## Reasonableness of Surety Collateral Demands

By David A. Harris  September 30, 2019

The General Agreement of Indemnity typically includes a collateral demand provision that gives the surety a right to demand collateral security from the indemnitors to protect against future losses. To enforce the provision the surety will seek specific performance, requiring the Court to consider whether the collateral demanded by the surety is reasonable.

This was the question before the Court in *RLI Insurance Co. v. Pro-Metal Construction, Inc.*, Case No. 18-cv-2762(AJN), 2019 WL 1368851 (S.D.N.Y. March 26, 2019). In this case the bond claimants were a class of laborers who had filed a class action lawsuit against the bond principal and surety for the unpaid portion of prevailing wages. The claimants demanded $3.9 million and the surety made a collateral demand in that amount. The indemnitors argued that the amount of the collateral demand was unreasonable and offered to deposit collateral of just under $800,000.

The Court's analysis of whether the surety's demand was reasonable is instructive because it rejects two extremes. The Court would not either blindly validate the surety's judgment or completely replace the surety's analysis of its risk of loss with an amount the Court calculated after examining the underlying claim.

First, the Court insisted on reviewing the demand to determine if it was "reasonable" despite the plain language of the indemnity agreement. The agreement required the indemnitors to deposit collateral "equal to the amount of the reserve set by [RLI] or equal to such amounts as [RLI], in its sole judgement, deems sufficient to protect it from loss or potential loss." The Court determined that an analysis of the reasonableness of the surety's judgment was required because, according to the New York courts, the reasonableness standard cannot be contracted around.

However, the Court then refused to replace the surety's analysis of its risk of loss with the Court's own judgment by independently evaluating the merits of the claim and deciding for itself what would be a reasonable amount. The Court correctly pointed out that the right to collateral security exists even if the surety has no liability on the claim. The Court did not rewrite the indemnity agreement to provide for collateral security only in the amount of the surety's probable loss in the opinion of the Court.

Ultimately the Court determined that the issue required an examination of whether the surety "behaved reasonably in demanding $3,953,273.03 as collateral." This is a subtle but important distinction. The Court examined the reasonableness of the surety's decision-making but did not undertake to recalculate the collateral amount in substitution for the surety's judgment. Because the surety acted reasonably, its demand was enforced by the Court.

The Court did leave room for additional examination of collateral demands based on the bond claim amount. The surety argued that the amount demanded was *per se* reasonable because it was the amount the claimants had demanded the surety pay. The Court declined to rule on that argument because this case did not involve a bond claim amount that was impossible on its face. By implication, a surety's demand for collateral in the amount claimed on its bonds should be deemed reasonable *unless* that claim is facially impossible.