Surety Claims Institute

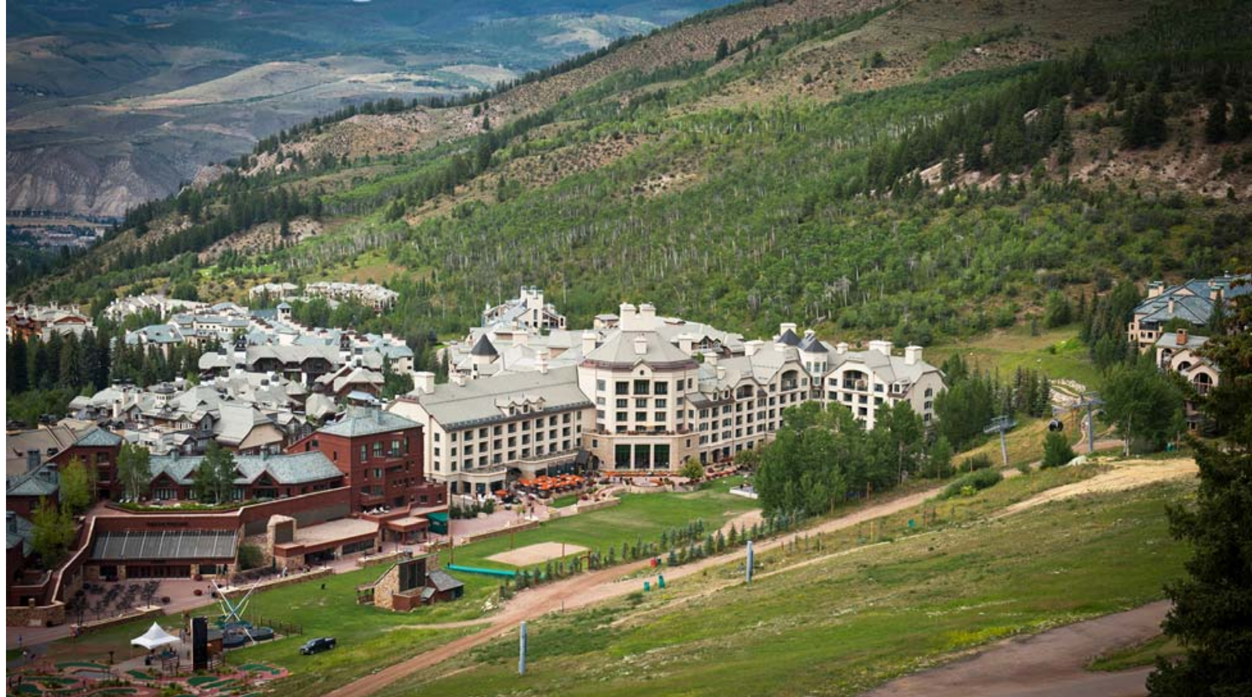
Volume 32 September, 2018 Number 3

Newsletter

www.scinst.org

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

SURETY CLAIMS INSTITUTE 43RD ANNUAL MEETING



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

The SCI's 43rd Annual Meeting hit a true Rocky Mountain High this past June at the Park Hyatt Beaver Creek Resort in Beaver Creek, Colorado. The 43rd Annual Meeting had its highest attendance since 2007 with over 50 surety company employees and 90 attorneys and consultants attending.

Amy Bentz (The Bentz Law Firm, Pittsburgh, PA), in her final year as SCI's Program Chair, organized a program which was well received. Amy received well-deserved recognition and thanks from all attendees. The program content feedback from the attendees has been uniformly excellent. As usual, SCI delivered an outstanding program including an ethics panel which qualified for an hour of both CLE and CE credit for those attendees who have either CLE or CE requirements. The ethics program, which was the last program on Friday, was presented by Marilyn Klinger (SMTD Law, Los Angeles, CA) and David Barton (The Bentz Law Firm, Pittsburgh, PA). Marilyn and David went forward without Al Salamirad (SMTD Law, Irvine, CA) who played a key role in preparing the written materials. Ali who was called *(continued on page 6)*

In This Issue:

Comments From The Editor: Bonding Set-Aside Contracts After *Narula* 2

In Memoriam – James M. Mulvaney 5

Leveraging Transactional Risks To Negotiate Favorable Bond Terms 8

The Pros and Cons of Notifying Banks About Trust Fund Provisions 15

Surety Casenotes 17

Fidelity Casenotes 23

Legislative Update 27

Save the Date 30

SURETY CLAIMS INSTITUTE

www.scinst.org

Officers

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

Vice President
Kevin O'Connor, *Boston, MA*
David Pharis, *Wayne, PA*
Gerard P. Sunderland, *Baltimore, MD*

Treasurer
Ed Hancock, *Tampa, FL*

Secretary
Ellen M. Cavallaro, *Morris Twp., NJ*

Executive Secretary
Diane Kennedy
Surety Claims Institute
4420 Madison Avenue
Suite 200
Kansas City, MO 64111-3407
email:dkennedy@dysarttaylor.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
Christopher R. Ward, *Dallas, TX*

Surety Casenotes Editor
Kenneth W. Rockenbach, *Seattle, WA*

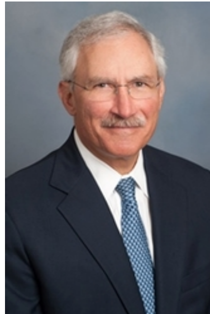
Fidelity Casenotes Editor
Robert M. Flowers, *Hartford, CT*

Legislative Activities Editor
Angela Gleason, *Washington, DC*

Board of Directors

Bernard L. Balkin
Ellen Cavallaro
Kimberly Czap
Edward F. Dudley
Robert Duke
Sharon M. Edwards
Ronald F. Goetsch
Elizabeth L. Gordon
Gary Judd
David C. Kitchin
David Kotnik
David Koziel
Frank Lanak
T. Scott Leo
Kim McNaughton
Robert W. Monaghan
Steven D. Nelson
Kevin O'Connor
David M. Pharis
Jason R. Potter
Kenneth Rockenbach
Armen Shahinian
H. Bruce Shreves
Carol Z. Smith
Gerard P. Sunderland
Gregory R. Veal
J. Blake Wilcox
Richard S. Wisner
Keith Witten

Comments From The Editor: Bonding Set-Aside Contracts After *Narula*



It has now been one year since the *Narula* reverse False Claims Act decision sent shock waves through the surety industry. In *Narula*,[1] a U.S. District Court Judge sitting in the District of Columbia ruled that reverse false claims liability and the potential for treble damages can extend to a surety where its agent becomes aware of facts suggesting that the bonded principal was fraudulently participating in a government set-aside program and the surety nonetheless proceeded to issue Miller Act bonds on behalf of such principal. While the

[1] *United States ex rel Scollick v. Narula*, 2017 WL 3268857 (D.D.C. July 31, 2017).

case remains pending and will hopefully yield a subsequent decision which will substantially narrow its scope, its potential for undermining government set-aside programs remains real, and sureties continue to grapple with the risks associated with bonding MBE/DBE and similar set-aside projects. While the decision, on its face, would seem to be one aimed toward protecting the integrity of set-aside programs, it creates the potential for completely undermining those programs.

In *Narula,* a plaintiff-relator alleged that defendant individuals were engaged in a scheme to fraudulently obtain service-disabled veteran-owned small business status, HUBZone status, or Section 8(a) status for certain companies in order to bid on and obtain set-aside contracts when those bidders did not in fact qualify for the status claimed. Defendants are alleged to have falsely certified their status, made false claims regarding past performance, hidden aspects of the management and control of the companies at issue and hidden or falsified information regarding the control and beneficial ownership of those companies. I will not belabor these Comments with a full recitation of the facts, but note that claims were also asserted against the sureties issuing bonds on behalf of the companies alleged to have been qualified through fraud; and the alleged liability of the sureties was based upon the sureties' agent and attorney-in-fact allegedly having known of facts suggesting that ownership and control over the bonded principals were not, in fact, as certified, and that the principals were, in fact, shell companies. It was further alleged that underwriting and due diligence by the sureties would have revealed that the principals did not have the necessary construction experience or financial capabilities to perform the work and that the actual beneficial ownership and control of the companies was not vested in the individual represented to control and manage them; and, therefore, that they did not qualify with respect to the set-aside contracting requirements. Plaintiff asserted that, in issuing the Miller Act bonds, the sureties agreed to compensate the government for losses should the principal fail to meet the bonded contract specifications, including contracting requirements with respect to the contractor's qualifications, that the sureties knowingly concealed information and facilitated the fraudulent scheme, causing the other defendants to violate the False Claims Act. It was alleged that the sureties' bond broker was intimately familiar with the business dealings of the defendants involved in the alleged scheme, and that defendants were bidding on set-aside contracts even though they were not qualified to submit such bids. Therefore, the sureties should not have issued the bonds, and, having done so, they assisted the defendants in perpetrating the fraud upon the government. The liability alleged was for, among other things, treble damages in the full amount of the penal sums of the bonds at issue.

The sureties moved to dismiss and were initially successful, but the court denied the motion to dismiss as to an amended complaint which provided more factual detail to support the allegations made.

It is not clear from the court's recitation of the facts whether any representatives from the sureties' underwriting department participated in the on-site inspections of the principal's operations from which knowledge was or should have been obtained, and the decision is unclear regarding whether the court intended to pronounce a rule that the broker/agent's knowledge will always be imputed to a surety. The court's observation that the sureties' actions were crucial to the principals' ability to bid on and obtain set-aside contracts, appears to have been central to its conclusion regarding the sureties' potential exposure for aiding and abetting the fraudulent scheme. What is of extraordinary concern is the notion that the sureties' liability, based upon these allegations, could give rise to treble damages measured by the full penal sum of the bonds. Whistleblower relators extorting monies from sureties by asserting False Claims Act liability to the extent of three times the penal sum of any bonds based upon the imputed knowledge of the surety, is a frightening prospect.

It is important to note that this decision was rendered on a motion to dismiss and not after a full development of the facts. Thus, the setting for the court's decision was most unfavorable to the sureties. On motions to dismiss, courts will often bend over backwards to find that liability *could* attach based upon allegations which may conceivably be proven at trial, so as to give a plaintiff his day in court. In doing so, courts sometimes make pronouncements that may unfortunately become the guiding basis for future resolution of

dispositive motions. In contrast, after a trial or on a motion for summary judgment supported by detailed affidavits containing a complete presentation of the facts, a court might be much less favorably inclined toward an aggressive plaintiff and less willing to give the plaintiff the benefit of any doubt. Frankly, it is for this reason that I often will hesitate to file motions to dismiss cases at an early stage.

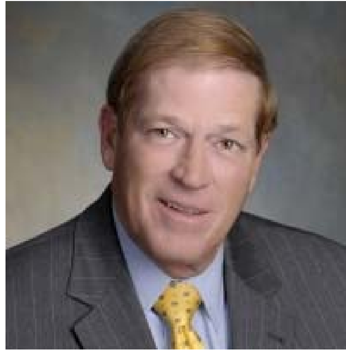
Whatever the final resolution of the *Narula* case may be, one wonders, both as to the impact of this decision on sureties' underwriting bonds on set-aside contracts and on whether the Court had any real sense of appreciation for the potential impact of its decision. If the court was motivated by a desire to protect the integrity of set-aside programs, that is not likely to be the primary impact of the decision. Rather, sureties will now have to grapple with the tremendous increase in the risk associated with bonding set-aside contracts, as the maximum loss potential with respect to such bonds has been increased beyond what many sureties will tolerate, thus potentially destroying, rather than protecting, such programs.

Of course, I disagree with many of the court's observations and its approach. In addition, there is some split among the circuits regarding what the proper measure of damages ought to be where there is a violation giving rise to False Claims Act liability. Some courts suggest that any payment made with respect to a contract for which the recipient was not entitled due to failure to meet contract requirements is subject to being disgorged with such liability trebled. Other courts suggest that liability should be limited to only actual damages, which then might be trebled. The question is, does the government get the building for free, plus a recovery of triple the amount of the contract sum paid, or should it only obtain a recovery for three times the spread between what the contract amount was as bid by a set-aside contractor versus what the bid amount would have been had bidding been open to all potential contractors? These issues have not been fully fleshed out, and there is no definitive answer from the courts regarding the scope of potential liability.

As a matter of public policy, however, imputing liability to a surety based upon what an agent knew or should have known where the government has itself made the determination that a principal qualifies for a set-aside program, seems both unrealistic and counter-productive. Whether or not set-aside programs are wise is a separate issue about which there might be some legitimate debate. However, if such programs are appropriate public policy, and legislatures certainly have so determined, allowing these programs to be eviscerated through imputation of huge liability upon the sureties that might otherwise be willing to accept the other risks associated with bonding small startup-type enterprises, provides an opportunity for those who might disagree with the public benefit of such programs to effectively kill them. Without bonding, minority business enterprises cannot survive; and imposing huge additional liability exposure for what a surety knew or should have known about a potential principal creates all sorts of unmanageable risks. Should a surety conduct more underwriting due diligence to acquire additional knowledge to fulfill what the surety "should have known"? Can the sureties really supervise agents adequately to determine what they might know about who might be exercising control over managerial decisions? Is acquiring more information really going to provide comfort to a surety as to what it "should have known"? It is important to note that, in *Narula*, the government itself passed on the opportunity to prosecute claims against the sureties, thereby allowing the relator to proceed in the relator's own interest to pursue such claims. Thus, the government presumably did not believe the claims to be meritorious or worth pursuing, but left the opportunity to the supposed "whistleblower" to profit from what might otherwise be deemed extortionate claims. Hopefully. once a final decision is rendered in *Narula*, the court will walk back substantially the scope of potential surety exposure so as not to undermine all set-aside programs. If those programs should not survive as a matter of public policy, that should be a legislative decision, not a decision driven by the opportunity for so-called "whistleblowers" to undermine their existence through extortionate claims.

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

IN MEMORIAM
JAMES M. MULVANEY



By: John Morris, Adam Schwartz and Ted Baum, McElroy, Deutsch, Mulvaney & Carpenter, Rochester, NY

The surety industry lost a friend last month. Long-time Surety Claims Institute member James M. Mulvaney passed away on July 9, 2018, just a week after celebrating his seventy-first birthday with son Ryan and daughters Jennifer and Colleen, followed (of course) by a round of golf. Jim will long be remembered as an accomplished construction, surety and fidelity lawyer, a shrewd litigator, a cherished colleague, a proud veteran of the U.S. Army, an avid golfer, and most importantly, a kind hearted father and friend.

Jim started his career at the Fireman's Fund Insurance Company in Newark, New Jersey. He then established a solo law practice above a hardware store in Morris Plains, New Jersey. During a four-year litigation concerning the construction of a hospital, Jim met Edward Deutsch, the attorney for a co-defendant. The resulting bond of friendship was based upon mutual professional respect. In 1984, Jim and Ed founded a two-man law firm which would become McElroy, Deutsch, Mulvaney & Carpenter, LLP and grow to its current complement of nearly 300 lawyers with fourteen offices in nine states. Jim counted his son, Ryan P. Mulvaney, among his partners.

Jim was a lawyer of the old school. He had an incredible work ethic. Jim was as gentlemanly and polite, as he was an intense and demanding lawyer, and viewed the law as a valued profession. Among staff at the Morristown, New Jersey headquarters of MDMC, it came as no surprise that Jim continued to practice law during a hard fought battle with cancer. In a way, death may have come to Jim as he preferred – "with his boots on."

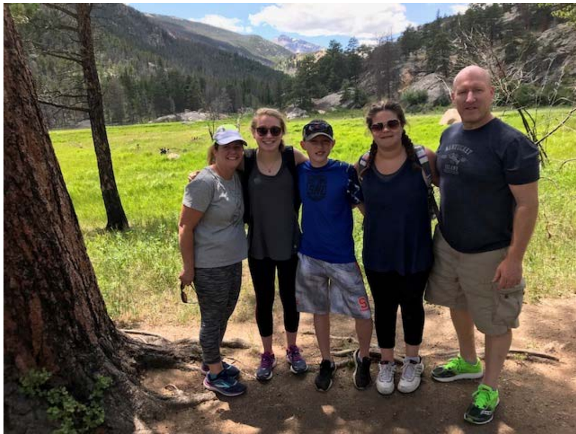
Quoted in the publication NJBIZ, long-time MDMC managing partner Ed Deutsch spoke of Jim Mulvaney this way: "I will always remember Jim as a humble leader, a devoted father and son, a lawyer's lawyer, and a wonderfully loyal partner and dear friend. In our more than thirty-five years together, both in good and tough times, we were able to build a successful firm without ever exchanging a single harsh word. I'm really going to miss him as will everyone who had the good fortune to know him." Part of Jim's obituary read: "He taught his family to do for others, to exist for others, and to have strength to lead and persevere even in the most difficult of time. He had his own way, and indeed, Jim did it his way – 'end of discussion.'"

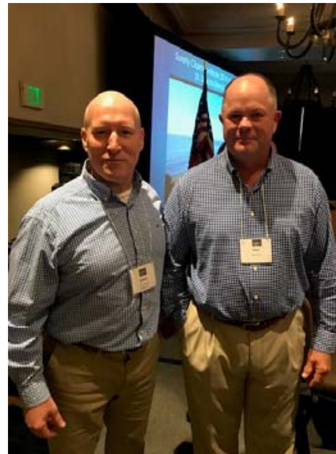
Among the scores of people comforting his family at calling hours and paying final tribute at a funeral mass in Chatham, New Jersey were his many friends from the surety industry, professional colleagues from both MDMC and other law firms, and numerous clients and judges.

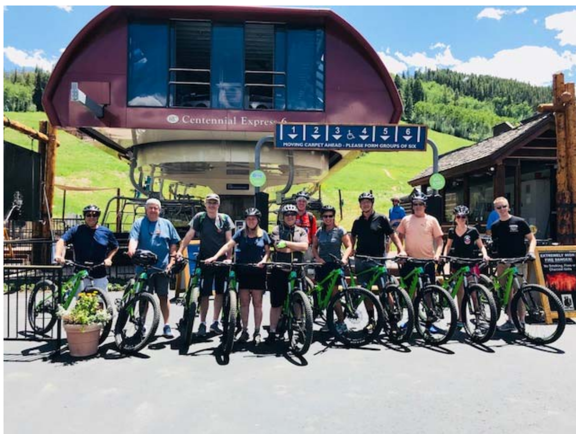
Jim Mulvaney will be greatly missed by his family and by his colleagues at MDMC. Professionally and personally, Jim's shoes will not be easily filled.

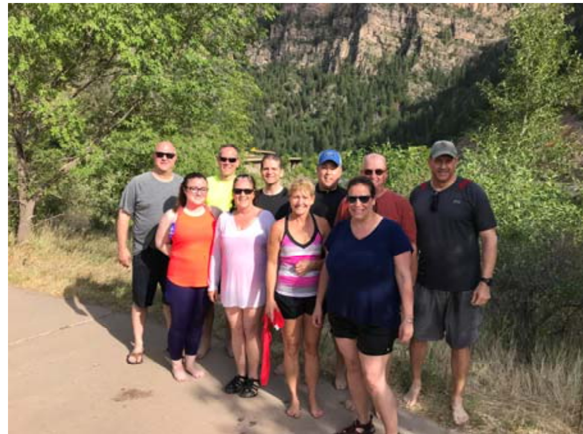
SURETY CLAIMS INSTITUTE 43RD ANNUAL MEETING

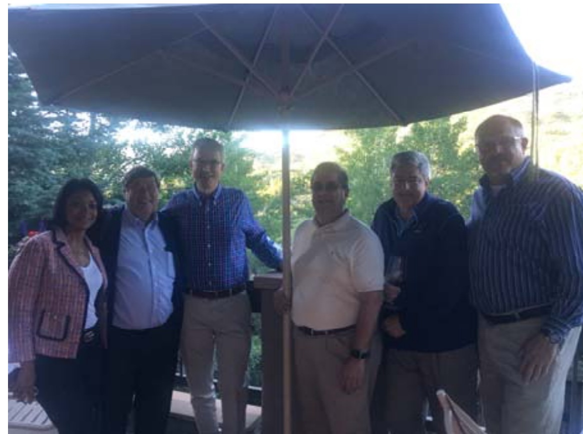
(continued from page 1)







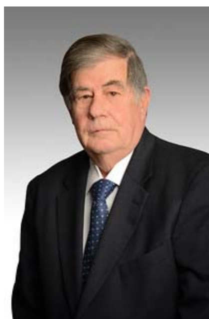




back to California to handle a pressing problem. He was sorely missed. This panel focused on ethical problems and solutions involved when a surety tenders a defense, including attorney billing issues, unintended disclosures and related ethical issues.

The educational portion of the program commenced on Thursday morning with the annual Surety Law Update presented by Michael Burkhardt (Liberty Mutual, King of Prussia, PA), Patricia Wager and Benjamin Lentz (Torre, Lentz, Gamell, Gary & Rittmaster, Jericho, NY). As they have in the past years, Michael, Patricia and Ben concentrated on the major cases which have affected the industry over the past year and the key holdings in those cases.

Their presentation was followed by Timothy D. Martin (Great American Insurance Company, Cincinnati, OH) and Lloyd "Sonny" Shields (Shields Mott, New Orleans, LA) who analyzed the potential erosion of the surety's traditional overpayment defense, including practice hints for a surety that has to deal with



an obligee which has depleted the bonded contract funds to the detriment of the surety, and methods to deal with the issue in jurisdictions which have weakened this traditional surety defense.

The next program was a panel discussion with Paul Schraf (Liberty Mutual, King of Prussia, PA), Gregory Daily (the Hartford, Hunt Valley, MD), Robert Fox (The Whiting Turner Contracting Company, Towson, MD), Dennis O'Neill (Beacon Consulting Group, Medford, MA), Munther Shamieh (JS Held, San Antonio, TX) and Will Ekerd (Ikerd Consulting, Denton, TX) who presented an informative and interesting introduction to the Building Information Modeling ("BIM") system. The BIM system continues to develop as a tool for the design and construction of many new buildings. They discussed the problems with standard form construction contracts which have not developed as quickly as has BIM technology. Their presentation focused on identifying how contract language should be modified to adopt to the BIM system in contract development.

Blake Wilcox (Liberty Mutual, Seattle, WA), Frank Lanak (Tokio Marine HCC, Los Angeles, CA) and Keith Langley (Langley LLP, Dallas, TX) closed the Thursday program with their usual blend of a humorous and informative presentation addressing complicated issues facing the surety claim professional and the best ways to overcome these challenges. Their program focused on a surety's ability to settle its principal's affirmative claims, problems which a surety faces when it issues bonds on behalf of a minority or disabled business enterprise and the practical problems which may arise when an MBE or DBE is defaulted. They also addressed the emerging issue of the potential scope of a surety's liability under the False Claims Act based upon its or its agent's knowledge gained during the underwriting process regarding the MBE/DBE's ownership or management.

On Friday morning, Carla Crapster and Ben Weible (Clark Hill Strasburger, Dallas, TX) presented their annual Fidelity Law Update. This was expanded this year to also provide updates on commercial surety law.

This presentation was followed by Jessica Bowers (Smith Bowers, Raleigh, NC), Michael Cronin (Markel Surety, Austin, TX), Michael Hurley (Berkley Surety, Morristown, NJ), and Stephen Ferretti (Cashin Spinelli & Ferretti, Hauppauge, NY) addressing the never-ending problem for a surety when it has to deal with state and local public obligees and the unique problems which those entities present to a surety when asserting performance bond claims.

Prior to the Ethics program, Laurence Jortner (CNA Surety), Christopher McRae (McRae & Metcalf, Tallahassee, FL), Brad Carver (Hinshaw & Culbertson, Boston, MA), and C. Hamilton Jarrett (Connor, Gwyn & Schenck, Raleigh, NC) provided practical tips and suggestions for the surety to utilize when negotiating a takeover and tender agreement.

Finally, Chris Ward and Phil Pemberton (Clark, Hill Stasburger, Dallas, TX) and Michael Carson (QBE North America, Philadelphia, PA) presented a program identifying the three key issues a surety should consider when structuring a financing agreement in order to mitigate its losses.

In addition to fulfilling its primary role to provide timely and comprehensive educational programs for all attendees, the SCI continued its history of providing programs in a relaxed and family friendly social setting. All participants enjoyed the Park Hyatt. Attendees were able to enjoy the natural beauty of the Colorado Rockies, participate in hiking, fly-fishing and white water rafting, and visit the

many nearby attractions, including the well-known ski resort in Vail, Colorado.

The very large attendance at this year's meeting has encouraged the SCI's Board to continue plans to hold the SCI's Annual Meeting every three years at a western location. This past year was especially successful because the SCI did not face the wildfires it faced the last time it was in Colorado at the Cheyenne Mountain Resort in Colorado Springs. The Board is tentatively exploring Park City, Utah as a site for its 2021 meeting in order to continue holding its Annual Meeting at a western location on a rotating basis and to provide SCI members from the western part of the United States a more convenient location than always holding the meeting in the eastern United States. Attendees and their guests were also able to ride the ski lifts to the top of Beaver Creek Mountain, enjoy the views and visit the Betty Ford Gardens, which were named after the late First Lady. The late President's house was plainly visible from Beaver Creek Mountain.

The SCI's meeting planning committee, consisting of Kevin O'Connor, Bob Monaghan, and Dan Lund, did their usual wonderful job in planning the meals and entertainment which were enjoyed by all.

For the SCI's 44th Annual Meeting, the SCI will do something new. It will travel from the Rocky Mountains to the Georgia coastline to hold its Annual Meeting at the King & Prince Resort on Saint Simons Island, Georgia, from June 19 to 21, 2019. The SCI's Board hopes all members will plan to attend next year and enjoy the Georgia low country hospitality. This will be the first time the SCI has ever held its Annual Meeting at a beach front location. We hope to see you all there!

LEVERAGING TRANSACTIONAL RISKS TO NEGOTIATE FAVORABLE BOND TERMS

By: Bryan A. Badeaux, Krebs Farley, PLLC, Dallas, Texas

I. Introduction

"Let us never negotiate out of fear. But let us never fear to negotiate." – John F. Kennedy

By undertaking the obligations of guarantor under a surety bond, the surety's liability absent a contrary statutory scheme is primarily defined by the language of the bond itself and the series of agreements incorporated by reference therein.[2] As such, the surety's ability to effectively negotiate favorable bond and integrated contract terms is paramount to maintaining a minimal loss book of business. Often, a surety is balancing the practical business need of generating premium against the risk of catastrophic loss. Complicating this delicate balance, a surety must be cognizant of the fact that a failure to write a particular bond may cause the surety to lose an otherwise lucrative account or, even worse, a profitable agency's book of business to another surety willing to take greater risk to acquire new

[2] *See, e.g., JMR Constr. Corp. v. Envtl. Assessment & Remediation Mgmt., Inc*., 243 Cal. App. 4th 571, 595, 198 Cal. Rptr. 3d 47, 66 (2015), as modified on denial of reh'g (Jan. 28, 2016) ("A surety contract is interpreted pursuant to the same rules that govern the interpretation of contracts generally. To determine the surety's liability, we look first to the express terms of the performance bond. Performance bonds typically incorporate by reference the general contract or subcontract for which the bond was issued. As such, the bond and the contract should be read together and construed fairly and reasonably as a whole according to the intention of the parties."); *Beard Family P'ship v. Commercial Indem. Ins. Co*., 116 S.W.3d 839, 846 (Tex. App.—Austin 2003, no pet.) ("The intent of the parties to a surety bond as well as their rights and obligations are determined by the language of the bond itself. Although the performance and payment bonds at issue incorporate the terms and conditions of the construction contract, any conflicting clauses must be harmonized to reflect the intent of the parties.").

business. It is no secret that developers and general contractors with substantial regional and national footprints are aware of these soft market risks and often seek to capitalize on market forces by requiring onerous bond and contract terms disproportionately slanted in their favor.

A surety will often discover facts during the course of its investigation of a claim which, if known at the time of issuance, would have likely lead the surety to require additional security, refuse to issue bonds, or require bonds in a different form. If claims departments can impute their postmortem experiences upon the underwriters manning the frontlines, however, it is likely that many crises could be avoided. Other than financial capacity, no single factor is more likely to directly circumvent catastrophic loss than the favorability of the bond terms at issue. Thus, it is essential that sureties be aware of the transactional factors that may better their standing to negotiate bond terms when presented with a bond request.

III. **Factors Affecting Negotiation Leverage**

"If you are unable to understand the cause of the problem, it is impossible to solve it." – Naoto Kan

Prior to taking steps to obtain concessions from the prospective obligee, the surety should consider the practicality, necessity, and business risk associated with negotiating bond terms as well as the transaction specific concerns that may affect its standing in negotiations.

A. Underwriting Considerations.

Before commencing negotiations, the party acting on behalf of the surety must understand that sureties, at their core, operate under a premium driven business model. As such, the surety's counsel must avoid being perceived as an academic impediment to booking premium. The mindset of counsel should not be to find what is wrong with a specific transaction, but how to get a deal done in the most prudent and least intrusive manner. Sureties operate in a competitive market driven by agent account acquisitions, and if the surety begins to obtain a reputation of being hyper-technical, agents will simply move accounts and quit submitting new business. As such, sureties must pick their battles and not engage in short-term inconsequential negotiations given the long-term business implications.

From a practical stand point, if the indemnification prospects balanced against the prospective bond exposure evidences little to no risk of loss to the surety then it is unnecessary to encumber resources and potentially burn political capital in meaningless negotiation. For example, if a surety is presented with a fully collateralized "one-off" bond request, the content of the bond would be of little concern (e.g., supersedeas or lien release bond). On the other end of the spectrum, when sureties are underwriting accounts with large backlogs of bonded exposure, the determination of whether to take on additional risk under unfavorable bond terms should involve a detailed analysis of situational risk specific to the implicated account. Beyond evaluating the typical financial disclosures, the surety's considerations should include: (1) the project size compared to historical completion data and work-in-progress; (2) whether the project presents geographic concerns for the account; (3) whether the project involves a transition of the account to a new trade; (4) continuity of the account's key personnel or ownership; and (5) the account's cashflow position, costs control procedures, and competency in estimating and maintaining contract profitability. Weighing the aforementioned considerations collectively, the surety should answer a simple question: "If this project results in a catastrophic loss for the account, will the surety be at risk of incurring an uncollateralized loss?" If the answer to this question is yes, then the surety should justly have reservations about issuing the requested bond in an unfavorable form.

B. Bond Forms.

The first consideration is an obvious one: is the proposed bond form unfavorable to the surety? To adequately make this initial determination, the surety's representative must truly understand the nature of the proposed bond and how it will be construed at law. There are two primary categories of contract surety bonds: (1) "Statutory Bonds" mandated by federal or state statute[3] and (2) "Common-law Bonds"

[3] Statutory Bonds may be categorized into several subparts and include bonds issued in connection with federal public works projects pursuant to the Miller Act, state public works projects pursuant to state adopted "Little Miller Acts", or bonds issued on

which are not required or issued in compliance with controlling statutes. While all bonds have the primary objective of protecting the obligee and other specified beneficiaries against contractor payment and performance defaults, they can vary drastically in terms and the scope of protections afforded. Typical bond form types include: (1) statutory prescribed forms; (2) standardized forms produced by trade groups, such as the AIA; (3) indemnity forms; (4) completion forms; and (5) manuscript forms. Because, more than likely, the underlying contract has been incorporated by reference into the bonds, the surety will be charged with knowledge of all the terms, stipulations, and legal consequences of the underlying contract, and in determining the surety's liability on the undertaking, the bonds and construction contract will be construed together to ascertain the true intent of the parties.[4] As a threshold question, the surety must determine whether any of the express bond language or incorporated contractual language is objectionable and whether there are statutory or common-law rules of construction which restrict or foreclose the potential to negotiate unfavorable provisions.

Generally, with Statutory Bonds, the relevant statutes are implied by law to be part of the bond and set forth the minimum obligations regardless of contrary language contained within the bond.[5] As such, the surety cannot bargain to modify a bond form in such a way that would directly conflict with the operative statutes.[6] More likely than not, attempts to bargain terms in conflict with operative statutes would be a futile exercise as, regardless of the bond's terms, a presiding court will either read omitted statutory provisions into the bond or eliminate as surplusage and deny legal effect to bond provisions that do not comply with the statutory requirements.[7] While attempting to eliminate statutorily prescribed minimum protections is futile, most bonding statutes authorize or have been construed to not prohibit the surety and principal from assuming obligations broader than those statutorily prescribed; thereby, in some cases, converting an otherwise Statutory Bond into a Common-law Bond.[8] If faced with an unreasonable attempt to expand the surety's statutory undertaking, the surety should question the obligee's authority and motive for attempting to expand its protections beyond statutory prescription. In the author's experience, such obligees are often unable to articulate a rational basis for expansion and, when pressed, often concede to the statutory minimums.

Common-law Bonds are interpreted as private contracts enforceable in accordance with their terms; as such, Common-law Bonds vary considerably as to the nature, scope, and conditions applicable to the undertaking. As with other written contracts, the surety and obligee are free to negotiate all the protections competing business interest will allow, so long as the terms are not illegal or against public policy.[9] Most Common-law Bonds issued in connection with private works jobs are issued as standardized bond forms which provide the

private works projects in which a particular state has statutes governing surety bonds for private works projects.

4 *See, e.g., City of Elgin v. Arch Ins. Co.*, 2015 IL App (2d) 150013, ¶ 23, 53 N.E.3d 31, 41, appeal denied, 60 N.E.3d 871 (Ill. 2016) ("even where the bond does not expressly refer to the underlying contract the two documents may still be read together to determine the intent of the contracting parties"); *BMD Contractors, Inc. v. Fid. & Deposit Co. of Md.*, 679 F.3d 643, 654 (7th Cir. 2012), as amended (July 13, 2012) ("the very existence of a surety implies an underlying obligation between the principal and its obligee. Accordingly, … courts have recognized that where a contract and a surety bond are executed together, they must also be construed together.").

5 *See, e.g., Paige Int'l, Inc. v. XL Specialty Ins. Co*., 267 F. Supp. 3d 205, 212 (D.D.C. 2017) ("[c]ourts construe bonds pursuant to ... statutes in favor of laborers and material suppliers and strictly against the surety by referencing the terms of the statute applicable to the bond."); *United Pac. Ins. Co. v. Chism Homes, Inc*., 102 Nev. 494, 498, 728 P.2d 809, 811 (1986) ("when a bond required by a statute contains language inconsistent with the purpose of the statute, the language of the statute will be 'read into' the bond so as to accomplish the purpose of the statute.").

6 *See e.g., Am. Home Assur. Co. v. Plaza Materials Corp*., 908 So. 2d 360, 370 (Fla. 2005) ("provisions of bonds posted pursuant to [a public works bonding statute] shall, regardless of form, be construed and deemed statutory bond provisions, subject to all [statutory] requirements. However, a company issuing a bond which fails to incorporate all statutorily required information … may be estopped from asserting the claimant's noncompliance with the [statutory] notice provisions.").

7 *See, e.g., Renasant Bank v. St. Paul Mercury Ins. Co*., 882 F.3d 203, 206 (5th Cir. 2018) ("If a statutory bond contains provisions which do not comply with the requirements of law, they may be eliminated as surplusage and denied legal effect. That is to say, terms that conflict with the relevant statute must be "read out" of a statutory bond."); *United Fire & Cas. Co. v. Acker*, 541 N.W.2d 517, 518–19 (Iowa 1995) ("statute providing for the giving of a bond becomes part of the bond, and imports into it any omitted conditions required by the statute. They prevail over additional or contrary bond provisions, which are treated as surplusage without effect.").

8 *See, e.g., Bridgeport, Inc. v. Tampa Roofing Co*., 903 So. 2d 306, 308 (Fla. Dist. Ct. App. 2005) ("[a] payment bond is a common law bond if it provides more expansive coverage than that provided for in the statute."); *Lum v. Lee Way Motor Freight, Inc*., 1987 OK 112, 757 P.2d 810, 816 (If terms of bond are broader than those imposed by statute, excess liability may be enforced if it does not offend public policy and was voluntarily assumed.).

9 *Id*.

surety with well-defined conditions and favorable options of performance in the event of a contractor default.[10] Indemnity Bonds are typically the least favorable to sureties and should be closely scrutinized prior to issuance. As the name suggests, Indemnity Bonds may allow the obligee to unilaterally proceed with completion and require the surety to indemnify the obligee for any losses that the obligee may suffer as a result of the principal's failure to perform the bonded obligations.[11] Completion bonds are an infrequently used form of performance bond typically written on behalf of a developer, as principal, and provide the surety with a singular option upon a contractor default, which is to take over and complete the contract work. The term manuscript bond refers to bond forms drafted by sureties which may address transaction specific concerns in atypical situations. Manuscript bonds often contain special provisions related to the scope of the work to be bonded, the surety's obligations for performance and the manner of said performance. The risk to the surety under indemnity bonds is great as the surety may have little or no control over the cost of completion and may have substantial open-ended risks to a host of consequential damages.[12] Clearly, the more preferable options are one of the more familiar standardized bond forms or a manuscript form prepared by the surety.

C. Prior Assumption of Liability.

A significant determinative in establishing the boundaries within which a surety may negotiate bond terms is the extent to which the principal and surety have previously bound themselves to a specified bond form. In many formal solicitations, the prospective obligee will have specified the required bond forms; therefore, by submission of its bid or proposal the principal already may have agreed to tender bonds in the forms specified. Such being the case, absent a larger transactional risk for the prospective obligee, it is likely the surety's bargaining leverage has already been significantly hampered. On the other hand, where the obligee has not prescribed a specific bond form, the surety is in a good position to negotiate more favorable bond terms.

Another significant consideration is whether the surety has assumed bid bond liability. Almost all public and many private solicitations require responsive bids to be accompanied by bid security in the form of a bid bond,[13] traditionally in an amount between five and ten percent of the bid submitted. The bid bond undertaking is quite simple in nature, providing that the obligee can make a claim against the bid bond should the principal, after award of the contract, fail to enter into the contract and provide the required payment and performance bonds.[14] While issuance of a bid bond does not, in most cases, obligate the surety to issue performance and payment bonds, even though refusal may result in contractor default, the prior assumption of monetary liability significantly impedes a surety's appetite to decline issuance of final bonds.[15] In such a case, absent a large bid spread marginalizing the benefits of the bid bond, the surety's leverage to negotiate the terms of the final bonds is suboptimal.

D. Obligee Risk Factors.

In the author's experience, sureties too often fail to investigate an obligee's own

---

[10] *See, e.g.,* AIA Document A311; AIA Document A312; *see also Int'l Fid. Ins. Co. v. Americaribe-Moriarty JV*, 192 F. Supp. 3d 1326, 1334 (S.D. Fla. 2016), aff'd, 681 Fed. Appx. 771 (11th Cir. 2017) (granting summary judgment to surety discharging its bond obligations based upon obligee's failure to comply with AIA A312-2010 conditions precedent); *Balfour Beatty Const., Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82, 86 (D. Conn. 1997) (enforcing notice requirements).

[11] *See, e.g., Dooley & Mack Constructors, Inc. v. Developers Sur. & Indem. Co.*, 972 So. 2d 893, 894 (Fla. Dist. Ct. App. 2007) (holding language in bonded contract allowing the obligee to either terminate the contract for default or take over the work and complete the contract itself, eliminated the bond requirement for notice of default and termination when the obligee chose the second option).

[12] *See, e.g., N. Am. Specialty Ins. Co. v. Chichester Sch. Dist.*, 158 F. Supp. 2d 468, 473 (E.D. Pa. 2001) (despite no express statutory allowance, surety obligated for obligee's attorney's fees as expressly provided for in the bond).

[13] Other bid security alternatives include letters of credit and cashier's checks.

[14] *See* § 7:40. Project risks—Contract formation risks—Refusal of prime contractor to honor its bid: Bid bond, 2 BRUNER & O'CONNOR CONSTRUCTION LAW § 7:40.

[15] *See, e.g., Chas. H. Tompkins Co. v. Lumbermens Mut. Cas. Co.*, 732 F. Supp. 1368, 1373 (E.D. Va. 1990) ("commercially reasonable for sureties … to insert language in indemnity contracts with principals negating any duty to issue a payment and performance bond simply because a bid bond was issued. And it is commercially sensible, as well as legally correct, for the courts to give effect to this plain language."); *Indep. Sch. Dist. No. 24 v. Weinmann*, 243 Minn. 469, 474, 68 N.W.2d 248, 251–52 (1955) (finding that contractor did not submit his bid in reliance on representations by surety that it would furnish the performance bond).

transactional risks during the underwriting process. Failing to account for the obligee's transactional risks is tantamount to a voluntary forfeiture of negotiation leverage. Experience has shown that the following factors can be determinative of an obligee's amenability to alternative bond language: (1) familiarity with the principal's work; (2) obligee's relationship with its own client; (3) novelty of the bonded trade; (4) availability of bondable alternative contractors; (5) geographic impediments; (6) potential schedule impacts; (7) large bid spreads; and (8) insufficiency of bid security. When approached with the proposition of alternative bond terms obligees tend to respond with a "take-it-or-leave-it" attitude; however, if the surety has done its homework, it should be in a good position to call the obligee's bluff under the right circumstances.

IV. Exercising the Surety's Negotiation Leverage

"Don't bargain yourself down before you get to the table." – Carol Frohlinger

The surety's leverage to negotiate bond terms ripens at two distinct times: (1) prior to the contractor submitting its bid and the surety issuing a bid bond (when required), and (2) upon being notified that the contractor has been awarded a contract by receipt of a request for final bonds. Faced with a request for issuance of bonds containing unfavorable terms, an adequately prepared surety should be equipped to thoroughly evaluate the necessity and availability of alternative bond terms and weigh the transactional factors necessary to identify points of leverage.

A. Preemptive Negotiation.

Bond term negotiations generally have a greater chance of success if commenced prior to the principal's submission of a bid. The opportunity to exercise this type of preemptive negotiation is most likely to occur in a solicitation that has a bid bond requirement. When faced with a bid bond submission, the surety would be well served to obtain a complete copy of the solicitation package including, to the extent applicable, the specified contract form and specifications to identify the scope and/or nature of the obligations that will be assumed by issuance of final bonds. While this seems like a fairly obvious proposition, in practice it is seldom done in an effective manner. If such a review is properly performed prior to issuance of a bid bond, the surety can avoid an unfortunate loss and business impacts by either declining bid bond issuance or seeking pre-bid concessions as to the final bond terms in advance of bid submission.

One "out-of-the-box" approach gives the appearance of approval while simultaneously shielding the surety from loss under its bid bond. This approach likely would not be possible on public projects under public bidding laws, but is feasible on private projects or for subcontract bonds. Under this approach the surety's bid bond approval is conditioned upon the principal's bid containing an express exclusion of the obligee's specified bond forms and incorporating alternative bond forms dictated by the surety.[16] An obligee receiving such a bid is faced with a decision: (1) accept the bid thereby waiving the specified requirement for the unfavorable bond form or (2) reject the bid as unresponsive thereby eliminating any exposure to a bid bond penalty. Utilization of this strategy avoids conflict by shifting the burden of weighing the transactional risk factors to the obligee. This strategy can also be successful in situations in which the solicitation documents do not specify bond terms, allowing the surety to dictate highly favorable manuscript bond terms. Alternatively, the surety can communicate its disfavor of the specified bond terms to the obligee and its principal and attempt to negotiate written concessions or an addendum from the obligee expressly authorizing alterative bond terms prior to bid submission.

B. Post-Award Negotiations.

Once a contract requiring the posting of surety bonds has been executed, the principal has more than likely bound itself to post the required bonds within the contractually specified period. The principal having signed the contract, and fearful of a potential default declaration, will be anxious to obtain bonds promptly.

[16] Note that by having the Principal expressly exclude the specified bond forms in its own proposal, rather than containing such a condition within the bid bond from itself, the surety can avoid potential liability that might arise form issuance of a defective or deficient bid-bond. *See, e.g., United Bonding Ins. Co. v. Crum*, 239 So. 2d 600, 601 (Fla. Dist. Ct. App. 1970) (upholding judgment against surety for loss of profits suffered as a result of the rejection of principal's bid because of a defective and deficient bid-bond issued by surety).

Similarly, where the surety has assumed risk under a bid bond, the surety will be more inclined to ignore unrealized transactional risks associated with unfavorable bond terms in favor of avoiding the pending risk of a bid bond loss. Taken collectively, these factors create a suboptimal backdrop for bond form negotiation, but they certainly do not foreclose the opportunity.

Upon receiving a post-award final bond submission, in addition to the executed contract and conditions, the surety should at minimum seek to acquire the following to evaluate its potential leverage to negotiate more favorable bond terms: (1) the complete solicitation package including the project manual/specifications; (2) the bid tabulation report and/or engineer's estimate; (3) the pre-bid meeting sign-in sheet; (4) a copy of the baseline and any progress update schedules; (5) to the extent relevant a copy of the obligee's last approved upstream pay application with schedule of values; and (6) the principal's takeoff, costs-to-complete and cashflow models.

The bounds of the surety's negotiation leverage will largely be dictated by cost variance and the availability of alternative qualified contractors. If the obligee has several cost-effective options, the market dictates the obligee's entitlement to onerous terms tipped in its favor. However, by reviewing the bid tabulation report and related documents, the surety may discover that the obligee's options are not so plentiful or cost effective, thereby tipping the scales of leverage in the surety's favor. Another useful strategy involves comparing the pre-bid meeting sign-in sheet with the bid tabulation report to determine which and how many contractors decided not to bid the project. If a host of pre-bid attendees did not bid the work, it could signal, amongst other things, that the particular trade is in high demand, that the project is one involving heightened risk and/or that alternative prospects are bleak. A simple call placed to one or two of the non-bidders can be made to confirm such and may even uncover unknown risks that caused contractors to non-bid the project.

In determining its leverage to negotiate despite bid bond exposure, the surety should be cognizant of the damage model dictated by the bid bond form. Bid bonds typically contemplate one of two damage models: (1) actual costs between awarded bid and next lowest bid up to the penal sum and (2) the entire penal sum enforceable as liquidated damages without regard to actual damages.[17] If the bid tabulation evidences that the bid bond penalty will fall woefully short of making the obligee whole for the costs escalation associated with contracting with the second lowest bidder, than it is unlikely the obligee will forgo favorable pricing to avoid accepting more reasonable bond terms.

In situations where a general contractor is obtaining post commencement subcontract bids, the surety should also reference the obligee's upstream schedule of values to correlate the general contractor's pricing and mark-ups for the principal's scope of work. If the obligee would incur a significant profit fade or loss on that scope of work by electing to go with the second lowest bidder, then the obligee has little to no bargaining power and the surety should seek to capitalize on that fact.

Another potential point of leverage for the surety can arise in the context of unit rate contracts. If the bid submissions or bid tabulation report demonstrate substantial variations in the bidders' unit rate pricing on speculative quantity items (e.g., rock removal, dredging, etc.), the obligee may be more willing to accept reasonable bond terms to avoid the risk of costly quantity overruns that might occur with an alternate contractor's less favorable unit pricing.

Additionally, the obligee may be more amenable to making bond form concessions if it is under tight schedule deadlines and wishes to avoid project delays occasioned by protracted bond form negotiations and/or recommencing contract negotiations with an alternative contractor. Similarly, the more closely aligned the principal's proposed performance duration is to the completion time expectations of the obligee, the greater the surety's bargaining position.

While the negotiation strategies listed above are by no means exhaustive, they

---

[17] *Compare Guido & Guido, Inc. v. Culberson County*, 459 S.W.2d 674, 677–78 (Tex. Civ. App.—El Paso 1970, writ ref'd n.r.e.) ("this judgment, which is the extent of the bid bond, cannot be called a penalty, but should rightfully be designated as liquidated damages to compensate the [Obligee] for the default of [Principal], to go forward with its bid. In other words, much of the damage was not easily ascertainable."), *with Weinmann*, 68 N.W.2d at 252 ("Where contractor failed to provide a performance bond and enter into a contract awarded him by [obligee] as the lowest responsible bidder, [obligee]'s damages were the difference between the contractor's bid and that of the next lowest responsible bidder.").

demonstrate that even in the post-award context saddled with bid bond exposure, a surety might have more negotiation leverage than may be perceived on first impressions. Nevertheless, processes must be established to identify points of leverage before a surety can capitalize.

V. Identifying Problems and Picking Battles

"If you're going to skin a cat, don't keep it as a house cat." – Marvin Levin

In all things, but particularly in contract negotiations, parties should avoid recommending non-essential revisions. Experience has taught that nothing kills negotiations and business relationships quicker than irrationality; accordingly, if you cannot articulate with conviction exactly why a contemplated revision is essential, it shouldn't be proposed. In the author's experience, the most productive manner in which to approach bond form negotiations is to itemize the surety's practical concerns, then review the bond form and contemplate how the Surety's most essential goals can be achieved with the least defilement of the original form. Some practical questions a surety should consider when determining what concessions it wishes to obtain from the obligee are as follows:

1. Is the bond subject to controlling statutes, and does it expand obligations beyond those statutorily prescribed?
2. Does the bond incorporate objectionable contractual terms which unduly compromise typical surety protections?
3. Does the bond adequately define and restrict the beneficiaries afforded coverage?
4. Is the bonded obligation adequately limited in scope and types of labor, materials and services for which coverage is provided?
5. Does the bonded obligation extend to warranty or maintenance obligations, and, if so, for what duration?
6. Is the surety's obligation subject to enforceable conditions precedent and notice requirements?
7. Does the bond provide the surety with an affirmative right to elect its preferred method of mitigating damages?
8. Is there a commercially reasonable period for the surety to investigate a claim before responding or electing its preferred method of performance?
9. To what extent does the surety waive alterations to the contractual undertaking?
10. What exposure does the surety have for attorney's fees, interest, finance charges, penalties, wage and fringe benefit compliance, actual or liquidated delay damages, and other consequential damages?
11. Does any provision of the bond potentially expose the surety to liability in excess of its penal sum?
12. What is the applicable jurisdiction and procedure for resolution of contractual disputes arising under the bond?
13. What is the applicable period of limitations and what event(s) trigger the commencement of the limitations period?

VI. Conclusion

"That's all folks." – Porky Pig

Hopefully, this article will spur further discussion between outside counsel, surety claims professionals, underwriters, and bond producers as to practical methods of approaching bond form negotiation and dispel the stigma that bond form negotiation cannot be done with regularity without compromising premium producing business relationships. If proper procedures are put in place and the frontline staff are adequately prepared to identify the pertinent transactional risk factors, there is no reason why a surety should not be able to have its cake and eat it too.

THE PROS AND CONS OF NOTIFYING BANKS ABOUT TRUST FUND PROVISIONS

By: Shane C. Mecham and Jason S. Leiker, Levy Craig, Kansas City, MO

The fact that the principal holds bonded contract funds in trust for the completion of the project and the benefit of subcontractors and suppliers is an essential element of the surety's security. Many states have statutes declaring that bonded contract funds are held in trust.[18] With or without the applicable state statutes, general indemnity agreements nationwide commonly contain trust-fund provisions.[19] Those provisions are often enforceable, even though some courts have invalidated them.[20]

The surety receives numerous benefits from a trust-fund provision. For example, a principal which wrongfully takes trust funds may not be able to discharge its subsequent indemnity obligations to the surety through bankruptcy.[21] The trust-fund provision is also valuable when a surety is seeking to recover bonded contract funds from the principal's bank. The principal might have wrongfully directed the trust funds obtained from a bonded project to pay the principal's loans instead of paying its subcontractors and suppliers, or the bank might have swept the proceeds of the obligee's checks or trust funds out of the principal's accounts to pay the principal's other debts to the bank. Either way, the surety could demand that the bank replace the bonded contract funds because they are held in trust for the benefit of the project. The bank might respond that it was entitled to use or receive the obligee's check to repay the principal's debt(s) because it was not on notice that the funds were subject to a trust. That dispute raises the question: when issuing bonds (in states that do not have express trust fund statutes), should sureties ask principals to disclose the identity of banks into which trust

---

*Shane Mecham and Jason Leiker are shareholders of the Levy Craig Law Firm in Kansas City, Missouri (levycraig.com). Special thanks to James A. Breckenridge and Ann V. Wolf for their research and contributions to this article.

[18] Construction trust fund statutes vary widely by State. Some provide civil remedies (such as attorney's fees or interest) if the funds are misappropriated. Others create criminal penalties for taking funds. States with trust fund statutes include: Colorado (Colo. Rev. Stat. Ann. § 38-22-127); Delaware (Del. Code Ann. tit. 6, § 3502); Illinois (770 Ill. Comp. Stat. Ann. 60/21.02); Maryland (Md. Code Ann., Real Prop. §§ 9-201 to -204); Michigan (Mich. Comp. Laws Ann. § 570.151 – .153); Minnesota [Minn. Stat. Ann. § 514.02 (2003)]; New Jersey (N.J. Stat. Ann. § 2A:44-148); New York [N.Y. Lien Law §§ 70-79-a (McKinney 1993 & Supp. 2004)]; Oklahoma (Okla. Stat. tit, 42, §§ 152, 153); South Carolina (S.C. Code Ann. § 29-7-10); South Dakota [S.D. Codified Laws § 44-9-13 (2004)]; Texas (Tex. Prop. Code Ann. §§ 162.001 – .033); Vermont (Vt. Stat. Ann. tit. 9, § 4003); Washington (Wash. Rev. Code § 60.28.010); Wisconsin [Wis. Stat. § 779.16 (2003)]. States that do not have a trust fund statute include: Alaska, Arkansas, California, Connecticut, Florida, Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Massachusetts, Mississippi, Missouri, Montana, Nebraska, Nevada, New Mexico, North Carolina, Oregon, Pennsylvania, Rhode Island, Tennessee, Utah, Virginia, West Virginia, and Wyoming.

[19] *See* 3 Philip L. Bruner & Patrick J. O'Connor, Jr. *Construction Law,* § 10:103.10 (Supp. Dec. 2016).

[20] Judicial challenges to the sufficiency of indemnity agreement trust creation clauses center on the allowance of co-mingling of assets. Sureties would do well to clarify or modify indemnity agreement clauses to require separate accounts into which bonded contract payments must be deposited and select a choice of law provision in a state with more favorable law. Many courts have held that a trust may arise within the confines of an indemnity agreement. *See e.g., Wright v. Gulf Ins. Co. (In re Wright)*, 266 B.R. 848, 852 (Bankr. E.D. Ark. 2001) (determining debt to surety was nondischargeable for defalcation based on express trust in indemnity agreement); *Cumberland Sur. Ins. Co. v. Smith (In re Smith)*, 238 B.R. 664, 672 (Bankr. W.D. Ky. 1999) (same); *Gillespi v. Jenkins (In re Jenkins)*, 110 B.R. 74, 76-77 (Bankr. M. D. Fla. 1990) (same); *Federal Ins. Co. v. Fifth Third Bank*, 867 F.2d 330, (6th Cir. 1989) (holding, in non-bankruptcy context, that the state's contract with general contractor created express trust on progress payments for job creditors); *In re Alcon Demolition, Inc*., 204 B.R. 440 (Bankr. D.N.J. 1997) (valid trust created by indemnity agreement); *contra Harleysville Worcester Mut. Ins. Co. v. Bank of Am., N.A. (In re Suprema Specialties, Inc.)*, 370 B.R. 517 (S.D.N.Y. 2007) (indemnity agreement allowed for comingling of funds, which was "fatal to the Sureties' claim of an express trust").

[21] The United States Bankruptcy Code excepts from discharge "debts which are for . . . defalcation while acting in a fiduciary capacity. . . ." 11 U.S.C. § 523(a)(4).

proceeds will be deposited and notify those banks of the trust-fund provisions?

Pros

The reason to send notice is to improve any future claim the surety might have against the principal's bank. A principal which is failing to pay for or perform a bonded project likely also has loans that it is not repaying. If it is simply a race to the bonded contract funds, the bank will virtually always beat the surety. Banks often have more and more current information about the principal's finances. Banks are also in possession of obligee payments directly deposited or deposited by the principal.

However, notice from the surety that obligee payments are to be held in trust for the benefit of the surety, laborers, subcontractors and suppliers will prevent the bank from taking those funds or may give rise to causes of action in favor of the surety to force the bank to return them. "If a bank in which trust funds have been deposited has notice that funds deposited are trust funds, it cannot set off against its liability on the deposit a debt owing to it from the trustee personally."[22] Where banks have express knowledge of trust-fund provisions and accept principal payments on bank debt, sureties have a host of remedies at their disposal, including third-party beneficiary claims and claims for conversion, civil conspiracy, trespass to chattels, etc.[23]

The surety's early notice to a bank of the existence of a general agreement of indemnity and specifically the surety's trust fund rights may not in itself prejudice the principal in its relationship with that bank. In fact, a short cover letter to the bank could commend the principal on being awarded a bonded project. The surety could share with the bank that the surety's own underwriting has found the principal to be worthy of credit in the form of bonds. The surety could simply enclose the general indemnity agreement with its trust-fund provision.[24]

Cons

While an early notice would certainly help the surety in a lawsuit to recover obligee payments from the bank, there are other considerations that weigh against providing that notice. First, a notice from the surety—no matter how nicely worded—may adversely impact the principal's credit or potential for more credit with the bank. The bank may read the notice to mean that the principal does not have as many unencumbered receivables as the bank once believed. The bank might also decide that the risk of inadvertently misusing bonded trust funds is simply too great. If principals cannot get credit from their banks, or that credit becomes more expensive, they might turn to sureties for financing; or worse, they may default on projects that they otherwise could have completed.

Second, the surety risks being exposed to claims for tortious interference. Principals have pursued claims such as tortious interference against their sureties when the surety directed obligees to withhold payment from a contractor.[25] Principals have also pursued tortious interference claims when the surety's actions obstructed an existing relationship with the principal's lender.[26] Note, though, that courts have protected a surety from tortious interference claims when the general indemnity agreement gave support for the surety's actions.[27] A surety may, therefore, be protected against a claim of tortious interference where the general indemnity agreement includes the surety's right to provide notice to the principal's bank(s).

Third, principals might circumvent this protection by working with a new bank after its surety issues bonds. The surety could protect itself by drafting the general indemnity agreement to require the principal to disclose any and all banks that the principal uses. If the principal breached that contractual remedy, however, it would only create another cause of action against the principal which is already obligated to indemnify the surety and which is likely insolvent. No revisions to the general

[22] Restatement (Second) of Trusts § 324, cmt. i.

[23] Only a minority of states would allow a trust beneficiary to make a claim against a bank that had no positive knowledge of the trust arrangement.

[24] It is also a good idea for the surety to immediately perfect any security interest created by the indemnity agreement by filing a financing statement with the secretary of state.

[25] *See Nat'l Sur. Corp. v. Prairieland Constr., Inc.*, 354 F. Supp. 2d 1032, 1034 (E.D. Mo. 2004).

[26] *See Reginella Constr. Co. v. Travelers Cas. & Sur. Co. of Am.*, 971 F. Supp. 2d 470 (W.D. Pa. 2013).

[27] *See Reginella Constr. Co.*, 971 F. Supp. 2d at n.2; *Nat'l Sur. Corp.*, 354 F. Supp. 2d at 1040.

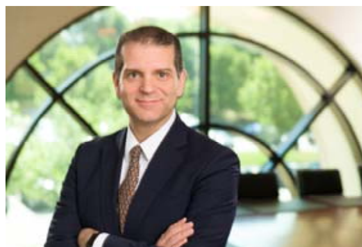
indemnity agreement will improve the surety's claim against a new bank which lends money to the principal without knowledge of the trust-fund provision.

Finally, even with notice, a bank might successfully defend its right to retain the obligee payments over the surety's demands. The bank might take the position that it is not responsible for monitoring the principal's account or tracking the funds deposited by the principal, especially where the funds are not deposited into a separate trust account. The bank might argue that it was entitled to receive any payments made by the principal or even sweep the principal's account because there is no way for the bank to determine if the funds in the account are bonded contract funds held in trust or profits earned by the principal. Even where there is a separate trust account, the bank could contend that it never received valid consideration to monitor such funds. So it would argue it had no obligation to do so. By way of response, the surety could likely assert that the bank knew the nature of its customer's business and knew the source of the funds from the face of each check. Certainly, in states with trust fund statutes at least, that knowledge should be imputed to the bank.

A surety could go so far as to require the principal to deposit bonded contract funds into a trust account monitored by a title company or some other third party. That company could ensure that bonded trust funds are paid to subcontractors and suppliers. The obvious downside is that it complicates issuing the bond and making project payments and may undermine the principal's access to bank financing. It also increases the cost of the bond to the principal. Sureties routinely using this approach may find it difficult to place their bonds. Contractors incorporating those more expensive bonds into their bids might have trouble being the low bidder and winning projects.

Ultimately, whether to issue a notice to a principal's bank is yet another example of sureties' ongoing need to balance offering bonds that are attractive to principals with limiting potential future losses. A surety that creates a regular practice of notifying banks in a positive, non-confrontational way, though, would have a powerful weapon in its battle to recover obligee payments when a principal defaults.

Surety Casenotes



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

Statute of Limitations for Employee Organization Bringing Claims Under New York Labor Law § 220-g Measured From Last Underpayment to Any Employee

Trustees of the N.Y. City Dist. Council of Carpenters Pension Fund v. Arch Ins. Co., (N.Y. Sup. Ct. Apr. 3, 2018),

Certain labor unions asserted claims for underpayment of wages against the payment bond surety of a bankrupt principal, Recine Materials Corp. ("Recine"), for work performed by the union's members on the Myrtle Avenue Subway Line in Brooklyn, New York. Although the surety did not deny that the individual workers were underpaid or its liability under the bond, the surety disputed the amount it owed under the bond. Citing New York Labor Law § 220-g, the surety argued that many of Recine's employees' claims were time-barred because those employees did not commence an action within one year form the date of the last underpayment as to those specific employees.

The unions argued that Labor Law § 220-g allows an employee organization, such as the unions, to commence an action on behalf of

a member employee "against the contractor, the subcontractor, or the issuer of such bond, without prior notice, within one year of the date of the last alleged underpayment." Because the surety was unable to cite a case supporting the proposition that the statute runs per individual employee when an entire employee organization has sued, and in light of the "remedial nature of the statute," the court held that the statute began to run on the last day any carpenter performed work on the Project.

The court rejected as "irrelevant" the surety's argument that the union should look to the surety bonds posted by Recine as required by certain collective bargaining agreements. The court observed that "[t]here is no question that [the surety] issued a bond covering materials and labor performed on the… project. There is also no question that Recine failed to pay for that very same work and declared bankruptcy. Accordingly, [the surety] is liable to pay in its place." The court also rejected the additional discovery and evidentiary arguments raised by the surety. Based on the foregoing, the court entered summary judgment in favor of the unions and scheduled an inquest to determine the amount owed.

Limitations Period in Board Resolution Incorporated by Subdivision Bond Supersedes Expiration Date of Bond

Town of Brookhaven v. Navigators Ins. Co., 2018 WL 2123968 (N.Y. Sup. Ct. Apr. 18, 2018).

In February 2005, the surety issued a subdivision bond, which provided that it was for a three-year term, expiring in February 2008. The bond incorporated by reference a municipal security agreement sought by the Town of Brookhaven's Planning Board calling for release of the bond upon municipal satisfaction with completion of the underlying project. The project was not completed on a timely basis and in May 2013, the Planning Board passed a resolution declaring the surety to be in default of its obligations under the bond. The Town commenced a lawsuit in February 2015. The surety filed a motion for summary judgment, arguing that the action was barred by the six year statute of limitations. The court denied the motion and the surety moved for reargument.

On reargument, the surety argued that the court misapprehended or overlooked its arguments concerning accrual of the statute of limitations. The court acknowledged that the applicable six-year limitations period, when based on the February 2008 expiration date in the bond, would be February 2014. However, the court found that the bond incorporated the Planning Board's resolution approving the bond, which provided that the bond ran for a term ending upon the obligee's determination of satisfactory completion. The court concluded that the limitations period ran from May 2013, when the principal was declared in default. Utilizing a May 2013 date of accrual, the court found that the action was filed timely. The court thus denied the motion to reargue. It also rejected the surety's prior argument that the court's decision failed to account for the obligee's failure to provide discovery regarding when the obligee completed the defaulted work. The court held that such discovery would not affect its analysis that the limitations period began to run in May 2013.

Waiver of Rights Under Miller Act Given Prior to Furnishing of Labor or Materials Is Invalid

Pinnacle Crushing & Constr. LLC v. Hartford Fire. Ins. Co., 2018 WL 1907569 (W.D. Wash. April 23, 2018).

Cherokee General Corporation ("Cherokee") entered into a prime contract with the U.S. Army Corps of Engineers (the "Corps") in connection with a project known as USACE-S YTC Repair Selah Airstrip, Yakima WA. SCI Infrastructure, LLC ("SCI") was a subcontractor to Cherokee and Pinnacle Crushing and Construction, LLC ("Pinnacle") was a subcontractor to SCI. The Cherokee-SCI subcontract (the "SCI Subcontract") contained a provision incorporating the prime contract by reference, as well as the applicable clauses of the Federal Acquisition Regulations required by the prime contract. The SCI Subcontract further provided that the dispute provisions of the prime contract would apply to any disputes and Cherokee agreed to present to the Corps all of SCI's claims for additional monetary compensation and to further invoke, on behalf of SCI, those provisions in the prime contract for determining disputes." SCI agreed to be "bound by the procedure and final determinations as specified in any such Disputes clause."

The subcontract between SCI and Pinnacle also contained a disputes provision that called for Cherokee to "pass through" Pinnacle's claims to the Corps. Pinnacle agreed to be bound "by the terms of the Main Contract and by any and all procedures and resulting decisions, findings, determinations, or awards made thereunder by the person so authorized in the Main Contract, or by an administrative agency, board, [or] court of competent jurisdiction or arbitration." Pinnacle further agreed that "it will not take, or will suspend, any other actions"—including Miller Act claims—"and will pursue no independent litigation with respect thereto, pending final determination of any dispute resolution procedure between" Cherokee and the Corps.

The Corps terminated the prime contract and withheld certain payments. Cherokee disputed the Corps' actions and submitted a claim in accordance with the prime contract. SCI and Pinnacle ("Plaintiffs") provided Cherokee with their claims, which Cherokee passed to the Corps. Thereafter, SCI and Pinnacle commenced a lawsuit against Cherokee and its surety ("Defendants") under, among other things, the Miller Act.

Defendants filed a motion to dismiss or stay the case arguing that Plaintiffs' claims against the surety are entirely contingent on Cherokee's liability and that the surety is therefore not liable because "the damages SCI and Pinnacle have alleged are the responsibility of the Corps and are being resolved through the Contract Disputes Act process." Defendants further argued that Plaintiffs' claims are unripe—and the court therefore lacks subject matter jurisdiction—because the parties are in the process of pursuing their claims administratively using the subcontracts' pass-through mechanisms. In the alternative, Defendants asked the court to stay the case pending resolution of the administrative process.

Plaintiffs opposed the motion, arguing that any contractual provisions requiring them to wait before pursuing their Miller Act claims are invalid waivers of their rights thereunder. They also argued that a stay would be prejudicial because "the upstream dispute resolution process will possibly take years to complete." The court agreed with Plaintiffs, holding "a subcontractor can waive its Miller Act rights only after furnishing labor or material used in performing the contract." Because Plaintiffs executed the subcontracts before they provided labor or materials, the waiver set forth therein is invalid. The court denied Defendants' request for a stay for substantially the same reasons. In doing so, the court distinguished other cases enforcing provisions staying proceedings under the Miller Act pending resolution of the prime contract's dispute resolution process. The court found that, unlike the subject subcontracts, the contractual stay provisions in those subcontracts left the subcontractors' claims intact pending exhaustion of the contractual remedy procedure. The subject subcontracts required that Plaintiffs be "bound by the final determinations as specified" in the prime contract.

Court Holds Obligee's Unilateral Retention of Replacement Contractor Did Not "Thwart" Surety's Rights Because Replacement Contractor Did Not Perform Principal's Scope of Work During Surety's Election Period Under the Bond

Developers Sur. & Indem. Co. v. Archer W. Contractors, LLC, 2018 WL 2100032 (M.D. Fla. May 7, 2018).

Archer Western Contractors, LLC ("Archer") entered into a contract with the Florida Department of Transportation to work on the Central Florida Commuter Rail Transit Station Finishes Project. Archer entered into a subcontract (the "Subcontract") with Prince Land Services, Inc. ("Prince") to perform landscaping and irrigation work on the project. In May 2014, disputes arose relating to Prince's performance, eventually leading to Archer defaulting Prince. Archer thereafter engaged LaFleur Nurseries & Garden Center ("LaFleur") to "make up for Prince's alleged shortcomings."

After obtaining a June 19, 2014 proposal from LaFleur, Archer retained LaFleur to perform limited landscaping services at the project on June 28, 2014. After Prince defaulted, LaFleur and Archer entered into a replacement subcontract with LaFleur to complete the work originally subcontracted to Prince (the "LaFleur Subcontract"). LaFleur and Archer exchanged communications regarding drafts of the proposed subcontract and pricing between July 14, 2014, and July 22, 2014. LaFleur signed the LaFleur Subcontract on July 25, 2014; Archer signed on July 29, 2014.

In the weeks before the LaFleur Subcontract was executed, Archer notified

Prince and its surety of the default. On July 3, 2014, Archer emailed Prince a Notice of Default, notifying Prince of numerous alleged failures of performance. The Notice further instructed that if Prince did not cure the default within seventy-two hours, Archer would "take whatever steps it deems necessary to mitigate the damages caused by Prince's default." On July 9, 2014, Archer sent the surety a letter making a claim on the bond. The surety responded by letter dated July 14, 2014, stating that the bond claim lacked sufficient documentation of Prince's alleged deficiencies and requested additional information. The letter also indicated that the surety had commenced a preliminary investigation, and advised that it would formally respond to Archer's claim "within fifteen (15) calendar days of receipt of the requested documents." Thereafter, Archer and the surety did not communicate for months.

After learning of the LaFleur Subcontract, the surety sent Archer a letter dated October 16, 2014, stating that the bond was null and void due to Archer's (1) failure to provide the documentation requested by the surety and (2) unauthorized, unilateral decision to replace much of the work performed by Prince under the Subcontract. The surety letter further provided that Archer's actions to replace Prince with LaFleur interfered with the surety's rights under the bond to mitigate damages caused by default and, therefore, formally denied Archer's bond claim. After completing its work on the Project, Archer sent the surety a letter dated August 29, 2016, demanding reimbursement of $631,148.65—the excess cost to complete Prince's work.

The surety filed an action seeking declaratory judgment that Archer breached by the bond by unilaterally completing the Subcontract. Archer asserted counterclaims seeking a declaration that the surety breached the bond, Archer was authorized to hire a replacement subcontractor to remediate Prince's default and that the surety is liable to Archer for $631,148.65. Both parties filed cross-motions for judgment.

In opposing the surety's motion, Archer argued that it retained LaFleur only after the surety failed to take action under Paragraph 4 of the Bond within the fifteen-day time limit set forth therein for the surety to act. Before the surety's "time to respond deadline" passed, Archer alleged that it only retained LaFleur to perform "clean-up" work, which was specifically authorized by the Subcontract. Archer also asserted that it had no obligation under the bond to provide the "extensive documentation" requested by the surety to support Prince's default.

The court denied the surety's motion, finding that "Archer did not breach the bond by retaining LaFleur to perform clean-up work or by negotiating with LaFleur during [the surety's] election period." In reaching its decision, the court distinguished the 11th Circuit's recent decision in *Int'l Fid. Ins. Co. v. Americaribe–Moriarty JV*, 681 Fed. App'x 771 (11th Cir. 2017) (obligee's unilateral retention of completion contractor discharged surety from further obligations under performance bond). Although the court acknowledged the parallels between this matter and *Americaribe*, the court found no evidence that Archer's retention of LaFleur during the notice period "thwarted" the surety's ability to choose among the options it had for remedying Prince's default. Nor did the court find that there was any evidence supporting the surety's contention that the work LaFleur performed before the surety's mitigation period ended was within Prince's original scope of work.

The surety further argued that Archer breached the bond by failing to supply the surety with information documenting Prince's alleged breach. The surety argued that it was entitled to make its decision having made an independent investigation of the facts and circumstances of the alleged default. Archer asserted that neither the Subcontract nor the Bond imposed a duty on Archer to assist the surety with its "independent investigation." The court agreed with Archer, holding that the bond only required Archer to give the surety notice of Prince's default and that the "implied covenant of good faith and fair dealing" simply prohibited Archer from taking any action to knowingly delay or hinder the surety's performance—"the implied obligation of good faith cannot be used to vary the terms of an express contract." The court entered summary judgment in favor of Archer.

Subcontractor's Claims Against Miller Act Surety Stayed Pending Arbitration With Principal

United States ex rel. Red Hawk Contracting, Inc. v. MSK Constr., Inc., 2018 WL 2121625 (M.D.N.C. May 8, 2018).

Red Hawk Contracting, Inc. ("Red Hawk") commenced an action against MSK Construction, Inc. ("MSK") and its Miller Act surety, alleging, among other things, that MSK had not fully paid it for materials, equipment and labor, on a Department of Veterans Affairs project in North Carolina. MSK and its surety filed a motion to dismiss or for a stay under the Federal Arbitration Act ("FAA") during the pendency of arbitration in South Carolina, based upon an arbitration clause in the subcontract. Although Red Hawk conceded that the dispute falls under the scope of the arbitration clause, it argued that the FAA did not apply because the matter involved solely a North Carolina transaction and did not involve interstate commerce. Red Hawk additionally argued that, if the arbitration is permitted to proceed and the pending action stayed, Red Hawk should be permitted to separately proceed against the surety.

The court rejected Red Hawk's argument that the FAA was not applicable, finding that because MSK was a South Carolina corporation, its surety was a Delaware corporation and Red Hawk was a North Carolina corporation, MSK's payments to Red Hawk presumable cross state lines and thus involved interstate commerce. Under the circumstances, the FAA would preempt state law and compel arbitration. With respect to Red Hawk's seeking to proceed against the surety, the court found that "because determining the extent of [the surety's] liability to [Red Hawk] will rely on common issues of fact to be settled during the arbitration, this court finds that, in the interest of judicial economy, the entire action should be stayed until arbitration is had in accordance with the agreement."

Surety Is Not Liable for Bad Faith or Violations of the Insurance Fair Conduct Act Under Washington Law; Surety Entitled to Award of Counsel Fees Based on Prevailing Party Fee Clause in Bonded Contract

Kenco Constr., Inc. v. Porter Bros. Constr., Inc., 2018 WL 2966785 (Wash. Ct. App. June 11, 2018).

The Highline School District No. 401 entered into a contract with Porter Brothers Construction Inc. ("Porter"), to serve as the general contractor to construct Raisbeck Aviation High School. Porter entered into two subcontracts with Kenco Construction Inc. ("Kenco"). Porter furnished surety bonds in connection with each of the subcontracts. Porter also entered into a subcontract with Totem Electric of Tacoma, Inc. ("Totem"). The project encountered numerous problems affecting both Kenco's and Totem's work. Porter withheld progress payments from both Kenco and Totem, which both demanded arbitration as provided in the contract—Porter refused. Kenco filed suit against Porter for breach of contract and to compel arbitration, as provided for in the contract. Porter counterclaimed for breach of contract, asserting claims against Kenco's surety, including bad faith and violations of the Insurance Fair Conduct Act ("IFCA"). Totem filed a separate complaint for breach of contract, which was later consolidated into the subject lawsuit.

The matter was bifurcated for trial, with the contract dispute between Porter, Kenco and Totem tried first. Porter's claims against Kenco's surety were to be tried separately. At trial, the jury found in favor of Kenco and Totem. Because the jury found Porter liable, the court dismissed Porter's claims against Kenco's surety on summary judgment. As such, no trial on the bad faith or IFCA claims was held.

On appeal, the court affirmed the judgment against Porter with respect to the construction contract dispute. With respect to the bad faith claims, Porter argued that the surety's denial of coverage under both bonds amounted

to both common law bad faith and violation of IFCA. Porter asserted that the Supreme Court of Washington's decision in *Colorado Structures, Inc. v. Ins. Co. of the W.*, 167 P.3d 1125 (Wash. 2007) stood for the proposition that sureties are to be treated the same as liability insurers with respect to duties, and therefore are subject to bad faith. The court rejected this argument, finding that Porter was reading the case too broadly. The court held that *Colorado Structures* addressed the narrow issue of a surety's liability for attorneys' fees. It did not hold that a surety could be held liable to an obligee for bad faith. The court characterized Porter as a third party to the relationship between Kenco and its surety and, thus, found that the surety did not have a fiduciary relationship with Porter. Therefore, the Court held that the Porter could not pursue a claim for common law bad faith. The court similarly affirmed the dismissal of the IFCA claim, concluding that the IFCA did not give third party claimants the right to sue.

Finally, Porter appealed the court's award of attorneys' fees and expert fees to Kenco and Totem and attorneys' fees to Kenco's surety. With respect to expert fees, the court found that the plain language of the subcontract provided for the award of expert fees in arbitration, not litigation, and thus vacated the award. The court affirmed the award of attorneys' fees to the subcontractors, finding that applicable law provided for the award of attorneys' fees to the prevailing party. The court affirmed the award of attorneys' fees to the surety because the subcontract had a provision for the award of attorneys' fees to the prevailing party, and the bond incorporated the subcontract. The court concluded that, to the extent the surety was defending the subcontractor's actions, it was acting in the shoes of the subcontractor under the subcontract and accordingly entitled to fees in the same manner.

Surety Not Liable for Delay Damages Where Such Damages Are Prohibited by the Bonded Contract

Welsbach Elec. Corp. v. Judlau Contracting, Inc., 2018 WL 3224083 (N.Y. Sup. Ct. July 2, 2018).

Subcontractor Welsbach Electric Corp. ("Welsbach") filed a complaint against the general contractor, Judlau Contracting, Inc. ("Judlau"), and its surety, seeking, among other things, additional costs incurred by Welsbach on account of project delays, accelerations, compressions, schedule changes, site access issues, failure to issue change orders and failure to coordinate work of subcontractors. Judlau and the surety filed a motion to dismiss on the grounds that Welsbach's claims all refer to delay damages that are prohibited under the Welsbach's subcontract and are, thus, not compensable. Although Judlau and the surety acknowledged that the New York Court of Appeals has recognized four exceptions to "no-damage-for-delay" clauses, Welsbach had not alleged facts that fit into any of them.

In response, Welsbach pointed to language in the subcontract which provided that it was entitled to additional compensation "to the extent [Judlau] obtains same from the Owner, if the Owner or [Judlau] changes any schedule for the work, or prioritizes certain work or otherwise limits [Welsbach's] access or ability to provide work, and such decision results either in an acceleration compression, for [Welsbach] to maintain the schedule or in a delay." Welsbach argued that this language limited the reach of the otherwise broad no-damage-for-delay clause in the subcontract.

The court rejected Welsbach's reading of the subcontract, noting that its claims were limited "to the extent Judlaw obtains" recovery from the owner. Because Welsbach did not allege that Judlau recovered from the owner, its claim was barred. With respect to Welsbach's claim against the bond, the court held that because Welsbach could not recover under the subcontract, it is barred from recovery against the payment bond.

Fidelity Casenotes

By: Matthew C. Kalin, Travelers, Braintree, MA

<u>Potential For Double Recovery Under State Unreasonable Delay/Denial Statute</u>

Am. Family Mut. Ins. v. Barriga, 418 P.3d 1181 (Co. 2018).

In 2009, the Insureds suffered a loss as a result of a fire in their apartment building. The carrier and Insureds coordinated repair efforts after the fire, resulting in payments of $209,816.43 under the policy. At that time, the contractor adjusted the repair estimate to allegedly account for additional repairs and asbestos remediation to a figure in excess of the initial estimate. In response to the increased estimate, the carrier commenced a third-party appraisal process through a provision in the policy. The intent of the third-party appraisal process was to create an independent, impartial assessment of the necessary repairs. The third-party appraiser set the award of damages at $322,141.79. Thereafter, the carrier made an additional payment of $122,325.36, accounting for sums already paid, plus further payment of $5,435.44 related to board-up services. The Insureds sued the carrier alleging breach of contract and a violation of Colorado's statutes concerning unreasonable delay or denial of insurance benefits. The jury found for the Insureds on all claims, finding $9,270.00 in breach of contract damages (and damages unreasonably denied) and $127,660.80 in benefits unreasonably delayed. Pursuant to the relevant statutes, the trial court's award included a statutory doubling of the jury award ($136,930.80 x 2 = $273,861.60), with a reduction for the amounts already paid, i.e., payments unreasonably delayed ($127,660.80). As a result, the trial court entered a total award of $146,200.80 on the statutory claim.

The Colorado Court of Appeals, without a written opinion, did not agree with the trial court's approach and permitted double recovery without any reduction for amounts already paid. On appeal, the Supreme Court of Colorado held: (1) the statutes permit the doubling of an award of benefits unreasonably delayed or denied and does not require a reduction for those benefits unreasonably delayed but eventually paid by the carrier; and (2) the general rule against double recovery for a single harm does not apply to an action for common law breach of contract, in one count, and a statutory claim for unreasonable denial or delay, in another count. With respect to the former, the court found that the statutes providing for multiple damages pursuant to a jury award for benefits unreasonably denied or delayed did not explicitly provide for or require the reduction imposed by the trial court. Further, the court found nothing in the statutory scheme that suggested as a whole that the legislature intended to so limit recovery, and rejected the carriers' "inverted reading" of the statute. Turning to the general rule in Colorado that a claimant may not receive double recovery for the same injuries, the court found that a claim under a theory of breach of contract was so factually distinct from a claim under the statutes at issue that an award of damages under both theories of recovery does not provided multiple awards for the same wrong. The court distinguished the situation before the court from those cases where a plaintiff seeks redress for a single wrong based under a single set of indistinguishable facts. Here, the court found that the facts underlying the breach of contract and statutory claims were "separable" to a sufficient degree so as to assuage any concerns about double recovery. As such, the court permitted the Insureds to recover both its breach of contract damages and its multiple statutory

damages without any reduction for those benefits delayed but paid by the carrier.

Insured Recovers Email Spoofing Loss Under Computer Fraud in New York

Medidata Sol., Inc. v. Fed. Ins. Co., 729 F. App'x 117 (2d Cir. July 6, 2018).

The Insured provides cloud-based services to research scientists performing clinical trials. In 2014, the Insured's employees approved and ordered a wire transfer in the amount of $4,770,226.00 at the behest of a perpetrator impersonating the Insured's president and alleged counsel through a series of emails, via Google's Gmail-based email platform used by the Insured for company emails, and at least one phone call. The perpetrator(s) communicated with real employees of the Insured via spoofed company emails that appeared to be legitimate. The Insured submitted the claim for coverage with its carrier, which denied coverage for the loss under the policy's computer fraud, funds transfer fraud and forgery coverages. Thereafter, the Insured commenced suit.

With respect to computer fraud coverage, the District Court found the perpetrator(s)' actions satisfied the definition in the policy. Specifically, the District Court determined that the Insured suffered a loss as a result of receipt of spoofed emails "armed with a computer code" sent into the Insured's email system designed to mask the fraudulent nature of the communication. In so finding, the court determined that this "entry" into the Insured's email system changed data related to the Insured's emails, and the sum of these activities caused the transfer. The court also found coverage under the policy's funds transfer fraud coverage. Here, the court determined that the fact that a third-party masked him/herself as an authorized representative and directed an employee of the Insured to initiate a transfer with the bank satisfied the elements of coverage for funds transfer fraud because, in part, the employee would not have ordered the transfer absent the fraudulent instructions. Finally, the court found that there was no coverage for the loss under the policy's forgery coverage because of the absence of a forgery or alteration of a "financial instrument," as that term is defined in the policy.

On appeal, the Second Circuit affirmed the decision and opined on the applicable causation standard. In a brief opinion, the court agreed with the District Court that there need not be a hacking-type event in order to trigger coverage under this policy's computer fraud insuring agreement. The court determined that the perpetrators' computer-based attack manipulated the Insured's computer system and that such activity, i.e., the entry of spoofing code into the computer system that altered the appearance of emails, amounted to the fraudulent entry of data contemplated by the language of the insuring agreement at issue. In so finding, the court determined that the Insured's "email system itself was compromised," which resulted in the required finding of a violation of the integrity of the Insured's computer system. The court did not opine on coverage under either the funds transfer fraud or forgery insuring agreements, as its affirmation of the District Court's determination under computer fraud was dispositive. In addition to the foregoing, however, the Second Circuit responded to the carrier's arguments concerning the applicable causation standard. Citing 1990 and 2013 New York state appellate decisions, the court held that New York interprets the phrase "direct loss" to mean proximate cause. In making this determination, the court noted that even the actions of the Insureds' employees – not involved in the fraud – were not enough to sever the causal relationship between the perpetrators' actions and the loss.

Computer Fraud Provision Covers Vendor Social Engineering Loss

Am. Tooling Center, Inc. v. Travelers Cas. & Sur. Co. of Am., 895 F.3d 455 (6th Cir. 2018).

The Insured is a tool and die manufacturer that transacts with overseas vendors by outsourcing portions of the die manufacturing process. In March 2015, the Insured requested copies of all outstanding invoices from a particular vendor. In response, the Insured received an email from a perpetrator impersonating the vendor. The purported vendor provided the Insured with new banking instructions that directed payment on legitimate invoices to an alternate, new bank account. The Insured complied and wired approximately $834,000.00 as directed by the perpetrators, only

to later discover the fraud. The Insured sought coverage under its policy's computer fraud provision. The carrier denied the claim under this coverage, citing a lack of trigger of the insuring agreement, as well as several exclusions. The Insured commenced litigation on a breach of contract theory. In September 2017, the District Court awarded summary judgment to the carrier finding that the facts of the claim did not trigger the computer fraud coverage agreement because the Insured did not suffer a "direct loss" "directly caused by computer fraud," relying upon recent similar decisions in *Apache Corp. v. Great Am. Ins. Co.*, 662 F. App'x 252 (5th Cir. 2016) and *Pestmaster Servs., Inc. v. Travelers Cas. & Sur. Co. of Am.*, 656 F. App'x 332 (9th Cir. 2016).

On appeal, the Sixth Circuit reversed the district court's decision. In so doing, the court found that the Insured suffered a direct loss, that the facts of the claim triggered the computer fraud insuring agreement and that the computer fraud directly caused the loss. The court also cast aside the carrier's contention that three exclusions in the policy excluded coverage regardless of whether the insured suffered a triggering computer fraud event. First, the court determined the Insured suffered a direct loss because the Insured lost the funds at the moment it issued the wire payment. As part of its analysis, the court cited to an unpublished Michigan appellate court decision to construe the word "direct" using a proximate cause analysis, rather than interpret "direct" as more immediate and without intervening acts, as the court had itself held in a 2012 opinion. Second, the court rejected the carrier's citations to and the district court's reliance on *Apache* and *Pestmaster*, among others, and held that the perpetrator(s)' mere sending of fraudulent emails to the Insured using a computer which caused the Insured to transfer funds was a computer fraud. In so doing, the court specifically rejected the concept that computer fraud was akin to and/or required some form of "hacking" or similar activity. Third, the court found that the Insured's loss was directly caused by the aforementioned computer fraud. The court, applying a proximate cause analysis to the underlying facts, held that the fraudulent emails led to a chain of events that eventually resulted in the transfer of funds. Finally, the court rejected the carrier's reliance on three exclusions. The court held that the policy's "exchange or purchase" exclusion did not apply because the Insured did not transfer funds to the perpetrators in an actual exchange or purchase. Stated another way, the court found that the Insured did not transfer the money to the perpetrators in exchange for anything and, therefore, there could be no exchange or purchase on which to support the application of the exclusion. In addition, the court rejected the application of two other exclusions. The exclusions, read in conjunction, generally excluded claims where the Insured, relying upon fraudulent information, enters its own system and lawfully and with full authorization enters electronic data that leads to a loss. The court held that manual entry of the perpetrators' wire instructions into a computer was not electronic data under the policy; rather, the court held that such entry of information by the Insured were "instructions" or "directions," which are specifically syphoned out of the definition of electronic data. As a result, the court found that these two exclusions, which rely upon the lawful entry of electronic data, were not applicable.

Liability to Others for Unauthorized Trading Not Covered By Financial Institution Bond

Fed. Ins. Co. v. COR Clearing LLC, 2018 WL 3575896 (D. Neb. July 25, 2018).

The Insured is a settlement and clearing firm that permits independent broker dealers to purchase and sell securities for their customers. In 2014, the Insured investigated the alleged actions of one of its registered representatives. In this instance, the registered representative allegedly opened accounts under customers' names without their knowledge, and executed unauthorized trades of stock of a company named VGTel Inc. This registered representative had no authority to make the trades and eventually admitted as much when confronted. In March 2017, a jury in the United States District Court for the Southern District of New York found the registered representative guilty for securities fraud, wire fraud, and conspiracy to commit both.

At some point, complainants to the Financial Industry Regulatory Authority ("FINRA") named the Insured as a party in two separate arbitration proceedings. One of the FINRA proceedings concerned an investment in VGTel Inc. and the alleged acts of a person who was not an employee of the Insured. The second

FINRA proceedings concerned the alleged unauthorized trading of VGTel Inc. stock by another third-party, also not an employee of the Insured, and implicated the Insured's registered representative. The Insured resolved the two FINRA proceedings for $2,080,000.00 in total ($80,000.00 for the former and $2,000,000.00 for the latter), and then sought coverage under both its liability policies and the financial institution bond. The carrier denied coverage, and in May 2016, commenced a declaratory judgment action.

The District Court, applying New Jersey law, awarded summary judgment to the carrier. The court analyzed coverage under four insuring agreements, centering on the bond's 1.B. coverage concerning dishonest acts of employees arising out of trading. Under this insuring agreement, the carrier argued that the Insured did not suffer a loss because the funds received from the liability carrier reduced the Insured's alleged loss to a figure below the applicable deductible in the bond. With little analysis, the court refused to make a dispositive ruling on this issue, noting, however, the potential application of an exclusion requiring that a single loss exceed any applicable deductible. The court also held that the issue of intent, i.e., whether the Insured's registered representative had the intent to cause the Insured any loss, was not an issue properly decided on summary judgment. The court noted that this case fell somewhere on the intent spectrum common in employee dishonesty matters, where embezzlement is at one end and a direct benefit to the Insured is at the other. Notwithstanding the court's unwillingness to decide these issues in favor of the carrier, the court decided that the Insured's payments to resolve the FINRA proceedings were not a direct loss directly caused by the registered representatives dishonest acts under New Jersey law. The court found that the only loss suffered by the Insured was the payment of the settlements, as there was evidence that its own assets were at risk due to the actions of the registered representative. In so holding, the court noted that the bond is "not liability or indemnity insurance," and only protects the Insured for employee dishonesty as opposed to "'liability to third parties.'" (Emphasis in original.) As a result, in addition to finding no coverage under three other insuring agreements, the court awarded summary judgment to the carrier.

Direct Loss Requires Immediacy Without Intervention or Interruption Under Computer Fraud Coverage

Interactive Commc'ns Int'l, Inc. v. Great Am. Ins. Co., 731 F. App'x 929 (11th Cir. 2018).

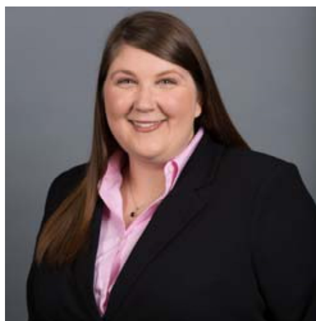
The Insured provides a service through which consumers are able to add funds to prepaid debit cards. In this process, the consumer purchases a "chit," sold at common retailers, and uses the chit to add funds to a prepaid debit card. The purchase of a chit sets off a process by which the relevant parties transfer funds in order to settle their obligations. The retailer sends the payment it received for the chit to the Insured. The Insured holds those funds in its bank. To redeem the chit, the consumer calls the Insured's automated system and provides certain unique pieces of information (account number, code, etc.). Once inputted, the value of the chit is made available on the card, and the Insured transfers the funds to the bank associated with the prepaid debit card. That second bank then holds the funds until the consumer makes a transaction, at which time the bank sends the funds to the seller involved in that transaction. Between November 2013 and May 2014, and mostly between April and May 2014, the Insured's automated system contained a glitch which allowed multiple, simultaneous redemptions of chits. All told, there were 25,553 unauthorized redemptions involving 1,933 chits. The unauthorized redemptions resulted in the Insured transferring $11,477,287.00 to various banks associated with the prepaid debit cards, the overwhelming majority of which involving one bank. The Insured sought coverage for these funds under the computer fraud coverage offered by its carrier. Great American denied coverage in May 2015. Thereafter, the Insured commenced litigation.

The district court, sitting in diversity, applied Georgia law. The court awarded summary judgment to the carrier holding that: (1) the claim did not trigger the computer fraud insuring agreement because there was no use of a computer (the telephone used by the perpetrators is not a computer); and (2) the Insured did not suffer a direct loss from the alleged computer use. On this latter issue, the court held that the alleged loss did not result directly from the redemption of the chits because there were several intervening steps from that

moment to the point at which the prepaid debit card bank transferred the funds to settle consumer transactions. The court ruled that the Insured did not suffer a loss until the prepaid debit card bank account settled with the sellers in the consumer transaction, and not when the Insured transferred the funds from its bank to the prepaid debit card bank account following the redemption of the chit. The court refused to acknowledge the telephonic redemptions of the chits as the direct cause of the alleged loss because of the lack of immediacy between the redemption and the transfer of funds to the seller in the consumer transaction. In doing so, the court noted that the Insured's transfer of funds from its bank account actually resulted directly from its contractual obligations to the prepaid debit card banks and its choice to fulfill said obligations.

The Eleventh Circuit Court of Appeals affirmed. In doing so, the court disagreed with the district court on the issue of whether the chit redemptions involved the use of a computer, as required by the computer fraud coverage grant. Simply put, the court held that phone calls to an automated system that used computers would satisfy the use of a computer requirement in the coverage because the perpetrators converted the Insured's computer system to their use via the telephone calls to redeem the chits. That said, the Court of Appeals agreed with the district court that the Insured's loss did not result directly from the telephonic chit redemptions and use of the Insured's computers. Specifically, the court held that "directly" equates to "straightaway, immediately, and without any intervention or interruption." With that definition as the backdrop, the court outlined and examined the steps in the process from redemption to settlement with the seller in the consumer transaction, and ruled that the Insured's loss was too "temporally remote" to trigger coverage under the computer fraud coverage grant. The court agreed with the carrier that the Insured's loss did not occur until the prepaid debit card bank account issued the funds to the sellers as settlement for the consumer transactions because that was the point where the Insured could not recover its funds, dubbing that moment as the point of no return.

LEGISLATIVE UPDATE



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

One objective of this article is to highlight legislative trends that may be of interest to those in the surety industry. For instance, there have been waves of Public Private Partnership (P3) legislation in the recent past, which have implications for how public projects are funded. There is a strong industry effort to clarify that payment and performance bonds are required for P3 projects just as they would be for any other public construction project. This edition of the legislative activity article focuses on a relatively new legislative trend for commercial bonds - the elimination of occupational licensing obligations. To date, the legislation in this area has focused on reviewing existing and future obligations to implement the least restrictive form of regulation possible, to include a review of bonding obligations. Legislation in Louisiana, Missouri, Nebraska, and Oklahoma are examples of this trend. Please see the statutory section or bill number identified in the text and footnotes below for complete details on the aforementioned legislation and a sampling of other surety issues.

Alaska

Appraisal Management Licensee Bond

Alaska is one of the newest states to require real estate appraisal management companies to register with the state.[1] The registration process includes providing evidence that the company has posted a surety bond in an amount to be set by the Board of Certified Real Estate Appraisers. The bond cannot exceed $50,000.

Connecticut

Mortgage Lender, Mortgage Correspondent Lender, Mortgage Broker, and Debt Negotiation Licensee Bond

Starting October 1, 2018, mortgage lenders, mortgage correspondent lenders, mortgage brokers, and debt negotiation licensees will be required to file quarterly reports reflecting their residential mortgage loan volume to confirm they have the correct penal sum for their surety bond.[2] Previously, the law required an annual confirmation. The Banking Commissioner is also permitted to make claims on the bond for restitution and unpaid examination costs. H.B. 5490 also establishes a 30-day notice of cancellation requirement for the sureties on these licensee bonds.

Kansas

Captive Insurance

The Kansas legislature has made it clear that a captive insurer cannot provide surety insurance.[3]

Kentucky

Reclamation Bond

To obtain a surface coal mining and reclamation permit in Kentucky, applicants must file a reclamation bond conditioned upon the faithful performance of all the requirements of the Surface Coal Mining Chapter and the permit. HB261[4] eliminates the ability of the applicant to act as its own surety by demonstrating a suitable service of process agent, history of financial solvency, and continuous operation.

Louisiana

Occupational Licensing

As government agencies continue to evaluate the burdens of licensing requirements, Louisiana adopted a bill that requires all agencies to report on the examination requirements, standards, criteria and qualifications that are necessary for admission to a trade, occupation or profession. The agency shall also file annual reports on the number of applications and the names of those admitted to practice along with an accounting of the amount of examination, admissions, and annual fees that are extracted for the privilege of maintaining the license. The disciplinary procedures and fines and penalties shall also be identified. The Governor shall annually review at least 20% of the agency reports thereby concluding the review within 5 years. These reports will be available to the public.[5]

Additionally, the legislature adopted H.B. 372[6], which establishes an Occupational Licensing Review Commission (Commission). The Commission shall be responsible for reviewing every proposed occupational licensing regulation ensuring that it meets the state policy to impose the least restrictive regulation necessary to protect consumers from present or potential harm and threats to public health, welfare, or safety. The following is outlined in the law as a list of measures from least to most restrictive: market competition; third party or consumer-created ratings and reviews; Unfair Trade Practices and Consumer Protection Law civil remedies; regulation of the process for providing specific goods or services to consumers; inspection; bonding or insurance; registration; and an occupational license.

Missouri

Motor Vehicle Dealer License Bond

The bond amount for licensed motor vehicle dealers increased from $25,000 to $50,000. In addition, the definition of a motor vehicle dealer now requires the sale of 8 or more

[1] Alaska Stat. § 08.87.135 (S.B. 155).
[2] Conn. Gen. Stat. § 36a-489 (H.B. 5490).
[3] Kan. Stat. Ann. § 40-4302(a)(3) (S.B. 410).
[4] Ky. Rev. Stat. Ann § 350.064 (H.B. 261).
[5] La. Rev. Stat. Ann. § 49:903 (H.B. 748).
[6] La. Rev. Stat. Ann. § 37:41 et seq.

motor vehicles or trailers in any calendar year as evidence that the person is engaged in the motor vehicle business and eligible for licensure. Prior to the amendments in S.B. 707[7], the threshold was 6 or more motor vehicles or trailers.

Occupational Licensing

After January 1, 2019[8] regulatory agencies filing a bill related to licensure must include a report explaining a number of factors including why bonding and insurance, registration, certification, occupational license to practice or another type of regulation is being proposed, why that regulatory alternative was chosen, and whether the proposed method of regulation is appropriate. The law also outlines a hierarchy of 4 restrictive occupational regulations to aid in review. Least to most restrictive are as follows: bonding or insurance; registration; certification; and occupational license.

The legislature also requires certain oversight bodies, as identified in the Act, to waive any examination, educational, or experience requirements of an applicant, if it determines a business, professional, or occupational license has been issued in another state and the licensing requirements in that state are substantially similar to or more stringent than the Missouri licensing requirements. This shall not be construed to waive fee, surety bond, or insurance requirements.[9]

Nebraska

Occupational Licensing

The Nebraska legislature adopted legislation similar to the two Louisiana bills identified above. L.B. 299 (not yet chaptered) not only creates the Occupational Licensing Review Commission for proposed licensing laws, but also includes a 5-year review schedule for existing licensing laws. The same least to most restrictive hierarchy for reviewing laws that is in the Nebraska law is included in this bill as well. The hierarchy comes from the American Legislative Exchange Council (ALEC) model Occupational Board Reform Act originally adopted by ALEC in 2016.

Oklahoma

Occupational Licensing

Oklahoma also created a licensing review commission, the Occupational Licensing Advisory Commission (Commission). The purpose of this Commission is to review each occupational or professional licensing not less than once every 4 years. Any new licensing act shall be revised within 90 days and thereafter added to the 4-year review schedule. The findings of the Commission shall be presented at an annual public meeting.[10]

South Carolina

General and Mechanical Licensure License Bond

General and mechanical contractors applying for licensure in South Carolina are now permitted to provide a surety bond in lieu of providing a financial statement showing their minimum net worth. The bond shall be in an amount two times the required net worth for the applicant's license group at initial or renewal application. The licensee group is based on the job and bid amounts of the applicant. For example, Group One includes bids and jobs less than $50,000 per job and the required net worth for that group would be $10,000. The surety bond could only be cancelled after 30-day notification to the South Carolina Contractor's Licensing Board.[11]

[7] Mo. Rev. Stat. §§ 301.550 and 301.560.
[8] Mo. Rev. Stat. § 324.047 (H.B. 1500).
[9] Mo. Rev. Stat. § 324.009 (S.B. 840).
[10] Okla. Stat. 40, §800 et seq. (S.B. 1475).
[11] S.C. Code Ann. § 40-11-262 (H.B. 4612).

SUGGESTIONS & COMMENTS??

As to program suggestions:

Patrick R. Kingsley
Stradley Ronon Stevens & Young, LLP
2005 Market Street
Suite 2600
Philadelphia, Pennsylvania 19103
Ph: (215) 564-8029
email: pkinglsey@stradley.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
4420 Madison Avenue
Suite 200
Kansas City, MO 64111-3407
Ph: (816) 931-2700
email: dkennedy@dysarttaylor.com

As to Address Changes:

Diane Kennedy
Surety Claims Institute
4420 Madison Avenue
Suite 200
Kansas City, MO 64111-3407
Ph: (816) 931-2700
email: dkennedy@dysarttaylor.com

VISIT OUR WEBSITE

Please be sure to visit our website www.scinst.org and take advantage of what it has to offer SCI Members. Learn all about our many programs, both past and contemplated. Download registration materials. Access all recent Newsletters on line. Check our extensive archive of presented papers. The Website has numerous pictures taken at our meetings. And more. If you have not paid dues in the past full year, you will not be able to access the "member place" to pay dues. For dues paying information, you may communicate with Diane Kennedy at (816) 931-2700 or dkennedy@dysarttayler.com. For additional information regarding the website, e-mail Jason Potter at jpotter@wcslaw.com or call him at (410) 659-1340.

SAVE THE DATE

June 19 – 21, 2019

The King and Prince Beach & Golf Resort
St. Simons Island, Georgia

https://www.kingandprince.com