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Newsletter

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

GREAT MEETING WITH GREAT FRIENDS! RECAP OF SURETY CLAIMS INSTITUTE'S 44th ANNUAL MEETING

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

The Surety Claims Institute held its 44th Annual Meeting at the King & Prince Beach and Golf Resort in St. Simon's Island, Georgia from June 19 to June 21, 2019. On all counts, the meeting was a tremendous success! Patrick Kingsley of Stradley Ronon Stevens & Young, LLP in Philadelphia served as the educational program chair. Pat's program focused on unique situations that Pat had encountered but which lacked an "established" answer. The program's experienced speakers guided the attendees through challenging scenarios to offer practical guidance in seeking a resolution that is often times the best of a bad situation. Despite the difficult nature of the topics, the program speakers provided excellent advice on resolving the these often "unresolvable" situations.

Thursday's educational program began with the annual Surety Law Update, presented this year by Patricia Wager of Torre, Lentz, Gamell, Gary & Rittmaster and Liberty Mutual's Tiffany Schaak. This SCI staple provides updates on important decisions *(continued on page 3)*

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SURETY CLAIMS INSTITUTE

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Officers

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

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

Executive Secretary
Diane Kennedy
Surety Claims Institute
4420 Madison Avenue
Suite 200
Kansas City, MO 64111-3407
email:dkennedy@dysarttaylor.com

Newsletter Staff

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

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

Articles Editor
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Comments From The Editor:

I have been involved with the Surety Claims Institute for over 25 years and have enjoyed the friendships that have endured during that time and the new friendships that continue to be made at its Annual Meeting. It has been a very "comfortable" group, and sometimes comfort can lead to complacency. Given the fact that this is an organization which controls attendance to ensure that members can speak candidly to a friendly audience about ways to improve the surety claims handling process and regarding noteworthy legal developments; and because membership is arranged through a (simple) nomination process, a certain perception of exclusivity has developed which can, for some, seem off-putting. While candor of

communication and the notion that members are dedicated to the proper representation of the surety industry are important, we cannot lose sight of the fact that our organization needs to be vital and have a steady infusion of youth so that the retirement of veterans does not erode the organization, but is simply a part of the natural renewal process. (No, I have no intention of retiring anytime soon.) Thus, it is important for us all to identify the younger folks who will be the leaders of the future in the surety claims industry and to encourage them to join the Surety Claims Institute and become active in its membership. It is not difficult to nominate a proposed member, and the process for admission is simple. The Membership Committee is not designed to exclude anyone who is truly involved with servicing and advancing the surety claims industry. It is incumbent upon us all to identify prospective younger members and alert our great Executive Secretary, Diane Kennedy, to a proposed nominee so that she can pass along information regarding the proposed nominee to the Membership Committee. With modest due diligence, the Membership Committee will then likely advance the membership application to a quick approval. We look forward to receiving your nominations!

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

SURETY CLAIMS INSTITUTE 44th ANNUAL MEETING

(continued from page 1)

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LET'S GO SHRIMPIN'

affecting the surety claims industry that have been handed down over the preceding year, with a particular focus on payment and performance bond claims, indemnity actions, as well as various commercial bond disputes. Sarah Wilson from The Hartford and Todd Regan from Robinson + Cole followed with their presentation on best practices for making the case against a product manufacturer or supplier for a defective product installed by a bond principal. Sarah and Todd theorized about bringing claims against the product manufacturer for breach of contract, breach of warranty, or indemnification, and discussed the legal framework through which a surety might have standing to do so. Following Sarah and Todd, Jessica Bowers of Smith Bowers, Jennifer Leuschner of Philadelphia Indemnity, Kathleen Maloney from IFIC, Catherine Squillace of Sirius America, and Greg Veal from Bovis, Kyle, Burch & Medlin, provided a thoughtful analysis of pre-default meetings, including whether to attend, who should attend, what documents to bring (or not), as well as tips for communicating with a potentially recalcitrant obligee (or bond principal). Thursday's educational program concluded with an analysis from Sharon Edwards of Swiss Re and Brian Kantar of Chiesa Shahinian & Giantomasi of the self-performing surety's MBE/WBE requirements. Sharon and Brian provided an overview of MBE/WBE contracting generally as well as the extent to which a self-performing surety is liable for a defaulted principal's failure to comply with set-aside contracting requirements. Sharon and Brian also identified a number of strategies to assist the surety in successfully meeting such goals during its own performance.

Friday's program began with another SCI staple, the annual Fidelity Law Update, which was presented by Toni Scott Reed and Ben Weible from Clark Hill Strasburger. The Fidelity Law Update, like its surety law cousin, examines important cases that have come down during the preceding year that affect the fidelity claims profession. Toni and Ben were followed by Michael Bramhall of Arch Insurance, Scott Leo from the Law Offices of T. Scott Leo, John O'Donnell of Liberty Mutual Surety, and Scott Williams of Manier & Herod, who demystified Chapter 11 bankruptcy proceedings with pointers for protecting the surety's rights in the debtor principal's assets. The panel's paper (available to members on the SCI website) bears special recognition, as it was one of the most in-depth papers presented in recent SCI memory. Doug Dearie from Liberty Mutual Surety, Jeff Katz from Vertex, and Lauren McLaughlin from Smith, Currie & Hancock then took the audience through a review of project submittals and how they impact both payment and performance bonds claims. Friday's penultimate presentation was led by Great American's Ed Dudley and Phelps Dunbar's Dan Lund, who discussed the ownership of stored materials. Ed and Dan offered an overview on the competing claims to such materials following a principal's default or in the lead up to the default, as well as providing suggestions to completing sureties on how best to maximize their own rights in such materials. Friday ended, as it always does, with the ethics portion of the program. Will Pearce from Arch Insurance, David Burkholder from Wisler Pearlstine, and Patrick Welch of Jennings, Strouss & Salmon presented an overview of the ethical issues that may arise from use of key provisions in the General Agreement of Indemnity, including its attorney-in-fact provision, its assignment claims, its confession of judgment clause, as well as other common provisions used throughout the industry.

As always, SCI's annual meeting was located at a first-class resort with a wealth of charm and beauty. The King and Prince sits along the shores of the Atlantic Ocean and offered our members and their guests beautiful beaches, quaint shopping areas, golf, tennis, and a range of other activities. It also offered our members the opportunity to reconnect with old friends while meeting new partners, particularly as we look towards our next annual meeting in 2020.

In 2020, the SCI will revisit the Hyatt Regency Chesapeake Bay Golf Resort, Spa and Marina on Maryland's Eastern Shore. The SCI

was last at this fabulous location in 2013 and the success of that meeting encouraged the SCI Board to return in 2020. We hope to see you there!

Restoration of Surety's Right to Enforce Conditional Payment Clauses on State Projects

By: Michael Lane, Riess LeMieux, New Orleans, LA

Introduction

A discernable shift has emerged in the last decade in favor of sureties asserting conditional payment clauses as a defense to payment bond claims on state public projects. For more than a half-century, state and federal courts almost universally ruled that a surety could not enforce its principal's pay-if-paid or pay-when-paid clause in defense of a claim against the bond. To this day, federal courts continue to neglect traditional suretyship principles in favor of the public policy underlying the Miller Act on federal projects. But in the last ten years, courts applying state law have increasingly acknowledged the right of a payment bond surety, as secondary obligor, to raise a conditional payment clause as a defense. This article examines a recent wave of decisions that may foreshadow a restoration of traditional suretyship defenses on the state level.[1]

Surety Principles vs. Public Policy

It is a fundamental precept of suretyship that the payment bond surety's liability can be no greater than that of the principal obligor.[2] The common law has long recognized that the surety may raise, as a defense to a payment bond claim, any defense available to the principal obligor, except personal defenses.[3] If a general contractor has a valid defense to payment to a subcontractor based upon a conditional payment provision in a subcontract,[4] the surety should also be able to assert the defense even if the principal chooses

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[1] This article does not directly address the jurisprudence as it relates to private construction projects, but suffice it to say that many state and federal courts have applied the same logic to preclude payment bond sureties from asserting a conditional payment clause on private projects.

[2] 3 PHILIP L. BRUNER & J. O'CONNOR, JR., BRUNER & O'CONNOR CONSTRUCTION LAW § 8:50 (2018).

[3] RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 34 (1996). These personal defenses typically are limited to discharge of the underlying obligation in bankruptcy or unenforceability of the underlying obligation due to the principal's lack of capacity.

[4] Few courts have distinguished between pay-if-paid and pay-when-paid clauses in the context of analyzing the surety's right to assert the defense. For the purpose of this article, the author included both terms in the definition of a conditional payment clause.

not to raise the defense.[5] Regrettably, many courts disregard this bedrock suretyship rule when analyzing a payment bond surety's liability where the principal obligor has a valid contract defense based upon a pay-if-paid or pay-when-paid provision.

The passage of the Miller Act in 1935 created tension between traditional suretyship principles and the public policy of ensuring payment to subcontractors and suppliers that perform work or provide materials on public jobs. The Miller Act "represent[ed] a congressional effort to protect persons supplying labor and material for the construction of federal public buildings in lieu of the protection they might receive under state statutes with respect to the construction of nonfederal buildings."[6] The purpose of the Miller Act is "to provide a surety who, by force of the Act, must make good the obligations of a defaulting contractor to his suppliers of labor and material."[7]

Every state subsequently passed its own version of the Miller Act, known colloquially as a "Little Miller Act," sometimes bringing the statutory regime in conflict with suretyship principles. Like their progenitor, the Little Miller Acts were enacted to protect subcontractors and suppliers from the risk of nonpayment on state public projects. The public policy promoted by these statutes often came into sharp conflict with suretyship law—to the extent it has been recognized at all—when a payment bond surety raised a conditional payment clause as a defense. Until recently, most courts answering the question have concluded that the public policy of ensuring payment to subcontractors and suppliers trumps the contractual rights of payment bond sureties.

Courts Historically Favored Public Policy

A review of the case law reveals that most state and federal courts have skewed towards well-meaning public policy arguments and eschewed—or completely ignored—traditional principles of suretyship.[8] Within twenty years of the Miller Act's passage, federal courts began to hold that the purpose of the statute would be thwarted if a payment bond surety were allowed to enforce a conditional payment provision in a subcontract.[9] Over the next fifty years, a majority of state and federal courts held that sureties were barred from raising such a defense under state or federal law.

Federal courts addressing the issue in a Miller Act context have consistently held that a payment bond surety cannot assert a conditional payment clause as a defense.[10] This holds true today. The rationale underlying these rulings is that the liability of the surety is "coextensive with the contractual liability of the principal ***only*** to the extent that it is consistent with the rights and obligations created under the Miller Act."[11] As the argument goes, precluding a subcontractor from recovering against a payment bond due to a conditional payment clause would effectively forfeit the claimant's Miller Act rights. Consequently, the courts ruled that the public policy protecting claimants outweighs traditional suretyship principles and freedom of contract.

Most courts followed suit in cases involving Little Miller Acts. With few exceptions, courts found that the public policy

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[5] RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 34 (cmt. a. Defenses).

[6] *United States ex rel. Sherman v. Carter*, 353 U.S. 210, 216 (1957).

[7] *Id.* at 216-17.

[8] For more background about how courts have historically addressed this issue, the author recommends the article entitled "The Slow Erosion of Suretyship Principles: An Uncertain Future for 'Pay-When-Paid' and 'Pay-If-Paid' Clauses in Public Construction Subcontracts" published in the Public Contract Law Journal. 38 PUB. CONT. L.J. 47 (2008).

[9] *United States ex rel. Ackerman v. Holloway Co.*, 126 F. Supp. 347, 348 (D. N.M. 1954).

[10] *United States ex rel. Walton Tech., Inc. v. Weststar Eng'g, Inc.*, 290 F.3d 1199 (9th Cir. 2002); *United States ex rel. T.M.S. Mech. Contractors, Inc. v. Millers Mut. Fire Ins. Co. of Tex.*, 942 F.2d 946 (5th Cir. 1991); *United States ex rel. DDC Interiors, Inc. v. Dawson Constr. Co., Inc.*, 895 F. Supp. 270 (D. Colo. 1995), *aff'd*, 82 F.3d 427 (10th Cir. 1996); *United States ex rel. Straightline Corp. v. Am. Cas. Co. of Reading, PA*, No. 5:06-00011 2007 WL 2050323 (N.D. W. Va. July 12, 2007).

[11] *United States ex rel. Walton Tech., Inc.*, 290 F.3d at 1206 (emphasis added).

reflected in the Little Miller Acts superseded the contractual right of a surety to assert a conditional payment clause as a defense.[12] In an oft-cited 2000 decision applying state law, the Fourth Circuit succinctly explained the prevailing majority view:

> On the contrary, the very purpose of securing a surety bond contract is to insure that claimants who perform work are paid for their work *in the event that the principal does not pay.* To suggest that non-payment by the Owners absolves the surety of its obligation is nonsensical, for it defeats the very purpose of a payment bond.[13]

A handful of courts bucked the national trend, holding that a surety could assert a pay-if-paid or pay-when-paid clause as a defense to a Little Miller Act claim.[14] Even in those cases, however, some courts ruled for the surety by weighing competing public policies, not out of deference to suretyship principles. For example, the Supreme Court of West Virginia concluded that "the public policy of freedom of contract is more compelling and outweighs the public policy found in [the Little Miller Act]."[15] Nevertheless, a solid majority of state and federal courts continued to elevate public policy concerns over traditional suretyship rules.

On both ends of the spectrum, an important consideration that has been overlooked by nearly all courts addressing this issue is how these rulings impact the principal's contractual rights, particularly the effect of the general indemnity agreement (GIA). That subject is beyond the purview of this article; however, it could be argued that if a surety is not permitted to assert a pay-if-paid clause as a defense, the surety is not the only adversely affected party. Under the terms of the GIA, the principal will ultimately be on the hook for payments made by the surety when the principal did not owe the obligation to the claimant. This circumvents the bargained-for pay-if-paid clause in the principal's agreement with the claimant. From the principal's perspective, the public policy favoring freedom of contract is disregarded and the principal's contractual rights are effectively rendered meaningless by the public policy favoring the claimant.

What a Difference a Decade Makes

It appears the trend has reversed in the last ten years to the benefit of sureties, as more state and federal courts have come around to the view that public works payment statutes—though liberally construed—should not be interpreted to abrogate suretyship principles or the right of parties to enter contracts freely. At least six courts have explicitly acknowledged that a payment bond surety can assert the defense of its principal to enforce a pay-if-paid or pay-when-paid clause.[16] The states where the pro-surety view has taken root include Arkansas, Indiana, Kansas, Michigan, New Jersey, and Pennsylvania.

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[12] *Fed. Ins. Co., Inc. v. I. Kruger, Inc.*, 829 So. 2d 732 (Ala. 2002); *Everett Painting Co., Inc. v. Padula & Wadsworth Const., Inc.*, 856 So. 2d 1059 (Fla. Dist. Ct. App. 2003).

[13] *Moore Bros. Co. v. Brown & Root, Inc.*, 207 F.3d 717, 723 (4th Cir. 2000).

[14] *See, e.g.*, *Star Contracting Corp. v. Manway Constr. Co.*, 337 A.2d 669 (Conn. Super. Ct. 1973); *St. Paul Fire & Marine Ins. Co. v. Ga. Interstate Elec. Co.*, 370 S.E.2d 829 (Ga. Ct. App. 1988); *Allen Elec. Co. v. Fid. & Deposit Co. of Md.*, 1989 WL 54791 (Tenn. Ct. App. May 24, 1989).

[15] *Wellington Power Corp. v. CNA Sur. Corp.*, 614 S.E.2d 680, 686 (W. Va. 2005) (internal citations omitted).

[16] *BMD Contractors, Inc. v. Fid. & Deposit Co. of Md.*, 679 F.3d 643 (7th Cir. 2012); *Sloan & Co. v. Liberty Mut. Ins. Co.*, 653 F.3d 175, 181 n. 9 (3d Cir. 2011); *Great Lakes Travel Hotel Supply Co. v. Travelers Cas. & Sur. Co. of Am.*, No. 12-12481, 2013 WL 12122069 (E.D. Mich. Jan. 24, 2013); *Faith Techs., Inc. v. Fid. & Deposit Co. of Md.*, No. 10-2375-MLB, 2011 WL 251451 (D. Kan. Jan. 26, 2011); *Fixture Specialists, Inc. v. Global Constr., LLC*, No. 07-5614 (FLW), 2009 WL 904031 (D. N.J. Mar. 30, 2009); *Travelers Cas. & Sur. Co. of Am. v. Sweet's Contracting, Inc.*, 450 S.W.3d 229 (Ark. 2014).

Most of these decisions relied on traditional suretyship principles. For example, in *BMD Contractors, Inc. v. Fid. & Deposit Co. of Md.*,[17] the Seventh Circuit issued an insightful opinion adopting the minority position. The *BMD* court examined the history of courts denying sureties the right to rely upon a conditional payment clause. In applying state law, the *BMD* court rejected the reasoning of another federal appeals court, concluding that a payment bond surety could rely on a pay-if-paid clause:

> The clear trend of recent caselaw bolsters the basic principle of Indiana law that a surety may assert all the defenses of its principal. Fidelity, no less than [the general contractor], may rely on the pay-if-paid clause in the . . . subcontract to defend against this suit on the payment bond.[18]

In another well-reasoned decision, the U.S. District Court for New Jersey rejected the majority view, finding that public policy concerns do not override the rights of payment bond sureties:

> In addition, underlying surety and contract principles are not trumped by the public policy considerations reflected in these decisions…. Similarly here, if the Court were to depart from those principles, it would erode and abrogate the state's established surety law.[19]

Conversely, few courts in the last ten years have adhered to the majority view. No doubt a handful of state courts still rely upon the established jurisprudence by prohibiting payment bond sureties from asserting such a defense on a state public works claim.[20] And there have been no federal appellate court decisions in the last decade to buttress the longstanding holdings of earlier federal district and appellate courts that established the majority approach. In concert with the recent decisions benefiting payment bond sureties, the dearth of adverse court decisions may portend good things to come.

There has been no such shift among courts applying the federal Miller Act, which have "uniformly held that sureties cannot assert pay-when or pay-if paid clauses in subcontracts" when a claim is made against a payment bond on a federal project.[21] That, however has not prevented more and more courts from allowing sureties to raise the defense in response to Little Miller Act claims. It remains to be seen if state and federal courts will continue to build on the momentum from the last decade and reinforce the payment bond surety's traditional right to assert the defense. If the trend holds true, a restoration of the payment bond surety's rights may already be well under way.

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17 *Supra*.

18 *Id.* at 657.

19 *Fixture Specialists, Inc., supra,* at *11.

20 *See, e.g., Glencoe Educ. Found., Inc. v. Clerk of Court and Recorder of Mortgs. for the Parish of St. Mary*, 2010-1872 (La. App. 1 Cir. 5/6/11); 65 So. 3d 225, 232.

21 *Great Lakes Travel Hotel Supply Co., supra*, at *8(citing *United States ex rel. J.H. Lynch & Sons, Inc. v. Travelers Cas. & Sur. Co. of Am.*, 783 F. Supp. 2d 294 (D. R.I. 2011)).

INCORPORATION BY REFERENCE CLAUSES IN PERFORMANCE BONDS: WHAT TERMS ARE ACTUALLY INCORPORATED?

By: Jonathan P. Cohen and Elizabeth S. Rivera, Jonathan P. Cohen, P.A., Fort Lauderdale, FL

Introduction

A performance bond is a type of contract generally subject to the principles of contract interpretation, and the liability of the surety issuing the bond is tied to the language of the bond. Traditionally, the language of the bond was considered to be *strictissimi juris* and would be interpreted strictly and not extended by construction or interpretation beyond its specific scope of coverage. While that principle of construction has been eroded somewhat in some jurisdictions, it remains the majority view. However, the four corners of the bond are often not the only source from which the liability of the surety may be derived. Typically, a performance bond contains language broadly incorporating the bond principal's contract by reference with language such as the following: "subcontract between general contractor and subcontractor is hereby referred to and made a part hereof." Commonly referred to as an "incorporation by reference" clause, these deceptively simple contractual provisions create an array of issues for courts that are tasked with interpreting the bond language and ascertaining the true intentions of the parties.

Including the incorporation by reference clause in the bond may not place the same benefits and burdens on the surety, obligee, and principal; there are limits. In 1992, the Florida Supreme Court decided the case of *American Home Assurance Co. v. Larkin General Hospital*.[22] In that case, the court ruled that while a surety's liability is coextensive with that of its principal, that liability is limited by the purpose and, more importantly, the terms of the performance bond; the surety's liability cannot be extended beyond that purpose.[23] While *Larkin* did not involve the application of an incorporation by reference provision, it is the best place to start an analysis as to surety liability. *Larkin* recognized the general rule that a surety's obligation is controlled by the terms of the bond.

The question then becomes to what extent, if at all, is a surety's obligation expanded when an incorporation by reference provision is involved? There is a large volume of case law concerning this very question, and those cases tend to fall into certain areas: categories of damages, statutes of limitations, notices of default, and mandatory arbitration provisions. This article will explore how courts have interpreted incorporation by reference clauses and applied them in those circumstances. Additionally, this article will be a guide for the surety that otherwise may be concerned that the inclusion of an incorporation by reference clause might amount to an automatic win for an obligee seeking damages allowable under the bonded contract.

[22] 593 So. 2d 195 (Fla. 1992).

[23] *Id*. at 198.

I. Delay Damages

Not surprisingly, the type of damages to which a bond obligee is entitled may become a point of contention, and in particular, treatment of delay damages varies according to the jurisdiction. In *Larkin*, the Florida Supreme Court refused to enlarge a surety's obligation under a performance bond to include both damages for costs of completion and delay damages.[24] The obligee contracted to build a hospital, and the surety issued a performance bond. Eighteen months after the project was to have been completed, the obligee terminated the contract and gave notice to the surety, which elected not to complete the project and instead allowed the obligee to utilize another contractor. The obligee filed suit against the surety for breach of the performance bond, and the matter proceeded to arbitration resulting in a net award against the contractor for $1,860,545.00. The trial court confirmed the arbitration award, holding that the surety's liability to the obligee, including delay damages, was $2,314,579.58.[25] The trial court additionally assessed attorney's fees incurred in the arbitration confirmation hearings against the surety.[26]

The appellate court affirmed the trial court, and in doing so certified conflict with another court of appeals case that held a surety of a performance bond could not be held liable for damages caused by delays in completing the contract.[27]

The performance bond at issue obligated the surety to cover the costs of completion and "other costs and damages."[28] On appeal to the Florida Supreme Court, the obligee argued that "other costs and damages" included delay damages. The court noted that while a surety's liability is coextensive with the principal's liability, a surety's liability is limited by the terms of the bond.[29] The court went on to state, "Florida courts have long recognized that the liability of a surety should not be extended by implication beyond the terms of the contract, i.e., the performance bond."[30]

Ultimately, the court found that the purpose and terms of the performance bond made it clear the goal was to merely guarantee completion of the project and nothing more, and it denied the request to impose delay damages.[31] The court held "a surety cannot be held liable for delay damages due to the contractor's default unless the bond specifically provides coverage for delay damages."[32] Importantly, no incorporation by reference provision was included in the terms of the bond.

A California court revisited *Larkin* when a similar situation arose but when an incorporation by reference provision was in fact present. The California court found the Florida Supreme Court's reasoning in *Larkin* unpersuasive. Based upon the language of the underlying contract incorporated into the bond, the California court awarded delay damages, reasoning as follows:

> It long has been settled in California that where a bond incorporates another contract by an express reference thereto, the bond and the contract should be read together and construed fairly and reasonably as a whole according to the intention of the parties. To ascertain the nature and extent of the liability to which the surety has bound itself, courts must examine the language of the undertaking by the light of the [construction] agreement, faithful performance of the terms of which it guarantees. As a general rule, the obligation of a surety must be neither larger in amount nor in other respects more burdensome than that of the principal . . . . Even assuming, for purposes of argument, that the performance bond in *American Home* contained language substantially

[24] *Id.* at 198.
[25] *Id.* at 197.
[26] *Id.*
[27] *Id.* at 197; *see also U.S. Fid. & Guar. Co. v. Gulf Fla. Dev. Corp.,* 365 So. 2d 748 (Fla. Dist. Ct. App. 1978).
[28] *Am. Home Assur. Co.,* 593 So.2d at 197.
[29] *Id*. at 198.
[30] *Id.* at 198 (internal quotations and citations omitted).
[31] *Id.*
[32] *Id*. at 196.

> similar to the bond at issue here, we are not persuaded. The Florida court appears to have viewed the purpose of a performance bond narrowly and to have determined the surety's obligations without reference to the underlying construction contract. While that may reflect the rule in Florida, firmly established California precedent holds otherwise.[33]

In 2003, the Eleventh Circuit, which includes Florida, revisited a performance bond surety's liability for delay damages. The bond at issue in that case again contained an incorporation provision, but the contrary result was reached.[34] The owner alleged that the surety was contractually liable for liquidated delay damages because the bonds incorporated the underlying subcontracts by reference, and those subcontracts, in turn, expressly provided for delay damages. The surety denied any responsibility for delay damages, arguing that such damages were unrelated to the completion of the bonded construction projects and that the performance bonds did not expressly recognize liability for delay damages. The court stated as follows:

> [T]he purpose of the bond must be considered, which requires reference to the contract secured by the bond. Where a provision for liquidated delay damages is clearly delineated in the underlying contract and incorporated by reference into the bond, the surety is on notice of the time element of performance and the contractual consequences of failure to timely perform in accordance with the contract.[35]

This case makes it clear that an incorporation by reference provision can significantly impact the scope of a surety's liability.

Though state and federal courts vary when it comes to an award of delay damages depending upon whether or not the bond contains an incorporation provision, all cases have a common thread, which is the consideration of the true purpose and intent of the performance bond. As such, a surety's best defense to an award of additional damages that may have been inadvertently agreed upon through an incorporation provision is to specify the purpose of the bond and the intended scope of the guarantee.

II. Statutes of Limitation

An incorporation provision may also affect the applicable statute of limitation. In 1998, the Florida Supreme Court decided the case of *Federal Insurance Co. v. Southwest Florida Retirement Center*.[36] In 1981, the obligee contracted with a contractor to build a retirement center. The surety issued a performance bond, which incorporated the construction contract by reference. In 1993, nearly ten years after the project was completed, the obligee sued the contractor and surety for latent defects that amounted to a breach of an express warranty provided by the contract. The obligee alleged a cause of action against the surety for breach of the performance bond for failure to cure the warranty violation. The trial court granted the surety's motion for judgment on the pleadings, ruling that the claim on the performance bond was time barred by Florida Statute 95.11(2), which imposed a five-year statute of limitation on claims on written contracts.[37]

The appellate district court reasoned that "by incorporating the construction contract into the bond, the surety's liability becomes coextensive with that of the general contractor. . ." and "a timely contractual claim against the general contractor would result in a valid claim against the surety's bond."[38] The court concluded

[33] *Cates Constr., Inc. v. Talbot Partners*, 980 P.2d 407, 415 (Cal. 1997) (internal quotations and omitted).

[34] *Nat'l Fire Ins. Co. v. Fortune Constr. Co.,* 320 F.3d 1260, 1274 (11th Cir. 2003).

[35] *Id.* at 1275.

[36] 707 So. 2d 1119 (Fla. 1998).

[37] *Id*. at 1121-22 (citing FLA. STAT. § 95.11(2)(b) (1981)).

[38] *Id.* at 1132 (footnote omitted).

that because the contracts were coextensive, "the limitations period for an action against the surety did not begin to run until discovery of the latent defects constituting the breach of warranty."[39] The dissent, on the other hand, argued that the majority opinion "extends the liability on the bond by implication beyond the terms of the bond contract. . . ." and such an "additional burden" was contrary to the Florida Supreme Court's holding in *American Home Assurance Co. v. Larkin General Hospital*.[40]

On appeal, the Florida Supreme Court reasoned that the intent of a performance bond is a financial guarantee of the general contractor's completion obligations in compliance with the conditions of the contract, and, as such, a surety is liable for patent and latent defects whether or not discovered before or after substantial completion.[41] The court then turned to the application of the statute of limitations and agreed—at least partially—with the dissent in ultimately holding that the statute of limitations on a performance bond begins to run on the acceptance date of substantial completion of the project, not from the date of discovery of a latent defect.[42] As such, despite the presence of an incorporation by reference provision that arguably could have been grounds to bind the surety to the same extended timeframes as the contractor, the court declined to do so. The court's holding, which specifically declined to extend *Larkin* beyond its application to delay damages,[43] seems to be more strongly rooted in the fact that it found a tolling of the statute of limitation improper as opposed to the argument that the surety's liability was being extended past the terms of the bond. Despite that, the *Southwest* case demonstrates that an incorporation by reference provision does not equate to an automatic extension of a surety's liability and instead offers the surety a plausible position to take when arguing against an overly broad application of the incorporation provision. And again, we see that the courts look first and foremost to the true purpose and intent of the particular bond as a guide to determine how or when an incorporation provision will be applied rather than starting with the purported stronghold premise that an incorporation by reference clause makes a surety's liability coextensive with that of its principal in every respect.

III. Notice Requirements

Although bonds come in different sizes and shapes, a performance bond will often give a surety several options from which to choose when the principal defaults. Many bonds provide that notice is a condition precedent to the surety's obligation to perform one of these options. But what happens when there is an incorporation by reference provision, and the principal's contract, unlike the bond, does not require notice? How do the courts read the documents together and apply the notice requirements?

In 2008, the Florida Third District Court of Appeal heard the case of *Dooley & Mack Constructors, Inc. v. Developers Sur. & Indem. Co.*,[44] which addressed this exact issue. The trial court granted summary judgment in favor of the surety as it was undisputed that the bond obligee contractor had remedied the subcontractor's default and brought suit against the surety without first notifying the surety. The bond at issue, which incorporated the subcontract by reference, provided that the surety's obligation arose after notice. On the other hand, the subcontract, which was drafted by the contractor obligee, stated that the contractor could remedy the default itself and later sue the surety. It did not contain an explicit notice requirement.

The appellate court reversed the trial court and noted that all portions of the documents had to be read together.[45] It concluded that the options were alternatives, and since the obligee chose the option as provided under the subcontract that contained no explicit notice provision, the surety was financially obligated for the costs of completion and was not entitled to notice.[46] The dissent expressed frustration with the majority's conclusion. Citing *American Home Assurance Co.*, the dissent argued that its "analysis is consistent with the fact that in any dispute between the obligee and a surety, the

[39] *Id.* at 1120.
[40] *Id.* at 1120-1121 (internal citations omitted).
[41] *Id*. at 1121.
[42] *Id*. at 1121-22.
[43] *Id*. at 1121.
[44] 972 So. 2d 893 (Fla. Dist. Ct. App. 2007).
[45] *Id.* at 895.
[46] *Id*.

bond is necessarily the primary determinant of surety liability."[47] The dissent went on to state that the reasoning for that proposition was plain. The contract preceded the bond. Renegotiation of the contract after issuance of the bond to assuage all of the surety's concerns is impractical.[48]

Thankfully, the *Dooley* case appears to be an outlier. The Northern District of Alabama[49] and the Southern District of Florida[50] have since both rejected the logic of *Dooley* and have instead, specifically citing the reasoning of the dissent,[51] held that the bond language is the primary determinant on notice. Stated otherwise, the lack of a notice requirement in the subcontract cannot override a notice requirement within the bond. Nonetheless, if a bond is going to contain an incorporation by reference provision, a surety issuing a bond in Florida may be wise to include language in the notice provision, such as "notwithstanding language to the contrary within the principal's contract," to avoid having its notice provision eviscerated.

IV. Mandatory Arbitration Clauses

Oftentimes the principal's contract contains a mandatory arbitration provision. As such, when an obligee files suit with the principal, the matter proceeds from court to arbitration with little fanfare. However, if the performance bond contains an incorporation clause, and the obligee also makes a claim on the bond, a procedural dispute over the proper forum can quickly arise. Does the incorporation provision bind the surety to the mandatory arbitration clause included within the principal's contract?

Unfortunately, jurisdictions continue to vary greatly on this particular issue. Notably, two federal courts recently came to completely opposite conclusions in cases that had the same surety, same obligee, and the same contract language.[52] Both cases began with an arbitration demand filed by the contractor on claims of breach of a performance bond. The surety filed declaratory judgment actions in both cases seeking a determination that the incorporation by reference provision did not bind it to arbitrate. The surety argued that by its own terms, the arbitration clause would not apply because the claims were on the bond and the arbitration clause specified that it applied only to claims "between the Contractor and the Subcontractor."

The South Carolina court ultimately held the surety was bound by the arbitration provision.[53] The court reasoned the bond should be construed together with the agreement it incorporates to determine the parties' intent and that a surety clearly obligates itself under a bond to the same liability as the principal.[54]

The Kansas court reached the opposite conclusion, finding the surety did not consent to arbitrate the dispute despite the presence of an incorporation by reference provision.[55] Unlike South Carolina, the Kansas court agreed that the language of the arbitration provision was limited to disputes between the subcontractor and contractor.[56] The Kansas court also reasoned that even though there was an incorporation by reference provision, the surety had not agreed to assume "any or all obligations" of the subcontractor but only "certain" obligations in the event of a default by the subcontractor.[57]

In Florida, arbitration is favored as a matter of public policy, and as such it is no surprise Florida courts mandate arbitration when such obligation was deemed incorporated by

[47] *Id.*at 899.
[48] *Id*.
[49] *See Fid. & Deposit Co. of Md. v. Jefferson Cty. Comm'n*, 756 F. Supp. 2d 1329 (N.D. Ala. 2010).
[50] *See CC-Aventura, Inc. v. Weitz Co., LLC,* No. 06-21598-CIV, 2008 U.S. Dist. LEXIS 53439, 2008 WL 2937856 (S.D. Fla. July 14, 2008).
[51] *Jefferson Cty. Comm'n*, 756 F. Supp. 2d at 1338; *Weitz Co., LLC,* 2008 U.S. Dist. LEXIS 53439 at *29-30.
[52] *Compare Developers Sur. & Indem. Co. v. Carothers Constr., Inc.,* No. 9:17-1419-RMG, 2017 U.S. Dist. LEXIS 111021 (D.S.C. July 18, 2017) *with Developers Sur. & Indem. Co. v. Carothers Constr., Inc.,* No. 17-2292-JWL, 2017 U.S. Dist. LEXIS 135949 (D. Kan. Aug. 24, 2017).
[53] *Developers Sur. & Indem. Co. v. Carothers Constr., Inc.,* 2017 U.S. Dist. LEXIS 111021 at *10-11.
[54] *Id.* at *10.
[55] *Developers Sur. & Indem. Co. v. Carothers Constr., Inc., 2017 U.S. Dist. LEXIS 135949* at *13-14.
[56] *Id.* at 12-13.
[57] *Developers Sur. & Indem. Co. v. Carothers Constr., Inc.,* 2017 U.S. Dist. LEXIS 135949 (D. Kan. Aug. 24, 2017).

reference.[58] The District of Columbia also comes down in favor of arbitration.[59]

A Maryland court recently took a different approach to the incorporation by reference of arbitration clauses. In *Schneider Electric Building Critical Systems, Inc. v. Western Surety Company,* the Maryland Court of Special Appeals held that the mere incorporation by reference of a contract containing an arbitration clause did not obligate the surety to arbitrate, reasoning that the incorporation of one contract into another contract involving different parties does not automatically transform the incorporated document into an agreement between the parties to the second contract, unless there is "an indication of a contrary intention."[60] In short, there must be some indication that the surety was agreeable to being obligated to arbitrate. This analysis is similar to that of the Kansas court in the *Developers* case.

As the preceding opinions make clear, cases from around the country on this particular issue can be found both in favor of and against mandatory arbitration clauses binding the surety based upon the incorporation of the underlying contract by reference. Ultimately, if a surety desires to avoid such disputes arising in its claims, the surety may wish to consider whether the incorporation by reference clause specifically states which terms of the principal's contract are or are not incorporated. Better yet, the provision might specifically state whether dispute resolution provisions are meant to be incorporated, the goal being to ensure that the language of the bond accurately reflects the intent of the bond with respect to the dispute resolution forum in which the surety's obligations are to be determined.

V. Conclusion

It is common for a performance bond to incorporate by reference the terms of the principal's contract, which may expose a surety to rights or obligations the principal and obligee have negotiated outside the presence of the surety. A deceptively simple incorporation provision can create disputes over an array of areas regarding the intent of the parties regarding the scope of the surety's obligations. The courts, while recognizing that a surety's liability is generally meant to be coextensive with that of its principal, will first and foremost look to the purpose and intent of the bond itself to determine the scope of the surety's obligation where the bond includes an incorporation by reference provision.

[58] *See U. S. Fid. & Guar. Co. v. W. Point Constr. Co.,* 837 F.2d 1507 (11th Cir. 1988).

[59] *See Tower Ins. Co. of New York v. Davis/Gilford,* 967 F. Supp. 2d 72, 83 (D.D.C. 2013).

[60] 149 A.3d 778, 780 791 (Md. Ct. Spec. App. 2016).

Surety Casenotes

By: Brian Kantar, Chiesa Shahinian & Giantomasi PC, New York, NY and West Orange, NJ

Eighth Circuit Holds That Completing Surety for Prime Contractor Equitably Subrogated to Rights of Prime Contractor Against Subcontractor's Surety

United States ex rel. Wesco Distrib., Inc. v. Liberty Mut. Ins. Co., 921 F.3d 744 (8th Cir. 2019).

In March 2012, Greenleaf Construction Co. ("Greenleaf") entered into a prime contract with the federal government to build an Army Reserve Center in Des Moines, Iowa. Greenleaf provided performance and payment bonds in accordance with the Miller Act. Greenleaf, in turn, entered into subcontract with International Electric, Inc. ("IE") pursuant to which IE agreed to perform certain electrical and communications work. IE provided performance and payment bonds naming Greenleaf as obligee.

In January 2014, Greenleaf, its surety and the government entered into a takeover agreement in which Greenleaf and the government agreed to an immediate consensual termination of the prime contract and its surety agreed to complete the prime contract in accordance with its terms. The government agreed to accept the surety's consultant as the surety's completion contractor. Greenleaf's surety entered into a ratification agreement with IE pursuant to which Greenleaf's surety agreed to pay IE for work previously performed under the subcontract and IE agreed to perform the balance of the work for the remaining unpaid subcontract balance in accordance with the terms of IE's subcontract. Disputes arose between IE and the surety's consultant, resulting in IE not returning to the project. Ultimately, Greenleaf's surety terminated IE for default and asserted a claim against IE's performance bond. IE's surety refused to complete IE's subcontract; thus, Greenleaf's surety arranged with another electrical subcontractor to complete IE's scope of work. That contractor concluded that much of IE's work needed to be redone and charged Greenleaf's surety a substantial premium to complete IE's scope of work.

This action began as a claim by the federal government against Greenleaf, IE and their respective sureties on behalf of an unpaid subcontractor. Although that claim was resolved, Greenleaf's surety asserted claims against IE and its surety in the litigation. The trial court granted Greenleaf's surety partial summary judgment on the grounds that it may assert claims against the performance bond issued by IE's surety, the bond was not discharged by replacement or material alternation and IE's surety's obligations were triggered by the satisfaction of the bond's conditions precedent. After a bench trial, the trial court entered judgment in favor of Greenleaf's surety and against IE's surety in the full penal sum of IE's performance bond. IE's surety appealed on the grounds that: (1) Greenleaf's surety was not Greenleaf's successor entitled to assert a claim on the bond; (2) the Ratification Agreement discharged IE's surety under the performance bond because it was either an entirely new agreement or materially altered IE's subcontract; and (3) Greenleaf's surety's claims did not meet conditions precedent to the performance bond's coverage. The Eighth Circuit rejected all three arguments and affirmed the district court's entry of judgment against IE's surety.

With respect to the successor issue, the court found that by satisfying Greenleaf's

obligations under the prime contract and IE's subcontract, Greenleaf's surety became subrogated to Greenleaf's rights through equitable subrogation. Although IE's surety urged the court to adopt a narrower definition of successor that is more in tune with corporate law, the court found that when a general contractor's surety takes over completion of a federal government construction project and steps into the shoes of its principal, "the purposes of the Miller Act and the FAR regulations to protect the government are served if the surety is subrogated to the principal's contract rights vis-à-vis a subcontractor such as [IE] and, if the subcontractor defaults, its surety."

The court found IE's surety's arguments with respect to the material alteration to be "a more difficult issue." After examining case law and the Restatement (Third) of Suretyship & Guaranty, the court held that the Ratification Agreement did not materially alter IE's obligations under the subcontract. Specifically, the Ratification Agreement expressly left IE's performance obligations, time to complete its work and compensation unchanged. Although IE's surety argued that the Ratification Agreement was a material and prejudicial alteration to the subcontract because the chief financial officers of IE and Greenleaf were close personal friends, the court rejected the argument "because it would automatically discharge a subcontractor surety's performance bond whenever the general contractor's surety operating under a Takeover Agreement becomes a successor bond obligee." IE's surety additionally argued that the Ratification Agreement was a material alteration because, as a result of changing the bond obligee, IE's surety has been ordered to pay hundreds of thousands of dollars to redo work that Greenleaf accepted. Again, the court rejected this argument because the claim arose from defective work IE performed before Greenleaf's surety took over the project and that such claim could have been asserted notwithstanding the default or the existence of the Ratification Agreement.

Finally, the court dismissed IE's surety's arguments with respect to failure to comply with conditions precedent. IE's surety argued that one such condition precedent was that Greenleaf could not be in default under the subcontract and that Greenleaf could not have been performing thereunder because it was terminated under the prime contract. The court found that this contention was without merit because it was inconsistent with Greenleaf's surety's rights as successor obligee and because no allegation has been asserted that Greenleaf's surety failed to perform under IE's subcontract. The court rejected as frivolous the contention that the notice of default to IE was ineffective because it was sent by Greenleaf's surety's consultant instead of directly from the surety.

Seventh Circuit Holds Release of Rights Under Indemnity Agreement Precludes *Quia Timet* Relief Even Though Surety Reserved Rights to *Quia Timet* Claims in Settlement Agreement

Fid & Fep. Co. of Md. v. Edward E. Gillen Co., 926 F.3d 318 (7th Cir. 2019).

Edward E. Gillen Company ("Gillen") entered into a joint venture with two other entities to perform a harbor construction project in Chicago. The joint venture subcontracted some of the work to Gillen, which in turn subcontracted with various other companies for labor and materials. The joint venture obtained over $30 million in performance and payment bonds. The bonds were secured by an indemnity agreement and a net worth retention agreement executed by, among others, Gillen. Over a dozen subcontractors sued Gillen and its surety, alleging failure to pay for labor and materials used on the harbor project. Although several of the suits have been resolved, several remained pending. The surety sued Gillen in federal court, alleging, among other things, breach of the indemnity agreement and *quia timet*. After several years of litigation, the parties settled all claims at mediation, with the exception of the surety's *quia timet* claim. Gillen filed a motion for summary judgment seeking to dismiss the *quia timet* claim, which was granted by the district court. The surety appealed.

The court examined the history of the doctrine of *quia timet* and explained its usage in modern litigation. The court noted that the district court granted Gillen summary judgment on the *quia timet* claim on account of Gillen's insolvency. The Seventh Circuit held, however, that insolvency does not preclude *quia timet* relief. Indeed, "a principal's insolvency may often serve as a reasonable basis for a surety to

fear the principal's nonperformance or nonpayment and seek court intervention."

Notwithstanding the district court's error, the circuit court affirmed the dismissal on the grounds that the surety cannot "use general equitable principles to obtain rights beyond those for which it negotiated in a written indemnity agreement." The court held that "after negotiating for specific collateralization and indemnification rights, suing on that indemnity agreement, and then settling its breach of contract claims, [the surety] cannot now use this ancient equitable doctrine to get additional relief."

Bankruptcy Court Holds that Surety's Equitable Subrogation Right to Recover Retainage Is Superior to Creditor's Previously Perfected Security Interest

Kappa Dev. & Gen. Contracting Inc. v. Hanover Ins. Co. (In re Kappa Dev. & Gen. Contracting Inc.), 2019 WL 2867110 (Bankr. S.D. Miss July 2, 2019).

Kappa Development and General Contracting Inc. ("Kappa") executed a promissory note in favor of The First, a national banking association ("The First"), together with a number of modifications thereto. In connection therewith, The First filed a UCC Financing Statement that covered, among other things, Kappa's interests in accounts receivable. Subsequently, Kappa entered into a number of unrelated government contracts for which the surety issued performance and payment bonds. Ultimately, the surety was required to make payments to Kappa's subcontractors and suppliers under its payment bonds on two projects. The surety was also required to pay workers compensation premium on account of Kappa's failure to remit same with respect to one of the bonded projects.

Ultimately, The First disputed the surety's arguments that its rights to the contract balances under the theory of equitable subrogation were superior to The First's rights, arguing that the surety made voluntary payments and that Kappa did not sign one of the payment bonds. The court rejected both arguments, finding that (a) "the record speaks for itself" with respect to the surety's obligation to make the payments, and (b) "…the [p]ayment [b]ond binds [the surety] jointly and severally with Kappa...

The court found that, as a matter of law, the surety's rights to retainage were superior The First's rights therein because "the surety's right of equitable subrogation is based on equity, not the U.C.C." and "it is immaterial whether The First filed its financing statement before or after the Bond was issued." In reaching this conclusion, the court rejected The First's arguments that the contract balances were not retainage as being without merit. It appears that under Mississippi law, "the surety's right of equitable subrogation extend only to retainage, not to progress payments". Although the issue was not dispositive in this matter because the court found that the funds were retainage, Mississippi law on this issue is a departure from established case law in virtually every other jurisdiction. If an obligee can exercise its right of setoff in progress payments, the surety's equitable subrogation rights should allow it to step into the obligee's shoes and therefore extend to such progress payments.

Finally, the court found that the surety's subrogation right includes the right to be indemnified for its expenses and attorney's fees incurred as the result of Kappa's default. The court provided the surety with fourteen days to submit a request for attorney's fees and expenses paid as a result of Kappa's defaults.

District Court in Hawaii Denies Surety's Motion to Dismiss Based on Questions of Fact and Finds that No Court Has Resolved Whether Bad Faith Claims May Be Asserted Against Sureties in Hawaii

Nan, Inc. v. AIM Steel Int'l Corp., 2019 WL 3646576 (D. Haw Aug. 6, 2019).

Nan, Inc. ("Nan"), a prime contractor, issued a purchase order to AIM Steel International Corp. ("ASIC") under which ASIC was to deliver certain materials to Nan. ASIC provided a supply contract bond in the penal sum of $3,836,891.02 naming ASIC as principal and Nan as obligee. Nan commenced an action against ASIC and the surety, alleging that ASIC failed to deliver the material required by the purchase order and that the surety was in breach of the bond. Nan also asserted a claim for bad faith against the surety.

The surety filed a motion to dismiss on the grounds that: (1) Nan failed to provide

sufficient notice of ASIC's default; (2) Nan failed to bring suit within the later of one year of final payment under the purchase order or one year following the expiration of any express warranty provided under the purchase order; and (3) Hawaii courts have not recognized a bad faith claim against a surety. The court denied the surety's motion. First, the court found that "at this stage of the proceedings the Court will not make a factual determination" with respect to the sufficiency of the notice provided by ASIC. Second, the court held that the surety's argument with respect to final payment "rests on a flawed assumption: that the final payment had to be made prior to or on the date of termination." The court found that simply terminating a contract does not mean that any payment occurring thereafter is not a payment under the contract and that such argument would require the court to make factual determinations, which, at best, appear to be disputed, and thus, are inappropriate in the context of a motion to dismiss.

Finally, with respect to the bad faith claims, the court observed that it was a "much closer call." Nevertheless, at this stage in the proceedings, "the Court [did] not believe it appropriate to wrestle with whether a bad faith claim may be asserted against a surety under Hawaii law because, to do so, required further factual development of the record." Although the Hawaii Supreme Court has found that bad faith claims may be brought in the insurance context under certain limited circumstances, no court in Hawaii has yet decided whether a bad faith claim may be asserted against a surety.

Court Finds That Performance Bond's Incorporation of Bonded Subcontract Is Limited and Does Not Bind Surety to The Terms of the Subcontract, Including Its ADR Provisions

The Hanover Ins. Co. v. E.E. Cruz & Tully Constr. Co., 2019 WL 3778348 (N.Y. Sup. Ct. Aug. 12. 2019).

E.E. Cruz & Tully Construction Co., A Joint Venture, LLC ("CTJV") entered into a general contract with the New York City Transit Authority to perform certain work on the New York City subway system. CTJV, in turn, entered into a subcontract with 4J's Plumbing LP ("4J's") for plumbing, fire standpipe and temporary fire standpipe work. CTJV ultimately terminated 4J's subcontract and made a demand upon 4J's surety to complete the subcontract. 4J's surety agreed to complete the Subcontract and entered into a Letter Agreement with CTJV, which provided, among other things, that the surety agreed to be paid in accordance with the terms of the subcontract. CTJV was satisfied with the completion contractor's work, but CTJV failed to timely payments to the surety. The surety sent several notices to CTJV in connection with its failures to make payments due, as well as payments for extra work pursuant to change orders which the surety submitted to CTJV. The surety ultimately declared CTJV to be in default and sent a Termination Letter listing each of CTJV's alleged breaches and excusing the surety from further performance. The surety subsequently commenced an action asserting breach of contract and quantum meruit. CTJV filed a motion to dismiss the complaint.

First, CTJV argued that the performance bond incorporated the terms of the subcontract between 4J's and CTJV and that the surety agreed in the Letter Agreement that CTJV would pay the surety "in accordance with the terms of the subcontract." Although the decision did not elaborate why the plenary incorporation of the subcontract would have excused CTJV from making timely payment, the court held that the surety did not agree to be bound by the subcontract. Instead, the surety agreed only that CTJV may process payment applications "in accordance with the terms of the subcontract."

Second, CTJV argued that the complaint should be dismissed because the surety failed to fulfill the subcontract's express condition precedent that the parties mediate prior to arbitration or mediation. Although the court previously found that the subcontract was not incorporated into the performance bond, the court added that "arbitration clauses must be specifically incorporated into the performance bond even if one exists between the original parties to the subcontract." Inasmuch as the performance bond contemplated litigation (i.e., "any suit under this bond must be instituted before the expiration of one year from the date on which final payment under the subcontract falls due") and there was no language in the performance bond specifically incorporating the ADR provisions, failure to comply with this

condition precedent does not defeat the surety's claims.

CTJV raised other defenses arising out of the subcontract, but the court rejected each of them based upon the lack of incorporation of the subcontract. The court did, however, dismiss the surety's quantum meruit claims on the basis that the surety performed pursuant to a written agreement. Accordingly, the quantum meruit claim was duplicative of the surety's breach of contract claim.

Bankruptcy Court Extends Automatic Stay to State Court Litigation Against Payment Bond Surety

Durr Mech. Constr., Inc. v. I.K. Constr. Inc. (In re Durr Mech. Constr., Inc.), --- B.R. ----, 2019 WL 3806002 (Bankr. S.D.N.Y Aug. 12, 2019).

Durr Mechanical Construction, Inc. ("Durr") entered into a general contract with Covanta Essex Company ("Covanta") to provide construction management and other services relating to the building of three incinerators in Newark, New Jersey. Durr subcontracted with I.K. Construction Company ("I.K.") to perform the structural steel work for the project in the amount of $4,410,000. The subcontract permitted Durr to terminate for delay or to perform work if I.K. failed to cure its default after three-days' notice. Durr ultimately terminated I.K. after sending a three-day cure notice and arranged for completion of I.K.'s scope of work. Although I.K.'s remaining contract balance was $533,700, Durr contended that I.K. was not due anything because it cost $1,305,614 to complete I.K.'s scope of work. I.K. contends that Durr wrongfully terminated the subcontract after I.K. completed approximately 95% of the agreed-upon work and needed less than one month to complete its work. I.K. additionally contends that any delay may have been attributable to issues arising out of the contract between Durr and Covanta.

I.K. asserted a payment bond claim against Durr's surety demanding payment in the aggregate sum of $1,924,128. The claim included, among other things, retainage, alleged change orders and progress payments. On February 17, 2017, I.K. commenced litigation against Durr and its surety in the Superior Court of New Jersey. On December 7, 2018, Durr filed a chapter 11 petition in Bankruptcy Court for the Southern District of New York. Inasmuch as I.K. did not seek relief from the automatic stay, Durr was administratively dismissed from the New Jersey litigation. However, I.K.'s claims against Durr's surety remained pending.

On March 7, 2019, I.K. filed a proof of claim in the bankruptcy court in the amount of $1,924,128 (the same amount as the bond claim). Durr commenced an adversary proceeding against I.K. in the bankruptcy court seeking, among other things, declaratory and/or injunctive relief against I.K. with respect to its claim and to extend the automatic stay to enjoin the I.K.'s claims against Durr's surety in the New Jersey litigation. Durr subsequently filed a motion seeking to extend the automatic stay to the New Jersey litigation, arguing that the continuation of said litigation will have an immediate, adverse economic impact on the estate because Durr has "an absolute obligation under the [Indemnity Agreement] to indemnify [the surety] for its litigation expenses, including its attorneys' fees." Durr added that its indemnity obligation will increase the surety's secured claim and diminish the recovery available to other creditors. Durr also argued that the New Jersey litigation will draw Durr and its personnel into protracted litigation on the surety's behalf, draining valuable time and resources from Durr at a critical juncture in the bankruptcy case. I.K.'s response to the motion was that it would be inequitable to compel I.K. to re-assert its claims in the bankruptcy case because it already spent two-and-a-half years litigating them in the New Jersey litigation, which is less than one month away from trial. I.K. also argued that Durr failed to show any immediate, adverse economic consequence that would follow from the continued prosecution of the New Jersey litigation against the surety.

The court granted Durr's motion and extended the automatic stay to I.K.'s claims against Durr's surety in the New Jersey litigation. Although the court acknowledged the general rule that the automatic stay "may not be invoked by entities such as sureties…", the court cited to Second Circuit precedent recognizing a limited exception to the general rule "in circumstances where a claim against the non-debtor will have an immediate, adverse economic impact on the estate." The court held that because Durr had an "absolute obligation to indemnify" the surety for its losses, which was secured by Durr's assets,

"the continuation of the New Jersey litigation against [the surety] will have an immediate, adverse economic impact on the estate and its unsecured creditors." The court observed that the adverse impact was exacerbated by I.K.'s actions and inactions. Rather than seek relief from the automatic stay to pursue its claims against Durr in the New Jersey litigation, I.K. allowed its claims against Durr to be dismissed and filed a claim in the bankruptcy court, thereby subjecting itself to the bankruptcy court's equitable jurisdiction and claims resolution process. Because Durr filed the adversary proceeding in connection with I.K.'s claim, allowing I.K. to proceed with the New Jersey litigation would require Durr to pay for the same trial twice: (i) the New Jersey litigation against the surety, and (ii) in the bankruptcy court as part of the claims allowance process.

Miller Act Does Not Preclude Claimant From Asserting Separate Bad Faith Claim Under State Law

U.S. ex rel. Metal Sales Mfg. Corp. v. A.C. Dellovade, Inc., 2019 WL 4060876 (W.D. Okla. Aug. 28, 2019).

Metal Sales Manufacturing Corporation ("MSMC") agreed to supply Dellovade, Inc. ("Dellovade") with materials pursuant to a subcontract related to a construction project on Tinker Air Force Base. MSMC provided materials to Dellovade, but never received payment. MSMC unsuccessfully attempted to collect payment from Dellovade's surety and subsequently commenced an action against Dellovade and its surety, alleging two claims against the surety, as follows: (i) breach of contract and the Miller Act; and (ii) bad faith. The surety filed a motion to dismiss the bad faith claim, arguing that federal law preempts it and that it was insufficiently pled.

The surety argued that the Miller Act provided MSMC with its sole avenue of relief regarding the non-payment of federal construction contracts and that the state bad faith claim must be dismissed. Relying on Tenth Circuit precedent, the district court held that the Miller Act does not preclude alternative forms of recovery under state law. Although applicable case law proscribes MSMC from seeking bad faith under the Miller Act, it does not prohibit MSMC from seeking separate state law claims premised on the underlying contract (including bad faith). The court also rejected the surety's argument that MSMC's cause of action for bad faith was insufficiently pled.

Fidelity Casenotes

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

Minnesota Federal District Court Denies Cross Motions for Summary Judgment Concerning Rescission

Nat'l Credit Union Admin. Bd. v. CUMIS Ins. Society, Inc., 2019 WL 1229793 (D. Minn. March 15, 2019).

In January 2014, St. Francis Campus Credit Union ("St. Francis") discovered that one of its managers embezzled over $3,000,000.00. Shortly thereafter, the National Credit Union Administration Board ("NCUAB") was appointed receiver, "in whole or in large part" due to the loss. CUMIS Insurance Society, Inc. ("CUMIS") had issued a fidelity bond to St. Francis. In late 2014, the NCUAB submitted a proof of loss with CUMIS. In June 2015, CUMIS reached out to the NCUAB to inform it that

CUMIS was rescinding the bond. CUMIS called the NCUAB's in house counsel and emailed the NCUAB's outside counsel to convey this determination. CUMIS attached copies of the rescission letter and the return of premium check to the email to make the NCUAB aware that the same were in the mail. The stated basis for the rescission was the fidelity principal's purportedly false statement in the application that she had no knowledge or information of any act, error or omission that might give rise to a claim. After receipt, the check and letter were separated in the NCUAB's mailroom, after which personnel at the NCUAB deposited the check in the normal course. In addition, due to an error at CUMIS, CUMIS issued a second check that the NCUAB also deposited.

In January 2016, the NCUAB commenced suit against CUMIS seeking a declaration that CUMIS must provide coverage for the loss. Prior to the opening of discovery in the matter, CUMIS filed a motion for summary judgment arguing that it had rightfully rescinded the bond because either the manager's misrepresentation was grounds for rescission under Minnesota state law or the NCUAB agreed to the rescission by virtue of the cashing of the premium refund check. The court denied CUMIS's motion, but it noted that the discovery phase of the litigation could provide the necessary support to grant such a motion.

Later, CUMIS renewed its motion arguing again that the NCUAB's depositing of the check and failure to respond to the rescission letter clearly showed that the NCUAB agreed to the rescission. The NCUAB cross-moved, arguing that the loss represented a covered claim under the bond, and that the NCUAB had satisfied all other conditions in the bond. The NCUAB also argued that the misrepresentations in the bond application could not be imputed to the NCUAB. Finally, the NCUAB argued that the Federal Credit Union Act protects the NCUAB from the rescission of the bond.

The court determined that material issues of fact remained as to the rescission issue but that the Federal Credit Union Act does not shield the NCUAB from a claim for mutual rescission. The court's opinion focused largely on whether there was a mutual rescission on the facts presented. CUMIS's main argument was that because the NCUAB did not respond to the denial/rescission letter <u>and</u> it deposited the return of premium check that the NCUAB clearly and unequivocally agreed or expressed agreement on the issue of rescission. CUMIS pointed to the fact that at least five attorneys at the NCUAB were aware of the letter and, therefore, the NCUAB was well advised on the consequences of not responding and depositing the check, going so far as to find another similar claim where the NCUAB responded to a similar letter and returned the check as opposed to depositing it. In sum, CUMIS argued that the NCUAB's actions demonstrate that it had the requisite knowledge and intent as to rescission when it cashed the premium return check. In response, the NCUAB argued that while the matter was reviewed by several attorneys, there was no intent to agree to rescission simply due to the depositing of the check, as the mailroom process had separated the check from the denial letter. Further, the NCUAB argued that it never agreed to the rescission, demonstrated most clearly by the filing and serving of the complaint in the litigation.

In finding material issues of fact preventing an award of summary judgment either way, the court was unwilling to hold that the failure to respond to the denial letter and the depositing of the check amounted to an actual intent to agree to rescind. The court noted that while the NCUAB could have acted in a more prudent manner upon receipt of the letter and check, about which it had advanced notice, mere inaction with respect to the letter coupled with the what probably amounted to an internal miscommunication with respect to the check does not unequivocally support the contention that the NCUAB intended to rescind or agree to the rescission of the bond. As a result, the court determined that fact issues remained with respect to the NCUAB's intent to rescind, and that whether the NCUAB's actions "clearly expressed" an intent to rescind or rejection of CUMIS's rescission are questions of fact best suited for a jury. Finally, the court held that the Federal Credit Union Act does not shield the NCUAB from a finding of mutual rescission.

New Jersey Federal Court Partially Denies Motion to Dismiss in Social Engineering Matter

The Childrens Place, Inc. v. Great Am. Ins. Co., 2019 WL 1857118 (D.N.J. April 25, 2019).

In July 2017, the insured discovered that two payments totaling $967,714.29, intended for a real vendor of the insured, were instead made to an unknown third-party. According to the insured, the perpetrator impersonated not only the vendor but the insured as well in the email communications. Specifically, the perpetrator impersonated the vendor when communicating with the insured and impersonated the insured when it provided a Vendor Setup Form to the vendor. The Vendor Setup Form, containing the payment instructions, is used by the insured to assist in setting up the vendor for future payments. Here, according to the insured, the perpetrator provided the Vendor Setup Form with alternate payment instructions so as to divert all payments to the perpetrator's account. The communications from the perpetrator informed the insured of the new payment instructions, changed because of an "audit," and directed payment in accordance with the fraudulent payment details provided. In accordance with the instructions, the insured made a payment of $498,753.58 and three days later made a second payment of $468,960.71. The insured submitted its claim for the loss to the carrier seeking coverage under the Computer Fraud, Forgery or Alteration and Fraudulently Induced Transfers coverage. The carrier denied coverage under the policy.

The insured commenced suit seeking a declaratory judgment as to coverage and relief due to a purported breach of contract. In response, the carrier moved to dismiss, arguing that the Computer Fraud and Forgery or Alteration insuring agreements do not provide coverage and that the insured failed to comply with a condition precedent to the Fraudulently Induced Transfers insuring agreement. The court dismissed the counts related to the Forgery or Alteration and Fraudulently Induced Transfers coverage, and it denied the carrier's motion to dismiss with respect to the claim for coverage under the Computer Fraud insuring agreement.

With respect to Computer Fraud, the carrier argued that the insured did not allege facts showing that the perpetrator gained access to the insured's computer system or that, even if such access occurred, that it caused the transfer of funds. The court refused to dismiss this count on these grounds. In doing so, the court highlighted allegations in the complaint that, whether accurate or not, allege that the perpetrator accessed and used the insured and its vendor's email systems. The veracity of these allegations in the complaint, according to the court, could not be resolved on a motion to dismiss. As a result, the court denied the carrier's motion to dismiss the count related to the Computer Fraud insuring agreement.

However, the court did grant the carrier's motion to dismiss the counts related to the Forgery or Alteration and Fraudulently Induced Transfers. As to the former, the court agreed with the carrier that, assuming there was a forgery on the Vendor Setup Form or other correspondence purportedly from the vendor, those documents are not promises or orders to pay, and they do not direct the payment of a sum certain. The court found that none of the documents that the insured claims contained a forgery or alteration are the type contemplated under the insuring agreement (i.e., checks, drafts, promissory notes, or similar written promises, orders, or directions to pay a sum certain…). Accordingly, the insured's allegations fail to state a claim under the insuring agreement. As to the Fraudulently Induced Transfers insuring agreement, the carrier argued that there could be no coverage under the facts alleged in the complaint because the insured had failed to perform a callback verification with respect to the change in payment instructions sent by the perpetrator. Rather than stating that it complied with this condition in the policy, the insured stated that the condition made the coverage illusory. The court refused to agree and agreed with the carrier in dismissing this count.

In its opinion, the court afforded the insured an opportunity to amend its complaint.

Supreme Court of Wisconsin Affirms Decision that Forged Delivery Tickets Fall Outside the Scope of Forgery or Alteration Coverage

Leicht Transfer & Storage Co. v. Pallet Cent. Enter., Inc., 928 N.W.2d 534 (Wis. 2019).

The plaintiff in this matter is a warehousing service company that routinely uses

pallets to assist in the shipping and storing of items. Between January 2013 and February 2015, the plaintiff purchased pallets from the above-named defendant. As part of that relationship, the parties developed a course of conduct whereby the defendant would prepare a delivery ticket that would state the number and type of pallets, delivery date and identify the trailer delivering the goods. Once delivered, the personnel for the plaintiff would verify the shipment and sign the delivery ticket. The defendant would use the signed delivery ticket as part of the invoicing process back to the plaintiff. At some point, the plaintiff noticed a dramatic increase in the amount of invoices for pallets. After conducting an internal investigation, the plaintiff determined that it received delivery tickets with forged signatures of its own personnel. All told, the plaintiff alleged that the defendant submitted $751,000.00 worth of delivery tickets of which plaintiff paid $505,000.00.

The insured submitted its purported loss to its commercial crime carrier, alleging a loss under the Forgery or Alteration insuring agreement. The carrier denied coverage and the insured commenced suit. Thereafter, the carrier moved for summary judgment arguing that the delivery tickets were not the type of documents identified in the Forgery or Alteration insuring agreement ("checks, drafts, promissory notes, convenience checks, HELOC checks, or similar written promises, orders or directions to pay a sum certain …") that must be drawn upon the insured. The insured argued that the delivery tickets were used by the defendant pallet provider as a means of directing payment and were therefore a direction to pay a sum certain. The lower court agreed with the carrier and granted the motion. The insured appealed.

On appeal, the insured argued that the phrase "similar written promises, orders or directions to pay a sum certain" was ambiguous and such ambiguity should weigh in the insured's favor. Reviewing the matter *de novo* the Supreme Court of Wisconsin affirmed. The court first broke the coverage under the insuring agreement into three parts. The insured must show: (1) that a delivery ticket is included in the list of enumerated documents; (2) that it is made or drawn upon the insured, or purported to be so made or drawn; and (3) that the loss resulted directly from the forgery. On the first element, the court found no ambiguity in the policy. Examining the delivery tickets, the court found no actual directions to anyone to pay anything. In addition, the court was unable to find any reference to a sum certain. In fact, at oral argument, the insured admitted that the receipt of a delivery ticket alone would not have generated a payment. Importantly, the court went on to say that even if you bundle the delivery ticket with the corresponding invoice there would still be no coverage because the invoice is a "request for payment, not a direction to pay." In this regard, the court noted that the combination of a document representing proof of delivery and another document representing a request for payment does not transform the two into an enumerated document contemplated by the insuring agreement. Before closing its opinion, the court also carefully examined a distinction made by the insured, to wit, that while the delivery ticket <u>is</u> not direction to pay, it <u>functioned</u> as such; therefore, there should be coverage. The court resorted back to the plain language of the policy in ruling that such a distinction cannot be the basis for coverage. The insuring agreement must be applied as written, and covered claims, according to the court, will only include those sets of facts involving the actual documents referenced in the insuring agreement, not those that may play the same role as some form of proxy.

Of note, this opinion contains a dissenting opinion by one justice who determined that all elements of the coverage existed, and that a reasonable person would conclude that all conditions for coverage were fulfilled.

<u>Washington Federal Court Dismisses Computer Fraud Claim Under Social Engineering Exclusion</u>

Tidewater Holdings, Inc. v. Westchester Fire Ins. Co., 2019 WL 2326818 (W.D. Wash. May 31, 2019).

In November 2017, an accounts payable clerk at the insured received a fraudulent email directing the clerk to change the payment information the insured had on file for a general contractor. In response, the clerk complied. Thereafter, the insured paid $568,448.92 per the fraudulent payment instructions. After an

internal investigation, and with the help of a consulting firm, the insured recovered $288,288.91, resulting in a net loss of $280,060.01 plus the cost of the investigation. The insured submitted a claim to its carrier for coverage. The carrier acknowledged coverage under a supplemental funds transfer provision, provided by endorsement, and offered to reimburse the cost of the investigation, subject to the respective limits and deductibles. The referenced funds transfer coverage carried a $150,000.00 limit and a $25,000.00 deductible. The insuring agreement under which the carrier offered to reimburse the insured for the cost of the investigation carried a $25,000.00 limit and a $5,000.00 deductible. The insured interpreted this offer by the carrier as a denial under the computer fraud provision and rejected the offered payment. The lawsuit and a motion to dismiss by the carrier ensued.

The court first rejected the carrier's attempted application of recent case law concerning similar factual scenarios but apparently dissimilar policy language. The court found the sweeping conclusions by the carrier based on case law interpreting completely different policies to be unpersuasive. Rather, the court set out to interpret the policy under the facts presented. In doing so, the court assumed for the purposes of argument that the policy covered the loss under both the computer fraud coverage, as argued by the insured, and the funds transfer coverage, as argued by the carrier. In fact, at no point does the opinion determine whether the facts presented would actually trigger coverage under the computer fraud provision. The court highlighted an exclusion accompanying the funds transfer coverage in the endorsement that read: "[w]ith respect to all Insuring Clauses other than the Supplemental Funds Transfer Insuring Clause, the Insurer shall not be liable for any loss result from any Fraudulent Transfer Request." The insured's argument before the court was that this exclusion was ambiguous. The court disagreed and stated that a fair and reasonable reading of the exclusion was that it was not ambiguous and that it applied to the matter at hand. As a result, the court found for the carrier and agreed that coverage in this instance was limited to the supplemental funds transfer provision, excluding coverage under all other insuring agreements, including the computer fraud provision.

New York Federal Court Dismisses Computer Fraud Claim Under Social Engineering Exclusion

Children's Apparel Network Ltd. v. Twin City Fire Ins. Co., 2019 WL 3162199 (S.D.N.Y. June 26, 2019).

In August 2018, multiple executives of the insured received an email purportedly from a paralegal working at a law firm retained by the insured. The fraudulent email requested payment in the amount of $755,250.00 from the CEO of the insured, and requested the insured make the payment to a specific bank account in Hong Kong. Not long after the receipt of this email, other executives at the insured received a second email purportedly from the president of the insured directing them to wire $755,250.00 to a bank in Hong Kong. Under the impression that the emails were real, personnel at the insured ordered the wire transfer. It appears as if the insured discovered the fraudulent nature of the emails the next day, and it unsuccessfully attempted to reverse the transfer.

The insured tendered the matter to the carrier seeking coverage for the loss. The carrier reviewed coverage under the computer and funds transfer fraud coverage, and it denied the claim under these insuring agreements citing an exclusion for loss involving deception fraud. Instead, the carrier directed the insured to the limited coverage provided by another insuring agreement that deals specifically with deception fraud. This insuring agreement carried a $15,000.00 limit which the carrier paid to the insured. Thereafter, the insured commenced litigation seeking redress for the whole loss, and the carrier moved to dismiss.

The court granted the carrier's motion to dismiss, upholding the validity of the exclusion at issue dealing with deception fraud. The insured's main argument was that it was entitled to coverage under the computer fraud and funds transfer coverage, and the exclusion cited by the carrier was ambiguous and rendered the coverage illusory. The court rejected all of the insured's arguments. The carrier's main point appears to have been that regardless of the insuring agreement concerning computer fraud and funds

transfer fraud, the exclusion as to deception fraud served to exclude the loss other than the coverage provided in the specific insuring agreement dealing with deception fraud.

The court first held that the exclusion at issue was not ambiguous. Second, the court held that the facts of the claim presented a situation squarely addressed by the exclusion. Specifically, the exclusion applies to scenarios where an insured employee is tricked by a perpetrator impersonating an employee, owner or vendor. The court held the exclusion unambiguously and aptly applied to the purported senders of the two emails in question. The scenario also met the definition of deception fraud, as the emails were attempts to intentionally mislead an employee of the insured to part with funds. Finally, the court addressed the insured's argument that the exclusion rendered the policy illusory. The court again sided with the carrier, identifying at least two scenarios where there could be coverage under the policy's computer fraud and funds transfer fraud coverages without implicating the exclusion at issue.

LEGISLATIVE UPDATE

By: Angela Gleason, Associate Counsel, American Property Casualty Insurance Association, Washington, D.C.

Included below is a sampling of bills adopted during the 2019 legislative sessions. The Indiana legislature clarified that Public Private Partnerships must be bonded; and Kentucky, Rhode Island and Wyoming all increased their bond threshold for public works projects. Additionally, Missouri and Illinois both extended their payment bond requirements to expand the parties eligible to benefit from the bond protections. For example, in Illinois bond coverage must include not only the material used in the work, but also the apparatus, fixtures and machinery used in the work. Contract surety legislation was also passed in Florida to provide for a forfeiture of a claimant's rights under a bond if it files a fraudulent notice of non-payment. In the commercial surety space, we did not see the level of enacted laws eliminating occupational licensing requirements that we might otherwise have expected given increased state activity in this area. In fact, Alabama increased the bond requirement for motor vehicle dealer bonds and there is a new licensing requirement for consumer loan companies in Kentucky. For complete details about these bills and a sampling of other surety issues, please see the statutory section or bill number identified in the text and footnotes below.

Alabama

<u>Increase in Motor Vehicle Dealer License Bond</u>

The penal sum of the license bond required for a master dealer has been increased from $25,000 to $50,000 or an amount prescribed by the Department of Revenue.[61] A master dealer license can be issued to a new motor vehicle dealer, used motor vehicle dealer, motor vehicle rebuilder, or motor vehicle wholesaler. A new requirement also has been added to the bond to include coverage for the penalty costs as well as

[61] Ala. Code § 40-12-398 (H.B. 393).

the failure to pay the tax liability incurred from the sale of a motor vehicle.

Alaska

Alcoholic Beverage Tax Bond Exemptions

Every alcoholic beverage brewer, distiller, bottler, jobber, wholesaler and manufacturer must furnish a $25,000 surety bond to cover any failure to pay taxes.[62] Senate Bill 16 creates a new exemption to this requirement such that any brewer, distiller, bottler, jobber, wholesaler and manufacturer that has timely filed monthly tax returns and paid monthly taxes over the most recent 3 consecutive years will not be required to maintain a bond.

Arkansas

General Contractor License Bond

Arkansas has been a key state in recent efforts to review and reform occupational licensing requirements. During the 2019 legislative session, legislators addressed contractor and subcontractor licensing requirements. Under existing law[63] any person seeking to be licensed by the Contractors Licensing Board (Board) must provide a copy of their financial statement, which has been reviewed by a certified public accountant. S.B. 342 amends this requirement to allow the contractor to provide a surety bond in lieu of providing the financial statement. The bond amount shall be ten times the required net worth for the licensee's classification. In addition, the State shall be listed as an obligee of the bond for the benefit of any person damaged by an act or omission of the licensee and the State shall have priority over all other claims against the bond. Sixty-days advanced notification of cancellation of the bond must also be provided to the Board. Additionally, subcontractors will now be exempt from licensing requirements, if they are properly registered with the Board.

Connecticut

Paid Family Leave Self-Insurance Bond and Public Official Bond

The Connecticut legislature created a new Paid Family Leave Act (Act)[64]. For an employer to be approved as meeting its statutory obligations through a private plan in the form of self-insurance, the employer must furnish a surety bond in a form approved by the Paid Family and Medical Leave Insurance Authority (Authority) and in an amount determined by the Insurance Department. The Act also requires the Authority to establish a Board of Directors. Every officer or member of the Board authorized to handle funds or sign checks shall execute a $50,000 surety bond. As an alternative, the Chairman may obtain a $50,000 blanket bond for the executive director and each member of the board and authorized employee.

Florida

Contract Surety (Public Construction) – Bond Forfeiture for Fraudulent Notice of Nonpayment

In Florida an action for labor, services, or materials may not be instituted against a contractor or surety unless a notice to the contractor and notice of nonpayment have been served as required by law. A new provision[65] is added to the law which will forfeit a claimant's rights under the surety bond, if such claimant files a fraudulent notice of nonpayment. A notice is fraudulent if: (1) there is willful exaggeration of the amount unpaid; (2) there is willful inclusion of a claim for work not performed or materials not furnished; or (3) it is prepared with such willful and gross negligence as to amount to a willful exaggeration. A minor error or good faith dispute in the amount unpaid does not operate to defeat an otherwise valid claim against the bond. The law also states that the negligent inclusion or omission of any information in the notice of nonpayment (required contents are identified in the statute) that has not prejudiced the contractor

[62] Alaska Stat. § 43.60.040.
[63] Ark. Code Ann. § 17-25-304 (S.B. 342).
[64] Public Act 19-25 (S.B. 1; not yet chaptered).
[65] Fla Stat. § 713.23.

or surety does not constitute a default that operates to defeat an otherwise valid bond claim.

Illinois

Payment Bond Coverage

Under existing law,[66] the payment bond guarantees payment for material used in the work and all labor performed in the work. The legislature expanded the coverage to require the bond guarantee payment for not only the material used in the work, but also the apparatus, fixtures and machinery used in the work. "Material, labor, apparatus, fixtures, and machinery" include rented items that are on the construction site and those rented tools that are used or consumed on the construction site in the performance of the contact on account of which the bond is given.

Indiana

Public Private Partnerships

Indiana has three separate public-private-partnership (P3) enabling statutes. These authorize P3s for public facility projects, Indiana Finance Authority projects, and Department of Transportation projects. As of July 2, 2019, each of these authorizing statutes will contain language requiring a payment bond for not less than 100% of the design and construction costs and a performance bond in an amount not less than 50% of the design and construction costs.[67]

Kentucky

Payment and Performance Bond Threshold

The Kentucky Little Miller Act for local government public projects[68] has been amended to increase the threshold from $25,000 to $100,000.

Consumer Loan Company License Bond

Kentucky will now require a consumer loan company (company engaged in providing loans to consumers for personal, family or household use in an amount or value of $15,000 or less) to provide a financial instrument as part of the licensing process.[69] The consumer loan company must deposit an irrevocable letter of credit, a corporate surety bond, evidence of an account payable to the state, or a savings certificate to cover all licensed locations. The amount of the instrument utilized by the consumer loan company is different depending on whether the company is publicly traded or privately held. For any new application submitted on or after January 1, 2020, the instrument for a privately held company should be for $100,000 and for publicly traded company, $250,000. A claim on the instrument must be brought within 3 years after the act upon which the claim is based.

Mississippi

Payment and Performance Bonds for Private Construction

A new code section was created in Mississippi to regulate surety bonds for private construction projects. Miss. Code Ann. § 85-7-432 permits a person entering into a formal contract for construction, alteration, or repair of any private project to provide a surety bond. If such person provides a bond, the bond must conform to the following requirements: (a) a performance bond in an amount not less than the amount of the contract and conditioned for the full and faithful performance of the contract; (b) a payment bond payable to the owner but conditioned for the prompt payment of all persons supplying labor and material used in the execution of the contract and in an amount not less than the amount of the contract; and (c) the bond can be provided by a surety authorized to do business in Mississippi and listed on Treasury's T-list.

[66] 30 Ill. Comp. Stat. §§ 550/1 and 550/2.

[67] Ind. Code §§ 5-23-3-2; 8-15.5-5-2; and 8-15.7-5-1.5 (H.B. 1374).

[68] Ky. Rev. Stat. Ann. § 45A.435 (H.B. 26).

[69] Ky. Rev. Stat. Ann, § 286.4-450 (H.B. 285).

Missouri

Payment and Performance Bond Applicability and Extension of Bond Coverage

Missouri Senate Bill 167[70] makes clear that a person providing or arranging for construction services on a public works project under contract to a public entity for a governmental purpose must comply with the statutory payment and performance bond obligations. Likewise, a person that contracts, provides or arranges for construction services on a public works project for a nongovernmental purpose when acting as a lessee, agent, designee, or representative of a public entity must comply with the statutory payment and performance bond obligations. In addition, the bill will now extends payment bond protections under the bond to a supplier at any tier. However, remote suppliers shall not be entitled to recovery under the bond, unless such supplier has given written notice to the contractor that it has not been paid within 90-days of the time the supplier last supplied materials on the public works project. The remote supplier is defined as one that has a contract with a second, or lower, tier subcontractor or with another material supplier of any tier.

Rhode Island

Payment and Performance Bond Threshold

The threshold in the Rhode Island Little Miller Act has been increased from $50,000 to $150,000.[71]

Payment and Performance Bond – Road Repairs

The Rhode Island legislature created the Rhode Island Utility Fair Share Roadway Repair Act.[72] Any public utility or utility facility must obtain a performance bond prior to being issued a permit by the Department of Transportation. If the public utility or utility facility fails to complete the repairs, the Department of Transportation will initiate the repairs through the performance bond claim process and/or recover the amount required to complete the repairs from the public utility or utility facility.

Utah

Liquor Transport License Bond

As states begin to review occupational licensing requirements as potential barriers to entry, the Utah legislature created a new bond licensing obligation for liquor transporters.[73] A person that picks-up or delivers liquor to a retail licensee must obtain a license. As part of the licensing requirement the transporter must submit a $10,000 surety bond payable to the Department of Alcoholic Beverage Control (Department) in a form approved by the attorney general and conditioned upon the faithful compliance with the law. The Department is permitted to make a claim against a bond for money owed the Department without the Alcohol Beverage Control Commission first revoking the liquor transport license bond.

Wyoming

Payment and Performance Bond Threshold

The Wyoming Little Miller Act[74] is amended to require any state, county, city, town, school district or political subdivision's public works project exceeding $50,000 to be bonded. Prior to these amendments the bond threshold was $7,500. It remains unchanged that if the amount of the contract is $150,000 or less, a state or political subdivision approved form of guarantee is permitted in lieu of the bond.

[70] Mo. Rev. Stat. § 107.170.

[71] R.I. Gen. Laws § 37-12-1 (H.B. 5367/S.B. 585).

[72] R.I. Gen. Laws. §§ 39-2.2-1, et. seq. (H.B. 5028/S.B. 189).

[73] Utah Code Ann. § 32B-17-206 (H.B. 453).

[74] Wyo. Stat. Ann. § 16-6-112 (H.B. 65).

SUGGESTIONS & COMMENTS??

As to program suggestions:

Patrick R. Kingsley
Stradley Ronon Stevens & Young, LLP
2005 Market Street
Suite 2600
Philadelphia, Pennsylvania 19103
Ph: (215) 564-8029
email: *pkinglsey@stradley.com*

As to Newsletter Contents:

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

As to SCI Activities Generally:

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

As to Address Changes:

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

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June 24 – 26, 2020

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100 Heron Blvd., Cambridge, Maryland
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