Surety Claims Institute

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Newsletter

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President: David C. Kitchin Editor-in-Chief: Armen Shahinian

42nd Surety Claims Institute Annual Meeting and Seminar To Be Held At The Nemacolin Woodlands Resort, Farmington, Pennsylvania

Nemacolin Woodlands Resort – Front Entrance

By: Gerard P. Sunderland, Wright Constable & Skeen, LLP, Baltimore, MD

The Surety Claims Institute's 42nd Annual Meeting will be held June 21 through June 23, 2017 at the fabled Nemacolin Woodlands Resort in Farmington, Pennsylvania. Since the SCI was founded, its fundamental purpose has been to provide first rate educational programs dedicated to the surety industry as part of an annual meeting and to provide a relaxed venue for surety claims professionals and their families to get to know one another better. This year's meeting and venue will serve both purposes.

Amy Bentz of the Bentz Law Firm in Pittsburgh, PA, is the Program Chair for 2017 and 2018. She has put together an excellent educational program with a diverse group of speakers addressing topics which should be of interest to all attendees. Amy's program will also, as usual, include an ethics component for which the SCI expects to receive CLE and CE credits.

(continued on page 5)

In this issue:

Comments from the Editor 2
An Invitation to Revisit the Surety Claims Institute's Improved Website 3
In Memoriam: Kenneth A. Cranston 4
Using The "Trust Fund" and/or "Special Purpose" Theory to Hold Banks Accountable for Sweeping Bonded Contract Proceeds............ 7
Arbitration Involving Non-Signatories 18
Surety Casenotes 27
Fidelity Casenotes............34
Legislative Update............38
Preliminary Program Agenda 39

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Comments From The Editor

Elsewhere in this issue of the Newsletter is an "In Memoriam" tribute to Ken Cranston, who passed away on January 2 after a battle with glioblastoma. I will not repeat the details of Ken's life in the "In Memoriam" section, but I wanted to reflect on both the man and the nature of relationships formed in the industry.

I first started working with Ken in the early 1990's when he was managing performance bond claims for Continental Insurance Company in Farmington, Connecticut. He was one of my favorite guys in the industry to work with. He was very well organized, thorough in his analysis, practical, smart, fair, and an all-around good guy.

Ken was not a pushover in any way, with respect either to claimants or to his dealings with outside counsel and service providers.

However, pervading all of his actions was a fundamental decency and commitment to doing the right thing, both for his employer and for those asserting proper claims which ought to be honored.

Ken was a detail guy who conducted a thorough analysis of the facts in order to determine the proper course of action to be followed in the handling of surety claims. He was not a lawyer, but he knew the law applicable to sureties. He was the kind of guy whom you admired for playing it straight and being fair, but also being tough where appropriate.

He certainly is not the first surety claims manager with whom I have worked who has retired or passed on whom I will miss. But, reflecting on his passing, I know that I was privileged for having worked with him and his ilk; and it is the opportunity to have worked with and established relationships with the likes of Ken Cranston that makes the day-to-day stress of surety claims management and litigation substantially more rewarding than it otherwise would be. His memory and positive influence live on, and he will be remembered by many for his basic decency, honesty and fairness. His is an example to be honored and followed.

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AN INVITATION TO REVISIT THE SURETY CLAIMS INSTITUTE'S IMPROVED WEBSITE

By: Jason R. Potter, Wright, Constable & Skeen, LLP, Baltimore, MD

The Surety Claims Institute's website (www.scinst.org) has been updated and expanded to include a treasure trove of valuable resources for the surety claims professional. We encourage you to visit the website and take advantage of these resources. In 2014, SCI decided to make available through the SCI website all papers presented at all SCI Annual Meetings from 1991 to 2015 (and continuing forward thereafter). Those papers are available to all SCI's members through the "Members Only" link on the homepage. Once logged in, select the "Online Archive of Papers" link to the left of the page. To access a particular paper, simply click on its title. The paper will open in .pdf format that is fully searchable by utilizing the browser's search feature.

As part of its effort to make its resources more widely accessible to its members, SCI has also uploaded all the SCI newsletters from 2007 to the present. Like the papers, the newsletters are only available to SCI's members. To access them, log onto the "Members Section" of the website and select the "Newsletters" link on the left side of the page. To access a particular newsletter, click the newsletter's date, and it will open in a full text searchable pdf format.

The SCI website also offers members the opportunity to pay dues, update contact information, register for SCI's annual meetings, or view photos from past SCI events. SCI has always been, and continues to be, strongly committed to the ongoing education of its members. We hope you find that the updated SCI website evidences that commitment and that you will find it informational and useful. We note, too, that the website is currently in the process of being redesigned, but its content remains unchanged. If you have suggestions for any additional improvements or updates to it, please feel free to contact Jason Potter at jpotter@wcslaw.com. For login assistance, you can contact either Jason or Diane Kennedy at dkennedy@gh-ks.com.

IN MEMORIAM:
KENNETH A. CRANSTON

By: Francis G. Bogdan, Hartford Financial Services Group, Hartford, CT

Kenneth A. Cranston, Jr. of Cromwell, CT passed away on Monday, January 2, 2017 at the age of 68 after a battle with glioblastoma. Ken was diagnosed with the disease in March of 2016. Ken was well known in the contract surety claims industry for his knowledge and expertise, having spent over 20 years at The Travelers Companies, and additional years at Continental Surety, and most recently, Hartford Financial Services Group, Inc.

Born on September 15, 1948 in Wilkes-Barre, PA, Ken was one of five children. He was raised in Glen Ridge, NJ and graduated from Muhlenberg College with a Bachelor's Degree and the University of Connecticut with a Master's of Business Administration. In 1973, Ken was working in Miami and was in Hartford for a conference. On a night out, he had a chance meeting with a young lady named Carol at the Last National Bank Restaurant in downtown Hartford. Ken was eventually transferred to Hartford and he and Carol married under an apple tree approximately ten months after they met. Ken and Carol settled in Cromwell, Connecticut where they lived together for 42 years. They had two beautiful children, Amy Bowers of Philadelphia and Ian Cranston of Cromwell. And Ken loved his three grandchildren, Lucy, Bea, and Sylvie.

At work, Ken was always known for being meticulous and detailed in his preparation. He was extremely thorough in his analysis. He never "winged" anything and spent countless hours preparing for everything he did by doing his homework. He had an inquisitive mind. When it came time for a visit to a contractor's office, he felt that he should know more about a contractor's business than the contractor knew itself. He was an expert in his field and highly effective at what he did. Ken was called upon by his employers to manage the highest dollar exposure contract surety claim cases. Ken was tall in stature, both literally and figuratively. He was a man who always demonstrated a professional demeanor and loyalty to his employer.

Generally, Ken was a man of few words but when he spoke he was direct and made his words count. He was practical, smart, and fair. Under his businesslike exterior, Ken was a great guy with a good sense of humor, and well- liked by those who worked with him. He had a memorable, hearty laugh. As a manager, Ken encouraged employees in their growth and development and he would quietly fight for them when it was the right thing to do.

Outside of work, Ken was an accomplished cook, painter, woodworker, gardener, and lover of the great outdoors, the arts, travel, and slapstick humor. He was a tireless laborer and a steadfast support to friends and family.

One of Ken's favorite things to do was to relax by heading back to the Endless Mountains of Pennsylvania and setting out in his canoe on the Susquehanna River on a clear,

quiet afternoon. In the springtime, Ken will return to the area near the Susquehanna River where his ashes will forever become a part of the land he loved.

Ken, thanks for being who you were, living the life you led, gracing us with your presence, and for giving us some fond memories, many of which will always bring a smile to our faces.

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(continued from page 1)

Nemacolin Woodlands Resort – Chateau Lobby

The ethics portion of the program should be especially interesting to all attendees who are lawyers as it highlights potential pitfalls for attorneys, whether in-house or outside counsel, which can result in inadvertent violations of the Attorney's Code of Professional Responsibility.

The program will also address issues regarding the sanctity of the penal sum of a surety bond and how a surety may inadvertently waive the penal sum limit. There will be discussions regarding the Federal Rules of Civil Procedure and the potential for shifting discovery costs to the surety. Scott Leo of The Leo Law Firm in Chicago will provide guidelines to ease the surety's undoubtedly painful experience navigating the principal's bankruptcy. There also will be an update on the Unfair Claims Settlement Practices Act and practical tips as to how to deal with regulators who may try to enforce an administrative claim against a surety for an alleged violation of that Act. As usual, annual fidelity and surety law updates will be presented. Additional program details will be furnished in the spring issue of the SCI Newsletter.

In order to maintain and keep a fresh approach to the annual topics, several years ago, the SCI's Board of Directors determined that the Program Chair should serve a term of no more than two years. Amy agreed to accept a two-year term, with this year marking the first program she has assembled. It promises to be an excellent one.

It is important to remember that potential attorney/consultants members have to be vetted by SCI's Membership Committee to ensure that these individuals are dedicated to the advancement of the surety industry. Therefore, because the speakers are dedicated surety claims professionals, and the SCI's papers are posted on its restricted website and comments are only accessible to SCI members, speakers and authors are encouraged to express frankly their opinions and ideas, knowing that the SCI's audience is comprised solely of surety claims professionals, accountants and attorneys dedicated to serving the surety industry.

The SCI hosts its annual meetings at locations which are attractive to attendees and their families. The SCI has always encouraged its members to bring their families including children. This year, the Nemacolin location is especially suitable for that.

At Nemacolin, there are perhaps even more activities available to attendees and their guests than in recent years. Nemacolin has opportunities to zip line, navigate rope courses, rent an off road vehicle and visit its zoo, among other things. Yes, it has a real zoo with numerous species of animals including lions, bears and wolves among other animals. In addition, if an attendee so desires, there is the opportunity to drive a dog sled at the resort. The resort's activity center is available to all attendees and contains other activities, such as bowling.

The resort is privately owned by the Hardy Family, who founded the 84 Lumber Company. Their personal art collection, worth in excess of $45 million, is displayed throughout the hallways of the hotel. Based on personal experience, the art collection is amazing and incredibly interesting.

The SCI has also organized a Thursday afternoon activity which will be a visit to the renowned architect Frank Lloyd Wright's incredible Fallingwater House.

In addition, the Thursday afternoon golf tournament will be held at Nemacolin's Mystic Rock Course which was rated as one of the top golf courses in the State of Pennsylvania and one of the top 100 publicly accessible courses in the United States. The Mystic Rock Course was home to the PGA's 84 Lumber classic for a number of years.

The property is serviced by a very efficient in-house shuttle service. Therefore, after arrival, there is no need for anyone to use their personal cars. The hotel is accessible by car from most locations in the Northeast. It is 3 hours 30 minutes from Washington, D.C., 4 hours 30 minutes from Philadelphia, 6 hours from New York City, and approximately 1 hour 45 minutes from Pittsburgh International Airport. Once you have been to this extraordinary venue, I am sure you will agree that the trip was well worth it!

We look forward to seeing everyone at the 2017 Annual Meeting and hope you find the program and activities as rewarding as we expect.

USING THE "TRUST FUND" AND/OR "SPECIAL PURPOSE" THEORY TO HOLD BANKS ACCOUNTABLE FOR SWEEPING BONDED CONTRACT PROCEEDS

By: Jarrod W. Stone, Manier & Herod, P.C., Nashville, TN

I. Introduction

When a principal becomes unable to meet its financial and other obligations under bonded construction contracts, the surety and the principal's bank often find themselves pitted against one another in a legal battle over the proceeds of those contracts. Once the principal defaults on its payment obligations to the bank, bonded contract proceeds are often swept from the principal's account and/or are otherwise applied to the principal's debt to the bank, which could lead directly to payment and/or performance bond exposure for the surety. The bonded contract proceeds may be swept away or applied before the surety becomes aware of the principal's financial difficulties or the surety otherwise sustains any loss that would give rise to equitable subrogation rights. When a surety demands that a bank disgorge bonded contract proceeds in an effort to avoid any payment or performance bond loss, the surety's demands often fall on deaf ears.

This exact scenario was recently encountered in *Selective Insurance Co. of America v. Environmental, Safety & Health, Inc.*,[1] where the surety alleged, among other things, that the bank was liable for conversion based upon the trust fund nature and/or special purpose of the bonded contract proceeds over which the bank had exercised dominion/control.[2] This article uses the *Selective* case to highlight a number of issues that may arise when the surety relies upon the "trust fund" and/or "special purpose" theory to recoup bonded contract proceeds from a bank.

As detailed herein, a bank generally possesses both a common-law and contractual right to set off funds in the principal's account against debts the principal owes to the bank. A bank also often possesses a perfected security interest in the principal's deposit accounts and the principal's accounts receivable, which accounts receivable may include amounts owed under bonded contracts. However, a bank may be liable for conversion if it sweeps bonded contract proceeds from the principal's account or otherwise applies those funds to debts owed to the bank, provided the bank has actual or constructive knowledge that (a) the principal held those funds in trust for the benefit of the surety and/or the principal's subcontractors/suppliers or (b) those funds were deposited for a special purpose (such as the statutorily/contractually mandated payment of subcontractors/suppliers on bonded projects). When a bank possesses actual or constructive knowledge of the trust nature of the funds at issue or the statutorily/mandated purpose of those funds, the bank may be guilty of

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[1] No. 3:14-CV-531-TAV-CCS, 2015 WL 914824 (E.D. Tenn. Mar. 3, 2015),

[2] The surety in the *Selective* case also asserted that it was entitled to recoup the bonded contract proceeds from the bank under the theories of "aiding and abetting breach of fiduciary duty," "conspiracy to violate the Misapplication Statute" (as defined herein), "money had and received," and "common-law/statutory tortious inducement of breach of contract."

conversion if it sets off against or otherwise applies those funds to the satisfaction of the principal's debts to the bank — regardless of whether the bank was purportedly acting pursuant to its own setoff rights or a properly perfected security interest in the principal's accounts. Bonded contract proceeds may constitute "trust funds" and/or may be deemed to have been deposited for a "special purpose" by virtue of the surety's indemnity agreement, the bonded contract, state law, and/or federal law.

In the *Selective* case, the court concluded that the "trust fund" issue "begins and ends" with the terms of the surety's indemnity agreement, the terms of which the court deemed to be sufficient to impress an express trust on the bonded contract proceeds under Tennessee law. However, whether an indemnity agreement is sufficient to create an express trust varies by state law, and a different result may have been reached if a different state's law had applied. Accordingly, in addition to discussing various issues that may arise when a surety relies upon its indemnity agreement as grounds for the trust fund or special purpose theory of recouping bonded contract proceeds from a bank, this article also addresses the trust fund nature and special purpose of bonded contract proceeds arising from bonded contracts as well as pertinent state and federal statutes.

II. A Bank Cannot Lawfully Set Off Against Funds It Knows Or Should Know Are Held In Trust Or Were Deposited For A Special Purpose

Though the *Selective* case involved Tennessee law, the court's analysis of a bank's right to set off against funds held in trust and/or deposited for a special purpose (or, more appropriately, the lack of such a right) is similar to the analysis of that issue throughout the United States. Like the law of most states, Tennessee law precludes a bank from exercising its setoff rights or otherwise exercising dominion/control over funds in a customer's account with knowledge (whether actual or constructive) that the customer holds the funds in trust **or** the funds were deposited into the customer's account for a particular purpose.[3]

In one of the leading cases on that issue under Tennessee law, *Wagner v. Citizens' Bank & Trust,*[4] the bank's customer was a furniture company that petitioned for bankruptcy protection. Prior to the company's bankruptcy petition, various creditors of the company, including its bank, agreed that the company's inventory would be converted into cash, deposited into the company's account at the bank, and then disbursed to the company's creditors on a pro rata basis.[5] After the company petitioned for bankruptcy protection, the bank exercised its setoff rights against the sale proceeds in the company's account.[6] The bankruptcy trustee challenged the bank's setoff on the basis that the company held the sale proceeds in trust for the benefit of its creditors and/or that those proceeds were deposited into the customer's account for the special purpose of distributing them to the customer's creditors.[7] While considering the competing interests of the bank and the company's creditors, the Tennessee Supreme Court recognized the following exceptions to the general rule that a bank may exercise a right of setoff against funds held in its customer's account:

> **"The proposition that there is no right of set-off against a trust deposit, nor any lien for the trustee's personal debts, is axiomatic."**
>
> . . . .
>
> "Where the bank deals with a depositor as trustee, and recognizes funds standing in his name as trust funds, knowing them to be such, **it cannot appropriate them to the payment of the trustee's individual indebtedness to the bank**."
>
> . . . .
>
> "**It is a general rule that funds deposited in bank for a special purpose, known to the bank, cannot be withheld from that purpose, to the end that they may be set off by the bank**

[3] *Wagner v. Citizens' Bank & Trust Co.*, 122 S.W. 245 (Tenn. 1909).

[4] 122 S.W. 245 (Tenn. 1909).

[5] *Id*. at 246.

[6] *Id*. at 246-47.

[7] *See id*.

> **against a debt due to it from the depositor**."[8]

The court held that the bank's setoff against the sales proceeds in its customer's account was unlawful because those funds had become "a trust deposit for specific purposes, with the knowledge and consent of the bank, **and the latter had no right of set-off in said fund against the bankrupt's indebtedness to the bank**."[9] Therefore, although no express trust existed, the funds were immune from setoff because they had been deposited for a specific purpose, which purpose was known to the bank.

Courts throughout the United States have similarly held that a bank may not set off against or apply trust funds or funds deposited for a special purpose to debts owed to the bank when the bank possesses actual or constructive notice of the trust nature or the specific purpose of the funds at issue. For example, the Bankruptcy Court for the Eastern District of Tennessee summarized the rule as follows:

> [W]here a bank has knowledge of a third party's interest in deposited funds, or (absent actual knowledge) notice of facts sufficient to necessitate inquiry as to the deposit's true character, the debtor-creditor relationship is altered and the bank's right of setoff is subject to the rights of such a third party. **The general rule is that the bank cannot set off such funds against the depositor's individual indebtedness to the bank**.[10]

The Georgia Court of Appeals likewise has held that a bank's setoff rights do not apply "to receipts which are designated as trust funds or are received by the bank with knowledge that they are intended to discharge a particular obligation, such that they partake of the character of trust funds."[11] The Western District of Kentucky has also recognized that a "bank may not apply a deposit, consisting of trust funds or funds belonging to one other than the depositor, to the individual indebtedness of the depositor if 'it knows, or can properly be charged with knowledge of, the trust character or true ownership of the funds.'"[12] Numerous other courts have embraced these principles.[13]

Specifically in the construction context, the Sixth Circuit has held that a bank was not entitled to exercise any right of setoff against progress payments in the contractor's account where those funds were held in trust for the benefit of subcontractors/suppliers.[14] Similarly, the California Court of Appeals has found that "[a] bank that has knowledge sufficient to require inquiry whether funds deposited by a general contractor to its account with the bank are trust funds cannot, as against the subcontractors, set off the funds to pay an indebtedness owed the bank by the general contractor."[15] That court further noted that "[t]he principle is by no means new or novel, having been promulgated with the ten commandments when it was said, 'Thou shalt not steal.'"[16] The Michigan Court of Appeals has likewise held that "money held in an account by a contractor as trustee . . . is not property of

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[8] *Id*. at 247-48 (internal citations omitted) (emphasis added).

[9] *Id*. at 248-49 (emphasis added).

[10] *In re Prop. Leasing & Mgmt., Inc.*, 46 B.R. 903, 908 (Bankr. E.D. Tenn. 1985) (emphasis added).

[11] *Nat'l City Bank of Rome v. Busbin*, 332 S.E.2d 678, 681 (Ga. Ct. App. 1985).

[12] *Acuity v. Planters Bank, Inc.*, 362 F. Supp. 2d 885, 889-90 (W.D. Ky. 2005) (internal citations omitted).

[13] *See, e.g., In re Marrs-Winn Co.*, 103 F.3d 584 (7th Cir. 1996); *Am. Nat'l Bank of St. Paul v. Nat'l Indem. Co. of Omaha*, 222 F.2d 513 (8th Cir. 1955); *Safeco Ins. Co. v. Wheaton Bank & Trust Co*., No. 07 C 2397, 2009 WL 2407740 (N.D. Ill. Aug. 4, 2009); *In re Milano Textiles, Inc.*, 38 B.R. 964 (Bankr. D. Mass. 1984); *In re Tonyan Constr. Co*., 28 B.R. 714 (Bankr. N.D. Ill. 1983); *Whooping Creek Constr., LLC v. Bartow Cnty. Bank*, 713 S.E.2d 871 (Ga. Ct. App. 2011); *Westview Investments, Ltd. v. U.S. Bank Nat'l Ass'n*, 138 P.3d 638 (Wash. Ct. App. 2006); *Utica Sheet Metal Corp. v. J. E. Schecter Corp*., 278 N.Y.S.2d 345 (N.Y. Sup. Ct. 1967).

[14] *Fed. Ins. Co. v. Fifth Third Bank*, 867 F.2d 330, 334-35 (6th Cir. 1989) (stating "a bank does not have an automatic right of setoff when the funds are held by the [contractor] in a fiduciary capacity, and, here, we have concluded [the contractor] held these funds in a fiduciary capacity for the job creditors").

[15] *Chang v. Redding Bank of Commerce*, 35 Cal. Rptr. 2d 64, 66 (Cal. Ct. App. 1994).

[16] *Id*. at 69.

the contractor subject to setoff by the contractor's bank-lender."[17]

III. A Bank May Be Liable For Conversion When It Exercises Dominion/Control Over Funds Held In Trust Or Funds Deposited For A Special Purpose

A bank may have potential liability for conversion for exercising dominion/control over funds held as trust funds and/or deposited for a special purpose. In short, a bank may be liable for conversion if the bank sets off against or otherwise exercises dominion/control over funds held in trust or funds deposited for a special purpose — regardless of whether the bank was purportedly acting pursuant to its common-law setoff rights or a properly perfected security interest.

Under Tennessee law, "[c]onversion is the appropriation of another's property to one's own use and benefit, by the exercise of dominion over the property, in defiance of the owner's right to the property."[18] To be liable for conversion, "the defendant need only have an intent to exercise dominion and control over the property that is in fact inconsistent with the plaintiff's rights, and do so; good faith is generally immaterial."[19] A federal court applying Tennessee law has recognized that a bank exercises control over funds in a customer's account sufficient to give rise to a conversion claim when the bank applies those funds to the customer's existing debt in defiance of a plaintiff's rights in those funds.[20] Upon appeal of that ruling, the Sixth Circuit confirmed that, under Tennessee law, wrongful intent is irrelevant to the existence of a conversion claim.[21] Other courts have recognized that a bank converts trust funds by setting off against them.[22]

Therefore, even if the bank was acting under the good faith belief that it was entitled to do so, a bank may still face liability for conversion as result of the bank's setting off against funds held in trust or deposited for a special purpose or otherwise applying such funds to debts owed to the bank with actual or constructive knowledge of the trust nature or special purpose of those funds. In order to state a claim for conversion under these circumstances, a surety must demonstrate that it possesses a superior interest in the bonded contract proceeds, which is an issue the bank will hotly contest.

IV. Trust Fund/Special Purpose Theory Based Upon Indemnity Agreement

Modern indemnity agreements often include trust fund provisions, under which the principal agrees to hold all proceeds of bonded contracts in trust for the sole purpose of satisfying obligations for which the surety would be liable under its bonds. On the one hand, numerous bankruptcy courts have considered whether the trust fund provision of an indemnity agreement is sufficient to create an express trust under state law and a corresponding fiduciary duty flowing from the principal/indemnitors to the surety, the breach of which may constitute a defalcation and may further constitute grounds for objecting to the discharge of the principal's debt to the surety.[23] On the other hand, however, very few courts have considered the issue of whether the trust fund provision of an indemnity agreement, to which the bank is not a party and to which the bank did not consent, can deprive a bank of the right to exercise its common-law and/or contractual setoff rights against funds in the principal's account. Nonetheless, the competing arguments of the surety and the bank in the *Selective* case as to whether the indemnity agreement was sufficient

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[17] *Blair v. Trafco Prods., Inc.*, 369 N.W.2d 900, 903 (Mich. Ct. App. 1985).

[18] *Ralston v. Hobbs*, 306 S.W.3d 213, 221 (Tenn. Ct. App. 2009).

[19] *Mammoth Cave Prod. Credit Ass'n v. Oldham*, 569 S.W.2d 833, 836 (Tenn. Ct. App. 1977).

[20] *Am. Bank, FSB v. Cornerstone Cmty. Bank*, 903 F. Supp. 2d 568 (E.D. Tenn. 2012).

[21] *Am. Bank, FSB v. Cornerstone Cmty. Bank*, 733 F.3d 609, 614-15 (6th Cir. 2013) (citing *White v. Empire Express, Inc.*, 395 S.W.3d 696, 720 (Tenn. Ct. App. 2012)).

[22] *See, e.g., Travelers Cas. & Sur. Co. of Am. v. Paderta*, No. 10 C 0406, 2010 WL 5419065 (N.D. Ill. Dec. 23, 2010); *Westview Investments, Ltd. v. U.S. Bank Nat'l Ass'n*, 138 P.3d 638 (Wash. Ct. App. 2006).

[23] *See, e.g., In re Poynter*, 535 F. App'x 479 (6th Cir. 2013) (indemnity agreement); *Favre v. Lyndon Prop. Ins. Co.*, No. 1:07cv1261HSO-JMR, 2008 WL 3271100 (S.D. Miss. Aug. 6, 2008) (indemnity agreement); *In re Hastings*, 438 B.R. 743 (Bankr. N.D. Ala. 2008) (indemnity agreement); *In re McCormick*, 283 B.R. 680 (Bankr. W.D. Pa. 2002) (indemnity agreement); *In re Wright*, 266 B.R. 848 (Bankr. E.D. Ark. 2001) (indemnity agreement).

to create an express trust under Tennessee law provide a general roadmap of the obstacles that may arise when a surety relies upon the trust fund provision of an indemnity agreement to recoup bonded contract proceeds from a bank.

The statutory requirements for creating an express trust under Tennessee law are articulated in Section 35-15-402(a) of the Tennessee Code, which provides, in relevant part:

> A trust is created only if: (1) The settlor has capacity to create a trust; (2) The settlor indicates an intention to create the trust; (3) The trust has a definite beneficiary . . . ; (4) The trustee has duties to perform; and (5) The same person is not the sole trustee and sole beneficiary.[24]

Section 35-15-106 of the Tennessee Code clarifies that Tennessee's common law of trusts supplements these statutory requirements.[25] The Sixth Circuit has described the common-law requirements for creating an express trust under Tennessee law as follows:

> Under Tennessee law, establishing the existence of an express trust requires proof of three elements: (1) a trustee who holds trust property and who is subject to the equitable duties to deal with it for the benefit of another, (2) a beneficiary to whom the trustee owes the equitable duties to deal with the trust property for his benefit, and (3) identifiable trust property.[26]

The court further explained that "where a person has or accepts possession of personal property with the express or implied understanding that he is not to hold it as his own absolute property, but is to hold and apply it for certain specific purposes or for the benefit of certain specified persons, a valid and enforceable express trust exists."[27]

As dictated by those principles, the surety in the *Selective* case argued that, by virtue of the surety's indemnity agreement, all proceeds of its bonded contracts were impressed with an express trust under Tennessee law for the benefit of the surety and the principal's subcontractors/suppliers for the exclusive purpose of satisfying the conditions of the surety's bonds. The trust fund provision at issue in the *Selective* case stated, in relevant part:

> All consideration, including all funds paid, due or to become due and all securities, warrants, checks or other evidence of indebtedness and the proceeds thereof, given upon or under any contract in connection with which Surety shall have issued a Bond ("Trust Funds") **shall be impressed with a trust in favor of and for the benefit of laborers, materialmen, suppliers, subcontractors and Surety for the exclusive purpose of satisfying the conditions of the Bonds**. In the event of a default by any Indemnitor in the performance or compliance with any promise, covenant or obligation under this agreement, the Surety may demand and the Indemnitors shall cause all funds or the proceeds of all consideration received or to be received from any contract referred to in any Bond to be deposited into separate trust accounts with a bank or similar depository designated by Surety and such accounts shall be controlled by an escrow agent to be designated by Surety . . . .[28]

Though the surety had asserted that the principal also held the bonded contract in trust on a number of other grounds, the court in the *Selective* case explained that the trust fund issue "begins and ends with the terms of the GAI because it finds that the GAI creates an express

[24] TENN. CODE ANN. § 35-15-402(a).
[25] TENN. CODE ANN. § 35-15-106.
[26] *In re Cannon*, 277 F.3d 838, 849-50 (6th Cir. 2002).
[27] *Id*. at 850.

[28] *Selective*, 2015 WL 914824 at *4 (emphasis added).

trust under Tennessee law."[29] The court further elaborated:

> The Court finds that [the trust fund] provision of the GAI satisfies all of the requirements for the creation of an express trust. First, [the principal] indicated its intention to create a trust by agreeing that "[a]ll consideration, including all funds paid, due or to become due and all securities, warrants, checks or other evidence of indebtedness and the proceeds thereof, given upon or under any contract in connection with which Surety shall have issued a Bond" be impressed with a trust. Second, [the principal], as trustee, has certain duties, including dedicating the bonded contract proceeds for the exclusive purpose of satisfying the conditions of [the surety]'s bonds (such as paying [the principal]'s subcontractors and suppliers), and, upon demand, depositing the bonded contract proceeds into separate trust accounts. Third, there are definite beneficiaries: [the surety] and [the principal]'s subcontractors and suppliers. Finally, there is identifiable trust property; that is, all funds paid, due, or to become due under the bonded contracts. "[W]here a person has or accepts possession of personal property with the express or implied understanding that he is not to hold it as his own absolute property, but is to hold and apply it for certain specific purposes or for the benefit of certain specified persons, [as here,] a valid and enforceable express trust exists."[30]

The *Selective* court also rejected the bank's argument that the surety was precluded from maintaining a conversion claim against the bank because the surety had consented in the indemnity agreement to the principal's assignment of the bonded contract proceeds as collateral and the principal had in fact assigned the bonded contract proceeds to the bank as collateral. Though the indemnity agreement at issue undisputedly authorized the principal to assign bonded contract proceeds as collateral, the surety argued that the bank's right to receive the bonded contract proceeds as an assignee was derivative of, and could be no greater than, the principal's right to receive and retain the bonded contract proceeds. By virtue of the express trust impressed upon the bonded contract proceeds and the sole purpose for which the bonded contract proceeds were to be utilized, the principal merely possessed bare legal title to any bonded contract proceeds in its accounts, while the beneficiaries of the express trust — the surety and the principal's subcontractors/suppliers on the bonded projects — possessed equitable title to those funds.[31] The conditions of the principal's bonds had not been satisfied because the principal's subcontractors/suppliers remained unpaid. According to the surety, the principal never obtained equitable title to the bonded contract proceeds, and the bank's purported security interest in the bonded contract proceeds never attached and/or was ineffective as a matter of law. On that note, the court agreed as follows:

> The Court does not find that reading [the indemnity agreement] in accord with [the surety] ignores the plain language of the GAI that allows the Indemnitors to assign collateral rights because, under Tennessee law, a trustee "holds legal title and in that sense, owns the property, holding it for the benefit of the beneficiary who owns the equitable title." Thus, because the Court has found that the GAI creates an

[29] *Id.* .

[30] *Id*. at *5 (internal citations omitted).

[31] Id. at *6 (citing *Myers v. Myers*, 891 S.W.2d 216, 219 (Tenn. Ct. App. 1994) (explaining that a trustee "holds legal title and in that sense, owns the property, holding it for the benefit of the beneficiary who owns the equitable title"); *In re Marrs-Winn Co.*, 103 F.3d 584, 589-93 (7th Cir. 1996) (holding that a bank's priority security interest did not apply to funds in trust because assignor only possessed bare legal title)).

> express trust and one may infer from the allegations of the amended complaint that the purpose of the trust had not been satisfied, it follows that [the principal] held only legal title to the bonded contract proceeds.[32]

Though the court in *Selective* held that the trust fund provision was sufficient to create an express trust under Tennessee law, a different result may have been reached if a different state's law had applied. For example, the bank cited *Acuity, v. Planters Bank, Inc.*[33] in support of its argument that the trust fund provision was not sufficient to create an express trust because no identifiable trust property existed at the time the indemnity agreement was executed. In *Acuity*, which was governed by Kentucky law, the court specifically found that the trust fund provision of the indemnity agreement evidenced the principal's "intent to create a trust," that "the beneficiaries seem sufficiently certain," and the principal was identified as a trustee.[34] Nonetheless, the court held that no express trust was created upon the principal's execution of the indemnity agreement under Kentucky law because "the subject matter of the trust must be definite or definitely ascertainable from facts **existing at the time of the creation of the trust**."[35] Because the principal did not actually possess any bonded contract proceeds at the time the indemnity agreement was executed, the court held that that the surety's trust fund argument failed "**due to the absence of a coincidence between the existence of a trust res and a declaration of intent**."[36] However, no coincidence between the principal's possession of trust property and the principal's declaration of its intent to create a trust was required under Tennessee law.[37] Upon the principal's actual receipt of bonded contract proceeds, which occurred after the indemnity agreement had been executed, those funds were impressed with an express trust under Tennessee law because the "last required trust element, identifiable trust property, was then satisfied."[38] Thus, the success of a trust fund argument under an indemnity agreement may be dependent upon whether the jurisdiction at issue requires a "coincidence" between the expression of the intent to create an express trust (*i.e.*, the execution of the indemnity agreement) and the existence of identifiable trust property (*i.e.*, bonded contract proceeds in the principal's hands).

A different result may have also been reached if the *Selective* case had been litigated in a state in which the comingling of trust funds with other funds could impact the analysis. For example, Ohio law requires segregation of trust funds to establish an express trust.[39] Conversely, neither Section 35-15-402 of the Tennessee Code, which articulates the statutory requirements for the creation of an express trust, nor Tennessee's common law require segregation of trust funds for the creation/maintenance of an express trust. Moreover, the Sixth Circuit has expressly held that a trust agreement's failure to expressly require that trust funds be held in separate accounts "is not a determining factor of whether a trust was formed."[40] Because the principal in *Selective* had undisputedly deposited both bonded and non-bonded contract proceeds into a single account at the bank, the surety's trust fund argument may not have been successful if Ohio law applied.

In order to state a claim for conversion based upon the trust fund provision in an indemnity agreement, the surety may be required to prove that the bank had actual or constructive knowledge of that provision. A surety might file its indemnity agreements as a financing

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[32] *Id.* at *8.

[33] 362 F. Supp. 2d 885 (W.D. Ky. 2005).

[34] *Id.* at 893.

[35] *Id*. (emphasis added).

[36] *Id*. (emphasis added).

[37] *Crews v. Overbey*, 645 S.W.2d 388, 390-91 (Tenn. 1983) ("We align ourselves with those jurisdictions that require the transfer of title to a trustee for the benefit of the trust of an identifiable res, as the event that brings a trust into existence").

[38] *In re Appalachian Oil Co.*, 471 B.R. 199, 208 (Bankr. E.D. Tenn. 2012).

[39] *In re Constr. Alternatives, Inc.*, 2 F.3d 670 (6th Cir. 1993).

[40] *Fifth Third Bank*, 867 F.2d 334; *see also In re Poynter*, 535 F. App'x 479 (6th Cir. 2013) (confirming that lack of segregation "is not a determining factor of whether a trust was formed"); *In re Appalachian Oil Co., Inc.*, 471 B.R. 199 (Bankr. E.D. Tenn. 2012) (applying Tennessee law and stating "[t]he fact [the putative trustee] failed to segregate the TEL trust funds and commingled them with its own funds does not destroy the previously established trust or the parties' fiduciary relationship").

statement under the Uniform Commercial Code after the principal defaults on its bonded obligations. When a bank becomes aware of the principal's financial difficulties, a bank may investigate the status of the principal's accounts receivables and the status of financing statements that have been filed against the principal. Thus, a bank may obtain actual or constructive notice of the trust fund provision of an indemnity agreement by virtue of a surety's filing of its indemnity agreement as a financing statement under the Uniform Commercial Code. To the extent the surety anticipates that a bank may sweep bonded contract proceeds from the principal's account or may otherwise exercise dominion/control over those funds, the surety should consider providing the bank actual notice of the terms of the trust fund provision at the time it demands that the bank refrain from sweeping and/or affirmatively disgorging bonded contract proceeds.

V. Trust Fund/Special Purpose Theory Based Upon Bonded Contract(s)

A surety may also be able to argue that an express trust was impressed upon bonded contract proceeds and/or that bonded contract proceeds were deposited into the principal's account for a special purpose based upon the terms of the bonded contract(s) at issue. For example, the Sixth Circuit has held that the following trust fund provision in a public construction contract was sufficient to create an express trust under Ohio law, which precluded the bank from exercising its setoff rights against proceeds of the contract:

> All monies paid on account to any contractor for materials or labor **shall be regarded as fund [sic] in his trust for payment of any and all obligations relating to this contract** and no such amount of monies shall be permitted to accrue to the contractor until all such obligations are satisfied. Evidence satisfactory to the state may be required to show that all current obligations relating to this work are satisfied before releasing any payment due on the work. Before payment of the final estimate, each contractor shall file an affidavit with the state, stating that monetary oblications [sic] relating to lienable items in connection with the work have been fulfilled.[41]

After noting that the surety could equitably subrogate to the rights of the principal's subcontractors/suppliers as trust beneficiaries, the Sixth Circuit explained: "In summary, we hold that an express trust was formed by the contract provision, with the State as settlor, [the principal] as trustee, the job creditors as beneficiaries, and the progress payments as trust funds."[42] A number of other courts have recognized that trust fund provisions contained in bonded contracts may impress an express trust upon bonded contract proceeds, which renders those funds immune from a bank's common-law and/or statutory setoff rights.[43]

Thus, the terms of the bonded contract(s) should be examined to determine whether they impress an express trust upon bonded contract proceeds and/or mandate that the bonded contract proceeds be utilized for the sole purpose of paying the principal's subcontractors/suppliers on the bonded project. The surety may not qualify as a beneficiary under such bonded contract provisions, but the surety may subrogate to the rights of the principal's subcontractors/suppliers as beneficiaries of the trust funds and/or the specially deposited bonded contract proceeds.

[41] *Fed. Ins. Co. v. Fifth Third Bank*, 867 F.2d 330, 332 (6th Cir. 1989) (emphasis in original).

[42] *Id*. at 334.

[43] *See, e.g., In re Marrs-Winn Co., Inc.*, 103 F.3d 584 (7th Cir. 1996) (recognizing that "a trust fund may be created in which payments from a contractor to a subcontractor constitute the trust res"); *Westview Investments, Ltd. v. U.S. Bank Nat'l Ass'n*, 133 Wash. App. 835, 138 P.3d 638 (Wash. Ct. App. 2006) (stating "the construction contracts at issue created express trusts designating progress payments made for the benefit of subcontractors to be trust funds"); *Chang v. Redding Bank of Commerce*, 35 Cal. Rptr. 2d 64 (Cal. Ct. App. 1994) (recognizing that "trust law provides that the contract established a trust as to the progress payment funds").

VI. Trust Fund/Special Purpose Theory Based Upon State or Federal Statutes

A surety may also be able to argue that an express trust was impressed upon bonded contract proceeds and/or that bonded contract proceeds were deposited into the principal's account for a special purpose based upon the terms of certain state or federal statutes that may apply to the bonded contract(s) at issue. While the trust nature and/or special purpose arising from state statutes will necessarily vary from state to state, the competing arguments of the surety and the bank in the *Selective* case as to the impact of various Tennessee statutes are illustrative of issues that may arise when a surety relies upon state statutes when contesting a bank's exercise of dominion/control over bonded contract proceeds..

For example, in *Selective*, the bonded contracts were subject to Tennessee's criminal contract payment misapplication statute (the "Misapplication Statute"), codified at Section 66-11-138 of the Tennessee Code, which provides, in pertinent part:

> (a)(1) Any prime contractor or remote contractor who, with intent to defraud, uses the proceeds of any payment made to that contractor on account of improving certain real property **<u>for any purpose other than</u> to pay for labor performed on, or materials, services, equipment, or machinery furnished by that contractor's order for the real property**, and overhead and profit related thereto, while any amount for the labor, materials, services, equipment, machinery, overhead, or profit remains unpaid shall be liable to an injured party for any damages and actual expenses incurred, including attorneys' fees, if the damages and expenses incurred are the result of the misapplication of the payment.
>
> (2) A violation of subdivision (a)(1) is a Class E felony.[44]

In construing a prior version of the Misapplication Statute, the Tennessee Supreme Court has noted that "[a] statute of this nature is intended to make the payments to the contractor **trust funds for the payment of labor and materials**."[45] However, the Tennessee Court of Appeals later noted that the Misapplication Statute was alone insufficient to give rise to an express trust under Tennessee law because, "[w]hile several states have statutes explicitly making funds paid to a contractor a trust for the benefit of laborers and materialmen, **Tennessee only has [the misapplication statute]**, which imposes criminal liability for misapplication of contract payments before debts to subcontractors have been satisfied."[46] Thus, even if the state at issue has a similar criminal misapplication statute, there is no guarantee that a court will deem that statute to create an express trust over bonded contract proceeds. If that is the case, the surety should educate the court that funds deposited for a special purpose are also immune from a bank's common-law and/or contractual setoff rights under the majority rule.

Some states do in fact have statutes that expressly require principals to hold the proceeds of construction contracts in trust for the benefit of subcontractors/suppliers. However, it is important that the surety closely examine those statues to determine whether they contain any loopholes banks may exploit. For example, after the Tennessee Court of Appeals concluded that the Misapplication Statute alone was insufficient to create an express trust on the proceeds of Tennessee construction contracts, the Tennessee General Assembly enacted the Tennessee Prompt Pay Act of 1991 (the "TPPA"), under which "[p]erformance by a subcontractor, materialman or furnisher in accordance with the provisions of such person's written contract with a contractor for improvement of real property shall entitle such person to payment from the contractor."[47] The TPPA also dictates that any retainage withheld "shall become **the sole and**

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[44] TENN. CODE ANN. § 66-11-138 (emphasis added).

[45] *Daugherty v. State*, 393 S.W.2d 739, 741 (Tenn. 1965) (emphasis added).

[46] *Sequatchie Concrete Serv., Inc. v. Cutter Labs.*, 616 S.W.2d 162, 166 (Tenn. Ct. App. 1980) (emphasis added).

[47] TENN. CODE ANN. § 66-34-301.

separate property of the . . . remote contractor to whom they are owed."[48] More importantly, the TPPA explicitly provides:

> Any sums received by the contractor as payment for work, services, equipment and materials supplied by the subcontractor, materialman or furnisher for improvements to real property **shall be held by the contractor in trust for the benefit and use of such subcontractor, materialman or furnisher and shall be subject to all legal and equitable remedies**.[49]

Thus, by enacting the TPPA, Tennessee's General Assembly seemingly eliminated the only obstacle to an express trust arising from the Misapplication Statute and signaled its intent that contractors must hold payments held in trust for payment of their subcontractors/suppliers. In other words, as evidenced by the interplay between the Misapplication Statute and the TPPA, a contractor on a construction project in Tennessee must accept payment from the owner with the understanding that the contractor "is not to hold it as his own absolute property, but is to hold and apply it for certain specific purposes or for the benefit of certain specified persons," which should be sufficient to give rise to a "valid and enforceable express trust" under Tennessee law.[50]

Nonetheless, the TPPA additionally states that it "does not apply to any bank," and a federal court applying Tennessee law has held that the exclusion of banks from the strictures of the TPPA means that no provision of the TPPA could affect a bank's rights as a secured party.[51] Such a holding ignores the interplay between the Misapplication Statute and the TPPA and has never been endorsed by any Tennessee court. In fact, but for the ruling in its favor on the trust fund argument under the indemnity agreement, the surety in the *Selective* case intended to push the court to certify the interpretation of the TPPA to the Tennessee Supreme Court. The Texas Supreme Court has reached a similarly flawed result in construing a similar exclusion of banks from a Texas statutory scheme that requires contractors to hold the proceeds of construction contracts in trust for subcontractors/suppliers.[52] Consequently, even though a state statute may appear to clearly and unambiguously impress bonded contract proceeds with an express trust in favor of the principal's subcontractors/suppliers, a surety should be wary of any language that excludes banks from the applicability of the statute.

If any of the bonded contract proceeds at issue relate to federal projects, the surety should argue that the bonded contract proceeds are immune from the bank's common-law and/or contractual setoff rights because they were deposited into the principal's account for the statutorily mandated special purpose of paying the principal's subcontractors/suppliers by virtue of the Federal Prompt Pay Act (the "FPPA") and the applicable provisions of the Federal Acquisition Regulations (the "FAR")[53] In that regard, the FPPA provides, in pertinent part:

> (b)(1) A payment request may not be approved . . . unless the application for such payment includes –
>
> (A) substantiation of the amounts requested; and
>
> (B) **a certification by the prime contractor, to the best of the contractor's knowledge and belief, that –**
>
> (i) the amounts requested are only for performance in accordance with the specifications, terms, and conditions of the contract;
>
> (ii) **payments to subcontractors and suppliers have been made <u>from previous payments received under the contract</u>, and timely payments <u>will be made</u>**

[48] TENN. CODE ANN. § 66-34-104(b) (emphasis added).

[49] TENN. CODE ANN. § 66-34-304 (emphasis added).

[50] *Cannon*, 277 F.3d at 849-50.

[51] *AMC Demolition Specialists, Inc. v. Bechtel Jacobs Co.*, No. 3:04-CV-466, 2006 WL 2792401 (E.D. Tenn. Sept. 26, 2006).

[52] *RepublicBank Dallas, N.A. v. Interkal, Inc.*, 691 S.W.2d 605 (Tex. 1985).

[53] *E.g.,* 48 C.F.R. § 52.232-27.

from the proceeds of the payment covered by the certification, in accordance with their subcontract agreements and the requirements of this chapter; and

(iii) the application does not include any amounts which the prime contractor intends to withhold or retain from a subcontractor or supplier in accordance with the terms and conditions of their subcontract.[54]

Thus, the FPPA does not merely require the principal to pay its subcontractors/suppliers, but it mandates that the principal pay its subcontractors/suppliers "from previous payments received under the contract" and/or "from the proceeds of the payment covered by the certification." The FPPA further provides, in pertinent part:

(b) Each construction contract awarded by an agency **shall** include a clause that requires the prime contractor **to include in each subcontract** for property or services entered into by the prime contractor and a subcontractor (including a material supplier) for the purpose of performing such construction contract –

(1) a payment clause which obligates the prime contractor to pay the subcontractor for satisfactory performance under its subcontract **within 7 days out of such amounts as are paid to the prime contractor by the agency under such contract** . . . .[55]

The FAR provides, in pertinent part:

(c) Subcontract clause requirements. The Contractor **shall include in each subcontract** for property or services (including a material supplier) for the purpose of performing this contract the following:

(1) Prompt payment for subcontractors. A payment clause that obligates the Contractor to pay the subcontractor for satisfactory performance under its subcontract **not later than 7 days from receipt of payment out of such amounts as are paid to the Contractor under this contract** . . ..[56]

The provisions of the FPPA and the FAR highlighted above make it crystal clear that a principal is not entitled to treat the proceeds of federal construction contracts as the principal's absolute property but, instead, must first pay its subcontractors/suppliers "out of such amounts as are paid to the [principal]" under the bonded contract. At a minimum, banks should be tasked with constructive knowledge of the terms of the FPPA and the FAR. Accordingly, the proceeds of federal construction contract should be immune from a bank's common-law and/or contractual setoff rights under the FPPA and the FAR.

VII. Conclusion

When it found itself pitted in a battle against a bank over the right to bonded contract proceeds, the surety in *Selective* was able to establish that the trust fund provision of its indemnity agreement was sufficient to impress the bonded contract proceeds with an express trust under Tennessee law, which rendered the bonded contract proceeds to be immune from the bank's common-law and/or contractual setoff rights against funds in the principal's account. The issue of whether a trust fund provision of an indemnity agreement is sufficient to create an express trust is an issue that will be governed by state law, and the court in *Selective* may have

[54] 31 U.S.C.A. § 3903 (emphasis added).
[55] 31 U.S.C. § 3905 (emphasis added).
[56] 48 C.F.R. § 52.232-27(c)(1) (emphasis added).

reached a different result if a another state's law had applied. Therefore, when relying upon a trust fund provision in an indemnity agreement, the surety should investigate, among other issues, whether the relevant jurisdiction requires "coincidence" between the execution of the indemnity agreement and the principal's possession of bonded contract proceeds and whether comingling of trust funds with other funds destroys the trust character of the funds. The surety should also determine whether the bonded contract(s) contain language impressing an express trust on the proceeds of the bonded contract(s). Any applicable state and federal statutes should also be examined to determine whether they may impress an express trust on bonded contract proceeds and/or mandate that the principal utilize those funds for the sole purpose of paying its subcontractors/suppliers on the bonded project. If the bonded contract and/or statutes do in fact create an express trust or mandate a special purpose for the bonded contract proceeds, the surety may be able to recoup the bonded contract proceeds through equitable subrogation to the rights of the principal's subcontractors/suppliers as beneficiaries of the trust and/or the special purpose of the bonded contract proceeds.

Arbitration Involving Non-Signatories

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I. Introduction

For decades, arbitration has been a common method for resolving disputes in the construction industry. Arbitration is generally considered a consensual procedure, meaning one to which the parties have agreed by signing a contract containing an arbitration provision. There is, however, a developing body of law that recognizes theories under which non-signatories to arbitration agreements can either be bound or compel other parties to arbitrate.

Courts have recognized six theories under which a non-signatory may be compelled to arbitrate: (1) equitable estoppel; (2) incorporation by reference; (3) third-party beneficiary; (4) alter ego; (5) agency; and (6) assumption.[1] To illustrate the six theories, primarily Texas state court cases are discussed below. However, the theories are recognized in other jurisdictions and federal courts. The Texas Supreme Court has noted the importance of having consistent federal and state law in this area, as both federal and state courts have concurrent jurisdiction to enforce the Federal Arbitration Act.[2]

II. Equitable Estoppel – Seeking the Benefits of a Contract that Contains an Arbitration Provision

In *In re Kellogg Brown & Root* (the "KBR Case"), the Texas Supreme Court decided, under the theory of "direct benefits estoppel," that a non-signatory to a contract containing an arbitration provision was not required to arbitrate claims involving two parties that were signatories to the contract.[3] The KBR Case involved three primary entities: (1) a contractor hired to build elevator trunks for two cruise ships ("MacGregor"); (2) a subcontractor hired by MacGregor to fabricate a set of the elevator trunks for one of the ships

[1] *E.g.*, *Rachal v. Reitz*, 403 S.W.3d 840, 846 n.5 (Tex. 2013); *In re Kellogg Brown & Root, Inc.*, 166 S.W.3d 732, 739 (Tex. 2005).

[2] *In re Kellogg Brown & Root, Inc.*, 166 S.W.3d at 739.

[3] *Id.* at 741.

("Unidynamics"); and (3) a second-tier subcontractor hired by Unidynamics to furnish labor, equipment, and facilities to fabricate the elevator trunks (KBR).[4] The subcontract between MacGregor and Unidynamics contained a broad arbitration provision, which stated as follows: "Any disputes arising from the interpretation or application of this contract including any document pertaining thereto, shall be settled by arbitration in accordance with [the] General Conditions . . . ."[5] The second-tier subcontract between Unidynamics and KBR did not contain an arbitration provision.[6]

The buyer of the ships subsequently declared bankruptcy, and MacGregor was directed to cease work and instruct its subcontractors to do likewise.[7] After KBR ceased work, it put the elevator trunks and other equipment in storage and sent Unidynamics invoices for unpaid services and storage costs.[8] KBR asserted liens on the elevator trunk fabrications and associated materials (the "Collateral").[9]

A dispute arose between MacGregor and Unidynamics concerning who owned the Collateral and who was responsible for paying KBR for its services and the storage costs.[10] The dispute involved an Agreement Concerning Passing of Title (the "Title Agreement"), executed by MacGregor and Unidynamics and incorporated into their fabrication subcontract.[11] The Title Agreement provided that title to the Collateral would pass irrevocably to MacGregor immediately after MacGregor issued two payments to Unidynamics.[12] MacGregor timely made the two payments to Unidynamics, but Unidynamics asserted that the payments were ineffective to pass title to MacGregor.[13] Unidynamics refused to release the elevator trunks to MacGregor, and the Collateral remained in KBR's possession.[14]

Pursuant to the arbitration agreement in their subcontract, MacGregor initiated arbitration proceedings against Unidynamics to resolve their dispute.[15] MacGregor sought (1) damages against Unidynamics for refusing to release the Collateral; (2) a determination of which party owned the Collateral; and (3) a determination as to MacGregor's proportionate responsibility for the storage costs billed by KBR.[16]

During arbitration, both MacGregor and Unidynamics demanded that KBR release the Collateral.[17] KBR refused and filed a lawsuit against MacGregor and Unidynamics.[18] KBR asserted that Unidynamics breached their subcontract and, alternatively, that KBR was entitled to recover *quantum meruit* damages against Unidynamics and MacGregor.[19] KBR also sought declaratory relief to determine which defendant owned the Collateral and, subject to the court's ruling on ownership, that KBR's liens against the Collateral were valid.[20]

MacGregor answered and sought injunctive relief requiring KBR to release the Collateral.[21] Unidynamics argued that KBR's court action should be abated because the Collateral's ownership was at the heart of the ongoing arbitration between MacGregor and Unidynamics.[22] The three parties ultimately negotiated an agreement under which MacGregor posted a $1 million bond and KBR released the Collateral to MacGregor.[23]

In the meantime, MacGregor filed a motion to abate the state court proceedings pending its arbitration with Unidynamics or, in the alternative, to compel KBR to pursue its claims in the arbitration.[24] The trial court denied MacGregor's motions, and MacGregor appealed.[25] The court of appeals conditionally granted mandamus relief, ordering the trial court "to vacate its order denying MacGregor's plea in abatement and motion to compel arbitration, to issue an order compelling KBR to arbitrate all claims, and to stay all proceedings pending

[4] *Id.* at 734–35.
[5] *Id.* at 735.
[6] *Id.*
[7] *Id.*
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] *Id.* at 735–36.
[17] *Id.* at 736.
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] *Id.*
[24] *Id.*
[25] *Id.*

arbitration."[26] KBR subsequently appealed to the Texas Supreme Court.[27]

The Texas Supreme Court began its discussion by noting that the parties did not dispute the court of appeals' holding that the arbitration provision at issue was governed by the Federal Arbitration Act (FAA).[28] Under the FAA, a party seeking to compel arbitration generally must establish that: "(1) there is a valid arbitration agreement, and (2) the claims raised fall within that agreement's scope."[29] Doubts about an agreement's scope must be "resolved in favor of arbitration because there is a presumption favoring agreements to arbitrate under the FAA."[30] "However, 'the presumption arises only after the party seeking to compel arbitration proves that a valid arbitration agreement exists[.]'"[31]

The court explained that under the FAA, ordinary principles of state contract law determine whether a valid agreement to arbitrate exists.[32] However, "courts have applied both federal and state law to determine the related, but distinct, issue of whether non-signatory plaintiffs should be compelled to arbitrate their claims."[33] "The FAA does not specify whether state or federal law governs, and the United States Supreme Court has not directly addressed the issue."[34]

In the KBR Case, MacGregor asserted that KBR was bound to arbitrate under the doctrine of "direct benefits estoppel," a type of equitable estoppel applied by federal courts in the arbitration context.[35] The court explained that under "direct benefits estoppel," a non-signatory plaintiff that seeks the benefits of a contract is estopped from also attempting to avoid other contract obligations, such as the obligation to arbitrate disputes.[36] So, if a non-signatory's breach-of-contract claim is based on terms of a written contract, the non-signatory cannot avoid the contract's arbitration provision.[37] But if a non-signatory can maintain its claims independent of the underlying contract, then the non-signatory generally should not be compelled to arbitrate under this theory.[38] Therefore, the key issue before the court was whether KBR sought to enforce the terms of the subcontract between MacGregor and Unidynamics—which contained the arbitration provision—by asserting a *quantum meruit* claim against MacGregor.[39]

Recovery under *quantum meruit* is generally not available "when there is a valid contract covering the services or materials furnished."[40] Thus, KBR's *quantum meruit* claim could exist independent of the MacGregor/Unidynamics subcontract. However, MacGregor argued that KBR's *quantum meruit* claim was "based" on the subcontract because the services provided by KBR were inextricably tied to that subcontract.[41] The court acknowledged that KBR was performing work that was central to the MacGregor/Unidynamics subcontract and that KBR relied on that subcontract's specifications.[42] But under direct benefits estoppel, a non-signatory cannot be compelled to arbitrate based solely on the fact

[26] *Id.* (quoting *In re MacGregor (FIN) Oy*, 126 S.W.3d 176, 184–85 (Tex. App.—Houston [1st Dist.] 2003), *vacated in part*, 174 S.W.3d 419 (Tex. App.—Houston [1st Dist.] 2005)).

[27] *In re Kellogg Brown & Root, Inc.*, 166 S.W.3d at 736.

[28] *Id*. at 737.

[29] *Id.* (citing *In re FirstMerit Bank*, 52 S.W.3d 749, 753 (Tex. 2001)).

[30] *In re Kellogg Brown & Root, Inc.*, 166 S.W.3d at 737 (citing *In re FirstMerit Bank*, 52 S.W.3d at 753).

[31] *In re Kellogg Brown & Root, Inc.*, 166 S.W.3d at 737 (quoting *J.M. Davidson, Inc. v. Webster*, 128 S.W.3d 223, 227 (Tex. 2003)).

[32] *In re Kellogg Brown & Root, Inc.*, 166 S.W.3d at 738.

[33] *Id.* (citing *Wash. Mut. Fin. Grp., LLC v. Bailey*, 364 F.3d 260, 267–68 (5th Cir. 2004) (applying federal law); *Bridas S.A.P.I.C. v. Gov't of Turkm.*, 345 F.3d 347, 355–63 (5th Cir. 2003) (applying federal law); Fleetwood *Enters. v. Gaskamp*, 280 F.3d 1069, 1074–77 (5th Cir. 2002) (applying state law); *Lakeland Anesthesia, Inc. v. United Healthcare of La., Inc.*, 871 So. 2d 380, 386 (La. Ct. App. 2004) (applying federal and state law); *Sw. Tex. Pathology Assocs., L.L.P. v. Roosth*, 27 S.W.3d 204, 208–09 (Tex. App.—San Antonio 2000, pet. dism'd w.o.j.) (applying state law); *Nationwide of Bryan, Inc. v. Dyer*, 969 S.W.2d 518, 520 (Tex. App.—Austin 1998, no pet.) (applying state law).).

[34] *In re Kellogg Brown & Root, Inc.*, 166 S.W.3d at 738.

[35] *Id.* at 739.

[36] *Id.* (citing *R.J. Griffin & Co. v. Beach Club II Homeowners Ass'n*, 384 F.3d 157, 160–61 (4th Cir. 2004)).

[37] *Id.*

[38] *Id.* at 739–40.

[39] *Id.* at 740.

[40] *Id.*

[41] *Id.*

[42] *Id*.

that "but for the contract containing the arbitration provision, it would have no basis to sue."[43] The court noted that lower-tier subcontracts are inherently tied to contracts higher in the contracting chain.[44] If such ties alone were sufficient to bind a non-signatory subcontractor, "arbitration agreements would become easier to enforce than other contracts, counter to the FAA's purpose."[45] The court concluded that under "direct benefits estoppel," the fact that a non-signatory's claim merely relates to a contract containing an arbitration provision is insufficient in itself to bind the non-signatory to the provision.[46] "Instead, a non-signatory should be compelled to arbitrate a claim only if it seeks, through the claim, to derive a direct benefit from the contract containing the arbitration provision."[47] KBR was seeking payment for services rendered under its subcontract with Unidynamics, not through the MacGregor-Unidynamics subcontract.[48] Thus, the court of appeals was found to have abused its discretion to the extent it compelled arbitration of KBR's *quantum meruit* claim against MacGregor.[49]

The KBR Case should be instructive for downstream subcontractors and suppliers seeking to avoid the reach of an arbitration provision contained in a prime contract or upstream subcontract. Conversely, a non-signatory lower-tier party that has a basis for asserting a claim that is directly based on a higher-tier contract that includes an arbitration provision may have a basis for compelling arbitration of its claims against the signatories. Lower-tier subcontractors and suppliers obviously would not be furnishing labor, material, or equipment to a project in the absence of a prime contract, which very well may contain an arbitration provision. However, without more, the fact that the services or materials furnished by a non-signatory downstream party "relate to" the upstream contract containing the arbitration provision is insufficient to bind the non-signatory to the upstream contract's arbitration agreement.

[43] *Id.*
[44] *Id.*
[45] *Id.* (citing *InterGen N.V. v. Grina*, 344 F.3d 134, 145–46 (1st Cir. 2003)).
[46] *Id*. at 741.
[47] *Id.*
[48] *Id.*
[49] *Id.*

III. Incorporation by Reference of an Agreement Containing an Arbitration Provision

Construction contracts and subcontracts frequently incorporate by reference other agreements or documents. Under the doctrine of incorporation by reference, where one contract refers to another contract or instrument, the second document may properly constitute part of the original contract.[50] Incorporation by reference is also a theory under which a non-signatory may be bound to an arbitration agreement contained in a document it did not sign.

In *Cappadonna Electrical Management v. Cameron County*, a group of subcontractors attempted to use incorporation by reference to compel a public owner to arbitrate claims alleged by the owner against the subcontractors.[51] A dispute arose between Cameron County, Texas, and a general contractor (Landmark) in connection with damages allegedly sustained by the county following the construction of a jail.[52] The county filed suit against Landmark and various subcontractors, asserting against the subcontractors claims for negligence, negligence per se, breach of express warranty, and breach of fiduciary duty.[53] Landmark filed cross-claims for contribution and indemnity against the subcontractors, and the subcontractors filed the same cross-claims against Landmark.[54]

Landmark and the subcontractors filed motions to compel arbitration.[55] The trial court "signed an order (1) denying the [s]ubcontractors' motions to compel arbitration, (2) granting Landmark's motion to compel arbitration with the [c]ounty, and (3) severing" into a separate lawsuit the county's claims

[50] *Owen v. Hendricks*, 433 S.W.2d 164, 166–67 (Tex. 1968); *City of Port Isabel v. Shiba*, 976 S.W.2d 856, 858 (Tex. App.—Corpus Christi 1998, pet. denied); *MTrust Corp. N.A. v. LJH Corp.*, 837 S.W.2d 250, 253-54 (Tex. App.—Fort Worth 1992, writ denied); *Milam Dev. Corp. v. 7*7*0*1 Wurzbach Tower Council of Co-Owners, Inc.*, 789 S.W.2d 942, 945 (Tex. App.—San Antonio 1990, writ denied).
[51] 180 S.W.3d 364 (Tex. App.—Corpus Christi 2005, no pet.).
[52] *Id.* at 368.
[53] *Id.*
[54] *Id.*
[55] *Id.*

against Landmark.[56] The subcontractors subsequently filed a petition for a writ of mandamus with the court of appeals.[57]

On appeal, the subcontractors argued that the trial court abused its discretion by entering the order denying their motion to compel arbitration because of the application of the doctrines of incorporation by reference and equitable estoppel.[58] After discussing the general law in Texas under which arbitration may be compelled, the court discussed the subcontractors' assertion that they were entitled to arbitration under the theory of incorporation by reference.[59] The court explained that it would use general rules concerning contract interpretation to discern the parties' intentions.[60]

> The prime contract between the county and Landmark included the following provision: Any claims, disputes, or controversies between the parties arising out of or relating to the Agreement, or the breach thereof, which have not been resolved . . . shall be decided by arbitration in accordance with the Construction Industry Arbitration Rules of the AAA then in effect, unless the parties mutually agree otherwise.[61]

The trial court determined this language to be an enforceable agreement to arbitrate between the county and Landmark.[62]

The trial court then determined that the subcontractors were not parties to the prime contract and were therefore not parties to the arbitration clause in the prime contract, based on the following language in the prime contract:

> Nothing in the Contract Documents is intended or deemed to create any legal or contractual relationship between Owner [the County] and any Design Consultant. . . . Nothing in the Contract Documents is intended or deemed to create any legal or contractual relationship between Owner [the County] and any Subcontractor or Sub–Subcontractor including but not limited to any third-party beneficiary rights.[63]

The trial court also found that the standard form subcontracts between Landmark and the various subcontractors did not attempt to incorporate the terms of the prime contract.[64] The subcontractors disagreed, based on the following provision contained in the subcontracts:

> Insofar as the provisions of the General Contract do not conflict with specific provisions herein contained, they and each of them are hereby incorporated into this subcontract as fully as if completely re-written herein, except that all of said non-conflicting provisions are amended as follows: wherever the "Owner" is referred to therein, the word "Contractor" shall be substituted therefor, and wherever the "Contractor" is referred to therein the word "Subcontractor" shall be substituted therefor. The Subcontractor agrees not to violate any term, covenant, or condition of the General Contract.[65]

The subcontractors argued that this provision was an "incorporation provision" that served to enable them to invoke the arbitration agreement in the prime contract.[66]

The court of appeals disagreed, finding that although the "incorporation provision" clearly borrowed some of the terms of the general contract, it nonetheless was a "different and separate" contract between Landmark and the subcontractors.[67] "The incorporation provision does not, however, create a relationship *between the Subcontractors and the County*, nor does it impose any duties or obligations on the Subcontractors *with respect to*

[56] *Id.* at 368–69.
[57] *Id.* at 369.
[58] *Id.* at 370.
[59] *See id.* at 371.
[60] *Id.*
[61] *Id.*
[62] *Id.*

[63] *Id.* (alterations in original).
[64] *Id.*
[65] *Id.* at 371–72.
[66] *Id.* at 372.
[67] *Id.*

the County."[68] According to the court, the removal of all references to the county in the "incorporation provision" clearly was intended to prevent the formation of any contractual relationship between the county and the subcontractors, especially when viewed in conjunction with the express disclaimer language above.[69]

The court of appeals found that, pursuant to existing precedent, "only the Subcontractors and Landmark, as signatories to the subcontract, would be bound by the arbitration clause incorporated into their subcontracts."[70] The court added: "The incorporation by reference doctrine applies when a party incorporates a document by reference into its own contract and thereby binds *itself* to provisions within the incorporated document."[71] The unilateral activity of the subcontractors (incorporating provisions of the prime contract into their subcontracts) could not act to bind the county, and the county did not agree to incorporate the subcontracts into the prime contract.[72]

The court of appeals did, however, find that the county should be compelled to arbitrate its claims against the subcontractors based on the equitable estoppel theory.[73] The county had sought damages against the subcontractors for breach of fiduciary duty by alleging the following:

> The agreement between the County and Landmark required results in strict compliance with the agreement between them. Landmark's performance pursuant to their agreement with the County did not strictly conform to those requirements and is therefore defective. Applicable construction regulations and/or practices were not followed by Landmark and some or all of [the Subcontractors]. Landmark *and the* [*Subcontractors*] are subsequently liable under *their* agreement with the County. Landmark *and the* [*Subcontractors*] failed to strictly comply with the agreement and are liable for damages proximately caused by such breach . . . .[74]

The court of appeals found that this allegation contained an implication on the part of the county that the subcontractors and the county were in a contractual relationship with each other by way of the intermediate contracts made between each of them and Landmark.[75] Therefore, the county had "attempted to 'exploit (and thereby assume) the [Subcontractor–Landmark] agreement itself,' and has not simply attempted to '[exploit] the contractual relation of [the] parties.'"[76] According to the court, "[t]his establishes direct benefits estoppel even under the strict test espoused in [the KBR Case]."[77]

Cappadonna Electrical Management v. Cameron County teaches that signing an agreement that incorporates an arbitration provision only acts to bind the parties that sign the *incorporating* agreement. A party that does not sign the incorporating agreement—like the county—does not have its rights or obligations affected simply because an agreement to which it was a signatory was incorporated into another contract. Therefore, a subcontractor should not view an incorporation-by-reference provision in a subcontract to enable it to arbitrate any claims that may arise between it and the owner or any other party that did not actually sign the subcontract. And, as always, it is important for a party to understand the agreements and other documents being incorporated into a contract prior to signing the contract.

IV. Third-Party Beneficiary

A non-signatory to a contract that contains an arbitration provision may be compelled to arbitrate, or may compel arbitration, if the non-signatory is a third-party beneficiary of the contract.[78] In *Hale-Mills*

[68] *Id.* (emphasis added).
[69] *Id.*
[70] *Id.* at 373.
[71] *Id.*
[72] *Id.*
[73] *Id.* at 374–75.

[74] *Id.* at 374 (alterations in original) (emphasis added).
[75] *Id.*
[76] *Id.* (quoting *MAG Portfolio Consultant, GMBH v. Merlin Biomed Grp. LLC*, 268 F.3d 58, 61 (2d Cir. 2001)).
[77] *Cappadonna Electrical Management*, 180 S.W.3d at 374.
[78] *See In re Kellogg Brown & Root, Inc.*, 166 S.W.3d 732, 738 (Tex. 2005).

Construction, Ltd. v. Willacy County, a 2016 opinion, a Texas court of appeals addressed whether a non-signatory county should be compelled to arbitrate its claims against a general contractor based on the county's status as a third-party beneficiary of contracts between the contractor and three individual government corporations created by the county.[79]

Hale-Mills entered into four contracts with the three government corporations created by Willacy County to construct public facilities located in the county.[80] Each of the contracts contained a broad arbitration clause, but the county itself did not sign any of the contracts.[81] Several years after the completion of the last facility, the county sued Hale-Mills for breach of contract, breach of warranty, negligence, fraudulent inducement, and unjust enrichment, complaining about the quality of work and materials used to construct the four facilities.[82] "In response, Hale-Mills filed a motion to compel arbitration."[83] The county then filed a plea to the jurisdiction, asserting, among other things, that the county was a non-signatory to the arbitration agreements.[84] The trial court denied Hale-Mills' motion, stating that, as a non-signatory to the agreements to arbitrate, the county had not consented to arbitration, and that the county's designation as a third-party beneficiary in each of the contracts "[did] not rise to the level of making it a signatory."[85] Hale-Mills appealed the trial court's denial.[86]

Hale-Mills argued that the county was bound to arbitration because: (1) the county's claims fell within the scope of valid arbitration agreements; (2) the government corporations were agents of the county; (3) the county was a third-party beneficiary to the four contracts; and (4) the county was estopped from refusing to arbitrate because it sued on the contracts and made claims that arose from the contracts.[87]

After determining that it was "abundantly clear that valid arbitration agreements exist," the court focused on whether the county should be compelled to arbitration based on Hale-Mills' theory of third-party beneficiary.[88] To qualify as a third-party beneficiary, a party must have more than an interest in, or receive a benefit from, a contract.[89] Instead, "the contracting parties to the contract must have specifically '*intended* to secure some benefit' for that third party."[90] The court noted that although the equitable estoppel and third-party beneficiary theories may be applied similarly, under the third-party beneficiary theory, a court must examine "the intentions of the parties at the time the contract was executed," whereas under the equitable estoppel theory, the "court looks to the parties' conduct after the contract was executed."[91] In other words, the language of a contract and other evidence showing the parties' intent at the time the contract was executed will be integral to determining whether the contract has any third-party beneficiaries.

The language in the contracts at issue in the *Hale-Mills* case left very little doubt that the parties intended for the county to be a third-party beneficiary of the contracts. For example, two of the contracts contained provisions that expressly stated that Willacy County was a third-party beneficiary of the agreements and "that Willacy County 'shall be bound by the dispute resolution procedures' of the contracts."[92] The third contract stated that the contract was intended for the benefit of the owner (the government corporation) and Hale-Mills, and was not "intended for the benefit of any third party, *except the county*."[93] Although the fourth contract contained no express language concerning third-party beneficiaries, the court found that there was "ample evidence that the County was intended as a third-party beneficiary on this and the other contracts."[94]

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[79] No. 13-15-00174-CV, 2016 WL 192133 (Tex. App.—Corpus Christi Jan. 14, 2016, no pet.) (mem. op.).
[80] *Id.* at *1.
[81] *Id.* at *4.
[82] *Id.* at *1.
[83] *Id.* at *2.
[84] *Id.*
[85] *Id.*
[86] *Id.*
[87] *Id.* at *3.
[88] *Id.* at *4.
[89] *Id.* (citing *Bridas S.A.P.I.C. v. Gov't of Turkm.*, 345 F.3d 347, 362 (5th Cir. 2003) (applying Texas law)).
[90] *Hale-Mills Construction, Ltd.,* 2016 WL 192133, at *4 (quoting *MCI Telecomms. Corp. v. Tex. Utils. Elec. Co.*, 995 S.W.2d 647, 651 (Tex. 1999)).
[91] *Hale-Mills Construction, Ltd.,* 2016 WL 192133, at *4 (emphasis omitted) (citing *Bridas*, 345 F.3d at 362).
[92] *Hale-Mills Construction, Ltd.,* 2016 WL 192133, at *4.
[93] *Id.*
[94] *Id.*

For example, the three government corporations all specified in their articles of incorporation that anything belonging to them at the time of dissolution, including property or other rights, would be transferred to the county, and all three entities had since lost their charters and been dissolved.[95] According to the court, all parties to the contracts knew that any benefit given to the local government corporations "would ultimately be bestowed upon the County because by their very nature, the . . . entities were created for the direct benefit of the County."[96] Therefore, the court found that Willacy County was a third-party beneficiary on all four contracts.[97] The court noted that although some courts may be reluctant to compel arbitration against a third-party beneficiary, they should be less reluctant to do so when the third-party beneficiary was the one to initiate the lawsuit.[98] The court also found the county's claims against Hale-Mills fell within the broad scope of the arbitration provisions.[99]

As shown by the *Hale-Mills* case, a third party may be compelled to arbitrate regardless of whether it executed any agreement related to the dispute being arbitrated. Three of the four contracts in the *Hale-Mills* case contained language that clearly expressed the parties' intent that Willacy County was a third-party beneficiary of those contracts. Although contracts containing such clear language establishing a third-party beneficiary are relatively rare, the court in the *Hale-Mills* case found that the fourth contract also established the county as a third-party beneficiary even though it contained no overt language to that effect. Instead, the court looked to other circumstances (the government corporations' articles of incorporation and the nature of the corporations' existence) to compel arbitration under the third-party beneficiary theory. Therefore, in addition to the language of the contract, other evidence that shows the parties' intention that a third party secure some benefit from a contract can be used to invoke the contract's arbitration provision against a non-signatory, regardless of the nature of the claims that have been asserted in the dispute.

V. Alter Ego

The alter ego theory is generally employed to compel arbitration of a non-signatory based on an arbitration agreement executed by an entity closely related to the non-signatory, often a corporate subsidiary. However, an alter ego relationship will not be established unless the parent entity exercises sufficient control over its subsidiary. "[T]he degree of control exercised by the parent must be greater than that normally associated with common ownership and directorship."[100] Without more, even complete stock ownership and commonality of officers and directors are not sufficient to establish an alter ego relationship between two corporations.[101] But even though proving the existence of an alter ego relationship is a high hurdle, the more control that a non-signatory exercises over one of its subsidiaries, the more likely the non-signatory is to be compelled to arbitration based on an agreement signed by the subsidiary. A construction company wishing to avoid possible alter ego claims has many important reasons—arbitration included—for being careful in dealings with related entities.[102]

VI. Agency

An agent is one who is authorized by a person or entity to transact business on behalf of the person or entity. Under certain circumstances, principles of agency may bind a non-signatory to an agreement to arbitrate.[103] The same reasoning has been used to compel arbitration against non-signatories who resisted arbitration.[104] In *In re Merrill Lynch Trust Co. FSB*, the Texas Supreme Court rejected a plaintiff's attempt to avoid an arbitration agreement by filing suit against non-signatory

[95] *Id.*
[96] *Id.*
[97] *Id.*
[98] *Id.* (citing *Bridas S.A.P.I.C. v. Gov't of Turkm.*, 345 F.3d 347, 362 (5th Cir. 2003).
[99] *Hale-Mills Construction, Ltd.,* 2016 WL 192133, at *5.

[100] *Alpine View Co. v. Atlas Copco AB*, 205 F.3d 208, 219 (5th Cir. 2000) (quoting *Hargrave v. Fibreboard Corp.*, 710 F.2d 1154, 1160 (5th Cir. 1983)).
[101] *Hanson Pipe & Prods., Inc. v. Bridge Techs., LLC*, 351 F. Supp. 2d 603, 612 (E.D. Tex. 2004), *aff'd*, 160 Fed. Appx. 380 (5th Cir. 2005).
[102] *Walker Ins. Servs. v. Bottle Rock Power Corp.,* 108 S.W.3d 538, 549 (Tex. App.—Houston [14th Dist.] 2003, no pet.).
[103] *In re Kellogg Brown & Root, Inc.*, 166 S.W.3d 732, 738 (Tex. 2005).
[104] *Lee v. Chica*, 983 F.2d 883, 884 (8th Cir. 1993).

employees and affiliates of Merrill Lynch, rather than directly against Merrill Lynch, which was the entity that executed the arbitration agreement with the plaintiffs.[105] The plaintiffs, Mr. and Mrs. Alaniz (Alaniz) had recovered more than $2 million after Mr. Alaniz was injured in a refinery explosion.[106] Alaniz engaged Merrill Lynch, through its employee, Henry Medina, to provide investment services.[107] Alaniz was unhappy with the financial services being rendered and sued Medina—but not Merrill Lynch—"alleging a dozen multifarious claims."[108] Medina filed a motion to compel arbitration, which the trial court denied.[109]

On appeal, the Texas Supreme Court determined that Alaniz's claims against Medina must go to arbitration for two reasons.[110] "First, 'parties to an arbitration agreement may not evade arbitration through artful pleading, such as by naming individual agents of the party to the arbitration clause and suing them in their individual capacity.'"[111] The court noted that corporations can act only through human agents, and business related torts can be asserted against either a corporation or its employees.[112] If a plaintiff could avoid an arbitration agreement by choosing to sue an employee rather than the employer, then such an agreement would be illusory on one side.[113] Second, Alaniz's claims against Medina were really against Merrill Lynch, even though Merrill Lynch had not been named as a defendant.[114] Assuming Medina was acting within the course and scope of his employment with Merrill Lynch, if Medina were liable for the torts alleged against him, then Merrill Lynch also would be liable.[115] The court noted, however, that its decision in this case would not allow employees to invoke the arbitration agreements of their employers for accusations falling outside the scope of their employment.[116] In the context of construction law, the *Merrill Lynch* case illustrates that a plaintiff cannot avoid an arbitration agreement in a construction contract by filing a lawsuit against an employee of a defendant, for example, a project manager, unless the claims involve conduct by the employee outside the scope of his or her employment. It is conceivable that an individual being sued on the basis of the construction trust fund statute might also be able to invoke arbitration where that individual's conduct was within the scope of his or her employment (if, of course, an arbitration agreement exists between the claimant and the employer).

VII. Assumption

Under the theory of assumption, a non-signatory may bind itself to arbitration through its participation in the arbitration process, similar to a party that submits to the otherwise improper jurisdiction of a court by participating in litigation. In *Gvozdenovic v. United Air Lines, Inc.*, it was held that a group of non-signatory flight attendants was bound to an arbitration award where the group had sent a representative to act on its behalf in arbitration proceedings.[117] According to the *Gvozdenovic* court, a party's consent to arbitration may be implied from the party's conduct.[118] "[B]y their actions, the parties may agree to arbitrate disputes that they were not otherwise contractually bound to arbitrate."[119]

VIII. Conclusion

While it still generally is true that a party must sign an arbitration agreement in order to be bound by it, the developing body of case law applying the common law principles described above provides numerous avenues by which a non-signatory may be bound to, or be entitled to compel, arbitration. Application of this developing case law tends to be very fact specific and may differ substantially based upon the circumstances presented. The theories discussed above also underscore the importance of not only the language of the contracts being executed, but also the manner in which claims are asserted. It is apparent that some of the cases discussed above could have reached a different

[105] 235 S.W.3d 185, 188 (Tex. 2007).
[106] *Id.*
[107] *Id.*
[108] *Id.*
[109] *Id.*
[110] *Id.*
[111] *Id.* (quoting *Ivax Corp. v. B. Braun of Am., Inc.*, 286 F.3d 1309, 1318 (11th Cir. 2002)).
[112] *In re Merrill Lynch Trust Co. FSB*, 235 S.W.3d at 188.
[113] *Id.* at 188–89.
[114] *Id.* at 189.
[115] *Id.*
[116] *Id.* at 190.
[117] 933 F.2d 1100, 1104 (2d Cir. 1991).
[118] *Id.* at 1105.
[119] *OMG, L.P. v. Heritage Auctions, Inc.*, 612 F. App'x 207, 210 (5th Cir.), *cert. denied*, 136 S. Ct. 503 (2015).

outcome based on a change in contract wording or the way in which the claims were asserted. A thorough understanding of the theories described above may allow a party to either avoid arbitrating a dispute or, conversely, to compel arbitration of a dispute that would otherwise be restricted to a courthouse

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Surety Casenotes

By: Brian Kantar, Chiesa Shahinian & Giantomasi, PC, West Orange, NJ

Indemnitors' Unsupported Challenge to Reasonableness of Attorney and Consultant Fees Incurred by Surety Deemed Insufficient to Create Question of Fact as to Surety's Entitlement to Indemnification

Colonial Sur. Co. v. Eastland Constr., Inc., 2016 WL 4245396 (N.Y. Sup. Ct. Aug. 11, 2016).

The surety issued performance and payment bonds in connection with three public improvement projects. The surety incurred losses on each of the projects and moved for partial summary judgment to enforce its indemnity rights under the Indemnity Agreement; the motion was granted by the court in November 2014. The surety subsequently moved for partial summary judgment, this time seeking judgment against its indemnitors for the attorney and consultant fees incurred by the surety as a result of having issued the bonds and its enforcement of the Indemnity Agreement. Although the indemnitors conceded liability, they argued that the overall legal fees and consultant expenses were unreasonable.

With respect to the attorney fees, other than objecting to approximately $12,000 out of the over $1,000,000 in fees sought by the surety, which the surety voluntarily agreed to waive, the indemnitors failed to raise "a triable issue of fact concerning the bona fides of the payment or the reasonableness of the amount" of such fees. The indemnitors submitted affidavits in opposition to the consultant fees that the surety was seeking to recover, arguing, in a conclusory manner, that the fees were unreasonable based upon defendants' "expert" experience and the belief that the requested amount is excessive for the services rendered.

The court found that, pursuant to the terms of the Indemnity Agreement, the surety demonstrated its prima facie entitlement to summary judgment on based on its submission of an itemized statement sworn to by an officer of the surety. In light of the indemnitors' failure to offer any evidence of unreasonableness of the consultant fees, other than the indemnitors' own conclusory affidavits, the court held that the indemnitors failed to raise a triable issue of fact regarding the appropriateness of these consulting fees and granted the surety's motion.

Prime Contractor's Miller Act Surety Not Entitled to Stay Based upon Pay-if-Paid Clause or Dispute Resolution Procedures in Subcontract

United States ex rel. Tusco, Inc. v. Clark Constr. Group, LLC, 2016 WL 4269078 (D. Md. Aug. 15, 2016).

Clark Construction Group, LLC ("Clark") contracted with the United States to provide construction services with respect to a federal project located in Bethesda, Maryland known as Intelligence Community Campus-B) North Campus (the "Project"). The surety issued a payment bond on behalf of Clark in accordance with the Miller Act. Clark entered into a subcontract with Tusco, Inc. ("Tusco") in connection with the Project. The subcontract contained a pay-if-paid clause. The subcontract also included several clauses governing changes in the scope of Tusco's work under the Project

and generally permitted Clark to order such changes unilaterally. With respect to changes ordered by the government, the subcontract provided that "Clark's receipt of payment from the Owner on account of pending changes made by the Owner shall be a condition precedent to Clark's obligation to make payment for changed work to Subcontractor." For changes made by Clark autonomously, the subcontract provided that "Subcontractor shall be entitled to an equitable adjustment in the Subcontract price." In the event of disputes between Clark and Tusco with respect to changes directed by the government, the subcontract provided that Tusco agreed to be bound to Clark to the same extent that Clark was bound to the government pursuant to the prime contract.

Tusco performed all of the work under the original scope of the subcontract. However, Clark requested that Tusco perform additional work for which Tusco submitted change orders. Clark did not pay for any of the extra work (which Clark claimed was directed by the government) and Tusco ultimately commenced suit against Clark for breach of contract and quantum meruit and against the surety under the Miller Act payment bond. Clark filed a motion to dismiss the breach of contract and quantum meruit claims. The surety filed a motion to stay, arguing that its liability is derivative of Clark's under the subcontract and that, per the subcontract, Tusco was obligated to exhaust the dispute resolution procedures prior to the initiation of any claims against the surety. The court denied all motions.

The court denied Clark's motion to dismiss Tusco's breach of contract claim because; i) sufficient facts have not been developed to determine whether the condition precedent language created by the pay-if-paid clauses has been satisfied, and ii) at the motion to dismiss stage, a court must accept all factual allegations in the complaint as true. The court also denied Clark's motion to dismiss the quantum meruit claim because if it is determined that Tusco's work was outside the scope of the subcontract, a quantum meruit theory of recovery would potentially lie.

The court similarly denied the surety's motion for a stay holding that "the principal's and the surety's liability are only coextensive to the extent permitted by the terms of the Miller Act." The court observed that the Miller Act gives a subcontractor the right to sue a payment bond surety based on passage of time, not on the payment from the federal government to a prime contractor. The court added that it was not "overly troubled" by the surety's argument that allowing the litigation to proceed could lead to inconsistent decisions and duplicative, costly litigation as that is a risk the prime contractor must bear and "transferring the risk of nonpayment for work performed from the subcontractor to the prime contractor is one of the purposes of the Miller Act."

<u>Subcontractor's Breach of Underlying Subcontract Precludes Miller Act Claim</u>

United States ex rel. Metric Electric, Inc. v. CCB, Inc., 2016 WL 4491831 (D. Mass Aug. 25. 2016).

CCB, Inc. entered into an agreement with the General Services Administration to renovate the John F. Kennedy Federal Building at Government Center in Boston (the "Project"). CCB hired Metric Electric, Inc. ("Metric") to perform electrical work for the Project in four phases. The subcontract required Metric to submit certified payroll reports and to pay the "prevailing wage" to its employees on a weekly basis, as required by the Davis-Bacon Act. From December 21, 2013, through April 26, 2014, the owner of Metric signed weekly reports, under oath, certifying that Metric had paid its employees in full for the work performed the prior week on the Project. Despite the certifications, it is undisputed that Metric failed to pay wages to its employees during the first quarter of 2014.

On May 5, 2014, CCB met with Metric's owner to express concern over Metric's ability to provide ample manpower to meet the schedule requirements for the project. On May 16, 2014, CCB sent Metric a notice declaring Metric in breach of its duty under the Subcontract to meet the required schedule and setting out in detail the work that remained uncompleted. Metric abandoned the job altogether on May 30, 2014. On June 10, 2014, CCB formally terminated the Subcontract, citing unpaid wages and failure to timely perform. CCB then hired a replacement subcontractor to complete the electrical work. At the time of termination, Metric had completed only 75% of the work on Phase I and 44% of the work on the entire job.

Metric filed an action against CCB and its Miller Act surety alleging, among other things, breach of contract, quantum meruit and violation of the Miller Act. CCB and the surety filed motions for summary judgment. The court held that Metric's failure to pay its employees in a timely fashion, as required by the subcontract and the federal Davis-Bacon Act, constituted a material breach of the subcontract as a matter of law. Metric's breach relieved CCB of any further duty to perform under the subcontract and hence any duty to continue to make progress payments under its terms. The court rejected Metric's request for the equitable remedy of quantum meruit as a "nonstarter" on account of Metric's unclean hands. Finally, the court dismissed Metric's Miller Act claim, holding that "as a ticket of admission to recovery under the Miller Act, Metric must establish that it is entitled to damages under the subcontract. Because Metric cannot do so, its Miller Act claim is also destined to fail."

Massachusetts Court Holds Quantum Meruit Claim Recoverable Under Massachusetts Little Miller Act Payment Bond

Aggregate Indus.—Ne. Region, Inc. v. Hugo Key & Sons, Inc., 57 N.E. 3d 1027 (Mass. App. Ct. 2016).

Hugo Key and Sons, Inc. ("Hugo Key") entered into a subcontract with Aggregate Industries-Northeast Region, Inc. ("Aggregate") for the supply of material and labor for a public works construction project in Massachusetts. Aggregate's initial proposal contained provisions relating to grader services and an escalation clause for the cost of bituminous concrete pavement work. Hugo did not sign the estimate, advising that "Hugo Key would not deal with Aggregate if the agreement included an escalation clause." Hugo Key subsequently sent Aggregate a purchase order that was silent as to grader service and the escalation clause. Aggregate signed the purchase order with a handwritten notation attempting to incorporate the escalation clause. In response Hugo Key rejected the term. Hugo Key prepared another purchase order that did not include the escalation clause. Aggregate signed the purchase order and began performing the work.

Hugo Key later determined that it required grader services from Aggregate, which Aggregate performed and then billed at the price quoted on the original estimate. After completion of the project, Aggregate billed Hugo Key $89,989.90, which included $11,400 for "grader rental" and $10,064.50 for "liquid asphalt escalation." Aggregate filed a lawsuit on account of non-payment alleging claims against Hugo Key for breach of contract and quantum meruit and against Hugo Key's surety under Massachusetts' Little Miller Act. Shortly after the complaint was filed, Hugo Key paid Aggregate the undisputed amount and indicated a willingness to pay a reasonable fee for the grader rental. Aggregate refused the offer of payment. Following a one-day bench trial, the judge concluded that the contract formed between Aggregate and Hugo Key did not incorporate the escalation clause or the grader rental fee, but that Aggregate was entitled to the fair and reasonable sum of $7,125 on its quantum meruit claim for grader rental. Nevertheless, the judge dismissed the portions of the complaint seeking recovery under the payment bond, reasoning that "[f]airness would be the victim if this court permitted Aggregate to recover under the bond, with its right to attorneys' fees, on a quantum meruit claim that Hugo Key was ready, willing, and able to resolve at the fair and reasonable value of the services provided at or about the time this action was commenced."

On appeal, the court held that, Aggregate was entitled to recover its quantum meruit claim under the payment bond, together with its attorney's fees, which are compulsory under Massachusetts' Little Miller Act. Although Massachusetts' Little Miller Act requires a claimant to have "a contractual relationship with the contractor principal furnishing the bond", the court found that because the purpose of the statute is remedial in nature, "it is to be construed liberally in favor of…subcontractors and materialmen."

Court Denies Surety's Motion for Summary Judgment to Dismiss Principal's Negligence Claims on Account of Surety's Inadvertent Non-Renewal of License Bond

CoreLogic, Inc. v. Zurich Am. Ins. Co., 2016 WL 4698902 (N.D. Cal. Sept. 8, 2016).

CoreLogic Collateral Solutions, LLC ("CCS"), a Utah appraisal management company, was required to have a surety bond in place as a condition of doing business in the

state. CCS communicated its request for a license and permit bond through CCS' parent company's (CoreLogic, Inc.) broker. The surety issued the bond for a one year period and it provided that the bond "may be renewed from year to year by continuation certificate executed by said Surety." The surety incorrectly logged the bond on its system as a term bond and as such, the surety did not issue the continuation certificate, which would have been issued automatically had the bond been coded correctly.

Thirty days after the end of the bond term, Utah's Division of Real Estate (the "Division") suspended CCS's license to operate as an appraisal management company. Thereafter, CoreLogic's main customer, Wells Fargo Bank, advised it was "suspend[ing] all orders submitted to Corelogic Valuation Services" after "reviewing the recent Corelogic compliance violation." The shutoff applied not only to Utah business, but to CoreLogic business throughout the country. CoreLogic asserted this result was foreseeable given the regulatory requirements facing financial institutions described in CoreLogic's 10-K.

The surety wrote a letter to the Division explaining the bond had been "cancelled" due to an internal processing error, but was reinstated retroactively to the start of the year. CoreLogic later sued to remove the suspension and the Division formally expunged the license lapse from CCS' record. The Division concluded the failure to provide a continuation certificate "was the direct result of a clerical error committed by a [surety] employee outside of CoreLogic's supervision and control." At the time of the bond's lapse, CoreLogic was in the midst of negotiating to sell CCS. The deal was eventually completed, but CoreLogic submits it lost over $4.25 million it would have earned had Wells Fargo not suspended its business prior to the sale. In addition, the CCS buyer allegedly reduced the purchase price by $10 million expressly because of the lost future business with Wells Fargo.

CoreLogic, through counsel, sent the surety a letter seeking damages in excess of $15 million. Prior to that date, the surety submits it lacked knowledge of CoreLogic's nationwide business relationship with Wells Fargo or CoreLogic's intentions to sell CCS, or that CCS had been sold. The surety further disclaimed professional experience with the strict regulatory environment to which banks and service providers are subject. CoreLogic disputed each of these assertions, noting, among other things, that it entered into an indemnity agreement with the surety in 2011 to provide security for all bonds issued to CoreLogic entities nationwide, the surety issued over 200 individual bonds for CoreLogic, CoreLogic's 10-K disclosed it services Wells Fargo and other large mortgage originators, and the surety published a whitepaper observing "[r]egulators are intensifying their focus on vendor management within financial institutions." CoreLogic subsequently commenced suit against the surety alleging they committed professional negligence and ordinary negligence.

The surety filed a motion for summary judgment, arguing that: i) CoreLogic's claims arise only in contract, not in tort, ii) even if styled as a tort, the surety did not owe any legal duty, and iii) the surety is not subject to any "professional" standard of care. The court denied the surety's motion finding that the alleged injury did not arise out of the surety's obligations under the bond (i.e., to pay Utah $25,000 if CCS violated applicable regulations), but from the surety's alleged failure to record the bond properly in its internal records (a subject on which the court found the text of the bond was silent). The court also found that the economic loss rule did not bar recovery because it does not apply to claims involving defective services. The court rejected the surety's argument that it did not owe a duty to CoreLogic, as the surety conceded that under a very general standard of foreseeability, "it is foreseeable that a failure to renew a bond could cause the bond purchaser to lose income because of its inability to accept assignments while its license is suspended." Finally, the court held that disputed issues of material fact precluded a determination as to whether the surety was subject to a professional standard of care.

Prior Broad Release to Surety Precludes Payment Bond Claimant from Asserting Claim on Account of Action by Bankruptcy Trustee for Claimant to Disgorge Preference Payments Received from Bankrupt Principal

Kimball Constr. Co., Inc. v XL Specialty Ins. Co., 2016 WL 6082411 (D. Md. Oct. 18. 2016).

Surety issued three payment bonds on behalf of Blumenthal Kahn Truland Electric, LLC ("Truland"). Kimball Construction Company, Inc. ("Kimball") served as a subcontractor to Truland on the three construction projects. Truland filed a Chapter 7 bankruptcy petition on July 23, 2014. Prior to filing its bankruptcy petition, Truland made payments to Kimball in May and June of 2014 in the aggregate amount of $588,127.01. In December 2014, the surety made payments to Kimball under each of the three payment bonds totaling $380,286. In exchange for each payment, Kimball signed a "Final Affidavit, Release, and Assignment" ("Release") for the benefit of the surety in connection with the three bonds. In the Releases, identical for each respective bond, Kimball agreed to "release, acquit, exonerate and discharge Surety from all acts, suits, claims, damages and liabilities whatsoever which [Kimball] may have against Surety and Contractor covering the following contracts."

On October 16, 2015, the trustee in the Truland bankruptcy filed a complaint against Kimball seeking to avoid the payments made by Truland as avoidable transfers under 11 U.S.C. § 547(b). Although Kimball is defending against the Trustee's suit, Kimball commenced an action on June 14, 2016 against the surety contending that the surety is ultimately liable under the bonds for any amounts that Kimball may be compelled to pay the Trustee in the bankruptcy proceeding. The surety subsequently filed a motion to dismiss, or in the alterative, for summary judgment, arguing that the broad language of the Releases precluded Kimball's claims. The court agreed, rejecting Kimball's argument that the Releases were premised on Truland's payments to Kimball in May and July of 2014 and should be set aside for reason of "mutual mistake, supervening illegality, or frustration of purpose." The court observed that, "while it is clear that the bankruptcy trustee initiated the adversary proceeding after the Releases were executed, the bankruptcy action itself was filed over four months prior to the Releases' execution." Thus, Kimball signed the Releases with clear notice of Truland's bankruptcy and could have contemplated the possibility of future preference actions. The court also held that Kimball could not recover under the theory of unjust enrichment because a claim of unjust enrichment is not available when there is an express contract (i.e., the bonds) between the parties.

Local New Jersey Board of Education Does Not Have Discretion to Reject Release of Lien Bond from a Licensed Surety

Am. Motorists Ins. Co. v. N. Plainfield Bd. of Educ., 2016 WL 6122867 (N.J. Super. Ct. App. Div. Oct. 20, 2016).

A surety entered into three takeover agreements with the North Plainfield Board of Education (the "Board") on account of the Board's terminating the surety's principal on each of the three bonded contracts. Prior to entering into two of the takeover agreements, the surety's Certificate of Authority was revoked by the U.S. Department of Treasury. Although the surety achieved substantial completion on each of the three projects, the Board withheld contract funds on account of, among other things, various mechanics liens having been filed against the projects. To comply with the takeover agreements and have the Board release the withheld payments, the surety tendered self-issued lien-release bonds to the Board. Later that month, the Board learned that the surety had withdrawn from the surety bonding business. The Board questioned whether the surety was "legally authorized to issue the Discharge of Lien Bonds and also whether the company [was] financially solvent." Thereafter, the surety's counsel provided a copy of its Certificate of Authority from the New Jersey Department of Banking and Insurance (NJDBI), along with its March 31, 2004 Quarterly Statement. The Board rejected the surety's lien-release bonds on the grounds that its deteriorated financial condition violated the New Jersey Bond Act, but stated it would make contractually-mandated payments when adequate security was provided.

Thereafter, the architect discovered defective work at the schools and decertified the work to zero percent complete as of January 2005. The architect certified that the total value

of the decertified work was "approximately $256,000." The architect further certified that the surety never completed the work, failed to complete "punch list" work, and failed to provide many deliverables required by the contracts, such as "warranties, operation and maintenance manuals, insurance certificates and record documents." In April 2005, the surety filed a complaint against the Board alleging that it breached the takeover agreements and the covenant of good faith and fair dealing; the Board filed counterclaims. While the litigation was pending, in August 2012, a state-court judge in Illinois entered an Agreed Order of Rehabilitation, and ultimately, in May 2013, an Order of Liquidation with a Finding of Insolvency, enjoining any claim against the surety outside the Illinois insolvency proceeding. In December 2012, the Board's counterclaims in the New Jersey action were dismissed without prejudice due to the Illinois insolvency proceeding. The court's order allowed the Board to re-file its claims against the surety in the rehabilitation proceeding.

In May 2014, the court granted partial summary judgment in favor of the surety as to liability on the breach of contract claims. On appeal, the Board asserted that the court erred by concluding it breached the contract by, among other things, withholding payment from the surety and determining the surety's insolvency excused performance. As to the Board's general argument that it was entitled to withhold the entire contract balance for filed mechanics' liens, the court held that the surety's posting of its self-issued lien-release bond was sufficient to satisfy its obligations under the takeover agreements because a municipality or board may not "condition acceptance of a performance or maintenance bond upon its approval of the surety," as "N.J.S.A. 17:31–1 clearly bars a municipality from exercising its discretion in determining whether to approve properly executed bonds given by foreign insurance companies ... which are authorized by statute to conduct business in New Jersey pursuant to N.J.S.A. 17:17–1(g)."

The court likewise rejected the Board's argument that the surety's insolvency resulted in a material breach of the takeover agreements and warranted its non-payment of the contract sum. The Board argued, among other things that: (1) the surety's financial deterioration breached the performance and payment bonds when it lost its authorization to issue surety bonds from the United States Department of Treasury; and (2) the surety's entry into insolvency proceedings in 2012 created a supervening failure of consideration relieving the Board from any responsibility to pay for the completed work. The court noted that the Board entered into two of the three takeover agreements with full knowledge of the surety's financial condition and as such cannot claim material breach for a condition that already existed prior to entering into these agreements. Moreover, even if the Board did not know of the surety's financial condition when it entered into those agreements, the record indicated that the Board knew about the surety's condition about a month later and yet did not rescind the contract for material breach; instead it permitted the surety to substantially complete the projects. Finally, the court found the Board's argument that the surety's 2012 insolvency resulted in a failure of consideration under the bonds to be unavailing because the surety substantially completed the projects in late 2004. By the time the surety became insolvent, the work had already been done, and the lawsuit was ongoing. As such, the court held that the 2012 insolvency could not be a supervening failure of consideration for work performed eight years earlier.

<u>Sixth Circuit Affirms Surety's Right to Settle Its Principal's Claims Against Obligee</u>

Great Am. Ins. Co. v. E.L. Bailey & Co., Inc., 841 F.3d 439 (6th Cir. 2016).

In 2006, E.L. Bailey & Company, Inc. ("Bailey") executed an indemnity agreement (the "Agreement") in favor of the surety wherein Bailey agreed to indemnify the surety for all payments or other expenses the surety incurred due to issuing bonds, and to pay upon demand collateral in an amount to be determined by the surety. The Agreement further provided that in the event of Bailey's alleged breach of contract, subcontract, or the Agreement itself, Bailey assigned to the surety all Bailey's rights "growing in any manner out of" its contracts, as well as all its claims "against any party" and the resulting proceeds. The Agreement further granted the surety the right to settle any claim in connection with any related contract.

In September 2009, Bailey entered into a nearly $5,000,000 contract (the "Contract") with the State of Michigan (the "State") to serve

as the general contractor for the construction of a prison kitchen at the Huron Valley Women's Correctional Facility in Ypsilanti, Michigan (the "Project"). The surety provided a performance bond and a payment bond in connection with the Contract. The Contract permitted the State to withhold liquidated damages of $1,000 per day. Although Bailey and the State disputed the Project's due dates, the latest due date for what the contract referred to as "substantial completion" was April 2, 2011. The contract required "final completion" sixty days later, which would have been June 1, 2011. The State alleged in the Michigan Court of Claims that Bailey achieved substantial completion on April 4, 2012, and had not achieved final completion as of January 1, 2013. Bailey argued that it achieved substantial completion on December 15, 2011. Bailey never finalized completion, and the surety later reached an agreement with the State to have another contractor complete the Project.

A State-appointed mediator reviewed the evidence submitted by both parties and found that substantial completion occurred on April 4, 2012, 368 days after the April 2, 2011 due date. The mediator apportioned 278.5 days of this delay to Bailey and 89.5 days to the State. Bailey blamed the Project's delays on the State and its architect/engineer. The State acknowledged in an email that the original design for the power source represented a "serious design flaw."

This matter involved three separate lawsuits. First, Bailey and the State brought claims against each other in the Michigan Court of Claims in October 2011. The Court of Claims stayed the case pending mediation, and in August 2012 the mediator recommended that the State offer Bailey $220,400.75 to resolve all claims. The State rejected the mediator's recommendation. The claims between Bailey and the State were later transferred to another mediation-like method of alternative dispute resolution called facilitation, scheduled for September 12, 2013. On September 11, the surety's counsel informed Bailey's counsel that the surety had agreed to a proposed settlement with the State, releasing Bailey's claims against the State with prejudice in exchange for the State paying the surety $358,000, representing final payment under the construction contract. Bailey alleged that the surety had secretly negotiated with the State since February 2013, and that Bailey was unaware of the negotiations until the agreement had already been reached.

Second, some of Bailey's subcontractors brought claims in Washtenaw County Circuit Court against Bailey and against the surety under the payment bond for amounts due for Project work. In April 2012, the surety demanded $1.4 million in collateral from Bailey for these subcontractor claims. Bailey offered to pledge as collateral its accounts receivable, including its claims against the State, which the surety rejected. In November 2013, the surety reduced its demand for collateral to $653,998. Bailey never provided any collateral in response to either demand. The surety ultimately settled the subcontractors' claims.

The surety commenced an indemnity action in July 2012, seeking indemnification for Bailey's alleged breach of the Agreement by failing to provide collateral for the subcontractors' claims. The surety amended its complaint in December 2014 to add a declaratory judgment claim regarding the surety's right to settle Bailey's claims against the State. Bailey's answer asserted bad faith as an affirmative defense. The surety moved for summary judgment on the declaratory judgment and indemnification claims, and Bailey responded by contesting the surety's right to settle Bailey's claims against the State. Although Bailey's response discussed its allegation that the surety settled in bad faith, it argued that the bad faith issue was not ripe for review until the court determined whether the surety had a right to settle Bailey's claims. The district court granted summary judgment to the surety, finding that the surety had that right under the Agreement and awarded damages for the indemnification claim. Despite Bailey's position that a bad faith defense was not yet ripe, the court considered and rejected Bailey's bad faith argument, finding that Bailey's argument was based only on its disagreement with the settlement amount. Bailey appealed, contesting only the bad faith finding.

As an initial matter, the appeals court held that the district court properly considered the bad faith arguments. Since bad faith was pled as an affirmative defense, the court found that it was Bailey's burden to substantiate that the surety acted in bad faith; the surety was not required to substantiate its good faith. In defining bad faith, the Court applied Michigan law (the court acknowledged that the

applicability of the cases cited, which relate to traditional first-party insurers, to sureties, is not clear), which provides that "good-faith denials, offers of compromise, or other honest errors of judgment are not sufficient to establish bad faith." However, "if the insurer is motivated by selfish purpose or by a desire to protect its own interests at the expense of its insured's interest, bad faith exists, even though the insurer's actions were not actually dishonest or fraudulent." The court found that Bailey provided neither evidence about the surety's state of mind nor any reason why the surety's interest in settlement would differ from Bailey's. The court stated that there was no evidence that the surety's settlement of Bailey's claims was undertaken with selfish purpose at Bailey's expense. Rather, the court noted, the surety and Bailey shared an interest in securing the highest possible settlement from the State. Although Bailey argued that the surety could have secured a higher settlement had it properly understood Michigan law, the court found that "honest errors of judgment are not sufficient to establish bad faith."

Finally, the court rejected Bailey's argument that the surety acted in bad faith by concealing its negotiations with the State until the latter two reached an agreement on the eve of the facilitation. The only evidence proffered by Bailey regarding concealment is the date on which the surety informed it of the settlement; no evidence substantiated Bailey's claim that the surety had been in negotiations with the State for months. The emails between the surety and the State showed communication only during the week prior to reaching the agreement and the date on which the surety informed Bailey of the settlement. The court held that these facts are not sufficient evidence of concealment to establish bad faith.

The court added that even if Bailey did not know of the surety's negotiations with the State until they were complete, Bailey had warning that the surety might take control of these claims, just as the surety had settled and paid the subcontractor claims. Bailey also had the opportunity to regain control of its claims by providing the collateral requested by the surety. Thus, the court held that Bailey had both the notice and the opportunity to prevent an undesirable settlement, which undermines its argument that the surety's alleged concealment constituted bad faith.

Fidelity Casenotes

By: Lynda Riesgo Jensen, Travelers Bond & Specialty Ins., Braintree, MA

<u>Cross-Jurisdictional Uniformity When Loss Not Directly From Use Of Computer</u>

Apache Corp. v. Great Am. Ins. Co., --- F. App'x ----, 2016 WL 6090901 (5th Cir. Oct. 18, 2016), *vacating* 2015 WL 7709584 (S.D. Tx. Aug. 7, 2015).

The insured oil producer's employee received a telephone call from a fraudster identifying itself as an insured vendor. The caller instructed the employee to change bank account information for future vendor payments. The employee directed the vendor to submit its request in writing on the vendor's letterhead. A week later, the fraudster sent an email request using a slightly different domain name to the insured's accounts payable department submitting a request to change banking information on fictitious vendor letterhead. The insured employee attempted to verify the authenticity of the request by calling the number on the letterhead, instead of a pre-existing number, and the fraudster, not the insured, confirmed the request. A different insured

employee approved and implemented the change. The insured processed future vendor payments to the new account number. Within one month, the vendor notified the insured that it had not received approximately $7 million that the insured paid. The insured investigated and discovered the fraudulent scheme. The insured recovered all but approximately $2.4 million of the funds. The insured submitted a claim under the Computer Fraud provision of its crime policy. The insurer denied the claim stating, *inter alia*, that the "loss did not result directly from the use of a computer nor did the use of a computer cause the transfer of funds." The insured brought suit in state court, and the insurer removed it to federal court on diversity grounds. Both parties moved for summary judgment, and the District Court granted the insured's motion, blurring the language "resulting directly from" with the concept of "cause in fact." The insurer appealed.

In a *per curiam* decision, the Fifth Circuit vacated the District Court's grant of summary judgment and rendered judgment for the insurer. The Fifth Circuit analyzed the policy's requirement that the loss result directly from the use of a computer to fraudulently cause the transfer in view of the email's incidental relationship to the transfer of money involved in the loss. The Fifth Circuit observed that Texas law does not address the issue directly, and after surveying the body of case law nationwide, it determined that there is "cross-jurisdictional uniformity in declining to extend coverage when the fraudulent transfer was the result of other events and not directly by the computer use." The Fifth Circuit found that the insured made the transfer when it elected to pay legitimate invoices, not because it received fraudulent information, and determined that the insured made the authorized transfer to a fraudulent account because it failed to investigate properly the new information provided to it. The Fifth Circuit held that the plain meaning of the policy's language and the uniform interpretations across jurisdictions dictate that the insured did not suffer a covered loss under the Computer Fraud provision of the crime policy.

<u>Contractual Limitations On Timing For Filing Suit And Equitable Estoppel</u>

Hantz Fin. Servs., Inc. v. Am. Int'l Specialty Lines Ins. Co, --- F. App'x ----, 2016 WL 6609544 (6th Cir. Nov. 9, 2016).

An employee of the insured broker-dealer embezzled client funds by depositing checks written or endorsed by those clients directly into his own bank accounts. The insured learned of the employee's scheme in March 2008 when clients served the insured with a FINRA arbitration action. The insured investigated the allegations and learned that the employee embezzled from 22 clients. The insured settled with 20 clients without litigation before the end of July 2009 and arbitrated claims through FINRA with two other clients, one settling on July 24, 2009 and one resulting in an award affirmed on December 17, 2010. While undertaking settlement and litigation efforts, the insured filed claims under its fidelity bond and a separate policy. The insured submitted Proof of Loss in May 2008 and after investigation, the insurer denied coverage under the bond in March 2011. The insured, along with its corporate parent, brought suit in federal court on March 18, 2013, alleging breach of contract. The parties cross moved for summary judgment, and the District Court granted the insurers' motion. The insured appealed.

Applying Michigan law, the Sixth Circuit affirmed the District Court's grant of the insurers' motion. As a threshold matter, the Sixth Circuit determined that the insured failed to bring suit timely under the bond. The bond provides that the insured may not bring legal proceedings against the insurer to recover for its losses "after the expiration of 24 months from the date of such final judgment or settlement." The insured conceded that the action is time barred as to the 20 clients with whom it settled in 2009. As for the remaining two clients, the Sixth Circuit held that the suit filed on March 18, 2013 was filed more than 24 months after the insured settled with its client on July 24, 2009 and after the award was affirmed for the insured's other client on December 17, 2010.

Necessarily, the limitations periods expired for those losses as well. The insured argued that failing to define "final judgment" in the bond rendered it ambiguous and leaves open the potential for appeals. The Sixth Circuit observed that the absence of a definition does not render the term ambiguous and determined that a reasonable understanding of the term in the context of the policy language would be a final judgment ending litigation at that level. The Sixth Circuit elected not to read ambiguity into a contract where none existed. The insured also argued that the insurer on the bond should be equitably estopped from enforcing the provision where extensive and lengthy investigation functioned as a waiver and induced the insured into believing that the insurer would not rely on the limitations period. To prevail on this argument, the insured would need to establish, among other things, that the insurer's conduct induced it into believing that the insurer would not enforce the limitations period and that the insured justifiably relied on that belief. The evidence did not support such a conclusion.

Condition Precedent Not Satisfied Before Termination Triggered By Appointment Of FDIC As Receiver

Fed. Deposit Ins. Corp., as Receiver of New Frontier Bank v. Kan. Bankers Sur. Co., 840 F.3d 1167 (10th Cir. 2016).

The insured bank provided notice to its surety claiming that a customer, acting in concert with an insured loan officer, circumvented lending limits to perpetrate a fraudulent scheme. The loan officer pled guilty and was imprisoned. The customer filed an adversary proceeding against the insured bank, loan officer and others alleging that the loans and conduct of the loan officer were coercive and intended to benefit the insured bank at the customer's expense. The insured bank sought a defense from its surety under its bond, but the surety elected not to defend. In making that election, terms of the bond extended the deadline by which the insured bank must submit proof of loss. However, despite the extended deadline, the surety urged the insured bank to submit proof of loss before any takeover by a receiver, citing a separate condition, Condition 14 in the bond, that states the bond terminates immediately upon a receiver takeover and bars that receiver from making a claim unless the surety received proof of loss prior to termination. The banking commissioner closed the insured bank and appointed the FDIC as receiver. The insured bank failed to submit proof of loss prior to the FDIC taking over as receiver. The FDIC settled the adversary proceeding for part of the amount that the insured loaned to the customer and sought the loss delta from the surety under the bond. The surety denied the claim on the ground that it did not receive proof of loss before the FDIC's appointment as receiver. The FDIC filed suit in federal court, and the surety moved for summary judgment. The District Court granted the surety's motion holding that Condition 14 controlled over the extended deadline and did not violate public policy. The FDIC appealed.

Applying federal and Colorado law, the Tenth Circuit affirmed the District Court's grant of summary judgment. The FDIC argued that the District Court erred in holding that Condition 14 controlled because the provision contains non-standard and ambiguous language and because the insured bank substantially complied with the proof of loss requirements. The Tenth Circuit held that the FDIC forfeited these arguments by failing to raise them before the District Court and preserve them for appeal. The Tenth Circuit observed that a casual reference to an argument during briefing is a "far cry" from presenting it as an argument on which to challenge the coverage decision. The FDIC had "ample opportunity to present its arguments, but failed to do so. The Tenth Circuit rejected the FDIC's claim that the arguments present pure questions of law or that the District Court's decision was plainly erroneous. The FDIC also argued that Condition 14 is void as against public policy. Although the FDIC did preserve this challenge, the Tenth Circuit did not find the argument persuasive on appeal. Both federal and Colorado law permit provisions like Condition 14 limiting the broad powers of receivers. Moreover, although the FDIC stands in the shoes of the insured bank, it does not have a right to enforce a claim against the surety that the insured bank itself did not enjoy. Coverage did not vest before the FDIC took over because the insured bank did not comply with the condition precedent of submitting the proof of loss. As a result, the FDIC never acquired the right to enforce the bond.

Application of Adverse Interest Doctrine

Everest Nat'l Ins. Co. v. Tri-State Bank and Trust, 2016 WL 5062155 (W.D. La. Aug. 2, 2016).

The vice president of operations of the insured bank managed day-to-day operations and deposit accounts for lending and investments. When the vice president fell ill and another bank employee began handling work in his absence, the insured bank learned that the vice president had manipulated the electronic banking system to build in a balancer that allowed the vice president and his employee wife to embezzle funds totaling nearly $2 million. The insured bank submitted a claim under the employee dishonesty coverage of its bond. The insurer used a service to process the claim and conduct an investigation. The investigation revealed misrepresentations in the application process. Specifically, in 2011, the insured bank submitted an application confirming that the insured bank segregated and reviewed employee accounts for unusual activity, had a formal program segregating duties in every area so no one employee could control a single transaction from origination to posting and had no knowledge of any fact, circumstance or situation involving the insured bank which reasonably could give rise to a future claim. In 2014, the insured bank submitted a renewal application again confirming that the insured bank had a formal program segregating duties. Both the 2011 application and the 2014 renewal application contained affirmations that the statements contained in them were made to the best of the knowledge and belief of the person signing them, in both instances, the president and the vice president. Rather than deny the claim, the insurer, after consulting with the service performing the investigation, filed suit in District Court seeking to rescind the bond based on the misrepresentations or in the alternative a declaration that the insured bank is not entitled to recover under the bond. The insured bank filed a counter claim, and both parties moved for summary judgment.

Applying Louisiana law, the District Court denied the insurer's motion because the insurer failed to establish that misrepresentations in the application process render the bond *void ab initio* and entitled it to rescind the bond. Under a Louisiana statute, the insurer bore the burden of establishing that the misrepresentations were material and were made with the intent to deceive. The insured bank did not dispute the materiality of the statements. However, the District Court applied the adverse interest doctrine and elected not to impute the vice president's knowledge of his own wrongdoing to the insured bank. The District Court held that because the vice president acted in his own interest by lying on the applications and because his interest "starkly diverged from the best interests" of the insured bank, knowledge of the vice president's defalcations are not imputable to the insured bank. The District Court found that the vice president's position of authority did not render him in sole control so as to skirt the application of the adverse interest doctrine. Likewise, the District Court found unpersuasive the insurer's argument that as an innocent third party, the bank, not the insurer, should bear the risk of the dishonesty. Relying on the Restatement of Agency, the District Court explained that voiding coverage under such circumstances would render the fidelity coverage illusory. The District Court denied the insured bank's motion for partial summary judgment on the grounds that questions of fact remain regarding whether the insurer acted arbitrarily, capriciously or without probable cause in rendering its coverage determination, potentially entitling the insured bank to statutory penalties for failing to investigate the claim timely, and whether the insured bank detrimentally relied on statements during the investigation of the claim that jeopardized the insured bank's ability to mitigate damages by seeking recovery on its own.

LEGISLATIVE UPDATE

By: Angela Gleason, Associate Counsel, American Insurance Association, Washington, DC

By the 4th quarter of 2016 most state legislatures had already adjourned for the year, but some highlights of recent California enacted legislation are included below. Legislation governing the testing of autonomous vehicles continues to evolve and financial assurance requirements for surface mining and oil and gas operators were amended. For complete details please see the statutory section or bill number identified in the text and footnotes below.

California

Autonomous Vehicle Pilot Project – Bond Requirement

The legislature amended its autonomous vehicle testing law to add a new section authorizing the Contra Costa Transportation Authority to conduct a pilot project of an autonomous vehicle that does not have a driver in the driver's seat, has no steering wheel or brake pedal, or an accelerator.[1] Prior to this new section, autonomous vehicle tests were limited to tests that involved a driver in the driver seat that could immediately take control in the event of a failure. All autonomous vehicle testers must obtain insurance, a surety bond, or proof of self-insurance in the amount of $5,000,000, prior to beginning any tests.

Surface Mining Financial Assurance

A person conducting surface mining operations must obtain a permit and have their reclamation plan approved. Certain approval requirements were amended by Assembly Bill 1142 and revisions were made to the financial assurance provisions (surety bonds are a permissible form of financial assurance). At annual review, if the financial assurance costs estimates identify a need to increase the financial assurance amounts, an operator shall be required to increase an approved financial assurance to account for the estimated increased cost for reclamation of the surface mining operation.[2]

Oil and Gas Well Operator Reclamation Bond

Beginning January 1, 2018, the blanket bond amounts for oil and gas operations will be $200,000 for an operator having 50 or fewer wells in the state; $400,000 for 51-500 wells; $2,000,000 for 501 to 10,000 wells; and $3,000,000 for more than 10,000.[3]

Student Loan Servicing Act

A.B. 2251 created the Student Loan Servicing Act,[4] which provides for the licensure, regulation and oversight of student loan servicers. Such licensees will be required to obtain a surety bond of at least $25,000. Only one surety bond is required for licensees with multiple locations and the bond shall be used to recover expenses, fines, and fees levied against the licensee for losses or damages incurred by borrowers resulting from noncompliance with the Act.

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[1] Cal. Veh. Code §§ 38750 and 38755 (A.B. 1592).

[2] Cal. Pub. Res. Code § 2773.1

[3] Cal. Pub. Res. Code § 3205 (A.B. 2729).

[4] Cal. Fin. Code § 28142.

2017 SURETY CLAIMS INSTITUTE ANNUAL MEETING
PRELIMINARY PROGRAM AGENDA

INTRODUCTION

This year's program will focus on advanced obligee negotiation and techniques and will address practical claims handling and settlement practices. There will also be a review of significant surety and fidelity cases published over the past year. The ethics topic will address ethical obligations that can take sureties by surprise.

DAY ONE

Thursday

1. Annual Review of Surety Case Decisions.

   Speakers: Ben Lentz
   Patricia Wager

2. The Penal Sums – When is the penal sum really the penal sum, and what can we do to preserve it.

   Speaker: Ed Dudley and Gregory Veal

3. Advanced obligee negotiation/discussion techniques.

   Speakers: Daniel Pentecost
   Jonathan Bondy

4. Modifications to the Federal Rules of Civil Procedure and the "Shifting burdens" on discovery costs for sureties.

   Speakers: Douglas James Wills
   David C. Olson

5. Assignments—Avoiding Problems in Taking Assignments (Assuming Liabilities, Rights that Cannot be Assigned, Assignment of Rights Against Surety Bonds, Inadvertently Releasing Assignment Rights, Assignments of Lien Right, Balancing of the Equities and the Subrogated Surety).

   Speakers: Sharon Edwards
   Patrick Kingsley
   Todd R. Braggins

DAY TWO

Friday

1. Annual Review of Fidelity Case Law.

   Speaker: Carla C. Crapster

2. Dealing with the Regulators and the Unfair Claim Settlement Practice Acts, state and federal.

   Speakers: William Pearce
Sarah E. Wilson
Elizabeth L. Gordon
Brandon Bains

3. Complex Mediations and Settlement Techniques for Sureties.

   Speakers: Matthew Horowitz
Kim Czap
James Gibson
Steve Nelson
Tracy Haley
H. Bruce Shreves

4. The Surety's opportunities in the Contractor's Bankruptcy: A Guidebook to ease the next vacation in Hell.

   Speakers: Blake Wilcox
T. Scott Leo

5. Ethics: Ethical Violations that Take the Attorney by Surprise—How Attorneys Inadvertently or Innocently Violate the Rules.

   Speakers: Christina Craddock
John B. Dunlap, III

SUGGESTIONS & COMMENTS??

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