Surety Claims Institute

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Newsletter

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President: Steven D. Nelson Editor-in-Chief: Armen Shahinian

2018 Surety Claims Institute Annual Meeting To Be Held At Park Hyatt Beaver Creek Resort, Beaver Creek, Colorado

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

The Surety Claims Institute's 43rd Annual Meeting will be held June 20 through June 22, 2018 at the **Park Hyatt Beaver Creek Resort and Spa** in Beaver Creek, Colorado. SCI seeks to hold its annual meetings at family friendly, upscale locations, and the Park Hyatt Beaver Creek promises to be an exceptional choice for both criteria. Amy Bentz, from the Bentz Law Firm in Pittsburgh, will return for the second year of her two-year tenure as the educational program chair with a lineup of experienced surety claims practitioners and timely educational topics.

Amy's program begins on Thursday with the traditional surety law update. Thursday's program will be followed by a presentation on the overpayment defense and tips for dealing with obligees who deplete bonded contract funds. It will also include a discussion of *(continued on page 4)*

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SURETY CLAIMS INSTITUTE

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Officers

President
Steven D. Nelson
Markel Surety
5741 Legacy Drive
Suite 210
Plano, TX 75024
(512) 330-1850
snelson@markelgroup.com

Vice President
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Secretary
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Executive Secretary
Diane Kennedy
Surety Claims Institute
9225 Indian Creek Parkway
Suite 1070
Overland Park, KS 66210
email:dkennedy@gh-ks.com

Newsletter Staff

Editor-In-Chief
Armen Shahinian
Chiesa Shahinian & Giantomasi PC
One Boland Drive
West Orange, New Jersey 07052
Ph: (973) 530-2002
Fax: (973) 530-2202
email:ashahinian@csglaw.com

Managing Editor
Brian Kantar, *West Orange, NJ*
Chiesa Shahinian & Giantomasi PC

Articles Editor
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Comments From The Editor:
"Strictissimi Juris and the Compensated Surety"

When I was a young attorney just starting out in the practice of surety law, there existed a pretty reliable, if old, body of law in which a surety was considered a "favorite of the law". This body of law existed despite the fact that, for much of the prior century, surety companies were regulated as insurance companies and had increasingly become divisions of insurance companies as opposed to stand alone sureties. And insurance companies had not been "favorites of the law" for quite some time. During the course of my career, more and more courts have begun to create or cite case law distinguishing "compensated"

sureties from historic individual sureties and have suggested that bonds issued by "compensated" sureties should be interpreted differently. Rather than being interpreted strictly, their thinking might be that bonds ought to be interpreted so as to afford the full coverage reasonably anticipated by the beneficiaries; and this conclusion might be articulated even while citing prior decisions holding that the coverage of the bond should not be extended by interpretation or construction beyond its terms. As a result, there are cases today that can be cited for whatever type of construction an advocate would like to see adopted; and advocacy remains of particular importance in the realm of suretyship in which the chances are that the court has no substantial prior suretyship expertise. Rather, the court may well have some expertise or familiarity with insurance concepts; and, increasingly, the names under which sureties operate include the words "Insurance Company" more often than "Bonding Company" or "Fidelity and Guarantee Company". Thus, it falls upon surety attorneys to be vigilant in taking the time not only to cite old case law regarding "strictissimi juris", but also to educate the court as to why the concept exists and ought not be considered antiquated.

Specifically, a surety is not issuing a policy of insurance wherein it is accepting the risk that a fortuitous event will occur. An insurer, in exchange for a premium calculated on the basis of an actuarial analysis that the insured risk will occur, accepts such risk and becomes primarily liable for the damages flowing from the risk up to the policy limits. By way of contrast, a surety does not contract to become a primary obligor in exchange for a premium payment. Rather, its premium is calculated based upon the assumption that the primary obligor will remain the named principal and its underwriting determination that it has the character, cash and capacity to perform the bonded obligation. The surety receives a fee in the form of a premium for its underwriting analysis backed by its guarantee. But the principal remains the primary obligor and no loss is contemplated. And, in the majority of circumstances, individual guarantors execute an agreement of indemnity whereby they assume personal responsibility for any loss the surety may incur. Thus, when a claim is received by a surety, there is no pooling of risks that results in an insurance company bearing a loss contemplated by an actuarial calculation of the likelihood of such loss. Rather, the surety is called upon as a secondary obligor, the term used by the Restatement of the Law (Third) of Suretyship & Guaranty to identify the surety, to assure that the bonded obligation is fulfilled either by supporting or cajoling performance by the principal obligor, seeking enforcement of its right of exoneration by the principal, or by arranging performance or payment itself and seeking indemnity from the principal and individual indemnitors. Therefore, the ultimate loss is not intended to rest with the surety even if its name includes the words "insurance company". Instead, the loss ultimately is to be borne by the bonded principal or the individual owners of a corporate principal, or relatives of an individual principal or similarly related persons who have agreed to stand behind the obligation and save the surety harmless. These indemnitors act as sureties themselves, with circumscribed defenses contractually agreed upon through a general agreement of indemnity. In this economic arrangement, the old relationship of a non-compensated surety is effectively preserved, and the ultimate loss will rest with such individuals if loss to the surety is not otherwise avoided. Thus, the same policy reasons for the time-honored doctrine of strictissimi juris remain vital. And most states' regulations exempt sureties from their Unfair Claims Settlement Practices Acts because state regulators recognize that sureties are different from insurers. In a dispute between a principal and obligee, the playing field ought not be tilted in favor of an obligee simply because an insurance company, as surety, stands behind a principal. The principal, and usually individual indemnitors, will bear the loss before the surety; thus, resolving disputes or ambiguities in favor of an obligee or in favor of broad bond coverage, simply because there is a compensated surety existing as an intermediate link in a chain that usually ends with individual indemnitors or other non-insurer corporate indemnitors, is inappropriate and unwarranted.

No court is likely to figure all this out on its own. But, like in most legal advocacy, unless the advocate paints the picture as to why a certain result is appropriate and equitable, merely citing old cases is not likely to convince a court, which is comfortable with broadly interpreting the obligations of "insurance companies". And tendered counsel will not

likely have the expertise or sophistication to make these arguments convincingly without support.

This all ties into a broader trend in the surety industry that I have witnessed over the course of my 40 year career as a surety attorney. When I was a young attorney, there were more stand-alone sureties or insurance companies in which the surety claims departments had substantial autonomy and its product was considered different. Claims were not subject to being shoe-horned into a property and casualty model of cookie cutter claims. Hourly rates were different and higher than for property and casualty defense because the analytical and writing skills needed to be an effective surety attorney and advocate was (and remains) different. I have witnessed many firms that at one time had robust surety practices leave those practices behind because they no longer generated the revenue needed to hire the best young attorneys with the best analytical and writing skills. And even for firms still practicing in the surety arena, expense sensitivity often results in the bill auditors' suggestion that everyone ought to already have a form to deal with any situation which may arise and the surety should not be billed for "routine items and motions" beyond minimal amounts, causing pressure to cut corners and do the minimum. There is no appetite to spend the money needed for thorough and effective advocacy. I believe that the deterioration in the law relating to surety defenses is tied to these cost control pressures. And attorneys with the knowledge, ability and expertise to combat this deterioration are left with the need to overcome bad case law attributable to tendered or inexperienced or squeezed counsel not taking the time to effectively make the arguments needed to preserve the older treasured precedents. There are public policy reasons and ultimately equitable principles that stand behind the old and favorable decisions. It takes time, sophistication and commitment to articulate those public policy and equitable arguments. And time and expense dollars are worth spending. (Sounds awfully self-serving, but these issues will certainly outlast me in the practice of surety law!!) In any event, finding case law to support your position is just the start of the process of advocacy. An effective advocate has to explain to the court not only that there is precedent to be followed justifying the result sought by the surety, but that this result is appropriate and equitable under the circumstances. That takes extra time, but it is time and money well spent.

Armen Shahinian
Editor-In-Chief
Chiesa Shahinian & Giantomasi PC
West Orange, NJ
New York, New York

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building envelope, mechanical, and subsurface conditions and how the surety claims professional can mitigates any losses arising from such conditions. Thursday's program will conclude with a discussion of advanced surety claim issues, including the surety's potential liability for disadvantaged business enterprise fraud, reinsurance, and indemnity-related issues, as well as binding subsidiary and affiliated companies using the indemnity agreement.

Friday's educational program will begin with the annual review of fidelity cases. It will continue with an analysis of structured surety financing agreements and strategies for avoiding losses. Friday's program will also contain a review of best practices for negotiating takeover

and tender agreements, as well as a discussion of best practices for dealing with state and local public bodies, particularly educational and institutional infrastructure and municipal authorities. Friday will conclude with the ethics portion of the program, which will focus on the myriad of issues that can create conflicts of interest, particularly when defense is tendered to the bond principal.

In addition to SCI's top class educational program, the Park Hyatt Beaver Creek boasts an array of world class amenities and sightseeing opportunities. Situated at the base of Beaver Creek, this luxury resort features scenic views of Beaver Creek mountain, as well as five outdoor hot tubs, a pool, tennis courts, championship golf, and a world class spa. The resort's surroundings also contain numerous attractions and opportunities to take advantage of its mountain location. Take a ride to the top of Beaver Creek Mountain on the Centennial Express high speed chair lift. The top of Beaver Creek Mountain hosts a complimentary 18 hole championship disc golf course, tetherball, hiking, horseshoes, and much more. For those who want to get away, the Glenwood Hot Springs is located about an hour away and draws visitors from all over the world to its naturally heated pools, which run between 102 and 104 degrees. At the 4 Eagle Ranch (http://4eagleranch.com/), about 30 minutes from Beaver Creek, one can enjoy horseback riding, free rodeos, western dancing, ziplining, and numerous other outdoor activities. The area is home to other outdoor activities, which include hot air ballooning and Jeep and ATV tours through the Colorado high country. For those who may be more interested in sedentary adventures, Alpenglow Adventures Train Tours (http://alpenglowadventurestours.com/) offers tours on the Colorado Zephyr, Royal George, and Georgetown Loop Railroads in 3, 5, 8, or 12 hour packages. Finally, the National Mining Hall of Fame and Museum (https://mininghalloffame.org/) in Leadville, Colorado memorializes those who pioneered the discovery, development, and processing of our nation's natural resources, and offers the chance to tour the Matchless Mine, one of the richest silver mines of its era.

For those who enjoy golf, the annual Thursday afternoon tournament will be held at the Eagle Ranch Golf Club, an Arnold Palmer "signature" designed course. As always, SCI will provide food and transportation to and from Thursday's tournament.

We look forward to seeing everyone at the 2018 Annual Meeting and hope you will find the program and activities as rewarding as we believe they will be.

REMEMBER, ONLY "*WE* HOLD THESE TRUTHS TO BE SELF-EVIDENT": ENFORCING THE TIMING OF THE SURETY'S EQUITABLE SUBROGATION RIGHTS TO CONTRACT FUNDS PAID TO A BANKRUPT PRINCIPAL

By: Eric H. Loeffler, Hinshaw & Culbertson LLP, Boston, MA

Surety and bankruptcy practitioners have one thing in common (beyond the obvious adrenaline-inducing nature of their work): both wield zealously their own set of sacrosanct "rights." In that regard, both act with the unwavering impression that others routinely fail

to understand those rights, and therefore they must be defended without restraint. The intersection of surety and bankruptcy often results in a zero-sum paradigm, with each side emphatic that its particular, and often intricate, set of rights is superior. Compromise is rare, concession scarce. The inevitable stand-off must be resolved by a court which, of course, implicates another unique yet insistent perspective. Fortunately, in most cases, surety interests have a slight advantage, namely that surety professionals routinely deal with bankruptcy issues, though the opposite is not necessarily true. To prevail, one must have a firm grasp of both the concepts and authority governing both surety and bankruptcy issues, and, most importantly, must be able to demonstrate where a bankruptcy trustee's translation of the surety's rights has gone awry.

A favorable application of those notions can be found in two recent decisions by the United States Bankruptcy Court in Massachusetts, deciding a contest between a surety and a bankruptcy trustee over three payments made by bond obligees to the bankrupt principal in connection with two public projects. In *Dwyer v. Ins. Co. of the State of Pa. (In re Pihl, Inc.) (Pihl I)*[1] and *Dwyer v. Ins. Co. of the State of Pa. (In re Pihl, Inc.) (Pihl II)*,[2] a Chapter 7 bankruptcy trustee sought turnover of contract funds that had been paid into the operating account of the principal. The trustee argued that payment of the funds to the principal divested the surety of its equitable subrogation rights, on a variety of grounds, including the claim that equitable subrogation only applied to funds actually held by an obligee.

The surety, on the other hand, properly asserted it had a superior right to the payments under the doctrine of equitable subrogation and, secondarily, under the assignment provision in the general indemnity agreement. After a trial, the court recognized the surety's superior equitable subrogation rights. While noting dissenting views, the court adopted the "majority view" and held that "subrogation principles remain applicable in bankruptcy." The court found that the surety was equitably subrogated to the rights of project obligees by virtue of funding completion, and had a right to payments issued to the principal following its failure to perform the bonded work. Specifically, the court held that the surety's rights arose when it had a legal obligation to pay, triggered when the principal notified the surety it would not continue working on the projects. The court rejected the trustee's argument that the surety's obligations could only arise upon the owners' declaring default and terminating the principal, which events were necessarily forestalled by the bankruptcy petition and the effect of the automatic stay.

A Common Story of a Defaulting Principal

In *Pihl I* and *Pihl II*, the surety issued bonds on behalf of a contractor specializing in bridge construction projects.[3] On September 12, 2013, the principal notified the surety it was unable to complete the bonded projects, terminated its employees and, the following day, closed its doors and abandoned the bonded work.[4]

On September 13, 2013, the surety sent letters to the bond obligees, the Massachusetts Department of Transportation (DOT) and the Massachusetts Department of Conservation and Recreation (DCR), notifying them that the principal had terminated all of its employees and was unable to complete the bonded projects.[5] The surety demanded that no further funds be released to the principal without the surety's written consent and direction.[6]

On the same day, the surety sent a notice reminding the principal of its indemnity obligation, and confirming that the principal had terminated all of its employees and was unable to complete the bonded projects.[7] The principal did not respond, prompting the surety to serve a collateral demand and file a UCC-1 financing statement on September 17, 2013.[8]

Notwithstanding the surety's prior notice and direction to the obligees, on September 17, 2013, DCR deposited $391,428.74 in bonded contract proceeds into the principal's operating account.[9] At that time, there was a pre-existing balance in the account stipulated as bonded contract proceeds paid by

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[1] 529 B.R. 414 (Bankr. D. Mass. 2015).

[2] 560 B.R. 1 (Bankr. D. Mass. 2016).

[3] *Pihl I*, 529 B.R. at 419; *Pihl II*, 560 B.R. at 4.

[4] *Pihl II* at 5.

[5] *Id.*

[6] *Pihl II*, 560 B.R. at 5.

[7] *Id.*

[8] *Id.*

[9] *Id.* at 7.

DOT on September 3, 2013.[10] On September 18, 2013, the surety commenced an action against the principal seeking damages and a trustee process attachment of the principal's bank accounts, which was approved by the court on September 19, 2013.[11] The following day, the principal filed a voluntary petition for relief under Chapter 7 of the United States Bankruptcy Code.[12] On October 3, 2013, without consent or direction from the surety, DCR made an additional deposit of bonded contract proceeds into the principal's bank account in the amount of $207,088.66.[13] Thereafter, the bankruptcy trustee filed an adversary proceeding against the surety and the principal's bank seeking turnover of the funds held by the bank.[14]

The thrust of the trustee's argument rested on its belief that a surety is never subrogated to funds earned and paid to a contractor, and that equitable subrogation applies only to amounts remaining to be paid under a bonded contract.[15] The trustee also argued that the surety was not entitled to the funds in the principal's bank account on the basis of equitable subrogation because it claimed the monies were attributable to deposits made into the principal's account prior to the surety incurring any losses under the bonds.[16] Lastly, the trustee asserted that the surety was not entitled to the funds deposited into the principal's account prior to any assertion or declaration of default by the obligees.[17]

The Surety's Equitable Subrogation Rights In Bonded Contract Funds Are Not Limited To Payments Yet To Be Made.

In *Pihl I* and *Pihl II*, the trustee initially maintained that a surety is never subrogated to funds earned by and paid to a principal, but instead is subrogated to the principal only as to amounts remaining to be paid under a bonded contract.[18] The trustee's argument reflected a flawed and narrow understanding of the surety's equitable subrogation rights. Not only is a surety equitably subrogated to contract funds in its principal's hands, courts in Massachusetts and elsewhere have expressly recognized that a surety may pursue third parties, including banks, who have received bonded contract proceeds with notice of the principal's default and the surety's equitable interest.[19]

In support of its assertion that payment of the funds to the principal divested the surety of its equitable subrogation rights, the trustee relied upon a number of cases, including *In re Union City Contractors, Inc.*,[20] wherein the court stated that "sums fully earned and paid-out are free of any superior equitable interest or right of subrogation in a surety, in order to promote the free flow of commerce, and in order to insure that parties that receive such progress payment funds from a contractor do not have to be concerned with potential future claims for return of the money."[21] In *Union City*, three rival claimants (a bank and two competing sureties) to funds in the debtor's bank account sought relief from the automatic stay to obtain possession of the funds.[22] The debtor's bank claimed priority to the funds pursuant to a UCC perfected security interest.[23] The first surety claimed second priority to the funds in the account in excess of the amount claimed by the bank, based on its own UCC perfected security interest.[24]

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[10] *Id*.
[11] *Id.* at 8.
[12] *Id.* at 6.
[13] *Id.* at 7.
[14] *Id.* at 3 (The bank merely held the funds as a stakeholder as the debtor owed no funds to the bank and, surprisingly, there were no other competing creditors.).
[15] *Id*. at 10.
[16] *Pihl I*, 529 B.R. at 423.
[17] *Pihl II*, 560 B.R. at 10.
[18] *Pihl I*, 529 B.R. at 422; *Pihl II*, 560 B.R. at 10.

[19] *See, e.g., Aetna Cas. & Sur. Co. v. Harvard Trust Co.*, 344 Mass. 160, 171 (1962) ("Of course, where the person receiving payment has notice of all the facts giving rise to the surety's [equitable] interest, the moneys paid over may be followed" by the surety); *Labbe v. Bernard*, 196 Mass. 551, 552 (1907) ("all persons who have in the meantime received any such securities or payments from either party to the principal contract, with notice of the facts and of the surety's responsibilities and consequent rights, must in equity hold them for [the surety's] benefit"); *Pac. Indem. Co. v. Grand Ave. State Bank of Dallas*, 223 F.2d 513 (5th Cir. 1955) (appeal by surety on a construction contract to recover proceeds of a check issued to the contractor in partial payment for work done on the contract, and deposited into contractor's account; surety, who had taken over completion of defaulted contract, was entitled to payments in preference to trustee in bankruptcy).
[20] No. 09-20823, 2010 Bankr. LEXIS 984, at *1 (Bankr. W.D.N.Y. Mar. 31, 2010).
[21] *Id.* at *38.
[22] *Id.* at *33.
[23] *Id.* at *22.
[24] *Id.* at *28.

The second surety claimed priority to the funds based on its contention that it was equitably subrogated to the debtor's rights by virtue of its payment of claims against payment bonds issued on the contracts.[25]

In holding that the second surety did not have an equitable right of subrogation that was superior to the rights of the prior perfected creditors, the court in *Union City* noted that the funds were earned by the debtor when it was not in default under the contracts, were paid to the debtor by the government approximately ten months before the filing of the debtor's bankruptcy petition, and were paid nearly nine months before the second surety made payments under its payment bond.[26] Thus, contrary to the suggestion of the trustee in *Pihl I*, *Union City* did not find that the trustee's claim to the funds was superior to that of the surety.[27] Rather, the trustee in *Union City* expressly acknowledged that its rights were inferior to the three claimants, including the equitable subrogation rights of the second surety.[28]

The trustee's application of *Union City* under the circumstances presented was flawed, and the trustee's argument was correctly rejected.[29] While courts have over time examined the nature of the contract funds themselves (i.e., whether the contract funds are retainage, progress payments, or other types of bonded contract funds), the majority of cases recognize that the surety's equitable subrogation rights are the same regardless of whether the bonded contract funds are paid or unpaid, or consist of retainage, progress payments, or proceeds of claims.[30] Thus, the court in *Pihl I* acknowledged that if a party (in this case, the principal itself) with notice of the surety's rights receives funds from an obligee, equity requires that the receiving party hold the funds for the surety's benefit.[31]

The Surety's Equitable Subrogation Rights Are Triggered When A Legal Obligation Arises, And Do Not Wait For Losses or Contract Formalities

The trustee next argued that the surety must have already incurred losses under either the payment or performance bonds before being subrogated to the funds.[32] The bankruptcy court also rejected this assertion, holding that a surety is entitled to subrogation as soon as the surety incurs a legal obligation, such as when the principal defaults:

> There is disagreement about when subrogation rights arise. Some courts require a surety to begin making payments before its subrogation rights are triggered; others recognize subrogation rights as soon as a surety incurs a legal obligation to pay . . . I agree . . . that the latter approach is the correct one. Thus, as soon as the Sureties incurred a legal obligation to the Project Owners, they were entitled to contract retainages and progress payments that were earned by but not yet paid to [the debtor].[33]

The trustee, in arguing that equitable subrogation principles did not apply to any of the payments at issue, focused on the default and termination provisions of the bonded contracts.[34] Each contract at issue in *Pihl I* and *Pihl II* permitted the obligees to terminate the contract

[25] *Id.* at *28.
[26] *Id.* at *36-38.
[27] *See id.*
[28] *Union City*, 2010 Bankr. LEXIS 984, at *34 ("The Trustee has now acknowledged that . . . the rights of [the three creditors] in and to the funds on deposit in the [bank] account are superior to his [i.e. the trustee's] rights").
[29] *Pihl I*, 529 B.R. at 425.
[30] *See, e.g., Nat'l Shawmut Bank of Bos. v. New Amsterdam Cas. Co.*, 411 F.2d 843 (1st Cir. 1969) (rejecting the argument that the surety's rights should be limited to retainage and not extend to progress payments); *Capitol Indem. Corp. v. Heidkamp*, 312 B.R. 437, 442 (Bankr. M.D. Fla. 2003) (adopting *Pearlman* when the bonded contract funds were in the form of a progress payment); *In re Alcon Demolition, Inc.*, 204 B.R. 440 (Bankr. D.N.J. 1997) (proceeds of arbitration); *In re Alliance Properties, Inc.*, 104 B.R. 306 (Bankr. S.D. Cal. 1989) (claim proceeds); *Bank of New Mexico v. Romero*, 918 P.2d 1337, 1339 (N.M. Ct. App. 1996) (rejecting trial court's conclusion "that recovery on a claim for equitable subrogation had to come from a preexisting, withheld fund").
[31] *Pihl I,* 529 B.R. at 426 (citing *Labbe*, 196 Mass. at 555).
[32] *Id.* at 422.
[33] *Pihl II*, 560 B.R. at 9-10.
[34] *Id.* at 10.

for cause.[35] The DCR contract stated in relevant part:

> The DCR may without prejudice to any other right or remedy deem this Contract terminated for cause if any of the following defaults shall occur and not be cured within five (5) days after the giving of notice thereof by the DCR to the Contractor and any surety that has given bonds in connection with this Contract.[36]

The DOT contract contained a default termination section that stated in relevant part:

> If the Contractor shall be adjudged a bankrupt, or if he shall make a general assignment for the benefit of his creditors, or if a receiver of his property shall be appointed, or if the work done under the Contract shall be abandoned, . . . the Party of the First Part may notify the Contractor to discontinue all work, or any part thereof. Such notice shall be given to the Contractor in writing and thereupon the Contractor shall discontinue such work or part thereof.[37]

The trustee claimed default was the exclusive triggering event for termination of the bonded contracts and that the surety's subrogation rights would not have arisen until default and subsequent termination by the obligees.[38] The trustee claimed that the DOT contract was terminated no earlier than September 18, 2013, when the DOT sent the principal a letter declaring a default.[39] As DCR never declared a default, the trustee argued that the DCR contract was never terminated.[40] According to the trustee, the surety's subrogation rights in the DOT contract arose no earlier than September 18, 2013, and so, did not attach to the first payment received on September 4, 2013[41] The trustee further argued that the surety's subrogation rights never arose at all with respect to the DCR contract meaning the second and third payments were beyond the surety's grasp.[42]

In rejecting this argument, the court noted that the trustee was conflating "the rights of the DOT and DCR to terminate the [contracts] with the principal's obligations to perform under those contracts and the surety's guaranteeing such performance to the DOT and DCR."[43] In terms of defining default, the court held:

> [the obligee's] decision to terminate the contracts has nothing to do with triggering the Sureties' obligations under the payment and performance bonds. It is the failure of [the debtor] to perform that was the triggering event.[44]

The court's conclusion is in line with First Circuit and other precedent that there is no necessity that a "formal default" be declared for the surety's subrogation rights to mature, stating that "[s]uch a requirement would make form prevail over substance."[45] The court concluded that the surety's subrogation rights arose no later than September 13, 2013, when the principal ceased performing work on the bonded contracts.[46] As a result, the court held that the payments made after that date were subject to

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[35] *Id*. at 5.
[36] *Pihl II*, 560 B.R. at 5.
[37] *Id*.
[38] *Id.* at 10.
[39] *Id.*
[40] *Id.*

[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] *Id*. (The court further noted that there was nothing in the payment or performance bonds for either contract that requires a declaration of default to issue as a precondition to the surety's obligations to perform or its right to recoup its losses.)
[45] *Ins. Co. of N. Am. v. Northampton Nat. Bank*, 708 F.2d 13, 15 (1st Cir. 1983) (citing *First Alabama Bank v. Hartford Accident & Indem. Co.*, 430 F. Supp. 907, 911 (N.D. Ala. 1977) (default under the contract occurs either when the contractor states that it can no longer continue on the job or when it materially fails in performance, not on the formal declaration of default)).
[46] *Pihl II*, 560 B.R. at 10.

the surety's subrogation rights, and that the surety's rights to those funds were superior to the rights of the trustee.[47]

Conclusion: Timing is Always Important

It is common, bordering on inevitable, that a bankruptcy trustee will seek to misconstrue or otherwise limit a surety's equitable subrogation rights to the benefit of maximizing the "property of the estate." And, admittedly, in appropriate cases there are principal assets that fall outside the surety's interests. Though in a contest between a surety and a bankruptcy trustee to payments made to the principal, the surety's equitable subrogation rights are superior as to contract funds in the hands of the principal, and those rights arise once the principal notifies the surety it cannot continue working on the bonded projects. In *Pihl I* and *Pihl II*, the surety successfully defended against the trustee improperly encroaching on its sacred turf, and the court correctly rejected the trustee's efforts to convince the court to misconstrue the surety's fundamental rights. Awareness of both the reach and limitation of the respective rights of sureties and trustees, coupled with a commanding ability to convey those concepts is critical, particularly on the trustee's "home field" in a bankruptcy court.

[47] *Id.* at 11.

Surety Casenotes

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

Notice of Potential Default is Sufficient to Trigger Federal Government's Obligation to Protect Surety's Interest in Contract Funds

Hanover Ins. Co. v. United States, 133 Fed. Cl. 633 (Fed. Cl. 2017).

On August 4, 2009, B&J Multi Service Corporation ("B&J") entered into a contract with the Department of Veterans Affairs ("VA") to repair a steam system at a VA facility in Connecticut. The VA suspended B&J on February 17, 2010 for walking off the site, not paying subcontractors, and incorrectly certifying that subcontractors were being paid. During the course of the contract, B&J's subcontractors and suppliers submitted payment bond claims to B&J's surety. On December 22, 2010, the surety forwarded to the VA a fully executed assignment and direction of the contract funds from B&J to the surety, but with respect to a separate contract. The VA acknowledged receipt of the assignment.

On February 2, 2011, the surety informed the VA by email that it had been "writing large checks" to ensure that the work under the contract was being performed without disruption. Following a series of emails between, among others, the VA and the surety, the VA terminated the contract for convenience. On February 23, 2013, the VA copied the surety on an email containing its response to B&J's settlement proposal for termination for convenience costs. The surety responded on February 25, 2013, instructing the VA that "no monies are to be paid to B&J. if this matter is resolved, all payments will be to [the surety]."

The VA subsequently agreed to resolve B&J's claim for $440,000. Thereafter, the VA emailed the surety's counsel and asked whether the settlement payment should go directly to the surety. The surety's counsel responded that the surety was doubtful of B&J's authority to enter into a settlement agreement, given the surety's equitable and contractual rights, and again requested that no funds be released to B&J without the surety's consent.

By letter dated June 25, 2013, the surety reminded the VA of its subrogation claim, citing, among other things its losses under the payment bond. Notwithstanding the surety's communications, the VA paid B&J the $440,000. The surety commenced suit against the VA to recover the payment. The VA filed a motion to dismiss, citing to the Federal Circuit's decision in *Fireman's Fund Ins. Co. v. United States*, 909 F.2d 495 (Fed. Cir. 1990), which held that "the government as obligee owes no equitable duty to a surety…unless the surety notifies the government that the principal has defaulted under the bond." The VA argued that the surety's communications did not invoke the precise words "the principal is in default" prior to the VA's payment to B&J. The court denied the VA's motion, citing to case law holding that notice of a potential default can be sufficient to invoke the government's obligation to protect the surety's interest in remaining contract funds. The court held that the surety's June 25, 2013 letter was sufficient to place the government on notice that the principal had defaulted and the surety had been called upon to perform under its bond obligations.

Material Alteration of Bonded Contract Discharges Surety from Liability under Payment Bond

T. Mina Supply, Inc. v. Clemente Bros. Contracting Corp., No. 23125/2011 (N.Y. Sup. Ct. Queens Cnty. Aug. 18, 2017), *enforced*,

2017 WL 5652519 (N.Y. Sup. Ct. Queens Cnty. Oct. 23, 2017).

Surety issued payment bonds in connection with two requirements contracts, the SEQ and QED contracts, between Clemente Brothers Contracting Corp. ("Clemente") and the City of New York (the "City"). The stated duration for each of the contracts was a period of 365 days from the date the City issued a notice to proceed. The contracts each provided that: "Contract changes will be made only for Work necessary to complete the work included in the original scope of the contract. Changes are not permitted for any material alteration in the scope of the Work in the Contract." The contracts also provided that "extensions of more than 120 days were permitted only in the case of exceptional circumstances."

With respect to the SEQ contract, the 365 day duration expired on July 14, 2010. The City did not have a successor contract in place because it rescinded the successor contract it had awarded to Clemente on the ground that it was not a responsible bidder and no longer bondable. The City attempted to solve the problem by simply extending the term of the SEQ contract by almost a year so that work that would have been done under the successor contract could be done under the original contract bonded by the surety. The City similarly extended the term of the QED contract. However, the QED contract contained additional language, providing that "at the conclusion of the contract, any task order furnished to the Contractor in which work has not already commenced will be deleted from the contract." The City violated this provision by issuing additional task orders.

The surety received payment bond claims for materials delivered after the expiration of the contracts. Plaintiff, T. Mina Supply, Inc. ("T. Mina"), commenced this action seeking, among other things, to recover under the bonds. T. Mina filed a motion for summary judgment against the surety, Clemente and the City. T. Mina had argued that a subcontractor who relies on the existence of a payment bond is entitled to collect on the bond even if the payment bond would otherwise have been voided based on the material alteration of the prime contract. The court rejected this argument, finding that T. Mina had cited no case law which supported its argument. The court further found that T. Mina was not an innocent party because, prior to extending credit to Clemente, T. Mina performed some investigation into the bonds and knew of, or should have known of, the expiration date of the bonds and their scope. The court denied T. Mina's motion against the surety, holding that the material alteration of the bonded contract without the surety's consent released the surety from its obligations. The court granted T. Mina's motions for summary judgment against Clemente and the City.

<u>Surety's Claim Against Indemnitors on Separate, Related Indemnity Agreement in Connection with Separate Principal</u>

Greenskies Renewable Energy, LLC, v. Arch Ins. Co., 2017 WL 4023287 (D.N.J. Sept. 13 2017).

In 2012, the surety issued bonds on behalf of Greenskies Renewable Energy, LLC ("Greenskies") in the amount of $50,000. In connection with the issuance of those bonds, Greenskies, together with several individuals, executed a General Indemnity Agreement (the "Greenskies GIA") in favor of the surety. Signatories to the Greenskies GIA included Greenskies as Principal/Indemnitor, together with Centerplan Construction Company, LLC ("Centerplan"), Robert Landino ("Landino"), Michael Silvestrini, Andrew Chester, Arthur S. Linares, and Luis A. Linares, as Indemnitors. All bonds issued on behalf of Greenskies were discharged with no claims made against any bond. The Greenskies GIA defined "Indemnitor" as any signatory to the Greenskies GIA "or any other agreement that incorporates by references the terms of" the Greenskies GIA. The term "Principal" is defined as:

> any Indemnitor on behalf of which [the surety] may execute a Bond and/or any Person whose name is or has been furnished to [the surety] by any of the Indemnitors or on behalf of which [the surety] has issued any Bond at the request of any Indemnitor, including, but not limited to, any of the Indemnitors named or referred to as 'Principal' in any bond, undertaking or recognizance. The term 'Principal' also includes any present or future direct or indirect subsidiary, successor, affiliate or parent of any Indemnitor and any

> partnerships, LLCs, LLPs or other entities owned in whole or in part by any named Indemnitor.

The term "Bond" included "any and all bonds…issued by [the surety]…on behalf of Principal, whether issued prior to or subsequent to the effective date of this Agreement."

Between 2010 and 2016, the surety issued separate performance and payment bonds worth millions of dollars for two large construction projects to Centerplan and Center Earth, LLC ("Center Earth") (the "Centerplan Bonds"). In connection with the Centerplan Bonds, Centerplan, Center Earth, as well as Landino (the owner and CEO of Centerplan and Center Earth), his wife, and several companies owned by Landino, executed separate General Indemnity Agreements on July 10, 2010, October 15, 2010 and January 26, 2016 (the "Centerplan GIAs"). Greenskies was not a signatory to the Centerplan GIAs. Aside from Centerplan and Landino being Indemnitors for the Greenskies Bonds and Principal and/or Indemnitors on the Centerplan Bonds, the two sets of bonds were unrelated.

The surety received claims against the Centerplan Bonds and made payments totaling $8,424,302.57 and estimated its potential liability to exceed $18 million. On August 5, 2016, the surety's counsel wrote to the indemnitors under the Greenskies GIA demanding that they hold harmless and indemnity the surety for all losses incurred and to be incurred by the surety as a result of having issued the Centerplan Bonds. The indemnitors did not respond. Instead, they filed suit seeking declaratory judgment that they "have no obligation or duty to [the surety] under the Greenskies GIA for any losses [the surety] incurred or will incur under the Centerplan Bonds…" The complaint also alleged violations of the implied covenant of good faith and fair dealing, the New Jersey Consumer Fraud Act, and fraudulent inducement. The surety filed a motion to dismiss the action.

The court denied the surety's motion to dismiss that count of the complaint seeking declaratory judgment. The court held that it has jurisdiction to adjudicate the dispute under the Declaratory Judgment Act because the parties have clearly adverse legal interests regarding who is responsible for claims made pursuant to the Centerplan Bonds. As the plaintiffs face a substantial monetary harm if they are obligated to indemnify the surety, the matter is one of contractual interpretation for which the court is capable of rendering a conclusive legal judgment as to plaintiffs' liability.

The court granted the balance of the surety's motion. With respect to plaintiffs' claim that the surety breached the implied covenant of good faith and fair dealing, the court held that their "allegations… do little more than indicate a disagreement over contractual interpretation, and fail to provide with any specificity how [the surety] acted in bad faith. Such conclusory allegations and vague pleading fail to satisfy the requirements of Rule 8(a)(2)." The court granted the surety's motion to dismiss the indemnitors' fraudulent inducement claim because they failed to meet the heightened pleading requirements for fraud claims under FRCP 9(b). As currently plead, the indemnitors suggested "that because the parties have different understandings of the contract, [the surety] must have intended to defraud them. This is insufficient to plead fraud." The court also granted the surety's motion to dismiss the indemnitors' claims under the New Jersey Consumer Fraud Act because they did not sufficiently plead the surety's alleged "unconscionable practices" or fraud.

<u>Surety May Be Held Liable Under Performance Bond for Government's Costs in Reviewing a Fraudulent Claim Submitted by Principal, but Not Penalties; Surety May Be Held Liable for Penalties to the Extent Surety Pursued Fraudulent Claims in Its Own Right</u>

Hanover Ins. Co. v. United States, --- Fed.Cl. ----, 2017 WL 4082075 (Fed. Cl. Sept. 15, 2017).

Lodge Construction, Inc. ("Lodge") entered into a contract with the Army Corps of Engineers on August 24, 2010. The contract was terminated for default on July 23, 2012. The surety entered into a Tender and Release Agreement with the Corps on December 21, 2012, pursuant to which the surety paid the Corps the difference between the unpaid contract balance and the cost to complete the contract. The Agreement also contained a provision releasing the surety from any and all, past, present and future claims of any kind, including fraud. Thereafter, Lodge and the surety challenged the default termination and

sought money damages. The surety also asserted an equitable lien against all proceeds that may be recovered by Lodge.

Lodge contended that it subsequently discovered that its complaint included a claim for work it did not commence prior to termination and thus moved to amend its complaint to remove reference to the claim. In answering the amended complaint, the government asserted as an affirmative defense that Lodge's claims were barred by illegality as a result of submitting a false claim. The government also asserted fraud counterclaims against Lodge and the surety for forfeiture and damages pursuant to the Special Plea in Fraud defense, the anti-fraud provision of the Contract Disputes Act, and the False Claims Act.

The government argued that Lodge committed fraud when it submitted claims to the contracting officer with the intent to cause the government to pay Lodge amounts to which Lodge knew it was not entitled to receive and again committed fraud by including those claims in its lawsuit. The government also argued that the surety "committed fraud by pursuing Lodge's entire claim in this court." The government alleged that the surety is liable for Lodge's fraud. The government filed its counterclaims while a motion to amend its answer to assert the same counterclaims was pending. Lodge and the surety opposed the motion.

The court granted the government's motion for leave to amend its counterclaims finding that the motion was timely, showed no improper purpose and would not unduly prejudice Lodge or the surety. In rendering its decision, the court held that if Lodge committed fraud, the surety could not recover as its right of subrogation could be no greater than that of its principal. Critically, the court ruled that if Lodge committed fraud, the surety could be held liable under the performance bond for the government's costs to review the fraudulent portion of Lodge's claims, but not any penalties assessed against Lodge (e.g., treble damages). In so ruling, the court observed that "a surety is not in privity of contract with the government. A performance bond is for the protection of the Government."

With respect to the government's direct claims against the surety, the court held that because a contracting officer does not have the authority under the Contract Disputes Act to release fraud claims, the language in the Tender and Release Agreement purporting to release such claims was ineffective. Thus, to the extent the surety committed fraud in its own right (by pursuing the principal's false claims), the court found that the government articulated plausible counterclaims against the surety that would survive a motion to dismiss.

Court Holds Surety May Be Held Liable Above Penal Sum Limit Under California Law for Breaches Independent of Conditions of Bond

Archer W. Contractors, LLC v. Int'l Fid. Ins. Co., 2017 WL 4286970 (S.D. Cal. Sept. 27, 2017).

General contractor Archer Western Contractors, LLC ("Archer") entered into a subcontract with Allied Industries, Inc. ("Allied). Archer ultimately terminated the subcontract and submitted a claim under the bond. Prior to performance, the surety demanded that Archer subordinate its interest in the contract balance to the surety, consistent with Paragraph 4 of what appears to be an AIA A312 Performance Bond. Archer did not do so, arguing that the surety "attempted to impose pre-conditions on [Archer], which were not authorized under the terms of the Performance Bond." Archer completed the subcontract with other subcontractors, suppliers and laborers and incurred damages in excess of the penal sum of the bond, which included extended overhead, extended general conditions, lost production as a result of delays and liquidated damages.

The surety filed a motion to dismiss Archer's claims in excess of the penal sum. The court granted the motion to dismiss the claim for damages in excess of the penal sum, but provided the prime contractor leave to amend its complaint. The contractor filed an amended complaint alleging, among other things, that the surety waived the penal sum limit by failing to timely perform on the contract. The surety filed another motion to dismiss Archer's claims against the performance bond and for declaratory relief. The court rejected the surety's argument that Archer was required to credit any remaining subcontract funds against its costs before seeking reimbursement from the surety under the performance bond. The court held that Paragraph 4 of the bond must be read in conjunction with Paragraph 5, which conditions

Archer's return of the subcontract balance funds upon "issuance of written notice by Surety to Obligee of the commitment to remedy the default through one of the options set forth in Paragraph 4." The court found that surety had to send written notice of a Paragraph 4 election before Archer was required to apply any subcontract balance funds. The court also rejected the surety's subrogation argument, holding that subrogation "only applies to sureties who have paid the debt of another and seek reimbursement." The court did not appear to address whether the surety was entitled to a credit in the amount of the remaining subcontract balance for the purpose of measuring Archer's damages, as Archer would reap a windfall if it were permitted to collect upon all of its damages and retain the remaining subcontract funds.

The court also denied the surety's motion to dismiss Archer's claim to the extent it exceeded the penal sum of the bond, holding that at the motion to dismiss stage, where the court's analysis is limited to whether a cause of action is viable, there is support in under California law to suggest that Archer may have a viable claim to the extent it can demonstrate that the surety committed a breach independent of the conditions of the bond. The court granted the surety's motion to dismiss the declaratory judgment claim, finding the claim to be duplicative of the breach of contract claim.

Court Dismisses Claim on Miller Act Bond for Delay Damages and Additional Work in the Absence of a Change Order, Pursuant to Terms of Subcontract

United States ex rel. Sustainable Modular Mgmt., Inc. v. Custom Mech. Sys. Corp., 2017 WL 4405050 (S.D. Ind. Oct. 4, 2017), *enforcing United States ex rel. Sustainable Modular Mgmt., Inc. v. Custom Mech. Sys. Corp.*, 2017 WL 1807111 (May 5, 2017).

Subcontractor Sustainable Modular Management, Inc. ("SMM") sued the prime contractor Custom Mechanical Systems, Corp. ("CMS") for breach of contract and quantum meruit claims, and CMS' surety under the Miller Act payment bond. CMS and the surety moved to dismiss all claims. In a prior ruling, the court held that CMS was not responsible for delay damages (enforcing a no-damage-for-delay clause), SMM was responsible for paying taxes in connection with materials that it purchased and that additional work was SMM's responsibility unless there was a written change order. SMM filed a Motion to Alter or Amend Judgment. Since the court had not issued a final judgment, it considered the motion as a motion for reconsideration. The court held that there was no basis to reconsider the prior decision to grant the motion to dismiss or to allow the subcontractor to amend its complaint.

Contract Disputes Act Prohibits Assignment of Contractor's Right to Seek Review of Contracting Officer's Determinations

Appeals of Ikhana, LLC, ASBCA No. 60462, 2017 WL 4966694 (ASBCA Oct. 18, 2017).

The government terminated Ikhana, LLC for default under the bonded contract and made a claim against the surety under its performance bond. The surety and government negotiated a settlement of the bond claim, whereby the surety tendered a completion contractor and paid the completion contractor the difference between the remaining contract balance and the cost to complete the project. As part of the settlement, the surety agreed to cause the dismissal of Ikhana's appeals of the termination. In exchange, the government agreed to release the surety from all liability under the performance and payment bonds, including liquidated damages and additional excess reprocurement costs.

In light of the settlement agreement, the government moved to dismiss Ikhana's appeals, arguing that Ikhana lacks standing because the surety was the real party in interest. The surety also moved to intervene to withdraw the appeals pursuant to the terms of the settlement agreement. Both the government and surety relied upon, among other things, Ikhana's assignment of claims in the indemnity agreement. The court denied the motions, holding that the Contract Disputes Act ("CDA") prohibits any attempt to contract away Ikhana's rights under the CDA to seek an impartial review of the contracting officer's decisions. The court noted that the government's and surety's equitable arguments could not override the contractor's unwaivable CDA right to Board review.

IRS Cannot Levy on Contract Funds Assigned to Surety Because the Principal Did Not Have an Interest in the Funds

Fid & Deposit Co. of Md. v. Ohio Dep't of Transp., 2017 WL 5622832 (S.D. Ohio Nov. 22, 2017).

The surety issued both payment bonds and separate performance bonds in connection with public works contracts that Cosmos Industrial Services, LLC ("Cosmos") secured to perform work for the Ohio Department of Transportation ("ODOT"). The surety issued its bonds based in part upon false and misleading financial information provided to the surety by Cosmos. Beginning in 2013, Cosmos failed to remit its Form 941 payroll taxes to the IRS. Ultimately, delinquent taxes were assessed against Cosmos covering periods ending on December 31, 2013, December 31, 2014, and June 30, 2015 in amounts that totaled more than $1.5 million. Notices of Federal Tax Liens were filed by the IRS on January 6, 2015, September 3, 2015, and September 30, 2015. In addition to failing to pay its employment taxes to the IRS, Cosmos had failed to pay a number of the projects' sub-contractors and suppliers. Beginning on August 7, 2015 and continuing through September 29, 2015, those unpaid entities served ODOT with thirteen notices of mechanics' lien. Upon receipt of the liens, ODOT was required to retain or withhold payment from sums that would otherwise be payable to Cosmos. ODOT withheld additional amounts under the Davis-Bacon Act after learning that Cosmos failed to pay federally mandated fringe benefits. The surety ultimately satisfied all claims.

On or about September 1, 2015, Cosmos alerted the surety that it was no longer able to meet its payroll obligations and therefore was seeking financial assistance. The surety agreed to provide financial assistance, conditioned on the execution of Letters of Direction, directing ODOT to pay to the surety any funds that otherwise would become due to Cosmos. The Letters of Direction are dated September 8, 2015, and were transmitted to ODOT by letter dated September 15, 2015. The surety proceeded to pay for the continuation and completion of work on bonded projects through a control account, which was managed by the surety's outside consultant. On October 2, 2015, Cosmos was placed in involuntary receivership in state court. The state court specifically acknowledged the surety's superior rights in the ODOT contract funds pursuant to the Letters of Direction. The IRS served its first Notice of Levy on ODOT on October 26, 2015 and an Amended Notice of Levy on December 28, 2015. In total, the levies reflected a liability of $1,336,105.82. ODOT ultimately declared Cosmos to be in default on April 4, 2016, on which date ODOT assigned to the surety the remaining scope of work.

The surety argued that the IRS may only levy upon property in which Cosmos has a property interest and that the IRS wrongfully levied on the contract funds because Cosmos held no property interest in them whatsoever. While the court found that the surety bears the burden of proof of establishing that the IRS wrongfully levied upon its contract funds, it concluded the surety satisfied that burden of proof. The IRS had argued that until ODOT declared Cosmos to be in default on April 4, 2016, Cosmos had a property interest in the payments due under the contract. The court found the IRS' position to be untenable and contrary to Ohio law for two reasons: First, Cosmos, at best, had a contingent future interest in periodic payments. If Cosmos ceased work, ODOT would cease payment. The contract provided only for payment for completed work. Second, the court held that after the surety stepped in, it became subrogated to Cosmos' future contingent right to payment. The court observed that even the state court in Cosmos' receivership proceedings recognized the surety's superior rights in the contract funds.

The court also found that the assignment of funds to the surety, which pre-dated the IRS' Notices of Levy, primed the IRS' Notice of Levy because at the time of the Levy, Cosmos no longer had any interest in the contract proceeds. In reaching this finding, the court relied upon principles of subrogation, and concluded that the surety's actions in filing Letters of Direction was entirely consistent with established law. Finally, the court rejected the IRS' argument that Cosmos had a property interest in funds retained by ODOT prior to September 1, 2015 on account of mechanic's liens and Davis-Bacon Act violations. The court held that ODOT withheld the funds in accordance with Ohio law and Cosmos, therefore, had no interest in said funds. Although the funds became releasable once the surety

satisfied the claims giving rise to the withholdings, the surety was subrogated to the rights of the claimants on whose behalf ODOT withheld the funds and the retained funds should be paid to the surety. The court ruled that all funds should be released to the surety.

Surety Establishes Debtor Acted With Reckless Disregard and Awarded Judgment Declaring Debt Non-Dischargeable on Account of Debtor's Defalcation

In re Ward, --- B.R. ----, 2017 WL 6033568 (Bankr. E.D. Va. Nov. 29, 2017).

The surety commenced an adversary proceeding against a bankrupt indemnitor seeking a determination that the debtor's debt was non-dischargeable, pursuant to 11 U.S.C. § 523(a)(4), on account of a defalcation while acting in a fiduciary capacity. The debtor, an attorney, allegedly failed to account for certain funds he was responsible to retain as a fiduciary for two estates and as a guardian for an incapacitated adult. Prior to accepting his role as a fiduciary, the debtor acknowledged his responsibilities and, for at least one of his assignments, executed an acknowledgment form that provided "I understand that I may be held liable for violation of [my responsibilities]". The surety incurred losses on its bonds and filed a motion for summary judgment, which was granted in part and denied in part. Although the court found that a debt exists between the debtor and the surety under, among other things, the terms of the applicable indemnity agreement, the court found that there were questions of fact with respect to whether the debtor acted intentionally or with a reckless disregard of a known duty under the Supreme Court's decision in *Bullock v. BankChampaign, N.A.*, 569 U.S. 267 (2013).

After a bench trial, the court found that the surety established, by a preponderance of the evidence, that "the Debtor consciously disregarded the risk that his failures to act would breach his fiduciary duties." The court's decision was influenced, in large part, by the debtor's testimony, which the court found to be not credible. Among other things, the court found that the debtor contradicted himself and was keenly aware of the harm his failure to act would cause. The court granted the surety judgment declaring the debtor's debt to be non-dischargeable.

Fidelity Casenotes

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

No Insured Ownership Interest After Insured Surrendered Funds Loaned to Ponzi Scheme Operator

Cooper Indus. Ltd. v. Nat'l Union Fire Ins. Co., 876 F.3d 119 (5th Cir. 2017).

The insured electrical equipment supplier offered its employees a pension plan. The committee that managed the pension plan divided its assets into a bond fund and an equity fund. The committee contracted with an investment company that offered an enticing hedge strategy opportunity. A portion of the assets were placed in equity fund investments through S&P futures and the balance was used to purchase a promissory note from a related company. The plan appeared to enjoy significant gains; however, some of the gains were illusory. The investment company actually operated a Ponzi scheme. After the scheme was uncovered, the Securities and Exchange Commission filed an enforcement action, and the court appointed a receiver, liquidated the investment company's assets and assessed the impact to the victims. The insured recovered a portion of its mismanaged funds, subject to a claw-back

action. It contended, however, that it was not made whole and submitted a claim to its insurer estimating a loss between $15 million and $57 million. The insurer denied the claim, and the insured filed suit in federal court. The parties cross moved for summary judgment. The District Court granted both motions, but entered a take-nothing judgment against the insured, holding the loss occurred only after the insured loaned its funds to the fraudsters at which point the insured neither owned the earnings nor the principal. The insured appealed, and the insurer cross appealed.

Applying Texas law, the Fifth Circuit affirmed the District Court's judgment. The Fifth Circuit held that the insured did not own the principal or earnings, as the term "own" is commonly understood. It did not have or possess the property. Rather, the insured loaned the money in exchange for the promissory note. When it made the loans, it surrendered possession and control of the funds. It "owned" the promissory note, not the funds. The insured argued that the policy contemplates equitable ownership, but the Fifth Circuit elected not to read such rights into the policy where no intent to provide such rights existed. The Fifth Circuit also held that the insured did not suffer a loss at the moment that it loaned the funds. The loan procured through fraud created a voidable, not void, loan. However, the loss did not occur until the funds were stolen, and the theft itself occurred after the loan was completed. Title to the principal already had passed, and the insured no longer owned the funds. Finally, the Fifth Circuit held that the insurer's cross appeal was improper because, although the insurer took issue with the District Court's order, the District Court's final judgment was in favor of the insurer. The Fifth Circuit dismissed the insurer's cross-appeal.

Single Occurrence for Series of Acts and Non-Stacking of Limits Over Two Policy Periods Under Renewed Policy

Tenn. Clutch and Supply, Inc. v. Auto Owners Mut. Ins. Co., 2017 WL 5634248 (Tenn. Ct. App. Nov. 22, 2017).

The insured maintained a commercial liability policy that included an employee dishonesty endorsement providing $15,000 of coverage. The insured discovered that its employee embezzled approximately $100,000 over a period spanning two policy periods. The insured submitted a claim seeking $30,000 of coverage, under the theory that there were separate occurrences in each of the two policy periods, which made available the full limits for the endorsements attached to the policy for each policy period. The insurer determined that that the facts gave rise to only one occurrence, which spanned multiple years, paid the $15,000 limit under the endorsement and denied the balance of the claim. The insured filed suit in state court alleging breach of contract. The parties stipulated to the material facts and filed cross motions for summary judgment as to whether the insurer owed an additional $15,000 to the insured. The trial court held that the policy language was ambiguous as to whether it constituted a continuous policy or two separate policies, construed the ambiguity in favor of the insured, determined that two separate policies existed with separate $15,000 limits of coverage and held that the insured was entitled to recover $30,000 in total for its loss. The insurer appealed.

Applying Tennessee law, the Court of Appeals reversed the trial court's judgment. First, the Court of Appeals held that the policy expressly evinced the clear intent of the parties that the policy for the later period was a renewal of the policy for the earlier period, not as a separate policy. Second, under the policy, all loss that stems from multiple consecutive acts of theft by one employee constitutes one occurrence. There is a policy limit of $15,000 per occurrence, and there was one continuous occurrence that spanned two years. Third, the policy contained a Non-Cumulation of Limits provision that unambiguously prohibited stacking of coverage over multiple policy years. The Court of Appeals remanded the case for entry of judgment in accordance with this ruling.

Direct Loss Under Discovery Form and Revision to Covered Employee Definition Held Retroactive Under Discovery Policy for Later Discovered Loss

Fed. Deposit Ins. Corp. v. Arch Ins. Co., 2017 WL 5289547 (W.D. Wash. Nov. 13, 2017).

An insured bank contracted with third parties to have them originate residential real property mortgage loans that the bank agreed to purchase. The bank discovered that a mortgage application, which one of the third party loan originators originated, grossly overstated the

borrower's income. The bank notified the loan originator and initiated a broader review that uncovered multiple loan applications with false income statements. The bank repurchased loans pursuant to its contractual obligations and requested that the loan originator do so as well. However, the bank learned that the loan originator's net worth had greatly declined over the past two years due to a shareholder distribution. The bank suspended the loan originator's selling privileges. The bank also purchased three fraudulent loans from a separate third-party loan originator during this same time period. Subsequent to this activity, the bank's insurance broker negotiated changes to the blended bonds underlying the excess insurer's layer. The renegotiated terms defined "loan originator" and granted coverage related to their services. By its renegotiated terms, an individual or company that originates mortgage loans, which the bank purchases, qualifies as an Employee for dishonesty coverage. The bank thereafter learned, through a pending criminal matter, that multiple mortgages, which one of the loan originators originated, were unsecured. The loan originator engaged in a fraudulent scheme to make the lending appear legitimate and ultimately compromised the bank's priority in the chain of title. The bank learned that it had purchased 124 fraudulent loans for $53,344,641.16 and notified its insurers, including the excess insurer. The excess insurer denied coverage on the grounds that the losses were indirect and the bonds did not cover fraudulent mortgages which originated prior to the bond period amending the employee definition to include a loan originator. The receiver, on behalf of the now-failed bank, brought suit in federal court. The excess insurer sought summary judgment.

Applying Washington law, the District Court denied the excess insurer's motion. First, the excess insurer argued that the losses do not trigger its obligations to indemnify because the loan originators were not employees under the bond at the time they sold the fraudulent loans to the bank. The District Court disagreed, citing the discovery language of the bond. The District Court noted that the bond contemplates covering frauds that occurred before the bond went into effect as long as they were discovered within the bond period. Second, the excess insurer argued that the cause of the loss was the bank's contractual obligation to repurchase faulty loans and not the loan originators' fraud. In evaluating the "resulting directly" language of the bond in view of Washington cases interpreting the word "direct," the District Court observed that, in the insurance coverage context, "direct" means "without any intervening agency or step: without any intruding or diverting factor." The District Court concluded that the loan originators perpetrated a fraudulent scheme designed to separate the bank from its money and that the bank suffered a loss the moment it delivered the funds to the loan originators and received worthless paper in return. The District Court found unpersuasive the argument that later, unsuccessful attempts at mitigation converted what it viewed as a direct loss from its inception into an indirect loss. The District Court held that the bank suffered an initial loss in the amount it paid for the fraudulent loans directly resulting from the loan originators' fraud.

No Ownership Interest In Property Where Insured's Client Has its Intended Payment of Invoice from Insured Diverted to Fraudster Pursuant to Social Engineering Scheme

Posco Daewoo Am. Corp. v. Allnex USA, Inc., 2017 WL 4922014 (D.N.J. Oct. 31, 2017).

The insured imported and exported chemicals and provided them to a chemical supplier. During the course of a business transaction with that chemical supplier, a fraudster intercepted certain communications, impersonated the insured's accounts receivable employee and perpetrated a social engineering scheme. The chemical supplier relied on the fraudster's communications without verifying their authenticity and made wire transfers from its own accounts in an effort to pay outstanding receivables it owed the insured. The chemical supplier encountered difficulties making the payments, and the fraudster repeatedly made adjustments to the account numbers to allow the chemical supplier to complete the payments. When the fraudulent scheme was discovered, the chemical supplier recovered only a portion of the funds. A dispute arose with regard to whether the chemical supplier had satisfied its obligation to pay for outstanding receivables with respect to the unrecovered funds, as the chemical supplier maintained it made the transfer of funds and satisfied its obligations. The insured contended it had not been made whole for the business transaction. Rather than

focus exclusively on its contractual remedy against the chemical supplier, the insured submitted a claim under its commercial crime policy contending that it suffered a computer fraud loss. The insurer denied the claim on the grounds, *inter alia*, that the insured did not own the property forming the basis of the loss, the insured did not suffer a direct loss and the insured did not suffer a computer fraud as the policy defined that term. The insured file suit in state court in New Jersey against the insurer and the chemical supplier, and the insurer removed the case to federal court based on diversity. The insurer moved to dismiss the complaint for failure to state a claim, and both the insured and chemical supplier opposed the motion.

Applying New Jersey law, the Court granted the insurer's motion, holding that the policy's Ownership provision was dispositive. The Ownership provision limited covered property to three scenarios. The Court determined that the first two scenarios – where the insured holds property for others or where the insured is legally liable for the property – were inapplicable under the specific facts at issue. The Court considered whether the third scenario – where the insured owned the property – was triggered. The Court held that the insured did not properly plead that it owned the money wired for which it sought coverage. The Court found that the insured did not plead facts sufficient for the Court to find that it rightfully had possessed or had legal title to the money, which the chemical supplier transferred. The chemical supplier's intent to transfer legal title in that money did not equate with the actual transfer of legal title. The Court did not address fully the computer fraud or direct loss arguments that the parties proffered because the Ownership provision disposed of the complaint. The Court gave the insured leave to file an amended complaint to plead an ownership interest, if any, in the property in which the insured claims a loss.

LEGISLATIVE UPDATE

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

The year was another busy one for surety issues. Below is a sampling of some additional bills that were adopted since the last Legislative Update. New Jersey joins the long list of states requiring registration bonds for appraisal management companies; California identified a new bond requirement for those licensed in the Cannabis profession; and Ohio created a requirement that state agencies review whether financial responsibility instruments, including bonds, required as a condition of licensure, are available in the market. In addition, New Hampshire and Wisconsin amended their respective Little Miller Acts. New Hampshire increased the threshold and Wisconsin eliminated the bi-annual escalation of the threshold based on the consumer price index. 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.

California

Cannabis Professionals License Bond

Cannabis professionals required to be licensed in California must post a surety bond to cover the costs of destruction of cannabis or cannabis products if necessitated by a violation of licensing requirements.[1]

[1] Cal. Bus. & Prof. Code § 26051.5 (S.B. 94).

Illinois

Motor Vehicle Dealer and Remittance Agent Bond

The minimum license bond amount for a remittance agent in Illinois is increased from $10,000 to $20,000. A remittance agent is the person engaged in accepting money for remittance to the state for payment of registration plates, vehicle certificates of title, taxes, or registration fees. In addition, Illinois amended the Consumer Fraud Act to increase the surety bond or certificate of deposit required for used and new motor vehicle dealers from $20,000 per location to $50,000 per location. Certain persons are exempt from obtaining the bond, including a licensee who the Secretary of State determines has faithfully and continuously complied with the conditions of the bond requirement for a period of 60 consecutive months subsequent to January 1, 2018. Prior to these amendments, the law provided for 36 consecutive months of faithful and continuous compliance.[2]

New Hampshire

Public Construction Bond Threshold

Prior to the amendments in H.B. 371[3], the threshold for a Little Miller Act bond in a public works project was $35,000. H.B. 371 increases and bifurcates the threshold as follows: $75,000 for state projects and $125,000 for political subdivision projects.

New Jersey

Appraisal Management Company Registration Bond

New Jersey adopted a new law to require the registration of appraisal management companies. The law requires a $25,000 surety bond.[4]

North Carolina

Reclamation Bond

House Bill 56[5] creates a cap for the reclamation bond associated with mining operations at $1 million. The law also eliminates the bi-annual renewal process for these permit bonds and establishes financial assurance waiver authority for risk-based clean-ups. A person conducting remediation of a contaminated site need not provide financial assurance if the only actions or controls to be implemented are annual reporting of land-use controls and/or the maintenance of durable or low-maintenance covers for contaminated soil.

Critical Infrastructure Assessments

When a county or city contracts with a private entity to construct a project on behalf of the county or city, the board of commissioners may agree to impose one or more assessments to reimburse the private party for actual costs incurred. Where a subdivision control ordinance is adopted and funded, in whole or in part, by one of these critical infrastructure assessments, the performance bond requirements applicable to ordinary subdivision control ordinances shall also apply thereto.[6]

Ohio

Review for Bond Availability

Prior to the review date of an existing rule, the state agency that adopted the rule must now review whether or not the rule requires liability insurance, a bond or any other financial responsibility instrument as a condition of licensure. If any of these instruments are required, the agency must conduct a diligent search to determine if insurance, a bond, or other financial instrument is readily available in the amount required. The agency must certify that this search was conducted.[7]

Wisconsin

Bond Threshold Indexing Eliminated

Wisconsin has long been the only state to base their Little Miller Act threshold on a bi-annual review of the Consumer Price Index. The legislature eliminated the indexing of the bond threshold this year, freezing it at $369,000 for state projects and $148,000 for local projects.[8]

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[2] 625 Ill. Comp. Stat. 5/3-905; 5/5-101; 5/5-102; and 5/5-107 (S.B.1556).
[3] N.H. Rev. Stat. Ann. § 447:16.
[4] N.J.S.A. § 45:14F-35 (A.B. 1973).
[5] N.C. Gen. Stat. §74-52; 74-54; and 130A-310.72.
[6] N.C. Gen. Stat. §153A-210.4 and 160A-239.4 (H.B. 158).
[7] Ohio Rev. Code Ann. §106.03.
[8] Wis. Stat. § 779.14 (A.B. 64).

MARK YOUR CALENDARS NOW – JUNE 20-22, 2018

43rd Annual Meeting and Seminar
Surety Claims Institute

Join us for two half-day seminar sessions with dynamic speakers, audio-visual presentations and a valuable collection of articles for your resource library, covering timely surety, fidelity and commercial bond topics. This year's program will focus on advanced surety and construction topics including practical approaches and best practices for claims handlers, their counsel and consultants. There will be a presentation on bad surety and fidelity cases and how to deal with them as well as an hour of ethics dedicated to real problems confronting surety professionals. The tentative schedule is below, but is subject to change.

Beaver Creek

136 E. Thomas Place
Beaver Creek, CO 81620
Tel: 1-970-949-1234
beavercreek.park.hyatt.com

PRELIMINARY 2018 PROGRAM AGENDA

INTRODUCTION

Thursday

1. Annual Review of Surety Case Decisions Including the Really Bad Ones.

   Speakers: Benjamin Lenz
   Trisha Wager

2. Erosion of the Overpayment Defense and tips for Sureties when dealing with Obligees that have depleted Contract Funds.

   Speakers: Sonny Shields
   Timothy D. Martin

3. What Every Surety Professional Should Know About Building Envelope, Mechanical and Subsurface Conditions Which Lead to Claims and How a Surety Can Best Mitigate its Losses.

   Speakers: Paul Schraf, Greg Daily, Robert Fox
   Dennis O'Neill, William Ikerd, Munther Shamieh

4. Advanced Problems Confronting Claims Handlers and Practical Approaches to Addressing Them.
   a. Surety's liability for DBE fraud.
   b. Reinsurance and indemnity issues.
   c. Trying to Bind Subsidiary and Affiliated Companies Using the Indemnity Agreement.

   Speakers: Blake Wilcox
   Frank Lanak
   Keith Langley

Friday

1. Annual Review of Fidelity Decisions Including Significant Commercial Surety Cases.

   Speakers: Carla Crapster
   Ben Weible

2. Guidance When Dealing With State and Local Public Bodies, Including Educational and Institutional Infrastructures and Municipal Authorities.

   Speakers: Michael Cronin
   Jessica E. Bowers
   Michael Hurley
   Stephen Ferretti

3. Best Practices for Negotiating Takeover and Tender Agreements.

   Speakers: Laurence P. Jortner
   Chris McRae
   Brad Carver
   C. Hamilton Jarrett

4. <u>Structured Surety Financing Arrangements of the Principal and Related Strategies for Avoiding Losses</u>.
Speakers: Michael Carson
Chris Ward

5. <u>Ethics: Real Problems Confronted by Surety Professionals, Including Issues of Conflict of Interest.</u>
Speakers: Ali Salamirad
Marilyn Klinger
David J. Barton
Chris Bartholdt

* Ziplinine above the canyon floors through the Rocky Mountains
* Ride the Centennial Express Chairlift to the top of Beaver Creek Mountain where various activities await: disc golf, tetherball, hiking, horseshoes, and much more.
* Check out the 25-foot climbing wall at the base of Beaver Creek Mountain
* Horseback ride up to Beaver Lake
* Take a Jeep, Hummer or ATV mountain tours on the rugged all-terrain trail that takes you up 12,500 feet
* Raft or kayaking on a number of waterways is ideal for all ages and skill levels
* Fly Fishing
* Hot Air Ballooning
* The resort also offers an outdoor pool, and kiddie pool to enjoy the afternoon in the mountains. A world class spa, tennis, and shopping are also available.

Complete information and registration forms are scheduled for mailing in March.
Mark your calendar and make plans for a family vacation while enjoying the superb educational experience offered by our annual programs.
We look forward to seeing you at the Park Hyatt Beaver Creek Resort.
If you have questions, call Diane Kennedy at (913) 317-5100 or email Diane at dkennedy@gh-ks.com
For more information about SCI, visit our website at www.scinst.org

SUGGESTIONS & COMMENTS??

As to program suggestions:

Amy Bentz
Bentz Law Firm, P.C.
Washington Center Bldg.
Suite 200
680 Washington Road
Pittsburgh, PA 15228
Ph: (412) 563-4500
e-mail: aebentz@bentzlaw.com

As to Newsletter Contents:

Armen Shahinian
Chiesa Shahinian & Giantomasi PC
One Boland Drive
West Orange, NJ 07052
Ph.: (973) 530-2002
Fax: (973) 530-2202
e-mail: ashahinian@csglaw.com

As to SCI Activities Generally:

Diane Kennedy
Surety Claims Institute
9225 Indian Creek Parkway
Suite 1070
Overland Park, KS 66210
Ph: (913) 317-5100
email: dkennedy@gh-ks.com

As to Address Changes:

Diane Kennedy
Surety Claims Institute
9225 Indian Creek Parkway
Suite 1070
Overland Park, KS 66210
Ph: (913) 317-5100
email: dkennedy@gh-ks.com

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