Surety Claims Institute

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Newsletter

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SCI'S 42nd ANNUAL MEETING REVIEW

Nancy and Dave Kitchin with thanks by Jerry Sunderland on completion of Dave's term as SCI President.

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

The SCI's 42nd Annual Meeting was held June 21 through June 23, 2017 at the Nemacolin Woodlands Resort in Farmington, Pennsylvania. The meeting was, again, well-attended, particularly by company employees. Everyone who attended the meeting was impressed by the quality of Nemacolin's facilities and the numerous activities available for adults and children.

Nemacolin offered a range of activities, from access to their zoo, to off-road driving. Some parents reported their children woke every morning to the roar of the lions roaming freely in the adjacent zoo. The zoo held a wide variety of animals, including a rare white tiger, which could be seen by walking around the perimeter of the zoo. Other attendees enjoyed amenities such as the ropes course, zip lines, and a miniature golf course. The resort's *(continued on page 3)*

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Comments From The Editor

Just as this Newsletter was about to be sent out, I learned the sad news of the passing of Josephine Monaghan, the wife of our dear friend and longtime SCI Board member and former officer Bob Monaghan. So I scrapped my comments from the editor in order to share a few thoughts and remembrances of Josephine. Most of the folks who have been members of the Surety Claims Institute for a long time knew and remember fondly Josephine. For many years Josephine was the friendly, warm and cheerful woman helping out our dear departed former Executive Secretary Adella LaRue at the Annual Meeting registration desk. Josephine always had a smile on her face, radiated warmth and good cheer and was ready and willing to help Adella and the SCI in any way she could. In addition to her volunteer efforts for the SCI, she was very

active in many civic and charitable activities in her native Massachusetts. She was one of those people in life that whenever you encountered her, she made you feel good and brightened the day. In the last 8 years or so she was in failing health and her radiance has been missed at our Annual Meetings. She has been and always will be greatly missed. We were all lucky to have known Josephine!! Our thoughts, sympathy and condolences go out to Bob and his family.

Armen Shahinian
Editor-In-Chief
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SCI'S 42nd ANNUAL MEETING REVIEW

(continued from page 1)

Photo credits to: Charlie Cloud and Keith Witten

Scott Leo, Amy Bentz and Bruce Shreves

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John McDevitt

Dave Kitchin, Mike Hurley, Susan and Pat Pike

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Joel Beach and Tricia Wager

David Koziel and Don Bieda

Pat Kingsley and the other Blake Wilcox

Nancy Kitchin, Laura Shields, Dave Kitchin and Ed Dudley

Keith Langley after receiving a deposit from the Bank of Shahinian

Amy Bentz and Betsy Gordon

Jason Potter and Kiran Sandhu

Candy and Kim McNaughton

John and Jill Dunlap

Trevor Hash

Kate Wilson, Sarah Wilson, and Rachel Walsh

displays also included the airplane featured in the Alfred Hitchcock movie "North by Northwest." Attendees were able to choose from a choice of rooms, including townhouses which were perfect for families with children.

For the golfers, the players enjoyed the Mystic Rock Golf Course, which is rated as one of the top golf courses in Pennsylvania. Everyone found the golf course extremely challenging and quite interesting to play.

On Thursday afternoon, in addition to the annual golf tournament, the SCI arranged a trip to Fallingwater, the famous Frank Lloyd Wright House. Also nearby is a replica of Ft. Necessity, where George Washington, then a militia officer, had his first battle as a commanding officer.

Everyone agreed that the facilities were wonderful and the staff incredibly responsive, courteous, and helpful. Many attendees noted that Nemacolin may have be best venue the SCI has visited to date.

While family and guests of the attendees reveled in Nemacolin's activities, the attendees benefited from Amy Bentz's incredibly well-developed educational program, which is the real focus of the SCI's annual meetings. As surety company employees. Presenters prepared detailed and well-organized research papers which can be used by all attendees. In addition, all members should remember that the SCI's Annual Meeting papers are now available in a word searchable format in the "Members Only" section of the SCI web page.

As usual, the program incorporated updates on the most recent and important cases in the fidelity and surety areas during the past year. Benjamin Lentz and Patricia Wager, Torre Lentz Gamell, Gary & Rittmaster, LLP, and Rachel Walsh from Liberty Mutual Surety presented the Surety Law Update. Carla C. Crapster, Strasburger & Price, LLP, presented the Fidelity Law Update.

Edward Dudley, Great American Insurance Company, and Gregory R. Veal, Bovis, Kyle Burch & Medlin, addressed an increasingly problematic topic in the industry - how a surety can preserve its protection of the penal sum. Jonathan Bondy, Chiesa Shahinian & Giantomasi & Samson PC, and Daniel Pentecost, Westfield Group, discussed advanced negotiation techniques. Patrick Kingsley, Stradley Ronon Stevens & Young, Sharon Edwards, Swiss Reinsurance America, and Todd Braggins, Ernstrom & Dreste, LLP, discussed

issues regarding the surety's rights of assignment.

There are perils and pitfalls for all sureties under various state regulations and unfair settlement practices acts, which every surety studiously avoids. Sarah Wilson, Hartford Insurance Company, Will Pearce, Arch Insurance Company, Brandon Bains, Langley LLP, and Elizabeth L. Gordon, Shields Mott, LLP, provided excellent detailed advice as to how to avoid these pitfalls.

Amy arranged a panel of extremely experienced attorneys, including both outside counsel and in-house claims executives, consisting of Bruce Shreves, Simon Peragine Smith & Redfearn, Steven Nelson, Markel Surety, Tracy Haley, Zurich American Insurance Company, Matthew M. Horowitz, Wolf Horowitz & Etlinger, LLC, and James Gibson, Liberty Mutual Insurance Company, to present a detailed discussion on mediations and settlement techniques. The panel's years of experience in this area was obvious and their comments and suggestions were well-received by all.

Scott Leo, The Law Offices of T. Scott Leo, PC, and Blake Wilcox, Liberty Mutual Surety, provided an interesting and detailed paper and presentation regarding the issues faced by a surety in its contractor/principal's Chapter 11 proceeding. Numerous insightful tips were provided for maneuvering through the morass of a principal's Chapter 11 and for avoiding traps that might otherwise ensnare an unwary surety.

Finally, Christina Craddock, Liberty Mutual Surety, and John Dunlap, Dunlap Fiore, LLC, presented a timely topic on how a surety attorney, whether inside or outside counsel, can inadvertently violate an attorney's ethical obligations.

At the traditional Thursday night dinner, the attendees bid a fond farewell to David Kitchin, Great American Insurance Company, who has served as SCI's President for the past four years and welcomed Steve Nelson, Markel Surety, as our new President. At the same time, Larry Jortner, CNA Insurance Company, was recognized as the 2017 Founders Scholarship awardee. Dan Pentecost, Westfield Insurance Group, was recognized as the 2018 Founders Scholarship recipient.

We all look forward to seeing each other again at the 2018 Annual Meeting which will be held at the Park Hyatt Hotel in Beaver Creek, Colorado from June 20 to 22, 2018.

MEET SCI'S NEW OFFICERS AND DIRECTORS

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

At the SCI's Board of Directors' meeting in June, the SCI Board elected several new officers and directors. Dave Kitchin, Great American, who served for several terms as the SCI's President, decided it was time for him to relinquish his duties. Dave has assured everyone that he will remain involved. He will continue as a member of the Site Selection Committee and the SCI's newly formed Budget and Finance Committee. At Thursday night's dinner, everyone showed their great appreciation for Dave.

Steve Nelson, who is the Chief Claims Officer for Markel Surety and an experienced mediator, was elected to replace Dave as President. Steve has been a long-time SCI member attending SCI's meetings since the mid-1980s. Steve has embraced several new concepts which hopefully will improve communications between the SCI leadership and the general membership.

Jerry Sunderland, who is a partner in the Baltimore law firm of Wright, Constable & Skeen, LLP and has served as both a Director

and Secretary remains a Director and was elected Vice President. Jerry will continue in his role as Co-Chair of SCI's Site Committee and a member of the SCI's newly formed Budget and Finance Committee.

Ellen Cavallaro, an Assistant Vice President and Surety Claims Attorney for Berkley Surety, who has served for several years on the Board, was elected Secretary to replace Jerry. Ellen was also appointed Chair of the newly formed SCI Budget and Finance Committee.

Sharon Edwards, Vice President, Property & Casualty Business Management, Swiss Re America Holding Corporation, was elected to her first term as a Director. Sharon looks forward to involving herself on one or more committees. Her views will be important because Sharon's entire family attends the annual meeting and will be a voice for those attendees.

David Kotnik, Surety Claims Leader, Westfield Insurance also joins the Board. David and Westfield are strong SCI supporters.

Jason Potter, a partner in the Baltimore law firm of Wright, Constable & Skeen, LLP, was elected as a Director. Jason has served as Co-Program Chair for five years. He is also Co-Chair of the SCI's Website Committee.

Congratulations to each of these individuals who look forward to getting to know every member better and to continuing to build upon the progress which their predecessors have made. With their leadership, we are confident that they will succeed in assuring that the SCI remains one of the industry's best surety claims organizations.

MESSAGE FROM THE PRESIDENT

By: Steve Nelson, President, SCI

In June, the SCI Board discussed the results of a survey conducted by the Strategic Planning Committee. The Strategic Planning Committee submitted a questionnaire to all current SCI members, asking various questions regarding members' perceptions of the SCI and whether they might like to see anything changed or explained.

This is planned to be the first in a series of articles to be published in the Newsletter addressing members' questions and perceptions.

A review of the questionnaire revealed that the most discussed questions and issues related to site selection for the SCI's Annual Meeting. The most frequent comments were:

1. Annual Meeting proximity to a nearby airport;
2. More western locations;
3. More locations in the northeast;
4. Chicago; and
5. More accessible locations.

The members overwhelmingly supported rotating conference locations.

I asked Jerry Sunderland and Betsy Gordon, who are currently the Co-Chairs of the SCI Site Selection Committee, to respond to these questions. The following are Betsy's and Jerry's comments, which I have reviewed. At the conclusion of this article, I have attached Jerry's email address. Jerry tells me that he welcomes emails suggesting future locations and any other comments regarding potential meeting sites.

General – The Site Selection Committee generally starts its search for a meeting location three years prior to the meeting. Currently, the Site Selection Committee and the Board are reviewing potential locations for 2020. (Our 2018 Annual Meeting will be in Beaver Creek, Colorado from June 20 to 22, and our 2019 Annual Meeting will be at the King and Prince Hotel, St. Simon Island, Georgia from June 19 to 21.) The Site Selection Committee solicits

comments and suggestions not only from every Director, but also every Committee member. Jerry and Betsy have developed a network of national hotel sales companies which represent numerous hotels and meeting coordinators to obtain initial proposals. After these initial proposals are received, the entire Committee evaluates the proposals, costs and contract terms. Thereafter, generally each June, the Committee presents its preliminary recommendations to the Board. Thereafter, a Subcommittee of the Site Selection Committee visits the site preferred by the Board.

The Board considers accessibility, costs, amenities, family friendly sites, nearby attractions, and golf. While golf may not be the most important criteria, it is certainly important. In June, forty percent (40%) of the registrants played golf. Locations which meet all criteria are difficult to locate.

When the Site Visitation Subcommittee visits a potential site, the hotel generally provides complimentary rooms and one or two meals. The remaining costs, including airfare, car rental and other expenses are not paid by the SCI. The Site Visitation Subcommittee's law firms and/or employers pay the costs. The SCI does not pay any commissions.

2, 3, and 4. The expressed desire for more western locations, northeast locations and Chicago reflect a divergence of members' views regarding meeting locations. For many years, the SCI held its annual meeting in a rotation of sites on the east coast, and, with the exception of the early years at Lake of the Ozarks, never traveled west of the Mississippi. In 2012, the SCI broke this pattern. The 2012 meeting was held at Cheyenne Mountain in Colorado Springs, Colorado. Three years later, the SCI meeting was held in New Mexico; and in 2018, the meeting will be held in Beaver Creek, Colorado. The SCI's Board has informally developed a three-year rotation to allow for western meeting locations. The Board currently has a proposal for the 2021 meeting to be held in Park City, Utah. The Board will likely make a semi-final decision on that location at the June, 2018 meeting after reviewing 2018 attendance.

The Board to date has bypassed California as a potential site. The FSLC's Spring Meeting is often times held in California, which is generally four to six weeks prior to the SCI's meeting. Moreover, the Pearlman meeting is always held in Seattle in September. The Board decided not to be perceived as competing with either one of those organizations.

Another problem with some western venues is the lack of reasonably priced locations in a pleasant climate. A substantial majority of easily accessible resorts which suit SCI's needs are in either Texas or Arizona. SCI has rejected both states simply because the weather in June at these locations is so inhospitable.

Several years ago, the Board considered Chicago as a location. Chicago was rejected at the time because it could identify only one potential non-urban site. In the Board's opinion, that site did not meet SCI standards. In addition, a majority of the company representatives on the Board rejected Chicago because their employers often hold their internal meetings in Chicago and they did not think Chicago would be an attractive location for a late June family-friendly meeting.

The northeast also has a limited number of suitable and easily accessible family resort sites that provide the same level of service and activities to which members have become accustomed. Most recently, Jerry and Betsy contacted a destination company based in Boston for suggestions for the 2020 meeting. Three sites were suggested. The Massachusetts site was rejected simply because it did not meet the quality test. A Portland, Maine location was suggested, but again, it would not be a "resort." This location was only a hotel and not a family resort type facility that would entice SCI members to bring their families. Finally, there were a number of locations suggested in southern Cape Cod. However, every proposal required a room rate substantially in excess of $300, which exceeded the SCI's self-imposed room rate limit.

In the past, the Site Selection Committee has explored locations in Maine, New Hampshire, Vermont and New York. The Site Selection Committee, even with the help of outside sources, has been unable to find a site for the SCI in those areas that contain the desired amenities and cost point and which are reasonably close to an airport.

The Committee continues to explore potential northeast locations, but there is a lack of suitable non-urban sites, and if the SCI selects an urban hotel, it will likely not have the usual amenities and will have substantially higher costs. The SCI's meeting costs are generally

higher in the northeast than in other parts of the country, though for many members, family transportation costs are lower. The Site Selection Committee will continue to search for northeast locations and welcomes comments.

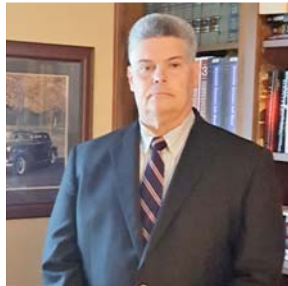
1 and 5. The thorniest issue which faces both the Site Selection Committee and the Board is a location close to a major airport. A large number of the locations which have the amenities which the SCI prefers and which are close to a major airport are in the south. This presents issues with weather in June. In addition, the SCI's Board has tried to select sites with no more than 300 rooms in order to ensure that SCI's meeting constitutes a large commitment by the hotel to ensure that the SCI receives the best service. While this may sound hard to believe, there are limited sites which have the amenities which the SCI requires within an hour of any major airport with a favorable climate. In June, the Board considered a site in northern Virginia, which is within 30 minutes from Dulles Airport. This certainly meets the first criteria, but, the costs and the contract terms were unacceptable to the SCI's directors.

Again, if there are thoughts or suggestions for locations, please tell us.

I hope this provides answers to some of your questions. As noted, if you have comments, please send them to Jerry, who has promised to respond to any inquiry. His email is gsunderland@wcslaw.com. I look forward to communicating with you in the next newsletter, which likely will address questions raised regarding meeting costs. Thanks for your continued participation in and support for the SCI!

While we will never find the "perfect" site, embraced by all, I am confident that our legacy of outstanding programming and unparalleled networking opportunities will continue to draw our members to our annual meetings.

Financing to Completion: A Multi Step Ordeal



By: Jack Nicholson, CPA, CFF, CGMA, Nicholson Professional Consulting, Inc., Roswell, GA

It is not unusual for a financially distressed contractor to ask the surety for financial assistance. And it is not unusual for a surety to consider this approach as a means of mitigating bonded performance obligations. For example, the surety may determine that the remaining contractual timeframes for performance completion are too short with regard to the actual time necessary for completion and the resulting potential liquidated damages exposure. Perhaps the technical aspects of the remaining work do not lend themselves to the use of an alternative performance completion option. Or the alternative expense of relieving the surety of its performance completion options is simply not cost effective. As a result, the surety may choose to finance its contractor to complete the bonded performance obligations.

Assuming that the principal is qualified and acceptable to the obligee, the surety is faced with the decision of how much additional money is going to be paid over and above the estimated cost to complete. Who deals with defects, especially latent defects, and at what cost? Is the surety going to incur material LDs during the time period of transitioning to another completion option?

From an accounting and cost perspective, this course tends to be one of the most difficult to initially quantify and subsequently contain. The decision to finance a contractor to completion is considerably more complex than simply comparing the cost of alternative completion options to the contractor's cost to complete and adding a general and administrative cost contribution.

The greatest unknown variable in that decision process is how much more, over and above the general and administrative amounts, it will really cost to support the contractor to the completion of the bonded performance obligation. Considerable time and effort should be taken up front to ensure that the surety really wants to pursue this course of action and to understand how much it is really going to cost.

The process is much more than simple math. The surety cannot simply look at costs to complete with an add-on for indirect support of the contractor as the measure of potential mitigation against other performance options. There are numerous cost items that may not fall under the obligations of the bonds issued on the contractor's behalf that should be considered when evaluating the finance to completion performance mitigation option. Following are several cost items the surety should consider in its decision process.

I. Integrity of the Contractor

The most difficult obstacle to overcome is a lack of character in your contractor. You can fix a financial shortfall with the payment of additional money. You can fix a technical or operational shortfall with the supplementation of qualified professionals; but you cannot fix bad character.

At the outset, you need to evaluate whether or not you think your new partner, the contractor/principal, is going to play things straight with you. If you have any concerns about the lack of character in your contractor, be prepared to spend a lot of time and effort keeping that contractor on the straight and narrow path. It is not going to be easy, and it is going to be costly.

A lack of character in your contractor will very likely negate any perceived benefits of the financing to completion performance mitigation model. And in the end, the costs savings will not be worth the anguish you experience in trying to look under every rock to prevent diversion of contract funds. The concern relating to a contractor with bad character is not a matter of whether bonded contract funds are diverted; it is a matter of how much. "Catch me if you can" is not a fun game to play with a contractor. A dishonest contractor is not going to get better over time, regardless of how many controls you have in place to protect your bonded contract funds.

The surety can expect to spend a material amount of additional accounting fees to safeguard its funds from potential diversion by an untrustworthy contractor. If the contractor cannot pass the character test, the perceived cost benefit of financing that contractor to completion is completely negated. The decision process should end here.

II. Ability of the Contractor to Complete the Work

Generally, there are two common obstacles facing a defaulted contractor. First, the contractor is perceived by the obligee as not performing the work in accordance with the terms of the bonded contract. Second, the contractor is experiencing some manner of financial distress. Usually, one begets the other. There are obviously exceptions, but this is generally the case with most defaulted contractors.

The surety's first consideration is whether the contractor has the technical ability to perform the work. A financial problem for an otherwise able contractor is fairly straightforward to quantify and remedy, but if the contractor is not technically capable of completing the work, no amount of money is going to cost-effectively improve the contractor's performance. The surety may be able to supplement the technical shortcoming of the contractor, but the question becomes a matter of cost. For example, how much will the surety need to supplement a pool contractor to finish a water treatment plant, or a schools contractor to finish a prison, or a Michigan-based roads contractor working in Miami?

III. Desire of the Contractor to Complete the Work

Before the surety starts down the finance-to-completion road, it should ensure that the contractor wants to complete the work. Generally, involvement of the surety is the option of last resort. Usually, by the time the contractor resorts to contacting its surety, its financial resources are depleted, and it has waited well beyond the cure of a simple one-time infusion of financial assistance. The contractor's key players are often emotionally defeated and mentally distracted by concerns over their individual financial futures.

While the infusion of additional resources will temporarily relieve some of the

contractor's anxiety, the effects of long-term stress of the events leading up to the financial distress may not be permanently remedied. The contractor may not be willing to stay in place for the long term to see the bonded work through to completion.

IV. Willingness of Key Employees to Stay Through Completion

It is important to determine whether the principal's key employees are willing to stay. One of the driving forces to consider in financing a contractor is the ability to retain the knowledge base of the key employees. Such employees can be invaluable in maintaining continuity of the work in process, providing firsthand knowledge of potential claims details, and providing assistance in closing out the work in process.

As discussed above, most contractors will wait to the last possible moment to admit financial distress and subsequently ask for help from their surety. At that point, many of the contractor's key employees are emotionally drained from the financial distress and may not be interested in staying on.

In addition, due to the financial distress of the contractor, the key employees have likely begun to look for employment elsewhere. They will have well-founded concerns that the contractor may not survive after the bonded work is completed. In addition to those concerns, competitors may very well try to pick them off, knowing that those key employees are ripe for raiding.

As a result, simply paying the key employees their back wages and benefits may not be incentive enough to have them stay on. It is not uncommon for the surety to offer some form of incentive to the key employees to ensure their retention through the work in process completion period.

V. Consideration of All Potential Indirect Costs

Most competent consultants routinely calculate the magnitude of the hard, direct numbers within reasonable accuracy. The difficult analysis in a finance-to-completion model is understanding and quantifying the indirect costs.

General and Administrative Costs

The principal indirect cost component is usually general and administrative expenses. A fair representation of future general and administrative expenses is found by evaluating those same costs from a historical basis. It is not uncommon for the contractor to make the case that it is going to cut general and administrative costs and be a more cost effective operation going forward. The main problem with relying upon a contractor seeking financial support is credibility. In this case, questioning credibility is not an attack on the contractor's character. Instead, you cannot help but ask yourself, if the contractor was such an astute manager of its financial assets, then why are we here? Inevitably, you will hear common excuses: the current financial distress is due to one bad job, the contractor had a bad estimator, the contractor encountered an unreasonable owner, etc. But the point still remains that it may not be safe to rely on the prospective representations of a financially distressed contractor when attempting to quantify future general and administrative costs. The better analysis is to start with historic costs and evaluate whether represented reductions in the contractor's look-forward projections are realistic.

It is also important that funding limitations are established up front with the contractor as to amounts acceptable for indirect costs, such as general and administrative costs, compensation, and other costs. Often, the contractor requests funding for items not contemplated and previously agreed to in the financing documents. In addition, it is not unusual for consideration of exceptions to the terms of the financing documents. It seems there is always some indirect cost item that, while not initially contemplated in the financing documents, still requires funding in order to achieve performance mitigation cost-effectively.

Debt

Another significant financial concern is debt. Most contractors have some amount of debt, and it is usually a material component of their liabilities and uses of cash. A common debt instrument is a line of credit secured with a blanket UCC with financial covenants and an annual renewal evaluation. In addition, most lenders require the contractor to also place its operating and other bank accounts at the institution of the lender.

The blanket UCC often specifically identifies cash on hand, accounts receivable, computers, software, facilities, and equipment as collateral for the line of credit. All of these items are subject to being impaired or confiscated by the lender, with a demand for payment in order to secure their release and or use by the contractor and the surety. While payment of debt is not expected to be a responsibility of the surety, it may very well be necessary to make some form of payment to continue use of the underlying assets the contractor has pledged as security for that debt.

The same concerns exist for vehicle and equipment notes. It is important to understand at the outset, the importance of the encumbered assets needed to complete the work in process, and the potential costs of having use of those assets during the performance mitigation process. It may not be sufficient to simply expect that the surety can rely upon the availability of encumbered assets through continued payment of the debt terms as originally negotiated by the contractor. It is not uncommon for the creditor to demand payment more in line with rental rates as opposed to the monthly payment amount agreed to with the contractor. The creditor will make the case that its collateral is being depleted to the benefit of the surety. As a result, the creditor may insist that it should be compensated for that depletion. This, of course, will likely be countered by the surety's suggestion that the creditor will be better off if it continues to accept regular payment than no payment.

Union Dues and Benefits

Absent specific bonds for the payment of union obligations, the surety is not normally expected to fund union obligations on non-bonded projects. While this is a valid expectation from an accounting perspective, it often proves difficult to meet that expectation if a particular union decides not to staff any of the contractor's projects, including the bonded ones, until all of the past due amounts are paid. And while there may be some ultimate remedies for that dilemma, the mitigation efforts on the bonded work in process can suffer due to the delay resulting from inadequate labor staffing. As a result, the surety may find it has to pay union dues on non-bonded work, in order to get the bonded projects completed.

Payroll taxes

Unpaid taxes are often another item with similar concerns. While there may not be a requirement under the bonds to pay any or some portion of the unpaid tax obligations of the contractor, it is not unusual for taxing authorities to confiscate some or all of the contractor's assets, including bonded receivables, computers, software, facilities, and equipment. The surety may need to make a business decision whether to pay some of these items that normally may not fall under the obligations of the bonds issued on behalf of the contractor.

Non-Bonded Work

It is not uncommon for a bonded contractor to also have non-bonded work. It is important for the surety to establish up front how indirect costs are to be allocated between the bonded projects and the other work of the contractor. A common method is an allocation based on unearned contract balances. But this method is not necessarily applicable to all contractors. From an accounting perspective, the allocation should be based on the actual use of the indirect costs. If the non-bonded work requires more of the indirect costs to prosecute that work, then it seems reasonable for those non-bonded projects to incur a greater share of the indirect costs. Unfortunately, many contractors will take issue with the lack of funding of its indirect costs.

Indirect Costs Caps

It is also not uncommon for a surety to simply cap the indirect costs funding each month for a contractor based on a percentage of the work completed. For example, a cap of 8 to 10% paid for indirect costs may be used based on the earned, bonded-project revenue. The downside of this methodology is what happens when a contractor fails to actually dial back its indirect costs. While the surety may be fully compliant with the terms agreed upon in the financing documents, by not allowing for funding over the agreed-upon cap, the resulting lack of funding could cause disruption of completion of the bonded work in process. Some of the casualties of the funding cap may include utilities, fuel costs, and employee expenses. The surety may take the position that it is not going to pay those indirect costs items because of the agreed-upon cap, but such a lack of funding may ultimately impact performance of the bonded contract. In

taking that position, the potentially may have lost sight of the bigger picture.

VI. Safeguarding of Cash

One of the surety's first priorities in dealing with a financially distressed contractor on a bonded project is to secure the bonded contract funds (accounts receivable, retainage receivable, and unearned contract balances). Early engagement of counsel in this regard is critical. At this point in the financial life of the contractor, there are numerous parties competing for those funds. It is important to ensure that those funds are safeguarded into accounts under the federal tax identification number of an entity other than the contractor.

Often a lender or a taxing authority will seize bonded contract funds and make every effort to avoid releasing those funds to the surety. While the surety certainly has viable options to pursue the return of those bonded contract funds, the impact of loss of use of those funds, and the costs to pursue them, can be substantial. The more cost-effective approach is to head off the confiscation of those funds as soon as possible.

After deciding to finance the contractor to completion, the Surety, counsel, and consultant need to be prepared to closely monitor the contractor. There will be times when certain costs for which a contractor requests payment cannot be verified and therefore will not be funded by the Surety. In some instances, the contractor will request payments for unsupported costs, non-bonded project costs, or payments for overhead that were not agreed upon.

We find that a common fault with most financially distressed contractors is a failure to properly and timely prepare, and submit, contract billings. It is important that the surety ensure the consultant or attorney has an understanding of the billing terms of each contract and additional contract provisions. The consultant or attorney should have knowledge of each construction contract and how it is billed (lump sum, unit cost, cost plus, etc.). They should also review and understand whether provisions are in place for disadvantaged business enterprises ("DBEs") to avoid penalties. And the consultant or attorney should also understand how monthly payment applications are processed and the requirements regarding same.

Collection of contract funds is an important and integral part of financing the contractor to completion. A common method of securing bonded contract balances is the utilization of letters of direction, commonly provided by the surety's counsel, to ensure collection of contract funds from obligees. However, even with timely submission of letters of direction to obligees, it is not uncommon for funds to be remitted to the contractor. Continuous reconciliation of billings and collections, along with monitoring and access to the contractor's bank accounts, is necessary to ensure that all bonded contract funds are received and ultimately remitted into the non-contractor owned control account.

Once the funds are secured in a non-contractor-owned control account, the next step is to set up a series of procedures for disbursement of funds from that account. A common and recommended process is via the use of some sort of check request form, set up though the surety, executed by the contractor and the indemnitors, and vetted by the appropriate professionals for reasonableness, accuracy, and compliance with the financing agreements executed by the surety and the contractor. The intent with this process is to safeguard the assets and head off any future disputes with the indemnitors over disbursements from the account.

It is not uncommon for most contractors to comingle contract funds between projects, and to also use funds for other disbursements unrelated to the efforts that generated those contract funds. As the financial distress of the contractor continues, the comingling generally escalates. As a result, bonded contract funds can be diverted to uses other than the payment of the subcontractors and suppliers that earned them.

In addition, it is not unusual for lenders and taxing authorities to sweep the contractor's accounts, and even payroll accounts, in an effort to gather up assets to offset a perceived default by the contractor. While there may be legal remedies for inappropriate seizures of assets, the point still remains the lender may have succeeded in diverting those assets needed for timely mitigation of the surety's bonded obligations, and may be withholding them from the surety.

As a result, it is imperative that the surety secure the bonded receivables and contract balances into a surety controlled

account. The surety can then work with the contractor to ensure contract funds are disbursed to those subcontractors and suppliers who earned them and that trust obligations, if any, are met.

VII. Loss Adjustment Expense

Perhaps the highest profile additional cost impact from the surety's perspective is the increased loss adjustment expense ("LAE"), which includes additional expenses like administrative costs, attorney's fees, and consulting costs that will be incurred in the finance-to-completion performance mitigation model. Generally, the initial evaluation by the consultants and attorneys takes approximately 30 days or so to provide the surety with a lay of the land. The surety can then take those data inputs from its attorneys and consultants and make an informed decision as to how best to mitigate the potential obligations under the bonds issued on behalf of the contractor.

If the surety decides to move forward with the finance-to-completion performance mitigation option, it is very likely that the claims manager will require the further assistance of the attorneys and consultants going forward. As a result, it follows that LAE costs may materially increase as well. The surety is now relying on the attorneys and consultants for time and services long past the initial evaluation. As a result, the costs for that time and the related services will be significantly greater.

While it is likely more cost effective to use the contractor's accounting staff as much as possible, it is critical that someone independent of the contractor oversee the activities of his staff. The accounting consultant often provides, at a minimum, oversight of the contractor's accounts payable back office operations to ensure that subcontractors, suppliers, overhead, and additional project costs are properly paid. The accounting and construction consultants usually review check requests in a timely manner and oversee payments to the contractor's vendors and subcontractors.

The accounting consultant usually ensures the collection of interim, partial, and final releases for each disbursement from the control account. The accounting consultant is normally engaged to prepare cash flow reports of amounts collected and disbursed, by project. Periodic reconciliations between the initial overall financial assessment and the financial performance to date are encouraged. Variances between hard number net assessments are not uncommon. Generally, sufficient contingencies allow for overall net assessments to stay within an acceptable range of the initial assessments. Given the fluid dynamics of the financing to completion performance mitigation option, it is important to be mindful of the magnitude and reasons for material variances in the initial financial assessments and the current financial status to date.

Summary

Regardless of the reason, the surety sometimes expects that financial support of the contractor may be the option involving the least additional cost. The surety may also anticipate that it can mitigate its losses best by gaining control of the disbursement of the bonded contract funds. The goal is to mitigate the bonded performance obligations while also exercising some control over the contractor's bonded projects' revenues and costs. The contractor's bonded costs and revenues can be controlled through careful project accounting and management of a control account. It can be a successful option, but the surety needs to be prepared to spend some time and money to make it work.

Overseeing your contractor/principal to completion can be tedious and costly. But in spite of all the traps you must navigate, the finance-to-completion model can also be an effective performance mitigation tool in managing the surety's overall loss. The surety needs to understand that the finance-to-completion performance mitigation process requires the funding of items that are not normally obligations of the surety under the bonds it has issued on behalf of the contractor. In addition, it is very likely that substantive professional resources will be needed to get to the end of the bonded performance obligations. The finance-to-completion performance mitigation model can be a cost-effective alternative to the other options available to the surety, but the surety must ensure it has the data and analysis upfront to make an informed decision and to monitor whether and to what extent unforeseen contingencies change the initial analysis, potentially warranting a change in the surety's approach to contract completion.

IMPROPER AND UNTIMELY NOTICE: THE LIFE AND DEATH OF CLAIMS

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I. Introduction

The American Institute of Architects' Document A201-2007,[1] entitled "General Conditions of the Contract for Construction" ("General Conditions"), contains numerous provisions requiring either the owner or the contractor (or the surety in takeover) to provide specific and timely notice before engaging in certain courses of action. The failure to strictly comply with these provisions can be fatal for extra time, money, or damages. And particularly for sureties, proper versus improper notice can mean the difference between liability and no liability at all. This paper provides a framework for consideration of those notice requirements and when they should be furnished in accordance with the General Conditions in their native, unmodified form. Additionally, it highlights several cases construing these strict requirements and what happens when the contractor or owner (or the surety in takeover) fails to comply with notice requirements.

II. AIA A201-2007 General Conditions & Notice Requirements

a. Section 13.3 – Written Notice

Generally speaking, "written notice" under Section 13.3 of the General Conditions is "deemed to have been duly served if delivered in person to the individual, to a member of the firm or entity, or to an officer of the corporation for which it was intended," or if otherwise delivered, sent by registered, certified mail or other courier service that provides proof of delivery, to the last known business address of the recipient. The AIA Document Commentary to A201-2007 General Conditions of the Contract for Construction ("Commentary") provides clarification that if the above notice requirement is met, "notice will have been effectively given, whether or not actually received."[2]

Though it may seem clear from a simple reading of the text, courts often view verbal notice as insufficient to comply with provisions explicitly requiring written notice.[3] As with contracts in general, "where the provisions of a contract are unambiguous, courts may not violate the clear meaning of the words in order to create an ambiguity, and certainly may not rewrite the contract."[4] Thus, where the General Conditions explicitly require that notice be in writing, this simple requirement should not be overlooked or disregarded.

b. Section 2.3 – Owner's Right to Stop the Work

Section 2.3 of the General Conditions pertains to the Owner's right to stop the work on the project. It provides the Owner the option, but not the obligation, to issue a written order to the Contractor to stop the work on the project, or any portion of such work, when the Contractor fails to correct work rejected by the Architect, or otherwise repeatedly fails to carry out the work

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[1] The AIA recently revised its General Conditions. This paper only addresses the 2007 version.

[2] *See* AIA Document Commentary, A201-2007 General Conditions of the Contract for Construction, 50 (2007), available at http://aiad8.prod.acquia-sites.com/sites/default/files/2017-02/a201-2007%20commentary.pdf.

[3] *See Fla. Recycling Servs. v. Greater Orlando Auto Auction*, 898 So. 2d 129 (Fla. 5th DCA 2005).

[4] *Id.* at 131; *see also Fid. & Deposit Co. v. First State Ins. Co.*, 677 So. 2d 266, 269 (Fla. 1996) (holding that notice of cancellation of insurance contract via telephone is insufficient when the contract clause unambiguously required written notice; mortgagee may not be subjected to the impermanence of the spoken word when the contractual obligation of insurer is to provide written notice).

in accordance with the contract requirements.[5] The Owner's written notice to stop the work will continue until the underlying cause for the written order has been eliminated.[6]

Importantly, unlike other provisions of the General Conditions discussed below, Section 2.3 does not itself contain a specified time within which the Contractor must correct work on the project. One court evaluating Section 2.3 rejected an owner's argument that it was entitled to stop all work on a project and terminate the contract because the contractor failed to remedy certain defective windows in what the owner deemed to be a timely manner.[7] The court, instead, held that the contractor was only obligated to complete the pertinent repairs by the "substantial completion" date as fixed by the contract.[8] Thus, because that "substantial completion" date was not in jeopardy at the time the owners stopped the work, their actions constituted a breach of the contract.[9] As discussed below, the General Conditions contain specific requirements for terminating or unilaterally correcting work, none of which the owners above seem to have followed, to their detriment.

c. Section 2.4 – Owner's Right to Carry Out the Work

Building off of the Owner's rights under Section 2.3, Section 2.4 of the General Conditions establishes the specific procedure the Owner must follow before "undertaking and/or correcting some or all of the work under the contract."[10] If the Contractor defaults or neglects to carry out the work in accordance with the contract, the Owner must give the Contractor ten days' written notice to commence and correct the default with diligence and promptness.[11] Following the expiration of the ten-day period, if "remedial action has not been undertaken" by the Contractor, the Owner may step in and correct the deficiencies.[12] Importantly, the Contractor's obligation is to "commence and continue to correct deficiencies" within this ten-day period, and need not "necessarily finish such corrective work."[13]

If the Owner goes this route, "an appropriate Change Order shall be issued deducting from payments then or thereafter due the Contractor the reasonable cost of correcting such deficiencies, including Owner's expenses and compensation for the Architect's additional services" resulting from the Contractor's default, neglect or failure.[14] If the amount due to the Contractor is insufficient, the Contractor must pay the difference.[15] The Architect is required to pre-approve the Owner's actions under this Section, and must also approve the amounts to be charged to the Contractor.[16]

As the Commentary makes clear, "[c]orrecting the work is not intended to preclude the owner from pursuing other remedies such as arbitration or legal action for breach of contract or breach of a warranty."[17] However, the Owner's failure to follow this procedure and provide the requisite notice may prevent it from claiming damages resulting from the Contractor's default.[18] Additionally, this notice requirement may remain in effect after substantial completion.[19] In this case, courts

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[5] § 2.3, AIA Document A201-2007.
[6] *Id.*
[7] *Ranta Constr. Inc. v. Anderson*, 190 P.3d 835, 841-42 (Colo. App. 2008).
[8] *Id.* at 841.
[9] *Id.* at 841-42.
[10] *See* AIA Document Commentary, supra note 2, at 9.
[11] § 2.4, AIA Document A201-2007.
[12] *See* AIA Document Commentary, supra note 2, at 9.

[13] Werner Sabo, *Legal Guide to AIA Documents*, 309 (5th ed. 2008).
[14] § 2.4, AIA Document A201-2007.
[15] *Id.*
[16] *Id.*
[17] *See* AIA Document Commentary, supra note 2, at 9.
[18] *See* Sabo, supra note 13, at 310 (*citing State Sur. Co. v. Lamb Constr. Co.*, 625 P.2d 184 (Wyo. 1981) (holding owner was not entitled to damages it incurred hiring another contractor to complete a defaulting contractor's work based upon the absence in the record showing the owner complied with the procedure and notice requirements prior to doing so); *and Bouchard v. Boyer*, 1999 Conn. Super. LEXIS 1285, at *14 (May 17, 1999) ("In a contract containing a termination clause requiring the owner to give notice to the contractor that, unless the noted defaults are cured, the contractor will be terminated, the failure to provide this notice will invalidate the termination.")).
[19] *See Moravian Assocs., L.P. v. Henderson Corp.*, No. 06-cv-2165, 2008 U.S. Dist. LEXIS 62260, at *30-32 (E.D. Pa. 2008) (holding contract provision mirroring General Conditions Section 2.4 remained in effect after "substantial completion" was certified as to the project, requiring written notice to

hold that an Owner cannot recover damages by failing to furnish notice before doing so – even for punch list work.[20]

d. Section 3.7.4 – Concealed or Unknown Conditions

Section 3.7.4 pertains to a Contractor's right to an increase or decrease of cost or time because of concealed or unknown conditions. Specifically, notice under this Section is required if the Contractor encounters either subsurface or concealed physical conditions differing materially from that as disclosed in the contract documents, or "unknown physical conditions of an unusual nature, that differ materially from those ordinarily found to exist and generally recognized as inherent in construction activities of the character provided for in the Contract Documents."[21] In short, "[i]f the difference between what the contractor could reasonably have expected and what it actually found were material to the required work, a claim would be appropriate."[22]

If the Contractor encounters these conditions, it must provide notice to both the Owner and the Architect "before conditions are disturbed and in no event later than 21 days after first observance of the conditions."[23] Upon the Architect's receipt of this notice, it must undertake an investigation and determine if the conditions in fact differ materially and will cause an increase or decrease in the cost of or time required for performing the work.[24] If a material difference exists, the Architect is to recommend an equitable adjustment.[25] If the Contractor fails to provide timely notice, courts may hold that the Contractor cannot recover damages.[26]

e. Section 9.7 – Failure of Payment

Section 9.7 establishes the Contractor's rights to stop work for nonpayment. Specifically, the Contractor may stop work if the Architect fails to timely issue a Certificate of Payment within seven days of receiving the Contractor's Application for Payment, or if the Owner otherwise fails to pay the Contractor within seven days of the date established by the contract.[27] The Contractor must, however, provide seven days' written notice to both the Owner and the Architect before it stops work.[28] Payment must be at least seven days late, and "the contractor must give an additional seven days' notice after the initial seven-day lapse before stopping work" under this Section.[29]

As one court explained in construing Section 9.7, an Owner's failure to pay in accordance with the Architect's certification of payment constitutes a material breach that relieves the Contractor from further performance under the contract; that is, of course, as long as proper notice under Section 9.7 is provided prior to the contractor stopping work.[30]

f. Section 14.1 – Termination by the Contractor

Section 14.1, along with its subparts, provides the procedures the Contractor must follow to properly terminate the contract. Specifically, Section 14.1.3 requires the Contractor provide **seven days**' written notice to the Owner and Architect prior to terminating the contract for the reasons specified in either Section 14.1.1 or 14.1.2, which notice, as will be discussed, is in addition to other timing requirements set forth within those Sections.[31] Importantly, Section 14.1.3 "does not allow for an opportunity to cure on the part of the owner," such that once the time periods discussed below have passed or expired, "the contractor has an

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contractor prior to owner's undertaking certain Punch List work).

[20] *Id.* at 33-34.

[21] § 3.7.4, AIA Document A201-2007.

[22] *See* AIA Document Commentary, supra note 2, at 13.

[23] § 3.7.4, AIA Document A201-2007.

[24] *Id.*

[25] *Id.*

[26] *See. e.g., J. WM, Foley Inc. v. United Illuminating Co.*, 158 Conn. App. 27, 42, 118 A.3d 573, 583 (2015) (holding party irrevocably waived and released claim for delay damages as a result of extension of completion deadlines purportedly caused by unknown or misidentified site conditions where party failed to provide notice of such site conditions within time prescribed by contract provision).

[27] § 9.7, AIA Document A201-2007.

[28] *Id.*

[29] *See* Sabo, supra note 13, at 433.

[30] *James Talcott Constr., Inc. v. P&D Land Enters.*, 2006 MT 136, ¶ 35, 332 Mont. 368, 378 (2006); *see also Commonwealth Constr. Co. v. Cornerstone Fellowship Baptist Church*, 2006 Del. Super. LEXIS 349, *82-85 (Super. Ct. Aug. 31, 2006) (holding contractor did not breach contract when it stopped work as a result of non-payment where contractor complied with Section 9.7 written notice requirement).

[31] § 14.1.3, AIA Document A201-2007.

absolute right to terminate, but only after giving this notice."[32]

Section 14.1.1 provides an exclusive list of events giving rise to a Contractor's right to terminate the contract if the work is stopped. Such right, however, may only be invoked if the work is stopped for a period of thirty consecutive days, and where such stoppage is "through no act or fault of the Contractor or a Subcontractor, Sub-subcontractor or their agents or employees or any other persons or entities performing portions of the Work under direct or indirect contract with the Contractor."[33] Those enumerated reasons include only the following: (1) a court order or order of any other public authority "having jurisdiction" that requires all work to be stopped; (2) "[a]n act of government," to include, among other things, a declaration of national emergency, requiring all work to be stopped;[34] (3) the Architect's failure to issue a Certificate of Payment and failure to notify the Contractor of the reason for withholding such certification, as set forth in Section 9.4.1, or the Owner's failure to make payment on a Certificate of Payment within the contractual time period; or (4) the Owner's failure to provide, after the Contractor's request for, "reasonable evidence that the Owner has made financial arrangements" to fulfill its contractual obligations, as more fully set forth under Section 2.2.1.[35] Thus, in conjunction with Section 14.1.3, the Contractor must provide seven days' written notice in addition to the full thirty consecutive days of work stoppage.[36] If the Contractor terminates the contract prior to the expiration of the above time periods, courts hold that the Contractor is in breach of the contract.[37]

Section 14.1.2 provides another mechanism for the Contractor to terminate the contract if "there are delays to the project that total the lesser of: 120 calendar days in any 365-day period, or 100 percent of the scheduled work days."[38] This Section, similar to Section 14.1.1, however, requires that such suspensions, delays or interruptions not result from an "act or fault of the Contractor or a Subcontractor, Sub-subcontractor or their agents or employees or any other persons or entities performing portions of the work under direct or indirect contract with the Contractor."[39] And, similar to Section 14.1.1, the seven-day notice requirement is in addition to awaiting the expiration of the full time periods specified in 14.1.2.[40]

Sections 14.1.1 and 14.1.2 are clear that if any of those individuals or entities are responsible for any delay, "the contractor has no right to terminate the contract" under those Sections.[41] If, however, the reasons exist, the Contractor may recover payment for work already executed, which includes retainage, and also for "reasonable overhead and profit," costs the Contractor incurs as a result of termination, and damages.[42]

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[32] *See* Sabo, supra note 13, at 506.

[33] § 14.1.1, AIA Document A201-2007.

[34] For a discussion of Section 14.1.1's requirement of a work stoppage of "30 consecutive days" and a contractor's right to terminate following the devastation caused by Hurricane Katrina in New Orleans, see *Frischhertz Constr. Co. v. Audubon Comm'n (In re Frischhertz Constr. Co.)*, Nos. 05-21605, 06-1011, 2007 Bankr. LEXIS 3495, at *4 (U.S. Bankr. E.D. La. 2007), *rev'd on other grounds*, *In re Roy Frischhertz Constr. Co.*, 401 Fed. Appx. 861, 862 (5th Cir. 2010) (holding contractor entitled to and did properly terminate based upon, among other things, New Orleans' mayor's "proclamation of emergency" that was in effect for more than 30 days).

[35] Specifically with regard to the Owner's failure to provide reasonable evidence of its financial arrangements, the Contractor can only terminate after it has made the requisite demand under Section 2.2.1, and, having not received a prompt response, stop the work for thirty consecutive days. *See* Sabo, supra note 13, at 506.

[36] *Id.*

[37] *See Winter v. Pleasant*, 222 P.3d 828, 837 (2010) (holding contractor breached contract by, among other things, terminating contract prior to the expiration of the 30-day period set forth in the contract); *but see Gillard v. Green*, 2001 Ohio App. LEXIS 6019, *15-18 (Ct. App. 2001) (holding contractor did not materially breach contract's Section 14.1.3 written notice provision where it provided written notice indicating that contract was terminated effective immediately, but stayed on construction site to wrap up certain work and only left site after owner failed to respond to termination letter within seven days; holding "[t]his was, at most, a mere technical breach that worked no prejudice against [the owner] and, consequently, can be disregarded.").

[38] Sabo, supra note 13, at 506.

[39] § 14.1.2, AIA Document A201-2007.

[40] Sabo, supra note 13, at 506.

[41] AIA Document Commentary, supra note 2, at 52.

[42] § 14.1.3, AIA Document A201-2007; *see also In re Roy Frischhertz Constr. Co.*, 401 Fed. Appx. 861, 862 (5th Cir. 2010) (holding Section 14.1.3 entitles

Importantly, the Commentary points out a correlation between Section 9.7, pertaining to the Contractor's right to stop work upon nonpayment, and the Contractor's right under Section 14.1 to terminate the contract.[43] In pertinent part, "[i]f the contractor stops work in accordance with Section 9.7 due to non-payment, the contractor must wait an additional 30 days before terminating the contract."[44] Thus, a strict reading of these provisions suggests that in order to fully comply with the notice provisions of these separate Sections, the Contractor must (1) go unpaid for a period of seven days, (2) provide written notice of such nonpayment and wait seven days before stopping work, (3) stop work for thirty consecutive days, and (4) thereafter provide an additional seven-days' notice prior to terminating the contract because of such nonpayment.

Section 14.1.4 provides additional recourse when the contract work is stopped for a period of sixty consecutive days as a result of the Owner's repeated failure to "fulfill the Owner's obligations under the Contract Documents with respect to matters important to the progress of the work." In this event, the Contractor must provide the Owner and Architect seven days' written notice, after the full sixty consecutive days of work stoppage, prior to terminating and seeking damages as discussed above and set forth in Section 14.1.3.[45] This provision is triggered because of, among other things, "the owner's failure to give approvals, to provide necessary surveys or other documents, to provide access to the site, or any other duty of the owner or its agents."[46] Again, however, the Contractor's right to terminate the contract under this Section is contingent upon the stoppage of the work being through no "act or fault of the Contractor or a Subcontractor or their agents or employees or any other persons performing portions of the Work under contract with the Contractor."[47]

contractor to retainage in event contract is properly terminated).

[43] AIA Document Commentary, supra note 2, at 52.

[44] *Id.*

[45] *Id.* at 53.

[46] Sabo, supra note 13, at 507.

[47] § 14.1.4, AIA Document A201-2007.

g. Section 14.2 - Termination by the Owner for Cause

Section 14.2 of the General Conditions, on the other hand, provides the Owner's right to terminate for cause. The Owner may do so only upon one of four enumerated events: (1) the Contractor's repeated refusal or failure to "supply enough properly skilled workers or materials;" (2) the Contractor's failure to pay Subcontractors for materials or labor as required under their respective subcontractors or agreements; (3) the Contractor's repeated disregard for "applicable laws, statutes, ordinances, codes, rules and regulations, or lawful orders of a public authority;" or (4) if the Contractor is "otherwise guilty of substantial breach of a provision of the Contract Documents."[48] The Commentary clarifies that the enumerated conduct must occur "repeatedly," and isolated instances of insufficient workers or improper materials, or other "isolated infractions" will not justify termination.[49]

Additionally, the Owner's right to terminate the contract and to certain recourse exists only after the "Initial Decision Maker" (the Architect, unless the contract specifies otherwise) certifies that sufficient causes exist to justify terminating the contract.[50] This certification "serves to protect the contractor against unreasonable action by the owner and serves to protect the owner from the consequences of acting prematurely."[51] Courts hold that an Owner's failure to obtain the necessary certification is a breach of the contract that renders the termination invalid.[52]

[48] § 14.2.1, AIA Document A201-2007.

[49] AIA Document Commentary, supra note 2, at 53.

[50] § 14.2.2, AIA Document A201-2007.

[51] AIA Document Commentary, supra note 2, at 53.

[52] *See* Sabo, supra note 13, at 508 (*citing Supreme Indus. v. Tom of Bloomfield*, 2007 WL 901805 (Conn. Super. March 8, 2007)); *see also Mike Bldg. & Constr., Inc. v. Just Homes, LLC*, 901 N.Y.S.2d 458, 469-70 (Sup. Ct. 2010) (holding owner's failure, *inter alia*, to obtain certification from architect as to cause for termination constituted breach of contract); *Paragon Restoration Grp., Inc. v. Cambridge Sq. Condos.*, 2006 NY Slip Op 52579(U), ¶ 7, 14 Misc. 3d 1236(A), 1236A, 836 N.Y.S.2d 501, 501 (Sup. Ct. 2006) ("The failure to permit the contractor the contractual cure period . . . along with the requisite certificate from the Architect . . . before termination, renders the termination wrongful."); and *Stonington Water St. Assoc., LLC v. Hodess Bldg. Co.*, 792 F.

Following the Architect's certification, the Owner must give the Contractor, and the Contractor's surety, if any, **seven days**' written notice of the events justifying termination.[53] Then, and only then, may the Owner terminate the contract and, "subject to any prior rights of the surety," undertake one of the following remedies: (1) exclude the Contractor from the project and take immediate "possession of all materials, equipment, tools, and construction equipment and machinery thereon owned by the Contractor;" (2) accept assignment of certain subcontracts as set forth in Section 5.4; or (3) finish the contract work.[54] If the Owner decides to finish the work, it must provide to the Contractor, upon the Contractor's written request, a detailed accounting of the costs it incurred.[55]

h. Section 14.3 - Suspension by the Owner for Convenience

Short of terminating the Contractor for cause, Section 14.3 establishes the Owner's right to suspend, delay or interrupt the work for the Owner's convenience and without cause. Section 14.3.1 specifically provides the Owner the right, upon written notification, to "suspend, delay or interrupt the Work in whole or in part for such period of time as the Owner may determine." The Commentary warns, however, that "repeated suspensions, delays or interruptions may be grounds for termination by the contractor under Section 14.1.2."[56] In such event, Section 14.3.2 requires the Owner compensate the Contractor by an adjustment to the contract sum and contract time.

i. Section 14.4 – Termination by the Owner for Convenience

As a corollary to Section 14.3, Section 14.4 establishes the Owner's right to terminate the contract for the Owner's convenience, without cause. This provision, unlike the others, contains no time period for when the Owner is to furnish written notice, and does not require architect certification.[57] In addition, "[t]he termination need not list any specific reason, and such a termination will not constitute a wrongful termination so long as it was not done in bad faith."[58]

If terminated solely for the Owner's convenience, the Contractor "shall be entitled to receive payment for Work executed, and costs incurred by reason of such termination, along with reasonable overhead and profit on the Work not executed."[59] This provision is "intended to compensate a contractor who is terminated solely for the owner's convenience for the monies to which the contractor would have been entitled (less the actual cost of completing the work) had the termination not occurred."[60]

j. Section 15 – Claims and Disputes

Section 15 of the General Conditions pertains to written notice of a "Claim," which is defined as "a demand or assertion by one of the parties seeking, as a matter of right, payment of money, or other relief with respect to the terms of the Contract," or "other disputes and matters in question between the Owner and Contractor arising out of or relating to the Contract."[61] Section 15.1.2 requires that claims be made by written notice to the other party and to the "Initial Decision Maker" (the Architect, unless otherwise specified in the contract), and that such be provided within twenty-one days of either the occurrence of the event or recognition of the

Supp. 2d 253, 263-67 (D. Conn. 2011) (holding owner's "failure to terminate [contractor] when reason to do so arose and then to properly comply with the notice procedures set forth in section 14.2.2," including, among other things, the obligation to obtain architect's certification, "is a material breach of the bond and underlying contract.").

[53] § 14.2.2, AIA Document A201-2007.

[54] *Id.*

[55] *Id.*

[56] AIA Document Commentary, supra note 2, at 54.

[57] § 14.4.1, AIA Document A201-2007; *DJB Bldg. & Constr., LLC v. Parkville Plaza, LLC*, No. CV085025762, 2009 Conn. Super. LEXIS 2621, at *13 (Super. Ct. 2009) (explaining, "unlike in a termination for cause, an architect does not need to certify the grounds for terminating the contract" for convenience).

[58] *See* Sabo, supra note 13, at 513; *see also 400 15th St., LLC v. Promo-Pro, Ltd.*, 2010 NY Slip Op 51580(U), ¶ 8, 28 Misc. 3d 1233(A), 1233A, 960 N.Y.S.2d 341 (Sup. Ct. 2010) (holding owner could properly convert termination for convenience into termination for cause, which would be binding on surety, so long as sufficient cause exists and owner independently complies with notice requirements for termination for cause).

[59] § 14.4.3, AIA Document A201-2007.

[60] AIA Document Commentary, supra note 2, at 55.

[61] § 15.1.1, AIA Document A201-2007.

condition giving rise to the claim, whichever is later.[62]

Specifically with regard to claims for additional costs, Section 15.1.4 mandates that the Contractor provide written notice "before proceeding to execute the Work."[63] Similarly, Section 15.1.5.1 requires the Contractor provide written notice of any claim for an increase in the Contract Time, which must include "an estimate of cost and of probable effect of delay on progress of the Work."[64]

III. The Surety and Incorporation of the Contract by Reference

Recently, the Eleventh Circuit Court of Appeals weighed in on the strict compliance with bond and contract notice provisions. In *Int'l Fid. Ins. Co. v. Americaribe-Moriarty JV*,[65] the issue surrounded the Contractor's purported failure to comply with certain notice requirements under the bond and subcontract. There, Americaribe-Moriarty JV ("Americaribe") entered a subcontract ("Subcontract") with Certified Pool Mechanics 1, Inc. ("CPM") for certain pool work at the Brickell CityCentre Super Structure in Miami ("Project").[66] International Fidelity Insurance Company and Allegheny Casualty Company (collectively, "Fidelity"), issued a performance bond[67] on CPM's behalf, which expressly incorporated the Subcontract by reference ("Bond").[68] Importantly, the Subcontract required three days' notice of termination before Americaribe could complete the Project on its own.[69] The Bond also included certain provisions pertaining to, among other things, Americaribe's requirement to provide notice in the event of any declaration of default against CPM, and Americaribe's obligation to provide seven days' notice to Fidelity of its failure to timely act before Americaribe could enforce other remedies.[70]

Performance issues arose regarding CPM's work, and Americaribe issued a notice of default to CPM and Fidelity in accordance with its notice requirements under the Bond.[71] Americaribe then sent CPM and Fidelity a letter officially terminating CPM, and agreeing to pay the balance of the contract price.[72] However, Americaribe contracted with another party, Dillon Pools, Inc. ("Dillon"), to complete CPM's subcontract work, prior to the expiration of the time for Fidelity to respond.[73] After Dillon already began work, Americaribe sent the seven-day notice to Fidelity as to its purported failure to act after CPM's default.[74] Fidelity responded, notifying Americaribe that its actions discharged Fidelity's Bond obligations.[75] Americaribe responded in turn by declaring Fidelity in default for not acting with reasonable promptness following CPM's default.[76] Fidelity formally denied the claim and brought a declaratory judgment action, seeking to establish that Americaribe failed to satisfy the conditions precedent under the Bond, and that Americaribe breached the Bond.[77] The district court agreed and granted Fidelity's motion for summary judgment. Americaribe appealed.[78]

On appeal, the Eleventh Circuit agreed that Americaribe was obligated to comply with both the Subcontract's as well as the Bond's notice provisions.[79] Specifically, the Subcontract required three days' notice before Americaribe could undertake to complete the work, and the Bond provided Fidelity an undefined period of time to choose among four options to undertake the work itself after Americaribe complied with its Bond obligations.[80] The Eleventh Circuit highlighted the fact that this "undefined period of time" was followed by yet another Subcontract notice requirement that obligated Americaribe to provide seven days' notice before Fidelity could be held in default.[81] Because Americaribe failed to comply with these notice requirements prior to hiring Dillon, it stripped Fidelity of its

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[62] § 15.1.2, AIA Document A201-2007.
[63] § 15.1.4, AIA Document A201-2007.
[64] § 15.1.5.1, AIA Document A201-2007.
[65] 2017 U.S. App. LEXIS 3628 (11th Cir. 2017).
[66] *Id.* at *1-2.
[67] The performance bond Fidelity issued on CPM's behalf was an AIA A312 Performance Bond.
[68] 2017 U.S. App. LEXIS 3628, at *3.
[69] *Id.* at *2-3.
[70] *Id.* at *3-5.
[71] *Id.*at *5.
[72] *Id.*
[73] *Id.* at *5-7.
[74] *Id.* at *6.
[75] *Id.*
[76] *Id.*
[77] *Id.* at *6-7.
[78] *Id.*at *7.
[79] *Id.* at *8-10.
[80] *Id.* at *10.
[81] *Id.*

bargained for rights, relieving it of any Bond liability.[82]

This same issue was before the court in *Stonington Water St. Assoc., LLC v. Hodess Bldg. Co.*[83] There, Stonington Water Street Assoc., LLC ("Stonington") entered into a construction contract (which included the same General Conditions discussed above), with Hodess Building Company, Inc. ("Hodess"), for a condominium in Stonington, CT. National Fire Insurance Company of Hartford ("National Fire") issued the performance bond[84] on Hodess's behalf, which incorporated the contract by reference.[85] Once construction began, the project suffered a number of difficulties including delays and Hodess's financial abilities to pay subcontractors.[86] After Hodess continued to experience performance and payment issues, it eventually ceased work and Stonington opted to hire three of Hodess's employees to complete the work.[87] Nearly two months later, Stonington notified National Fire that it was terminating Hodess and declaring a contractor default pursuant to the performance bond. Seven days later, it notified National Fire that it was responsible to complete "Hodess's contractual obligations, namely warranty work and any additional expenses incurred by Stonington arising out of Hodess's defaults and delays."[88] National Fire, in turn, disputed its liability on the basis that Stonington failed, among other things, to comply with the contract and bond notice provisions. Stonington eventually sued both Hodess and National Fire.[89]

National Fire moved for summary judgment "on the limited issue whether Stonington complied with the conditions precedent to invoking coverage under the bond."[90] It argued, among other things, that Stonington failed to satisfy its conditions precedent under the bond following Hodess's default.[91] The court considered whether Stonington properly declared Hodess in default under Section 14.2 of the General Conditions discussed above.[92] Reading the bond and contract together, the court reasoned that Stonington had to obtain written certification from the architect that sufficient cause existed to justify the termination, and provide Hodess and National Fire seven days' written notice informing them that cause existed to justify Hodess's termination.[93] Only upon the expiration of those seven days could Stonington terminate Hodess.[94]

National Fire did not dispute that Hodess breached the contract by abandoning the project, but instead, it argued that the breach did not excuse Stonington's obligation to comply with the contract's termination provisions.[95] The court concluded that Stonington did not notify Hodess and National Fire that cause existed and that it was terminating the contract, and failed to provide National Fire seven days' notice of its obligation to perform on Hodess's behalf.[96] Regardless of whether National Fire had notice of Hodess's performance issues, "that fact does not equate to providing the surety with actual notice of default."[97] Thus, Stonington's failure to properly terminate Hodess and provide the requisite notice prior to hiring successor contractors was a material breach of the bond and underlying contract, thereby discharging National Fire's bond obligations.[98] The court granted summary judgment in National Fire's favor and dismissed it from the case.

IV. Legal Authority on the Effect of the Failure to Provide Requisite Notice

In *Underwater Eng'g Servs. v. Util. Bd.*,[99] Florida's Third District Court of Appeal considered, among other things, the effect of an owner's failure to provide contractually-required notice and opportunity to cure certain defective construction work before hiring a different contractor to correct and repair the work. There, Underwater Engineering Services, Inc. ("Underwater") contracted with the Utility Board of the City of Key West ("Board") to

[82] *Id.* at *13.
[83] 792 F. Supp. 2d 253 (D. Conn. 2011).
[84] The performance bond National Fire issued on Hodess's behalf was an AIA A312 Performance Bond. *Id.* at 255.
[85] *Id.* at 263.
[86] *Id.* at 258.
[87] *Id.*at 259.
[88] *Id.*
[89] *Id.*
[90] *Id.* at 261.
[91] *Id.*
[92] *Id.* at 263-64.
[93] *Id.* at 264.
[94] *Id.*
[95] *Id.*
[96] *Id.* at 264-65.
[97] *Id.* at 266.
[98] *Id.* at 267.
[99] 194 So. 3d 437 (Fla. 3d DCA 2016).

perform certain maintenance and repairs to concrete and steel poles.[100] Disagreements arose as to Underwater's performance on the project, with the Board refusing to pay it for work it performed, which led to Underwater filing suit against the Board for breach of contract.[101] The Board, in turn, asserted a counterclaim against Underwater, arguing that Underwater defectively performed a portion of its work.[102] Underwater defended arguing that "despite the contract language, the [Board] never provided Underwater with the opportunity to cure" the defective work as it was contractually obligated to do prior to engaging another contractor to correct, repair or replace the work.[103] After a nonjury trial, the trial court entered judgment against Underwater on both its breach of contract claim, and awarded judgment to the Board on its counterclaim against Underwater for breach of contract. Underwater appealed.[104]

On appeal, as to the Board's counterclaim against Underwater for breach of contract, Florida's Third District Court of Appeal agreed with Underwater's position as to the notice and opportunity to cure requirements.[105] The court concluded that the uncontested evidence at trial established the Board's failure to provide Underwater with notice and opportunity to cure its purportedly defective work.[106] Thus, the court held that the trial court erred in finding in favor of the Board on its counterclaim against Underwater and awarding it damages.[107] The court reversed and remanded for entry of final judgment in Underwater's favor.

Other courts have likewise held that an owner's failure to provide the requisite notice, or failing to obtain the architect's certification as to termination for cause constitutes a breach of contract.[108]

Just as an owner's failure to provide the required written notice may be fatal to its claims against the contractor, a contractor's (and the surety's in takeover) similar failure may be fatal to its claims. The Eighth Circuit Court of Appeals weighed in on this issue in *Cameo Homes v. Kraus-Anderson Constr. Co*.[109] There, Cameo Homes contracted with the City of East Grand Forks ("City") to perform certain concrete work on four construction projects following a severe flood.[110] Kraus-Anderson Construction Company ("Kraus") served as the construction manager on those projects. Each of Cameo Homes' contracts incorporated the standard General Conditions discussed above, which included the requirement that "change orders" be signed by Kraus, the City, the project architect, and Cameo Homes. In addition, like the General Conditions discussed above, "claims," distinguished from "change orders," were to be presented to the architect within twenty-one days of the event or discovery giving rise to the demand.[111]

During the course of its work on several projects, Cameo Homes experienced delays and additional costs for work excluded from the contract.[112] Specifically, Cameo Homes asserted that it incurred significant overtime expenses having to work to complete one project on schedule despite delays caused by other contractors, costs to remove and repour concrete as a result of defects in the City's blueprints, and costs to install certain fire treated lumber not required under the contract, among other things.[113] Cameo Homes ultimately sued the City and Kraus, though it did so without first giving written notice of its claims to the architect on the project.[114] The trial court entered summary judgment on the basis that Cameo Homes failed, among other things, to

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[100] *Id.* at 438.
[101] *Id.* at 442.
[102] *Id.*
[103] *Id.* at 443.
[104] *Id.*
[105] *Id.* at 445-46.
[106] *Id.* at 446.
[107] *Id.*
[108] *See Bouchard*, 1999 Conn. Super. LEXIS 1285, at *16 (holding owner's termination of contractor without providing required seven days' written notice constituted a material and substantial breach of the contract); *Mike Bldg. & Constr., Inc.*, 901 N.Y.S.2d at 468-70 (holding owner's failure to provide notice and opportunity to cure, and failure to obtain and provide architect's certification, constituted a material breach of the contract); *and Paragon Restoration Group, Inc. v. Cambridge Sq. Condominiums*, 836 N.Y.S.2d 501 (holding owner's failure to obtain appropriate certificate from architect and failure to provide notice and time to cure, as conditions precedent to termination for cause, constituted breach of contract entitling contractor to summary judgment on issue of owner's liability).
[109] 394 F. 3d 1084 (8th Cir. 2004).
[110] *Id.* at 1085.
[111] *Id.*
[112] *Id.* at 1086.
[113] *Id.*
[114] *Id.*

give proper notice as a condition precedent to initiating its lawsuit.[115]

On appeal, Cameo Homes argued that the claims submittal process was the same as the change order process, and that its submission of change order requests to Kraus was "effectively equivalent to submission of claims to the architect."[116] The court, however, disagreed, and concluded that Cameo Homes wrongfully equated the change order process, "designed to modify the terms of an agreement, with the claims process, designed for the assertion of rights under the existing terms of an agreement."[117] Thus, because Cameo Homes failed to provide written notice to the architect of its breach of contract and negligence claims, it was barred from bringing such claims in the instant lawsuit.[118]

V. Conclusion

Though the various provisions of the A201-2007 General Conditions are not, at first glance, terribly complex, determining what events properly give rise to a party's notice requirements, and the time period within which one must provide notice before undertaking a certain course of action, can often be time consuming and perplexing, especially when the main focus of parties is to simply finish the project. The various notice and claim requirements cut both ways. Just as a contractor or surety should look to the terms and conditions of the contract documents to verify that the owner has complied with the notice requirements and waited the appropriate time before terminating and/or taking over a project, an owner will look to the terms and conditions to verify that a contractor has complied with the strict notice requirements for additional money or time. And, in the takeover context, especially when the obligee refuses to enter into a takeover agreement, it is imperative that the surety and its consultants read and fully understand the notice requirements of the bonded contract. Failure to do so can be detrimental, even fatal, to one's claims or planned course of action.

[115] *Id.* at 1087.
[116] *Id.*
[117] *Id.*
[118] *Id.* at 1087-88.

Surety Casenotes

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

Surety Denied Contractual Indemnification Claim Because Principal was Not a Signatory to Indemnity Agreement

Star Ins. Co. v. Reginella Constr. Co. Ltd., 685 F. App'x 118 (3d Cir. 2017).

Reginella Construction Company LTD ("Reginella"), among others, executed an indemnity agreement in favor of the surety. Thereafter, one of Reginella's apparent affiliates, Reginella Construction Company ("Reginella Corp"), entered into a contract with a school district. The surety issued performance and payment bonds on behalf of Reginella Corp in connection with the contract. After receiving claims under the bonds, the surety commenced litigation against both Reginella and Reginella Corp seeking to enforce the surety's rights under the indemnity agreement. The indemnitors moved to dismiss on the grounds that the indemnity agreement only applied to bonds issued on behalf of Reginella and the subject bonds were issued on behalf of Reginella Corp. The district court granted the indemnitors' motion and the appeals court affirmed, holding that since the indemnity agreement was unambiguous, the court could not consider extrinsic evidence regarding the parties' intentions. The court also rejected the surety's common law exoneration claim because the surety's obligation had not yet become absolute.

Cause of Action Under Indemnity Agreement Accrues at Time of Payment; Surety's Reservation of Rights under Indemnity Agreement in Subsequent Settlement Agreement Preserves Surety's Rights under Indemnity Agreement

Great Am. Ins. Co. v. Nelson, Inc., 2017 WL 1417378 (W.D. Tenn. April 20, 2017).

The surety entered into a settlement agreement with its indemnitors, which provided for the indemnitors to make monthly payments to reimburse the surety for losses sustained on account of the principal's default on a military contract and to assist the surety in collecting remaining contract funds. The indemnitors failed to make full payments to the surety as set forth in the agreement. Subsequently, the Armed Services Board of Contract Appeals found that the Army Corps of Engineers improperly terminated the contract and paid the principal over $200,000. The surety commenced an action for breach of the indemnity and settlement agreements.

In opposing the surety's motion for summary judgment, the indemnitors argued, among other things, that: (i) the claims were allegedly time-barred, and (ii) the indemnity agreement merged into the settlement agreement, thus precluding claims thereunder. The indemnitors argued that the statute of

limitations had run from the time the principal was defaulted under the bonded contract, which was over six years from the time the surety had commenced suit. The court rejected this argument, holding that the statute of limitations did not begin to run until the surety actually incurred losses. The court similarly rejected the indemnitors' merger argument because the parties to the settlement agreement were not identical to the parties that signed the indemnity agreement, and the surety specifically reserved its rights under the indemnity agreement in the settlement agreement.

District Court in Nebraska Denies Surety's Motion for Preliminary Injunction Compelling Deposit of Collateral

Allied World Specialty Ins. Co. v. Abat Lerew Constr., LLC, 2017 WL 1476131 (D. Neb. April 24, 2017).

The surety commenced this action against its indemnitors seeking, among other things, specific performance of the indemnitors' obligation to deposit collateral to discharge claims that had been asserted against the surety on a payment bond and a performance bond. The surety also requested that the court enjoin the indemnitors from transferring or otherwise disposing of their assets until the indemnitors deposit the collateral. The indemnitors opposed the surety's application for a preliminary injunction, arguing that the surety had not yet actually incurred a loss, thus rendering any loss as speculative, and that there was no evidence that indemnitors had absconded or dissipated assets to avoid their obligations under the indemnity agreement.

The court denied the surety's motion for a preliminary injunction holding that it had not shown that "it will be irreparably harmed by denial of…injunctive relief" or "the defendants are insolvent or disposing of or secreting assets." In deciding the motion, the court observed that the surety "has not met the heavy burden it faces where, as here, granting the preliminary injunction will effectively give it substantially the relief it would obtain after a trial on the merits." Although the court observed that the surety did demonstrate "some probability of success on the merits of its claims," the court found that "the cases that grant specific performance of a collateralization clause generally involve motions for summary judgment and a full development of the record." The court noted that its analysis may have been different if the surety had argued that it lacked the funds to pay the bond claims or that the injury sustained by the indemnitor's failure to provide collateral could not be compensated with money damages.

Surety Not Liable to its Principal or Indemnitors for Bad Faith under Arizona Law

Allegheny Cas. Co., v. Vedadi, 2017 WL 1550481 (D. Ariz. May 1, 2017).

The surety issued a number of performance and payment bonds on behalf of its principal. The surety received a number of claims under the bonds, which it did not pay. The surety commenced an action against the indemnitors seeking indemnity pursuant to the terms of the indemnity agreement. The indemnitors asserted counterclaims for breach of the covenant of good faith and fair dealing and bad faith. The surety moved for a judgment on the pleadings to dismiss the indemnitors' bad faith claims.

Although the surety conceded that, under Arizona law, a surety can be liable in bad faith to an owner, the surety argued that no court had ever held, or would hold, that a surety could be a liable in bad faith to its principal or indemnitor. The court agreed, observing that Arizona case law recognized a tort bad faith action brought by an obligee under the bond because the obligee contracted for security rather than for profit or commercial advantage. On the other hand, the court stated that "it is irrefutable that the reason [the principal] contracted for the performance and payment bonds was for profit or commercial advantage." The court thus concluded that, under Arizona law, a surety cannot be liable in bad faith to its principal. The court also held that "for the same reasons that bad faith tort liability cannot lie based on the surety-principal relationship, neither can it lie based on any special duties running from surety to indemnitor through an agreement of indemnity." The court aptly observed that "it is the surety who looks to the indemnitor for indemnification, not the other way."

Surety's Motion to Compel Unfettered Access to Project Site Denied Because it Had Already Denied the Claim

Hunt Constr. Group, Inc. v. Cobb Mech. Contractors, Inc., 2017 WL 2199014 (W.D. Tex. May 18, 2017).

Hunt Construction Group, Inc. ("Hunt"), the general contractor on a project to construct a hotel, entered into a subcontract with Cobb Mechanical Contractors, Inc. ("Cobb") for the project's plumbing, piping and HVAC work on the podium and tower portions of the project. In July 2016, Hunt issued a series of default notices to Cobb and in November 2016 terminated Hunt's subcontract with regard to the podium portion of the project. At the same time, Hunt notified the surety of the termination and stated that it intended to arrange for another contractor to complete Cobb's subcontract with respect to the podium portion of the subcontract.

Beginning in early September 2016, prior to Cobb's partial termination, the surety and its consultant began visiting the project site to gather information, as a result of Hunt's notices of default. Based on a report provided to the surety's counsel by the consultant, which attributed fault for various delays to Hunt, not Cobb, the surety denied Hunt's claim under the performance bond. Given that the claim on the bond was denied, Hunt notified the surety that it would no longer permit the surety unrestricted access to the site, and set significant conditions on any visits by the surety. The surety filed an emergency motion seeking to compel access to the site.

The surety contended that it was entitled to continued access to the site because Hunt has continued to send Cobb notices contending that Cobb is in default under its subcontract with regard to Cobb's continuing work on the tower, and the surety must be allowed to investigate those allegations. The surety further alleged that Hunt was blocking access to the site to hamper the surety's investigations and hide Hunt's mistakes. Hunt countered, among other things, that allowing the surety daily unfettered access to the site is dangerous and that Hunt had not made a demand on the performance bond with regard to Cobb's work on the tower.

The court denied the surety's motion because the parties were engaged in litigation with respect to the denial of Hunt's claim relating to the podium portion of the contract and the surety had not served a formal discovery request upon Hunt seeking access to the site. The court held that "once [the surety] denied Hunt's claim, [the surety's] rationale for needing access to adjust the claim disappeared." With respect to Hunt's notices relating to the tower portion of the project, the court held that because a claim had not been submitted on the bond, the surety could not justify a demand for access to the tower. Notwithstanding the foregoing, since Hunt previously indicated that it would agree to permit the surety to access the site, albeit subject to several conditions, the court entered an order permitting the surety to visit the site subject to the conditions imposed by Hunt.

Court Grants Specific Performance of Collateral Deposit Provision, Finding that Surety Will Suffer Irreparable Harm if Provision Not Enforced as Written

Travelers Cas. & Sur. Co. of Am. v. C.R. Calderon Constr., Inc., 2017 WL 2256600 (D. Md. May 22, 2017).

A judgment in the amount of $207,599.34 was entered against a surety and its principal, C.R. Calderon Construction, Inc. ("Calderon"), on account of unpaid wages on a federal project. In accordance with the collateral security provision in the indemnity agreement, the surety demanded that the indemnitors provide collateral in the amount of $228,359.27, which represented the amount necessary for the surety to post a *supersedeas* bond to stay the judgment pending appeal. The surety also asserted a contractual indemnification claim for attorney's fees incurred to date. After the indemnitors failed to provide the requested collateral and reimburse the surety for its legal fees, the surety commenced litigation and moved for a preliminary injunction requiring specific performance of the indemnitors' obligation to post collateral security. The indemnitors opposed the application, arguing, among other things, that the indemnity agreement did not cover the posting of a *supersedeas bond* and that the collateral security provision did not provide specific performance as a remedy.

The court granted the surety's application for a preliminary injunction, finding that the surety is likely to succeed on the merits of its claim that the indemnitors breached the terms of the collateral security provision of the indemnity agreement. The court held that the

surety was not asserting that the indemnitors' obligations were tied to the issuance of a *supersedeas* bond. Rather, the surety argued, and the court agreed, that the amount of the *supersedeas* bond adequately reflected the sum the surety was entitled to as collateral security. The court rejected the indemnitors' claims that the collateral security obligation accrues only when there is an actual loss because the collateral security provision provided that it is triggered based on an actual or anticipated loss. In addition, the indemnity agreement provided that the surety "shall be entitled to specific performance of the terms of this Agreement", without exception. The court also found that the surety would suffer irreparable harm because "[w]ithout specific performance, the collateral security provision of an indemnity agreement would essentially be rendered a nullity, a result that runs contrary to basic precepts of contract construction." Finally, the court found that the equities tipped in the surety's favor.

Court Holds that Question of Whether Contract Funds Covered by Letters of Direction are Subject to Levy Potentially Precludes the IRS from Extending Benefit of Statute Immunizing Stakeholder of Such Funds

Fid & Dep. Co. of Md. v. Ohio Dep't of Transp., 2017 WL 2303673 (S.D. Ohio May 4, 2017), *adopted* 2017 WL 2289386 (S.D. Ohio May 25, 2017).

Cosmos Industrial Services, LLC ("Cosmos") entered into several contracts with the Ohio Department of Transportation ("ODOT"). Each of those contracts required that Cosmos provide performance and payment bonds. In late August 2015, Cosmos advised the surety that it was no longer able to meet its payroll obligations on its bonded projects. The surety agreed to provide financing to Cosmos, provided that Cosmos execute letters of direction wherein Cosmos directed CDOT to pay the surety any funds that would otherwise be due Cosmos on the bonded projects. The surety began advancing financing on or about September 1, 2015.

On October 26, 2015, the IRS issued a Notice of Levy to DOT, relating to taxes allegedly owed by Cosmos for the tax year ending December 31, 2013. The IRS issued an Amended Notice of Levy covering the tax periods ending December 31, 2014 and March 31, 2015. The surety filed an action seeking, among other things: (1) a declaratory judgment that the surety was entitled to the funds, (2) an order directing ODOT to deposit the funds with the court in return for a dismissal from any further obligation to comply with the Levy or Amended Levy, and (3) the funds were not owed to Cosmos and were thus not subject to levy.

The IRS opposed the application for ODOT to deposit funds with the court on the grounds that ODOT could simply provide the funds to the IRS and, in accordance with federal law, be immunized from further liability. To the extent the IRS wrongfully levied upon the funds, the IRS argued that the surety could seek a return of the funds from the IRS. The court rejected the IRS's arguments, finding that the statute which immunizes a party which remits levied funds to the IRS only provides immunity to the extent the funds were "subject to levy". Although the court did not rule upon the surety's priority to the funds, the court noted the surety's argument that it has a superior interest in the funds (i.e., because Cosmos did not have or obtain an ownership interest in the funds) called into question whether the contract funds were actually subject to levy. Accordingly, the court directed ODOT to deposit the funds into court.

Where Arbitration Tribunal's Rules Provide That Tribunal Has Authority to Determine Arbitrability and Such Rules Are Incorporated into Arbitration Agreement, Question Of Arbitrability Is to Be Decided by the Arbitration Tribunal

Portland Gen. Elec. Co. v. Liberty Mut. Ins. Co., 862 F.3d 981 (9th Cir. 2017).

Portland General Electric Company ("PGE") hired several related contracting companies (the "Contractor") to build an Oregon Power Plant. The subject construction contract (the "Contract") mentioned arbitration, but did not require it. The Contract required the contractor to obtain a performance bond (the "Bond"). The Bond incorporated the Contract by reference and stated that "any proceeding…under this Bond may be instituted in any court of competent jurisdiction…" The Bond is silent as to arbitration. The Contract also required that the Contractor obtain a guaranty of performance from a parent company, Abengoa S.A. ("Abengoa"). Abengoa

issued a guaranty to PGE (the “Guaranty”), in which both parties consented to submit any disputed “in connection with this Guaranty” to binding arbitration. The Guaranty further specified that arbitration is to be conducted by the International Chamber of Commerce (“ICC”) under its procedural rules and Oregon substantive law and that either party “may implead any other person or entity (with such person or entity’s consent) in, and/or raise any claim against, any other person or entity provided such claim arises out of or in connection with an agreement with a Subcontractor or this Guaranty”

PGE ultimately declared the Contractor to be in default and terminated the Contract. Abengoa subsequently filed a request for arbitration with the ICC, naming PGE as respondent and the Contractor as an impleaded party. Abengoa contended that the Contractor had not defaulted, PGE’s termination was wrongful and Abengoa owed nothing under the Guaranty. Abengoa subsequently filed a request for joinder, seeking to include the sureties in the arbitration. Abengoa sought a declaration that the sureties owed PGE nothing under the Bond. The sureties consented to the arbitration and sought similar relief. The sureties subsequently sent PGE a letter denying liability under the Bond.

PGE filed a diversity action in federal court against the sureties, alleging breach of the Bond and bad faith. PGE sought a preliminary injunction prohibiting the sureties from arbitrating their claims against PGE, claiming that Abengoa had improperly impleaded the Sureties. PGE also filed a jurisdictional objection before the ICC, arguing that “the entire arbitration is an improper and collusive effort orchestrated by Abengoa and its subsidiaries to drag into international arbitration claims that [PGE, the Sureties, and the Contractor] have agreed to litigate before the Oregon courts.” In the district court, the sureties opposed the motion to enjoin arbitration, arguing, *inter alia*, that “by virtue of PGE’s selection of the ICC Rules, it has expressly agreed that the arbitrator shall decide questions of arbitrability,” and that it is up to the ICC tribunal to decide whether Abengoa validly joined the Sureties and for what purposes. The sureties then moved to stay the litigation pending the resolution of the ICC arbitration, invoking both the mandatory stay provision of the Federal Arbitration Act (“FAA”) and the court's inherent authority to manage its docket. The district court refused to stay the litigation and granted the preliminary injunction, finding that the parties never agreed to arbitrate the dispute. The sureties appealed.

On appeal, PGE did not dispute the validity of the arbitration clause in the Guaranty—only its scope. PGE argued that the impleader provision and its acceptance of the ICC procedural rules in the Guaranty did not extend to the resolution of its dispute with the impleaded sureties. The court reversed the district court’s ruling, holding that, although questions of arbitrability are typically considered “gateway” issues that are to be decided by a court, the parties can and did delegate these issues to the ICC by virtue of the incorporation of the ICC procedural rules, which provide that the arbitration tribunal is empowered to determine questions of arbitrability, into the Guaranty. The appeals court thus stated that “whether Abengoa properly joined the sureties to the arbitration pursuant to the Guaranty and the ICC Rules, whether the sureties’ claim against PGE meets the Guaranty’s test of arising out of or in connection with an agreement with a Subcontractor or the Guaranty, and whether PGE has therefore agreed to arbitrate its dispute against the Sureties, are questions of the scope of the arbitration agreement in the Guaranty, delegated to the arbitrators.” The court further stated that the district court erred in denying the sureties a temporary stay of the litigation.

Reverse False Claims Liability May Be Extended to a Surety Where, Through Its Agent, the Surety Becomes Aware of Its Principal's Fraudulent DBE Scheme, but Nevertheless Continues to Issue Bonding

Unites States ex rel Scollick v. Narula, 2017 WL 3268857 (D.D.C. July 31, 2017).

In a case of first impression, a U.S. District Court judge, sitting in the District of Columbia, recently ruled that reverse false claims liability, and the potential for treble damages in connection therewith, can extend to a surety where its agent became aware of its principal’s alleged fraudulent participation in a government set-aside program and nevertheless continued to issue Miller Act bonds on behalf of the principal.

Plaintiff-relator Andrew Scollick alleged that a number of individuals engaged in a scheme to fraudulently claim or obtain service-disabled veteran-owned small business ("SDVOSB") status, HUBZone status, or Section 8(a) status for certain companies to bid on and obtain set-aside contracts, when in fact the bidders did not qualify for the status claimed. The defendants are alleged to have falsely certified their status, made false claims regarding past performance, hid certain aspects of the management and control of the companies at issue, and hid or falsified certain information regarding the employees of the companies at issue. Some of the defendants established a number of "front companies", including Centurion Solutions Group, for the purposes of allowing them to bid on and obtain SDVOSB set-aside contracts. To qualify for SDVOSB status, one of the defendants, Amar Gogia (who is a service-disabled veteran), was falsely identified as a 100% service-disabled owner of Centurion even though he did not actually exercise control or ownership over the entity. Centurion secured millions of dollars of government contracts. One of the defendants, Neil Parekh, established another entity, Citibuilders Solutions Group, to branch out his fraudulent SDVOSB contracting activity. Parekh falsely certified Citibuilders as a service-disabled veteran-owned entity, utilizing defendant Melvin G. Goodweather's service-disabled veteran status, even though Parekh was the de facto owner and controller of Citibuilders. He is also alleged to have misrepresented Citibuilders' past performance and project personnel. Citibuilders similarly obtained millions of dollars in government contracts. There were a number of other entities and individuals involved in the alleged scheme. Plaintiff claimed that, to varying degrees, the individuals and the companies established by them were alter egos of each other.

With respect to the surety defendants, plaintiff alleged that the bond broker, allegedly serving as the sureties' agent and attorney-in-fact, had a long-standing relationship with Parekh and knew that the companies shared a single office and that parties, other than service-disabled veterans, were in functional control of one or more of the front companies. Plaintiff further alleged that the sureties, through their "agent", understood that the front companies shared common ownership, requiring corporate resolutions acknowledging this fact, and "deliberately disregarded this fact when issuing bonds in connection with the false certifications contained in the bidding proposals submitted to the government." On these facts alone, the court initially dismissed plaintiff's reverse false claims allegations against the sureties.

However, plaintiff subsequently amended its complaint and further alleged that, among other things, during the underwriting process, the sureties conducted an on-site inspection of one of the front company's offices, after which the sureties "necessarily understood that [Centurion] was a shell company dependent on the resources and capabilities and capital of [the other front companies] and the experience and knowledge and financial backing of Parekh, Narula, and Madan", and that underwriting and due diligence "would reasonably have revealed that [Centurion] did not possess the necessary construction history or financial capabilities to carry out the scope of the contracting activity ultimately undertaken in the name of [Centurion]." The Amended Complaint further alleged that the underwriting and due diligence reasonably led to the conclusions that "Parekh, Narula, and Madan exerted dominance and control over [Centurion]," that "Gogia lacked the skill, knowledge, resources, and past performance to engage in the scope of contracting activity undertaken by the [Centurion] conspirators," and that "[Centurion] was not a service-disabled small business operating out of Harrisonburg." The court held that these additional facts were "sufficient to allege that the [sureties] had knowledge of [Centurion's] and Citibuilders' fraud, i.e., that they were fraudulently asserting status as SDVOSBs…" and that the sureties "continued to do business with [Centurion] and Citibuilders even though they were aware that [they] were committing fraud."

Under 31 U.S.C. § 3729, "knowingly mak[ing], us[ing], or caus[ing] to be made or used, a false record or statement material to an obligation to pay or transmit money or property to the Government, or knowingly conceal[ing] or knowingly and improperly avoid[ing] or decreas[ing] an obligation to pay or transmit money or property to the Government," violates the False Claims Act. Reverse false claims occur when "the defendant's alleged deception results in no payment to the government when a payment is obligated. In contrast to typical false

claims actions, a typical reverse false claim action involves a defendant knowingly making a false statement in order to avoid having to pay the government when payment is otherwise due." Plaintiff argued that, in issuing Miller Act bonds, the sureties:

> agreed to compensate the government for losses sustained should the specifications found in the contract, including the specification that the construction activity be paid a service-disabled, veteran-owned small business entity, fail to occur. The [sureties] exercised due diligence to obtain facts from the other defendants that the [sureties] knew or should have known violated the government's service-disabled, veteran-owned contracting requirements. For example, each time the [sureties] knew that the government made a payment that violated the service-disabled, veteran-owned specification they knowingly avoided an obligation to compensate the government for that loss. The [sureties] also knowingly concealed information and committed other acts that facilitated the fraudulent scheme and caused the other defendants to violate the FCA.

The court agreed that plaintiff plead a viable theory of liability, noting that the Miller Act bonds "were separate instruments entered between the United States government [and the sureties] and although submitted with the contract, did separately obligate the [sureties] to compensate the government for losses sustained if the specifications found in the contract, including the specification that the construction activity be paid a service-disabled, veteran-owned small business entity," were not followed.

Fidelity Casenotes

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

<u>No Ownership Interest In Stolen Funds</u>

3M Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh, 858 F.3d 561 (8th Cir. May 31, 2017)

The insured placed assets from an employee benefits plan into a trading company in which it held a limited partnership interest, and used investment advisors to make investments in hopes of gaining earnings on those assets. Unbeknownst to the insured, the investment advisors perpetrated a fraudulent scheme and stole funds. The general managing partners for the investment advisors pled guilty to federal criminal charges, and subsequent civil suits resulted in seizure of assets that they held. The court placed the seized assets into receivership and distributed them among defrauded claimants, including the insured. The insured ultimately recovered its capital contributions, but claimed that it also should recover lost earnings that legitimate investments produced. The insured sought coverage for the lost earnings under its commercial crime policies. The insurers denied the claim on the grounds that the insured lacked an ownership interest in the stolen funds. The insured filed suit in state court in Minnesota, and the insurers removed to federal court on diversity grounds. The parties cross-moved for summary judgment

and the District Court granted judgment in favor of the insurers. The insured appealed.

Applying Minnesota law, the Court of Appeals affirmed the District Court's ruling. The District Court determined that the trading company owned the earnings until it distributed those earnings to the insured partners, and as a result, the insured could not satisfy the ownership provision of the underlying policy. On appeal, the insured argued that the policy's failure to define the term "other property" in the Employee Dishonesty coverage grant to mean the insured's property meant that the ownership provision did not apply to the coverage grant. The insured argued that the Court could read the term broadly to include certain property that the trading company held. The insured continued that its limited partnership interest in the trading company entitled it to share in the profits and receive distributions of the partnership, such as the earnings at issue in the claim, and that the policy should cover its loss of that property. The Court of Appeals held that the proffered interpretation was unreasonable and that the ownership provision applied to the Employee Dishonesty coverage grant for loss of other property. It then agreed with the District Court that, until the trading company distributed the earnings to the insured partners, the trading company continued to own them. The insured attempted to raise fiduciary-based arguments that the Court of Appeals likewise found unpersuasive. It held that the ERISA regulations define the nature and scope of fiduciary duties, but they do not alter commercial property rights and they do not affect the ownership nature of the trading partnership's assets.

Forgery on Document in Loan Package Containing a Negotiable Instrument

Harvard Sav. Bank v. Sec. Nat'l Ins. Co., 2017 WL 2560900 (N.D. Ill. June 12, 2017).

The United States Department of Agriculture operated the Business and Industry Guaranteed Loan Program designed to bolster the availability of private credit by guaranteeing loans for rural businesses. Under the program, private lenders would issue loans, and the government would guarantee a portion of the loan, depending on its size. Two individuals at a bank who administered loans under the program and one individual who worked at a private consulting company that aided businesses in obtaining loans under the program colluded to perpetrate a fraudulent scheme using this program. The three individuals created a private business and falsified documents to make the business appear legitimate. They submitted false documents to the Department of Agriculture to become certified as a non-traditional lender and began placing loans under the program. The company placed 26 loans ranging from $2,500,000.00 to $10,000,000.00 that appeared to be between 70 and 90 percent guaranteed by the government. Each loan package consisted of five separate documents executed together: A term note, a loan note guarantee, an assignment guarantee agreement, a loan originator's letter of attestation and a confirmation of settlement. Each loan was, in fact, fraudulent, with no money actually lent to any borrower. In fact, neither the borrowers existed nor the loans contained actual government guarantees; however, on their face, neither defect appeared obvious and the loan packages were appealing to potential investors on the secondary market. The company sold the loans to a registered investment advisor who thereafter noticed some inconstancies in the loan documents during a routine review. The advisor followed up with the Department of Agriculture, which confirmed that it had no record of the loans and never guaranteed them. The three individuals' $179 million Ponzi scheme came to light, and the advisor reported to the insured that it had invested $18 million of its money in this scheme. The insured filed a claim under its bond seeking coverage consideration under the Forgery and Alteration and the Securities coverage grants. The insurer denied the claim, and the insured filed suit in federal court in Illinois on diversity grounds. The insurer moved for partial summary judgment.

Applying Illinois law, the District Court denied the insurer's motion. The crux of the District Court's analysis focused on the negotiability of the documents that comprised the loan package. The District Court started with the premises that the "Court construes documents as a single agreement where the documents were executed at the same time." The District Court gave weight to the fact that the five separate documents were executed as a single transaction and would not exist apart from the other, electing to construe them as a single agreement. The District Court observed that Illinois has adopted the UCC and that

"negotiability is favored in the law." It then found that the term note contained all indicia of negotiability. For each loan, the term note was signed by a maker, albeit a maker that did not actually exist. It contained a promise to pay that was not conditional, but instead certain, despite other conditional terms in the document. It was payable at a definite time and payable to order or bearer. The District Court found that no party disputed that a forgery existed on at least some document in the loan package and thus held that the insured established a *prima facie* case for coverage under the bond. The District Court did not address whether the bond contained anti-bundling language or what impact such language would have on its analysis.

Social Engineering Scheme Covered Under Specific Language of Computer Fraud Insuring Agreement

Medidata Solutions, Inc. v. Fed. Ins. Co., 2017 WL 3268529 (S.D.N.Y. July 21, 2017).

The insured provides cloud-based services to scientists conducting research in clinical trials. The insured used the Google Gmail platform to send, receive and store company emails as part of its business. Among other things, the platform compared incoming email traffic for a company match and displayed information about the insured's employees, including names and photographs, as well as domain names, in email fields. A flaw in the platform's system allowed a fraudster to exploit it by using a computer code that masked the fraudster's external email address, manipulated computer data and allowed the fraudster to impersonate the victim, giving the impression that the email was authentic. An accounts payable employee received an email from a fraudster impersonating the insured's president. The email advised that the insured was finalizing an acquisition, an attorney would contact the employee, and the employee should comply with the attorney's demands. The attorney contacted the employee and demanded a wire. The employee explained the internal approval process, and the fraudster complied with it. The employee processed the wire request, and two individuals at the insured approved the wire transfer. The fraudster contacted the employee to process a second wire. One approver became suspicious about the second request and contacted the insured's president. The insured uncovered the scheme. The insured submitted a claim to its commercial crime carrier in connection with the loss from the first wire transfer and sought consideration under the Computer Fraud, Funds Transfer Fraud and Forgery coverage grants. The insurer denied the claim, and the insured filed suit in federal court in New York on diversity grounds. The parties cross-moved for summary judgment.

Applying New York law, the District Court granted the insured's motion. The District Court held that Computer Fraud coverage existed under the insurer's policy language because the facts established that the malicious computer code manipulated Google's systems into identifying the email as coming from the insured's computer and because the fraudster induced the insured into wiring the funds, a triggering event under the specific coverage grant. The District Court held that the malicious code embedded in the email transmission satisfied the insurer's definition of Computer Violation. It distinguished or found unpersuasive case law requiring a direct causal link. The District Court also held, without citation to authority, that Funds Transfer Fraud coverage existed. The District Court found compelling the facts that that the fraudster masked itself as an authorized representative, the fraudster directed the employee to initiate the wire and the employee would not have sent the wire but for the manipulation of the emails. The District Court opined that the employee's willingness to press the send button for the bank's transfer does not transform the bank wire into a valid transaction and reminded that "larceny by trick is still larceny." The District Court held that Forgery coverage did not exist because no Financial Instrument, as the policy defines that term, contains a Forgery.

Computer Fraud Coverage Does Not Cover Authorized Transfer of Funds

Am. Tooling Ctr., Inc. v. Travelers Cas. & Sur. Co. of Am., 2017 WL 3263356 (E.D. Mich. Aug. 1, 2017).

The insured tool and die manufacturer outsources some of its work to die manufacturing companies overseas. As part of its business practice with one overseas die vendor, the insured would issue purchase orders, and the vendor would manufacture the dies. The insured issued payment after receiving invoices

from the vendor for its work. The insured emailed the vendor requesting copies of outstanding invoices and received an email from a fraudster, purporting to be the vendor, containing invoices and directing payment to a new bank account. Without verifying the changed instructions, the insured sent payment to the new account, and the fraudster, not the vendor, received the payment. After the insured uncovered the fraudulent scheme, the insured submitted its loss to its insurer for consideration under its Computer Fraud coverage. The insurer denied the claim, and the insured filed suit in federal court in Michigan on diversity grounds. The parties cross-moved for summary judgment.

Applying Michigan law, the District Court granted the insurer's motion. The District Court held that the insured did not suffer a direct loss because a series of intervening acts occurred between when the insured received the fraudulent emails and when the insured made the authorized transfer of funds. The District Court observed that direct means "'immediate,' without anything intervening." Here, the insured verified production milestones, authorized the transfers and initiated the transfers without verifying bank account information, all of which precluded finding a direct loss. Relying on case law across the nation, the District Court also held that sending and receiving fraudulent emails did not constitute "the use of any computer to fraudulently cause a transfer." The District Court noted that the emails themselves do not cause the transfer of funds; rather, someone authorized at the insured transfers them based on information contained in the emails. The District Court considered the holding in *Medidata Solutions, Inc. v. Fed. Ins. Co.*, 2017 WL 3268529 (S.D.N.Y. July 21, 2017) rendered 11 days earlier and distinguished it from the language at issue in the present case, both because the coverage grant at issue in the *Medidata* case did not contain the direct loss language at issue in the policy here, and because the definitions of Computer Fraud in the respective policies differ in meaningful ways. Specifically, the Computer Fraud language at issue here does not permit coverage for a "fraudulently induced transfer."

LEGISLATIVE UPDATE

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

At this point of the 2017 legislative season, most state sessions have adjourned for the year and it was again a very active season for surety legislation. Below is a sampling of some of the laws that were adopted to include a few new professional license bonds and more Public Private Partnership (P3) enacting legislation. P3 laws continue to be a top priority for the surety industry and, as these new laws are introduced, the focus is on making sure the construction portion of the project is required to be bonded, since a P3 project is just a new vehicle for delivering public projects. In addition, contract surety issues arose in Arkansas, with an increase in the Little Miller Act bond threshold; Tennessee adjusted the amount of the public contract bond; and Oklahoma adjusted the tail on the bond for public transportation projects. In the area of commercial bonds, financial service professional license bonds continue to emerge and motor vehicle dealer bonds continue to be amended. For complete details on the aforementioned legislation and a sampling of other surety issues included in this article, please see the statutory section or bill number identified in the text and footnotes below.

Alabama

Money Transmitter License Bond

As of August 1st, Alabama law regulating businesses engaged as sellers and issuers of checks for compensation is repealed[1] and replaced by the, "Alabama Money Transmission Act."[2] Under the new law a person may not engage in the business of money transmission or advertise, solicit, or hold itself out as providing money transmission unless the person is licensed. As a condition of licensure, the person must maintain a surety bond, letter of credit, or other similar security in an amount determined by rule or order of the Alabama Securities Commission, but in no event less than $100,000 or the average daily outstanding obligations for money received for transmission in Alabama plus 50% of the average daily outstanding payment instrument and stored value obligations in Alabama, whichever is greater. Ultimately, the bond is capped at $5 million. A direct action on the bond is permitted and the surety must cover claims for a minimum of 5 years after the licensee ceases to provide money transmission in Alabama.

Arkansas

P3

Arkansas is the newest state to enact a P3[3] authorizing statute. A state agency, department, institution of higher education, a board, or a commission may enter into a P3 arrangement for public facility and infrastructure projects (except for State Highway and Transportation Department projects). The Arkansas Economic Development Commission and the Arkansas Development Finance Authority shall jointly promulgate regulations to define the guidelines and criteria related to the development of qualifying projects including, for construction projects, delivery of maintenance, payment, and performance bonds in an amount that may be specified by the public entity in the comprehensive agreement.

Increase in Bid Bond Threshold

House Bill 1595[4] was enacted increasing the bid bond threshold from $20,000 to $35,000. A bid on a public construction project is considered void unless accompanied by a corporate bid bond or cashier's check.

Money Transmitters' License Bond and Mortgage Service Provider – Tail Extension and State's Ability to Bring Action on Behalf of Claimants

The Arkansas legislature amended the money transmitter licensing bond provisions[5] and the mortgage service provider licensing bond provisions[6] to clarify the ability of a claimant to bring a direct action on the bond. Prior to these amendments, the bond was payable to the state to secure the faithful performance of the obligations of the licensee and the claimant could bring an action or the commissioner could bring an action on behalf of the claimant. References to the bond being payable to the state for the benefit of claimants and the commissioner's ability to maintain an action on behalf of the claimant have been removed. The aggregate liability of the surety to all persons remains limited to the penal sum of the bond. In addition, in reference to a mortgage service provider's license, a provision was added to require the bond to cover claims for at least 5 years after the licensee ceases to provide mortgage services in this state or longer if required by the commissioner.

Hawaii

Appraisal Management License Bond

Hawaii is the newest state to adopt an appraisal management registration law.[7] As part of the law, each appraisal management company applying for or renewing a registration must post a $25,000 surety bond in a form satisfactory to the director of commerce and consumer affairs. The aggregate liability cannot exceed the principal sum of the bond and the law permits a direct action on the bond. Cancellation of the bond can only occur after 90-days written notice to the Appraisal Management Company Registration Program.

[1] Ala. Code § 8-7-1, et seq. (Repeal effective: 8/1/2017).
[2] Ala. Code § 8-7a-1, et seq. (Effective: 8/1/2017).
[3] Ark. Code Ann. § 22-10-101, et seq. (S.B. 651).
[4] Ark. Code Ann. § 22-9-203.
[5] Ark. Code Ann. § 23-55-204 (H.B. 1799).
[6] Ark. Code Ann. § 23-39-505 (H.B. 1801).
[7] Haw. Rev. Stat. § 466K-A, et seq. (H.B. 50).

Kansas

P3

This law specifically requires a contractor in a P3 project that exceeds $100,000 to furnish performance and payment bonds for the full contract amount, if not otherwise required by state law. The law permits claimants under the bonds to recover attorney fees and related expenses.[8]

Maine

Motor Vehicle Dealer Bond

The bond amounts for a motor vehicle dealer were increased as follows: 0-50 sales increased from $5,000 to $25,000; 51-100 sales increased from $10,000 to $50,000; 101-150 sales from $15,000 to $75,000; and 151 and over from $20,000 to $100,000.[9]

Missouri

Electrical Contractor License Bond

Missouri adopted an electrical contractor licensing requirement.[10] An applicant for a statewide license must provide proof of liability insurance and post a bond with each political subdivision in which he/she will operate. The amount will be determined by each political subdivision.

Montana

Wind Generation Facility Decommissioning Bond

A wind generation facility will have to provide the Department of Environmental Quality with a decommissioning bond in an amount that will be determined by the department based on the character and nature of the site and the current market salvage value of the facility, as determined by an independent evaluator. The bond is conditioned on the faithful decommissioning of the wind generation facility. If the facility is repurposed, the owner is not required to provide a bond and any existing bond shall not be released until the repurposed facility reaches its 5th year of operation. There are exceptions to obtaining the bond and the owner can apply every 5 years to have the amount of the bond reduced. The department must also develop rules regarding the procedures for submitting bonds, criteria for releasing the bond, the use of the bond in the event the facility fails to decommission, and additional issues specified in the law.[11]

Nevada

P3

The legislature permits a public body with a population of 700,000 or less to enter into P3 arrangements for transportation projects, which include transit facilities. The P3 agreement may require payment and performance bonds in accordance with the Little Miller Act for the design and construction portion of the project. If additional security is needed, surety bonds, parent guarantees, letters of credit or other acceptable security are permitted.[12]

Oklahoma

P3

Oklahoma also adopted P3 authorizing legislation this year.[13] A P3 partnership contract may contain a requirement for payment and performance bonds on all construction activities and letters of credit, surety bonds or other security in connection with the operation and development of qualifying public projects. The form and amount of the bonds shall be in an amount satisfactory to the responsible government entity.

Contract Bond Tail

Under existing law, a contract must provide a public agency with a bond or irrevocable letter of credit to protect the public agency from defective workmanship and materials for a period of 1 year after the acceptance of the work. That law is amended to require that, for a Department of Transportation or Oklahoma Turnpike Authority project, this

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[8] Kan. Stat. Ann. § 16-1909 (S.B. 55; effective: July 1, 2017).
[9] 29-a Me. Rev. Stat. § 901.
[10] Mo. Rev. Stat. § 324.900, et seq. (S.B. 240; effective 8/28/2017).
[11] Mont. Code Ann. § 75-x-xxx (H.B. 216; not yet chaptered).
[12] Nev. Rev. Stat. § 338-x (S.B. 448; effective 7/1/2017; not yet chaptered).
[13] 74 Okla. Stat. § 5151, et seq. (H.B. 1534 and S.B. 430).

bond must be available for 1-year after project completion.[14]

Oregon

Electric Charging Station Installation by a Tenant

Oregon created a new law[15] to regulate the installation of electronic charging stations in rental buildings. Tenants are permitted to install electronic charging stations if they meet certain requirements in the law and a landlord is permitted to require additional conditions such as requiring the person employed by the tenant to install the charging station to post a payment and performance bond in an amount equal to 125% of the anticipated cost of work.

Mortgage Loan Servicer Bond

A bond or letter of credit shall be required of each applicant for a mortgage loan servicer license. The bond shall be in an amount specified by rule. At license renewal the individual shall show that the surety bond or letter of credit remains in effect at the amount specified by the Director of the Department of Consumer and Business Services. This new law went into effect on August 2, 2017.[16]

Tennessee

Contract Bond Amount

The bond amount for a public works contract exceeding $100,000 is amended from 25% of the contract price to *not less than* 25%.[17]

Washington

Bond Threshold Increase

In lieu of payment and performance bonds, a public entity may retain a percentage of the contract amount. Washington amended its law to permit the general contractor or construction manager to choose which option it will take. The legislature also increased the threshold at which this option is available from $35,000 to $150,000 and the percentage that may be retained from 5% to 10%. The bill also prioritizes the recovery of unpaid wages and benefits for any action filed against the retainage. Finally, individual sureties are permitted to provide bonds in Washington on contracts of $150,000 or more, which is a $50,000 increase in the threshold.[18]

Motor Vehicle Dealer Bond

A wholesale vehicle dealer is no longer subject to Washington's motor vehicle dealer licensing law and, as such, is no longer required to obtain a surety bond[19].

[14] 61 Okla. Stat. § 113 (H.B. 1599).
[15] H.B. 2510 (not yet chaptered; effective 6/20/2017).
[16] S.B. 98 (not yet chaptered).
[17] Tenn. Code Ann. § 12-4-201 (S.B. 681/H.B. 891; effective 4/4/2017).
[18] Wash. Rev. Code §39.08.10 (S.B. 5734; effective 7/23/2017).
[19] Wash. Rev. Code § 46.70.070 (H.B. 1722; effective 6/30/2017).

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