Surety Claims Institute

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Newsletter

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2019 SURETY CLAIMS INSTITUTE MEETING KING AND PRINCE BEACH AND GOLF RESORT ST. SIMONS ISLAND, GEORGIA PROGRAM PREVIEW

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

The Surety Claims Institute's 44th annual meeting will be held June 19 through June 21, 2019 at the King and Prince Beach and Golf Resort on St. Simon's Island, George. This year, Patrick Kingsley of Stradley Ronon Stevens & Young, LLP begins his two tenure as chair of the educational program with a thoughtful and interesting array of topics. As always, the SCI Board of Directors endeavors to choose locations that offer a family-friendly atmosphere in an upscale setting. The King & Prince is no exception.

Families will enjoy the King & Prince's beachfront location, a first for SCI. The historic resort, which first opened as a seaside dance club in 1935, sits on St. Simon's Island overlooking the Atlantic Ocean. The resort's ECHO restaurant boasts the island's only waterfront dining, while the golf course, among the best in the state, contains over 800 feet of elevated cart bridges that culminate in four spectacular holes that sit atop beautiful marsh islands. The resort also offers a full service spa at the Royal Treatment Collage, har-tru tennis courts, and deep sea, bay, and inshore boating and fishing excursions. The resort also offers the opportunity to take a horseback ride, learn skeet or trap shooting, and to take a sailing or a dolphin tour.

St. Simon's Island houses the St. Simon's Lighthouse and Museum, where visitors may climb its 129 steps to spectacular views of the coast. Nearby is the Fort Frederica National Monument, where troops defeated the Spanish in the Battle of Bloody Marsh, ensuring Georgia's future as a British Colony. The monument and its archeological remains are protected and maintained by the National Park Service and the monument and visitors center are open daily from 9-5. *(continued on page 3)*

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Comments From The Editor:

As may be seen from the information in this Newsletter regarding our forthcoming Annual Meeting, we have an excellent program scheduled in what promises to be a great venue. I note that the Surety Claims Institute's former President, David Kitchin, has decided that St. Simons Island is such a perfect location that he has built his retirement home on the island. While he has not yet retired, his endorsement for the location cannot be demonstrated in any greater way. We look to seeing everyone in Georgia in June!

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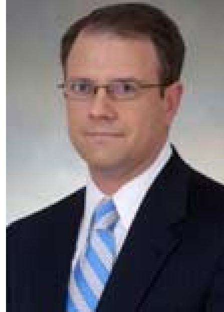
2019 SURETY CLAIMS INSTITUTE MEETING
KING AND PRINCE BEACH AND GOLF RESORT
ST. SIMONS ISLAND, GEORGIA
PROGRAM PREVIEW



(continued from page 1)

Fishing Pier Village, located on the south side of the island, serves as the downtown social hub and is a popular destination for shopping, dining, and gathering on the pier and nearby lighthouse, playground, and picnic areas. After dinner, visitors often enjoy strolling through the village, browsing through the boutique shops, and eating ice cream.

St. Simon's Island is one of four islands that make up the Golden Isles. Jekyll Island, the southernmost of the Golden Isles, is a short taxi or shuttle ride from the resort. Jekyll Island hosts a wide variety of family-friendly activities and attractions, which include ten miles of white sand beaches, golf, an outdoor tennis complex, the Summer Waves Water Park, dolphin tours, horseback riding tours, nature centers, bike trails, and the Georgia Sea Turtle Center.

In addition to all the amenities and offerings of the meeting's oceanfront location, we are also excited about the educational program that Pat Kingsley has put together, the focus of which is an array of topics that are likely to confront the surety claims practitioner but are not often discussed in other programs.

Thursday morning begins with the annual Surety Law Update, presented this year by Tricia Wager of Torre, Lentz, Gamell, Gary & Rittmaster, LLP and Tiffany Schaak of Liberty Mutual. The Update will be followed by Sarah Wilson of The Hartford and Joseph Wolenski of Thompson & Slagle, LLC, who will discuss strategies and theories for effectively presenting claims against product manufacturers and suppliers. Thursday's third presentation will focus on tips and strategies for what works (and what doesn't) in pre-default meetings with the principal and obligee, which will be presented by Jessica Bowers with Smith Bowers, PLLC, James Gibson of Liberty Mutual, Greg Veal of Bovis Kyle Burch & Medlin, LLC, Jennifer Leuschner of Philadelphia Insurance, Catherine Squillace of Sirius America Insurance, and Kathleen Maloney of IFIC. Finally, Thursday will end with Sharon Edwards of Swiss Re and Brian Kantar of Chiesa Shahinian & Giantomasi PC, who will discuss self-performance and minority or women business enterprises requirements and how they may affect the performing surety.

Toni Scott Reed and Ben Weible of Clark Hill Strasburger will begin Friday's program with the annual Fidelity Law Update. Scott Leo of the Law Offices of T. Scott Leo, PC, Scott Williams of Manier & Herod, Mike Bramhall of Arch, and John O'Donnell of Liberty Mutual, will demystify Chapter 11 bankruptcy and offer pointers as to how to more effectively protect the surety throughout the principal's Chapter 11 case. Friday's third presentation will be led by Jeff Katz of Vertex, Lauren McLaughlin of Smith Currie, and Mike Burkhardt of Liberty. Jeff, Lauren, and Mike will introduce the importance of submittals and the implications they can have on the performing surety. Friday's penultimate program will focus on delivered, stored, and paid for materials and the competing interests in them. Finally, we will conclude the meeting with Will Pearce of Arch, Dave Burkholder of Wisler Pearlstine, LLP, and Patrick Welch of Jennings, Strouss & Salmon, PLC, who will present the ethics portion of the

program with a discussion focusing on the ethical issues that can arise from the use of the general agreement of indemnity's provisions. As always, attendees will receive a full hour of ethics for their attendance.

For the golfers in attendance, the annual Thursday afternoon tournament will be held at the Hampton Club, the King & Prince-owned course that is a short drive from the resort. For those not golfing on Thursday, SCI has arranged for a tour of the scenic Marshes of Glenn aboard the Lady Jane, a United States Coast Guard certified passenger vessel. This is a first come, first served event, so sign up early!

We hope you are as excited as we are about this year's annual meeting, and we look forward to seeing everyone there!

44th ANNUAL SURETY CLAIMS INSTITUTE MEETING

SEMINAR PROGRAM SCHEDULE

THURSDAY PROGRAM

8:15 – 8:50 Surety Law Update
Tricia Wager and Tiffany Schaak

8:50 – 9:25 Making the Case Against Product Manufacturers and Suppliers
Sarah Wilson and Joseph Wolenski

9:25 – 9:40 BREAK

9:40 – 10:40 What Works At Pre-Default Meetings: Real Helpful Real World Tips
Jessica Bowers, James Gibson, Greg Veal, Jennifer Leuschner, Catherine Squillace, Kathleen Maloney

10:40 – 11:25 Self-perform/MBE/WBE Requirements and the Performing Surety
Sharon Edwards and Brian Kantar

FRIDAY PROGRAM

8:15 – 8:50 Fidelity Law and Commercial Surety Law Update
Toni Scott Reed and Ben Weible

8:50 – 9:25 Demystifying Chapter 11: Some Pointers for Vigilantly Protecting the Surety
Scott Leo, Scott Williams, Mike Bramhall and John O'Donnell

9:25 – 10:00 The Effect of Submittals and Implications for the Surety
Jeff Katz, Lauren McLaughlin and Doug Dearie

10:00 – 10:15 BREAK

10:15 – 10:50 Who Owns This Stuff? – Delivered, Stored and Paid-For Materials
Ed Dudley and Dan Lund

10:50 – 11:50 Ethics Issues in the Use of Key General Indemnity Agreement Provisions
Will Pearce, Dave Burkholder and Patrick Welch

Surety Claims Institute
44th Annual Meeting & Seminars

Tuesday, June 18 – Friday, June 21, 2019

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

AGENDA

Tuesday, June 18		
3:00 – 5:00 p.m.	Registration Desk Open	Lobby

Wednesday, June 19		
8:30 – 9:00 a.m.	Board of Directors Breakfast	Retreat Room
9:00 a.m. – Noon	Board of Directors Meeting	Retreat Room
2:00 – 5:00 p.m.	Registration Desk Open	Lobby
2:00 – 5:00 p.m.	Speakers' Rehearsal	Lanier Ballroom
6:00 – 9:00 p.m.	Get Acquainted Reception/ Buffet Dinner*	Hotel Lawn or Delegal Room

Thursday, June 20		
7:30 a.m.	Continental Breakfast for Registrants	Lanier Ballroom
8:00 a.m. – 11:30 a.m.	Seminar Program	Lanier Ballroom
1:00 – 5:00 p.m.	Golf Tournament*	Hampton Club
2:00 – 5:00 p.m.	Shrimp Boat Excursion*	Lady Jane
6:30 – 9:30 p.m.	Children's Party*	Retreat Room
7:00 – 10:00 p.m.	Reception and Banquet Dinner *	Lanier Ballroom

Friday, June 21		
7:30 a.m.	Continental Breakfast for Registrants	Lanier Ballroom
8:00 a.m. – Noon	Seminar Program	Lanier Ballroom
Noon	Adjourn	

*Reservations Required

Locations/Times/speakers/and educational topics subject to change

THE PERFORMANCE BOND SURETY'S DEFENSES TO A CLAIM BY A PROJECT OWNER WHO FAILS TO COMPLY WITH A CONTRACT'S TERMINATION REQUIREMENTS

By: Marc R. Lepelstat, Chiesa Shahinian & Giantomasi PC, New York, NY

I. Introduction

A performance bond surety must determine whether an obligee (the bond's beneficiary) that submits a claim is in compliance with the bonded contract. If the obligee fails to perform its obligations under that contract, the surety may be relieved of its obligations under the bond. The dismissal of the bond claim may be warranted if the obligee is in material breach of the contract. Dismissal may be appropriate under those circumstances because: (a) the liability of a surety depends on the liability of its principal—the co-obligor;[1] and (b) the principal would not have any liability to an obligee that is in material breach of the contract.[2]

Additionally, performance bonds commonly condition a surety's obligation on the obligee's performance of a bonded contract. Under bonds that contain this conditional language, the surety may be relieved of its obligation to perform if a court determines that the obligee was in material breach of the contract.[3]

Therefore, the improper termination of a bonded contract by an obligee may relieve the surety of its duty to perform because the failure to comply with the contract's termination procedures could constitute a material breach.[4]

In this article, I discuss: (a) the grounds for termination by a project owner; (b) common termination procedures contained in construction contracts, including cure provisions; (c) whether the failure by a project owner to comply with the termination provisions of a contract excuses the contractor from performing its obligations; and (d) the effect of an owner's improper termination of a contract on its right to assert a claim under a performance bond.

II. The Grounds for Termination

A contract may be terminated for cause or for convenience. A termination for convenience is the exercise of a contractual right to terminate a contract "without cause and at will."[5]

As distinguished from a termination "for convenience" or "at will", a termination for material breach is understood to be "for cause"

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[1] *See Travelers Cas. & Sur. Co. of Am. v. Ark. State Highway Comm'n*, 353 Ark. 721, 729, 120 S.W.3d 50, 54 (2003); *Wright Way Constr. Co. v. Harlingen Mall Co.*, 799 S.W.2d 415, 426 (Tex. App. 1990) (liability of surety is derivative in nature and depends upon principal's liability).

[2] *Am. Erectors, Inc. v. Ohio Farmers Ins. Co.*, No. 09-CV-13424, 2012 WL 13001913 at * 6 (E.D. Mich. 2012), cf. *Franklin Pavkov Constr. Co. v. Ultra Roof, Inc.*, 51 F.Supp.2d 204, 215-216 (N.D.N.Y. 1999).

[3] *See Gulf Ins. Co. v. Fid. & Deposit Co. of Md.*, No. 602448/04 2007 N.Y. Slip Op. 51440(U) at *4 (N.Y. Sup. Ct. July 20, 2007) (obligee's breach of the bonded contract—wrongful termination —relieved the surety from any liability to the obligee under the bond, because the surety's obligation to perform was conditioned upon the obligee's performance of the bonded contract).

[4] *Id*.

[5] *See* 5 PHILIP L. BRUNER & PATRICK J. O'CONNOR, BRUNER & O'CONNOR ON CONSTRUCTION LAW § 18:45 (2018).

or "at will."[6] Termination of a contract for cause is a fundamental common-law right of the non-breaching party whose interest in future contract performance is impaired by an uncured, unexcused, and unwanted material breach.[7]

Whether an event of default exists must be determined with reference to the contract itself. Many construction contracts, however, define at least the following acts or omissions by the contractor as events of default which entitle the owner, at its option, to terminate for cause:

A. Sub-Standard, Defective or Noncomforming Work

The contractor is obligated to perform its work in a good and workmanlike manner.[8] Moreover, the contract may provide express warranties regarding the quality of the work and the materials used. In AIA Document A201, which is a commonly used form for construction contracts, the Contractor warrants the following:

> …materials and equipment furnished under the Contract will be of good quality and new unless the Contract Documents require or permit otherwise…that the Work will conform to the requirements of the Contract Documents and will be free from defects, except for those inherent in the quality of the Work the Contract Documents require or permit. Work, materials or equipment not conforming to these requirements may be considered defective.[9]

In AIA Document A201, the architect has the authority to reject work that does not conform to the contract documents.[10] The performance of work by the contractor which is rejected by the architect may be a ground for termination of the contract.[11]

B. Failure to Pay Subcontractors and Suppliers

The failure of the contractor to pay its subcontractors and suppliers may expose the owner to mechanic's liens. Contracts may obligate the contractor to stay current with payment obligations to its subcontractors and suppliers. AIA Document A201 provides that the contractor:

> …warrants that upon submittal of an Application for Payment all Work for which Certificates of Payments have been previously issued and payments received from the Owner shall, to the best of the Contractor's knowledge, information and belief, be free and clear of liens, claims, security interests or encumbrances, in favor of the Contractor, Subcontractors, suppliers, or other persons or entities that provided labor, materials and equipment relating to the Work.[12]

Under AIA Document A201, the failure of the contractor to make payment to subcontractors or suppliers in accordance with the respective agreements between the contractor and the subcontractors or suppliers is a ground for termination.[13]

C. Failure to Pursue Work Diligently

In AIA Document A201, the contractor is required to prepare a construction schedule, which must be revised at appropriate intervals as required by the conditions of the work and project.[14] The contractor must "perform the Work in general accordance with the most recent schedules submitted to the Owner and Architect."[15] AIA Document A201 provides

[6] *Id*. at § 18:32.
[7] *Id*.
[8] *See, e.g., Tharpe v. G.E. Moore Co*., 174 S.E.2d 397, 399 (S.C. 1970); *Weck v. A:M Sunrise Constr. Co.*, 184 N.E.2d 728, 734 (Ill. App. Ct. 1962); *Miccio v. Wade Lupe Constr. Co.*, 615 N.Y.S.2d 513, 514 (N.Y. App. Div. 1994).
[9] AIA Document A201-2017 at 13, § 3.5.1.
[10] *Id*. at 18, § 4.2.6.
[11] *Id*. at 34, §§ 14.2.1, 14.2.2.
[12] *Id*. at 23-24, § 9.3.3.
[13] *Id*. at 34, § 14.2.1.2.
[14] *Id*. at 15, § 3.10.1.
[15] *Id*. § 3.10.3.

that the owner may terminate the contract if the contractor "repeatedly refuses or fails to supply enough properly skilled workers or proper materials."[16]

D. Violation of Laws, Ordinances, Etc.

Construction contracts may allow the owner to terminate if the contractor defaults by violating laws or ordinances that apply to the owner, the contractor and/or the project. In AIA Document A201, the owner can terminate if the contractor "persistently disregards laws, statutes, ordinances, codes, rules and regulations, or lawful orders of a public authority."[17]

AIA Document A201 specifically obligates the contractor to pay sales, consumer, use and similar taxes for the work provided by the contractor;[18] and to comply with, and give notices required by applicable laws, statutes, ordinances, codes, rules and regulations, and lawful orders of public authorities bearing on safety of persons or property or their protection from damage, injury or loss.[19]

E. Other Substantial Breach of Contract

AIA Document A201 further permits the Owner to terminate the Contract if the Contractor is otherwise guilty of a substantial breach of a provision of the Contract Documents.[20] Whether the breach is substantial or material is a question to be decided by the trier of fact.[21]

III. Termination Procedures And Notification Of Default

When the decision is made to terminate the contract because of default by the contractor, a contract typically requires that notice and an opportunity to cure must first be given to the contractor. Under AIA Document A201, for example, the owner must give the contractor (and the surety, if any) seven (7) days' written notice before terminating the contract.[22]

Depending on the type of default alleged, a contract may provide specific opportunities for the contractor to cure the default. In the case of defective or non-conforming work, for example, AIA Document A201 provides that if the contractor does not commence and continue the correction of the work within a ten (10) day period after receipt of notice by the owner to commence and continue correction of such default or neglect with diligence and promptness, the owner may, without prejudice to other remedies the owner may have, correct such default or neglect.[23]

Thus, in the contract language quoted above, as in many construction contracts, the owner may not peremptorily terminate the contract by reason of an alleged breach by the contractor. In many instances, the contract will allow the contractor a reasonable opportunity to cure the alleged breach and protect its interest under the contract once it receives notice of the owner's alleged basis for termination.

IV. The Consequences Of Wrongful Termination As Between The Parties To The Contract

The failure of the owner to terminate a contract in compliance with the contract's requirements may constitute a material breach precluding the owner from maintaining a claim for breach of contract against the contractor.

The elements of a claim for breach of contract are: "(1) the existence of an agreement, (2) adequate performance of the contract by the plaintiff, (3) breach of contract by the defendant, and (4) damages."[24]

Therefore, a party to a contract cannot recover damages on account of another's claimed breach of contract unless it proves that

[16] *Id.* at 34, § 14.2.1.1.
[17] *Id.* § 14.2.1.3.
[18] *Id.* at 14, § 3.6.
[19] *Id.* at 28, § 10.2.2.
[20] *Id.* at 34, § 14.2.1.4.
[21] *Liberty Mut. Ins. Co. v. City of Dearborn*, No. 11–13605, 2013 WL 6241585 at *18 (E.D. Mich. December 3, 2013).

[22] *Id.* at 34, § 14.2.2.
[23] *Id.* at 12, § 2.5.
[24] *Eternity Glob. Master Fund Ltd. v. Morgan Guar. Trust Co. of N.Y.*, 375 F.3d 168, 177 (2d Cir. 2004); *see also Arrow Electronics, Inc. v. United Connectivity Solutions, Inc.*, Civil Action No. CV–13–S–954–NE, 2013 WL 3874704 at *4 (N.D. Ala. July 25, 2013); *Res. Title Agency, Inc. v. Morreale Real Estate Serv., Inc.*, 314 F.Supp.2d 763, 769 (N.D. Ohio 2004).

it has performed its obligations under the parties' contract.[25]

A party is relieved of the duty to perform under a contract only when the other party has committed a material breach.[26] For a breach to be considered material, "it must go to the root of the agreement between the parties."[27]

The termination of a contract without following the contract's termination procedures may constitute a material breach.[28] Further, a material breach of the contract discharges the other party to the contract from all performance obligations and exposes the breaching party to liability for lost profits and other damages due to wrongful breach.[29]

No curable breach can be deemed sufficiently material to warrant termination without the breaching party first having been given notice of and an opportunity to cure the breach.[30] Cure is a fundamental common-law right implied in every contract as a matter of law.[31] The remedial purpose of the cure notice is to (1) give the breaching party a reasonable opportunity to cure the identified deficiencies or to provide adequate assurances of cure; (2) present evidence that the identified deficiencies are excused or waived; (3) provide reasonable assurances that the deficiencies can be avoided or cured in the future; (4) permit the parties and the design professional of record to reach agreement upon an acceptable cure; (5) give the breaching party's performance bond surety, if any, advance notice that it may be called upon to perform its performance bond obligations; (6) permit the breaching party to mitigate its own damages; and (7) promote the informal settlement of disputes. [32]

Given the remedial purpose of the cure notice, termination by the non-breaching party without providing notice and an opportunity to cure any curable breach deemed sufficiently material to warrant termination is itself a material breach resulting in a wrongful termination.[33]

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[25] *Id.*; see also *Blue Ridge Farms, Inc. v. Crown Equip. Corp.*, No. 01 CV 8460SJ, 2005 WL 755756, at *9-10 (E.D.N.Y. Mar. 28, 2005); *Franklin Pavkov Constr. Co.*, 51 F.Supp.2d at 215-16 .

[26] *In re Lavigne*, 114 F.3d 379, 387 (2d Cir. 1997).

[27] *Frank Felix Assocs. v. Austin Drugs, Inc.*, 111 F.3d 284, 289 (2d Cir. 1997).

[28] *Gulf*, 2007 N.Y. Slip Op. 51440(U) at *4, cf. *Gen. Supply and Constr. Co. v. Goelet*, 148 N.E. 778, 779 (N.Y.1925); *MCK Bldg. Assocs. v. St. Lawrence Univ.*, 754 N.Y.S.2d 397, 398–99 (N.Y. App. Div. 2003) (subcontract termination was wrongful because the subcontractor was not been provided seven days' notice and an opportunity to cure, and the contractor failed to obtain the architect's certification that sufficient caused existed to terminate). A contractor that improperly terminates a subcontract may suffer the same consequences vis-à-vis a subcontractor as an owner that improperly terminates a prime contract faces vis-à-vis a contractor. *See Franklin Pavkov Constr. Co.*, 51 F. Supp.2d at 219-20.

[29] *Franklin Pavkov Constr. Co.*, 51 F. Supp.2d at 219.

[30] *Gulf*, 2007 N.Y. Slip Op. 51440(U) at *4, cf. *Goelet*, 148 N.E. at 779; *MCK Bldg. Assocs.*, 754 N.Y.S.2d 397, 398–99.

[31] *See Restatement (Second) of Contracts* § 241(d) (Am. Law Inst. 1981) (advising that evaluation of materiality should take into consideration "the likelihood that a party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances"); *see also McClain v. Kimbrough Constr. Co., Inc.*, 806 S.W.2d 194, 198-199 (Tenn. Ct. App. 1990) (holding that in the absence of any termination provision, a contractor still had a duty to give to its subcontractor "notice and a reasonable opportunity to correct its defective work before terminating the contract"); *U.S. for Use and Benefit of Cortolano & Barone, Inc. v. Morano Constr. Corp.*, 724 F. Supp. 88, 98 (S.D.N.Y. 1989) ("Despite the absence of any contractual provision, a subcontractor alleged to be in default is entitled to receive more notice than [the subcontractor] received here.").

[32] 5 PHILIP L. BRUNER & PATRICK J. O'CONNOR, BRUNER & O'CONNOR ON CONSTRUCTION LAW § 18:41 (2018), cf. *Pollard v. Saxe & Yolles Dev. Co.*, 525 P.2d 88, 92 (Cal. 1974) (holding that "the requirement of notice of breach is based on the sound commercial rule designed to allow [the contractor] opportunity for repairing the defective item, reducing damages, avoiding defective products in the future, and negotiating settlement.").

[33] *Id.*; *Carter v. Krueger*, 916 S.W.2d 932, 937 (Tenn. Ct. App. 1995) (contractor "is not barred from recovering damages even though he may have been the first to breach the contract … because the [owner] failed to give notice of claim defects and failed to give [the contractor] an opportunity to cure the defects"); *Blaine Econ. Dev. Auth. v. Royal Elec. Co., Inc.*, 520 N.W.2d 473, 476-77 (Minn. Ct. App. 1994) (owner wrongfully terminated a construction contract by failing to first give a proper cure notice); *Bruning Seeding Co. v. McArdle Grading Co.*, 439 N.W.2d 789, 791 (Neb. 1989) (contractor's failure to give any written notice to the subcontractor before termination constituted a material breach of the subcontract);

Therefore, if the contract provides for notice and the opportunity to cure and the owner fails to comply with those requirements, the owner may be liable for a material breach of the contract, entitling the contractor to damages.[34]

However, not every deviation from the contract's termination requirements is deemed material enough to warrant the discharge of the contractor's obligations. For instance, if the contract provides for a manner of service of the notice of termination, such as personal delivery, and the owner employs a different manner of service, such as email, courts have held this deviation to be immaterial (if receipt of the notice is established) and courts have nevertheless found the termination of the contract to be valid and effective.[35]

Under the terms of a contract, an owner's termination for default without following the contract's termination requirements may result in the conversion of the termination to one of convenience. For instance, the 2007 Standard Specifications for Road and Bridge Construction, of the New Jersey Department of Transportation (the "NJDOT Specifications") obligate the owner to provide a pre-termination notice and an opportunity to cure the default, similar to AIA Document A201.[36] The NJDOT Specifications further provide that "(i)f, after declaration of default, a court determines for any reason that the Department's default of the Contract was legally improper, the rights and obligations of the parties are the same as if the Department had issued an order of termination for convenience."[37] Under a termination for convenience, the NJDOT must make payment to the contractor "for the items completed as of the date of termination at the Contract price."[38]

Accordingly, a contract term which provides for the conversion of a termination for default to a termination for convenience upon a determination of an improper termination could have the effect of discharging the contractor from any liability for the costs of completion.[39]

V. The Effect Of An Improper Termination On A Claim Under A Performance Bond

The improper termination of a bonded contract may discharge the surety of all liability under its performance bond. The surety may avoid liability under two theories. Initially, the liability of a surety depends on the liability of its principal.[40] As set forth above, the termination of a contract without following the contractual procedures for termination, including providing a cure notice, may render the termination invalid and in material breach of the contract.[41] Under those circumstances, the other party to the contract (whether it be a contractor for a prime contract or a subcontractor for a subcontract) would have no liability to the party which improperly terminated the contract (whether it be an owner for a prime contract or a contractor

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Morano Constr. Corp., 724 F. Supp. at 98 (subcontractor alleged to be in default was entitled to adequate notice of deficiencies alleged to be sufficiently material to warrant termination); *Burras v. Canal Constr. and Design Co.*, 470 N.E.2d 1362, 1367 (Ind. Ct. App. 1984) (because the subcontractor "was not given an opportunity to remedy any alleged defects, any incidence of defective performance did not constitute a breach of the construction contract").

[34] *Gulf*, 2007 N.Y. Slip Op. 51440(U)at *4, cf. *Goelet*, 148 N.E. at 779; *MCK Bldg. Assocs*., 754 N.Y.S.2d 397, 398–99; *see also Filmline v. United Artists Corporation*, 865 F.2d 513, 519 (2d Cir. 1989) ("since [defendant's] purported termination was in violation of the terms of the Agreement, it was inoperative and plaintiffs are entitled to recover for breach of contract.").

[35] *Thurston v. Sisca*, No. 1:14-CV-1150 (GTS/DEP), 2016 WL 4523930, at *6 (N.D.N.Y. August 22, 2016) (email notice did not violate the notice provision because it did not "undermine[ ] any of the objectives of the notice-requirement provision contained in ... the Purchase Contract...."); *Vista Outdoor Inc. v. Reeves Family Trust*, 234 F. Supp. 3d 558, (S.D.N.Y. 2017) (email notice rather than written notice sufficient where defendants received notice and did not claim any prejudice).

[36] NJDOT Specifications at 74, § 108.14.

[37] *Id*.

[38] *Id*. at 75, § 108.15.1.

[39] *See Franklin Pavkov Constr. Co.*, 51 F. Supp. 2d at 218. However, even if an owner improperly terminates a contract and is consequently liable to the contractor for breach of contract, the owner may still seek an offset for reimbursements for payment made to third parties to correct the contractor's defaults. *See Paragon Restoration Group, Inc. v. Cambridge Square Condominiums*, No. I 2004-12472, 2006 N.Y. Slip Op. 52579(U) at *7 (N.Y. Sup. Ct. 2006), cf. *Goelet*, 241 N.Y. at 33.

[40] *See Ark. State Highway Comm'n*, 120 S.W.3d at 54; *Wright Way Constr. Co.*, 799 S.W.2d at 426.

[41] *Gulf*, 2007 N.Y. Slip Op. 51440(U) at *4, cf. *Goelet*, 148 N.E. at 779; *MCK Bldg. Assocs*., 754 N.Y.S.2d 397, 398–99.

for a subcontract).[42] The party which improperly terminated the contract would, therefore, be unable to recover its costs of completion from the other party to the contract.[43]

Because the performance bond surety's liability is derivative of the liability of its principal and its principal may have no liability to the obligee that improperly terminated a contract, the surety would have the same defense to the obligee's claim.[44]

The improper termination of a contract by an obligee may also result in the discharge of a performance bond if the surety's obligations are conditioned on the obligee's performance of the contract. The AIA A312 bond does contain such a condition and provides the following in Paragraph 3: "If there is no Owner Default, the Surety's obligation under this Bond shall arise after…" The term "Owner Default" is defined in the bond as "Failure of the Contractor, which has neither been remedied nor waived, to pay the Contractor as required by the Construction Contract or to perform and complete or comply with the other terms thereof."

It has been held that when a performance bond is conditioned on the obligee's performance of its contractual obligations and the obligee fails to comply with at least one such obligation the surety is discharged from any liability.[45] Because an obligee's improper termination of a contract constitutes the failure to perform its contractual obligations, the improper termination could also constitute the failure of a condition precedent under a bond that the obligee perform its contractual obligations to the bond principal.

The failure of an obligee to comply with a condition in a bond that it perform its obligation under the bonded contract has resulted in the discharge of a performance bond surety.[46] In *Gulf*, the surety ("Gulf") for the general contractor ("Remco") was precluded from recovering against a performance bond surety ("F&D") for a subcontractor ("Tri-State"). No recovery was permitted under F&D's bond because the general contractor and bond obligee, "Remco," terminated the bonded subcontract with its subcontractor, "Tri-State," without complying with the Remco-Tri-State subcontract's conditions for termination. The court held that Remco (the breaching party) did not comply with the termination conditions of the subcontract, among other reasons, because Remco failed to give Tri-State and its surety (F&D) seven days written notice before terminating Tri-State's subcontract. The court held the following:

> Since Remco terminated Tri-State without following the contractual procedures, the termination was invalid and breached the Remco/Tri-State Contract. Where a contract provides that a party must fulfill specific conditions precedent before it can terminate the agreement, those conditions are enforced as written and the party must comply with them.[47] This general rule fully applies to construction agreements, whose parties cannot terminate contractors unless they follow the contractual procedures to the letter. *Gen. Supply & Constr. Co. v. Goelet*, 241 NY 28, 35 (1925) (finding the owner had wrongfully rescinded its agreement with a contractor because it had not provided the architect's certificate that the contract required); *MCK Bldg. Assocs., Inc. v. St. Lawrence U.*, 301 AD2d 726, 727-28 (3d Dept.), *leave dismissed*, 99 NY2d 651 (2003) (construction manager wrongfully terminated its agreement with subcontractor when it failed to provide ten days' notice, as contract required, and instead declared the termination effective immediately) . . . Remco's breach of the Remco/Tri-State

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[42] Id.

[43] *Id.*

[44] *See Ark. State Highway Comm'n*, 120 S.W.3d at 54; *Wright Way Constr. Co.*, 799 S.W.2d at 426.

[45] *See Roel P'ship v. Amwest Sur. Ins. Company*, 685 N.Y.S.2d 832 (N.Y. App. Div. 1999) (surety was relieved of its obligation under a performance bond as a result of the obligee's failure to comply with the terms of a bonded contract).

[46] *See Gulf*, 2007 N.Y. Slip Op. 51440(U) at *4.

[47] *A.S. Rampell, Inc. v. Hyster Co.*, 3 NY2d 369, 381-82 (1957).

> Contract also relieves F & D from any liability to Remco under the F & D Bond, because F & D's obligation to perform was conditioned upon Remco's performance of the Remco/Tri-State Contract. Remco materially breached the contract by wrongfully terminating Tri-State and by failing to provide F & D with seven days' notice of the termination and an opportunity to cure.[48]

Therefore, the failure of the obligee to terminate a contract in compliance with the contractual requirements could relieve the surety of any obligation under its performance bond.[49]

VI. Conclusion

It is imperative that the performance bond surety conduct an extensive investigation of all pertinent facts regarding the work performed by its bond principal, the requirements set forth in the bonded contract, and whether the obligee fully performed its contractual obligations. Specifically, the surety should endeavor to learn, among many other issues, the scope of work covered by the bonded contract together with any change orders, the value of approved change orders, the extent of monies paid to the principal, the failure of the obligee to make payments when they were due, the amount of unpaid work performed, and whether any overpayments were made for work not performed and for deficient work.

Equally important is the gathering of information by the surety as to the circumstances of a default and how the obligee responded to the default, including the termination of the bonded contract. If the surety discovers that the contract contains specific termination procedures, which are typically contained in construction contracts, and the obligee failed to comply with those procedures the surety may have an absolute defense under the its performance bond. This defense may exist whether or not the surety's duties are expressly conditioned on the performance of contractual obligations on the part of the obligee.

Conducting a proper investigation will save a substantial amount of time and resources that the surety would otherwise incur in litigating the technical issues that may arise in connection with the events of default. A determination that the obligee failed to terminate a contract in compliance with the contract's requirements, including notice and an opportunity to cure, should provide the surety with considerable leverage in resolving the performance bond claim. The surety's successful challenge to the obligee's termination of the contract, whether asserted at a mediation or on a motion for summary judgment, could result in the saving of tremendous expenses, both attorney's fees and expert fees, which the surety may otherwise incur in trying the factual issues regarding the events of default.

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[48] *Id*., (emphasis added).
[49] *Id*.

The Surety's Claims In Bankruptcy

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Introduction

This article will focus on the surety's claims in bankruptcy. One of the primary functions of the bankruptcy process is to ensure that the property of the estate in bankruptcy is distributed in accordance with the rules and priorities established in the Bankruptcy Code. The proof of claim is one of the important tools for accomplishing that distribution of the debtor's property. Accordingly, this discussion will start with a brief introduction to proofs of claims. We will then take a more in-depth look at the types of claims that may be asserted and the relationship between reimbursement claims and subrogation claims under the Bankruptcy Code. Next, we will focus on the claims administration process and the claims objection process. Finally, our discussion will close by touching briefly on post-petition claims.

I. Proof of Claims Generally

Let's start with a 30,000-foot overview of bankruptcy. When the debtor files a bankruptcy case, regardless of whether it's a chapter 7, 11, or 13, and regardless of whether there is a trustee involved or a debtor-in-possession, that filing establishes a bankruptcy estate that is comprised of all of the debtor's property and assets.[1] The United States Bankruptcy Code, 11 U.S.C. §§ 101 - 1532 (the "Bankruptcy Code" or "Code") purposefully defines property of the bankruptcy estate exceedingly broadly so as to capture all of the debtor's property wherever located and by whomever held and in whatever form.[2]

Once all of the property is gathered into the estate it is then distributed to the creditors in an orderly and organized fashion in accordance with the provisions of the Bankruptcy Code.[3] The Bankruptcy Code addresses treatment and priority of administrative claims and secured and unsecured claims. To the extent that there is any estate property that is free and clear of the claims of secured and priority creditors, that amount of the debtor's property will be distributed to the debtor's pre-petition unsecured creditors.

To help identify what the debtor's assets are and who the debtor's creditors are under the Bankruptcy Code, under Section 521 of the Code the debtor is required to file schedules identifying its assets and its creditors.[4] In order to share in any distribution under a plan or liquidation from a bankruptcy estate, the surety must be listed as a creditor with an undisputed and liquidated claim.

A problem that frequently arises is that the surety may not be listed in the debtor's schedules as a creditor, or if the surety is listed, the amount of the surety's claim is not listed correctly, or even if the surety's claim is correctly listed, it will typically be identified as "disputed." In addition, at the time a principal or indemnitor files bankruptcy, the surety's claims are typically not fully liquidated, as the surety may still be dealing with claims and performance issues. Accordingly, the surety will need to advise the debtor, any trustee and the court of the true and correct nature of the surety's claims through the filing of a proof of claim under Section 501 of the Bankruptcy Code.

As a threshold matter, the Bankruptcy Code defines a "claim" at § 101(5) as a:

> (A) right to payment, whether or not such right is reduced to judgment, liquidated,

[1] 11 U.S.C. § 541 (2018).

[2] *In re Continental Airlines, Inc.*, 134 B.R. 536, 541 (Bankr. D. Del. 1991).

[3] *See* 11 U.S.C. §§ 501 - 726 (2018).

[4] 11 U.S.C. § 521 (2018).

unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured;

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.[5]

Congress purposefully gave the term "claim" a broad definition in the Bankruptcy Code to further the overriding goal of providing a fresh start for a debtor.[6] Thus, the Bankruptcy Code definition of "claim" is extremely broad and extends to practically every type of claim that a surety may have against the debtor. Even if the claim is totally contingent and may never become an actual loss for the surety, it would still constitute a "claim" in bankruptcy.

II. The Types of Surety Pre-Petition Claims in a Debtor's Bankruptcy Case

A. Generally.

A surety's claim is a right to payment from the debtor. The surety has a reimbursement claim for its losses, which losses may include:

1. Payments under the surety bonds to obligees and other third-party claimants;
2. Payments for losses under the indemnity agreement with the principal, including professional fees and expenses; and
3. Payments for premiums for the surety bonds.

Each of these payments may be or have been reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, or undisputed. Regardless, they should be included in a surety's claim for reimbursement.

The surety, whether it is a contract bond surety or a commercial bond surety, wants to be reimbursed for its payments and losses, and has significant rights – legal, equitable, secured, or unsecured – outside of a bankruptcy case. The surety has:

1. Common law[7] rights and contractual rights of reimbursement pursuant to the indemnity agreement;
2. Rights against any collateral that the surety is holding; and
3. Subrogation rights.

The question is how these rights are affected by and enforceable in a debtor's bankruptcy case based upon the various types of claims that a surety may have.

B. The Types of Surety Claims.

1. <u>*The Surety's Secured Claim - Section 506 of the Bankruptcy Code*</u>

The surety's reimbursement claim may be secured by rights in or a lien on collateral which may be property of the debtor's bankruptcy estate. While the automatic stay may prevent the surety from exercising and enforcing its rights against the collateral,[8] the surety's lien

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[5] 11 U.S.C. § 101(5) (2018).

[6] *In re Morgan*, 197 B.R. 892, 896 (Bankr. N.D. Cal. 1996).

[7] The surety's common-law claim for reimbursement and/or indemnity against its principal is described in the Restatement (Third) of the Law, Suretyship and Guaranty, Section 22(1), which states that "when the principal obligor is charged with notice of the secondary obligation it is the duty of the principal obligor to reimburse the secondary obligor to the extent that the secondary obligor" (a) performs the secondary obligation or (b) settles with the obligee, thereby discharging the debt of the principal obligor. RESTATEMENT (THIRD) OF THE LAW, SURETYSHIP AND GUARANTY ch. 3, topic 2, § 22(1) (AM. LAW INST. 1996).

[8] While a surety may have a secured claim and either lien rights or other rights in the principal's real and/or

rights[9] and other rights in certain collateral may provide the surety with a secured claim against the debtor's real and/or personal property under section 506 of the Bankruptcy Code. The collateral and the surety rights may include:

a. Letter of Credit. The surety may have received a letter of credit as collateral. The letter of credit and the proceeds of the letter of credit are not generally property of the debtor's bankruptcy estate, and the surety may not be automatically stayed or prevented from drawing on the letter of credit or using the letter of credit proceeds to pay claims or reimburse the surety for its losses.

b. Contractual lien rights. The surety may have obtained as collateral - mortgages and deeds of trust against the debtor's real property and security agreements and perfected security interests in the debtor's personal property, including cash.[10]

c. Indemnity agreement secured rights. The surety may have a security interest under the indemnity agreement in collateral perfected with the filing of a UCC-1 Financing Statement.

d. Collateral demand/place in funds rights. The surety may have established a reserve and demanded collateral or to be "placed in funds" under the indemnity agreement, and may be holding collateral as a result.

e. Judicial liens. The surety may have obtained a judgment against the principal, now the debtor, under the indemnity agreement and recorded that judgment under state law as a lien against the principal's property.[11]

f. Setoff rights. The surety may have certain setoff rights against the principal that may provide either a recovery to the surety or the avoidance of an additional loss.[12]

g. Indemnity agreement trust fund rights. The surety may have applicable trust fund rights under the indemnity agreement.

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personal property, when the principal files its bankruptcy petition and becomes a debtor, the surety generally is automatically stayed from exercising its rights against the debtor's real and/or personal property under § 362 of the Bankruptcy Code. 11 U.S.C. § 362 (2018). The surety must seek to modify, condition, or terminate the automatic stay under § 362(d) of the Bankruptcy Code and obtain a court order prior to exercising and enforcing its rights against the debtor's property. *Id*. at § 362(d). One exception to this general rule is collateral in the form of letters of credit because the letter of credit is an obligation of the issuing bank and not a direct obligation of the debtors.

[9] 11 U.S.C. § 101(37) defines a "lien" to mean a "charge against or interest in property to secure payment of a debt or performance of an obligation." 11 U.S.C. § 101(37). Thus, any surety interest in the debtor's property to secure the payment of a debt owed to the surety may give rise to a secured claim.

[10] Under 11 U.S.C. § 101(50), a "security agreement" means an "agreement that creates or provides for a security interest." 11 U.S.C. § 101(50). Under 11 U.S.C. § 101(51), a "security interest" means a "lien created by an agreement." 11 U.S.C. § 101(51). The surety's liens and security interests may be created at the time that the indemnity agreement is executed or at any time thereafter.

[11] Under 11 U.S.C. § 101(36), a "judicial lien" means a "lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding." 11 U.S.C. § 101(36).

[12] Pursuant to the automatic stay of § 362(a)(7) of the Bankruptcy Code, the surety is stayed from exercising any setoff rights that it may have in the event that the surety owes a debt to the debtor that arose before the petition date against any claim that the surety may have against the debtor, and the surety's setoff rights may only be exercised after the surety obtains a court order granting relief from the automatic stay (termination, modification or conditioned) allowing the surety to exercise and enforce its setoff rights. 11 U.S.C. § 362(a)(7).

h. Subrogation rights. The surety may be secured by its subrogation rights to the rights of others, including the surety's subrogation rights against third parties, rights against collateral held by the bond obligee, namely the bonded contract funds, and statutory lien or statutory trust fund rights.[13]

To the extent that the surety has a secured claim, it must identify that claim by filing a proof of claim in the bankruptcy.[14]

The surety's rights as a secured creditor against the debtor's property are governed by section 506 of the Bankruptcy Code. The surety's allowed secured claim is secured by a lien on the debtor's property to the extent of the value of the surety's interest in the debtor's estate's interest in the property.[15]

There are two variables to any creditor's secured claim - the amount of the claim and the value of the collateral securing the claim. The surety frequently finds that both the amount of its claim[16] (the surety's payments and the surety's contingent and unliquidated liabilities under the bonds) and the value of its collateral[17] (the value and extent of the surety's liens and rights) are variable and/or unknown. The surety should file its proof of claim as a secured claim notwithstanding the potential unliquidated, disputed and/or contingent nature of the surety's claim.

Finally, the surety may be entitled to reimburse its secured claim from the collateral for the surety's payments to its attorneys, consultants and others, and for interest on its payments under section 506(b) of the Bankruptcy Code.

2. *The Surety's General Unsecured Claim - Sections 501 and 502 of the Bankruptcy Code*

The surety's reimbursement claim may be a pre-petition general unsecured claim against the debtor. The surety must file a proof of claim for the amount of its pre-petition losses, interest and professional expenses in order to obtain a pro rata distribution of the debtor's property under a plan or liquidation. Those pre-petition losses may be pre-petition in nature even if they are incurred or paid post-petition.[18] The surety may be able to include such incurred and paid professional expenses as part of its pre-petition general unsecured claim.

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[13] The term "statutory lien" is defined in 11 U.S.C. § 101 (53) and does not include a "security interest" or a "judicial lien."

[14] Pursuant to § 506(d)(2) "[t]o the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void unless - . . . (2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title." 11 U.S.C. § 506(d)(2) (2018). Therefore, if, in fact, a surety has a lien against the debtor's property, which is property of the bankruptcy estate, and the surety fails to file a proof of claim, that lien will remain on the debtor's property despite the surety's failure to file a proof of claim. It is not recommended that the surety fail to file a proof of claim.

[15] 11 U.S.C. § 506(a)(1).

[16] Pursuant to 11 U.S.C. § 502(c), the bankruptcy court may estimate for the purpose of the allowance of a claim "(1) any contingent or unliquidated claim, the fixing or liquidation of which, as the case may be, would unduly delay the administration of the case; or (2) any right to payment arising from a right to an equitable remedy for breach of performance." 11 U.S.C. § 502(c) (2018).

[17] Pursuant to Bankruptcy Rule 3012, "[t]he court may determine the value of a claim secured by a lien on property in which the estate has an interest on motion of any party in interest and after a hearing on notice to the holder of the secured claim and any other entity as the court may direct." FED. R. BANKR. P. 3012.

[18] Pursuant to 11 U.S.C. § 502(e)(2):

> A claim for reimbursement or contribution of such an entity that becomes fixed after the commencement of the case shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) of this section, the same as if such claim had become fixed before the date of the filing of the petition.

11 U.S.C. § 502(e)(2); s*ee also* 11 U.S.C. § 501(d) (2018).

The surety's proof of claim for its general unsecured claim is based on its common-law rights of reimbursement and its indemnity and reimbursement rights under the indemnity agreement, and possibly its subrogation rights. The surety should include in its liquidated, non-contingent and undisputed claim all of the surety's paid losses, including fees and professional expenses, and any unpaid premiums. The surety's proof of claim must reserve the surety's right to amend and/or supplement its proof of claim to add any additional liabilities and to reflect the surety's actual losses and expenses (the surety's liquidated loss). Finally, the surety's proof of claim should assert its contingent and unliquidated claim for all of the surety's possible liabilities and losses in an amount equal to the penal sums of all of the outstanding bonds, less any paid losses to date.

3. *The Surety's Priority Unsecured Claim - Sections 503 and 507 of the Bankruptcy Code*

A surety with a pre-petition general unsecured claim rarely, if ever, has a priority claim to the property of the debtor's bankruptcy estate as against other general unsecured pre-petition claims. Section 507 of the Bankruptcy Code sets forth certain specific pre-petition claims that have priority over other general unsecured pre-petition claims.[19] The indemnity agreement does not assign to the surety any of the priority rights of a creditor asserting a priority unsecured claim. Furthermore, under section 507(d) of the Bankruptcy Code, the surety may not be subrogated to the priority rights of a creditor in the event that the surety pays as part of the surety's bond obligations, such as a tax or customs bond, the claim of the creditor that would otherwise have priority rights.[20]

However, the surety may become subrogated to the priority rights of a creditor if the surety pays a claim that is a post-petition administrative expense claim allowed under the Bankruptcy Code. The surety's proof of claim must reserve the surety's right to amend and/or supplement its proof of claim in order to preserve any priority claims that the surety may have.

4. *The Surety's Reserve Claim*

Pursuant to the indemnity agreement, the surety may establish a reserve to cover claims, demands, liabilities, etc. The surety's establishment of a reserve constitutes a loss on the surety's books, and may be the basis for a portion of the surety's pre-petition claim, whether the surety's claim is a secured claim or a general unsecured claim, even if the surety has not actually paid losses up to the amount of the reserve.[21]

5. *The Surety's Executory Contract Rejection Claims*

The surety may have a claim if the debtor rejects an executory contract and such rejection causes a loss to the surety.[22] While such a rejection may result in the obligee's filing a bond claim and cause a subsequent loss to surety, the surety's rejection claim may be necessary if the proof of claim bar date has expired and the surety's general unsecured claim has already been disallowed.

6. *The Surety's Claim Resulting From the Return of Property*

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[19] 11 U.S.C. § 507 (2018).

[20] Section 507(d) of the Bankruptcy Code provides as follows:

> An entity that is subrogated to the rights of a holder of a claim of a kind specified in subsection (a)(1), (a)(4), (a)(5), (a)(6), (a)(7), (a)(8), or (a)(9) of this section is not subrogated to the right of the holder of such claim to priority under such subsection.

11 U.S.C. § 507(d).

[21] *See* THE SURETY'S INDEMNITY AGREEMENT – LAW & PRACTICE, 481-83 (Marilyn Klinger, George J. Bachrach and Tracey L. Haley eds., 2d ed. 2008). The surety's reserve claim may be estimated for purpose of allowance if it is found to be a contingent or unliquidated claim when the failure to fix or liquidate the claim would "unduly delay the administration of the [debtor's] case." 11 U.S.C. § 502(c).

[22] 11 U.S.C. § 502(g) (2018). *See also* 11 U.S.C. § 501(d). Any claim that the surety may have arising from the rejection of the contract and/or commercial surety bond (or bonds) as an executory contract shall be determined, and allowed or disallowed, "the same as if such claim had arisen before the date of the filing of the petition." 11 U.S.C. § 501(d).

Due to an Avoidance Action (Preferential or Fraudulent Transfer)

It is possible that the surety may obtain collateral and/or property of the principal that results in the surety receiving a preferential transfer due to the principal's filing of its bankruptcy petition. The surety is entitled to increase its secured or unsecured proof of claim to the extent that the surety must return property subject to the avoidance action to the debtor's estate.[23]

III. The Connection Between the Surety's Reimbursement and Subrogation Claims

A surety that pays a claim under a bond may have two types of claims under the Bankruptcy Code: (1) a claim for reimbursement or contribution under Section 502 of the Code, and (2) a subrogation claim under Section 509 of the Code. The Bankruptcy Code does not allow the surety to have an allowed claim in both categories because that would permit it to effectuate a double recovery. Section 502(e)(1)(C) provides that the court shall *disallow* any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured the claim of a creditor, to the extent that . . . such entity asserts a right of subrogation to the rights of such creditor under Section 509.[24]

Section 509(a) provides, "an entity that is liable with the debtor on, or that has secured a claim of a creditor against the debtor, and that pays such claim, is subrogated to the rights of such creditor to the extent of such payment."[25] Thus, Section 509 codifies the basic concept of subrogation.

There is a dispute among the courts as to whether Section 509 supplants and replaces equitable subrogation, whether it supplements equitable subrogation, or whether the two exist independently in bankruptcy.[26] Thus, depending on what jurisdiction you are in this could have an impact on your analysis.

For subrogation to exist under Section 509 of the Code the debtor must have been primarily liable for the indebtedness and must have received the consideration from the creditor. Of course, sureties typically satisfy this requirement. The surety faced with a decision whether to assert a claim as reimbursement or for subrogation should carefully consider its options by reviewing all aspects of the claims. For example, if the claim for reimbursement would be secured, then it may make the most sense to seek reimbursement. On the other hand, if the reimbursement is not secured, but the claim to which the surety would be subrogated is, then subrogation may be the election, because the surety would be entitled to the creditor's secured position. While the surety must make an election, the surety should carefully reserve and preserve its alternative rights in its proof of claim to avoid any waiver argument.

Notwithstanding the surety's rights of reimbursement and/or subrogation, the surety will not be entitled to a distribution on its allowed claim until the creditors who are the beneficiaries of the contracts and/or bonds, whether as obligee or claimant, have been paid in full. Section 509(c) of the Bankruptcy Code provides that the bankruptcy court shall subordinate the subrogation and reimbursement claim of a co-obligor of the debtor until the underlying creditor's claim is paid in full.[27]

IV. The Claims Administration Process

To participate in any of the debtor's distributions to general unsecured creditors and to obtain recovery from any collateral to the extent of the surety's secured claim, the surety must timely file a proof of claim. The Bankruptcy Code and the Bankruptcy Rules set out the requirements for any proof of claim.

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[23] *See also* 11 U.S.C. § 501(d). Pursuant to § 502(h), a surety's claim arising from the debtor's estate's recovery of the debtor's property "shall be determined and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition." 11 U.S.C. § 502(h).

[24] 11 U.S.C. § 502(e)(1)(C).

[25] 11 U.S.C. § 509 (2018).

[26] *In re Celotex Corp.*, 289 B.R. 460, 469 (Bankr. M.D. Fla. 2003)(discussing issue and collecting cases).

[27] 11 U.S.C. § 509(c).

A. Notices and Deadlines.

The Bankruptcy Court will send out a notice of the debtor's filing of the bankruptcy petition. If the case is a no asset Chapter 7 liquidation, then the notice will state that fact and no proof of claim needs to be filed. If assets are later located, then a new notice with the applicable proof of claim bar date will be sent to all creditors.

If the case is an asset Chapter 7 or a Chapter 11, then the Bankruptcy Court will send a Notice of Section 341 Meeting of Creditors that sets the proof of claim bar date and deadlines. In some larger Chapter 11 bankruptcy cases, there may be a special Notice of a Bar Date Order and deadline.

If you know that one of your principals or indemnitors has filed a bankruptcy case and the surety has not received a notice of the case from the bankruptcy court – which occurs very frequently – then the surety must locate where the bankruptcy case was filed and obtain any proof of claim bar date orders or notices.

B. The Surety's Proof of Claim – Form 410

There is a standard Form 410 cover sheet for most proofs of claim, although some large bankruptcy cases have their own cover sheet Forms. The proof of claim is filed with the bankruptcy court unless, in some large bankruptcy cases, a specific claims agent at some other location is named.

C. The Surety's Proof of Claim – Substance.

The Form 410 proof of claim cover sheet does not have enough room to adequately describe the surety's proof of claim. Therefore, the surety must attach the surety's proof of claim narrative that sets forth the nature of the surety's claims. This includes:

1. The type(s) of the surety's claims;
2. The basis for the surety's claims; and
3. The amount of the surety's claims, whether:
    a. Liquidated or
    b. Contingent.

There are a number of documents to attach to the surety's proof of claim narrative. Generally, these include:

1. The indemnity agreement;
2. A list of the surety's bonds, but copies of the bonds do not have to be attached;
3. The amounts of the surety's payments, although a list of the surety's payments may be optional and copies of the checks or drafts do not have to be attached.

If the surety is filing a secured claim, the proof of claim narrative should include written evidence of the surety's liens and/or interests in collateral, including, where appropriate:

1. A description of the surety's liens and security interests in the debtor's property and attaching all evidence and documents concerning the surety's liens and security interests;
2. A description of any judgment the surety has obtained against the debtor, attaching a copy of the judgment to the proof of claim, and any other evidence and documents concerning the attachment of the judicial lien to any of the debtor's real or personal property;
3. A reservation of any and all rights the surety has with any respect to any setoffs that the surety may have against the debtor and any of the debtor's claims against the surety; and
4. A description and reservation of the surety's subrogation rights to any rights against or assets of the debtor and to the rights of others.

Finally, the proof of claim narrative should include the surety's reservation of and/or non-waiver of rights in the proof of claim. These would include:

1. The right to amend and/or supplement its proof of claim;
2. The right to increase its liquidated claim;
3. Priority claim rights;
4. Post-petition administrative expense claim rights;
5. Assumption of executory contract rights;
6. Setoff rights;

7. Subrogation rights (including post-petition administrative expense claim rights and non-dischargeability rights);
8. The surety's non-waiver of rights, including
   a. No admission of any liability or waiver of any defenses with respect to any bond claims or indemnity agreement claims
   b. No waiver or release of any exoneration rights
   c. No waiver or release of any subrogation rights
   d. No waiver or release of any other surety remedies (no election of remedies).

V. The Claims Objection Process

Section 502 of the Code deals with the allowance or disallowance of claims. Whether a claim is allowed or not is important because it determines whether the party can participate in any distribution, and only allowed claims can vote on chapter 11 plans.

After the surety's proof of claim is executed and filed under Section 501, the proof of claim is "deemed allowed" under section 502(a) and is prima facie evidence of the validity and amount of the surety's claim.[28] However, an objection to the surety's proof of claim may be asserted.[29]

The claim objection process is spelled out in Federal Rule of Bankruptcy Procedure 3007. This rule provides that any party in interest may file an objection to a claim.[30] Parties in interest may include the debtors, trustees, debtors-in-possession and, in certain limited cases, may also include other creditors.[31]

[28] 11 U.S.C. § 502(a).
[29] *Id.*
[30] FED. R. BANKR. P. 3007(a).
[31] *In re Magnolia Gas Co., L.L.C.*, 255 B.R. 900 (Bankr. W.D. Okla. 2000); *Power Five, Inc. v. General Motors Corp.*, 219 B.R. 513 (S.D. Ind. 1998); *In re Williamson*, 43 B.R. 813 (Bankr. D. Utah 1984).

Rule 3007 generally sets forth the form of the objection and procedure for filing. However, the Rule does not set a deadline for the filing of objections to claims. Section 704 of the Code regarding the obligations of trustees requires trustees to examine claims and object "if a purpose would be served."[32] Often it will not be known until later in the case whether there are substantial assets to be distributed and thus, whether the parties and the court should invest time in determining claims objections. Thus, there is a pragmatic approach to the timing of objections.

Once an objection is filed, it becomes a "contested matter" and an adversary proceeding in bankruptcy and is subject to traditional due process requirements and Federal Rule of Bankruptcy Procedure 9014.[33] It may be helpful to think of the claims objection process in the typical litigation setting–the filing of the proof of claim is similar to the filing of a complaint in a normal litigation matter and the objection to the claim is similar to an answer. Once the objection/answer is filed the issues are then joined and the case proceeds as a normal litigation matter.

As noted, the filing of the Proof of Claim is considered prima facie proof of the validity and amount of the claim. Thus, the burden is on the objecting party to provide evidence disputing the claim as well as any affirmative defenses like statute of limitations, set off, usury, etc. Once the objecting party meets its burden of rebutting the prima facie claim the burden shifts to the claimant to prove its claim.[34] The amount of a claim is determined as of the date of the filing of the bankruptcy, but as noted earlier, payments made by the surety post-petition will relate back to the pre-petition bond or indemnity agreement.

Section 502 sets forth a number of grounds for objecting to a proof of claim. Such grounds include *inter alia*: (1) the claim is unenforceable against the debtor and property of the debtor under contract or applicable law; (2)

[32] 11 U.S.C. § 704 (a)(5) (2018).
[33] 11 U.S.C. § 502(b) and FED. R. BANKR. P. 3007.
[34] *In re Equipment Serv., Ltd.*, 36 B.R. 241, 243 (D. Ala. 1983); *In re Frederes*, 98 B.R. 165, 166 (Bankr. W.D. N.Y. 1989).

the claim is for unmatured interest; (3) the claim was not timely filed.[35] Rule 3007 also provides as a basis for objection that: (1) the claim is a duplicate, (2) the claim was resolved/settled or satisfied, and (3) the claim was filed in the wrong case or wrong format, among others.[36]

Rule 3007 also establishes the so-called "Omnibus Claims Objection" which allows the objecting party to object to up to 100 claims at the same time in the same document, as long as the objections are of a procedural nature.[37] A surety needs to be vigilant with these omnibus objections, because so many claims are lumped together it can be easy to miss the fact that an objection has been filed as to your claim.

The surety's claim is typically under its indemnity agreement for reimbursement. Section 502(e)(1) of the Bankruptcy Code provides that:

> the court *shall disallow* any claim for reimbursement or contribution of any entity that is liable with the debtor on or has secured the claim of a creditor, to the extent that –
>
> (B) such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution;[38]

Thus, where the surety has paid claims under its bonds and incurred attorney's fees and consulting fees or has unpaid premiums due, such amounts are liquidated and certain and are generally recoverable as a claim under the surety's equitable rights, common law rights or the indemnity agreement. If the surety still has exposure under bonds it issued prior to the bankruptcy and it is possible that claims may still be made some day in the future, such claims are unliquidated and contingent. The bankruptcy court must disallow the surety's claim for reimbursement to the extent provided in section 502(e)(1) of the Bankruptcy Code. However, if Section 506(d) applies, the surety may be able to retain a lien on any collateral for its claim. Moreover, while the surety's right of reimbursement under the indemnity clause of the indemnity agreement may be contingent, its right to payment under the place in funds clause or clause allowing recovery in the amount of reserves posted may not be contingent. Because the ability of sureties to issue bonds is dependent upon the amount of the surety's capital and surplus and the posting of a reserve has an immediate impact upon such capital and surplus; and because the parties' promise in the indemnity agreement is to promptly pay the amount of the reserve so as to eliminate this harm to the surety, the surety's claim for payment of the amount of its reserve is not contingent.

Section 506(d) essentially provides that if a claim is disallowed solely under 502(e)(1) (contingent/unliquidated) and the claimant is holding collateral, its lien on that collateral will remain.[39] So, while the proof of claim may be disallowed, the surety will be able to retain its collateral and reimburse itself from that collateral if a disallowed contingent/unliquidated claim becomes liquidated in the future.

It should be noted that both the allowance and disallowance of a claim may be reconsidered for cause and in accordance with the equities of the case under Section 502(j).[40]

VI. The Surety's Post-Petition Claims

A creditor's post-petition claims are paid in full before there are any distributions to the debtor's pre-petition general unsecured creditors. As a result, a creditor, such as a surety, would prefer to have post-petition claims. The surety must be aware of what it pays and the timing – not the timing of the payment, but the timing of the obligation that the debtor incurs for which the surety makes a payment under a bond.

[35] 11 U.S.C. § 502 (2018).
[36] FED. R. BANKR. P. 3007.
[37] *Id*.
[38] 11 U.S.C. § 502(e)(1).
[39] *See* 11 U.S.C. § 506(2) (2018).
[40] 11 U.S.C. § 502(j).

A. The Surety's Administrative Expense Claim.

An allowed administrative expense claim[41] is one such post-petition claim that a surety may have that must be paid in full before there are any distributions to the debtor's pre-petition general unsecured creditors. One example may be post-petition renewal premiums for commercial surety bonds (license bonds, tax bonds, and others) that are necessary for the debtor's business operations to continue during the bankruptcy case.

B. The Surety's Subrogation Rights to Another's Administrative Expense Claim.

The surety may be subrogated to the administrative expense claim of some obligee (such as a utility bond obligee) that the surety pays under its bond. For example, a commercial surety debtor – such as a retailer – may establish a fund in the bankruptcy case to pay such utility bills incurred by the debtor post-petition. If the surety pays the post-petition utility bond claim, the surety may have subrogation rights to the obligee's rights in the fund for reimbursement of the surety's payment.

C. The Surety's Executory Contract Cure and Adequate Protection Claims.

If a debtor assumes an executory contract bonded by the surety, the debtor must cure or provide adequate assurance that it will promptly cure all defaults.[42] If the surety has made payments on the bonds for that contract, the debtor was probably in default of its payment obligations under the bonded contract. The debtor must cure the defaults by reimbursing the surety for its payments and must provide adequate assurance of future performance to the surety to avoid future defaults before the bonded contract can be assumed or assumed and assigned to another entity.

D. The Surety's Claim for Providing Post-Petition Surety Credit to the Debtor.

Finally, the surety may have post-petition administrative expense claims and possibly secured claims for issuing new surety credit post-petition to the debtor. Remember, however, that a surety's post-petition payment for an obligation (indemnity agreement or bond) executed pre-petition is NOT provided any post-petition rights or priorities to the assets of the debtor's bankruptcy estate.

Conclusion

The claims process in bankruptcy can be complicated and requires vigilant attention to the timing, nature of claims and knowledge of the Bankruptcy Code's various rules regarding priorities and asserting and preserving claims.

[41] The Bankruptcy Court may allow an administrative expense claim for "the actual, necessary costs and expenses of preserving the [debtor's] estate." 11 U.S.C. § 503(b)(1)(A) (2018).

[42] 11 U.S.C. § 365 (2018).

Surety Casenotes

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

Forum Selection Clause in Bonded Contract, Which Was Incorporated by Reference Into Bond, Deemed Enforceable Against Surety

Pioneer Mech Servs., LLC v. HGC Constr., Co., 2018 WL 6521529 (W.D. Pa. Dec. 12, 2018).

Pioneer Mechanical Services, LLC ("Pioneer"), as subcontractor, entered into a master subcontract agreement ("MSA") and subcontract agreement rider ("Rider") with HGC Construction, Co. ("HGC"). The MSA contained a dispute resolution clause, which provided, among other things, that the parties irrevocably submit to the jurisdiction of the state or federal courts located in Cincinnati, Ohio. The Rider incorporated the MSA by reference. Pioneer procured a subcontract performance bond (the "Bond") in favor of HGC, which secured Pioneer's obligations under the Rider. The Bond incorporated the terms of the Rider by reference.

Pioneer commenced suit against HGC, alleging that it completed its work, but that HGC failed to pay Pioneer in full. Pioneer contended that HGC breached the contract and unjust enriched itself. HGC asserted counterclaims against Pioneer and a third-party claim against Pioneer's surety. The surety asserted its own counterclaims against HGC, asserting unjust enrichment. HGC filed a motion to transfer venue based upon the forum selection clause in the MSA. Pioneer did not oppose the motion. The surety opposed the motion.

HGC argued that, because the Bond referred to the Rider and stated that it was "made a part hereof", the surety was also bound by the Rider's terms, including the forum selection clause in the MSA, which was incorporated into the Rider. The surety argued that, since it was not a party to the Rider, the forum selection clause was inapplicable to it. The surety further contended that because its counterclaim for unjust enrichment arose from common law and was independent of any claims asserted among Pioneer and HGC, the forum selection clause should not apply.

The court held that the surety was bound by the forum selection clause. Although a surety may place limits on the extent a bonded contract is incorporated by reference, the court did not find any evidence that the surety did so in the subject Bond. The Bond did not limit which of the terms in the Rider (or MSA) were incorporated and did not include its own forum selection clause. The court also rejected the surety's argument that its unjust enrichment claim provides a separate basis upon which to deny the motion, holding that the dispute "arises out of or relates to" the Rider and is therefore a dispute subject to the forum selection clause. The court further rejected the surety's argument that the court should sever the first and third party claims pursuant to Fed. R. Civ. P. 21 because the claims arose out of the same occurrence.

Arbitration Provision in Bonded Subcontract Held to be Unenforceable Because Decision to Arbitrate Was in Obligee's Sole Discretion

United States ex rel. Nat'l Fire Prot., LLC v. Selective Ins. Co., 2018 WL 6621507 (D. Md. Dec. 17, 2018).

DCM Architecture and Engineering ("DCM") entered into a prime contract with the United States General Services Administration

in connection with a certain project in Woodlawn, Maryland. DCM entered into a subcontract with National Fire Protection, LLC ("NFP") to perform certain fire sprinkler work on the project. NFP completed the project, but DCM did not pay the agreed-upon amount. The subcontract contained a provision, which states that "[DCM], at its sole discretion, may demand arbitration" and "[a]ny claim arising out of or related to the contract shall, at [DCM's] sole discretion, be subject to arbitration." DCM filed a demand for arbitration against NFP. Two months later, NFP filed a complaint against DCM and its surety in federal district court.

DCM and the surety moved to dismiss the action for lack of subject-matter jurisdiction, arguing that the arbitration clause stripped the court of jurisdiction to consider NFP's claim. NFP, in turn, filed a motion for summary judgment seeking a declaratory judgment that the arbitration clauses in the contract were unenforceable as a matter of law. NFP argued that because the arbitration clause vested DCM with the sole and absolute power to initiate arbitration proceedings, there was no consideration for the clause and it should be deemed unenforceable. The court agreed and granted NFP's motion. The court denied DCM's and the surety's motions as moot.

Surety Bound by Arbitration Clause in Subcontract Even Though Decision to Arbitrate Left to Obligee

First Ins. Co. of Haw., Ltd. V. P&S Constr., Inc., 2018 WL 6627102 (D. Guam Dec. 19, 2018).

P&S Construction, Inc. ("P&S"), as general contractor, entered into a subcontract with JWS Refrigeration and Air Conditioning ("JWS"). JWS provided performance and payment bonds in favor of P&S, each of which incorporated the subcontract by reference. The subcontract included an arbitration clause that provided, in relevant part, "[s]ubcontractor agrees that any and all claims or disputes arising out of or relating to this Agreement or the breach thereof shall be decided, at the sole discretion of [P&S], by submission to…arbitration…or judicial decision by the…Superior Court in the Commonwealth of Massachusetts". P&S ultimately terminated JWS and hired a replacement contractor and commenced arbitration proceedings against JWS and its surety in Boston, Massachusetts.
JWS, an entity based in Guam, commenced a lawsuit against P&S in the United States District Court for the District of Guam for breach of contract and related claims. P&S moved to dismiss or, alternatively, to stay the suit pending the outcome of arbitration. The Magistrate Judge filed a Report and Recommendation, which provided that the suit should be stayed pending the outcome of arbitration. JWS' surety commenced a separate suit in the District of Guam seeking a declaratory judgment that the surety was not bound to arbitration for P&S and that it had no obligations under the subject bond. P&S moved to dismiss or, alternatively, to stay the surety's suit pending the outcome of arbitration. P&S argued that because the performance bond incorporated the subcontract by reference, the surety was bound to the subcontract's arbitration provision covering "any and all claims or disputes arising out of or relating to" the subcontract. The Magistrate Judge issued a separate Report and Recommendation finding that the arbitration clause was limited in scope to disputes between P&S and JWS. P&S objected and the District Court sustained the objection.

P&S and the surety cited to various decisions that enforced and declined to enforce arbitration provisions. The court found that the decisions could be reconciled based upon a review of the arbitration clauses at issue in each such case. Where the arbitration clause was written to broadly cover "any and all claims or disputes arising out of or relating to" the subcontract, courts typically enforced the provision as against the surety. On the other hand, courts would not enforce such provisions against the surety where they contained language limiting them to the original contracting parties (e.g., "matters solely between Contractor and Subcontractor shall be decided by arbitration"). The court found that the subject arbitration provision was written broadly enough to bind the surety. The court rejected the argument that the introductory phrase "subcontractor agrees" limited that broad language, finding that it simply expressed JWS' agreement to P&S' term.

The Magistrate's Report and Recommendation additionally found language within the performance bond itself evincing the

surety's intent not to be bound by the arbitration provision, as follows: "[a]ny suit under this bond must be instituted before the expiration of two (2) years form the date on which final payment under the subcontract becomes due." The Magistrate reasoned that "suit" refers to proceeding in a court of law as opposed to an arbitration proceeding, so, by including the word "suit", the surety evinced an intent not to arbitrate. The District Judge rejected the Report and Recommendation, holding that the reference to suit was for setting a statute of limitations and did not evidence an intent to preempt the arbitration clause incorporated by reference.

Finally, the surety argued that the arbitration clause was unconscionable and, thus, not enforceable on the grounds that the decision to arbitrate was up to P&S' sole discretion. Finding that the parties were sophisticated business entities, the court concluded that the arbitration provision was not so patently unjust so as to rise to the level of substantive unconscionability.

Bankruptcy Court Holds Defalcation in Connection With Trust Created by Indemnity Agreement Forms Sufficient Basis to Object to Dischargeability

Great Am. Ins. Co. v. Brandt (In re Brandt), 594 B.R. 829 (Bankr. S.D. Fla. 2019).

The surety issued various bonds in favor of Structural Integrity Contractors, Inc. ("Structural"). Michael Brandt ("Brandt"), among others, executed an indemnity agreement in favor of the surety. The indemnity agreement contained a trust fund provision that provided, "[u]ndersigned covenant and agree that all funds received by them, or due or to become due under any contract covered by any Bond are trust funds whether in the possession of the Undersigned or another, for the benefit of all parties to whom Undersigned incurs obligations in the performance of the contract covered by the Bond." Brandt ultimately filed a petition for Chapter 7 bankruptcy protection pursuant to the United States Bankruptcy Code.

The surety received claims on two bonds and incurred losses in excess of $425,000. Structural received funds for work performed on the bonded contracts, but used these funds for, among other things, Brandt's personal expenses. The surety commenced an adversary proceeding against Brandt, objecting to discharge under 11. U.S.C. §523(a)(4) (exempting from discharge a debt which was incurred via "…fraud or defalcation while acting in a fiduciary capacity"). Brandt filed a motion to dismiss the surety's claims on account of the Supreme Court's decision in *Bullock v. BankChampaign, N.A.*, 569 U.S. 267, 133 S.Ct. 1754, 185 L.Ed.2d 922 (2013) (defining defalcation in § 523(a)(4) to require an intentional wrong).

The existence of a trust is determined as a matter of state law. The court found that the trust established by the indemnity agreement was valid as a matter of state law. The court held that the surety pleaded sufficient facts to allege that an act of defalcation occurred after a fiduciary relationship had been established and a factual issue exists as to whether Brandt's conduct was intentional. The court denied Brandt's motion to dismiss and permitted the surety's claims to proceed.

Supersedeas Bond Does Not Cover New Damages Awarded on Subsequent Remand

Sherman v. Sherrod, 2019 WL 254353 (Mich. Ct. App. Jan. 17, 2019).

Shirley T. Sherrod, M.D. ("Sherrod") sold her ophthalmology practice to Michael S. Sherman, D.O., PC ("Sherman"). In conjunction with the sale, Sherrod contracted to work part-time for Sherman for a one-year period in exchange for $50,000. This working relationship broke down, and Sherrod discontinued working for the practice, leading to Sherman initiating a breach of contract action and the successful grant of summary disposition in Sherman's favor in the trial court, resulting in an award of $181,048. Sherrod appealed the trial court's grant of summary disposition. The appellate court permitted Sherrod to continue the appeal "condition[ed] on ... either posting a bond to stay the enforcement of the judgment and order appealed…or presenting an appropriate officer ... for a creditor's examination under oath ...." Sherrod subsequently submitted proof of having procured a $250,000 bond.

The appeals court ultimately affirmed the grant of summary disposition on the breach of contract action in favor of Sherman, but remanded the issue of damages to the trial court for further proceedings. While a separate appeal by Sherrod was pending (there were eight

separate appeals), the trial court conducted a jury trial on the issue of damages, resulting in a verdict of $432,356. A judgment, including interest, was subsequently entered for $611,798.92. The trial court thereafter entered another judgment against Sherrod in the amount of $392,693.92 representing Sherman's attorney's fees and costs, in addition to $193,439.50 in sanctions. Sherrod appealed the judgments and the appellate court affirmed the award of attorney fees and sanctions under the indemnification provision of the parties' contract. The appellate court again remanded the matter to the trial court on the amount of breach of contract damages.

On appeal, Sherrod argued that the award of attorney fees and costs comprised a separate and distinct ruling from the breach of contract decision for which the appeal bond was initially procured and that the bond could not be used to discharge the attorney fee debt. Sherrod submitted that when the bond was issued, the indemnification provision and resultant judgment awarding attorney fees under that provision were not on appeal. When the appeal bond was initiated, it addressed prior appeals. Sherman had not fully prevailed in that the judgments rendered were not entirely affirmed, which required a remand to the trial court to reconsider the breach of contract damages awarded. At this juncture, the appeal bond was continued by the trial court and the appellate court declined Sherrod's application for leave to appeal that decision.

Sherman argued that the language of the appeal bond referencing affirmance of "the lower court judgment" encompasses the order awarding attorney fees under the indemnification provision. Sherrod countered that based on the disparate dates of the attorney fee award and the appeal bond (three years had elapsed), it was clear that the attorney fee judgment was not contemplated by the appeal bond. Based on the language of the bond and applicable Michigan statutes, the court agreed with Sherrod's interpretation and held that the bond was issued to provide assurance of payment, pending the outcome of the appeal on the breach of contract action. The appeal bond did not apply to subsequent or related judgments obtained after the issuance of the bond. The court observed that nothing precluded Sherman from seeking to have more than one appeal bond in this matter, particularly given the extensive number of appeals undertaken.

With respect to the application of the bond in connection with the pending appeal arising out of the breach of contract award, the court held that the basis for issuance or procurement of the appeal bond has not been satisfied. The original basis or reason for the filing of the appeal bond continues to exist because the issue of damages for the breach of contract remains to be determined, precluding disbursement of the appeal bond until a final judgment has been realized.

Court Holds Bank's Security Interest in Excess Contract Proceeds Has Priority Over Surety's Cross-Subrogation Claim to Profits on Bonded Projects for Same Obligee Against Losses on Other Bonded Projects

Liberty Mut. Ins. Co. v. SBN V. FBNC LLC, 2019 WL 346707 (E.D.N.C. Jan. 28, 2019).

The surety issued 48 performance and payment bonds on behalf of DeVere Construction Company, Inc. ("DeVere") in connection with various public and private construction projects across four states. The bonds included an indemnity provision assigning the surety all of DeVere's rights and interests in the proceeds of the bonded contracts. DeVere financed the projects by taking out loans from First NBC Bank ("First NBC"). To secure these loans, DeVere granted First NBC a security interest in its accounts receivable and other general intangibles, which was perfected by filing the appropriate UCC-1 financing statements in April 2011 (continued in February 2016).

In 2015, DeVere defaulted on both the bonded projects and the First NBC loans. DeVere abandoned the bonded projects. The surety completed performance, paid subcontractors and suppliers, and otherwise fulfilled DeVere's, obligations. In 2016, the surety brought an indemnity action against DeVere in federal court in the Eastern District of Michigan. In February 2017, the district court entered judgment in the surety's favor, against DeVere and other indemnitors, for $23,274,628, subject to modification for future losses under the bonds. The surety continues to have obligations under the bonds and has contingent

liability for claims that have not yet been discharged.

First NBC was closed in April 2017 and the Federal Deposit Insurance Corporation (FDIC) was named receiver. Defendant, SBN V FNBC LLC ("SBN"), entered into a loan sale agreement in October 2017 and purchased a pool of loans from the FDIC that included the loans First NBC had made to DeVere. As the successor-in-interest to First NBC, SBN holds a perfected security interest in DeVere's accounts receivable and other general intangibles (totaling $14,089,911.42).

Although the surety incurred a net loss on most of the bonded projects, totaling at least $32,622,491.52 in losses, on five of the bonded projects, receivables exceeded the costs and expenses that the surety incurred in the aggregate amount of $865,537.05. In February 2017, the surety initiated an action, seeking a declaratory judgment that it had a priority interest in all bonded contract receivables and funds to the extent of its net losses. SBN argued that its perfected security interest entitled it to the excess receivables. The parties each moved for partial summary judgment. The surety argued that it was entitled to offset its losses using the excess receivables on three of the five projects with excess receivables because, as surety, it is equitably subrogated to the rights of the project owners and can assert a set-off on behalf of those owners. SBN argued that its perfected security interest entitles it to the excess receivables and that the surety is not entitled to a set-off.

The district court held that the surety may not use its equitable right of subrogation to overcome SBN's perfected interest and that each bonded project must be treated separately. The court's decision, which appears to depart from generally accepted principles of law, appears to have been influenced by certain Fourth Circuit precedent that limits the surety's subrogation rights on a specific bonded contract basis. The court stated that "the Fourth Circuit has never recognized a surety's equitable right to set-off funds from one contract to reduce losses on a different contract at the expense of a secured creditor, and the Court declines to recognize such a right here." In reaching its decision, the court observed in *dicta* "[i]f the only question in this case was which party had a stronger public policy justification for receipt of the excess receivables, [the surety] would have a stronger argument that it was entitled to the surplus." The court entered summary judgment in favor of SBN.

Court Holds Surety Did Not Waive Privilege by Filing Indemnity Suit

W. Sur. Co. v. PASI of LA, Inc., 2019 WL 511839 (M.D. La. Feb. 7, 2019).

The surety commenced an indemnity suit against its principal PASI of LA, Inc. ("PASI") arising out of losses sustained by the surety in connection with subcontract performance and payment bonds issued on behalf of PASI. The general contractor, Harry Pepper & Associates, Inc. ("HPA") made a demand against the surety under the performance bond and filed suit in connection therewith, which was subsequently resolved by way of settlement between the surety and HPA. HPA also filed suit against PASI, which was referred to arbitration. The arbitration panel found that PASI has no liability and ordered HPA to pay damages to PASI.

In the context of the indemnity suit, PASI filed a motion to compel the surety to produce original invoices for professional fees upon which the surety sought recovery and correspondence by and between the surety, its attorneys and consultants relating to the settlement with HPA. PASI argued that the documents were not privileged or the surety has waived any such privilege by putting the documents "at issue" based on the claims asserted in the lawsuit. PASI further argued that the documents were relevant to establishing its defense that the surety did not act in good faith.

The surety responded that the indemnity agreement controlled PASI's obligation "such that the 'at issue' doctrine does not apply." The surety pointed to the prima facie evidence and right to settle clauses of the indemnity agreement in support of its argument. The court agreed, holding that "[i]f the enforcement of the rights protected by the Indemnity Agreement necessarily result in the Surety waiving any privileges, the terms of the parties' negotiated agreement would be vitiated." Since the court was not presented with any documents to review, it did not rule on the applicability of privilege with respect to any specific document. However, the court stated that "to the extent a

privilege…would apply, the Court finds that based on the record before it, such privileges have not been waived." The court denied PASI's motion to compel.

Assignment of Contract Rights in Indemnity Agreement Bars Principal From Asserting Claims Against Obligee After Termination

Primestar Constr., Inc. v. City of Dallas, 2019 WL 1033978 (Tex. App. Mar. 5, 2019).

Primestar Construction, Inc. ("Primestar") entered into a contract with the City of Dallas (the "City") to renovate and expand a recreational center. Primestar provided performance and payment bonds to the City. Under the terms of the indemnity agreement, among other things, Primestar gave its surety sole discretion to pay or settle claims on the bonds. The City ultimately terminated the contract for cause and demanded that the surety complete the project. The surety completed the project and the City paid the surety the contract balance. The surety commenced an indemnity action against Primestar. In turn, Primestar commenced suit against the City alleging that it wrongfully terminated the contract.

The City filed a motion to dismiss on two bases: (1) Primestar's lack of standing, and (2) the City's immunity from suit and liability. The trial court granted the City's motion and Primestar appealed on the grounds that, *inter alia*, the City's immunity has been waived by statute and that Primestar has standing to pursue its cause of action for breach of contract. The appellate court affirmed.

First, the court held that Primestar lacked standing to assert the breach of contract claims because it had assigned its "rights, title, and interests" in the contract to the surety pursuant to the terms of the indemnity agreement. The court rejected Primestar's reliance on a letter that was not in evidence, which purported to put the City on notice that Primestar reserved its claims against the City. In doing so, the court noted that, in the indemnity agreement, Primestar transferred all of its rights to the surety without any reservation of rights. As such, the letter did not raise a triable issue of fact with respect to Primestar's standing. The court also found that Primestar failed to plead facts with sufficient evidentiary support to constitute a claim for which immunity is waived.

Colorado Appeals Court Holds Surety Liable for All Attorney's Fees Incurred by Obligee Arising Out of Principal's Default

Whiting-Turner Contracting Co. v. Guar. Co. of N. Am. USA, --- P.3d ----, 2019 WL 1294176 (Colo. App. Mar. 21, 2019).

Whiting-Turner Contracting Company ("Whiting-Turner") and Klempco Construction (2013) Inc. ("Klempco") entered into a subcontract in which Klempco agreed to construct an anchor system for an office building's underground parking garage. Klempco's work included the installation of sprayed concrete, known as shotcrete, to support the anchoring system. The subcontract price was $1,785,783. Klempco's surety issued AIA A312 performance and payment bonds in connection with the subcontract.

Klempco fell behind schedule almost immediately and stopped paying its sub-subcontractors. Klempco subsequently directed Whiting-Turner to assume responsibility for the shotcrete installation and to work directly with two of Klempco's sub-subcontractors. Whiting-Turner sent Klempco and its surety a letter declaring Klempco in default under the Subcontract and requesting a meeting to discuss completion of the project. The parties attended a meeting where they agreed to reduce the subcontract price in the amount of the price of the shotcrete work and to permit the shotcrete sub-subcontractor to invoice Whiting-Turner directly. Two days after the meeting, Klempco advised Whiting-Turner that because Whiting-Turner had declared Klempco in default and was refusing to pay Klempco, Klempco would demobilize from the project. Whiting-Turner asked the surety how Whiting-Turner should proceed in light of Klempco's decision to demobilize. The surety did not respond.

Whiting-Turner thereafter terminated the subcontract. According to the decision, the surety did not respond to Whiting-Turner's "repeated demands" to "honor its obligations under the performance bond and advise Whiting-Turner how [the surety] intended to proceed." Whiting-Turner provided the surety with its calculation of the "Balance of the Contract Price", which, after adjustments, resulted in a negative balance. Klempco subsequently filed suit against Whiting-Turner alleging breach of contract on account of

Whiting-Turner's failure to pay sums due to Klempco. Whiting-Turner filed a counterclaim for breach of contract against Klempco and a third-party action against the surety for breach of the performance bond and payment bond.

At a bench trial, the surety argued that Whiting-Turner had failed to comply with the condition precedent set forth in section 3.3 of the performance bond (by miscalculating the "Balance of the Contract Price" and, consequently, not paying the correct sum to the surety) and, therefore, never trigged the surety's obligations under the bond. The trial court found that Whiting-Turner had complied with its obligations and that both Klempco and the surety had breached their obligations under the subcontract and the bonds, respectively. The trial court also found that the surety waived its arguments regarding section 3.3 by not responding to Whiting-Turner's requests for guidance after Klempco stopped performing under the subcontract. The trial court awarded Whiting-Turner $832,260.24 in damages against Klempco and the surety, jointly and severally.

Whiting-Turner moved for an award of attorney fees and costs against Klempco and the surety under the subcontract, Colorado's mechanic's lien statute and the bonds. The surety opposed the request and argued, in the alternative, that the surety was liable only for those fees attributable to Whiting-Turner's claims against the surety under the performance bond. The trial court found that it could not apportion Whiting-Turner's fees among the various claims and defenses litigated in the case, because "all of the claims of both parties arose out of the same operative facts." The trial court thus held Klempco and the surety jointly and severally liable to Whiting-Turner for $504,785.27 in attorney fees and costs and $18,990.14 in interest. The surety appealed the trial court's rulings on damages and attorney fees.

On appeal, the surety argued that the trial court erred in finding that Whiting-Turner was required only to substantially comply, rather than strictly comply, with the condition precedent set forth in section 3.3. The court held that the record did not support the surety's contention and need not address it, because the trial court did not find that Whiting-Turner only substantially complied with section 3.3. The surety further argued that the trial court erred in finding that the surety waived its argument that Whiting-Turner failed to satisfy the condition precedent set forth in section 3.3. The court, again, rejected the surety's argument, finding that the court's reference to waiver did not form the basis of its decision, but rather, formed "an alternative basis for its findings of fact and conclusions of law." The surety also argued that the trial court erred in finding that Whiting-Turner satisfied section 3.3 because it miscalculated the "Balance of the Contract Price" and, therefore, did not pay the contract balance to the surety. The court ruled that the record supported the trial court's finding that Whiting-Turner satisfied the condition precedent set forth in section 3.3.

The appellate court affirmed the trial court's award of attorney fees because Whiting-Turner complied with section 3.3 and the performance bond bound the surety to Whiting-Turner "for the performance of the subcontract, which is incorporated herein by reference." The subcontract contained language requiring Klempco to pay, among other things, Whiting-Turner's legal fees incurred as a result of a default, and "to indemnify Whiting-Turner against…attorney's fees, arising in whole or in part and in any manner for the acts or omissions of Klempco…in the performance of the subcontract." The court concluded that "[b]ecause the performance bond provided that [the surety] was jointly and severally liable with Klempco for all sums that Klempco owed Whiting-Turner under the Subcontract, [the surety] was liable to Whiting-Turner for the attorney fees that Klempco owed to Whiting-Turner." The appellate court also affirmed the trial court's decision not to segregate the fees chargeable to the surety.

Fidelity Casenotes

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

Arizona Federal Court Interprets Guarantee Under Bond and Rules as to Notice-Prejudice Rule's Application to Discovery-Based Bond Form

MBP Collection LLC v. Everest Nat'l Ins. Co., 2019 WL 110978 (D. Ariz. Jan. 4, 2019).

In 2012, the Insured, MBP Collection LLC, loaned $3,631,000.00 to an entity in connection with the purchase of two medical equipment companies. The loan did not cover the entire purchase price; therefore, the Insured required the borrower to agree to not make additional payments to any other creditors during the first four years of the loan repayment plan. In addition, the Insured also obtained Standby Creditor's Agreements from the sellers of the two entities being purchased. The agreements required the sellers to refuse any payments from the Insured for the first four years of the loan repayment plan and also turn over to the Insured any payments made by the borrower within the same four year period. In 2013, the borrower defaulted on the loan. In 2014, the Insured exercised its right of receivership over the borrower under the loan agreement. With the receivership in place, the Insured uncovered alleged misrepresentations in the loan application regarding the sale price of the two entities and that the Standby Creditor's Agreements contained forgeries. In 2016, the Insured notified the carrier of a claim under two financial institution bond coverage periods spanning 2013-2014 and 2014-2017. The Insured sought coverage under the bonds' Securities Insuring Agreement, Insuring Agreement E. The carrier denied coverage for the loan loss on the basis of untimely notice and that the Standby Creditor's Agreements did not qualify as one of the enumerated, covered documents in Insuring Agreement E.

Approximately six months after the Insured commenced litigation, the parties each moved for summary judgment. The issues before the Court included: (1) whether the Standby Creditor's Agreements fell within the enumerated list in Insuring Agreement E; and (2) whether the Court should apply the notice-prejudice rule in to this matter. The Court ruled in favor of the Insured on both issues. First, the Court held that the Standby Creditor's Agreements were Guarantees under the terms of the bond. In so holding, the Court focused on the two sellers' obligation to pay over to the Insured monies received by the borrower. With little analysis, the Court found this obligation on the sellers qualified the Standby Creditor's Agreements as Guarantees, despite the argument from the carrier that the definition of Guarantee was limited to circumstances of monetary default, as opposed to what could conceivably be described as non-monetary default, i.e., when and if the borrower paid the sellers and not the Insured. The Court dismissed the carrier's argument and found in favor of the Insured on this issue.

Moving to the issue of late notice, the Court held that the notice prejudice rule applied in this instance, putting the burden on the carrier to show prejudice in order to succeed on its denial on the basis of late notice. In this instance, the bonds at issue applied to losses discovered during the bond periods. The bonds required that the Insured provide notice to the carrier within 30 days and a proof of loss within six months. As part of the briefing, the Insured conceded that if a trier of fact concludes that discovery occurred during the 2013-2014 bond

period then there would be no coverage due to termination language in that bond combined with certain termination language in the 2014-2017 bond. With that in mind, the Court's determination concerned whether to apply the notice-prejudice rule where the Insured provided notice of the matter outside of the 30 day requirement but within the bond period. Highlighting the fact that the bond is a discovery-based trigger form, as opposed to occurrence or claims-made, the Court noted the rationale commonly used for not extending the notice-prejudice rule to claims-made products was not present in this instance. As such, the Court will apparently require the carrier to prove prejudice in order to support its denial on the basis of late notice under the above facts.

Pennsylvania Federal Court Dismisses Bad Faith Allegations Related to Employee Theft Claim

Wyo. Valley Fraternal Order of Police d/b/a Home Assoc. Lodge #36 v. Selective Ins. Co. of the Se., 2019 WL 626460 (M.D. Pa. Feb. 14, 2019).

The Insured is a charitable organization. In March 2016, the Insured reported a theft claim to its carrier under the crime coverage provided by its commercial policy. It appears that on and after February 2017, the Insured began making demands on the carrier for payment under the policy. Thereafter, in April 2017, the carrier denied coverage and refused to make payment on the claim. Following the denial, the Insured commenced suit in Pennsylvania state court alleging breach of contract and bad faith. The carrier removed the matter to federal court and moved to dismiss the bad faith count.

In ruling in favor of the carrier, the court highlighted Pennsylvania law requiring the Insured to prove by clear and convincing evidence that the carrier did not have a reasonable basis to deny the claim and that the carrier knew or recklessly disregarded the lack of a reasonable basis to deny. The overarching theme in the Court's opinion was that the Insured's pleading was insufficient to state a claim of a violation of this standard. Specifically, the Court found that the Insured cannot rely simply on "bare-bones conclusory allegations which are not sufficient to state a bad faith claim." Stated another way, the Court would not permit the Insured to simply make conclusory statements of law unsupported by specific factual allegations in the Complaint. In its written opinion, the Court dissected the defective count in the Complaint, emphasizing the conclusory nature of each allegation of bad faith, as well as noting the dearth of factual support of the same. Removing the conclusory statements, the Court whittled the Complaint down to only six facts: (1) the Insured had a policy with the carrier; (2) the policy provided coverage for theft; (3) the Insured reported the claim in March 2016; (4) the Insured complied with the terms of the policy and provided all requested documents; (5) on and after February 2017, the Insured demanded payment; and (6) the carrier denied the claim in April 2017. Without more, the Court concluded there could be no finding of bad faith because there were no factual allegations that could show a reckless disregard of a lack of a reasonable basis to provide coverage. The Court dismissed the bad faith count as constructed, and permitted the Insured to amend the Complaint consistent with the Court's opinion.

Nevada Federal Court Grants Stay of Additional Discovery Pending Outcome of Motion for Summary Judgment in Social Engineering Claim

Sanderina, LLC v. Great Am. Ins. Co., 2019 WL 356802 (D. Nev. Jan. 29, 2019).

In this matter, it appears the Insured suffered a loss as a result of a social engineering scheme. Specifically, an unknown third-party impersonated the majority owner of the Insured and sent emails to the Insured's controller requesting six separate funds transfers. The Insured's controller, believing the transfer requests were authentic and legitimately came from the Insured's owner, requested the same from the Insured's bank. All told, the Insured authorized the transfer of $260,994.00. Fortunately, the Insured and its bank were able to recover $82,234.79, leaving a loss in the amount of $178,759.21. Of note, it appears that the Insured's retained IT consultants were unable to find a "breach" of the Insured's computer system that could be associated with the loss.

The Insured notified the carrier – the issuer of a commercial crime policy. The policy at issue included insuring agreements covering loss resulting directly from forgery or alteration, computer fraud and fraudulent instructions, among other coverages. The carrier denied coverage and the Insured filed suit.

At some point in the litigation, the carrier filed a motion for summary judgment. At the same time, the carrier also filed a motion to stay discovery. The carrier sought to prevent future discovery it deemed unnecessary, including at least 5 depositions in different states, ranging from the adjuster of the claim to the account underwriter to sales agents. The carrier argued that not only did the parties possess the material facts so as to reduce the suit to a question of law for the court, but that the cost associated with the additional discovery was disproportionate to the amount in controversy. The carrier argued that the parties had sufficient evidence to determine coverage, and that no additional discovery would assist the Court. The Insured disagreed, arguing that there remained additional, necessary discovery that included not only these depositions but also responses to requests for the claim file, claims manuals and guidelines for the handling of crime claims.

The Court allowed the carrier's motion concerning discovery. In doing so, the Court noted that it made a "preliminary peek" at the carrier's motion for summary judgment, and determined that a stay of all further discovery was warranted. The Court found that the Insured was not specific enough in its plea for additional discovery. In addition, the Court specifically noted that it was "unclear" how discovery concerning the underwriting file, claims procedures or the depositions of the carrier's corporate witness, adjuster, supervisor, underwriter and sales agents bear on the dispositive factual issue at hand. The court went so far as to say that a ruling in favor of the carrier on the motion for summary judgment would be dispositive of the suit, and that the court could come to this conclusion without any further discovery.

New York State Court Awards Summary Judgment Where Insured Discovered Loss Prior to Inception of Bond

Starr Ins. Holdings, Inc., et al. v. U.S. Specialty Ins. Co., 2019 WL 954756 (N.Y. Sup. Ct. Feb. 27, 2019).

In August 2012, the plaintiff, an insurance company, commenced insuring warranty contracts in connection with consumer electronics. To facilitate entry into this market, the plaintiff used an experienced producer/broker that served as the plaintiff's managing general agent (of a network of dealers), and administered claims. The terms of the deal required the managing general agent to set up trust accounts for claims (funded by the plaintiff), as well as the premiums collected. It appears that the plaintiff learned "early on" in its relationship with its managing general agent that the managing general agent had cash flow issues arising out of a relationship with another client. According to the Court's written opinion, by May 2013, the plaintiff learned that the managing general agent was resolving its cash flow issues by commingling funds earmarked for the plaintiff in the managing general agent's operating account. The plaintiff also learned that the managing general agent was using the comingled funds to pay all of its own liabilities. Further, the plaintiff learned that the managing general agent was remitting alleged premiums earned using funds that the plaintiff had provided to the managing general agent to pay claims. The plaintiff apparently followed up in November 2013 with an audit of its managing general agent and found these practices still existed.

The defendant carriers issued a fidelity bond to the plaintiff that incepted on January 1, 2014. The plaintiff provided notice to the carriers in August 2014 and submitted a proof of loss in November 2014. The carriers, in turn, denied the claim for, among other reasons, the fact that the plaintiff knew of the theft and dishonest acts prior to the inception of the bond.

Once the matter progressed to litigation, the carriers moved for summary judgment. The

plaintiff attempted to argue that it was ignorant of the wrongdoing by the managing general agent, a contention the Court found the summary judgment record clearly refuted. The Court held that the plaintiff's knowledge of any dishonest act by the managing general agent was sufficient to trigger the termination clause in the bond. As part of its holding, the Court highlighted that the plaintiff knew, prior to the inception of the bond, that money was missing from plaintiff's trust accounts and that the managing general agent was using claim funds from the plaintiff to pay premiums back to the plaintiff. All told, the Court found that the plaintiff knew in 2013 all of the facts it submitted to the carriers in late 2014 in support of the claim. In closing the opinion, the Court stated that the plaintiff's arguments did not pass the "red face" test, and intimated that the plaintiff's position as a "sophisticated multi-line insurer that is completely conversant with the controlling principals of law that relate to Fidelity Bonds" rendered its position untenable.

Pennsylvania State Court Holds Financial Institution Bond May Cover Insured's Payments to Clients to Resolve Claims Arising Out of Former Employee's Ponzi Scheme

Janney Montgomery Scott LLC v. Nat'l Union Fire Ins. Co., 2019 WL 400533 (Pa. D. & C. Jan. 22, 2019).

The underlying claim in this litigation involved an alleged multi-million dollar ponzi scheme perpetrated by a former employee of the Insured. Specifically, the former employee would take client funds from accounts held by the Insured and deposit them into accounts over which she had control. The former employee would then move money out of those accounts to accounts held by the Insured and a personal account. According to the Insured, the former employee executed the ponzi scheme while in the employ of the Insured and at another brokerage firm. The Insured's clients eventually filed claims with the Insured who resolved the same. The settlement and/or arbitration of the claims resulted in losses to the Insured of approximately $3,000,000.00 in claim payments and defense fees and costs. The Insured submitted its claim to the carrier for coverage under a financial institution bond, the claim was denied and litigation ensured. At issue in this opinion were cross-motions for summary judgment primarily on the issues of whether payments to the Insured's clients and the defense fees and costs are covered by the bond.

With respect to the payments to the clients, the Court focused on the dispositive issue of whether the payments by the Insured to the clients were a loss resulting directly from the dishonest and fraudulent acts perpetrated by the former employee. The Court noted the possible distinction between the loss of the clients' investment funds when the former employee committed the bad acts and the Insured's loss of funds to reimburse the clients for the former employee's wrongdoing. The Court held that the funds paid to the clients could be a covered loss as long as conditions in the bond, such as the ownership of property provision, were met and coverage was not excluded. As to ownership of property, the Court noted that some of the funds may fit within multiple subsections of the condition – property held by the Insured in any capacity and property held by someone else under circumstances that would make the Insured responsible for the same prior to any loss – but that the actual determinations of amounts and applicability was an issue for trial. The Court went on to highlight other portions of the bond that "lend support to the view … [that the bond covers] … damages paid by [the Insured] to third parties, including customers," such as the definition of discovery and an exclusion in the bond concerning the Insured's legal liability.

Conversely, the Court found that the bond did not cover the Insured's defense fees and costs associated with the clients' claims. The bond in this instance had an express provision excluding coverage for fees, costs and expenses incurred by the Insured as a party to a legal proceeding, even if the legal proceeding exposes the Insured to a covered loss. The Court found that the plain language of the bond precluded coverage of these amounts. In doing so, the Court held that proceedings before FINRA are "legal proceedings" contemplated by the bond. In addition, the Court found that the Claim Expense coverage did not cover defense fees and costs, as it is clearly geared towards those expenses incurred and paid in creating and submitting the proofs of loss. Finally, citing the exclusion concerning lost profits, the Court

summarily rejected the Insured's plea for coverage for its clients' loss of use of the misappropriated funds, likening the use of the funds as the opportunity to generate the very things (income, interest and dividends) excluded.

SUGGESTIONS & COMMENTS??

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