurance Company in Hartford, Connecticut with over 13 years of contract surety claims handling experience.

the nature of the issues raised, some of the questions may not have definite or defined "answers." However, the exercise of raising the issues and discussing possible solutions, responses, concerns, etc. is important because it gets the claims professional thinking about the issues and raises the awareness of the issues, so that if and when such issues arise, they will hopefully be spotted and identified and then a more specific and tailored response can be explored.[1] In addition, the law is constantly in flux and any opinions or views expressed herein by the authors are accordingly subject to change as the law changes.

B. The AIA A-312 Payment Bond

In 1984, the American Institute of Architects (AIA) issued a new payment bond and performance bond form known as the A312. These new bonds replaced the A311 form which had been in circulation and use since 1970. In the *Payment Bond Manual, Second Edition*, 1995 it was stated at Appendix C:

> The newer Form A312 (Dec. 1984 ed.) has generally been shunned by the industry with very good reason. It imposes a series of duties to give unnecessary notices or responses on both claimants and the surety. It is an excellent example of overdrafting and "fixing" nonexistent problems. It differs so significantly from the Miller Act, and virtually all other bond forms that established case law will not be a dependable guide to the respective obligations of the parties. In the unlikely event Form A312 is actually used, one must consult its actual, involved terms to ascertain whether the claimant has given the required notices and is otherwise entitled to recover from the surety.

Until recently, contrary to the views of the authors of the *Payment Bond Manual*, the A312 bond forms have become one of the more widely used bond forms in the industry for private projects and are even used on public projects.[2] As noted, the A312 Payment Bond form (hereinafter the "A312") sets forth more structure in terms of claims submission requirements and surety response requirements than were previously set forth in most other bond forms including the old A311.

The A312 begins by binding the Surety and the Contractor (Principal), jointly and severally to the Owner (Obligee), "to pay for labor, materials and equipment furnished for use in the performance of the Construction Contract, which is incorporated herein by reference."[3] The A312 also provides the familiar

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[1] The opinions and/or views set forth herein are not intended to be the opinions and views of the surety industry, any particular surety company or Hartford Casualty Insurance Company or any of its affiliates, subsidiaries or parent entities.

[2] Philip L. Bruner & Patrick J. O'Connor, Jr., 4A *Bruner & O'Connor on Construction Law* § 12:16 (2009); *St. Paul Fire & Marine Ins. Co. v. VDE Corp.*, 603 F.3d 119, 124 (1st Cir. 2010).

[3] § 1, AIA A312 Payment Bond (1984).

"this obligation shall be null and void if the Contractor promptly makes payment, directly or indirectly, for all sums due."[4] The A312 establishes the notice requirements as a condition precedent stating that a Surety "shall have no obligation to Claimants until" the notice requirements are met.[5] The notice provisions are separated into requirements for Claimants who have a direct contract with the Principal and those that do not. For Claimants with direct contracts with the Principal, notice must be provided to the Surety with a copy to the Obligee "stating that a claim is being made under this Bond and, with substantial accuracy, the amount of the claim."[6] If the Claimant does not have a direct contract with the Principal, the A312 sets forth a more detailed claim notice process as follows:

> .1 Have furnished written notice to the Contractor and sent a copy, or notice thereof, to the Owner, within 90 days after having last performed labor or last furnished materials or equipment included in the claim stating, with substantial accuracy, the amount of the claim and the name of the party to whom the materials were furnished or supplied or for whom the labor was done or performed; and
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> .2 Have either received a rejection in whole or in part from the Contractor, or not received within 30 days of furnishing the above notice any communication from the Contractor by which the Contractor has indicated the claim will be paid directly or indirectly; and
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> .3 Not having been paid within the above 30 days, have sent a written notice to the Surety . . . and sent a copy, or notice thereof, to the Owner, stating that a claim is being made under this Bond and enclosing a copy of the previous written notice furnished to the Contractor.

AIA A312 Payment Bond, § 4.2 (1984).

It should be observed that the A312 (and its predecessor A311) does *not* require the submission of any proof of claim form, claim certification, copies of documents to substantiate the claim or an accounting of the claim. Accordingly, essentially all that a Claimant must do in the A312 notice is: (1) state that a claim is being made; (2) the amount of the claim and (3) if required state for whom the work was done. Obviously, the AIA wanted to make claims submissions as informal as possible, but this is a significant flaw in drafting and leads to substantial delay in responding to claims because often the Surety and its

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[4] *Id.* at § 3.

[5] *Id.* at § 4.

[6] *Id.* at § 4.1.

Principal must first get the most basic supporting documentation and information from the Claimant before the claim can even be addressed. As discussed at the end of this paper, the AIA has attempted to address this very issue in the new AIA A312 – 2010.

The A312 differed from the A311 form in terms of notice in several ways. In an improvement, the A312 actually requires a Claimant with a direct contract with the Principal to provide notice to the Surety, whereas the A311 did not require any notice from such Claimants. The A312 also requires Claimants without a direct contract to provide notice to the Principal and Owner within 90 days after last performing work and waiting for 30 days after providing that notice before providing notice to the Surety and Owner. The A311 only required notice to any two of the Owner, Surety or Principal within 90 days of having last performed work, which could have resulted in the Surety not being provided with direct notice of the claim by the claimant at all![7] The A312 also did away with the A311 requirement that notice be served by registered/certified mail or be served in a manner required for legal process.[8] Having modified the A311 notice requirements in the A312 to ensure that the Surety now must directly receive notice of the claim, the A312 then added a completely new provision regarding the Surety's response obligation to the claim. It is this new response obligation that has spawned a series of court decisions that have caused the concern that has gripped the surety industry.

The specific language of the A312 at issue is as follows:

> § 6 When the Claimant has satisfied the conditions of Section 4, the Surety shall promptly and at the Surety's expense take the following actions:
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> §6.1 Send an answer to the Claimant, with a copy to the Owner, within 45 days after receipt of the claim, stating the amounts that are undisputed and the basis for challenging any amounts that are disputed.
>
> §6.2 Pay or arrange for payment of any undisputed amounts.

AIA A312 Payment Bond 1984.

The A311 placed no response requirements or obligations on the Surety or the Contractor. Notice was simply a condition precedent to filing suit. The difficulty with the interplay between the notice and response obligations under the A312 is that the notice required is so basic and devoid of information and the response time so relatively short that the obligation can be difficult if not impossible to meet, especially if the issues involved are complex and/or the

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[7] AIA A311 (1970) § 3 (a).

[8] *Id.*

Principal/Claimant/Owner do not timely cooperate. The A312 also does not specify what the remedy is for breach of the response obligation, which has allowed some courts to impose drastic sanctions.

C. Judicial Interpretation Of The A312

From the seemingly innocuous language of the A312, several courts have imposed rather *draconian* obligations and consequences on sureties who have failed to respond to a claim within the 45 Day Period. In *National Union Fire Insurance Co. of Pittsburgh v. David A. Bramble, Inc.*, 879 A.2d 101 (Md. 2005), the highest court in Maryland held that the Surety's failure to respond to a payment bond claim within the 45 Day Period set forth in § 6.1 of the A312 constituted a waiver of the Surety's defenses to the claim and obligated the Surety to pay the claim in full. Following the Maryland Court's decision, the United States District Court for the Eastern District of Virginia in *Casey Industrial, Inc. v. Seaboard Surety Co.*, 2006 WL 2850652 (E.D. Va. Oct. 2, 2006), adopted the Maryland Court's reasoning and held that the Surety was limited to only the defenses it identified prior to the 45 Day Period in the A312 and that a failure to identify other defenses within that time frame resulted in waiver of those defenses, excluding only litigation defenses such as the statute of limitations. Finally, in *J.C. Gibson Plastering Co., Inc. v. XL Specialty Insurance Co.*, 2007 WL 2916399 (M.D.Fla. Oct. 8, 2007), the United States District Court for the Middle District of Florida held that the Surety could not rely on the response of the Principal and that a response just 3 days outside of the 45 Day Period resulted in waiver of the surety's defenses. It should be noted that the *J.C. Gibson* case was subsequently vacated at the request of the parties, but not for any procedural or legal infirmities, which means the Court's analysis may still be persuasive, at least in that district.

One of the many difficulties with these decisions is that they ignore or gloss over the realities of complex construction projects and the relationships between the surety and the other parties. Because the Sureties are not on the projects and do not typically follow the status of the projects on a day to day basis, Sureties are generally unaware of the circumstances surrounding the claim until notice is received. Then, after that first notice, the Surety must rely on the cooperation of the persons and entities who were directly involved with the project to develop a response. In addition, construction projects can generate tens of thousands of pages of documents, which might require review and analysis to say nothing of researching the specific legal and contractual requirements applicable to a particular claim, which will vary from state to state. It can be virtually impossible for a surety to fully investigate a claim and determine all of its potential defenses within the short 45 Day Period. In the case of *Methuen Construction Co. v. Austin Co.*, Mass. Superior Ct. C.A. No. 04-1207-G (Sept. 1, 2006), the trial court recognized the realities of construction projects and refused to find a waiver under the A312. Most recently in *Sloan Company v. Liberty Mutual Insurance Co.,* 2009 WL 2616715 (E.D. Pa. 2009), the Court applying Pennsylvania law refused to find a forfeiture of all defenses that were not identified in the Surety's initial rejection of the claim under an A312 bond

since the Surety had asserted a defense which resulted in a rejection of the entire claim.

Regardless of the merits of the opinions concerning the effect of the A312, the industry is currently stuck with the impact and uncertainty that the "waiver interpretation" of the A312 has generated. Whether a particular claim arises in Maryland, Virginia or Florida or whether the claim is in another state, the surety claims professional must be cognizant of the 45 Day Period of the A312 and handle claims in a manner to avoid becoming another "bad case jurisdiction." Accordingly, to understand the parameters of the issues that will addressed in this paper, the details and reasoning of the *Bramble, Casey Industrial* and *Gibson* cases must be analyzed.

1. ***National Union Fire Insurance Co. of Pittsburgh v. David A. Bramble, Inc.*, 879 A.2d 101 (Md. 2005).**

In *Bramble*, there were two cases that were consolidated for appeal – Bramble and Wadsworth. The issue squarely before the Court in both cases was the effect of a surety's failure to adhere to the contractual requirements of § 6.1 of the A312 requiring that the surety answer a subcontractor's payment bond claim within 45 days after receiving that claim. The Court ultimately held that the "[p]ayment bond requires the sureties to delineate those portions of the claim that they intend to dispute within the 45 day period and that, under the language of the bond, a failure to do so results in the entirety of the claim being undisputed."[9] The case arose out of the construction of a Hyatt Regency resort in Cambridge, Maryland. Clark Construction Group ("Clark") was the general contractor on the project and National Union Fire Insurance Company ("National Union"); Federal Insurance Company ("Federal") and Fidelity and Deposit Company of Maryland ("F&D") were the co-sureties.

In the *Bramble* companion case, the Claimant, David A. Bramble, Inc. ("Bramble"), entered into a subcontract with Clark to install water and sewer piping systems at the project. On June 14, 2002, Bramble provided notice of its claim in the amount of $455,511.53 to the co-sureties. One month later, Federal responded to the Bramble claim with a letter indicating that American Insurance Group ("AIG")[10] was the lead surety and it forwarded the claim to AIG. Federal also reserved its rights in its response letter as follows: "Federal Insurance Company writes this letter with a full reservation of its rights and with the understanding that any actions we have taken or may take do not constitute a waiver of any defenses available under the bond or applicable law . . ."[11] At some point thereafter, AIG requested that Bramble provide an executed Proof of

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[9] *National Union Fire Ins. Co. of Pittsburgh, PA,* 879 A.2d at 103.

[10] The reference to AIG is not explained by the Court, but most likely refers to AIG Claims Services which handled claims for AIG affiliates including National Union.

[11] *Id.* at 104.

Claim and other documentation supporting the claim. Bramble provided the executed Proof of Claim form on April 22, 2003, almost a year after the claim had been submitted.[12] On April 25, 2003, AIG sent a letter to Bramble advising that the amount of the claim should be reduced, but there was no further communication from AIG. Bramble filed suit against the sureties and obtained summary judgment. The case was appealed to the Maryland intermediate appellate court where the judgment was affirmed and the case was taken up by Maryland's highest appellate court on certiorari.

In the *Wadsworth* companion case, Wadsworth Golf Construction Company of the Midwest ("Wadsworth") the claimant, entered into a subcontract with Clark to build an 18 hole golf course and to perform rough grading and site work for all buildings at the Hyatt Regency project. Wadsworth submitted a claim in the amount of $720,963.45 on March 23, 2002. Federal responded to the claim within 10 days, again indicating that AIG was the lead surety and forwarded the claim to AIG. Federal's letter also reserved its rights as noted above in Bramble. AIG responded to the claim within a few weeks acknowledging the claim and requesting that a Proof of Claim form be completed and that supporting documents such as subcontracts, purchase orders and invoices be provided. AIG also reserved its rights as follows: "Please be advised that this action is taken at this time without waiver of or prejudice to any of the rights defenses, past or present, known or unknown which either the above referenced . . . may have in this matter." Wadsworth completed the Proof of Claim form and provided the information in about 28 days, which was within 45 days from the date of the claim. AIG responded that it would investigate the claim, but there was no further communication from AIG. Wadsworth sent a follow up letter requesting an answer to its claim, but none was provided. Wadsworth filed suit against the sureties and obtained summary judgment. The case was appealed to the Maryland intermediate appellate court where the judgment was affirmed and the case was taken up by Maryland's highest court on certiorari.

In *Bramble* the sureties advanced a number of arguments. First, the sureties argued that failure to answer within 45 days indicated that the entire claim was disputed. Second, if disputes were treated as waived by a failure to respond within 45 days such a result could force a surety to pay invalid claims and undeserving subcontractors would receive a windfall at the expense of other deserving claimants if the penal sum was not sufficient to satisfy all claims. Third, the sureties argued that at most claimants should be entitled only to consequential damages for a surety's failure to respond timely. Finally, the sureties argued that completely barring defenses is punitive and expands the scope of the bond.

The *Bramble* Court responded, after examining the history of suretyship, by first noting that "the rule is well settled . . . that a compensated surety is in effect an insurer, that its contract will be construed as an insurance contract most

[12] There was no statute of limitations issue because the project was a private project and Maryland's Statute of Limitations on bond claims is 12 years.

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."[13] The Court reasoned that the plain language of Paragraph 6.1 of the A312 requires the sureties to do three things: answer the claimant's claim, define what amounts are undisputed, and list the bases for challenging the payment of any amounts that are disputed.[14] Thus, under the Court's review the language clearly requires the sureties to affirmatively communicate what portions of the claim are disputed.[15] The Court stated that sureties must do more than simply state which portions of the claim are disputed, "they must also specifically delineate the grounds underlying the dispute."[16] The Court further observed, "[t]his places a greater burden on the sureties with respect to those amounts they wish to challenge as compared to those parts of the claim that are undisputed, the later of which the sureties must only list."[17] Thus, inaction cannot operate to dispute the claim in its entirety under the plain wording of the bond according to the *Bramble* Court.

The Court continued its analysis by noting the purpose of § 6.1 as being to "better facilitate the timely payment of claims under the bond, . . ."[18] Indeed, the Court stated, "[t]he very purpose of securing a surety bond contract is to insure that claimants who perform work are paid for their work in the event that the principal does not pay"[19] To "decide that the sureties through time and effort, could dispute the entirety of a claim *ad infinitum,* would greatly undermine the bond's purpose . . ."[20] The requirements of Paragraph 6 function to insure that subcontractors and sub-subcontractors are not forced to absorb the risk of non-payment over a protracted period by the contractor and the owner, through no fault of their own.[21]

The *Bramble* Court concluded, "[u]nder the terms of Paragraph 6, the sureties were required to delineate which portions of Wadsworth and Bramble's claim were disputed and failed to do so. Therefore, the effect of the provisions in

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13 *Id.* at 108.

14 *Id.* at 110.

15 *Id.*

16 *Id.*

17 *Id.*

18 *Id.*

19 *Id.* at 111.

20 *Id.*

21 *Id.*

Paragraph 6 is that the entirety of the claim is undisputed and the sureties are required to promptly pay the claims . . ."[22]

2. ***Casey Industrial, Inc. v. Seaboard Surety Co.*, 2006 WL 2850652 (E.D. Va. Oct. 2, 2006)**

The next case to address the A312 45 Day Period was the United States District Court for the Eastern District of Virginia in *Casey Industrial, Inc. v. Seaboard Surety Co.,* 2006 WL 2850652 (E.D. Va. 2006). In *Casey Industrial*, the surety, Seaboard Surety Company ("Seaboard") issued an A312 Payment Bond to the Owner of the project, Marsh Run Generation, LLC, in connection with the construction of an electrical power station in Virginia by the Principal, Ragnar Benson, Inc. ("RBI"). The claimant, Casey Industrial, Inc. ("Casey"), entered into a subcontract with RBI to perform concrete construction services and underground electrical work. Eventually, RBI was default terminated by the Owner and through a Takeover Agreement Seaboard hired a completion contractor and Casey continued working for that completion contractor. RBI also eventually filed bankruptcy. 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. 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.[23]

As noted, when Seaboard initially rejected the claim, within the 45 day period, it identified certain defenses. 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.

The Court found the *Bramble* decision to be persuasive and noted that the plain meaning of the bond controls under Virginia law and any ambiguities under the bond are construed against the drafter.[24] The *Casey Industrial* Court held that Seaboard was not entitled to rely upon a reservation of rights clause to delay identifying disputes to the claim within the 45 day period.[25] The Court further held that the claim was disputed as stated in Seaboard's November letter "and

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[22] *Id.*

[23] *Casey Industrial, Inc.,* 2006 WL 2850652 at *3.

[24] *Id.*

[25] *Id.* at *4.

other bases for challenging the amount in question are waived."[26] However, the waiver was held not to apply to "legal defenses," such as the statute of limitations or collateral estoppel, which the Court opined are not required to be asserted in response to a pre-litigation letter, and such defenses are held not to have been waived.[27]

On a motion for clarification of its prior ruling, the Court in *Casey Industrial, Inc. v. Seaboard Surety Co.,* 2006 WL 3299932 (E.D. Va. 2006), issued a second opinion reaffirming its prior ruling. The Court again stated that its ruling was based on the plain language of the bond, which required the Surety to include in its response letter within 45 days of receipt of the claim: (1) the amounts disputed and (2) the bases for challenging the amounts in dispute. In its discussion the Court again erroneously observed that Seaboard was the drafter of the A312 bond and that as such it should be construed against Seaboard.[28] The Court affirmed that the defenses set forth in the November denial letter were preserved and all other defenses to the claim were waived.[29] The Court stated that the surety is "precluded, however, from developing new bases for dispute outside the 45 day contractual period" with the exception of legal defenses, which need not be raised in the 45 day period.[30] In its ruling the Court specifically rejected the reasoning of *Methuen Constr. Co., Inc. v. The Austin Co.*, Superior Court C.A. No. 04-1207-G (9/1/06) finding that Virginia law bound the Court to the "plain language" of the bond.

3. ***J.C. Gibson Plastering Co., Inc. v. XL Specialty Insurance Company*, 521 F. Supp.2d 1326 (M.D. Fla. 2007).**

The next case to consider the A312 was *J.C. Gibson Plastering Co., Inc. v. XL Specialty Insurance Company,* 521 F. Supp.2d 1326 (M.D. Fla. 2007). In *Gibson,* the surety, XL Specialty Insurance Company ("XL"), issued an A312 Payment Bond on a large housing development project with its Principal, Auchter Company ("Auchter"), the general contractor. The claimant, J.C. Gibson Plastering Company, Inc. ("Gibson"), entered into a subcontract with Auchter to perform work on the project. Gibson submitted its claim against the A312 Payment Bond on February 9, 2007 in the amount of $736,416.66. The claim was received by XL on February 16, 2007. Based on the receipt date, the 45 day deadline was April 2, 2007. On February 12, 2007, Gibson sent a 14 page letter detailing the factual and legal bases for the claim and noted that all records supporting the claim had been previously furnished to Auchter. XL responded to

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[26] *Id.*

[27] *Id.*

[28] *Casey Industrial, Inc.,* 2006 WL 3299932 at *4.

[29] *Id.* at *2.

[30] *Id.* at *3.

the claim on February 22, 2007, requesting copies of all cost records supporting the claim. On March 20, 2007, Gibson sent XL all the requested materials. XL acknowledged receipt of the materials the next day and advised that it would confer with Auchter regarding the claim. On March 30, 2007, Auchter's counsel sent a letter to Gibson responding to the claim. On April 3, 2007, Gibson advised XL that it was in breach of the 45 day rule and filed suit on April 4, 2007. XL advised on April 5, 2007, that it appeared a legitimate dispute existed on the project and that XL had not been empowered to act as the judge, juror or arbiter as it relates to said dispute. XL further stated, "[i]t is not up to XL to determine which party is correct or incorrect as it relates to same" and that Gibson "would have to resolve the matter directly with Auchter."[31]

In *Gibson* the surety argued (1) that the original notice did not satisfy Paragraph 4 of the bond and that it was not until the cost records were provided that the 45 day period began to run; (2) that the responses of the Surety and Principal satisfied the bond requirements and (3) Florida law does not prevent a Surety from challenging a claim even if the terms of the bond were not complied with. The Court rejected the Surety's argument that Paragraph 4 of the A312 was not satisfied until the claimant submitted a proof of loss for the claim or other documents sufficient to substantiate the claim.[32] The Court held that the original notice was sufficient under Paragraph 4 of the bond because the bond does not require the claimant to provide a proof of loss form or sufficient information to verify the legitimacy of the claim.[33]

The *Gibson* Court noted that under Florida law the terms of the bond govern the requirements for submission of a claim and the bond is construed strictly against the surety and in favor of the claimant. "That the notice did not contain enough information for [the Surety] to verify the claim is immaterial because Paragraph 4 did not require notices to contain such information."[34] The Court also rejected the surety's argument that its prior communications satisfied the bond. The Court noted that the letters did not state the amounts that are undisputed and the basis for challenging any amounts that are disputed. The Court rejected the surety's argument that its principal's prior communications satisfied the bond stating that such an argument "strained credulity" because the Surety was not the source of the communication and the letter was insufficient to satisfy the bond requirements.[35]

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[31] *J.C. Gibson Plastering Co., Inc.,* 521 F. Supp.2d at 1328-29.

[32] *Id.* at 1330-1331.

[33] *Id.*

[34] *Id.* at 1333.

[35] *Id.* at 1334.

The *Gibson* Court also refused to follow the *Methuen* case and did not find any impracticability, noting that the surety set the 45 Day Period.[36] The obligations of Paragraph 6 cannot be met by "hinting" that a claim is disputed. The Court also rejected the surety's argument that its letter of April 5, 2007 was only 2 days late and thus substantially satisfied the 45 Day Period. The Court held that strict construction of the bond against the surety precludes allowing late compliance – 45 days means 45 days.[37] The Court rejected the argument that a breach of the bond does not require waiver of all defenses unless there was prejudice. The Court found the *Bramble* line of cases persuasive.[38] Finally, the Court found no need to find an exception to the *Bramble* rule based on frustration of the investigation because the claimant supplied the necessary information supporting the claim to the Principal.

As noted above, the *Gibson* decision was vacated by the Court with the agreement of the parties and the prior decision is not to be cited as precedent.[39] However, the decision does not appear to have been vacated on legal or procedural grounds, thus the analysis may still be persuasive in that District and in Florida.

4. ***Methuen Constr. Co., Inc. v. The Austin Co.*, Superior Court C.A. No. 04-1207-G (9/1/06).**

Standing in contrast to the *Bramble, Casey Industrial and Gibson* line of cases is the trial level court slip opinion in *Methuen Constr. Co., Inc. v. The Austin Co.*, Superior Court C.A. No. 04-1207-G (9/1/06). In *Methuen,* the surety, Seaboard Surety Company ("Seaboard") issued an A312 Payment Bond with its Principal, The Austin Company ("Austin") for a project involving the construction of a plant. The Claimant, Methuen Construction Co., Inc. ("Methuen") entered into a subcontract with Austin to provide HVAC and process piping for the project. On December 5, 2003, Methuen asserted a claim against the bond. Seaboard subsequently acknowledged the claim and requested that an Affidavit of Claim be completed. Methuen provided the Affidavit on February 3, 2004 and Seaboard forwarded the Affidavit to Austin and requested its response to the claim. Having received no response to the claim from Seaboard, Methuen filed suit against Austin and Seaboard. Relying on *Bramble* Methuen moved for summary judgment arguing that Seaboard had waived its defenses by failing to respond to the claim as required by the A312 within the 45 Day Period.

The *Methuen* Court denied the motion for summary judgment and declined to follow *Bramble*. The Court found that a surety bond was not an

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[36] *Id.* at 1335.

[37] *Id.* at 1335-1336.

[38] *Id.* at 1337.

[39] *J.C. Gibson Plastering Co., Inc. v. XL Specialty Insurance Co.,* 2009 WL 2710316 (M.D. Fla 2009).

insurance contract under Massachusetts law and the basis for *Bramble's* analysis was therefore not applicable. The Court further found that the 45 Day Period was not a sufficient amount of time for a response when dealing with a large, complex, multi-million dollar construction project. Further, the Court noted that the surety's request for an Affidavit of Claim in response to the claim was an indication that the surety had not accepted and was disputing the claim in satisfaction of the response requirement under the A312, noting that it would be "nearly impossible" for a surety to complete an investigation within the 45 days. Thus, no waiver was applied.

5. ***Sloan Company v. Liberty Mutual Insurance Co.,* 2009 WL 2616715 (E.D. Pa. 2009)**

The most recent case to consider the A312 45 Day Period refused to find a waiver in the unique facts of the case. In *Sloan Company v. Liberty Mutual Insurance Co.,* 2009 WL 2616715 (E.D. Pa. 2009), the claim arose out of a large condominium project. After the Owner failed to make payment as required, the Principal under the bond filed suit against the Owner. The Claimant, a drywall and carpentry subcontractor to the Principal, submitted its claim on June 7, 2007. The claim asserted that the Claimant had not been paid $1,074,260.09 for work performed on the project. Thirty five days later on July 12, 2007, Liberty Mutual responded to the claim denying the claim in its entirety on the basis of a pay-if-paid provision in the subcontract, because the Owner had not paid the Principal for the Claimant's work. The Claimant filed suit against Liberty Mutual, which was stayed pending the outcome of the Principal's suit against the Owner. Eventually, the Principal's suit was settled and the Claimant and Liberty Mutual filed cross motions for summary judgment. The surety contended that the Claimant had improperly calculated its claim and that is was only owed at most $785,067. The Claimant asserted in its motion that Liberty Mutual had waived any defense to the amount of the claim by only challenging the timing of when payment was due under the pay-if-paid clause within the 45 day period of the A312. The *Sloan Company* Court stated:

> [t]he Court does not read § 6.1 to proscribe a formalistic requirement that a Surety must list the undisputed amount, even if that amount is zero. Reading § 6.1 in such a way, so as to rule that Defendant forfeited its right to contest the claim amount, would run contrary to the Pennsylvania Supreme Court's directive to avoid forfeitures of rights when interpreting contracts. . . . Since Liberty Mutual disputed the entire amount of Sloan's claim, its response adheres to the plain and unambiguous requirements of § 6.1 of the Surety Bond.[40]

Interestingly, the Court ultimately ruled in the case that the clause relied upon by Liberty Mutual was not a pay-if-paid, but was a pay-when-paid clause. The *Sloan Company* opinion does not directly discuss the *Bramble, Casey*

[40] *Sloan Company,* 2009 WL 2616715 at *3.

Industrial or Gibson cases, but those cases were raised in the claimant's briefing on the motions in support of its argument.

D. Claims Handling Issues Arising Out Of The A312

As a result of the strict "waiver interpretation" of the A312 by *Bramble* and its progeny numerous issues can be conceived which might confront the surety claims professional from an ethical, legal and/or statutory standpoint such as:

- Is there an obligation on the Surety to notify the *Principal* of the existence of a 45 day "waiver interpretation" up front?
- Can the Surety deny the claim in its entirety based upon failure to receive timely information from the principal?
- Can the Surety assert defenses in denying the claim that it has no basis to know are valid due to the Principal's/Claimant's failure to provide information and documentation timely?
- Can the Surety deny the claim in its entirety based upon failure to receive timely information from the Claimant?
- Is there an obligation on the Surety to notify the Claimant of the 45 day limit?
- Is there an obligation on the Surety to notify the Claimant of its potential rights when the Surety has missed the 45 Day Period?

In order to analyze these issues, it is first necessary to examine the question of the distinction between suretyship and insurance, analyze the extent to which various claims settlement practices acts, state regulations and ethical requirements for claims adjusters and attorneys might apply and discuss the concept of the implied obligation of "good faith and fair dealing."

1. <u>The Distinction Between Suretyship and Insurance</u>

Suretyship has been described as:

> a contractual tripartite relationship in which one party (the surety) guarantees to another party (the obligee) that a third party (the principal) will perform a contract in accordance with its terms and conditions. The surety promises the obligee to answer the debt, default, or miscarriage of the principal. Suretyship is a form of guaranty. In exchange for a premium, the surety lends its financial strength and credit to the principal on the condition that, if the surety has to satisfy the principal's debt or default, the principal will indemnify the surety for its losses and expenses. In essence, the surety becomes the guarantor of the principal's ability to perform its obligations to the obligee.[41]

[41] Edward Etcheverry, *Rights and Liabilities of Sureties, in* FLORIDA CONSTRUCTION LAW AND PRACTICE at 8-7 (5th ed.2006).

Insurance on the other hand has been defined as "a contract whereby one [the insurer] undertakes to indemnify another [the insured] or pay or allow a specified amount or a determinable benefit upon determinable contingencies."[42] The insurer undertakes the obligation based on an evaluation of the market risks and losses. An insurer actually expects losses, and, indeed, such losses are actuarially predicted. The cost of the predicted losses are then spread throughout the market by the price of the insurance – the premium. Thus, courts have noted that the defining feature of an insurance contract is the shifting of the risk of loss.[43]

In contrast, a surety bond is written based on an evaluation of a particular contractor and that contractor's capacity to perform a specific contract or work program. No losses are expected by the surety. As a result of its underwriting process, the surety expects that the principal will have the ability to fully perform the bonded obligation and/or that the principal will possess the financial wherewithal to reimburse the surety for any loss sustained under the bond. Accordingly, the "price" for the issuance of a surety bond is based on a fact-specific evaluation of the risks involved in each individual case, not on an actuarial basis. Moreover, sureties typically maintain close relationships with the contractors they bond, checking on their financial performance periodically to determine if bonds should continue to be issued in the future. Sureties also generally require the contractor to sign a General Agreement of Indemnity in favor of the surety company. Thus, the surety will only sustain a loss if the principal fails to perform and then is financially incapable of reimbursing the surety for its loss. Under an insurance policy, on the other hand, the insurer does not have any right of reimbursement against its insured.

Therefore, a surety's relationship to its principal is more like that of a creditor/debtor than that of the traditional insurer/insured.[44] Indeed, suretyship has been characterized as involving "an extension of standby credit by which the surety guarantees the principal's performance of its contractual relationship."[45] A surety company grants credit via a mechanism known as the "pledge guarantee." In effect, the surety does not directly lend the contractor money, but instead

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[42] *See* § 624.02, Fla. Stat. (1999); *Dadeland Depot, Inc. v. St. Paul Fire and Marine Ins. Co.,* 945 So.2d 1216, 1226 (Fla. 2006); *see also Buck Run Baptist Church, Inc. v. Cumberland Sur. Ins. Co., Inc.*, 983 S.W.2d 501, 504 -505 (Ky. 1998).

[43] *See South Dakota Div. of Ins. v. Norwest Corp.,* 581 N.W.2d 158, 161-64 (S.D.1998); *National Home Ins. Co. v. King*, 291 F.Supp.2d 518, 525 (E.D.Ky. 2003).

[44] *See National Shawmut Bank of Boston v. New Amsterdam Casualty Co.,* 411 F.2d 843 (1st Cir.1969).

[45] 4A *Bruner and O'Connor on Construction Law* § 12:9 "Suretyship Distinguished From Insurance" (2003); *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 83 S. Ct. 232, 9 L. Ed. 2d 190 (1962) ("Suretyship is not insurance"); *See also* Cross, *Suretyship Is Not Insurance*, 30 INS. COUNSEL J. 235 (1963).

allows its financial resources to back the contractor's commitment.[46] Hence, a bond has been defined as a "financial accommodation."

Moreover, as noted above, suretyship involves a tripartite relationship between the surety, principal, and obligee. The relationship is based on the terms of the bond which are normally prepared by the obligee. The surety is generally requested by the principal to issue the bonds which are either paid for by the obligee directly or built into the price of the contract and paid by the principal. Thus, a surety bond is generally not an adhesion agreement. Insurance on the other hand involves a direct two-party relationship between the insurer and insured in which the terms and extent of coverage are dictated by the insurer.[47] These distinctions and others between suretyship and insurance have been well recognized by the courts.[48]

In *Pearlman v. Reliance Insurance Co.,* 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962), the Court stated that although suretyship and insurance have similar characteristics, "the usual view, grounded in commercial practice, [is] that suretyship is not insurance."[49] Similarly, in *National Shawmut Bank of Boston v. New Amsterdam Cas. Co.*, 411 F.2d 843 (C.A.Mass. 1969), the Court observed that suretyship "is neither ordinary insurance nor ordinary financing. The business of a construction contract surety is not one of ordinary insurance, for the risk is not actuarially linked to premiums, nor is there a pooling of risks."[50]

However, in spite of the well recognized differences and distinctions between suretyship and insurance, some courts and legislatures have routinely characterized, defined or equated suretyship to insurance and bonds to insurance policies, and, in so doing, have applied various common law and statutory duties to sureties which are normally applied only to insurance.

For example, the Supreme Court of Arizona, in *Dodge v. Fidelity & Deposit Co. of Maryland,* 161 Ariz. 344, 778 P.2d 1240 (1989), held that the surety on a bond could be held liable under the common law for the tort of bad faith failure in investigating a claim on the bond or in failing to remedy the

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[46] 4A *Bruner and O'Connor on Construction Law* §12:9.

[47] *Id.*

[48] *See Dallas Fire Ins. Co. v. Texas Contractors Sur. and Cas. Agency*, 159 S.W.3d 895 (Tex. 2004); *National Shawmut Bank of Boston v. New Amsterdam Cas. Co.*, 411 F.2d 843 (1st Cir. 1969); *U.S. for Benefit and Use of Ehmcke Sheet Metal Works v. Wausau Ins. Companies*, 755 F. Supp. 906 (E.D. Cal. 1991); *Buck Run Baptist Church, Inc. v. Cumberland Sur. Ins. Co., Inc.*, 983 S.W.2d 501 (Ky. 1998); *U.S. ex rel. SimplexGrinnell, LP v. Aegis Ins. Co.*, 2009 WL 90233 (M.D. Pa. 2009); *Intercon Const., Inc. v. Williamsport Mun. Water Authority*, 2008 WL 239554 (M.D. Pa. 2008); *Dobson Bros. Const., Co. v. Ratliff, Inc.*, 2009 WL 806800 (D. Neb. 2009).

[49] *Id.* at 140 n. 19, 83 S.Ct. 232; *see also W. World Ins. Co. v. Travelers Indem. Co.,* 358 So.2d 602, 604 (Fla. 1st DCA 1978).

[50] *National Shawmut Bank of Boston*, 411 F.2d at 845.

principal's default.[51] In reaching its conclusion, the Arizona court noted the legislature's inclusion of suretyship in Arizona's Insurance Code as one of the types of insurance regulated by the Code.[52] The court recognized the differences between liability insurance and suretyship, but reasoned that the analysis is not directed to whether there are differences, but rather, whether the legislature included suretyship among the classes of businesses it intended to regulate under the Insurance Code.[53] In *Colorado Structures, Inc. v. Insurance Co. of the West*, 161 Wash. 2d 577, 167 P.3d 1125 (2007), the Washington Supreme Court glossed over the well-recognized distinctions between suretyship and insurance to reach the conclusion that "there is little to distinguish construction performance bonds from other forms of insurance," and holding a surety liable as an "insurer" for attorney's fees for wrongful denial of coverage. Further, as previously noted, the Court in *Bramble* also held that "the rule is well settled . . . 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, . . ."[54] In numerous other states, suretyship has been judicially held to constitute insurance for various purposes.[55]

Moreover, a significant number of states, by specific statutory reference, include suretyship as subject to all or some aspects of insurance regulation by the state's insurance code.[56] For example, in New Jersey, Title 17 of the New Jersey Code provides in its definition of insurance: "a policy of insurance, without otherwise limiting its meaning, shall include ... guaranty and surety bonds."[57] The New Jersey Code provisions govern insurance in a variety of contexts and provide for surety companies to be treated in many respects as insurers. Thus, it has been held that surety companies fall under the auspices of the Commissioner of Insurance for numerous purposes, including incorporation, regulation, statutory deposit requirements and insolvency proceedings.[58]

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[51] *Id.* at 1241.

[52] *Id.* at 1241-42.

[53] *Id.* at 1242.

[54] *National Union Fire Ins. Co. of Pittsburgh, PA,* 879 A.2d at 108.

[55] *See Loyal Order of Moose, Lodge 1392 v. Int'l Fidelity Ins. Co.,* 797 P.2d 622 (Alaska 1990); *Transamerica Premier Ins. v. Brighton Sch. Dist. 27J,* 940 P.2d 348 (Colo.1997); *Int'l Fidelity Ins. Co. v. Delmarva Sys. Corp.,* No. 99C-10-065WCC, 2001 WL 541469 (Del.Super.Ct. May 9, 2001); *Bd. of Dirs. of the Ass'n of Apartment Owners of Discovery Bay Condo. v. United Pac. Ins. Co.,* 77 Hawaii 358, 884 P.2d 1134 (1994); *K-W Indus. v. Nat'l Sur. Corp.,* 231 Mont. 461, 754 P.2d 502 (1988); *Szarkowski v. Reliance Ins. Co.,* 404 N.W.2d 502 (N.D.1987); *Suver v. Pers. Serv. Ins. Co.,* 11 Ohio St.3d 6, 462 N.E.2d 415 (1984).

[56] *See* DeWitte Thompson, *The Fidelity and Surety Desk Reference Book* (ABA 2006).

[57] *N.J.S.A.* 17:29A-1(1)(e).

[58] *See N.J.S.A.* 17:17-1(g); *N.J.S.A.* 17:20-2; *N.J.S.A.* 17:22A-2(e); *N.J.S.A.* 17:29A-1(1)(e); *N.J.S.A.* 17:32-5; and *N.J.S.A.* 17:46B-1(b).

Further, the New Jersey Administrative Code specifically defines "insurance contract" to include surety bonds.[59]

2. Application of Claims Settlement Practices Act

All states have adopted some form of an unfair insurance practices act. An unfair insurance practices act is, in general, a body of legislation the purpose of which is to reduce what are considered to be abusive practices by insurance adjusters. A major participant in the development of such insurance regulation has been the National Association of Insurance Commissions ("NAIC"). The NAIC was formed in 1871 and is composed of the chief insurance regulatory officials of each state. In 1947, the NAIC promulgated the Unfair Trade Practices Act ("UTPA")[60] which relates to all aspects of the insurance business including, but not limited to, unfair claims settlement practices. In 1990, the NAIC separated the provisions dealing with unfair claims settlement practices into a newly adopted Unfair Claims Settlement Practices Act ("UCSPA").[61] The most current version of the UCSPA defines numerous acts which, if "committed flagrantly and in conscious disregard of this Act" or "committed with such frequency to indicate a general business practice" constitute unfair claims settlement practices.[62] Pursuant to these statutory schemes, several states authorize the state insurance commissioner to, among other things, promulgate claims handling regulations pertaining to insurers.

Unlike the UTPA, the UCSPA model provision specifically excluded sureties, stating in relevant part:

> The purpose of this Act is to set forth standards for investigation and disposition of claims arising under policies or certificates of insurance issued to residents of [insert state]. It is not intended to cover claims involving workers' compensation, fidelity, suretyship or boiler and machinery insurance.[63]

Unfortunately, while the intent of the NAIC in enacting the UCSPA was to exclude suretyship from the various states' regulatory schemes, in practice this did not occur uniformly on the state level. In fact, the majority of states either expressly or by implication include suretyship in some form or fashion in their unfair claims settlement practices statutes and related regulations.

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[59] *N.J.A.C.* 11:17.

[60] NAIC Unfair Trade Practices Act (1947).

[61] NAIC Unfair Claims Settlement Practices Act (1991).

[62] *Id.* § 3.

[63] *Id.* § 1.

The model UCSPA sets forth the following unfair claims settlement practices:

A. Knowingly misrepresenting to claimants and insured relevant facts or policy provisions relating to the coverage at issue;
B. Failing to acknowledge with reasonable promptness pertinent communications with respect to claims arising under its policies;
C. Failing to adopt and implement reasonable standards for prompt investigation and settlement of claims arising under its policies;
D. Not attempting in good faith to effectuate prompt, fair and equitable settlement of claims submitted in which liability has become reasonably clear.
E. Compelling insureds or beneficiaries to institute suits to recover amounts due under its policies by offering substantially less than the amounts ultimately recovered in suits brought by them;
F. Refusing to pay claims without conducting a reasonable investigation;
G. Failing to affirm or deny coverage of claims within a reasonable time after having completed its investigation related to such claim or claims;
H. Attempting to settle or settling claims for less than the amount that a reasonable person would believe the insured or beneficiary was entitled by reference to written or printed advertising material accompanying or made part of an application.
I. Attempting to settle or settling claims on the basis of an application that was materially altered without notice to, or knowledge or consent of, the insured;
J. Making claim payments to an insured or beneficiary without indicating the coverage under which each payment is being made;
K. Unreasonably delaying the investigation or payment of claims by requiring both a formal proof of loss form and subsequent verification that would result in duplication of information and verification appearing in the formal proof of loss form;
L. Failing in the case of claims denials or offers of compromise settlement to promptly provide a reasonable and accurate explanation of the basis of such actions;
M. Failing to provide forms necessary to present claim within fifteen (15) calendar days of a request with reasonable explanations regarding their use;
N. Failing to adopt and implement reasonable standards to assure that the repairs of a repairer owned by or required to

be used by the insurer are performed in a workmanlike manner.

The UCSPA has been adopted by virtually every state with only minor modifications. The impact of such claims settlement practices acts is that they may provide an overlay in addition to the terms of the A312 regarding claims handling and could create duties, rights and obligations where such duties, rights and obligations would not have otherwise existed under the bond.[64]

In addition to the UCSPA, some states have also enacted regulations regarding claims settlement practices. For example, California has adopted a series of regulations that, in part, apply to sureties.[65]

The Preamble to the California regulations provide in relevant part:

> Section 2695.1. Preamble
> (a) Section 790.03(h) of the California Insurance Code enumerates sixteen claims settlement practices which, when either knowingly committed on a single occasion, or performed with such frequency as to indicate a general business practice, are considered to be unfair claims settlement practices and are, thus, prohibited by this section of the California Insurance Code. The Insurance Commissioner has promulgated these regulations in order to accomplish the following objectives:
> (1) To delineate certain minimum standards for the settlement of claims which,
> . . . shall constitute an unfair claims settlement practice within the meaning of Insurance Code Section 790.03(h);
> (2) To promote the good faith, prompt, efficient and equitable settlement of claims on a cost effective basis; . . .
> * * *
> (c) These regulations recognize the unique relationship which exists under a surety bond between the insurer, the obligee or beneficiary, and the principal. In contrast to other classes of insurance, surety insurance involves a promise to answer for the debt, default or miscarriage of a principal who has the primary duty to pay the debt or discharge the obligation and who is bound to indemnify the insurer. Therefore, only sections 2695.1 through 2695.6, inclusive, section 2695.10, and sections 2695.12, 2695.13 and 2695.14, inclusive, shall apply to the handling or settlement of claims brought under surety bonds.

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[64] The terms "duties, rights and obligations" is not intended to refer primarily to tort or contract duties, but rather duties of an adjuster from a licensing or disciplinary standpoint. Whether a particular state recognizes private causes of action or tort/contract duties as arising from administrative/licensing statutes is a complex subject that varies from state to state and is beyond the scope of the paper.

[65] Cal. Admin. Code, Title 10, § 2695.1 *et seq.*

Section 2695.2 of the California regulations sets forth numerous definitions that relate to suretyship and that apply throughout the regulations. For example, the regulations define "Beneficiary" for the purpose of surety claims as "a person who is within the class of persons intended to be benefited by the bond;"[66] "Claimant" as any person "who asserts a right of recovery under a surety bond;"[67] "Insurer" as a person "licensed to issue or that issues a surety bond."[68] In addition, the regulations define "Principal" as "the person whose debt or other obligation is secured or guaranteed by a bond and who has the primary duty to pay the debt or discharge the obligation;"[69] and "Surety bond" or "bond" as "the written instrument in which a contract of surety insurance, as defined in California Insurance Code Section 105."[70] However, the regulations specifically provide that for purposes of the regulations the terms "Insurance policy" or "policy" do not include "surety bond" or "bond."[71]

The California regulations further provide at § 2695.4 (Representation of Policy Provisions and Benefits) that "[n]o [surety] shall conceal benefits, coverages or other provisions of the bond which may apply to the claim presented under a surety bond."[72]

> Regarding the duty of communication, the regulations provide at Section 2695.5:
>
> (b) Upon receiving any communication from a claimant, regarding a claim, that reasonably suggests that a response is expected, every licensee shall immediately, but in no event more than fifteen (15) calendar days after receipt of that communication, furnish the claimant with a complete response based on the facts as then known by the licensee. This subsection shall not apply to require communication with a claimant subsequent to receipt by the licensee of a notice of legal action by that claimant.
> * * *
> (e) Upon receiving notice of claim, every [surety], . . . shall immediately, but in no event more than fifteen (15) calendar days

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66 *Id.* at § 2695.2(a)(2).

67 *Id.* at (c).

68 *Id.* at (i).

69 *Id.* at (r).

70 *Id.* at (w).

71 *Id.* at (j).

72 *Id.* at § 2695.4(b)(clarification added).

later, do the following unless the notice of claim received is a notice of legal action:

(1) acknowledge receipt of such notice to the claimant unless payment is made within that period of time. . . .

(2) provide to the claimant necessary forms, instructions, and reasonable assistance, including but not limited to, specifying the information the claimant must provide for proof of claim;

(3) begin any necessary investigation of the claim.

Finally, with specific reference to sureties, the regulations provide at Section 2695.10 “Standards Applicable to Surety Insurance” as follows in relevant part:

(b) Within sixty calendar days after receipt by the [surety] of proof of claim, and provided the claim is not in litigation or arbitration, the [surety] shall accept or deny the claim, in whole or in part, and affirm or deny liability. Every [surety] that denies or rejects a claim in whole or in part, or disputes liability or damages, shall do so in writing. . . .

(c) In the event an [surety] requires more time than is allotted in subsection 2695.10(b) to determine whether a claim should be accepted and/or denied, in whole or in part, the [surety] shall provide the claimant with written notice of the need for such additional time within the time specified in subsection 2695.10(b). Such written notice shall specify the reasons for the need for such additional time, including specification of any additional information the [surety] requires in order to make such determination. The [surety] shall provide the claimant with written notice as to the continuing reasons for the [surety's] inability to make such a determination. Except in cases where extraordinary circumstances are present which materially affect the [surety’s] ability to comply, such written notice shall be provided within 30 calendar days of the date of the initial notification, and every 30 calendar days thereafter until such determination is made or notice of legal action is received. If the determination cannot be made until some event, process, or third party determination is made, then the [surety] shall comply with this requirement by advising the claimant of the situation and provide an estimate as to when the determination can be made.

(d) No [surety] shall fail to pursue diligently an investigation of a claim, or persist in seeking information not reasonably required for or material to resolution of a claim dispute.

(g) In determining whether the [surety] has violated this subchapter, the Commissioner shall take into consideration the amount of the bond, the principal's position as to its liability under the bond, the complexity and size of the claim and the nature and extent of any extraordinary circumstances. (clarification added).

In addition to the UCSPA and regulations, some states have also enacted "codes of ethics" for claims adjusters in connection with claims settlement practices. For example, Florida has a detailed code of ethics that is applicable to "all types and classes of insurance adjusters, (company, independent, and public), subject to Chapter 626 F.S., regardless of whether resident or nonresident, and whether permanent, temporary, or emergency licensees."[73] The Florida ethics code provides that a "[v]iolation of any provision of this rule shall constitute grounds for administrative action against the licensee" and that "[a] breach of any provision of this rule constitutes an unfair claims settlement practice."[74] The provisions further state:

> Code of Ethics. The work of adjusting insurance claims engages the public trust. An adjuster shall put the duty for fair and honest treatment of the claimant above the adjuster's own interests in every instance. The following are standards of conduct that define ethical behavior, and shall constitute a code of ethics that shall be binding on all adjusters:
> * * *
> (b)(2) An adjuster shall adjust all claims strictly in accordance with the insurance contract.
> * * *
> (d) An adjuster shall make truthful and unbiased reports of the facts after making a complete investigation.
> (e) An adjuster shall handle every adjustment and settlement with honesty and integrity, and allow a fair adjustment or settlement to all parties without any remuneration to himself except that to which he is legally entitled.
> (f) An adjuster, upon undertaking the handling of a claim, shall act with dispatch and due diligence in achieving a proper disposition of the claim.
> * * *
> (m) An adjuster shall not knowingly fail to advise a claimant of the claimant's claim rights in accordance with the terms and conditions of the contract and of the applicable laws of this state. An adjuster shall exercise care not to engage in the unlicensed practice of law as prescribed by the Florida Bar.[75]

In addition to Florida and other state ethics codes, there are numerous voluntary professional insurance adjuster associations with ethics codes as well, such as the National Association of Independent Insurance Adjusters, Society of Registered Professional Adjusters and the National Association of Public

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[73] Fla. Admin. Code, Rule 69B-220.201 *et seq.*

[74] *Id.* at 220.201(2)(a)-(b).

[75] *Id.* at 220.201(3) *et seq*.

Insurance Adjusters.[76] In addition to licensed claims adjusters, many surety claims professionals are licensed attorneys subject to Rules of Professional Responsibility. For the most part the ethical rules that govern attorneys relate to litigation, conflict of interests, dealing with one's client, advertising, etc. However, the ABA Model Rules of Professional Conduct (2002) do have provisions which address dealing with third parties. For example, Rule 4.1 "Truthfulness In Statements To Others" provides, "[i]n the course of representing a client a lawyer shall not knowingly: (a) make a false statement of material fact or law to a third person; or (b) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6. Similarly, Rule 4.4 "Respect For Rights of Third Persons" provides, "(a) In representing a client, a lawyer shall not use means that have no substantial purpose other than to embarrass, delay, or burden a third person, or use methods of obtaining evidence that violate the legal rights of such a person."

Like the claims settlement practices acts and regulations, the ethics codes can serve as an additional overlay on the surety claims professional's duties and obligations and may need to be considered in taking action on any claim to which such codes are applicable.

3. The Implied Covenant of "Good Faith and Fair Dealing"

The implied covenant of good faith and fair dealing has been held by many courts to be applicable to all contracts including contracts relating to suretyship.[77] The implied covenant must rest upon the existence of a specific contractual obligation.[78] Thus, a claim for breach of this duty cannot be maintained absent a "breach of an express term of the contract."[79] The implied covenant requires that one party not "unjustifiably hinder" the other party's performance of the contract.[80] It has been observed that, "[t]he implied promise

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[76] The NAPIA Rules of Professional Conduct and Ethics are adopted and made applicable to casualty adjusters under the Connecticut Insurance Code. *See* Regs. Conn. State Agencies § 38a-792-4.

[77] *Cates Construction, Inc. v. Talbot Partners*, 21 Cal.4th 28, 46, 980 P.2d 407, 417 (1999); *Arntz Contracting Co. v. St. Paul Fire & Marine Ins. Co.,* 47 Cal.App.4th 464, 482, 54 Cal.Rptr.2d 888 (1996) (standard of good faith implied in every contract to surety conduct); *Portland v. George D. Ward & Associates, Inc.,* 89 Or.App. 452, 456-57, 750 P.2d 171, *review denied*, 305 Or. 672, 757 P.2d 422 (1988); *The Hartford v. Tanner,* 22 Kan.App.2d 64, 70, 910 P.2d 872, *review denied*, 259 Kan. at 927, 916 P.2d 21 (1996); *Centurion Air Cargo, Inc. v. United Parcel Serv.,* 420 F.3d 1146, 1151 (11th Cir. 2005); RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.").

[78] *Foley v. Interactive Data Corp.,* 7 Cal.3d 654, 683-84 (1998).

[79] *Centurion Air Cargo, Inc.,* 420 F.3d at 1151-52; *Goodbys Creek, LLC v. Arch Ins. Co.*, 2008 WL 2950112, *6 (M.D.Fla. 2008).

[80] *In re Hennepin County 1986 Recycling Bond Litigation,* 540 N.W.2d 494, 502 (Minn. 1995), *quoting in part Zobel & Dahl Constr. v. Crotty,* 356 N.W.2d 42, 45 (Minn. 1984); *American*

requires each contracting party to refrain from doing anything to injure the right of the other to receive the benefits of the agreement. The precise nature and extent of the duty imposed by such an implied promise will depend on the contractual purposes."[81] The implied covenant "cannot impose substantive duties or limits on the contracting parties beyond those incorporated in the specific terms of their agreement."[82] It is read into contracts to protect the express covenants or promises of the contract, not to protect some general public policy interest that is not directly tied to the contract's purpose.[83]

Some courts have even applied the duty of good faith and fair dealing to third party beneficiaries.[84] Which, in the context of a payment bond, includes a payment bond claimant, since such claimants are typically regarded as third party beneficiaries of the payment bond.[85]

4. Specific Scenarios and Issues

(i) Is there an obligation on the Surety to notify the *Principal* of the existence of a 45 day "waiver interpretation" up front?

In general the answer to this question is no. Under UCSPA, regulations and ethical standards the surety would not have an obligation to inform the principal of the obligations under the bond, because the principal is not the claimant or the client and the principal in fact is a co-issuer of the bond. However, under the indemnity agreement a different analysis might be considered. Under traditional claim handling procedures, when a claim is received, the claims professional, among other actions, will generally do two things: (1) send a letter to the principal advising of the claim and requesting information as to defenses to the claim and (2) send a letter to the claimant acknowledging the claim, requesting that a proof of claim form be completed and that supporting documentation be provided. Depending on the level of

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Warehousing and Distributing, Inc. v. Michael Ede Management, Inc., 414 N.W.2d 554, 557 (Minn.App.Ct. 1987).

[81] *Egan v. Mutual of Omaha Ins. Co.,* 24 Cal.3d 809, 818, 169 Cal.Rptr. 691, 620 P.2d 141 (1979); *Penn Mut. Life Ins. Co. v. Glasser,* 2010 WL 3023420, *3 (D.Del. 2010).

[82] *Guz v. Bectel Nat'l, Inc.,* 24 Cal.4th 317, 349-50 (2000).

[83] *Id.* at 690; *Jackson v. Ocwen Loan Servicing, LLC*, 2010 WL 3294397, *3 (E.D.Cal. 2010).

[84] *See, e.g., 701 Main Street, LLC v. RLS Design Build, LLC,* No. FBTCV0785016969S, 2008 WL 5220689, at *2 (Conn.Sup.Ct. Nov. 20, 2008); *Blakeslee Arpaia Chapman, Inc. v. United States Fidelity & Guaranty Co.,* No. 520348, 1994 WL 76383, at *11 (Conn.Super.Mar.4, 1994); *Casey Elec., LLC v. Construction Management Services, Inc.*, 2009 WL 3853819, *2-3 (D.Conn. 2009).

[85] *Casey Elec., LLC,* 2009 WL 3853819 at *3, *citing Dow and Condon, Inc. v. Brookfield Development Corp.,* 266 Conn. 572, 833 A.2d 908, 914 (Conn. 2003).

sophistication of the claimant, such communications are generally responded to in some fashion, but typically all of the requested information is not provided in a timely manner.

If the claim is made on an A312 bond, as noted above, the *Bramble* line of cases requires the surety to respond to the claim and identify ALL defenses within the 45 Day Period. If the principal and/or claimant do not respond to the surety's request for information regarding the claim within the 45 Day Period and the surety is unable on its own to identify any defenses within the deadline, under such circumstances the surety may be required to satisfy the claim. In this situation, because of the lack of cooperation of the principal, the surety would look to the principal and indemnitors under the General Agreement of Indemnity to reimburse the surety for such loss. Thus, the lack of information and the principal's failure to respond to the claim in a timely manner can contribute to/trigger the indemnity/reimbursement obligation under the Indemnity Agreement. The surety should be careful to consider the scope of the duty of good faith and fair dealing in the specific jurisdiction to see if such implied duty requires the surety to apprise the principal and perhaps even the indemnitors that any failure to respond could prejudice the surety and thus bind or obligate the principal/indemnitors.

(ii) Can the Surety deny the claim in its entirety based upon failure to receive timely information from the principal?

The answer here is probably no. The surety could attempt to assert that its performance was hindered or delayed by acts out of its control, but the principal is rarely the sole source of necessary information required for a response. Further, under the law, the doctrine of impossibility and impracticability may not apply because cooperation of a third party was a foreseeable factor in the making of the contract. THE RESTATEMENT OF THE LAW (SECOND) CONTRACTS § 261 (the "Restatement of Contracts") states:

> Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.

The comments to this section of the Restatement of Contracts reveal that "if a party contracts to render a performance that depends on some act by a third party, he is not ordinarily discharged because of a failure by that party, because this is also a risk that is commonly understood to be on the obligor."[86] In order for a supervening event to discharge a duty under § 261, the non-occurrence of that event must have been a "basic assumption" on which both parties made the

[86] RESTATEMENT (SECOND) OF CONTRACTS § 261, cmt. e (1981).

contract. The comments note that the continuation of existing market conditions or the financial situation of the parties are ordinarily not such assumptions.[87]

In *Red River Wings, Inc. v. Hoot, Inc.,* 751 N.W.2d 206 the Court explained, citing to the Restatement of Contracts that the doctrine of impossibility of performance does not apply if the impossibility is caused by one of the contracting parties.[88] In the case of an A312 bond, the principal – the party who failed to cooperate – is a party to the bond and its failure to cooperate will most likely not operate to excuse the surety.

(iii) Can the Surety assert defenses in denying the claim that it has no basis to know are valid due to the Principal's/Claimant's failure to provide information and documentation timely?

The answer here is probably no. While the lack of cooperation of the claimant could provide a basis for the surety to challenge the claim, asserting "defenses" that the surety has no basis to know are valid would most likely be held to contravene the various UCSPA, regulations and ethical requirements. Under the UCSPA, the claims professional cannot "[k]nowingly misrepresenting to claimants and insured relevant facts or policy provisions relating the coverage at issue."[89] UCSPA further states, "[f]ailing in the case of claims denials or offers of compromise settlement to promptly provide a reasonable and accurate explanation of the basis of such actions."[90] Under the Florida Code of Ethics the claims adjuster is required to "make truthful and unbiased reports of the facts after making a complete investigation." The best practice is not to assert any defense unless there is a reasonable and good faith basis for doing so.[91]

(iv) Can the Surety deny the claim in its entirety based upon failure to receive timely information from the Claimant?

The answer here is maybe. Under the plain wording of the A312, the claimant is not required to provide any documents or supporting information beyond the fact that it is asserting a claim and the amount of the claim in order to assert it a valid claim. The *Gibson* Court rejected the surety's argument that the 45 Day Period did not begin to run until the proof of claim and other supporting

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87 *Id.* at cmt. b.

88 *Id.* at cmt. d.

89 UCSPA § A.

90 *Id.* § L.

91 *See e.g. Capelouto v. Valley Forge Ins. Co.*, 98 Wash.App. 7, 18-19, 990 P.2d 414, 420 (Wash.App. Div. 1 1999); *Industrial Indem. Co. v. Kallevig,* 114 Wash.2d 907, 917, 792 P.2d 520, 7 A.L.R.5th 1014 (1990).

documentation had been provided, noting that the bond did not require such information. However, the surety can argue effectively that there is an implied duty of cooperation. The implied duty of good faith and fair dealing requires that one party not "unjustifiably hinder" the other party's performance of the contract.[92] If the claimant must provide information for the surety to be able to evaluate the claim, it would be a breach of the duty to fail to provide the information. The doctrine of impossibility could also be asserted by the surety in this circumstance. The Court in *Gibson* sidestepped this issue by finding that the claimant had in fact provided the necessary information to the principal. The question will most likely turn on whether any failure of the claimant to cooperate actually prevented the surety from undertaking a thorough investigation. In other words, could the surety have identified defenses to the claim through other sources without the cooperation of the claimant?

(v) Is there an obligation on the Surety to notify the Claimant of the 45 day limit?

The answer here is probably not. Although certain provisions of the UCSPA do require the insured/surety to advise the claimant of coverage that might benefit the claimant, the 45 Day Period is not a coverage provision it is a claims handling provision.

(vi) Is there an obligation on the Surety to notify the Claimant of its potential rights when the Surety has missed the 45 Day Period?

The answer here is too close to call. In the first instance it would have to be absolutely clear that the waiver occurred and that it is binding on the surety – i.e. that the surety was in a *Bramble* type jurisdiction and there were no other possible defenses - this will likely rarely be the case. Assuming for the purpose of discussion that a waiver would be deemed binding on the surety, under the provisions of the UCSPA, regulations and ethics the surety could not misrepresent the status of "coverage" or material facts affecting the claim and could not fail to advise the claimant of its rights or fail to settle the claim fairly. Given these obligations, the surety would need to exercise extreme care and would not be advised to simply ignore the waiver and handle the claim as if it did not exist. This result might be different if the claimant was represented by its own counsel or was a sophisticated party.

E. Indemnity Issues

If the surety has in fact, or a trier of fact has determined that the surety, has failed to adequately respond to the claim under the A312 and has thus

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92 *In re Hennepin County 1986 Recycling Bond Litigation,* 540 N.W.2d 494, 502 (Minn. 1995), *quoting in part Zobel & Dahl Constr. v. Crotty,* 356 N.W.2d 42, 45 (Minn. 1984); *American Warehousing and Distributing, Inc. v. Michael Ede Management, Inc.,* 414 N.W.2d 554, 557 (Minn.App.Ct. 1987).

waived its defenses, and the surety is forced to pay the claim; can the surety seek recovery of its loss and expenses from the principal and the indemnitors? The answer is – it depends. It would seem that there are a number of factors that must be considered in order to analyze the issue, including: (1) why the surety failed to satisfy the A312; (2) whether the principal timely cooperated with the surety; (3) whether the alleged defenses that were waived were in fact valid; (4) whether the claim was valid; (5) whether the surety acted in "good faith" or otherwise complied with recognized claims handling requirements and (6) the terms of the Indemnity Agreement between the surety and principal/indemnitors. The answer will vary from jurisdiction to jurisdiction and will be impacted greatly by the specific facts of each case. Two of the important factors that must be considered in such situations include: (1) the specific terms of the indemnity agreement; and (2) whether the surety's handling of the claim constituted "bad faith" or "good faith" under the law of the particular jurisdiction.

1. Terms of the Indemnity Agreement

Under the common law, a principal had an obligation to reimburse the surety for the surety's loss and expenses in connection with bonds issued for the principal. THE RESTATEMENT OF THE LAW THIRD, SURETYSHIP AND GUARANTY (1995) § 22 ("Restatement of Suretyship") states:

> (1) Except as provided in § 24, when the principal obligor is charged with notice of the secondary obligation it is the duty of the principal obligor to reimburse the secondary obligor to the extent that the secondary obligor:
>
> (a) performs the secondary obligation; or
>
> (b) makes a settlement with the obligee that discharges the principal obligor, in whole or part, with respect to the underlying obligation.
>
> (2) The duty of the principal obligor to reimburse the secondary obligor does not arise until the time for performance, pursuant to the underlying obligation, of the duty satisfied by the secondary obligor's performance or settlement.[93]

The authors of the Restatement of Suretyship note that the duty of reimbursement arises from the equitable concepts.[94] However, this common law duty of reimbursement was not without defenses. For example, if the surety paid when there was no liability, the principal would have been able to assert that such payment was made by the surety as a mere volunteer because there was no liability.[95] The Court in *Fidelity and Deposit Co. of Maryland v. Bristol Steel &*

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[93] RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 22 (1995).

[94] *Id.* at cmt. (a)

[95] *U.S. Fid. & Guar.Co. v N.J.B. Prime Investors,* 377 N.E.2d 440 (Mass. App. Ct. 1978); *Anderson v. U.S.,* 97 Ct. Cl. 545 (1942).

Iron Works, Inc., 722 F.2d 1160, 1163 (4th Cir. 1983) observed that "[t]here is no dispute about the normal principle that 'equity generally implies a right to indemnification in favor of a surety only when the surety pays off a debt for which his principal is liable.'"[96] Indeed, the Restatement of Suretyship recognizes the limitations on the principal's obligation to reimburse as follows (in relevant part):

> § 24 When the Duty to Reimburse Does Not Arise
>
> (1) Notwithstanding § 22, the principal obligor has no duty to reimburse the secondary obligor to the extent that:
>
> (e) at the time of performance or settlement of the secondary obligation, the secondary obligor had notice of a defense of the principal obligor to the underlying obligation that was available to the secondary obligor as a defense to the secondary obligation (§ 34), unless it was a reasonable business decision for the secondary obligor to perform or settle the secondary obligation in light of factors, amounting to business compulsion, of which the principal obligor had notice at the time it incurred the underlying obligation; . . .[97]

However, the common law regarding the duty to reimburse has been altered significantly in the modern era by the wide-spread use of contractual agreements of indemnity ("Indemnity Agreements"), which include far broader and far reaching reimbursement obligations of not only the principal, but other indemnitors of the principal as well.[98] A typical Indemnity Agreement provides:

> *Indemnity and Exoneration.* The Indemnitors are jointly and severally liable to the Surety, and will indemnify, exonerate and hold the Surety harmless from all loss, liability, damages and expenses including, but not limited to, court costs, interest, attorney's fees, professional fees and consulting fees, which the Surety incurs or sustains (1) because of having furnished any Bond, (2) because of the failure of an Indemnitor to discharge any obligations under this Agreement, (3) in enforcing any of the provisions of this Agreement, (4) in pursuing the collection of any Loss incurred hereunder, or (5) in the investigation of any claim submitted under any Bond.
>
> In addition, the typical Indemnity Agreement generally provides that:

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[96] *Id. citing Com'l Ins. Co. of Newark v. Pacific-Peru Const.,* 558 F.2d 948, 953 (9th Cir.1977).

[97] RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 24 (1995).

[98] The Restatement of Suretyship notes the general rule that the obligations recognized in the Restatement and at common law could be varied by contract between the parties. *See Id.* at § 6.

> (1) originals or photocopies of claim drafts or payment records kept in the ordinary course of business . . . shall be prima facie evidence of the fact and amount of such loss; . . .

Moreover, sureties under the Indemnity Agreement generally reserve the exclusive right to decide and determine whether any claim, suit or judgment shall, on the basis of liability, expediency or otherwise, be paid, settled, defended or appealed, and the surety's determination is generally designated in the Indemnity Agreement as final, conclusive and/or binding. In part, the answer to the question of whether a surety can be reimbursed for a claim paid where the defenses to the claim were waived by the surety, will initially turn on the language of the Indemnity Agreement. If the language is broad enough to permit such recovery the analysis must continue, if it is not, the analysis ends.

2. Requirement of "Good Faith"

Indemnity Agreements and provisions like those referenced above are common between principals and sureties and are uniformly sustained, upheld and enforced by the courts.[99] However, many courts hold that notwithstanding the language of the Indemnity Agreement and the broad discretion typically granted to sureties in such agreements, the surety's exercise of such rights is not completely unfettered. The jurisdictions vary in their approach as to what limitations should be placed on the surety's rights and under what circumstances. For example, many jurisdictions have held that the surety is entitled to indemnification only for payments that were made in good faith.[100] Although some jurisdictions have limited the surety's duty of good faith to cases wherein

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[99] *See Com'l Ins. Co. of Newark v. Pacific-Peru Const.*, 558 F.2d 948, 953 (9th Cir. 1977); *Transamerica Insurance Company v. Bloomfield*, 401 F.2d 357, 362-63 (6th Cir. 1968); *Engbrock v. Federal Insurance Company*, 370 F.2d 784, 786 (5th Cir. 1967); *American Surety Co. of New York v. Inmon*, 187 F.2d 784, 786 (5th Cir. 1951); *United States Fidelity & Guaranty Co. v. Jones*, 87 F.2d 346, 348 (5th Cir. 1937); *Carroll v. National Surety Co.*, 58 App. D.C. 3, 24 F.2d 268, 270-71 (D.C. Cir. 1928); *National Surety Corporation v. Peoples Milling Co.*, 57 F. Supp. 281, 282-83 (W.D. Ky. 1944); *Martin v. Lyons*, 98 Idaho 102, 558 P.2d 1063, 1066 (1977); *Central Surety & Insurance Corporation v. Martin*, 224 S.W.2d 773, 779 (Tex. Civ. App. 1949); *Massachusetts Bonding & Insurance Co. v. Gautieri*, 69 R.I. 70, 30 A.2d 848, 850 (1943).

[100] *See, e.g., Gundle Lining Construction Corp. v. Adams County Asphalt, Inc.,* 85 F.3d 201, 210-11 (5th Cir.1996); *Fidelity & Deposit Co. of Maryland v. Bristol Steel & Iron Works, Inc.,* 722 F.2d 1160, 1162-63 (4th Cir.1983); *Transamerica Ins. Co. v. Bloomfield, supra*, 401 F.2d at 362; *Engbrock v. Federal Ins. Co., supra*, 370 F.2d at 786; *Carroll v. National Surety Co.,* 24 F.2d 268, 270-71 (D.C.Cir.1928); *United States Fidelity & Guaranty Co. v. Feibus, supra*, 15 F. Supp.2d at 583-85; *National Surety Corp. v. Peoples Milling Co.,* 57 F.Supp. 281, 282-83 (W.D.Ky.1944); *Martin v. Lyons,* 98 Idaho 102, 105-106, 558 P.2d 1063 (1977); *United States Fidelity & Guaranty Co. v. Klein Corp.,* 190 Ill.App.3d 250, 255, 146 Ill.Dec. 848, 558 N.E.2d 1047 (1989); *The Hartford v. Tanner,* 22 Kan.App.2d 64, 70, 910 P.2d 872, review denied, 259 Kan. at 927, 916 P.2d 21 (1996); *United States Fidelity & Guaranty Co. v. Napier Electric & Construction Co., supra*, 571 S.W.2d at 646; *International Fidelity Ins. Co. v. Spadafina,* 192 App. Div.2d 637, 639, 596 N.Y.S.2d 453 (1993); *Portland v. George D. Ward & Associates, Inc.,* 89 Or.App. 452, 456-57, 750 P.2d 171, review denied, 305 Or. 672, 757 P.2d 422 (1988); *Hess v. American States Ins. Co., supra*, 589 S.W.2d at 550; *301 *Fidelity & Deposit Co. of Maryland v. Wu, supra*, 150 Vt. at 230, 552 A.2d 1196.

the indemnity agreement has expressly imposed that duty upon the surety.[101] Other courts in jurisdictions that recognize the existence of an implied covenant of good faith and fair dealing in every contract have concluded that a surety owes a duty of good faith to its principal irrespective of whether the indemnity agreement expressly imposes that duty.[102]

Even where a duty of good faith is required, there is no consensus about what that duty entails.[103] Some courts define the duty of good faith to require the presence of actual fraud to breach the duty.[104] On the other extreme, a minority of jurisdictions have applied a reasonableness or negligence standard to the surety's conduct in determining whether good faith/bad faith has been exercised.[105] However, the majority of courts appear to fall in the middle

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[101] *See Associated Indemnity Corp. v. CAT Contracting, Inc.,* 964 S.W.2d at 278 (surety has no common-law duty of good faith under Texas law, but there was evidence to support finding that surety failed to satisfy contractual condition of good faith in indemnity agreement).

[102] *See, e.g.*, *The Hartford v. Tanner, supra*, at 71, 910 P.2d 872 ("obligation of good faith and fair dealing on the part of the surety is implied and in a sense superimposed on the entire surety contract"); *Portland v. George D. Ward & Associates, Inc., supra*, at 456-57, 750 P.2d 171 (applying "implied obligation of good **151 faith in ... every contract" to indemnity agreement); *see also Associated Indemnity Corp. v. CAT Contracting, Inc., supra*, at 282 ("[t]hose jurisdictions recognizing an affirmative duty of good faith in surety contracts have generally done so ... because they impose such duty in all contracts").

[103] T. Harris, *Good Faith, Suretyship, and the Ins. Commune*, 53 Mercer L.Rev. 581, 587 (2002).

[104] *See*, e.g., *Fireman's Ins. Co. of Newark, New Jersey v. Todesca Equipment Co., supra*, 310 F.3d at 37 (bad faith requires fraud or collusion under Rhode Island law); *General Accident Ins. Co. of America v. Merritt-Meridian Construction Corp.,* 975 F.Supp. 511, 516 (S.D.N.Y.1997) (indemnity agreement's right-to-settle clause is invoked "[i]n the absence of an indication of fraud or collusion"); *Banque Nationale de Paris S.A. v. Ins. Co. of North America,* 896 F.Supp. 163, 165 (S.D.N.Y.1995) (analogizing to business judgment rule and ruling that absent self-interest or fraud, surety's decision should be regarded as presumptively correct); *Reliance Ins. Co. v. Romine,* 707 F.Supp. 550, 552 (S.D.Ga.1989) (bad faith equated with arbitrary or capricious standard for proving abuse of discretion), *aff'd*, 888 F.2d 1344 (11th Cir.1989); *Hess v. American States Ins. Co., supra*, 589 S.W.2d at 551 (indemnity agreement "lodged in the indemnitee a discretion limited only by the bounds of fraud").

[105] *See*, e.g., *Rush Presbyterian St. Luke's Medical Center v. Safeco Ins. Co. of America,* 712 F.Supp. 1344, 1346 (N.D.Ill.1989) ("negligence and bad faith are synonymous" in context of determining good faith); *Arntz Contracting Co. v. St. Paul Fire & Marine Ins. Co., supra*, 47 Cal.App.4th at 483, 54 Cal.Rptr.2d 888 (surety's bad faith can be demonstrated by proof of "objectively unreasonable conduct, regardless of the actor's motive" [internal quotation marks omitted]); *Hawaiian Ins. & Guaranty Co., Ltd. v. Higashi, supra*, 67 Haw. at 14, 675 P.2d 767 ("burden of establishing that the amount paid in the settlement ... was reasonable and in good faith [is] upon the indemnitee"); *The Hartford v. Tanner, supra*, 22 Kan.App.2d at 76, 910 P.2d 872 ("good faith requires a surety seeking indemnification to show that its conduct was reasonable"); *Portland v. George D. Ward & Associates, Inc., supra*, 89 Or.App. at 458, 750 P.2d 171 (to prove bad faith in settling claim, indemnitors "needed only to prove that [the surety] failed to make a reasonable investigation of the validity of the claims against them or to consider reasonably the viability of their counterclaims and defenses, not that [the surety] acted for dishonest purposes or improper motives"); *see also* E. Gallagher, The Law of Suretyship (2d Ed. 2000) pp. 492-95 (discussing cases).

between the extremes and agree that the principal must establish something more than mere negligence to prove bad faith, but something less than fraud.[106] One common characterization used frequently, is that bad faith, in essence, means that the surety acted with an "improper motive" or "dishonest purpose."[107] Thus, the answer to the question of whether the surety can recover for losses incurred as a result of having waived any applicable defenses under the A312 will require an analysis under the Indemnity Agreement and the particular jurisdiction's standard of good faith/bad faith and all of the surrounding facts and circumstances involved in the waiver. A discussion of two examples will illustrate the issue.

In *Fidelity & Deposit Company of Maryland v. Bristol Steel & Iron Works, Inc.*, 722 F.2d 1160 (4th Cir. 1983), Bristol Steel & Iron Works ("Bristol") entered into a contract with the Pennsylvania Department of Transportation ("PennDOT") to construct a bridge. The Fidelity & Deposit Company of Maryland, The Home Insurance Company and North American Reinsurance Corporation ("Sureties") issued performance and payment bonds for the project with Bristol as the Principal. In addition, Bristol and the Sureties entered into a Indemnity Agreement. The Indemnity Agreement provided in relevant part:

> Payment ... shall be made to the Surety by the Contractor and Indemnitors as soon as liability exists or, is asserted against the Surety, whether or not the Surety shall have made any payment therefor. Such amount shall be equal to the amount of the reserve set by the Surety....
> * * *
> In the event of any payment by the Surety, the Contractor and Indemnitors further agree that in any accounting between the

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[106] *See*, e.g., *Engbrock v. Federal Ins. Co., supra*, 370 F.2d at 787 ("neither lack of diligence nor negligence is the equivalent of bad faith"); *Frontier Ins. Co. v. International, Inc.,* 124 F. Supp.2d 1211, 1214 (N.D.Ala.2000) (same); *United States Fidelity & Guaranty Co. v. Feibus, supra*, 15 F.Supp.2d at 587 ("[g]ross negligence or bad judgment is insufficient to amount to bad faith"); *Employers Ins. of Wausau v. Able Green, Inc.,* 749 F.Supp. 1100, 1103 (S.D.Fla.1990) (surety's actions may have been negligent but did not rise to level of deliberate malfeasance required to establish bad faith); *American Employers' Ins. Co. v. Horton,* 35 Mass.App. 921, 924, 622 N.E.2d 283 (1993) ("bad judgment, negligence or insufficient zeal" not evidence of bad faith); *Fidelity & Deposit Co. of Maryland v. Wu, supra*, 150 Vt. at 231, 552 A.2d 1196 ("[a]t best, the jury could draw the conclusion that [the] plaintiff was negligent ... there was no evidence of lack of good faith for the jury").

[107] *See, e.g*., *Engbrock v. Federal Ins. Co., supra*, at 787 (improper motive); *Travelers Casualty & Surety Co. of America, Inc. v. Jadum Construction Inc.,* United States District Court, 2003 WL 21653368, *2, 2003 U.S. Dist. Lexis 11861 *5 (July 11, D.Mass.2003) (dishonest purpose); *Fidelity & Guaranty Ins. Co. v. Keystone Contractors, Inc.,* United States District Court, Docket No. 02CV1328, 2002 WL 1870476, *4, 2002 U.S. Dist. Lexis 15403, *13 (E.D.Pa. August 14, 2002) (dishonest purpose); *Frontier Ins. Co. v. International, Inc., supra*, at 1214 (improper motive; dishonest purpose); *United States Fidelity & Guaranty Co. v. Feibus, supra*, at 587 (improper motive; dishonest purpose); *Safeco Ins. Co. of America v. Criterion Investment Corp.,* 732 F.Supp. 834, 841 (E.D.Tenn.1989) (improper motive); *Associated Indemnity Corp. v. CAT Contracting, Inc., supra*, 964 S.W.2d at 285, 289 (improper motive; dishonest purpose); *Ford v. Aetna Ins. Co.,* 394 S.W.2d 693, 698 (Tex.Civ.App.1965) (improper motive).

> Surety and the Contractor, or between the Surety and the Indemnitors, or either or both of them, the Surety shall be entitled to charge for any and all disbursements made by it in good faith in and about the matters herein contemplated by this Agreement under the belief that it is or was liable for the sums and amounts so disbursed, or that it was necessary or expedient to make such disbursements, whether or not such liability, necessity or expediency existed; ....

After Bristol completed the construction, but before PennDOT had issued an acceptance certificate, certain alleged defects were discovered in the bridge. After an inspection of the bridge was made by PennDOT and a substantial claim was made against Bristol for alleged default in performance under the contract. Bristol responded with a denial of liability and refused to make repairs at its expense. PennDOT then made demand on the Sureties. Relying on Bristol's denial of default, the Sureties also denied liability. Subsequently, PennDOT declared the Sureties in default under the performance bond. As a result of its declaration of default against the Sureties and the failure of the Sureties to accept liability under the performance bond, PennDOT disqualified the Sureties to act as surety on any performance bond required for work contracted by PennDOT. After such disqualification PennDOT and the Sureties reached a resolution of the claim whereby a substantial payment was made by the Sureties to PennDOT. There was never any question as to the reason the Sureties made the payment - they wanted to resume writing surety bonds in connection with road work in the State of Pennsylvania.

Bristol argued that it was not obligated to indemnify the Sureties for the payment made to PennDOT because the payment was made to protect the Sureties. The *Bristol Steel* Court held that the Sureties acted in good faith and without fraud and that they were entitled to indemnification.

In *PSE Consulting, Inc. v. Frank Mercede and Sons, Inc.*, 267 Conn. 279, 838 A.2d 135 (2004), the surety paid to resolve claims in an effort to avoid being "blacklisted" and without having performed an adequate investigation. The indemnitors objected to any indemnity obligation and asserted damages for bad faith against the surety. The Court upheld a jury verdict in favor of the indemnitors concluding that the surety breached the implied duty of good faith and fair dealing by failing to properly investigate the claims and by improperly settling the claims solely out of self interest.

F. Language Of The Surety's Response Letter

When a surety claims professional receives a claim on an A312 he/she will ultimately be required to respond to or answer the claim. The question is: in light of the case law, what should be included in that response letter?

1. <u>The Language of the Bond itself</u>

To address the question the first place to look is the language of the bond itself. The A312 simply provides that:

> § 6 When the Claimant has satisfied the conditions of Section 4, the Surety shall promptly and at the Surety's expense take the following actions:
>
> §6.1 Send an answer to the Claimant, with a copy to the Owner, within 45 days after receipt of the claim, stating the amounts that are undisputed and the basis for challenging any amounts that are disputed.
>
> §6.2 Pay or arrange for payment of any undisputed amounts.

AIA A312 Payment Bond 1984.

Under the terms of the A312 the surety is contractually required to "send" its response within 45 days from receipt of the claim. Thus, initially the claims professional must be sure to document exactly when the claim was received. The claims professional must then diary the 45 day response time so that the response can be sent within that time. If the surety is *not* disputing all or some portion of the claim, the A312 requires that the surety identify "the amounts that are undisputed . . ." Thus, if the surety does not dispute any of the claim, the response letter under A312 § 6.1 need only state that there is no dispute as to the entire claim. Then under § 6.2 the surety must pay or arrange for payment of the undisputed amount. To the extent that part of the claim is undisputed and part of the claim is disputed, the surety in its response must again state the undisputed amount and follow § 6.2 with respect to such amounts. But with respect to the disputed amounts, the A312 requires that the response state "the basis for challenging any amounts that are disputed." Thus, simply rejecting the claim or a portion of the claim is not sufficient under the terms of the bond. The reasons for challenging or disputing the claim must be identified. In a partially disputed claim scenario, the A312 does not expressly require the "disputed" amounts to be stated or listed, perhaps because once the undisputed amounts are listed, it is just a question of simple math, but the surety must state the basis for disputing or challenging such portions of the claim. Best practices would suggest that the claims professional provide an explicit breakdown of the portions of the claim it is disputing *and* those that are undisputed and then list the basis for disputing such amounts. If the surety disputes the entire claim it must in its response letter under the A312 identify the basis for disputing that amount.

2. Satisfying *Bramble* and its Progeny

If the surety has determined that it must dispute all or some portion of the claim what language must be included in the denial letter? The A312 only requires identifying "the basis for challenging any amounts that are disputed." However, under the *Bramble* line of cases the surety is compelled to include *every* defense and the basis for any defense that the surety can legitimately rely

upon based on the facts, the bond and applicable statutes and case law. Given the "waiver interpretation" applied by *Bramble* and its progeny, if the surety fails to identify a basis for a potential defense within the 45 Day Period such potential defense is waived. Simple incorporation by reference of unspecified "defenses" such as "all defenses that the Principal may be entitled to assert" or "all defenses that may exist at law or in equity" have been held by some of the *Bramble* line of cases to be insufficient.

Thus, for example in *Bramble,* Federal Insurance Company sought to reserve its defenses by stating that it did not intend to waive "any defenses available under the bond or applicable law . . ."[108] Similarly, AIG in *Bramble* sought to preserve its defenses by stating "[P]lease be advised that this action is taken at this time without waiver of or prejudice to any of the rights defenses, past or present, known or unknown which either the above referenced Surety (National Union Fire Insurance Company) or Principal (Clark Construction Group) may have in this matter."[109] The *Bramble* Court found such general language insufficient under the A312. In *Casey Industrial,* the surety, Seaboard attempted to preserve its defenses by stating that it:

> . . . 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.[110]

The *Casey Industrial* Court stated, "Defendant should not be allowed to rely upon a 'reservation of rights' clause to delay offering disputes to Plaintiff's claim."[111]

In the *Bramble* line of cases, specificity of defenses is required. Accordingly, if there is a specific case, statutory provision, contract clause or other provision upon which the surety wishes to rely, those provisions should be specifically identified to avoid any potential waiver along with all applicable facts. If there are technical issues such as mathematical or computational errors in the claim, those issues should be identified as well. If there are defenses such as timeliness of the notice, failure of the notice to satisfy the bond terms or applicable law, such issues should be identified. If there are more broad concepts applicable like interference, hindrance, failure to cooperate, breach of the covenant of good faith and fair dealing arising out of the Claimant's/Principal's/Owner's or other third party's refusal or failure to cooperate

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[108] *National Union Fire Insurance Co. of Pittsburgh PA*, 879 A.2d at 104.

[109] *Id.*

[110] *Casey Industrial, Inc.,* 2006 WL 2850652 at *4.

[111] *Id.*

and provide information with respect to the claim, those issues and all applicable facts should be set forth in the response. It is unclear if such "defenses" will be preserved in that circumstance, but the best practice is to identify, as much as possible, any impediments to the surety's investigation.

Caution should be exercised in the circumstance where one defense operates as a defense to the entire claim, but there are other lesser defenses as well. So, for example, in the *Sloan Company* case, the surety denied the claim in its entirety based on a pay-if-paid provision. But, the surety did not raise any other defenses within the 45 Day Period. The surety subsequently asserted that the claim had been improperly computed by over $300,000. The claimant argued that the defense of pay-if-paid was only a timing defense and that the challenge to the computation of the amount of the claim was not raised within the 45 Day Period and was waived. Although the Eastern District of Pennsylvania rejected the argument, best practices would dictate that all known defenses be asserted within the 45 Day Period to avoid a similar argument from a claimant. Don't rely on just one overall defense because if that defense ultimately fails, the surety will want to rely on other defenses that it might have and if those defenses were not identified within the 45 Day Period, it could be problematic. In *Sloan Company* the surety's defense of pay-if-paid was ultimately held to be invalid because the Court found that the clause was really a pay-when-paid clause.

Another area of caution for the surety claims professional is relying on the Principal or its counsel to assert defenses for the surety. In *Gibson,* the surety attempted to rely on the fact that the Principal's counsel had sent a letter to the Claimant in response to the claim. The Court rejected that defense and noted that such an argument "strained credulity" because the surety was not the source of the communication and the letter was insufficient to satisfy the bond requirements.[112] Aside from the fact that responses from Principals are not a response from the surety, the surety should also be aware that often the Principal and/or its counsel are not aware of the specific surety defenses that may be available and also may not be aware of the *Bramble* line of cases. Accordingly, such responses may not be specific enough to preserve all of the surety's defenses. A gray area exists when the surety takes a Principal's response to a claim and incorporates that response by reference or simply forwards the response to the claimant. In that situation, the best practice would be for the surety claims professional to specifically incorporate the Principal's response by reference in the surety's own response and expressly adopt the reasoning and defenses identified therein as part of the surety's response and provide a copy of the Principal's response with the surety's response. This will leave no doubt that the Principal's defenses are also the surety's.

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[112] *J.C. Gibson Plastering Co., Inc.,* 521 F.Supp.2d at 1334.

3. What if you are not in a *Bramble* and Progeny Jurisdiction

If a claim arises in a jurisdiction that is not covered by the *Bramble* line of cases, how should the surety claims professional respond to an A312 claim? The short answer is even if *Bramble* and its progeny do not apply, the best practice would be to respond as if they did! This will ensure that your response will be found adequate and it will ensure that the jurisdiction you are in does not become one of the *Bramble* progeny. Responding in this manner will also ensure that the Claimant receives a full and adequate response to its claim, which satisfies one of the purposes of the bond. Finally, responding in such a manner will ward off any indemnity issues once the claim has been resolved.

4. How can the surety Preserve Potential Defenses in its 45 Day Response that were Unknown and/or Undiscovered

When responding to an A312 claim the surety may have some sense that its investigation was limited in some way or did not cover all of the facts and circumstances that might give rise to potential defenses and the surety claims professional may want to attempt to preserve such potential defenses. As discussed above in the *Bramble* jurisdictions it may not be possible to preserve such defenses. Even so, the best practice would dictate that the surety still make every effort to identify and preserve potential defenses in the hope that such efforts might cause a change in the law or a further refinement of the law or allow the *Bramble* cases to be sufficiently distinguished. Of course, if you are not in a *Bramble* jurisdiction, every effort should also be made in the surety's response to the claim to anticipate potential defenses and preserve the right to raise such defenses outside of the 45 Day Period.

(a) Reservation of rights generally

Reservation of rights is a long standing practice by surety companies and insurance companies alike and it has its roots in the concepts of waiver. By providing a reservation of rights the surety is providing notice to the claimant that by its action, in whatever document the reservation is made, the surety does not intend to waive any rights or defenses specified and that the surety may in fact still seek to assert such rights and defenses. By providing the notice in the form of the reservation of rights the claimant will generally be precluded from later asserting that the given action constituted a waiver.

(b) The Law of Waiver Generally

To properly consider the Reservation of Rights it is necessary to consider the doctrine of waiver. The doctrine of waiver works to deprive a party of a right it would otherwise possess.[113] Waiver rests upon the intention of a party alleged to have waived its rights. In general, waiver is typically defined as, "the

[113] *See GEICO v. Medical Services*, 322 Md. 645, 650, 589 A.2d 464, 466 (1991)

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."[114] 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."[115] The question of whether there has been a waiver in any particular case depends upon the peculiar facts and circumstances of that case.[116] 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 relinquishment."[117] 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.[118] While a party may waive any condition or provision inserted in a document for its benefit,[119] it is generally recognized that the doctrine of waiver cannot operate to expand or establish coverage where none exists.[120]

(c) Elements of a Successful 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-

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[114] *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)

[115] *Garfield v. J.C. Nichols Real Estate*, 57 F.3d 662, 667 (8th Cir. 1995).

[116] *Royal Ins. Co. v. Drury*, 150 Md. 211, 132 A. 635 (1926).

[117] *St. Paul Fire & Mar. Ins. v. Molloy*, 291 Md. 139, 145, 433 A.2d 1135, 1138 (1981).

[118] *Royal Ins. Co., supra.*

[119] 26 C. J. 281.

[120] *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.

arching, common sense principles can be observed. First, to be effective, the reservation of rights must be adequately communicated to the intended recipient.[121] Second, the reservation must clearly and unambiguously inform the recipient of the surety's position.[122] 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.[123] Finally, the reservation must be asserted in a timely fashion.[124]

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.[125] 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.

(d) Other Options

In addition to a reservation of rights, are there other options available to attempt to stave off a waiver if the surety cannot respond to a claim within the 45 Day Period? The answer is maybe!

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[121] *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).

[122] *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).

[123] *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).

[124] *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).

[125] *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).

(i) Time Extension

One option that a surety may have to preserve defenses could include an attempt to reach an agreement with the Claimant to allow additional time for the surety to investigate. It is possible that the Claimant might be amenable to such an agreement rather than face the inevitable litigation over whether there was a waiver or not. Some claimants may not even be aware of the *Bramble* line of cases or may be in a non-*Bramble* jurisdiction and reaching an agreement for a time extension will be much less of an issue. If such an agreement is reached it should be put in writing and must be signed by the Claimant. Such an agreement should defuse any potential waiver issues.

(ii) Litigation

Another option, although expensive, would be for the surety to file a Declaratory Judgment action or seek Injunctive Relief on an emergency basis asking the court to rule that the 45 Day Period is insufficient under the facts of the claim, that impossibility exists or that the surety's investigation is being hindered or interfered with and its rights may be prejudiced under the Bond.

(iii) Speed-up Cooperation

If the surety is not receiving cooperation from the Principal a surety could file suit for a TRO seeking access to the books and records under the Indemnity Agreement or demand that the Principal and Indemnitors provide the surety with collateral to cover the potential claim if the Principal is not cooperating. Cooperation would then likely be a more attractive option than payment of collateral or litigation.

(iv) Negotiated Settlement

If all else fails or the other options are not options, it may make sense to reach a settlement of the claim on terms as favorable as possible before the 45 Day Period expires. A settlement of even a modest discount could be better than a complete waiver and liability for the full amount. Ideally, this would be a joint decision between the principal and surety to avoid any indemnity issues later.

G. Issues Related To Calculating The 45 Day Period

Questions can arise with respect to how the 45 Day Period in the A312 is calculated. The language of the A312 states that the 45 Day Period begins to run from the date of receipt of the claim. Thus, as an initial matter, the claims professional when dealing with an A312 bond must find some way to determine and document the exact date that the claim was received. In many cases, the date that the claims professional receives the claim may *not* be the date of actual receipt for purposes of the A312.

The triggering mechanism for the surety's response time under § 6 of the A312 is initially that there has been compliance with the notice provisions of § 4. Section 4 requires that a claimant give notice to the surety at the address described in § 12. Section 12 in turn requires that notice to the surety be mailed or delivered to the address shown on the signature page. The Section further provides, "[a]ctual receipt of notice by Surety, the Owner or the Contractor, however, accomplished, shall be sufficient compliance as of the date received at the address shown on the signature page." Some confusion can be engendered as to the receipt date because often the name and address of the agent/broker for the surety under the power of attorney is listed on the "signature page" of the bond and notices are some times sent to such persons by claimants. Section 12 would seem to designate the receipt date in that circumstance as being when the surety actually receives the notice at its address rather than at the agent's address.[126]

A further complicating factor to determining the date of receipt, is raised by § 5 of the A312 which provides, "[i]f a notice required by Paragraph 4 is given by the Owner to the Contractor or to the Surety, that is sufficient compliance." This Section is confusing. Does it mean when an Owner gives its own notice of a Claimant's claim or when the Owner gives the Claimant's notice of a claim? Does the provision allow an Owner to give the notice that is supposed to go to the surety under § 4 to the contractor instead? What if the Owner receives a mechanics lien notice against its property by a claimant that could assert a claim under the payment bond, if the Owner gives such notice to the surety is that sufficient to constitute a claim by the mechanics' lien claimant against the payment bond? Such questions are unresolved, accordingly, the claims professional should be alerted to the possibility of receiving notice from the Owner in some fashion and must respond accordingly.

Assuming that the date of receipt of the claim is established, is the date of the 45 Day Period then established as well? In *Gibson* the surety argued, unsuccessfully, that the 45 Day Period did not begin to run until the supporting documents or executed Proof of Claim was received, because it was only then that the surety could begin to analyze the claim. While this argument is perhaps contrary to the wording of the A312, the argument should still be considered in conjunction with local claims handling statutes as a basis for extending the triggering of the 45 Day Period if there is a problem. An argument could also be considered in jurisdictions where a specific claim response deadline is applicable to sureties that the specific statutory deadline applies. Similarly, if the applicable jurisdiction allows the claims handler to seek additional time to respond to a claim, the surety could consider making an argument that the statutory right is read into the bond by operation of law.

Is the surety only required to mail the response within the 45 Day Period or must the claimant receive the response within the 45 Day Period? The A312 states that the surety must "send" an answer to the Claimant within 45 days after

[126] The A312 bond identifies the agent/broker's name and address as being listed for "information only."

receipt of the claim. Thus, the bond form does not expressly by its terms appear to require "receipt" of the response by the claimant in the 45 Day Period; only that it be sent. The A312 does not define the word "send." Thus, pursuant to standard rules of contract construction such a term must be given its normal, customary and ordinary meaning. The *American Heritage College Dictionary*, p. 714 (4th ed. 2007), defines "send" as "[t]o cause to be conveyed by an intermediary to a destination"[127] The Uniform Commercial Code defines the word "send" as "to deposit in the mail or deliver for transmission...."[128] The *New World Dictionary* defines "send" as a verb that means "to dispatch, convey, or transmit (a letter, message, etc.) by mail, radio., etc.[129] The authors have been unable to find any authority that would define the word "send" as requiring "receipt." Thus, all the surety appears to be required to do is put the response in the mail within the 45 Day Period. Of course, the claims professional must be sure to carefully document the actual date that the response was sent in case the response is lost or destroyed before reaching the claimant or there is some other challenge later concerning the date of the response. Best practices here would dictate that the response be sent by certified mail or other method of delivery that can be independently documented and tracked.

Questions have been raised as to how the 45 Day Period is determined if the amount ultimately claimed includes amounts that were not claimed originally or were not in existence as of the running of the 45 day period on the original claim. The A312 does not prohibit multiple claims or amending of claims. Thus, logically there should be no prohibition against multiple 45 Day Periods existing as to various portions of amended or new claims. The best practice in such circumstances when new claims are added to an existing claim is to treat such additions as a new claim with a new 45 Day Period. It is doubted that even the *Bramble* line of Courts could justify a waiver of a claim that had not yet been submitted.

H. Revisions To The AIA 312 Payment Bond

In response to the *Bramble, Casey Industrial and Gibson* decisions, major surety companies began to issue directives to their agents not to issue A312 bonds without making significant modifications to the 45 day requirement of paragraph 6. After discussions between the National Association of Surety Bond Producers ("NASBP"), the Surety & Fidelity Association of America ("SFAA") and the American Institute of Architects ("AIA"), the parties reached agreement on interim modifications to the A312 bond form and on May 27, 2008, issued a joint press release regarding the modifications. The AIA recognized that with surety companies refusing to issue the A312 bond unless modifications were made and that such modifications would vary across the country and alter the rights and

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[127] *Kramer v. Perez*, 595 F.3d 825, 829 (8th Cir. 2010).

[128] U.C.C. § 1-201(b)(36)(A).

[129] *See U.S. v. Porter*, 994 F.2d 470, 476 (8th Cir. 1993).

obligations of claimants and sureties in unpredictable ways, that an interim stopgap measure should be instituted to allow the parties time to jointly study the issue with input from all participants. The press release stated that a full review and overhaul of the A312 bond form would be undertaken in the coming months.

1. The 2008 AIA Amendment Notice

Rather than issue a new interim bond form, the AIA issued a notice amending the existing A312 form (the "Amendment").[130] The changes made include extending the deadline to respond to claims from 45 days to 60 days in paragraph 6.1 and adding a new paragraph 6.3 which states:

> The Surety's failure to discharge its obligations under this Section 6 shall not be deemed to constitute a waiver of defenses the Surety or Contractor may have or acquire as to a claim. However, if the Surety fails to discharge its obligations under this Section 6, the Surety shall indemnify the Claimant for the reasonable attorney's fees the Claimant incurs to recover any sums found to be due and owing to the Claimant.

The NASBP stated that the Amendment "is a significant improvement over existing language, since it lengthens the surety's response period and it addresses the potential loss of defenses for a surety's untimely response."[131] However, the interim modification adds the recovery of attorney's fees for failure to adhere to the obligations of paragraph 6. The modification is not clear under what circumstances attorney's fees become recoverable. If the surety does not respond with all of its possible defenses within the extended 60 day deadline, would attorney fees become applicable? The language appears to merely swap waiver of defenses with recovery of attorney's fees. Of course the Amendment does not affect the A312 bonds that were issued before the modification became available and would not apply unless the Amendment was expressly made a part of the A312 bond executed by the parties in a given case.

2. The Revised A312 Payment Bond Form - 2010

In 2010, the AIA released revised forms for its A310 Bid Bond, A312 Performance Bond and A312 Payment Bond. The revised A312 – 2010 Payment Bond form incorporates numerous changes that are not relevant to the

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[130] The Engineers Joint Contract Document Committee ("EJCDC") reached agreement on interim modifications of the EJCDC C-615 bond form with the NASBP and SFAA. However, the EJCDC issued a revised payment bond form titled the C-615(A) which completely deleted the provisions of paragraph 6 (which had been substantially similar to the A312). *See* M. McCallum, *AIA and EJCDC Issue Interim Revisions to Payment Bond Forms to Help Ameliorate Industry Concerns*, NASBP Pipeline Newsletter, Spring 2008.

[131] M. McCallum, *AIA and EJCDC Issue Interim Revisions to Payment Bond Forms to Help Ameliorate Industry Concerns*, NASBP Pipeline Newsletter, Spring 2008.

discussion here and has reorganized the sections of the bond.[132] With respect to the issues addressed in this paper, the new A312 – 2010 incorporates into the form the provisions that were previously in the Amendment with some modifications and also adds some new terms. Specifically, consistent with the Amendment, the 45 Day Period has been extended to 60 days.[133] New § 7.3 (corresponding to Amendment § 6.3 with modifications) provides:

> The Surety's failure to discharge its obligations under Section 7.1 or Section 7.2 shall not be deemed to constitute a waiver of defenses the Surety or Contractor may have or acquire as to a claim, except as to undisputed amounts for which the Surety and Claimant have reached agreement. If, however, the Surety fails to discharge its obligations under Section 7.1 or Section 7.2, the Surety shall indemnify the Claimant for the reasonable attorney's fees the Claimant incurs thereafter to recover any sums found to be due and owing to the Claimant.

AIA A312 - 2010 Payment Bond.

The differences between the Amendment and the new § 7.3 seems to be limited to the renumbering of the Section references, adding the language "except as to undisputed amounts for which the Surety and Claimant have reached agreement" in the rejection of the waiver of defense provision and inclusion of the word "thereafter" in the attorney's fees provision which limits attorney's fees to those fees incurred after the surety fails to respond within the 60 days. The limitation on the attorney's fees is a potentially important limitation so that a surety is not hit will potentially massive fees incurred by a claimant's attorney in dealing with the claim from the very beginning of the dispute prior to even providing notice.

In addition, the revised A312 – 2010 also includes new language that allows the attorney's fees that are recoverable under new § 7.3 to be in ***excess of the penal sum of the bond***. New § 8 provides:

> The Surety's total obligation shall not exceed the amount of this Bond, **plus the amount of reasonable attorney's fees provided under Section 7.3**, and the amount of this Bond shall be credited for any payments made in good faith by the Surety.

AIA A312 - 2010 Payment Bond (emphasis added).

Further, in an effort to address the serious drafting flaw relating to the lack of information required to state a claim, the revised A312 – 2010 adds a new

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[132] *See* AIA Bond Form Commentary and Comparison at: http://www.aia.org/aiaucmp/groups/aia/documents/pdf/aiab083075.

[133] *See* AIA A312 – 2010 at § 7.1.

section defining the word "Claim." Section 16.1 defines "Claim" as a written statement by the Claimant including at a minimum:

.1 the name of the Claimant;
.2 the name of the person for whom the labor was done, or materials or equipment furnished;
.3 a copy of the agreement or purchase order pursuant to which labor, materials or equipment was furnished for use in the performance of the Construction Contract;
.4 a brief description of the labor, materials or equipment furnished;
.5 the date on which the Claimant last performed labor or last furnished materials or equipment for use in the performance of the Construction Contract;
.6 the total amount earned by the Claimant for labor, materials or equipment furnished as of the date of the Claim;
.7 the total amount of previous payments received by the Claimant; and
.8 the total amount due and unpaid to the Claimant for labor, materials or equipment furnished as of the date of the Claim.

AIA A312 – 2010 § 16.1 *et seq.*[134]

The new A312 – 2010 was drafted with input from all of the usual construction industry participants including the NASBP and SFAA. It remains to be seen how this new A312 - 2010 will be received by the surety industry. While the exposure for attorney's fees is probably an acceptable trade off for a complete waiver of defenses in the situation where the claim response period is not satisfied, it may have been "overkill" given the limited number of jurisdictions that had adopted the *Bramble* reasoning. The new definition of "Claim" and the requirement that certain information and documentation be provided is a good addition. Further, the "waiver" of the penal limit seems risky and uncalled for.

As with other AIA forms, when changes are made it generally takes a significant period of time for the revised forms to become mainstream and replace the older versions. Thus, with the 1984 version, 2010 version and 2008 Amendment floating in circulation, sureties, to the extent that they wish to utilize an A312 Payment Bond form, should be careful to specify which version they want and/or which version they are being "asked" to execute. In addition, sureties will still need to continue to be vigilant when dealing with an A312 bond form and claims professionals will need to determine if the Amendment has been incorporated into the specific A312 bond or if they are dealing with an unmodified 1984 version or the new 2010 version. Even with the 2010 version and 2008 Amendment, claims professionals will still need to be diligent in responding to claims because a failure to respond within the 60 day extended period may

[134] The notice sections in the A312 – 2010 require that a "Claim" be sent to the surety. *See* §§ 5.1.2 and 5.2.

introduce the prospect of recoverability of attorney's fees, which could be a significant added cost and could even exceed the penal limit of the bond.

BIOGRAPHIES OF THE AUTHORS

Michael A. Stover, Esquire
Wright, Constable & Skeen, LLP
One Charles Center
100 N. Charles Street
Suite 1600
Baltimore, Maryland 21201

Mr. Stover is a Partner with the law firm of Wright, Constable & Skeen, LLP. He practices in the field of surety and construction law in Maryland, Washington D.C. and Virginia. He has over 19 years of experience and regularly represents surety companies in all aspects of performance and payment bond losses and claims including financing, takeover and workouts, as well as litigation on behalf of the surety defending and prosecuting claims and pursuing/protecting rights against indemnitors. Mr. Stover obtained his Bachelor of Science Degree from the University of Maryland, College Park and his Juris Doctor from the University Of Maryland School Of Law with honors. Mr. Stover is admitted to the Bars of the State of Maryland, the United States District Court for the District of Maryland, the United States Courts of Appeals for the Fourth Circuit and for the Third Circuit and the United States Court of Federal Claims. Mr. Stover is a member of the American Bar Association, Fidelity and Surety Law Committee of the Tort Trial and Insurance Practice Section, Forum on the Construction Industry, the Public Contract Law Section of the American Bar Association and the Maryland State Bar Association. Mr. Stover has lectured on numerous occasions on surety and construction law issues.

David Anderstrom, Esquire
Hartford Insurance Company
Bond Claim - T-4
One Hartford Plaza
Hartford, CT 06155

Mr. Anderstrom is a Bond Claims Manager for Hartford Insurance Company in Hartford, Connecticut with over 13 years experience in the contract surety bond industry. Mr. Anderstrom holds a Juris Doctor Degree from Western New England College School of Law (1984) and a Bachelor of Science Degree from the University of Massachusetts (1976). Mr. Anderstrom was a First Lieutenant in the United States Air Force on active duty and a Deputy Staff and Staff Judge Advocate for the Air Force Reserve and during several activations to active duty for the Air National Guard. He is admitted to the Supreme Judicial Court of the Commonwealth of Massachusetts and the Federal District Court for the District of Massachusetts.