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Newsletter

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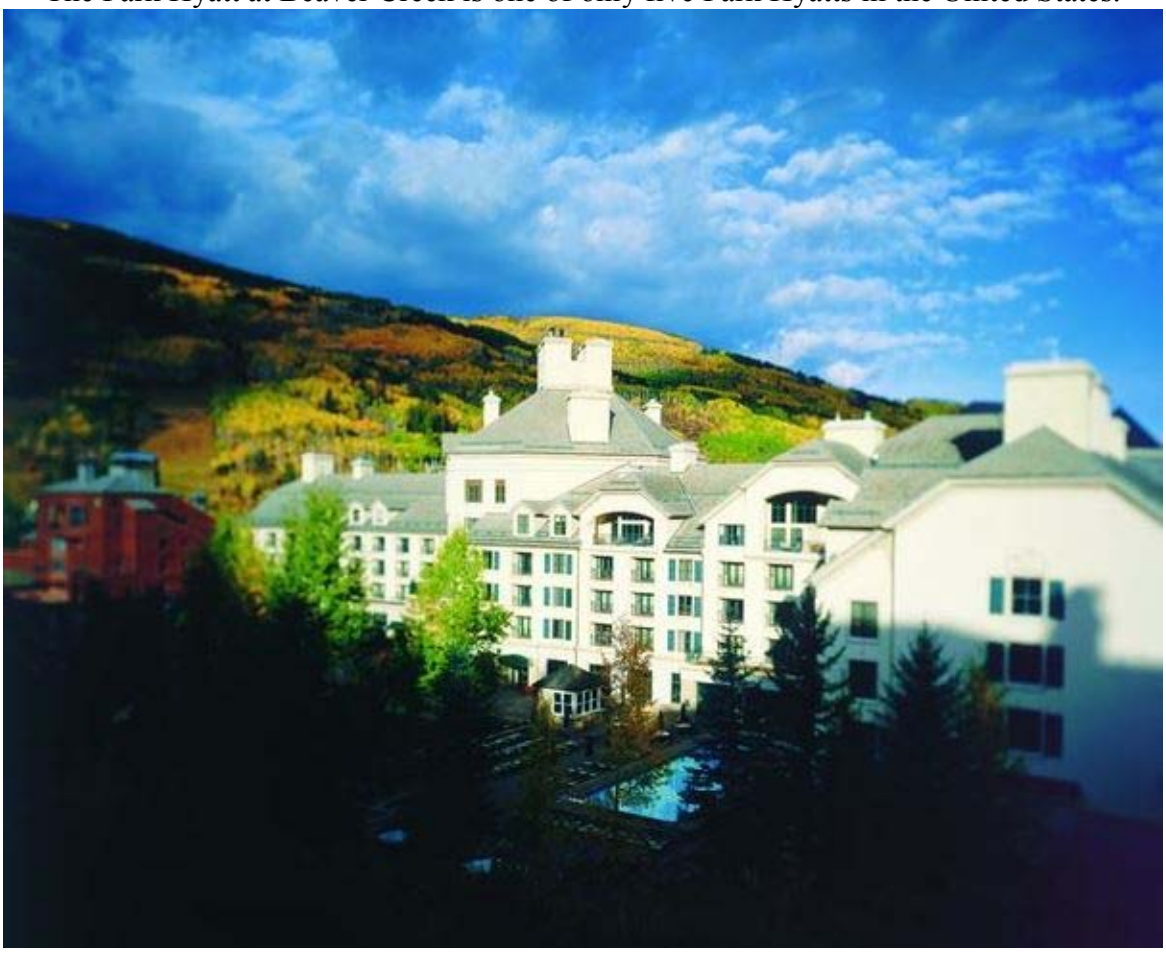
President: Steven D. Nelson Editor-in-Chief: Armen Shahinian

2018 Surety Claims Institute 43rd Annual Meeting To Be Held June 20 – 22, 2018 Park Hyatt Beaver Creek Resort, Beaver Creek, Colorado

The Park Hyatt at Beaver Creek is one of only five Park Hyatts in the United States.



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

Since its founding, the Surety Claims Institute ("SCI") has strived to meet two main objectives at its annual meeting. First and foremost, the SCI believes its primary function at the annual meeting is to provide a first-rate up-to-date educational program. Secondly, the SCI endeavors to hold its annual meeting at an attractive location which is not only in area where there many things to do, but is also family friendly. Attendees are encouraged to bring their families and meet and re-connect with both long-time colleagues and new colleagues in the industry.

This year, Amy Bentz, Program Chair, has planned an outstanding educational program. *(continued on page 3)*

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Comments From The Editor:

As the last issue of the SCI Newsletter contained a longer-than-usual version of the Comments From the Editor, I thought I should give you a break and make this short and sweet. Our Annual Meeting in Beaver Creek in June promises to be terrific and takes place in a great venue. I look forward to seeing you there!

Armen Shahinian
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2018 Surety Claims Institute 43rd Annual Meeting To Be Held June 20-22, 2018 At Park Hyatt Beaver Creek Resort, Beaver Creek, Colorado

(continued from page 1)

New speakers will be addressing topics, some of which have been addressed previously at other educational programs, from a new angle and with further thoughtful analysis of the issues.

As in the past, the Thursday morning program will start with an annual review of this year's major surety decisions, including some decisions which are truly adverse to the industry. Ben Lentz and Patricia Wager, Torre Lentz & Gamell and Michael Burkhardt, Liberty Mutual, will present this topic.

Lloyd "Sonny" Shields, Shields & Mott, and Tim Martin, Great American Insurance Company, will address the surety's traditional overpayment defense and analyze the extent to which the courts have eroded this defense. Sonny and Tim will present thoughts and ideas as to how the surety may preserve and revitalize this defense.

Paul Schraf, Liberty Mutual, has put together a panel of not only surety claims professionals, but consultants and contractors as well, to provide an analysis of the most commonly encountered construction defects. They will also address practical methods to assist the surety in mitigating the damages it may face as a result of claims involving these construction defects.

Keith Langley, Langley LLP, Blake Wilcox, Liberty Mutual, and Frank Lanak, HCC, will analyze developing issues which a surety claims handler may face, including the potential liability a surety may encounter in connection with various federal and local set-aside programs. They will also discuss developing issues with regard to reinsurance and indemnity. Finally, their panel will address methods which can be utilized to secure indemnity from subsidiaries and affiliated companies under the surety's indemnity agreement.

On Friday morning, Carla Crapster and Ben Weible, Strasburger & Price, will present their annual review of fidelity decisions. This year they have decided to expand this program and address at this meeting significant commercial surety cases which have not been addressed often. This will certainly be a new and interesting topic.

Mike Cronin, Jessica Bowers, Mike Hurley and Steve Ferretti will then provide guidance and insight as to issues which are unique to dealing with local government obligees.

There will be an updated presentation on negotiating takeover and tender agreements led by Laurence Jortner, CNA, and joined by Chris McRae, Brad Carver and Hamilton Jarrett.

Mike Carson and Chris Ward will present a paper dealing with suggestions as to how to structure a surety's financing agreement to mitigate the surety's losses.

Finally, Ali Salamirad, Marilyn Klinger, David Barton and Chris Bartow will present an hour-long ethics program. This topic will not only address ethical problems confronted by a surety claims professional in tendering defense to a principal's counsel, but also issues related to the use of the surety's normal counsel to assist the principal's counsel in litigating both defensive claims and affirmative claims, including the practical pitfalls which a surety can encounter in such arrangements. The SCI anticipates receiving an hour of CLE/CE credit for this topic.

Historically, the SCI's annual meeting has been held in the eastern, northeastern and southern locations. A number of years ago, Ron Geotsch who was then SCI's president, suggested that the SCI should consider periodically holding its annual meeting in western locations to allow attorneys and consultants whose offices are located in the western region and the surety companies based in the western region to more easily attend the

annual meeting. Since that decision was made, this will be the third meeting held in the western part of the United States. The previous two meetings have been very successful. Hopefully, this year's meeting will exceed that level of success.

The Park Hyatt at Beaver Creek is one of only five Park Hyatt's in the United States. The Park Hyatt hotels are the top tier of the Hyatt hotels. Everyone who attends this year's meeting will find that the level of service which we will receive is unsurpassed by any other Hyatt hotel which we have visited.

Beaver Creek is a gated community located west of the Rockies. Attendees who have never been to Colorado's Rocky Mountain region will find it completely different than the eastern part of Colorado. When traveling from Denver to Beaver Creek, attendees will pass through the Eisenhower Tunnel beneath the Rockies under the Loveland Pass. When emerging from the tunnel, attendees will find a completely different geography. There are high green mountains with beautiful mountaintops and multiple adventures. For more adventuresome drivers, you may also follow the old road which tracks the early western settlers trail across the Continental Divide.

The Park Hyatt offers numerous recreational activities for everyone. Depending upon the weather, Beaver Creek's outdoor ice skating rink may be open for families to enjoy a summer open-air ice skating experience. The Park Hyatt itself has swimming pools and outdoor seating for meals with tremendous views of Beaver Creek Mountain. Attendees and their families may want to ride the chair lift, which is literally adjacent to the hotel, to the top of Beaver Creek Mountain and enjoy the various activities at the top of the mountain. The more adventuresome attendees may then wish to consider hiking down from the top of Beaver Creek Mountain and enjoy the Betty Ford Gardens, named for the late First Lady. The late President and Mrs. Ford's house is visible from the ski lift.

Within a relatively short drive, there is the old Colorado mining town of Breckenridge. Breckenridge is home to very interesting and unique shopping areas, and for the very adventuresome, you can ride Breckenridge's chair lift up to an altitude of almost 10,000 ft. above sea level. There are also numerous other activities which were detailed in your invitation to the meeting. The museum of the Army's 10th Mountain Division, which was formed in the area and made its fame in the World War II's Italian Campaign, is also nearby.

This year's Surety Claims Institute's annual golf outing will be held at Eagle Ranch Golf Course. This is a "Arnold Palmer Signature Course" which means that he personally assisted in the design of the course. When the course opened, Arnold Palmer opened the course by playing a nine-hole exhibition.

For those attendees who wish to extend their trip, Rocky Mountain National Park is located in Estes Park which is northwest of Denver. It is the most visited National Park in the U.S. The Park has incredible scenery, hiking trails and is the habitat to numerous animals. Estes Park is also the home of the Stanley Hotel made famous by Jack Nicholson in the movie "The Shining". Should any of you decide to spend a few days there, we can assure you that you will have more company than did Jack Nicholson and Shelley Duvall, nor will your visit be as eventful as that of Scatman Crothers.

The Surety Claims Institute's Board looks forward to what promises to be a large turnout and the opportunity to renew old friendships and meet new friends and colleagues.

Enforcing The Surety's Rights To The Defaulting Principal's Contract Funds On Federal Projects: A Step-By-Step Guide to Navigating the FAR

By: Paul K. Friedrich, Williams Kastner, Seattle, WA

I. Introduction

The Miller Act, 40 U.S.C. §§ 3131-3134, requires a contractor ("Principal") on a federal project to post two bonds: a performance bond and a labor and material payment bond to guarantee completion of the construction according to the plans and specifications in the contract and payment of laborers, subcontractors, and material suppliers.[1] The Miller Act was amended in 2010, raising the applicable threshold amount of the contract to $150,000.00 from $100,000.00.[2]

If the Principal encounters financial problems during the project, the Miller Act surety ("Surety") is often called upon to finance completion of the bonded federal contract either by directly advancing money to the Principal or indirectly by paying the subcontractors and suppliers. In the event the Surety suffers financial loss as a result of the Principal's failure to meet its contractual obligations, the Surety will immediately look to mitigate its loss by enforcement of its equitable subrogation rights or through contractual rights assigned from the Principal to the Surety pursuant to the indemnity agreement.

The Miller Act is implemented through the Federal Acquisition Regulations (the "FAR"). The FAR is the principal set of rules and regulations issued by federal agencies which govern the process through which the federal government ("Government") purchases or acquires goods and services. The FAR is codified in Title 48 of the U.S. Code of Federal Regulations and although not statutory, courts have held that the FAR has the force of law and is binding on the government and contractors.[3]

The FAR contains a complex web of procedural requirements for any party who seeks to enforce rights assigned on a federal contract. Therefore, when faced with the Principal's default on a federal project, it is important to understand the regulations outlined in the FAR, including its subparts and supplements, in order to efficiently and effectively perfect the Surety's rights to contract proceeds held by the Government and, thereby, mitigate loss.

There are many risks for the Surety who does not take time to review and understand the FAR and, as a result, is unable to expedite the release of contract funds from the Government. The Surety may be in competition with other parties for contract funds held by the Government, including banks, trustees in bankruptcy or debtors-in-possession, subcontractors and/or suppliers. The longer contract funds remain in the Government's possession, the greater the risk that competing claimants will interfere with the Surety's interest in contract proceeds. For these reasons, it is critical that the Surety secure possession of bonded contract funds expeditiously. Oftentimes, however, the onerous nature of the FAR-mandated procedures may delay the Surety's ability to efficiently obtain possession of contract proceeds from the Government.

The purpose of this article is to provide a detailed overview of the specific requirements of the FAR, as well as best practices, in order to help surety claims representatives and

[1] *See* Miller Act, The Surety & Fidelity Association of America, available at http://www.surety.org/?page=Miller_Act&hhSearchTerms=%22miller+and+act%22.

[2] *Id.*

[3] *Davies Precision Machining, Inc., v. U.S.*, 35 Fed. Cl. 651, 657-58 (1995).

professionals navigate the FAR provisions specifically relating to assignment of contract proceeds on federal construction projects. This article will not address issues relating to takeover agreements or the assertion of claims against the Government.

II. Federal Assignment of Claims Acts

Beyond the burdensome nature of the FAR, the Surety's ability to assert rights assigned under an indemnity agreement is complicated by the Assignment of Claims Acts, or Anti-Assignment Act, 31 U.S.C. § 3727 and 41 U.S.C. § 15 (collectively "Assignment of Claims Acts" or "Acts"), which generally void any assignment of a Government contract or claim against the Government. During World War II, Congress amended the Assignment of Claims Acts to provide certain exceptions. While FAR Subpart 32.802(b) clearly outlines the parties who are eligible to receive an assignment (bank, trust company, or other financing institution, including any Federal lending agency), a Surety is not listed. Furthermore, case law interpreting Subpart 32.802(b) holds that a Surety does not qualify as a bank, trust company, or other financing institution under the Acts.[4] In *Fireman's Fund Insurance Co. v. England*, the Federal Circuit determined that none of the exceptions in the Acts validated the assignment in the General Indemnity Agreement.[5]

While the Assignment of Claims Acts and the decision in *Fireman's Fund* do not explicitly prohibit transfers or assignments of contract proceeds allowed by operation of law, including the doctrine of equitable subrogation, the Government may require that the Principal and Surety comply with the procedures set forth in the Assignment of Claims Acts, 31 U.S.C. 3727, and FAR Subpart 32.8, as a precondition to the Government's release of the Principal's contract funds to the Surety. Although the Assignment of Claims Acts and the decision in *Fireman's Fund* prohibit an assignment of contract funds to the Surety, the Government may be willing to waive FAR Subpart 32.802(b) and/or simply be unaware of the holding in *Fireman's Fund*, thereby allowing the Surety to exercise the FAR to secure a release of contract funds. Accordingly, it is imperative that surety claims representatives and professionals have a working knowledge of the policies and procedures outlined in FAR Subpart 32.8 in order to efficiently obtain an assignment and release of the Principal's contract funds.

III. FAR-Mandated Procedures for Assignment of Contract Funds to Surety

The Assignment of Claims Acts, 31 U.S.C. 3727(b), FAR Subpart 32.8, and Subpart 4.11 set forth the procedures for executing an assignment of contract funds on a federal project. More specifically, the Defense Federal Acquisition Regulation Supplement ("DFARS") provide Department of Defense-specific acquisition regulations that the Department of Defense ("DoD") government acquisition officials – and those contractors doing business with DoD – must follow in the procurement process for goods and services and provides additional information for filing the assignment with the Government on DoD projects.[6]

A. Format and Execution Requirements of Assignment of Contract Funds

In order to secure a release of contract funds from the Government, the Principal must first execute a valid assignment of claim ("Assignment") to the Surety in accordance with 31 U.S.C. 3727(b) and FAR Subpart 32.8. FAR Subpart 32.805(a) outlines the specific formatting and execution requirements for the Assignment:

> (1) Assignments by corporations shall be—
>
> (i) Executed by an authorized representative;
>
> (ii) Attested by the secretary or the assistant secretary of the corporation; and
>
> (iii) Impressed with the corporate seal or accompanied by a true copy of the resolution of the

[4] *Fireman's Fund Ins. Co. v. England,* 313 F.3d 1344, 1350 (Fed. Cir. 2002) ("[A]n assignment of a government contract to a surety [is] invalid under the Anti–Assignment Act because the surety was not a bank, trust company, or other financing institution.").

[5] *Id.*

[6] *See* Defense Federal Acquisition Regulation Supplement (DFARS) and Procedures, Guidance, and Information (PGI), available at https://www.acq.osd.mil/dpap/dars/dfarspgi/current/index.html.

corporation's board of directors authorizing the signing representative to execute the assignment.

(2) Assignments by a partnership may be signed by one partner, if the assignment is accompanied by adequate evidence that the signer is a general partner of the partnership and is authorized to execute assignments on behalf of the partnership.

(3) Assignments by an individual shall be signed by that individual and the signature acknowledged before a notary public or other person authorized to administer oaths.

As outlined above, FAR Subpart 32.805(a) outlines the requirements for an Assignment in connection with a corporation, a partnership, and an individual. Notably, however, FAR Subpart 32.805(a) does not provide instructions for the Assignment with respect to a limited liability company ("LLC"). This presents a potential compliance issue for sureties who issue bonds on behalf of LLC's because FAR Subpart 32.805(a) mandates certain execution requirements for the Assignment that cannot be satisfied by an LLC.

In the event the Principal is an LLC, the Surety should notify the Government that it will prepare the Assignment, to the extent possible, in compliance with FAR 32.805(a)(1)(i) (i.e., for a corporation), even though the Principal is an LLC. The Assignment should identify the "managing member" of the LLC and identify his/her authority to sign on behalf of the LLC. At the same time, if the Principal does not have a member or managing member whose authority and duties correspond to a "corporate secretary" (since it is an LLC, not a corporation), then it will not be able to satisfy the attestation requirement of FAR 32.805(a)(1(ii), which, again, applies only to corporations. In that event, the Principal should instead have the managing member's signature notarized in accordance with 31 U.S.C. 3727(b). In addition, the Principal should attach a signed Resolution of Limited Liability Company instead of a corporate seal or resolution of the corporation's board of directors, as required by FAR 32.805(a)(1)(iii).

While the Government may raise objections in the event the Principal is an LLC, the Government cannot reasonably justify invalidating an Assignment from an LLC on the basis that it does not meet the requirements of FAR 32.805(a) merely because the Government did not have the foresight to include execution requirements for an LLC in FAR 32.805(a).

B. Format and Execution Requirements of Notice of Assignment

In addition to the Assignment, the Surety must prepare and execute a Notice of Assignment. FAR Subpart 32.805(c) outlines the specific formatting and execution requirements for a Notice of Assignment, as required by FAR 32.802(e) and, in fact, includes a sample Notice of Assignment for the Surety's convenience. Although it is best practice to copy the format of the Notice of Assignment provided in FAR Subpart 32.805(c), the general requirements of the Notice of Assignment are as follows:

(1) The Notice of Assignment must identify the following: (a) Contract Number; (b) Contractor's name and address; (c) Government agency, name of office, and address; and (d) Describe nature of the contract;

(2) The Notice of Assignment must state that moneys due or to become due under the contract have been assigned to the Surety under the provisions of the Assignment of Claims Act of 1940, as amended, (31 U.S.C. 3727, 41 U.S.C. 6305);

(3) The Notice of Assignment must attach a copy of the executed Assignment as required by Subpart 32.802(e);

(4) The Notice of Assignment must state that payments due or to become due under the bonded contract should be made to the Surety as assignee;

(5) The Notice of Assignment must request the parties identified in Subpart 32.802(e) acknowledge and return signed copies of the Notice of Assignment to the Surety; and

(6) The Notice of Assignment must be signed by an authorized representative of the Surety.

C. Filing Requirements for Notice of Assignment and Assignment

FAR Subpart 32.802(e) and 31 U.S.C. 3727(3) generally state the filing requirements for the Notice of Assignment and Assignment;

however, FAR Subpart 32.805(b) provides more specific filing instructions:

> (b) Filing. The assignee shall forward to each party specified in 32.802(e) an original and three copies of the notice of assignment, together with one true copy of the instrument of assignment. The true copy shall be a certified duplicate or photostat copy of the original assignment.

Please note that DFARS 232.8 supplements the FAR and provides further detailed instructions for filing the Notice of Assignment and Assignment with the Government for DoD Projects.

D. Miscellaneous Procedural Requirements for Principal and Surety

In addition to the above requirements, FAR 32.805(d)(4) requires the Surety to register in the System for Award Management ("SAM") in order for the Government to process the release of contract funds.[7] In addition, the Surety must provide a Commercial and Government Entity ("CAGE") code and DUNS number. The CAGE code may be obtained when the Surety registers in SAM. A DUNS number is a unique, non-indicative 9-digit identifier issued and maintained by Dun & Bradstreet that verifies the existence of a business entity globally.[8] The CAGE code and DUNS number are required in order for the Government to process the release of contract funds to the Surety.

After the Government has reviewed and accepted the Assignment and Notice of Assignment and assuming the Principal has not yet submitted a final invoice, the Surety can expect the following:

(1) A contract modification will be issued changing the Payee on the contract to the Surety. The Principal must sign the contract modification.

(2) The Principal must submit a final invoice. In addition, the Principal and Surety will both need to execute a final release prior to the Government releasing the contract funds. The original signed release should be submitted to the Government and a copy should be included as an attachment to the final invoice.

(3) The Government will process the final invoice and release the contract funds to the Surety.

IV. Conclusion

When the Principal is a federal contractor, it is imperative that the Surety have a working knowledge of the FAR. A basic understanding of the FAR will position the Surety to effectively and efficiently facilitate a release of contract proceeds held by the Government in order to shield contract funds from competing creditors and mitigate the Surety's loss.

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[7] *See* The System for Award Management (SAM), available at https://www.sam.gov/portal/SAM/#1.

[8] *See* D&B D-U-N-S Request Service for US Federal Government Contractors and Assistance Awardees, available at https://fedgov.dnb.com/webform.

Surety Casenotes

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

Claims of Bad Faith Against Surety Dismissed Because Surety Reasonably Relied on Discharge of Principal's Liability as Basis to Deny Claim

JSI Commc'ns. v. Travelers Cas. & Sur. Co of Am., --- F. App'x ----, 2017 WL 6272274 (5th Cir. Dec. 8, 2017).

Prime contractor McMillan–Pitts Construction Company, LLC, ("McMillan–Pitts") entered into a subcontract with Tackett Electric Company, LLC, ("Tackett") on a Little Miller Act project in Mississippi. Tackett entered into an oral subcontract with JSI Communications ("JSI") for JSI to install and test voice and data cabling as well as fiber optic cabling for the project. In March 2012, a Tackett creditor, unrelated to the project, served a writ of garnishment on McMillan–Pitts. McMillan–Pitts initiated an interpleader action in state court, depositing the remaining contract funds, $19,445.16, owed to Tackett on the Project. McMillan–Pitts named the following entities as defendants: Tackett, the unrelated Tackett creditor, and two Tackett subcontractors (not JSI) on the project that had entered joint check agreements with McMillan–Pitts and Tackett. On August 20, 2012, the state court entered a judgment releasing McMillan–Pitts from liability on its subcontract with Tackett, the writ of garnishment, and the two joint check agreements.

In September 2012, after completing its work on the project, JSI submitted an invoice to Tackett in the amount of $36,346.09, which Tackett refused to pay. Shortly thereafter, JSI submitted a payment bond claim to McMillan–Pitts' surety. The surety responded to JSI, requesting a claim form to facilitate its independent investigation. The surety also asked McMillan–Pitts for "detailed input" for its "independent investigation and understanding of the claim." JSI submitted its claim form in October 2012. On October 25, 2012, McMillan–Pitts moved to amend its complaint for interpleader to include JSI and all "persons or entities supplying materials and/or labor to Tackett on the project." The court granted McMillan–Pitts' motion to amend and extended the previous release of liability to "any claim made by any other claimant made a party to the action." Relying upon the court's decision, the surety denied the payment bond claim.

JSI commenced a suit against the surety in state court, which the surety removed to federal court. JSI alleged that the surety was in breach of the bond and that it acted in bad faith. On its bad faith claim, JSI sought punitive damages of at least $100,000. The district court granted the surety's motion for summary judgment, finding that the surety's liability could not exceed that of its principal. The Fifth Circuit reversed, holding that Mississippi's Little Miller Act provides sub-subcontractors, like JSI, with "a right of action upon the ... payment bond upon giving written notice to [the] contractor within ninety (90) days from the date on which such person did or performed the last of the labor or furnished or supplied the last of the material for which such claim is made." The Fifth Circuit thus found that the state court's release of McMillan–Pitts had "no effect on JSI's ability to recover under the Bond." The Circuit Court further held that the scope of the interpleader should have been limited to the funds interpleaded—the release should have been limited to the proceeds of the contract between McMillan–Pitts and Tackett and should not have been extended to "any funds relating to [the] bond obligation." The court entered judgment in favor of JSI on its breach of

contract claim and remanded for the district court's consideration of the bad faith claim.

On remand, the district court granted the surety's motion for summary judgment dismissing the bad faith claim. The Fifth Circuit affirmed, holding that "[i]f an insurance company fails to pay a claim based upon an arguable or legitimate reason ... punitive damages will not lie." Because the surety reasonably relied upon "Mississippi's long-standing doctrine that a surety's liability is measured by that of its principal to conclude that the [c]ourt's release of McMillan–Pitts from liability included [the surety's] liability", the court held that the surety "had an arguable reason to deny JSI's claim." In issuing its ruling, the court observed that the surety could not have "easily adduced" that its defenses lacked merit because no Mississippi Court (before JSI I) had addressed the effects of a discharge of a principal's liability to the surety's liability under a Little Miller Act bond.

Surety's Right to Recover from Indemnitors Costs Incurred in Defending Bad Faith Claims of Bond Claimant Limited under South Dakota Law

Liberty Mut. Ins. Co. v. Milender White Constr. Co., 2017 WL 6361418 (D. Colo. Dec. 13, 2017).

The surety issued a payment bond on behalf of prime contractor Milender White Construction Company ("Milender"). Milender entered into the prime contract with the Oglala Sioux Tribe in South Dakota. The dispute arose out of Milender's subcontract with Double H Masonry, Inc. ("Double H"). Double H commenced suit against the surety in South Dakota as a result of Milender's failure to pay numerous invoices and a damages award entered against it by the Oglala Sioux Tribal Employment Rights Office. Milender demanded that Double H participate in arbitration pursuant to the terms of the subcontract to resolve the payment disputes. The surety moved to stay the action pending the outcome of the arbitration. Before the court ruled on the surety's motion, Double H amended its complaint to add claims against the surety for, among other things, bad faith. The action was ultimately stayed. Six months later, Double H moved to lift the stay on the grounds that the arbitrator awarded it $320,778.57 and awarded Milender $29,147.24 and that it intended to pursue attorney's fees under the payment bond. After another stay, the surety moved to dismiss the bad faith claims. In a matter of first impression, the South Dakota court allowed Double H's claim for tortious bad faith to proceed, but dismissed its claim for contractual bad faith. The surety and Double H ultimately settled.

The surety filed a third party complaint against the indemnitors, alleging a breach of the indemnity agreement, seeking common law indemnification against Milender, specific performance of the indemnitors' obligations to deposit collateral, *quia timet*, and unjust enrichment. After Double H's claims were resolved, the case was transferred to Colorado, with the surety realigned as the plaintiff. The surety filed a motion for summary judgment against the indemnitors. The indemnitors filed their own motion for summary judgment, arguing, among other things, that they have no obligation to indemnify the surety in connection with the bad faith claims asserted by Double H. After conducting a choice of law analysis, the court found that South Dakota law applied. The court held that, under South Dakota law, the surety could not be indemnified for its own bad faith unless the indemnity agreement clearly stated otherwise. In evaluating the language the indemnity agreement, the court found that "it is not clear and unambiguous under the Indemnity Agreement that [the indemnitors] agreed to indemnify [the surety] for [the surety's] bad faith." The court also held that "the bad faith claim asserted by Double H. Masonry against [the surety] is not a risk insured by the Indemnity Agreement such that [the indemnitors are] required to indemnify [the surety] for losses associated with defending it."

With respect to the losses incurred by the surety that were unrelated to the defense of the bad faith claim, the court entered summary judgment in favor of the surety. The court asked the parties to try and stipulate as to the amount of such losses. The court invited the parties to file another motion for summary judgment if they are unable to enter into a stipulation.

The indemnitors' motion for summary judgment also sought to dismiss the surety's claim for common law indemnification because such claim was subsumed by a contractual basis for indemnification and that their liability to indemnify the surety "turns on the language of the indemnity agreement," and not common law indemnity principles. The surety argued that as a surety, it has common law rights that it can

access and pursue concurrently with its contractual rights. The court agreed and held that the surety's common law indemnification rights against Milender do not preclude the surety from seeking indemnity in connection with the costs incurred by it in defending against the bad faith claims. The court stated that "a surety seeking such relief is limited only by whether the surety shares in any of the wrongdoing." The court concluded that the indemnitors did not carry their burden of proof "as to whether the bad faith claim arose as a result of [the surety's] active negligence" and denied their motion for summary judgment to dismiss the claim for common law indemnification.

Surety Has Standing to Enforce Forum Selection Clause in Bonded Contract

WCC Cable, Inc. v. G4S Tech. LLC, 2017 WL 6503142 (W.D. Va. Dec. 15, 2017).

G4S Technology LLC ("G4S"), the prime contractor, entered into a subcontract with WCC Cable, Inc. ("WCC") on a Little Miller Act project in Virginia. The subcontract contained a choice-of-law and forum selection clause, which provided that any disputes thereunder were to be governed under Nebraska law and resolved in a state or federal court located in Douglas County, Nebraska. Although the subcontract appears to have been prepared utilizing G4S' form, the parties did negotiate certain terms, including the incorporation of Virginia's interest payment provisions. The working relationship between WCC and G4S soured, with each side claiming the other breached the subcontract. G4S ultimately sent a notice of default and bond claim to WCC's surety. While the parties were attempting to schedule a meeting to negotiate a potential resolution of their disputes, G4S commenced an action in Nebraska. WCC subsequently filed its own suit lawsuit in Virginia.

WCC removed the Nebraska action to federal court and moved to dismiss based on improper venue and lack of personal jurisdiction. The federal court in Nebraska granted WCC's motion on the grounds that venue was not proper under 28 U.S.C. § 1391(b) (because no defendant resides in Nebraska and no events giving rise to the claim occurred in Nebraska) and transferred the matter to federal court in Virginia. The Nebraska court held open the possibility that the Virginia court may, after undertaking an analysis under 28 U.S.C. § 1404(a) (i.e., based on the parties' consent), determine that a transfer of the Nebraska action back to the District of Nebraska would be appropriate.

G4S and its surety each filed a Motion to Stay, or in the Alternative, Dismiss or Transfer Based Upon the First-to-File Rule, and a Motion to Transfer Venue pursuant to 28 U.S.C. § 1404(a). The federal court in Virginia consolidated the two actions and, even though G4S filed the first action in Nebraska, the court realigned the Nebraska action as a counterclaim. In doing so, the court expressed "its deep concern about G4S' litigation tactics in Nebraska." The court appeared to disapprove of G4S misleading WCC "into thinking G4S was a willing partner in settlement negotiations when, in fact, G4S purposefully engaged in dilatory tactics to gain an unfair advantage" by not disclosing its intentions to file the Nebraska Action prior to a settlement meeting.

With respect to the Motion to Transfer Venue back to Nebraska, the court found that "all other factors equal, this case belongs in [Virginia]. But the parties contractually obligated themselves to litigate in a court in Douglas County, Nebraska. The court cannot and will not disturb the parties' contractual bargain." In reaching this conclusion, the court noted that Virginia's strong public policy of having disputes regarding its public projects be decided within the Commonwealth. However, the court found that Fourth Circuit precedent, which it was bound to follow, held that a state's public policy cannot be utilized to invalidate a forum selection clause. The court thus granted G4S' motion to transfer venue.

The court next evaluated whether: (a) G4S' surety had standing to enforce the forum selection clause against WCC or, (b) G4S, as beneficiary of the bonds furnished by WCC, may enforce the forum selection clause against WCC's surety. The court answered both questions in the affirmative, holding that "a surety's liability to a subcontractor is derivative of the contractor's liability to the subcontractor, or vice-versa…For this reason, a party seeking to recover against a surety, who stands in the shoes of the principal and whose liability is contingent upon a subcontract that contains a forum-selection clause, may enforce that forum selection clause against the surety. Additionally, the surety may assert most defenses that the contractor could assert, including lack of subject

matter jurisdiction and such matters as the enforcement of venue selection clauses or arbitration clauses that strip a court of jurisdiction over a dispute." In reaching this decision, the court observed that "the story changes when the payment bond at issue has its own forum selection clause". In such cases, the forum selection clause in the bond would control. However, in the absence of such a clause, the forum selection clause in the subcontract was deemed to be enforceable. The entire case was transferred back to Nebraska

Under Georgia Law, Statute of Limitations for Action on Little Miller Act Payment Bonds Runs from Time Work is Complete, Not "Final Acceptance" of the Work

Strickland v. Arch Ins. Co., --- F. App'x ----, 2018 WL 327443 (11th Cir. Jan. 9, 2018).

Devin B. Strickland ("Strickland") supplied sand to Douglas Asphalt for use on a Georgia Department of Transportation ("GDOT") road project. In 2007, Douglas Asphalt went into default and the surety took over the project. Although Strickland did not supply sand to the surety's completion contractor, Strickland was never paid for the materials he previously supplied.

In August 2010, GDOT determined that the work on the project was substantially complete and ready for final inspection. In September 2010, the surety's completion contractor requested final inspection. The punch list generated from the inspection was complete by September 2011. In early 2012, the surety requested that GDOT accept the road improvement project for maintenance. In February 2012, a GDOT area engineer requested maintenance acceptance because the project had been satisfactorily completed. In March 2012, GDOT accepted project maintenance responsibilities retroactive to September 2011.

In September 2012, Strickland sent a demand letter to the surety. The surety acknowledged the claim and asked for additional documentation and a proof of claim. Strickland did not respond to the surety's requests. In 2014, Strickland learned that GDOT was preparing to close out the project. A GDOT employee told Strickland that he needed to file any claims he had immediately, as GDOT would not close out a project if there was a pending lawsuit. Strickland filed suit in August 2014. Later that month, a GDOT employee stated in an e-mail that the project had not yet received final acceptance and approval. In September 2014, GDOT sent a letter of "final acceptance," which stated that the project had "been accepted" by GDOT as of April 17, 2012.

On this record, the district court granted summary judgment in favor of the surety. It concluded that the one-year statute of limitations had run on Strickland's action because no genuine dispute of fact existed about the project being completed and accepted in September 2011. The appeals court affirmed, holding that, under Georgia law, the statute of limitations on a Little Miller Act payment bond claim bars suits for recovery on public works payment bonds brought after "one year from the completion of the contract and the acceptance of the ... construction by the proper public authorities." The court was unpersuaded by Strickland's argument that the project was not completed until 2014 because the contract specifications "provided that the contractor had work obligations of maintenance and repair until the issuance of written final acceptance." The court held that, for purposes of Georgia's Little Miller Act, "completion refers not only to total completion, but also to 'substantial completion,' with only punch-list items remaining to be done." With respect to acceptance, the court found that the case law provides that the statute of limitations begins to run when the project is accepted (i.e., when the actual work is complete, which was in 2012), not at "final" acceptance (which includes GDOT's internal procedure). Thus, the email from the GDOT employee which indicated that GDOT had not yet declared final acceptance was unavailing to Strickland.

The court was also unpersuaded by Strickland's argument that the statute of limitations had not run because the bond at issue remains in "full force and effect" until all suppliers are paid by the contractor, and Strickland had not been paid. This interpretation

of the statute of limitations would render the statute meaningless because the limitations period would never begin where a supplier or subcontractor had not been paid.

Certificate of Substantial Completion Does Not Release Performance Bond Surety from Liability to Complete Bonded Contract

City of Wolfe v. Am. Safety Cas. Ins. Co., --- S.W.3d ----, 2018 WL 792108 (Tex. App. Feb. 9, 2018).

McKinney & McMillen, LLC ("M&M) entered into a contract with the City of Wolfe City (the "City") for the installation of a water distribution and meter-reading system. Among other things, the contract required M&M to install 722 remote read water meters that would enable the City's employees to read the meters from their vehicles. The City subsequently issued a change order to change the automatic meter-reader system from a drive-by system to a fixed-base system in which a meter interface unit ("MIU") attached to the meters would electronically transmit information from the meters to the City's computer system. By March 27, 2013, most of the work under the contract had been completed and the City signed a certificate of substantial completion. Attached to the certificate of was a pre-final inspection punch list of items that needed to be corrected or completed within thirty days, including a requirement to "bring the…remote read water meter system up to full functional status." At the time the City issued the certificate of substantial completion, at least 85 MIUs had not been installed. On April 17, 2013, the City issued a second change order adding an additional eighty meters to the contract and extending the time to complete the project.

Thereafter, the City began experiencing significant problems with the system, including meters failing to correctly register the amount of water being used, meters running backwards, and meters randomly sending error messages. In addition, a number of the MIUs failed. Ultimately, the City made a demand on M&M's performance bond. After M&M stopped working to resolve the issues, the City filed suit. The surety filed a motion for summary judgment on the grounds that there was no evidence that M&M breached the contract and the surety was entitled to rely on the certificate of substantial completion to support its position that it owed no further obligation under the performance bond. The trial court granted the surety's motion and the City appealed. The appeals court reversed.

The court found that, under the terms of the bond, which incorporated the contract, the surety bound itself to perform M&M's contract with the City if M&M failed to do so. During discovery, M&M admitted that some of the MIUs failed, the water system was not fully functional and it ceased work on the project before the lawsuit was filed. In addition, the certificate of final completion contained a requirement for M&M to complete or correct the items on the attached punchlist within thirty days (including the requirement to bring the system to fully functional status). Since the contract required M&M to provide a fully functional system and the certificate of substantial completion did not release that duty, the court found that the surety could not rely on the certificate of substantial completion to discharge it of liability under the bond. In addition, the court noted that the bonded contract obligated M&M to correct or replace defective work within one year after the date of substantial completion. Since the performance bond incorporated the contract by reference, the court reversed the order of the trial court granting the surety summary judgment.

Miller Act Surety is Liable Only for Labor Used on Miller Act Project, Not Breach of Contract

Allan Spear Constr., LLC v. Caddell Constr. Co. (DE), LLC, 2018 WL 1135393 (D.S.C. Feb. 28, 2018).

Caddell Construction Co. (DE), LLC ("Caddell") entered into a contract with the Navy for the construction of a nuclear power facility. Caddell entered into a subcontract with Allan Spear Construction, LLC ("ASC") under which ASC agreed to provide supplemental concrete. The subcontract contains a provision, which states, "[ASC] will have a minimum of 12 consecutive weeks to provide a minimum of 20 workers over the 12 week period." ASC interpreted this provision to mean that Caddell would pay ASC for a minimum of twenty laborers for a period of at least twelve weeks regardless of whether Caddell actually used the laborers. ASC asserted that this provision was included so that ASC would be compensated for training, credentialing, lodging, transporting, and ensuring its concrete workforce would be on

hand for the facility. Caddell denied that it had any contractual obligation to compensate ASC for a minimum number of laborers if Caddell did not actually use them.

Caddell initially used at least twenty ASCI laborers and fully paid ASC for them. As Caddell began to meet its deadlines, it reduced its usage of ASC laborers but continued to compensate ASC for the minimum number. Caddell then requested ASC to allow Caddell to buy out the remainder of their contract. In response, ASC asked for a proposed buy-out figure but received no response from Caddell. Subsequently, Caddell continued to use a reduced number of ASC laborers and paid for laborers actually used, refusing to pay for the twenty-worker minimum. As a result, ASC demanded $595,060.00 from Caddell for money allegedly owed for the minimum labor provision. ASC filed suit in South Carolina state court against Caddell and its Miller Act surety. The suit was removed to federal court on the grounds of federal question and diversity.

The surety filed a motion for summary judgment because ASC's claims do not fall within the parameters of the Miller Act, which provides a remedy only to parties who actually furnish labor and materials rather than contract damages for unused labor. The court agreed and entered summary judgment in favor of the surety. 40 U.S.C. § 3133(b)(1) provides, in relevant part, that a civil action on a Miller Act bond may be brought by a "person that *has furnished labor or material* in carrying out work provided for in a contract for which [the] payment bond is furnished ... and that has not been paid in full" (emphasis added). The rationale of the Miller Act is to give those supplying labor and materials for government contracts protection comparable to that furnished by mechanics' liens where private construction is involved." The court observed that "courts have consistently held that the surety of a bond furnished by the Miller Act may not be held liable for claims which a subcontractor may have against the prime contractor not based on labor or materials furnished." By ASC's own admission, Caddell paid for the laborers actually used. The court held that the Miller Act does not provide a remedy for damages arising out of an agreement to pay for twenty laborers not actually used.

District Court in New York Rejects Indemnitors Bad Faith and Failure-to-Investigate Defenses to Indemnity Claims and Enforces Surety's Broad Discretion to Resolve Claims

Travelers Cas. & Sur. Co. of Am. v. DiPizio Constr. Co., Inc., 14-cv-576-FPG (W.D.N.Y. March 12, 2018), *adopted by* 2018 WL 1805551 (W.D.N.Y. April 17, 2018).

The surety filed an action against its indemnitors seeking to recover losses it incurred under five separate payment bonds and one performance bond. With respect to losses incurred by the surety under the performance bond, the indemnitors argued their obligations under the performance bond were not triggered because the declaration of default under the bonded contract was a nullity since it was not authorized by the obligee's board of directors. The court held that, under the terms of the indemnity agreement, the propriety of the declaration of default is irrelevant to the indemnitors' obligations under the indemnity agreement. The indemnity agreement provided that a default thereunder is triggered by, among other things, "a declaration of contract default by the obligee or entity for whom a contract is performed." In a related case, New York's Appellate Division previously held that "the definition is limited to a mere declaration of default, and does not require a judicial determination that the declaration was correct."

The indemnitors also argued that the surety failed to investigate to determine whether the principal was at fault; they alleged that this was a breach of the surety's obligation to act in good faith. The court summarily rejected this argument based on the Appellate Division's finding that the surety did not act in bad faith. The court added that "a surety's failure to investigate the claim fully or pursue a viable defense does not constitute bad faith" and that "New York courts routinely reject failure-to-investigate challenges to the enforcement of indemnification agreements." The court observed that "to hold otherwise would undermine the entire surety industry, forcing sureties to engage in protracted and often costly investigations…on the threat that should they fail to do so, the contractor could avoid its indemnification responsibilities."

In agreeing to take over the project, the surety entered into a takeover agreement which reserved the right to contest the propriety of the default with the obligee. The indemnitors argued that the language in the takeover agreement permitted them to contest their obligations to the surety under the indemnity agreement. Again, the court rejected the indemnitors' contentions. First, the Appellate Division, in the related case, held that the indemnitors were not a party to the takeover agreement and, in any event, assigned those claims to the surety under the terms of the indemnity agreement by virtue of their default. The language in the takeover agreement could not "un-assign" claims which the principal no longer possessed at the time the reservation was made. In addition, the surety's rights under the indemnity agreement were not the subject of the takeover agreement.

The indemnitors also argued that the surety acted in bad faith by selecting the completion contractor, which submitted the highest bid. The surety responded that the other bidders were previously the principal's subcontractors and the chosen completion contractor offered greater staffing and acceptance of more general conditions. The court held that the indemnitors' conclusory allegations of bad faith were insufficient to defeat the surety's motion for summary judgment.

Finally, the indemnitors contested the surety's decision to satisfy certain payment bond claims because they were subject to "pay when paid" provisions in the subcontracts or they were contested. The court again rejected the indemnitors' arguments, finding that "pay when paid" clauses were void and against public policy in New York and that the surety had broad discretion to settle claims under the indemnity agreement. The magistrate filed a report recommending summary judgment in favor of the surety, which was subsequently adopted by the district judge.

<u>Arbitration Provision in Bonded Contract Does Not Bind Surety to Arbitrate</u>

Developers Sur. & Indem. Co. v. Carothers Constr., Inc., 2018 WL 1383402 (D. Conn. March 19, 2018).

Prime contractor, Carothers Construction, Inc. ("Carothers"), entered into a subcontract with Seven Hills Construction, LLC ("Seven Hills"). Carothers declared Seven Hills to be in default and asserted claims against Seven Hills' surety. After the surety denied the claims, Carothers filed a demand for arbitration, naming the surety as the sole respondent, based upon an arbitration provision in the subcontract. Carothers' demand also sought to arbitrate disputes with the surety on three other projects. The surety commenced a declaratory judgment action on the grounds that it was not bound by the arbitration provision in the subcontract.

In analyzing the applicability of the arbitration provision to the surety, the court observed that three federal district courts around the country had previously addressed the same issue, reaching different conclusions. A district court in South Carolina found that the surety was bound to arbitrate with Carothers. Conversely, district court judges in Kansas and Georgia reached the opposite conclusion. The court agreed with the majority and found that the surety was not bound by the arbitration provision.

The court held that the plain language of the subcontract "leads the Court to conclude that the arbitration provision in question does not cover [the Surety]", because the language of the subcontract focused on disputes between Carothers and Seven Hills. Although the subcontract was incorporated by reference into the bond, neither the subcontract nor the bond provided for the surety's agreement to arbitrate claims. The court rejected as "implausible" Carothers' argument that the court should read the term "subcontractor" in the subcontract to mean "subcontractor and surety." The court ruled that, had the parties intended to bind the surety to arbitrate, the subcontract should not have limited the arbitration provision to disputes "between" Carothers and Seven Hills. In addition, the term "subcontractor and its surety" was used elsewhere in the subcontract. In its brief and at oral argument Carothers' counsel was unable to explain why the court should interpret the term "subcontractor" to mean "subcontractor and surety" in the arbitration provision "when the latter phrase is used elsewhere and to different effect." The court added that Carothers' suggested improvisation of the term subcontractor for subcontractor and surety would lead to absurd results. For example, the subcontract requires the subcontractor to furnish a performance bond and a payment bond. "If subcontractor were to be read universally through the subcontract to mean

subcontractor and its surety, then the surety would not only be responsible for Seven Hills' substantive obligations…but also responsible for obtaining the bond from itself and furnishing the bond to Carothers—a result that seems unlikely at best."

Carothers argued, in the alternative, that the surety should be estopped from seeking to avoid arbitration because: (a) the surety has asserted rights and defenses under the subcontract and "cannot now deny it is bound by the arbitration provision", and (b) the surety's rights, obligations and legal assertions are intertwined with issues arising under the subcontract, which provides for arbitration. In opposition, the surety argued that it was asserting its rights under the terms of the bond and under surety law generally, and not any rights or defenses specific to the subcontract. The court found no evidence that the surety has directly derived any benefits under the subcontract which would justify estopping the surety from avoiding arbitration.

Finally, Carothers asked the court to transfer venue to Georgia, based on the convenience of the parties, if an order is not entered enforcing the arbitration provision. Because other pending actions between the parties (i.e., the other federal actions) would not be consolidated in Georgia, the court found that the convenience of the parties did not compel transfer to Georgia. Since the surety would not consent to the transfer, the court concluded that it lacked the statutory authority to transfer the case to Georgia.

Fidelity Casenotes

By: Carla C. Crapster, Clark Hill Strasburger, Dallas, TX

<u>Discovery Disputes Involving Fidelity Claims</u>

Fed. Deposit Ins. Corp. v. Arch Ins. Co., No. C14-545RSL, 2017 U.S. Dist. LEXIS 51520 (W.D. Wash. Apr. 4, 2017).

The court examined whether the plaintiff could recover from the defendant insurance company "documents related to the insurers' handling, adjustment, or investigation of" the claim at issue. The defendants responded that most of the requested documents were irrelevant, privileged, or too voluminous to produce. The court held that the documents requested fell within the scope of Federal Rule of Civil Procedure 26, but reminded the plaintiff that the Rules require even requests for relevant documents to be proportional to the needs of the case. The court agreed that it would be burdensome for the defendant to have to produce all documents that "contained" the disputed policy terms, as opposed to those that would actually shed light on the meaning of those policy terms. The court also imposed a limited time-frame of four years and required the insurer to produce only documents that shed light on the meaning of the term at issue within the context of a fidelity bond like the one at issue in the case.

Nat'l Retail Sys. v. Markel Ins. Co., No. 17-672, 2018 U.S. Dist. LEXIS 69891 (E.D. Pa. Apr. 25, 2018).

The insurer sought to compel the production of documents that it believed would prove that an officer of the insured knew an employee now accused of theft had previously been charged with "theft of company time." The insurer wanted the insured to (1) answer interrogatories on this topic, (2) produce the personnel file of the officer who purportedly knew of the dishonest employee's previous theft of time, and (3) produce payroll documents that would clarify whether there had been a theft of company time. The court granted the motion to compel in part and denied in part. It held that the scope of the interrogatories and document

request had to be more narrowly tailored to reference the relevant time frame.

Court Sides with Insurance Company on Insuring Agreement (D) Issues; Does Not Dismiss Claim That Insurer Should Have Advised of the Need for Different Coverage

Hudson Heritage Fed. Credit Union v. Cumis Ins. Soc'y, Inc., No. 17 CV 2930, 2018 U.S. Dist. LEXIS 9823 (S.D.N.Y. Jan. 22, 2018).

The insured was a credit union that suffered a loss due to a scheme in which members of the credit union obtained car loans using false documents. Three separate times, "a member of credit union applied for a loan to purchase an automobile using a falsified New York State Department of Motor Vehicles title, which misrepresented the owner/seller of the automobile to be purchased with the loaned funds." The insured sought to recover its loss resulting from nonpayment on the loans under an insuring agreement covering forgery or alteration of an instrument, including a "document of title." The insurance company pointed out that the insured's pleading did not allege that there had been alterations to the original document of title—only to a photocopy or electronic version of the title. The plaintiff amended its pleading to state that "on information and belief," the original DMV titles were falsified. But the plaintiff had admitted that it had only received photocopies of the altered titles. The court held it was improper under these circumstances for the insured to allege "on information and belief" that the *originals* had been altered. The court refused to allow the plaintiff to take discovery to prove alteration of the originals. The court dismissed the claims for breach of contract and a declaratory judgment that coverage applied. But the court did not dismiss a claim of negligence, which was based on the argument that the insurance company should have advised the insured that it needed different coverage than it was purchasing. The court noted that the insurer and insured had a long-standing relationship and that the insured often looked to the insurer for advice on what coverage was needed. The court felt this was enough to survive a motion to dismiss the claim of negligence.

Court Refuses to Extend Computer Fraud Coverage to Social Engineering Scam

Aqua Star (USA) Corp. v. Travelers Cas. & Sur. Company of Am., No. 16-35614, 2018 U.S. App. LEXIS 9660 (9th Cir. Apr. 17, 2018).

The insured was a seafood importer. It purchased frozen shrimp from a vendor known as Longwei. In the summer of 2013, Longwei's computer system was hacked. The hacker apparently monitored e-mail exchanges between an Aqua Star employee and a Longwei employee before intercepting those email exchanges and sending fraudulent e-mails using "spoofed" e-mail domains that appeared similar to the employees' actual e-mails. In these fraudulent e-mails, the hacker directed the Aqua Star employee to change the bank account information for Longwei for future wire transfers. Aqua Star employees made the changes as directed and were ultimately defrauded of $713,890 by the hacker.

The question before the court was whether Aqua Star's losses were covered by its crime policy. The policy, in a Computer Fraud insuring agreement, covered "direct loss of, or direct loss from damage to, Money, Securities, and Other Property directly caused by Computer Fraud." The insurer denied coverage, relying on an exclusion that excluded loss resulting directly or indirectly from the input of electronic data by a person having authority to enter data into the insured's computer system. The district court agreed with the insurer that the exclusion applied. It found that an employee of the insured voluntarily entered data into a spreadsheet on the insured's computer system. The data entered into that spreadsheet was the data used to bring about the wire transfers. The court held that the entry of data into the spreadsheet was an intervening act by someone with authority. The court granted summary judgment in favor of the insurer with respect to the breach of contract claim and a claim of bad faith. On appeal, the Ninth Circuit agreed, focusing only on the application of the exclusion. The court held that the exclusion applied "squarely." It rejected the insured's argument that the efficient proximate cause doctrine barred application of the exclusion. That rule, it reasoned, applies only when there are two competing causes or perils in play. Here, the only peril in play was Computer Fraud.

The Direct Loss Requirement: Direct Means Immediate

Wilbanks Sec. v. Nat'l Union Fire Ins. Co., No. CIV-16-294-R, 2018 U.S. Dist. LEXIS 19278 (W.D. Okla. Feb. 6, 2018).

Stevens was an investment advisor for the insured, Wilbanks. In early 2012, Stevens advised a husband and wife to invest $1.5 million in an oil and gas company, Aztec Oil & Gas ("Aztec"). The investors were hesitant to put so much money into one company, but Stevens reassured them, going so far as to promise they would not lose their investment. The investors were finally persuaded to put their money into Aztec in early 2012. The investment performed for approximately two years. In May 2014, however, the investors expressed dissatisfaction with the investment. And shortly thereafter, it became clear that Aztec was in serious trouble and that the investors' money was lost.

Wilbanks claimed that Stevens engaged in fraudulent and dishonest acts by essentially guaranteeing performance of the investment. In fact, Stevens should not have been encouraging the investors to make this investment at all, because Stevens was not licensed to sell this type of investment. He failed his exam to obtain the necessary license shortly before the investors made this investment. The investors also alleged that there were forged signatures on a disclosure form that asked the investors to acknowledge information about the investment, including that it was a very risky investment. They claim that they never saw or signed this document. The loss the insured sought to recover was the amount it had to pay the investors in a FINRA arbitration.

The insured sought coverage under Insuring Agreements (A) and (D). The court held that coverage was available under neither provision. The court agreed that, with respect to Insuring Agreement (A), there was no evidence of the requisite manifest intent to either cause the insured a loss or obtain a financial benefit for the employee. The insurer further argued that even if the manifest intent were present, the loss to the insured resulted indirectly from Stevens' dishonest conduct. It agreed with the argument that the "resulting directly from" language is satisfied only if there is an immediate connection between the dishonest conduct and the loss. Here, the loss was liability to a third party (the investors). As to the forgery claim, the court held that the agreement alleged to have been forged was not a document of the type listed in Insuring Agreement (D) as it did not have inherent value.

The Limits of Reasonable Expectations in Pennsylvania

Wescott Elec. Co. v. Cincinnati Ins. Co., No. 17-4718, 2018 U.S. Dist. LEXIS 37938 (E.D. Pa. Mar. 8, 2018).

The Pennsylvania court analyzed whether the reasonable expectations doctrine could transform a discovery policy into a loss-sustained policy. It held that it could not. The insured in that case had an employee that stole almost $3 million from it over a period of approximately ten years. The insured had four policies in place over the ten-year period, including several multi-year policies. The theft was discovered in mid-2013, which was during the policy period of the last policy the insurer had issued. The policy in place provided coverage of $100,000 for each occurrence of employee theft. The insurer paid that amount. But the insured sought to recover under a previous policy and alleged that there had been more than one "occurrence." The policy at issue provided, however, that discovery had to occur during the policy period. Here, discovery had obviously occurred only once – during the last policy period. In addition, the policy at issue defined "occurrence" as the "combined total of all separate acts whether or not related; or a series of acts whether or not related; committed by an employee." Here, because all the thefts had been committed by a single employee, it was clear there had been only one occurrence. But the insured argued that under the reasonable expectations doctrine, this language should not be enforced because earlier policies the insured had purchased from this insurer were loss-sustained policies, with a one-year discovery period. The insured asked the court to reform the later policies to match this earlier language. It asserted that no one at the insurance company had ever related that there would be a change in policy language. The court agreed with the insured that Pennsylvania generally follows the reasonable expectations doctrine, but refused to apply it here for three reasons. First, the language was clear and conspicuous, which barred the insured from arguing that it had not read of understood the relevant language. Second, the insured had not requested the type

of coverage it was now asking the court to reform the policy to reflect. Third, the court noted that the insured had been given a copy of the policy before it took effect. The court agreed with the insurer that there had been only one "occurrence" and that the discovery nature of the policy could not be undone by the reasonable expectations doctrine.

Limiting Coverage to Instances in which the Dishonest Employee Received a Financial Benefit Is Consistent with a Mississippi Statute

Renasant Bank v. St. Paul Mercury Ins. Co., 882 F.3d 203 (5th Cir. 2018).

The insured was a bank which alleged that one of its loan officers engaged in lending transactions with her customers that resulted in losses to the bank. The insurer denied the claim, arguing that the bank did not prove that the loan officer received an improper financial benefit, as required by the bond. The bond was a statutory bond under Mississippi law, as it was furnished to comply with the statute that required employees of state chartered banks to be bonded (Miss. Code. Ann. § 81-5-15). The insured argued that the requirement of a showing of a financial benefit to the dishonest employee was inconsistent with the Mississippi statute. But the insurer argued that the "improper financial benefit" requirement was consistent with the intent of the statute. The statute requires the bond to cover losses caused by "dishonesty," which "inherently incorporates an element of intent." Thus, the insurer contended that provisions setting the parameters of intentional conduct, such as the improper financial benefit requirement, are consistent with the statute's intent. The bank's sole argument that the loan officer received an improper financial benefit was that she received commissions on the allegedly fraudulent loans. The bond expressly excluded commissions from the definition of financial benefit. Further, the "majority rule" is that receipt of a commission was not receipt of an improper financial benefit. The district court sided with the insurance company, and on appeal, the Fifth Circuit affirmed. The appellate court did not actually analyze whether the bond at issue was a "statutory bond" or not because it agreed with the insurance company that even if it was, the requirement of a showing of an improper financial benefit to the dishonest employee was consistent with the statute. The court reasoned that the purpose of this requirement was to allow the insurance company to avoid covering cases of simple bad business judgment. This was consistent with the Mississippi statute that required financial institutions to obtain coverage for employee dishonesty.

LEGISLATIVE UPDATE

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

The 2018 legislative sessions are well underway and a handful of states have already adjourned for the year. There has been a significant amount of surety related legislation, but compared to years past the number of enacted bill is smaller. One issue that continues to emerge as states determine how to fund public projects is Public Private Partnership (P3) legislation. From a surety perspective, it is critical to ensure that these projects are protected like any other public project with payment and performance bonds. Below we have highlighted the Indiana P3 legislation. In the commercial context, as states legalize marijuana, licensing bills are being introduced which sometimes include license bond requirements. For example, Utah enacted a medical marijuana license bond this year. Please see the statutory section or bill number identified in the text and footnotes below for complete details on the

aforementioned legislation and a sampling of other issues that may affect the surety industry.

Indiana

P3

The Indiana legislature has again urged an interim study on the issue of requiring bonds for P3 projects. If the study committee is formed, recommendations should be provided to legislative council no later than November 1, 2018.[1] At the same time, the legislature amended the existing Indiana Finance Authority (IFA) law to, among other things, eliminate the ability to enter into P3 arrangements for communication projects.[2] The IFA can still enter into a P3 for a state park inn and related improvements, but there are additional requirements imposed such as that the private entity must have completed a similar project within 2 years of the data of submission of the offer or proposal.

New Mexico

Reclamation Bond

New Mexico requires oil and gas operators to furnish financial assurance that a well will be plugged and abandoned in accordance with New Mexico laws. Such financial assurance can be in the form of a surety bond, irrevocable letter of credit, cash, or well-specific plugging insurance policy. The maximum blanket financial insurance amount has been increased from $50,000 to $250,000.[3]

Utah

Medical Marijuana Bond

The newly adopted "Cannabidiol Product Act"[4] requires licensed cannabidiol processors or laboratories to post a $100,000 surety bond for as long as the processor or laboratory operates. The form shall be in a form approved by the Attorney General and conditioned upon compliance with the law.

West Virginia

Bond Threshold – School Projects

The bond threshold for building or repairing school property has been increased from $100 to $25,000.[5]

Wyoming

Reclamation Bond

Under existing law[6] mining operations in Wyoming require a land quality permit. As part of the permitting process, a surety bond is required to ensure compliance with the law. The law was amended this year[7] to allow the Environmental Quality Council to promulgate rules allowing real property located in Wyoming to be posted as collateral in lieu of a surety bond.

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[1] Ind. Code § 8-15.5-1-2 (H.B.1301; effective July 1, 2018).
[2] Ind. Code § 8-15.5-1-2 (H.B. 1374).
[3] N.M. Stat. Ann. § 70-2-14 (S.B. 189).
[4] Utah Code Ann. § 4-43-203 (S.B. 130).
[5] W. VA. Code §18-5-12 (S.B. 561).
[6] Wyo. Stat. Ann. § 35-11-417.
[7] Wyo. Stat. Ann. § 35-11-417 (S.F. 56; effective: July 1, 2018).

43rd ANNUAL MEETING
SURETY CLAIMS INSTITUTE

2018 PROGRAM AGENDA

Tuesday, June 19	
3:00 – 5:00 p.m.	Registration Desk Open
6:00 -8:00 p.m.	Reception

Wednesday, June 20	
8:30 – 9:00 a.m.	Board of Directors Breakfast
9:00 a.m. – Noon	Board of Directors Meeting
2:00 – 5:00 p.m.	Registration Desk Open
2:00 – 5:00 p.m.	Speakers' Rehearsal
6:00 – 9:00 p.m.	Get Acquainted Reception/ Buffet Dinner*

Thursday, June 21	
7:30 a.m.	Continental Breakfast for Registrants
8:00 a.m. – 11:30 a.m.	Seminar Program
11:30 a.m. – 1:00 p.m.	Buffet Lunch *
1:00 – 5:00 p.m.	Golf Tournament*
6:30 – 9:30 p.m.	Children's Party*
7:00 – 10:00 p.m.	Reception and Banquet Dinner *

Friday, June 22	
7:30 a.m.	Continental Breakfast for Registrants
8:00 a.m. – Noon	Seminar Program
Noon	Adjourn

*Reservations Required

Times/speakers/and educational topics subject to change

43rd ANNUAL MEETING
SURETY CLAIMS INSTITUTE

SEMINAR PROGRAM SCHEDULE

THURSDAY PROGRAM
June 21, 2018

8:15 - 8:50 **Surety Law Update:**
Benjamin D. Lentz
Patricia Wager
Michael Burkhardt

8:50 – 9:35 **Erosion of The Overpayment Defense and Tips for Sureties When Dealing with Obligees that Have Depleted Contract Funds:**
Lloyd N. "Sonny" Shields
Timothy D. Martin

9:35 – 9:50 **BREAK**

9:50 – 10:40 **BIM (Building Information Modeling), Roads, and Completion Issues from a Contractor's Perspective:**
Paul C. Schraf
Greg Daily
Robert Fox
Dennis P. O'Neill
William Ikerd
Munther S. Shamieh

10:40 – 11:25 **Advanced Problems Confronting Claims Handlers and Practical Approaches to Addressing Them:**
J. Blake Wilcox
Frank M. Lanak
Keith A. Langley

SEMINAR PROGRAM SCHEDULE

FRIDAY PROGRAM
June 22, 2018

8:15 – 8:50 **Fidelity Law Update:**
Carla C. Crapster
Ben Weible

8:50 – 9:25 **Guidance When Dealing With State and Local Public Bodies, Including Educational and Institutional Infrastructures and Municipal Authorities:**
Michael T. Cronin
Jessica E. Bowers
Michael J. Hurley
Stephen R. Ferretti

9:25 – 10:00 **Best Practices for Negotiating Takeover and Tender Agreements:**
Laurence P. Jortner
Christopher T. McRae
Bradford R. Carver
C. Hamilton Jarrett

10:00 – 10:15 **BREAK**

10:15 – 10:50 **The Financing Trinity: 3 Key Considerations When Structuring a Financing Agreement to Avoid Losses**
Michael Carson
Christopher R. Ward

10:50 – 11:50 **Ethics: Real Problems Confronted by Surety Professionals, Including Issues of Conflict of Interest:**
Ali Salamirad
Marilyn Klinger
David J. Barton
Christine Bartholdt

REGISTER NOW – JUNE 20-22, 2018

43rd Annual Meeting and Seminar
Surety Claims Institute

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

Beaver Creek

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

ACTIVITIES BEFORE, DURING, AND AFTER THE MEETING

1. Centennial Express Chairlift Rides: Take a ride up to the top of Beaver Creek Mountain via the Centennial Express high-speed chairlift (fee applies). Take advantage of the complimentary activities at the top of the mountain including 18-hole championship disc golf course, tetherball, hiking, horseshoes, orienteering park, & much much more!

2. Jeep, Hummer, and ATV Mountain Tours: Let an experienced guide drive you through the beautiful Colorado high country in a comfortable four-wheel drive Jeep or Hummer. If you want to take the wheel, try an exciting ATV adventure. With easy-to-drive four wheelers, you can explore the historic Camp Hale area, four different mountain ranges, or the Continental Divide.

3. Hot Air Ballooning: Just after sunrise, hot air balloons ascend into flights that provide a bird's eye view of the Rockies for one to two hours. Experience the peaceful thrill of soaring above some of the finest scenery in the world.

4. Train Rides: Enjoy the beautiful scenery of the Rockies from the comfort of a train. Alpenglow Adventures Train Tours offers door-to-door service, and tours on the Colorado Zephyr, Royal Gorge and Georgetown Loop Railroads. Choose from 3-, 5-, 8-, or 12-hour tour packages that include many additional family-fun activities along with the excitement of "ridin' the rails!"

5. Mine Tours: Visit the National Mining Museum, which serves as a monument to the memory of the men and women who pioneered the discovery, development and processing of our nation's natural resources. And tour the Matchless Mine, one of the richest silver mines of its era.

We look forward to seeing you at the Park Hyatt Beaver Creek Resort.
If you have questions, call Diane Kennedy at (816) 931-2700 or email Diane at dkennedy@dysarttaylor.com
For more information about SCI, visit our website at www.scinst.org

SUGGESTIONS & COMMENTS??

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