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Newsletter

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

SNEAK PREVIEW OF THE 48TH ANNUAL MEETING AND SEMINAR AT THE HYATT REGENCY CHESAPEAKE BAY RESORT

By: Amy E. Bentz, Esquire, Bentz Law Firm, P.C., Pittsburgh, PA

The Surety Claims Institute's 48th Annual Meeting will be held June 21, 2023 through June 23, 2023 at the Hyatt Regency located on the gorgeous Chesapeake Bay in Cambridge, Maryland. This year, Brian Kantar of CSG Law begins his two-year tenure as Chair of the Educational Program with an array of relevant and interesting topics that affect each of us in our work. As always, the SCI Board of Directors endeavors to choose locations that offer a family-friendly atmosphere in an upscale setting. The beautiful Chesapeake Bay Hyatt Regency is no exception.

Families will enjoy the first class resort surrounded by the expansive waterfront complete with amenities and activities for everyone of all ages. The beach and marina options include water sports like kayaking, paddleboarding, boating and fishing. (*Continued on page 8)*

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COMMENTS FROM THE EDITOR

This past year has seen a spate of terrible surety/bankruptcy decisions from the U.S. Courts of Appeals for the Seventh Circuit (*Kimball Hill*) and Fifth Circuit (*Falcon*) and the U.S. District Court for the Southern District of Texas (*Fieldwood*). The

Kimball Hill and *Fieldwood* decisions are summarized in the surety casenotes in this issue and the *Falcon* decision was the subject of an article by my bankruptcy partner Scott Zuber in the last issue of this Newsletter. I am going to assume familiarity with these decisions for purposes of these Comments. And for those not familiar and who get involved in surety bankruptcy cases, I recommend that you become familiar with them, as each is dangerous in its own way and demonstrates pitfalls surety counsel face in efforts to protect traditional surety rights and interests in bankruptcies of bond principals. There are a variety of errors in these decisions; but errors that they all share include the incorrect treatment of bonds, effectively converting bonds into assets of the debtor's estate, and the failure to appreciate the nature of the surety bond's tripartite relationship.

While a bond principal is the primary obligor under the bond, each of these decisions effectively converts the bonds into assets of the estate. As a result, parties who are not obligees or beneficiaries of the sureties' bonds become beneficiaries. In each of these cases bonds are utilized by the debtor and its creditors, with the assistance of the bankruptcy court, to enhance the value of the debtor's assets. In each of these cases the secondary obligation of the surety is converted into an asset of the primary obligor/principal for the benefit of the principal's estate and its creditors. This turns on its head the nature of the surety/principal relationship.

There always seems to be an interest on the part of bankruptcy judges to arrive at a successful plan of reorganization. In achieving this result, they often will support a debtor's efforts to maximize the value of assets of the estate. Debtors have been increasingly taking advantage of this seeming predisposition to obfuscate the nature of the tripartite surety bond relationship. The most fundamental of these misunderstandings is the basic fact that the principal on the bond is the primary obligor. It is not the beneficiary of the bond; and the filing of a petition in bankruptcy does not convert the principal's primary obligation under the bond into an asset of the debtor's estate which it can utilize to increase the value of that estate. Yet that is precisely what the courts in each of these cases allowed. In *Fieldwood*, the court held that sureties could have no subrogation rights against purchasers of the debtor's offshore oil and gas leases. As a matter of clear federal statutory and regulatory law, the purchaser of oil and gas leases becomes a joint and several obligor with respect to the obligation to decommission leasehold infrastructure (platforms, wells, pipelines, etc.). Predecessor leaseholders are also jointly and severally liable. However, under case law interpreting the regulations, quite appropriately, the current leaseholder is the primary obligor and the predecessor leaseholders are secondary obligors. As such, the surety for a predecessor principal is a secondary obligor to the secondary obligor principal and as between the surety for the predecessor and the surety for the current leaseholder, the surety for the current leaseholder has primary liability when compared with the liability of the surety for the predecessor. Ironically, caselaw so holding includes a decision (*In re Tri-Union Dev. Corp.*, No. 03-44908, 2015 WL 5730745 (Bankr. S.D. Tex. Sept. 28, 2015) by the same bankruptcy judge (Judge Marvin Isgur in the Southern District of Texas) who confirmed the Fieldwood Plan of Reorganization. In *Tri-Union* Judge Isgur was correct. His decision in *Fieldwood* cannot be reconciled with his prior decision in *Tri-Union.* Nor can it be reconciled with longstanding principles of suretyship and subrogation.

In *Fieldwood*, the purchaser of the "good" federal oil and gas leases admitted that it would be obligated to decommission the infrastructure in place in the leases being acquired under applicable federal regulations. And according to the purchaser,

$350 million of the $1.03 billion in consideration it was providing for its purchase of the valuable leases was the assumption of those decommissioning obligations. Under well-established bankruptcy law (and the clear requirements of section 365 of the Bankruptcy Code), in order for a debtor to assume and/or assign a lease, it must cure any defaults and provide adequate assurance of future performance. Therefore, there were no defaults under the leases at the time of bankruptcy sale nor could there have been. The debtors also advised the bankruptcy court that the purchaser would not be relying upon any existing surety bonds to operate going forward, but would provide its own financial assurance.

So what was the problem? The problem was that the court confirmed a Plan which was amended in the days before Plan confirmation to provide that the sureties for the debtors would have no subrogation rights against the purchaser with respect to any losses the Fieldwood sureties subsequently might sustain under their bonds. The bankruptcy court found, without a rational basis, that the purchaser would not acquire the leaseholds if the court did not allow the sale of the assets of the debtors free and clear of future surety subrogation rights.

This conclusion makes no sense and should have been treated as clear error on appeal. The error is manifest on multiple levels. The only way the sureties for the predecessor leaseholder (debtor Fieldwood) can sustain a loss with respect to these good leases would be if the purchaser does not do what it promised to do under the Plan and what it is obligated to do under federal regulations: decommission the infrastructure after the purchaser has extracted the mineral resources (oil and gas) and abandons the leases. Because the purchaser had properly allocated $350 million of its purchase price for the cost of this decommissioning, if the purchaser complies with the Plan, the Fieldwood sureties will never have any subrogation rights because they would be making no payment and sustaining no loss. The only way the sureties can sustain a loss is if the purchaser does not fulfill its promise and does not perform the required decommissioning.

The notion that the purchaser would not purchase these leases without a sale free and clear of surety subrogation rights is therefore nonsensical on its face. If the purchaser was allocating $350 million of its purchase price to account for the cost of performing the $350 million of decommissioning, then the only way the sureties can sustain a loss is if the purchaser instead pockets the money which was to be dedicated to the decommissioning and fails to perform as promised and as provided in the Plan. The purchaser would not care if it spent that $350 million in hiring contractors to perform the decommissioning or instead paid the sureties which performed that $350 million of decommissioning costs due to the purchaser's own failure to do so. There would be no economic difference to it. It would be spending $350 million either way. With the elimination of the sureties' subrogation rights, however, the purchaser now has every incentive to pocket the $350 million allocated to pay for the decommissioning costs and hope that federal regulators call on the sureties to perform or pay under their bonds. There was no rational basis for the court to conclude that it would make a bit of difference to the purchaser as to who gets paid the $350 million, the contractors hired by the purchaser to perform the decommissioning or the sureties for Fieldwood if they are called upon to perform or pay because the purchaser failed to arrange and pay for the decommissioning.

The bankruptcy court also erred in finding that the debtor could sell the leases free and clear of the equitable lien which sureties may assert as a result of their subrogation rights. The bankruptcy court disregarded the fact that the sureties at the time of plan confirmation had no equitable

lien. A surety's equitable lien arises only upon payment. No payment had been made by the sureties at the time of the sale. Thus no equitable lien existed. And because the value of the leases being acquired substantially exceeded the future projected decommissioning costs, none would ever arise if the purchaser performed its obligations under the Plan and complied with federal law. So, the notion that the purchaser would not have acquired the leases without a waiver of the sureties' subrogation rights is nonsensical as a matter of simple math. The cost of performing the decommissioning is the same whether the cost is paid directly to performing subcontractors or is paid to the surety which pays such performing subcontractors due to the failure of the purchaser to do so.

The district court, in reviewing the Plan Confirmation Order as a result of the appeals of several of the Fieldwood sureties, affirmed the bankruptcy court's Plan Confirmation Order. In doing so, it avoided any analysis of surety subrogation rights. Rather, it found that the appeal was both statutorily and equitably moot based upon the consummation of the Plan Confirmation Order without a stay pending appeal. Given the hundreds of millions of dollars involved, in order to obtain a stay pending appeal to address the manifest errors of the bankruptcy court, the sureties would likely have been required to post appeal bonds for hundreds of millions of dollars. So the bankruptcy court confirmed revisions to the Plan providing a potential gift of hundreds of millions of dollars to the benefit of secured creditors of the debtor (who controlled the credit bid purchaser of the leases). In doing so, it enhanced the value of the debtors' estate by the sum of \$350 million, effectively converting the debtors' interest in the bonds from that of primary obligor to that of a beneficiary for the benefit of debtors' secured creditors.

The Seventh Circuit's decision in *Kimball Hill* was similarly misguided. There the surety which sustained losses under subdivision bonds was charged with having violated the Plan injunction by asserting post-confirmation subrogation claims against a subsequent developer of the property which the developer acquired from the bankruptcy estate. Not only was the surety deprived of subrogation rights against the subsequent developer when that developer ultimately failed to comply with the developers' agreement with the municipality, but the surety was socked with millions of dollars in contempt damages for its supposed breach of the Plan Confirmation Order's injunction with respect to the bankruptcy estate and third parties allegedly covered by the Plan injunction order. Again, the net effect of the decision of the Court of Appeals was to convert the primary obligation of the principal debtor into an asset of the estate for the benefit of a purchaser of the debtors' property.

There seem to have been two reasons for the Seventh Circuit to have gone astray. First, it seems to have considered the position of the surety as that of having asserted indemnity claims it had against the debtor as claims against the subsequent developer which purchased the property of the debtor. But the surety's claims were not indemnity claims against the debtor. Rather, they were claims arising as a result of the purchaser's own failure to comply with its obligations as a developer under applicable ordinances and the development agreement between the obligee municipality and the developer. The rights being asserted by the surety were not rights under its indemnity agreement with the principal. The surety's rights under the principal's indemnity agreement may have been discharged in bankruptcy; but that discharge and those rights were not the rights actually being asserted. Rather, when the subsequent developer itself failed to install the municipal improvements required by the developer's agreement and the surety was called upon to perform under its bond issued for the original

developer, the surety stepped into the shoes not of its principal, but of the bond obligee municipality. Nothing in the Plan injunction could serve as an indulgence allowing the purchasing developer to ignore municipal ordinances and the terms of the developer's agreement. The purchasing developer did not acquire from the debtor in the bankruptcy sale rights which the debtor did not have. Specifically, title to the development project did not come with rights to claim on the debtor principal's own surety bond or the right to ignore municipal obligations associated with the purchaser's development of the acquired property. The debtor was the primary obligor under the subdivision bond. It was not the beneficiary and cannot sell any right to the purchaser of any interest in the surety's bond. But again, the bankruptcy court and ultimately the Seventh Circuit effectively converted the principal's primary liability into an asset such that the purchaser of the development project somehow became immune from performing the installation of the subdivision improvements required under the developer's agreement with the municipality. And when the purchaser failed to install the improvements and the surety was called upon to do so and sustained losses in doing so, the Seventh Circuit effectively allowed recovery by the purchaser/new primary obligor under the development agreement against the prior developer's surety!! Again this result is simply nonsensical.

What the *Fieldwood* and *Kimball Hill* courts both failed to appreciate is that the debtors were not the beneficiaries of their own bonds and did not by selling their interests in the leases and debtors' development project convey anything more than what they had as principals: the right to exploit or develop the property subject to the obligations of the leaseholder under federal law and the debtors under the developer's agreement and requirements of municipal law. The *Kimball Hall* principal had no right to sell an exemption from municipal development obligations any more than Fieldwood had the right to sell federal leases free and clear of the obligation to comply with federal law governing decommissioning obligations.

In each of these cases the courts seem to have fundamentally misunderstood the tripartite surety relationship and the fact that the principal is the primary obligor under the bond. It cannot by selling assets encumbered by federal, state, municipal or contractual obligations separate the benefits of the contracts or property rights from the burdens. But that is what the courts have mistakenly allowed. A debtor holding a lease cannot sell the right to future occupancy of the tenancy free and clear of the obligation to pay rent. The benefits of each of these leases and contracts cannot be sold free and clear of the burdens. A purchaser can receive no more than that which the debtor has to sell.

So what is the moral of the story? First, it should be noted that the *Kimball Hill* case involved a plan containing third-party releases. A surety ought to opt out of third-party releases in any plan. Many courts have been taking a harder stance on third-party releases in bankruptcy plans in general and a surety opposing third-party releases in a proposed plan stands a good chance of avoiding being subject to such releases. But most importantly, sureties must continue to take nothing for granted with respect to a bankruptcy judge's ability to parse the rights and obligations of the parties under surety bonds. The court should be educated as to the fact that the debtor is the primary obligor under the bond, not a beneficiary. A surety bond is not an asset of an estate any more than a promissory note given by the debtor is an asset of the estate. It is a liability as to which the debtor is the primary obligor. The debtor has no right to sell the rights of the bond obligee to a third party and a third party who desires to succeed to the position of the debtor can get nothing more than the debtor had, which is the

primary duty to perform the primary obligations of the debtor under the bond.

Of course, the purchaser has no obligation to purchase the debtor's interest in any underlying asset. But if it acquires that interest, it acquires the obligations of the underlying contract as well as the rights thereunder. If it wants to acquire the lease or contract rights, it must pay the rent and perform whatever other obligations exist with respect to that leasehold or development right. And if it does not perform the obligations under that lease or contract and the surety is obligated to perform based upon the bond it issued on behalf of the original principal and in favor of the obligee, it is entitled to enforce the rights of the bond obligee as subrogee of that obligee. Courts should not be confused, and the surety must make very clear, that it is not seeking to enforce rights of the surety against the debtor which may have been discharged. It is seeking to enforce the rights of the bond obligee against the purchaser which itself is breaching an applicable statute or the burdens of the lease or contract it opted to purchase so as to obtain the benefits of that lease or contract. But any such purchase remains subject to the obligations imposed by contract or by law with respect to such lease or contract. Where the purchaser has failed to perform obligations owed to the obligee and the surety is called upon to so perform, it is entitled to assert the rights of that obligee as though that obligee did not have a bond at all. Under those circumstances, a performing surety is asserting the rights the obligee would have had had it sustained the loss itself as opposed to the loss having been sustained by the surety. The Restatement (Third) of the Law of Suretyship & Guaranty makes this point clearly and is worth citing, as has the Supreme Court in *Pearlman v. Reliance* and the many courts which have followed well-settled surety law in this regard.

But none of this is likely to be understood by bankruptcy courts which are looking to find money to support a successful plan of reorganization unless led by the nose by counsel for the sureties. But as *Fieldwood* made clear, even when so led the court may take advantage of its ability to effectively avoid appellate review through use of the concepts of equitable or statutory mootness which allowed the Fieldwood bankruptcy court to avoid substantial judicial review. And even review by a Circuit Court of Appeals is not guaranteed to produce a correct result as we have unfortunately found in *Kimball Hill* and *Falcon*. Oh for the days when the courts took seriously the notions of *strictissimi juris* and that sureties are favorites of the law. Now all we are left with is the biblical admonition that he who is surety for another shall smart for it!!

Armen Shahinian
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2023 SURETY CLAIMS INSTITUTE MEETING AT THE HYATT REGENCY CHESAPEAKE BAY RESORT CAMBRIDGE, MARYLAND PROGRAM PREVIEW

(*Continued from page 1)*Families will enjoy the first class resort surrounded by the expansive waterfront complete with amenities and activities for everyone of all ages. The beach and marina options include water sports like kayaking, paddleboarding, boating and fishing. There are numerous historically significant venues nearby in the area. The Hyatt Regency Chesapeake Bay offers all of the amenities you have come to expect from the SCI's annual meeting locations: rooms with beautiful views, an excellent golf course, spacious meeting and reception venues, various activities and attractions as well as other amenities.

In addition to the offerings of this fantastic venue, we are very excited about the introduction of a new Surety School, an educational / networking opportunity for our newer practitioners organized by yeoman efforts of Scott Williams of Manier & Herod and Gina Lockwood of Merchants Bonding Company, that we hope becomes a permanent feature of our annual meetings. This one day program takes place on Wednesday before the Annual SCI Meeting commences. The subjects covered in the Surety School range from underwriting to claims and include contract and commercial surety subjects.

This year's SCI Educational Program is designed for our more seasoned members and promises to provide a wealth of information that should not be missed. This "hot topic" program covers subjects that are not generally addressed or thoroughly examined in other programs.

Thursday morning opens strong with the dynamic duo of Pat Kingsley and Greg Daily discussing insider tips for a successful mediation. Laura Sherry and Alex Kahn follow with "My Bond Says What??," a lively discussion on the unexpected problems we often confront. Then, Chris Alexander and Jonathan Ord cover very recent developments in cryptocurrency and surety bonds.

After the break, Melissa Lee, Melissa Rice and Elizabeth Paquet discuss problems we all face such as price escalation, inflation and other issues facing the surety industry in the post-pandemic world. Thursday's program wraps up with the one hour ethics discussion on the surety's use of consultants.

Back by popular demand, Friday morning will begin with our Surety Law Update presented by Patricia Wager and Tiffany Schaak. Then, Joel Beach and Richard Pledger discuss the complex art of navigating the indemnitor's affirmative claims and defenses. Immediately following in a humorously titled program "The F Words (Fieldwork and Falcon) – What's the Fuss About?" Darren Grzyb, Scott Zuber, Robert Lavitt and Anthony Manganiello will discuss recent developments in this hot area. Friday's session concludes with a consummate program on the State of the Surety Industry. A more detailed seminar agenda and program schedule, setting forth the program topics and speakers, are reproduced later in this Newsletter. We look forward to seeing you in June!

48th Annual Meeting & Seminars

Tuesday, June 20 – Friday, June 23, 2023

The Hyatt Chesapeake Bay, Cambridge, Maryland

AGENDA

Tuesday, June 20		
3:00 – 5:00 p.m.	Registration Desk Open	Cutter A/B

Wednesday, June 21		
9:00 – Noon	Board of Directors Meeting	Skipjack A/B
10:30 – 4 p.m.	Surety School*	
2:00 p.m. – 5:00 p.m.	Registration	Bay Country Foyer I
1:00 – 5:00 p.m.	Speakers Rehearsal	Skipjack A/B
6:00 – 9:00 p.m.	Get Acquainted Reception/ Buffet Dinner*	Regatta Pavilion+

Thursday, June 22		
7:30 a.m.	Continental Breakfast for Registrants	Chesapeake E/F/G
8:00 a.m. – 11:30 a.m.	Seminar Program	Chesapeake E/F/G
1:00 – 5:00 p.m.	Golf Tournament*	
6:30 – 9:30 p.m.	Children's Party*	Camp Hyatt
7:00 – 10:00 p.m.	Reception and Banquet Dinner *	Chesapeake E/F/G

Friday, June 23		
7:30 a.m.	Continental Breakfast for Registrants	Chesapeake E/F/G
8:00 a.m. – Noon	Seminar Program	Chesapeake E/F/G
Noon	Adjourn	

*Reservations Required

**Inclement Weather Back up – Windjammer + Inclement Weather Back up – Chesapeake A/B/C/D

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

48th SURETY CLAIMS MEETING - SEMINAR PROGRAM SCHEDULE

THURSDAY PROGRAM

8:00 – 8:15 **Opening Remarks:** ***Steve D. Nelson, Markel Surety***
Program Remarks/Introduction of Speakers: *Brian Kantar, CSG Law*

8:15 – 8:45 **Tips for a Successful Mediation**
Speakers: Patrick Kingsley and Greg Daily

8:45 – 9:15 **My Bond Says What???**
Speakers: Laura Sherry and Alex Kahn

9:15 – 9:45 **Cryptocurrency and Surety Bonds: Recent Developments**
Speakers: Jonathan Ord and Chris Alexander

9:45 – 10:00 BREAK

10:00 – 10:30 **Price Escalation, Inflation, and the Post Pandemic World – Impacts to the Surety**
Speakers: Melissa Lee, Melissa Rice, and Elizabeth Paquet

10:30 – 11:30 **The Ethical Surety Consultant**
Speakers: Rebecca Glos, Frank Lanak, and Wayne Lambert

FRIDAY PROGRAM

8:00 – 8:15 **Opening Remarks:** ***Steve D. Nelson, Markel Surety***
Program Remarks/Introduction of Speakers: *Brian Kantar, CSG Law*

8:15 – 9:00 **Surety Law Update 2023 Update – Select Case Summaries**
Speakers: Patricia Wager and Tiffany Schaak

9:00 – 9:35 **Navigating Indemnitors' Affirmative Claims and Defenses**
Speakers: Richard Pledger and Joel Beach

9:35 – 10:15 **Oil & Gas Bonds – The F Words (Fieldwood and Falcon) – What's All the Fuss About?**
Speakers: Darren Grzyb, Scott Zuber, Robert Lavitt, and Anthony Manganiello

10:15 – 10:30 BREAK

10:30 – 11:30 **State of the Surety Industry**
Speaker(s): Special Guest

SURETY SCHOOL AT SCI –
A FAST TRACK FOR DEVELOPMENT OF NEW INDUSTRY PROFESSIONALS

By: Scott Williams, Manier & Herod, P.C., Nashville, TN and
Gina Lockwood, Merchants Bonding Company, Austin, TX

A brief word and thank you…

About a year ago, Gina and I were preparing our presentation for an upcoming seminar and reminiscing, as surety-folk tend to do, about how we landed in surety. We discussed how difficult it can be for new professionals starting out to describe to others (and themselves) what surety is, why it is important to business, and how rewarding *and* fun, it can be for those fortunate enough to land here and "stick with it." Gina and I have been in the surety industry for almost 35 years combined, and at least one of us will admit that it took some time to find the answers to these questions. We found them through education, and collaboration, and with the help of industry professionals in SCI and other organizations who were kind enough to mentor us along our way. We founded Surety School to fast-track, if-you-will, the time it takes to find these answers, and to shorten the time between when surety is something you do, and when surety is something you love. Surety becomes something you love when you want to learn, and when you are connected to your company and the industry. SCI has a long history of educating and connecting its members through quality programs in unique settings, and Surety School is honored that SCI has agreed to host our nascent program during its Annual Meeting. We want to thank SCI's Board and its membership for their support, and we look forward to seeing everyone in June.

Gina D. Lockwood

This year the Surety Claims Institute is partnering with Surety School to provide an intimate, educational roundtable and mentorship program for industry professionals with less than 5 years of surety experience. Consistent with SCI's mission of education and professional development,

Surety School exists to develop new professionals in the surety industry though education, mentorship, collaboration, and the creation of opportunities.

We want our students to cultivate a passion for surety by understanding the business of surety, establishing meaningful connections, and adhering to high professional standards to benefit all industry stakeholders. Surety School furthers these objectives through a well-rounded curriculum that provides students with industry insight and perspective, education and understanding of fundamental surety concepts, and meaningful opportunities to connect with their peers and industry leaders in a small group setting.

Although there is no cost to attend Surety School, enrollment is limited to 20 students to facilitate an interactive discussion between students and faculty. We are excited about the curriculum and faculty we have developed for the June 21, 2023, session at the Hyatt Regency Chesapeake Bay, which will run from 10 a.m. to 4:15 p.m., and will be followed by a student and faculty happy hour reception from 4:15 p.m. to 5:30 p.m.

Surety School will open with a discussion of "*The Broker-Underwriting-Claims Triumvirate – Understanding Industry Dynamics, Using Them to Manage Claims, and Looking to the Future,*" in which Tracey Haley and Ed Reilly will provide students with an understanding of the role of brokers, agents, and underwriters in extending surety credit, the account relationship, and the claims process. Jon Bondy and Doug Wills will transition the focus to the surety's indemnity agreement rights under standard contract and commercial forms and examine how sureties actually use those rights in "*The General Agreement of Indemnity, Trust Funds and Subrogation.*" During the lunch break, Steve Nelson will welcome students on behalf of SCI and preview the SCI program.

After lunch, students will participate in an "*Accounting and Engineering Workshop*" to learn surety accounting and engineering fundamentals, such as how to understand financial statements, loss runs, and WIP schedules from Pete Fascia and Brent McSwain. Next, surety-speak will be demystified in "*Contractor Default Dictionary*," where Chris Marron and Michael Cronin will discuss different types of construction contracts, the surety's performance bond options following termination, and mitigation tools available to the surety. Analyzing and understanding the complex world of commercial bonds will be examined by Ryan Dry and Scott Williams in "*Commercial Claims – For the Use and Benefit Of? Who is the Obligee?*" Stephani Miller and Gina Lockwood will lead the final discussion of the afternoon, "*The Claims Professional's Checklist for Contract and Commercial Claims*," where students will learn about the ins and outs of the claims handling process from these two company professionals.

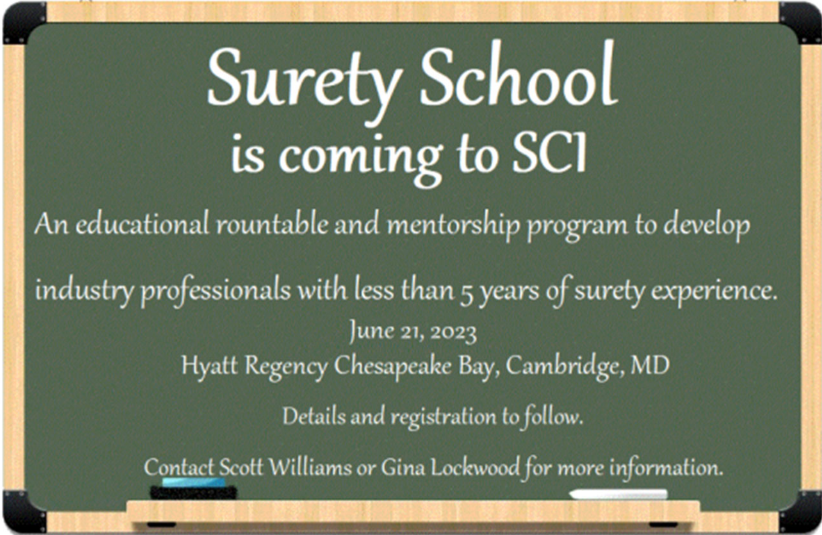
Immediately following the program, students and faculty will have an opportunity to socialize and network with each other at a Surety School happy hour, following which everyone will transition together to the SCI welcome reception.

If you or a colleague would like to register for Surety School please contact Gina Lockwood (glockwood@merchantsbonding.com) or Scott Williams (swilliams@manierherod.com). Alternatively, if you select "Surety School" when enrolling for SCI you will be contacted to complete a Surety School registration form.

Surety School Agenda

10:00 – 10:15 a.m.	*Welcome and Opening Remarks* Gina Lockwood, Merchants Bonding Company Scott Williams, Manier & Herod
10:15 – 11:00 a.m.	*The Broker-Underwriting-Claims Triumvirate – Understanding Industry Dynamics, Using Them to Manage Claims, and Looking to the Future.* Who's Who, Extending Surety Credit, Understanding the Account, and Roles in Managing and Handling Claims. Faculty: Tracy L. Haley, Zurich North America Edward Reilly, American Global
11:00 a.m. – 12:00 p.m.	*The General Agreement of Indemnity, Trust Funds and Subrogation* An in-depth review of standard contract and commercial form indemnity agreements, the surety's rights under each and how to use them, and the interplay among trust fund, assignment and subrogation rights. Faculty: Jon Bondy, CSG Law Doug Wills, Chubb
12:00 - 1:00 p.m. *12:30 – 12:45 p.m.*	*Lunch* *Surety Claims Welcome and Preview* Steve Nelson, Markel
1:00 – 1:45 p.m.	*Accounting and Engineering Workshop* How to Read and Understand the Principal's and Indemnitors' Financials, Loss Runs and WIP Schedules. Faculty: Peter Fascia, MDD Brent McSwain, Sage
1:45 – 2:30 p.m.	*Contractor Default Dictionary* Learn the lingo: Design Build, Design Bid Build, Lump Sum, Cost-Plus, Guaranteed Max, Unit Price, Termination for Default, Termination for Convenience, Takeover, Tender, Ratification, Freeze/Hold Funds, Letters of Direction, Default letters. Faculty: Chris Marron, Loewke Brill Michael Cronin, Markel
2:30 – 2:45 p.m.	*Break*

2:45 – 3:30 p.m.	*Commercial Claims – For the Use and Benefit Of? Who is the Obligee?* There's a bond for everything, and sometimes, for everyone. A look at bond forms that benefit unnamed obligees. Faculty: Ryan Dry, Dry Law Scott Williams, Manier & Herod
3:30 – 4:15 p.m.	*The Claims Professional's Checklist for Contract and Commercial Claims* Claim Acknowledgment, Investigation, Collateral, Indemnity, Recovery, UCC and Who's Who. Faculty: Stephani Miller, Liberty Gina Lockwood, Merchants Bonding Company
4:15 – 5:30 p.m.	*Student and Faculty Happy Hour Reception*



Surety School's mission is to develop new professionals in the surety industry though education, mentorship, collaboration, and the creation of opportunities. We want our students to cultivate a passion for surety by understanding the business of surety, establishing meaningful connections, and adhering to high professional standards to benefit all industry stakeholders.

We are thrilled to partner with Surety Claims Institute for our summer 2023 program on June 21, 2023 at the Hyatt Regency Chesapeake Bay in Cambridge, MD. This educational roundtable and mentorship program is open to industry professionals with less than 5 years of surety experience.

Details and registration to follow. Please contact Scott Williams (swilliams@manierherod.com) or Gina Lockwood (glockwood@merchantsbonding.com) for more information.

The Joint Venture Defense

By: Michael A. Stover, Wright, Constable & Skeen, LLP Baltimore, Maryland

Introduction

In the construction industry, it is not uncommon to see the use of a business association form known as a joint venture. The joint venture form of business is typically chosen in the industry for a variety of reasons. Sometimes, it is because the project is so large it takes the combined efforts of multiple contractors to be able to handle the project. Sometimes, one of the contractors provides the financial wherewithal while the other provides a valuable connection or relationship with an owner. Sometimes, one of the members is small and needs the larger member to pull off the project. Forming a joint venture allows the parties to join their resources, equipment, labor, talents, and skills to complete a potentially lucrative project.

Sometimes, the parties do not choose the joint venture as a business form, but their actions and conduct result in the existence of a *de facto* joint venture. This article will explore joint ventures, what they are, why a surety should care, and how a surety can determine if a business relationship is really a joint venture or just a garden variety contractor/subcontractor arrangement.

What is a Joint Venture?

A joint venture has been defined as an association or undertaking of two or more persons or entities to jointly carry out a single business enterprise for profit.[1] New York law holds that "a joint venture is formed when: (1) two or more persons enter into an agreement to carry on a venture for profit; (2) the agreement evinces their intent to be joint venturers; (3) each contributes property, financing, skill, knowledge or effort; (4) each has some degree of joint control over the venture; and (5) provision is made for the sharing of both profits and losses."[2]

Sometimes, joint ventures have been referred to as "a partnership for a single transaction."[3] Generally, a joint venture is considered to be indistinguishable from a partnership for all important purposes.[4] Indeed, in many jurisdictions a joint venture is considered to be a partnership and is governed by the Uniform Partnership Act.[5] For instance, under the Maryland Revised Uniform Partnership Act " . . . the

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[1] *Herring v. Offutt*, 266 Md. 593, 596-597 (1972) (citing James M. Mullen, *Joint Adventures*, 8 Md. L. Rev. 22 (1943)); *Hobdey v. Wilkinson*, 201 Md. 517 (1953); *Weiner v. Fleischman,* 816 P.2d 892, 895 (Cal. 1991).

[2] *SCS Comm'ns, Inc. v. Herrick Co., Inc.*, 360 F.3d 329, 341 (2d Cir. 2004); *Itel Containers Int'l Corp. v. Atlanttrafik Express Serv., Ltd.,* 909 F.2d 698, 701 (2d Cir. 1990).

[3] *Byrd v. E.B.B. Farms*, 796 N.E.2d 747 (Ind. Ct. App. 2003); *Wilger Enterprises, Inc. v. Broadway Vista Partners*, 115 P.3d 822 (N.M. Ct. App. 2005).

[4] *Madison Nat'l Bank v. Newrath*, 261 Md. 321, 328 (1971).

[5] *Seaboard Sur. Co. v. Richard F. Kline, Inc.*, 91 Md. App. 236, 247 (1992).

unincorporated association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership and whether or not the association is called 'partnership', 'joint venture', or any other name."[6] Accordingly, when one is dealing with issues relating to joint ventures, one can often turn to the law of partnerships for guidance.[7]

The United States District Court for the Southern District of New York, addressing joint ventures, observed as follows: "[p]recise definition of a joint venture is difficult. The cases are of little help since they are generally restricted to their own peculiar facts. Each case . . . depends of course for its results on its own facts, and owing to the multifariousness of facts, no case of coadventure rises higher than a persuasive precedent for another."[8]

Distilling the research down reveals that the essential elements of a joint venture are typically identified as: (1) intent of the parties to be associated as joint venturers; (2) mutual contribution to the joint undertaking; (3) shared joint control over the venture; and (4) sharing of profits and losses.[9]

While there must be mutual control in a joint venture, the requirement need not extend to every aspect of the venture.[10] A joint venturer may entrust actual control of the operation to his co-venturer and it still remains a joint venture. Joint venturers may agree that responsibility for particular tasks shall reside with less than all the venturers.[11] Similarly, while contribution of resources is generally necessary, it is not necessary that the parties furnish contributions in equal amounts; nor need the contributions be of the same character.[12] Thus, one party may contribute property or equipment and the other party may contribute money, skills or other resources.

In determining whether a joint venture exists, the sharing of profits is generally considered to be *prima facie* evidence that the association is a joint venture.[13] However, mere sharing of profits is not conclusive, and other factors must be considered.[14] It has been observed that while the presence of a profit motive is a pre-condition of a joint venture, the case law strongly emphasizes that profit sharing alone does not make a business arrangement a joint venture.[15] The case law recognizes that there are many circumstances where a share of

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[6] Md. Code Ann., Corps. & Ass'ns § 9A-202 (West 2022).

[7] *See Ioerger v. Halverson Const. Co.,* 902 N.E.2d 645, 648 (Ill. 2008) ("Under Illinois law, joint ventures are governed by partnership principles."); *In re Johnson,* 552 N.E.2d 703 (Ill. 1989); *Sheridan Healthcorp v. Amko*, 993 So. 2d 167, 170 (Fla. Dist. Ct. App. 4th 2008) ("A joint venture is similar to a partnership and is, in fact, 'governed by the principles which constitute and control the law of partnership.'"); *Weiner v. Fleischman,* 816 P.2d 892, 895 (Cal. 1991) (courts freely apply partnership law to joint ventures when appropriate).

[8] *United States v. Standard Oil Co. of Calif.*, 155 F. Supp. 121, 148 (S.D.N.Y. 1957), *aff'd* 270 F.2d 50 (2d Cir. 1959); *see also United States ex rel. PCC Constr., Inc. v. Star Ins., Co*., 90 F. Supp. 2d 512, 519 (D.N.J. 2000).

[9] *ITEL Containers Int'l Corp.,* 909 F.2d at 701; *Pinnacle Port Cmty. Ass'n, Inc. v. Orenstein*, 872 F.2d 1536, 1539 (11th Cir. 1989); *In re Hassell 2012 Joint Venture & Springwoods Joint Venture*, 2015 Bankr. LEXIS 1599 (S.D. Tex. May 8, 2015); *Art & Fashion Grp. Corp. v. Cyclops Prod., Inc.,* 992 N.Y.S.2d 7, 10 (App. Div. 1st Dep't 2014).

[10] *Summit Transp. Corp v. Hess Energy Mktg.*, No. CV145119JMVMF, 2019 WL 430863, at *10 (D.N.J. Feb. 1, 2019) (citing *Wittner v. Metzger*, 72 N.J. Super. 438, 444 (App. Div. 1962)).

[11] *Wittner*, 72 N.J. Super at 446.

[12] *Brown v. Thompson*, 413 P.3d 900, 904 (Okla. 2018).

[13] *John Nagle Co. v. Gokey*, 799 A.2d 1225, 1227 (Me. 2002).

[14] *B. L. Schrader, Inc. v. Anderson Lum. Co.*, 257 F. Supp. 794 (D. Md. 1966); *Presutti v. Presutti*, 270 Md. 193 (1973).

[15] *Warren v. Dorsey Enter., Inc.*, 234 Md. 574, 578 (1964).

profit can be a legitimate form of compensation. Rather, it is the sharing of losses, not just profits alone, which can be a critical indicator of joint venturer status.[16]

A joint venture can be established even when the members have not formulated their status in full detail.[17] Indeed, the agreement may be express or implied and need not necessarily be in writing.[18] Where there is no express agreement, the question of whether a partnership exists is to be gathered from the intention of parties revealed by their conduct and circumstances surrounding their relationship and transactions between them.[19]

The existence of a joint venture or partnership will not be presumed, but must be proven.[20] Joint ventures never arise by operation of law, but must arise from a form of contract or agreement.[21] The burden of proving a partnership is upon the party who asserts it.[22]

Why Should the Surety Care?

Why should a surety care if there is a joint venture relationship on a bonded project? The answer is because it is well-established that a bond claimant who is a joint venturer with the bonded principal cannot recover under a Miller Act payment bond.[23] The Miller Act was enacted to ensure that *subcontractors* are paid for labor and materials expended on federal projects. The Miller Act payment bond does not make a surety liable for labor and materials or for monies expended on the contract by a partner or joint venturer of the bonded principal.[24]

In United *States use of Walker v. USF&G*, the court, addressing this issue, stated:

> It seems quite evident that the rule of law should be, that a joint adventurer under these circumstances should not be permitted to recover upon a bond given to guarantee the fulfillment of the contract of his co-adventurer. The duty of the contractor to fulfill the provisions of his contract are no more imperative than those of one who is jointly interested with him in its success. The obligations are the same, to wit, to see that the contract is fulfilled in every particular before a surety should be compelled to answer for the default. As a matter of fact, the principal contractor might as well be entitled to recover for his own default against his own surety as to permit one jointly interested with him in its success to do so. Such a rule

[16] *U.S. for Use & Benefit of Woodington Elec. Co. v. United Pac. Ins. Co.*, 545 F.2d 1381 (4th Cir. 1976); *Brenner v. Plitt*, 182 Md. 348 (1943); *Powers v. State,* 178 Md. 23, 29 (1940).

[17] *Institutional Mgmt. Corp. v. Translation Sys., Inc.*, 456 F. Supp. 661, 664 (D. Md. 1978).

[18] *Geo. Bert. Cropper, Inc. v. Wisterco Investments, Inc.*, 284 Md. 601 (1979).

[19] *Presutti, supra.* note 11; *Garner v. Garner*, 31 Md. App. 641 (1976); *Shipley v. Perlberg*, 140 Md. App. 257 (2001).

[20] *Miller v. Salabes*, 225 Md. 53, 55 (1961).

[21] *Powers,* 178 Md. at 29.

[22] *LaRoque v. LaHood*, 93 Md. App. 625, 643 (1992), *cert. denied*, 329 Md. 337 (1993); *Shipley*, 140 Md. App. at 279-80.

[23] *Woodington Elec. Co.,* 545 F.2d at 1382; *Larson v. Granite Re, Inc.,* 532 F.3d 724, 732-33 (8th Cir. 2008).

[24] *U.S. for the Use of Briggs v. Grubb*, 358 F.2d 508, 511 (9th Cir. 1966); *St Paul–Mercury Indem. Co. v. United States ex rel. Jones*, 238 F.2d 917 (10th Cir. 1956); *U.S. ex rel. PCC Const., Inc.,* 90 F. Supp. 2d at 518–19; *U.S. ex rel. Johnson Pugh Mech. Inc. v. Landmark Constr. Corp.*, 318 F. Supp.2d 1057, 1069 (D. Colo. 2004) ("A partner or a joint-adventurer in the general contract itself, or a portion of it, would not be one of those protected by the Miller Act.").

of law would open the door to fraud of a serious type.[25]

Essentially, the joint venture defense boils down to the concept that a principal cannot make a claim against its own bond, and, therefore, the joint venturer or partner of the principal in the bonded project cannot make a claim against the bond either. The surety does not bond the relationship between the joint partners; that is not what the Miller Act was implemented for. If the parties made a bad business deal that is not the surety's responsibility.

One of the best ways to understand a concept is to see some examples of it in action. The following is a discussion of some of the cases that have addressed the surety's joint venture defense. In *Concrete Works & Paving, Inc. v. Great Midwest Ins. Co.*, the court granted the surety's motion for summary judgment, finding that the claimant was a joint venturer with the bond principal.[26] In that case, plaintiff, Concrete Works, sued the surety for payment under two bonds issued with Pioneer Construction, as principal, for two public projects. Concrete Works alleged that it subcontracted with Pioneer to provide labor and materials for the projects, that it performed the work in a timely and workmanlike manner, that the work had been accepted by the project owners, and that Pioneer failed to pay. The surety argued that Concrete Works acted as a de facto joint venture with Pioneer on the projects and was therefore, ineligible to receive payment from the bonds.

The undisputed facts established the following:

- Concrete Works was not eligible to bid on the projects because it did not have bonding capacity.
- Concrete Works was not a Florida Certified Business Enterprise (CBE) as required by one of the project owners; Pioneer was.
- The contracts required Pioneer to perform 75% of the work itself; it did not.
- The contracts prohibited assignment of work or payments.
- Pioneer agreed to pay 97% and 93% of the respective contract amounts to Concrete Works in exchange for Concrete Works supplying labor and materials for the projects.
- Concrete Works was never listed as a subcontractor on either project.
- Concrete Works subcontracted with OMB LLC to provide labor on the projects in exchange for a 50-50% split.
- Concrete Works obtained equipment and trucks and placed Pioneer logos on them.
- Concrete Works' owner and sole employee, Alvaro Medina, served as the Project Manager for Pioneer on both projects.
- Medina represented himself as Pioneer's project manager and prepared billing, payments, and CBE reporting for Pioneer.
- Medina knowingly misrepresented on monthly CBE reports to one project owner that Pioneer performed at least 65% of the work. Instead, the work was performed by OMB LLC.

According to the court, the undisputed facts clearly established that Concrete Works and Pioneer set up a relationship to secure the projects. Pioneer had bonding capabilities and CBE status; Concrete Works had neither. Pioneer purported to do the work, but it did not; Concrete Works did. Medina, as Project

[25] *United States use of Walker v. USF&G*, 4 F. Supp. 854, 855 (D. Wyo. 1933).

[26] No. 19-60312-CIV, 2020 WL 4464666, at *1 (S.D. Fla. June 15, 2020).

Manager, had the authority to bind Pioneer. Concrete Works was not paid for time and materials; rather it shared in the payments for the project on a percentage basis. The court believed that the parties' course of conduct revealed an intention to act as joint venturers, not as contractor-subcontractor.[27]

Concrete Works argued that no joint venture existed because Pioneer and Concrete Works did not share losses. However, the court noted that under Florida law, an agreement to share losses as joint venturers can exist as a matter of law "where one party supplies labor and skill, the other supplies capital, and both agree to share in the profits of the venture."[28] Based on the intentions of the parties evidenced by the undisputed facts, the court held as a matter of law that Concrete Works and Pioneer established a joint venture for the projects.[29] As a joint venturer with Pioneer, Concrete Works was not permitted to recover under the payment bonds.

In the second case, *United States use of Walker v. United* States *Fidelity & G. Co.*, the evidence showed that a joint venture existed between two parties in connection with the construction of a federal highway project.[30] As a result, the claim against the bond by one of the joint venturers was rejected by the court. In *Walker*, the project at issue involved construction of a highway adjacent to Jackson Hole, Wyoming. The parties were also working on two other projects, that were not directly at issue in the case. On one of the other projects, it was admitted that a joint venture was formed, but plaintiff denied the same arrangement was involved in the Jackson Hole project.

The parties opened a joint account in a bank for the purpose of transacting business together regarding these road contracts. Checks and remittances arising from the road contracts were deposited into the account and checks were written from the account, under the joint signatures of both parties, on printed checks bearing the names of both parties, to pay for services and materials which went into the performance of the several projects. The parties subsequently jointly borrowed money for the purpose of completing the projects.[31]

The court observed that the "mass of correspondence" introduced in evidence tended strongly to substantiate the theory that both parties were mutually interested in the success of the various projects.[32] The claimant contended that no absolute written agreement was ever consummated carrying the joint venture into definite form. The court held that such argument was unavailing when the evidence showed that, regardless of whether a formal written agreement existed, "the admitted activities of the parties left the unmistakable inference that they were acting jointly and considered themselves jointly responsible for the success of the several ventures."[33] Likewise, the court noted that "with all the accruing funds in one purse, it leaves the inference that the profits, if any, would be eventually marshaled and divided."[34] Accordingly, the court held that "there can be no other finding in the case but that the [parties] were joint adventurers."[35]

Finally, in the third case addressing the surety's joint venture defense, *Briggs v. Grubb*, the Bureau of Reclamation contracted with Grubb to relocate a road in connection with the Trinity Dam project located in

[27] *Id.* at *2-3.
[28] *Id.* at *3 (citing *Williams v. Obstfeld*, 314 F.3d 1270, 1276 (11th Cir. 2002)).
[29] *Id.*
[30] 4 F. Supp. 854 (D. Wyo. 1933).
[31] *Id.* at 855.
[32] *Id.*
[33] *Id.*
[34] *Id.*
[35] *Id.*

Northern California.[36] United Pacific Insurance Company was the Miller Act surety for Grubb. Grubb was an Oregon contractor and had never undertaken a California job, nor a job as large as the contract at issue. As a result, Grubb sought assistance from J. W. Briggs, a California contractor. Briggs just happened to be one of the unsuccessful bidders on the Trinity Dam road contract.[37]

After several meetings, the parties reached an agreement under which Briggs had assumed for all practical purposes the entire management of the job. Briggs subsequently transferred Grubb's employees to Briggs' own payroll, took over receiving and paying for most of the labor and materials used on the job, and assumed full management of the job. It was also agreed that Grubb would pay money to another company that was entirely owned by Briggs. Briggs contended that the payment represented a fixed fee for the performance of Briggs' services and that it was paid to the other company for tax reasons. At the time of the agreements with Briggs, Grubb was in serious financial difficulty. United Pacific alleged that Briggs knew of the financial condition of Grubb.[38]

As work progressed and progress payments were made to Grubb, Grubb did not pay over the full amount of the progress payments to Briggs, instead he diverted a portion of each such payment to the satisfaction of bills of other unrelated jobs. United Pacific alleged that this was done with the full knowledge of Briggs and with the purpose of allowing Grubb to bail himself out of his financial difficulties by diverting funds from the Trinity Dam project progress payments. As a result of the funds diversion, several subs and suppliers were not paid. Eventually, United Pacific took over the contract and completed the job. Subsequently, Grubb filed for bankruptcy and Briggs asserted a claim against the bond.[39]

The surety contended that Briggs had become a partner or joint-venturer and was therefore barred from recovery under the payment bond. The trial court agreed.[40] On appeal, the Ninth Circuit affirmed the lower court's judgment. [41]The appellate court listed a number of actions by Briggs that pushed the relationship between the parties into the "joint venture" category. First, Briggs assumed the payroll and disbursements for the entire project. Second, he approved all the bills. Third, he chose the other subcontractors for the project. Fourth, he had knowledge of Grubb's financial condition and misuse of funds. Taking these actions as a whole, the Ninth Circuit agreed with the trial court that Briggs and Grubb had become joint venturers and, as a result, Briggs was not entitled to maintain a claim against the surety.[42]

What Law Applies?

When the surety is looking at this issue, one question should be – what law applies? If you are dealing with the Miller Act, federal law will provide the scope of the remedy as well as the substance of the rights created thereby, not state law.[43] The liability of a Miller Act surety is controlled by federal law because determination of the extent of the liability involves the construction of a federal statute, under which it was created.[44]

If your case involves a Little Miller Act or private bond, you will need to consider

[36] 358 F.2d 508 (9th Cir. 1966).
[37] *Id.* at 510.
[38] *Id.* at 510-511.
[39] *Id.* at 511.
[40] *Id.* at 511-12.
[41] *Id.*
[42] *Id.*
[43] *F.D. Rich Co., Inc. v. United States ex rel. Indust. Lum. Co., Inc.*, 417 U.S. 116, 127 (1974).
[44] *Cont'l Cas. Co. v. Schaefer*, 173 F.2d 5, 8 (9th Cir. 1949).

the state law in the applicable jurisdiction. While in many jurisdictions, the courts will look to decisions under the Miller Act for guidance on state law, especially when interpreting similar Little Miller Act statutes, this is not always the case. In *Nat'l Union Fire Ins. Co. of Pittsburgh, Pennsylvania v. Elec. Transit Inc.*, the court acknowledged the federal authorities applying the joint venture defense in Miller Act cases.[45] However, the court stated that there was no indication in any of the California state authority that California law followed the federal prescription in cases interpreting the Miller Act prohibiting joint venturers from recovering under a surety payment bond. Therefore, the court denied the surety's motion for summary judgment on the basis that it could not rule as a matter of law that the claimant could not make a claim against the surety as a possible joint venturer. Similarly, in *Toporoff Engineers, P.C. v. Fireman's Fund Insurance Co.*, the Second Circuit Court of Appeals reasoned that the circumstances under which a joint venturer may be precluded from claiming under a surety bond was not settled under New York state law at that time in 2004.[46] Therefore, the federal preclusion under the Miller Act did not apply. The surety must always be mindful of what law applies.

How Do You Determine If a Joint Venture Exists?

How does a surety claims professional spot a joint venture? While there does not appear to be a hard and fast rule for determining whether a joint venture exists, courts addressing the issue have generally examined the agreements between the parties, as well as their conduct during the relevant time period.[47]

A. Look to the Terms of the Agreement

First, the surety should review the terms of any applicable agreement between the parties to determine if it supports the conclusion that a traditional subcontractor-general contractor relationship or a joint venture exists. In this exercise, the surety will begin by looking at the title and terminology of the contract. Is the agreement titled as a "Subcontract?" How are the parties identified or designated – contractor/subcontractor or partners, etc.? Next, analyze how the agreement addresses the work to be performed. Who will perform what, who has control over what, who will be paid what? The surety should look for language regarding the sharing of profits and losses, keeping in mind that just because there is some sharing of profits, that is not necessarily conclusive. What contributions are being made in terms of capital, equipment, resources, etc.? The use of the words "joint venture" in an agreement between two parties for a division of the profits of a business does not in and of itself make it a joint venture.[48] However, while the fact that the parties to a contract designate it as a joint venture may not be conclusive, it is certainly one of the elements to be considered in construing the contract.

B. Look to the Totality of the Circumstances and Conduct of the Parties

In the vast majority of cases, the parties will not make it easy – they will not enter into an express written joint venture agreement or refer to themselves as joint venturers or partners. Indeed, they will typically deny such a relationship exists. Accordingly, the surety will need to be looking for more than what the parties said or wrote. You will need to analyze the conduct and all of the surrounding circumstances.

[45] No. C04-03435 JSW, 2007 WL 735766, at *3 (N.D. Cal. Mar. 7, 2007).
[46] 371 F.3d 105, 109 n.1 (2d Cir. 2004).
[47] *See Woodington*, 545 F.2d at 1383; *Grubb*, 358 F.2d at 512.
[48] *Jasper v. Bernstein*, 20 N.Y.S.2d 362 (1940).

One issue to look for is the parties performing administrative tasks or functions that are out of the ordinary. A blurring of organizational responsibilities can create a reasonable basis upon which a fact finder could conclude that the relationship resulted in a joint venture between the parties. Also, where there is overlapping control of the parties, common ownership or leadership can indicate a joint venture. In one case, the court looked to evidence that the alleged subcontractor was submitting documents as the "administrator" of the project for the purported general contractor, including payment requests to the government.[49] Even though the purported subcontractor argued that there was no joint venture and that subcontractors could agree to serve as contract administrators for the general, the court found that the submissions created a question of fact as to whether the relationship went beyond the boundaries contemplated for a normal general contractor/subcontractor relationship.[50]

Another red flag is if employees of one company are placed on the payroll of the other company.[51] You may see this when a large company and a small company have joined together to perform a contract. In *PCC* and *Briggs*, the courts focused upon one party's assumption of the other entity's payroll as a key factor in their finding that a joint venture existed.[52] Such action is evidence of a commingling of fiscal responsibilities between the allegedly separate entities.

Another factor to look for is if there was a sharing of losses.[53] Even if the parties did not expressly state an agreement to share losses, the parties conduct can support a reasonable inference that such an agreement in fact or practice existed.[54] In one case, both parties assumed debts normally attributed to the other party.[55] The court noted that a reasonable inference of such conduct is that an implied agreement to share in losses associated with the endeavor existed.[56] A commingling of funds can also satisfy the sharing of losses factor and give rise to a joint venture.

Another key factor that is indicative of a joint venture is whether parties have an a typical right to control the performance of the work. A subcontractor does not normally schedule the project or manage other subcontractors. A general contractor does not normally direct the subcontractor's labor. Look for a comingling of control as evidence of a joint venture.[57]

Conclusion

The joint venture defense may clearly present itself in situations where the claimant is one of the venturers with the principal. However, in the vast majority of the cases, the surety will need to look for and prove the existence of a joint venture from all of the facts and circumstances in order to take advantage of the defense. No surety would willingly pay its principal for the principal's own default under a bond. So, make sure you are not paying the principal's partner/co-adventurer either.

[49] *See U.S. ex rel. PCC Const., Inc.,* 90 F. Supp. 2d at 518–19.
[50] *Id.*
[51] *See Briggs v. Grubb*, 358 F.2d at 512.
[52] *U.S. ex rel. PCC Const., Inc.*, 90 F. Supp. 2d at 520-21; *Briggs*, 358 F.2d at 512.
[53] *Woodington,* 545 F.2d at 1383.
[54] *Williams,* 314 F.3d at 1276.
[55] *Walker,* 4 F. Supp. at 855.
[56] *Id.*
[57] *Woodington*, 545 F.2d at 1382; *Briggs*, 358 F.2d at 508; *St. Paul–Mercury*, 238 F.2d at 917.

Surety Defenses to Claims of Liquidated Damages

By: Heather F. Shore, Esq., Shaffer Lombardo Shurin, Kansas City, MO

As sureties well-know, parties to a construction contract may stipulate in advance to an amount of damages to be paid in the event of delays attributable to a party's performance or lack thereof on projects, commonly referred to as liquidated damages. These clauses generally provide that for each day the contractor has delayed completion of the construction project beyond the date agreed upon in the contract documents, a specific sum certain will be paid by the contractor or assessed daily against the remaining contract balance until the project is substantially completed. Courts generally enforce reasonable liquidated damages provisions in construction contracts as a means of allowing the contracting parties to protect themselves against the difficulty, uncertainty, and expenses that necessarily follow judicial proceedings when trying to ascertain actual damages.

Although it is clear that a contractor can include a liquidated damages provision in its bonded subcontract, what is less clear is whether the surety is also obligated to pay liquidated damages to the obligee in the absence of the notice required by the AIA 312 Performance Bond or similar bond forms. Surety rights and obligations may vary depending upon bond language and the varying interpretations of the effect of incorporation of a construction contract that allows the obligee to assess liquidated damages, and the extent to which a surety has defenses to liquidated damages claims.

"Under a performance bond, a surety promises the obligee to remedy the inadequate performance of the principal, should the principal default on the underlying agreement."[58] Section 7 of the American Institute of Architects A312 Performance Bond (2010 version) specifically allows the obligee to recover liquidated damages. "Leading commentators in the area of construction law consider the A312 Performance Bond to be 'one of the clearest, most definitive, and widely used type of traditional common law 'performance bonds' in private construction.'"[59] Although Section 7.3 contemplates a surety may be liable for liquidated damages, it is not clear whether the surety's liability for liquidated damages is contingent on performance by the surety under Sections 5.1, 5.2, or 5.3 or on the obligee's having satisfied the requirements of Section 3, which include termination and default of the contractor. In those cases where an obligee does not default or terminate the contractor pursuant to Section 3 and the surety does not perform under Section 5 of the Performance Bond, Section 7 may not be

[58] *Flatiron-Lane v. Case A. Co.*, 121 F. Supp. 3d 515, 549 n.23 (M.D.N.C. 2015).

[59] *Mid-State Sur. Corp. v. Thrasher Eng'g, Inc.*, 575 F. Supp. 2d 731, 741 (S.D. W.Va. 2008) (quoting Philip L. Bruner & Patrick J. O'Connor, Jr., 4 Bruner & O'Connor Const. Law § 12:16 (2007)).

triggered, and the surety may have no obligation to pay liquidated damages.

Most courts have strictly construed the AIA A312's notice requirements, holding that if an obligee intends to terminate a bonded contract, it must first provide written notice of the default to the principal and an opportunity for the principal to cure that default.[60] If it does not, then the surety can argue it is discharged from any obligation under the bond due to the obligee's failure to provide contractually required notice.[61] In *Enterprise Capital*, where an obligee on a performance bond sued the principal and surety, the surety was excused from liability on summary judgment due to the obligee's failure to provide the contractually required seven-day notice of the principal's default, notwithstanding the surety's actual knowledge.[62] Under these circumstances, courts have concluded that one party's material breach of a contract may excuse performance by the other party to the contract.[63] In the surety context, the failure of the obligee to provide required notice and to allow the surety to elect one or more of its performance options generally will fully discharge the surety from any liability under the performance bond.[64]

Even when the bond does not expressly require such notice, the obligee may still be required to provide notice not only to the principal but also to the surety.[65] Some courts have held that an obligee is required to follow the bonded subcontract's time periods for giving a surety notice, even if the performance bond does not define the period of time for the surety to choose its performance option, so long as the bond expressly incorporates the subcontract.[66] Therefore, under these holdings, the surety is likely to avoid liquidated damages, even in the face of Section 7, if the obligee does not satisfy the conditions precedent in the bonded subcontract.

More recently, however, in *In re Cornerstone Pavers, LLC*, the court concluded that a surety may not necessarily have the right to receive notice prior to a demand for liquidated damages under the newer version of the AIA 312 Performance Bond, which lacks proscribed periods of time for notice under Section 3.[67] Specifically, in *Cornerstone,* the court held:

> [T]he older version of the bond form does *not* limit the extent to which noncompliance with section

[60] *Enterprise Cap., Inc. v. San-Gra Corp.*, 284 F. Supp. 2d 166 (D. Mass. 2003).

[61] *Id*.

[62] *Id*. at 179-81.

[63] *See, e.g., U.S. v. Gonzales & Gonzales Bonds & Ins. Agency, Inc.*, 103 F. Supp. 3d 1121, 1131 (N.D. Cal. 2015).

[64] *St. Paul Fire & Marine Ins. Co. v. City of Green River*, *Wyo.*, 93 F. Supp. 2d 1170, 1178 (D. Wyo. 2000), aff'd, 6 F. App'x 828 (10th Cir. 2001) ("courts have consistently held that an obligee's action that deprives a surety of its ability to protect itself pursuant to performance options granted under a performance bond constitutes a material breach, which renders the bond null and void."). "A clear declaration of default is a precondition to a surety's liability under a performance bond." *W. Sur. Co. v. T&L Zarda Invs., LLC*, 448 P.3d 499 (Kan. App. 2019) (citing *L & A Contracting Co. v. S. Concrete Serv., Inc.*, 17 F.3d 106, 110-11 (5th Cir. 1994) (clear declaration of default is a precondition to a surety's liability)); *see also Balfour Beatty Constr., Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82, 86 (D. Conn. 1997) (holding that notice only of a delay does not satisfy bond language requiring notice of default).

[65] *Blackhawk Heating & Plumbing Co. v. Seaboard Sur. Co.*, 534 F. Supp. 309, 315-16 (N.D. Ill. 1982) (concluding that although the bond did not expressly require notice of default, if the terms of the bond agreement can be interpreted to "create a condition of notice to the surety in order to hold the surety liable," the obligee is required to provide notice).

[66] *Int'l Fid. Ins. Co. v. Americaribe-Moriarty JV*, 681 Fed. App'x 776-77 (11th Cir. 2017) (case involving a A312 Performance Bond and the discharge of the surety's obligations resulting from a failure of the obligee to satisfy the bond's notice provisions, holding that the obligee's failure to comply with the notice requirements "thwarted [the surety's] ability to choose among the options" it had for performance and therefore relieved the surety of any liability under the bond).

[67] 642 B.R. 459, 468-70 (Bankr. E.D. Wis. 2022).

> 3.1 constitutes a failure to satisfy a condition precedent to the obligations of the surety. See, e.g., *Solai & Cameron, Inc. v. Plainfield Cmty. Consolidated Sch. Dist. No. 202*, 374 Ill.App.3d 825, 313 Ill. Dec. 217, 871 N.E.2d 944, 947 (2007). Second, the older version of the bond form *does* provide that the "Owner" cannot "declare[ ] a Contractor Default" under section 3.2 "and formally terminate[ ] the Contractor's right to complete the contract" until at least "twenty days after the Contractor and the Surety have received notice" under section 3.1 "that the owner is considering declaring a Contractor Default". See, e.g., *Seaboard Sur. Co. v. Town of Greenfield ex rel. Greenfield Middle Sch. Bldg. Comm.*, 370 F.3d 215, 216 (1st Cir. 2004). In other words, the bonds at issue in the cases cited by West Bend, like the bond at issue in *State Bank of Viroqua*, but unlike the bond at issue here, expressly require and *prescribe periods of time* for notice.[68]

There are other options available to a surety to defend against liquidated damages claims, however. Both contractors and sureties are aware of the need to develop sufficient facts that may reduce or absolve them from liability for liquidated damages as appropriate, including the defenses of concurrent causes of delay or that the obligee or other contractors or the obligee's design team are solely or partially responsible for the delay.

Prior to the advent of Critical Path Method ("CPM") scheduling, and more specifically, to the widespread application of CPM principles to delay disputes, there was no reliable means to distinguish between the effects of two different delays acting in the same time frame. The concept of the critical path analysis, which distinguishes critical work activities from noncritical ones, paved the way to defenses with respect to claims of liquidated damages based on the argument that the delays were beyond the contractor's control had affected the substantial completion of the project.

Prior to CPM scheduling, courts typically refrained from attempting to distinguish between the effects of different causes of delay during the same period, concluding that neither party could recover if both parties contributed to the delay.[69] Many states continue to apply this thought-process even in the CPM-era of construction, which can substantially benefit the surety if it can prove both parties contributed to overall project delay, because these courts conclude that neither party can be compensated for associated damages. Some courts view it as effectively impossible to allocate responsibility, so they do not even attempt it, even though obligees contend that this approach may lead to a harsh result.

In more recent years, many courts have come to accept that a party (or potentially both parties) may recover damages where there are multiple causes of delay to project completion, even in those cases where the delays are concurrent, "when clear apportionment of the delay attributable to each party has been established."[70] The party seeking recovery bears the burden of separating its delays from those chargeable to

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[68] *Id*. at 468-469.

[69] *See, e.g.*, *Newport News Shipbuilding & Dry Dock Co. v. U.S.*, 79 Ct. Cl. 25 (1934).

[70] *George Sollitt Constr. Co. v. U.S.*, 64 Fed. Cl. 229, 238 (2005); *see also S.W. Elec. Contracting Servs., Ltd. v. Indus. Accessories Co.*, No. MO:18-CV-00123-DC, 2022 WL 1468384, at *33 (W.D. Tex. May 10, 2022); *Flatiron*, 121 F. Supp. at 541; *Catel, Inc. v. U.S.*, No. 05-1113 C, 2012 WL 3104366, at *33 (Fed. Cl. July 30, 2012).

the other party. If this cannot be done, the delays are considered "concurrent or intertwined," and neither party may recover.[71] In such case, courts are more likely to revert to the traditional rule and deny recovery to either party.[72]

Ambiguity and argument over the meaning of the term "apportionment" have resulted in litigation involving whether courts should apportion fault caused by each party (and hence apportion the damages claimed) or apportion time by attributing the causes of different periods of delay to one party or the other, and then assigning responsibility for those delay periods and associated damages accordingly. In the absence of a contractual provision stating otherwise, most courts attempt to apportion specific periods of time by determining the days of delay for which each party is responsible. Courts typically avoid apportionment based on percentages of fault regarding a specific issue. CPM schedules, time impact analyses, and other evidence of which party caused delays during specific periods of time or caused delays that affected the critical path can be very useful to the surety in defeating a portion or all of the liquidated damages claim.

With respect to federal projects, the government bears the initial burden of showing that completion was late and that liquidated damages are due and owing. The burden then shifts to the contractor to show that the delay was excusable and that it should be relieved of all or part of the liquidated damages assessed. The contractor must then establish that the excusable delay hindered the overall completion of the project; i.e., that the delay affected activities on the critical path. The excusable or unforeseeable delay must also affect the critical path of performance. Liquidated damages claims should be cut off on the date of beneficial occupancy. Beneficial occupancy occurs when a project is substantially complete and is generally understood to take place where the work is suitable for its intended purpose.[73] Whether a building is substantially complete is determined by whether the facility in question is available to be "occupied and used by the government for the purpose for which it was intended."[74]

Whether delay on the part of both parties is concurrent or sequential also affects the analysis of liquidated damages. Concurrent delay occurs when both parties are responsible for the same period of delay, and sequential delay is when the parties' delays do not overlap.[75] Where both the government and the contractor are responsible for sequential delay, it is unsettled whether the government waives liquidated damages in the entirety pursuant to the "rule against apportionment" or whether delay can be apportioned.[76] The original rule, known as the "rule against apportionment," provides that when the government has contributed to the delay in contract completion, it waives its claim for any

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[71] *Blinderman Constr. Co. v. U.S.*, 695 F.2d 552, 559 (Fed. Cir. 1982).

[72] *Essex Electro Engrs., Inc. v. Danzig*, 224 F.3d 1283 (Fed. Cir. 2000); s*ee also Great Am. Ins. Co. v. E.L. Bailey & Co., Inc.*, 841 F.3d 439, 448 (6th Cir. 2016) (citation omitted) ("Both federal and other state courts, however, have been shifting away from the strict application of [non-apportionment] . . . . 'during the past 30 years' 'a strong majority' of courts have adopted the 'modern view and allow liquidated damages to be apportioned when faced with damages that are in fact divisible.'").

[73] *See Kinetic Builder's, Inc. v. Peters,* 226 F.3d 1307, 1315 (Fed. Cir. 2000); *Nippo Corp./Int'l Bridge Corp. v. AMEC Earth & Envtl., Inc.*, No. CIV.A. 09-0956, 2013 WL 1311094, at *54 (E.D. Pa. Apr. 1, 2013) (citing *Interstate Gen. Gov't Contractors, Inc. v. U.S.,* 40 Fed. Cl. 585, 607–608 (1998) (default termination set aside because the system was functioning and "the only items left to perform were punch-list items and debugging"); *Cont'l Ill. Nat. Bank & Trust Co. v. U.S.,* 101 F. Supp. 755, 758 (Ct. Cl. 1952) (minor punch list items did not prevent substantial completion).

[74] *Appeals of Nagy Enterprises*, 98-1 BCA P 29695, ASBCA No. 48815, 98-1 B.C.A. (CCH) ¶ 29695 (March 27, 1998) (citations omitted).

[75] *Cumberland Cas. & Sur. Co. v. U.S.*, No. 94-366 C, 2008 WL 4725449, at *8 (Fed. Cl. July 3, 2008).

[76] *George Sollitt Cont. Co.*, 64 Fed. Cl. at 244.

liquidated damages.[77] Some courts have declined to apply the reasoning in *United Eng'g & Constructing Co.* beyond its facts and have apportioned liquidated damages, thereby permitting the government to recover some, but not all, of the liquidated damages claimed.[78]

The contractor and surety may also present evidence supporting the argument that the government does not have the right to assess liquidated damages for time spent performing changes in the work that were directed by the Contracting Officer, resulting in delays beyond the contract completion date. Rather, the contractor is entitled to an extension of time to cover the period required to perform the changed work.[79] The Board of Contract Appeals has held that the burden of lateness in ordering added work after the completion date was not to be borne by the contractor.[80] This argument can serve as a basis for the government's remission of liquidated damages in their entirety. However, late changes to the contract work may serve only to provide the contractor and its surety with the basis for receiving extra days, but may not result in remission of liquidated damages in their entirety. For example, in *Appeal of Malan Constr. Co.*, the contractor argued that because extra work was ordered after the completion date, not only should the contract time be extended by an amount of time sufficient for it to perform the extra work, but the liquidated damages clause should be rendered unenforceable as to the unchanged work remaining at the time of the changes.[81]

Although sometimes more difficult to prove, the contractor and surety might also be able to defend a claim of liquidated damages by proving that their assessment would constitute a penalty. Some jurisdictions compare the amount that would be awarded under the liquidated damages provision with the actual damages that the obligee suffered in determining whether the liquidated damages clause should be considered to be an unenforceable penalty. This is known as the retrospective analysis. Unfortunately, many states laws do not allow the court or jury to consider the obligee's actual damages in determining whether liquidated damages are considered to be a penalty. These courts apply a prospective analysis, or a single-look test, to determine the reasonableness of a liquidated damages clause as of the time the contract was executed, not with the benefit of hindsight.[82]

Some obligees have developed creative arguments in response to challenges to liquidated damages provisions. For example, in *The Hanover Ins. Co. v. Binnacle Dev., L.L.C.*, the trial court held that the parties' liquidated damages clause was an unenforceable penalty.[83] On appeal, the obligee argued the damages clause was not a

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[77] *U.S. v. United Eng'g & Constructing Co.*, 49 Ct. Cl. 689 (1914) (holding that to enforce liquidated damages, the party assessing damages must not prevent performance under contract, and that if it does, even if completion is "delayed by the fault of the contractor, the rule of the original contract cannot be insisted upon, and liquidated damages measured thereby are waived").

[78] *Robinson v. U.S.*, 261 U.S. 486 (1923).

[79] *Appeal of A. Brindis Co.*, GSBCA No. 3085, 70-2 B.C.A. (CCH) ¶ 8527, *2 (Oct. 26, 1970) (citations omitted).

[80] *See, e.g., Appeal of Stramese Constr. Corp.* VABCA No. 1332, 79-2 B.C.A. (CCH) ¶ 13940 (June 29, 1979).

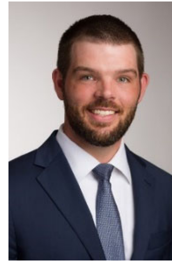
[81] VABCA No. 297, 1961 WL 169 (Apr. 27, 1961), The Veterans Affairs Board of Contract Appeals rejected the contractor's argument and determined that "[t]he extension attributable to the late order for extra work makes the liquidated damages clause inapplicable to any of the whole contract work during all of the extension period, *but the lateness feature can afford neither reason nor legal justification for excusing non-performance beyond the time required to complete the extra work*." *Malan*, VABCA No. 297, *5-6 (emphasis added).

[82] *Carrothers Constr. Co. v. City of South Hutchinson*, 207 P.3d 231, 241 (Kan. 2009); *see also Cybertron Int'l v. Capps*, No. 122, 439, 2022 Kan. App. Unpub. LEXIS 23, at *24 (Jan. 14, 2022) (citing *Carrothers*, 207 P.3d at 241) ("Comparing actual damages after the fact frustrates the very purpose of the clause by robbing the parties of the benefit of agreeing to liquidated damages.")).

[83] 57 F.4th 510 (5th Cir. 2023).

liquidated damages provision, but was merely a clause written to address and limit liability. In deciding this issue, the court looked to the substance of the terms of the contract to determine if the provision was in fact a liquidated damages clause. The court concluded that the provision did not set a ceiling on liability, but rather established a liquidated amount of damages of $2,500 per day for every day the project was delayed, therefore "bear[ing] little resemblance to recognized limitation of liability clauses."[84]

SURETY CASENOTES



By: Brian Kantar and Jase A. Brown, Chiesa Shahinian & Giantomasi PC, New York, NY and Roseland, NJ

Central District of California Finds That Performance Bond Surety Does Not Have Claim Against CGL Carriers Because Judgment Was Never Entered Against the Principal Which Is a Requirement for Triggering Coverage Under the Policies

Berkley Reg'l Ins. Co. v. Capitol Specialty Ins. Corp., 2022 U.S. Dist. LEXIS 174458 (C.D. Cal., Sept. 26, 2022).

The surety issued payment and performance bonds on behalf of subcontractor JMS Air Conditioning & Appliance Service, Inc. ("JMS"). The obligee on the bonds was general contractor Sinanian Development, Inc. ("Sinanian"). JMS was hired by Sinanian to perform certain work in connection with a construction project at Sierra Mesa Fundamental School in Sierra Madre, California. JMS's work at the project included the installation of underground chiller pipes and related backfilling.

Near the end of the project, or shortly thereafter, Sinanian sent a letter to the surety advising that JMS installed leaking hydronic piping that caused damage to the project and demanded that the surety perform. The surety investigated the claim and ultimately determined that Sinanian had a valid claim against the bonds. This resulted in the surety paying $365,634.75 to contractors and material suppliers hired to remedy the damage caused by the leaking pipes plus $9,736.86 for investigative expenses.

The surety sought reimbursement from JMS's CGL carriers, AmTrust International Underwriters Ltd. and Capitol Specialty Insurance Corporation, in the amount of $375,371.61 for the amounts it paid under the bonds. Each of the CGL policies was in effect for certain time periods during the course of the project. Each of the CGL policies contained language stating that the CGL carrier "will pay those sums that the insured becomes legally obligated to pay as damages

[84] *Id.* at 517.

because of ‘bodily injury’ or ‘property damage’ to which this insurance applies.”

After the surety filed suit against the CGL carriers, each of the CGL carriers filed motions to dismiss because they argued that JMS never became legally obligated to pay any “damages” which was required for coverage under the policies. The surety argued in opposition that “[o]nce [the surety] took action to handle Sinanian’s claim, JMS’[s] legal liability was established. . . . There was no reason for [the surety] to wait until Sinanian sued it or sued JMS or before the Project Owner filed suit, before it handled Sinanian’s performance and payment bond claim and paid contractors and material suppliers to correct JMS’s work.”

The court rejected the surety’s argument because it held that under well-established California law, an insurer on a CGL policy is only required to indemnify the insured for sums that the insured becomes legally obligated to pay pursuant to a court order. The court held that this was a bright line rule. The court noted that although the surety subrogated to its principal’s rights under the policies, the surety has no greater rights than the insured and is subject to the same defenses assertable against the insured. Therefore, the court granted the motions to dismiss.

On Issue of First Impression, Indiana Court of Appeals Holds That a Bad Faith Claim Is Not Available Against a Surety

Posterity Scholar House, LP v. FCCI Ins. Co., 2023 WL 2291510 (Ind. Ct. App., Mar. 1, 2023).

The surety issued a payment and performance bond for a general contractor in connection with the construction of two apartment buildings. The general contractor allegedly defaulted on the project and thereafter the obligee owner filed a claim against both bonds. The claim on the performance bond was for the surety to complete performance of the work and the claim on the payment bond was for the surety to pay the general contractor’s unpaid subcontractors.

After its investigation revealed that the owner was the party in default, and not the general contractor, the surety denied the performance bond claim. The surety also denied the claim under the payment bond due to the owner’s failure to provide certain information required by the bond; however, the surety advised that it would reconsider the denial of the payment bond claim to the extent the owner provided the missing information.

The owner filed suit against the surety alleging (1) breach of contract and (2) bad faith. The surety moved for partial summary judgment, arguing that a surety does not owe the bond obligee a common law duty of good faith in Indiana. The owner cross-moved for summary judgment on its breach of contract claim. The trial court granted the surety’s motion and denied the owner’s motion. The owner appealed both rulings.

On appeal the owner argued that under the state’s insurance code, a surety was an “insurer” and therefore owed a common law duty of good faith just like any other insurer. The appellate court disagreed, finding that Indiana law distinguished between suretyship and insurance and the fact that suretyship was included within the insurance code did not change the fact that the two relationships are inherently different.

The appellate court relied heavily on *Erie Ins. Co. v. Hickman*, 622 N.E.2d 515 (Ind. 1993), wherein the Indiana Supreme Court found that an insurer owes its insured a common law duty of good faith. The Indiana Supreme Court in *Erie* noted the “unique character” of insurance policies and the “special relationship” between insurer and insured.

Specifically, there is close, arms-length relationship that is present during the initial purchase of a policy. There is also a fiduciary relationship that arises from an insurer's duty to defend an insured against third-party claims. And there is an adversarial nature of the relationship on first-party claims when, in the face of calamity, a vulnerable insured makes a first-party coverage claim.

The appellate court found that suretyship, on the other hand, involves a tripartite agreement whereby one party (the surety) guarantees that a second party (the principal) will perform its contractual obligations owed to a third party (the obligee). If the principal defaults, the obligee may call upon the surety to perform, after which the surety may seek indemnification from the principal. Therefore, the principal retains the risk of loss. Citing to 4A Philip L. Bruner & Patrick J. O'Connor, Jr., *Construction Law* § 12:7, the appellate court noted that a surety bond is a financial credit product, not an insurance indemnity product. Therefore, the appellate court affirmed the trial court's holding that a bad faith claim is not available against a surety in Indiana.

With respect to the trial court's denial of the owner's cross-motion for partial summary judgment, the appellate court noted that it did not have jurisdiction over the denial because it was not a final order. Although interlocutory orders may be appealed if they are certified by the trial court, the appellate court noted that the only issue certified by the trial court for appeal was the bad faith claim. Therefore, the appellate court found that it lacked jurisdiction to consider the denial of the owner's cross-motion for summary judgment.

Seventh Circuit Affirms Bankruptcy Court's Imposition of $9.5 Million Sanction Against Surety for Violation of Discharge Injunction, Finding That Surety's Pre-Petition Indemnity Claims Were Discharged and Therefore the Surety Was Not Entitled to Assert Those Claims Against a Third-Party Asset Purchaser

In re Kimball Hill, Inc., 61 F.4th 529 (7th Cir. 2023).

The surety issued performance bonds on behalf of Kimball Hill, Inc. ("Kimball Hill") guaranteeing performance obligations owed by Kimball Hill under several land development agreements with municipalities in Illinois. In connection with the issuance of the bonds, Kimball Hill executed an indemnity agreement in favor of the surety.

Kimball Hill thereafter filed for chapter 11 bankruptcy, wherein the surety filed proofs of claim for its contingent liability on the bonds. The surety ultimately voted in favor of the plan of reorganization which included an injunction prohibiting entities that voted in favor of the plan from pursuing those claims that had been extinguished under the plan.

All of Kimball Hill's assets went into a liquidation trust "free and clear of any and all liens, claims, encumbrances and interests." Thereafter, the trust sold its development interests in the municipalities' land to TRG Venture Two LLC ("TRG").

Meanwhile, the municipalities sought to recover under the bonds for Kimball Hill's failure to develop the properties. However, the only way to recover on the bonds was to sue Kimball Hill to establish its non-performance. Therefore, the municipalities moved in the Bankruptcy Court for relief from the plan injunction which was granted. Several municipalities were then able to establish non-performance and sought recovery under the bonds.

The claims on the bonds were denied which led to litigation in state court. Many of the municipalities sued both the surety and TRG,

however some of the municipalities only sued the surety. In those cases where only the surety was sued, the surety interpleaded TRG claiming that TRG was the primary obligor responsible for the development of the properties, in contrast to the surety which was a secondary obligor. Three separate state appellate courts appear to have agreed that TRG was the primary obligor and the surety was the secondary obligor.

After approximately six years of litigation in state court, TRG filed an application in the Bankruptcy Court asking the Bankruptcy Court to enforce the plan injunction and sanction the surety for its violation of the plan injunction. The Bankruptcy Court granted the application and concluded that the confirmation order extinguished Kimball Hill's pre-petition duty to indemnify the surety. The Bankruptcy Court also found that sanctions were warranted because the surety knowingly extinguished its pre-petition indemnity claims but thereafter pursued them against a third-party successor-in-interest. The Bankruptcy Court imposed $9.5 million in sanctions, much of which related to the costs incurred by TRG in the six years of litigation.

The surety appealed to the District Court which affirmed the contempt sanction. The Seventh Circuit affirmed as well. The Seventh Circuit found that the sale from the trust to TRG was "free and clear" of any pre-petition liabilities. The court stated that "[p]re-petition claims extinguished upon plan confirmation do not spring back into existence upon post-confirmation asset sales." The court stated that the surety did not appreciate the difference between property-based claims and entity-based claims. Kimball Hill's obligations under the development agreements were covenants that run with the land, which is why the Bankruptcy Court found that Kimball Hill's development obligations survived the plan confirmation order. However, Kimball Hill's indemnity obligations, according to the Seventh Circuit, are entity-based and were extinguished under the plan. The Seventh Circuit stated that the surety's claims arose from pre-petition acts, as opposed to post-petition acts, and were therefore subject to the plan injunction. The Seventh Circuit appears to have considered only the surety's subrogation rights standing in the shoes of its principal without considering its subrogation rights standing in the shoes of the bond obligee.

Southern District of Texas Affirms Confirmation Order Which Authorized the Sale of Properties "Free and Clear" of Future Surety Subrogation Claims, Finding That Sureties' Argument Was Statutorily and Equitably Moot

In re Fieldwood Energy III LLC, 2023 WL 2402871 (S.D. Tex., Mar. 7, 2023).

The sureties issued bonds on behalf of Fieldwood Energy, LLC and its affiliates (collectively "Fieldwood") to ensure that Fieldwood would comply with its decommissioning obligations as a federal offshore oil and gas leaseholder under Bureau of Ocean Energy Management ("BOEM") regulations. Fieldwood ultimately filed for chapter 11 bankruptcy twice, first on February 14, 2018 and again on August 3, 2020.

In the second bankruptcy, over the objection of the sureties, the Bankruptcy Court entered a confirmation order which, among other things, authorized the sale of certain bonded offshore oil and gas leases to a credit bid purchaser "free and clear" of future surety subrogation claims as against the credit bid purchaser. The sureties filed a motion for stay pending appeal which was denied by the Bankruptcy Court.

The sureties thereafter appealed to the District Court that portion of the

confirmation order which authorized a sale free and clear of future surety subrogation rights. The sureties noted that the leases which were sold to the credit bid purchaser were all good leases with significant life remaining, which is why the credit bid purchaser sought to purchase those leases. The sureties further highlighted that at the time of bankruptcy there were no defaults on the leases by Fieldwood, nor could there have been any defaults on the leases because those defaults would have had to be cured before the leases could be assumed and assigned to the credit bid purchaser pursuant to 11 U.S.C. § 365(b)(1). Therefore, the sureties argued they had no "claim" against the bankruptcy estate at the time of bankruptcy – there was no need to order that the sale be "free and clear" of a theoretical future claim.

The sureties argued that the Bankruptcy Court could not sell the leases to the credit bid purchaser free and clear of future claims against the credit bid purchaser arising from the credit bid purchaser's own future defaults on the leases. Under the BOEM regulations, a purchaser of offshore oil and gas leases becomes the primary obligor for decommissioning the existing leasehold infrastructure (platforms, pipelines, etc.) the moment it becomes a leaseholder. Predecessors-in-interest, such as Fieldwood (and by extension, its sureties), are secondarily liable. Therefore, the credit bid purchaser became liable for decommissioning the assets as a matter of federal law the moment it acquired the leases. And in fact, the credit bid purchaser testified that $350 million of the $1.03 billion in consideration the credit bid purchaser was providing for the leases was not paid in cash, but consisted of its assumption of the decommissioning obligations associated with the leases.

On appeal to the District Court, the appellees argued that the sureties' appeal was both statutorily and equitably moot. The appellees argued that the appeal was statutorily moot because, among other things, the sureties failed to obtain a stay of the confirmation order pending appeal. 11 U.S.C. § 363(m). The appellees argued that the appeal was equitably moot because, among other things, they argued that reversing the portion of the confirmation order permitting a sale free and clear of future surety subrogation rights could unravel the plan and would negatively impact third parties that relied upon the plan.

The appellant sureties argued that the appeal was not statutorily or equitably moot because, among other things, the sections of the confirmation order challenged by the sureties were not "integral to the sale," which is an exception to mootness. The appellant sureties argued that the sureties' subrogation rights were at all times preserved (by agreement with the debtors and the credit bid purchaser) until the Bankruptcy Court at the Confirmation Hearing, *sua sponte*, decided to get rid of surety subrogation rights, at which time counsel for the debtors and the credit bid purchaser did a 180-degree turn and decided to follow the lead of the judge and argue that sureties should not be entitled to assert future subrogation rights.

The District Court, relying upon the testimony from Michael Dane (CFO of Fieldwood and CEO of the Credit Bid Purchaser) at the hearing on the motion for stay pending appeal, affirmed the confirmation order finding that the appeal was both statutorily and equitably moot. Michael Dane testified at the hearing that purchasing the assets free and clear of future surety subrogation rights was "paramount to the [credit bid purchaser's] consideration of how they would be willing to proceed with purchasing [debtors'] assets and contributing capital for all purposes of the plan." Mr. Dane further testified that making the changes requested by the sureties would "cause great pause and concern" to the credit bid purchaser. The Bankruptcy Court

accepted Mr. Dane's testimony and found that "the deal is unlikely to close if we change it, modify our order, and that the cost would be approximately $350 million to the estate."

The District Court found that the Bankruptcy Court's finding that the provisions challenged were "integral to the sale" was not "clearly erroneous" and noted that a factual finding is "not clearly erroneous if it is plausible in light of the record read as a whole." The District Court found that the Bankruptcy Court's factual finding was plausible and therefore denied the sureties' appeal as statutorily and equitably moot, refusing to address the subrogation argument on the merits. The Court seemed to ignore the reality that it would make no economic difference to the credit bid purchaser regarding whether it used the $350 million it was holding back to account for its own obligation to decommission or, in the event it failed to decommission and the sureties for Fieldwood were obligated to decommission, it paid that sum to the sureties. In either event, it would be paying the amount – $350 million – and the entity with the primary obligation to decommission will have been required to do what it was legally obligated to do or pay the decommissioning costs.

<u>Northern District of Texas Rejects Surety's Argument That Its Indemnity Agreement Created an Express Trust Giving It Priority over a Bank's Prior Perfected Security Interest</u>

Markel Ins. Co. v. Origin Bancorp, Inc., 2023 WL 2589231 (N.D. Tex. Mar. 21, 2023).

Lauren Corporation ("Lauren"), an engineering and construction company located in Texas, obtained a loan from Origin Bancorp, Inc. ("Origin") in 2013. As consideration for the loan, among other things, Lauren provided a security interest to Origin in its after-acquired accounts receivable. That security interest was perfected in the same year and was validly extended for another five years in 2018.

In June of 2018, Lauren executed an indemnity agreement in favor of the surety so that Lauren could obtain surety bonds. Among other things, the indemnity agreement stated that:

> Indemnitors declare that all monies due and to become due under any contract or contracts covered by Bonds issued by [the surety] are trust funds, whether in the possession of [Lauren] or otherwise, for the benefit of and or payment of all obligations for which [the surety] would be liable under any of said Bonds, and this Agreement shall constitute notice of such trust. Said trust also inures to the benefit of [the surety] for any liability or loss it may have or sustain under any of said Bonds, and this Agreement shall constitute notice of such trust.

In January 2021, Lauren defaulted on its loan and shortly thereafter Origin swept Lauren's bank accounts obtaining a total of $2.3 million from the sweeps. The surety, apparently aware of Lauren's financial difficulties, filed UCC-1 financing statements in March 2021, perfecting its security interest. Lauren ultimately filed for chapter 7 bankruptcy in April 2021.

When the surety became aware of the sweeps, it demanded that Origin return $1.3 million to the accounts because the money was allegedly held in trust for the surety. Origin refused and the surety thereafter filed suit against Origin.

Before the court were cross-motions for summary judgment, seeking a determination as to who was entitled to the funds. It was undisputed that Origin had a prior perfected security interest in the funds. The question before the court was whether the indemnity agreement created an express trust in favor of the surety, rendering the surety's interest in the funds superior to Origin's.

For an express trust to have arisen, under Texas law, the settlor must show an intent to create a trust and the beneficiary, the res, and the trust purpose must be identified. Thus, in determining whether an express trust exists, Texas courts consider whether: (1) the settlor's words are imperative and impose on obligation on the trustee, (2) the trust property is certain, and (3) the beneficiary is certain. The court noted that "a fiduciary relationship is an extraordinary one and will not be lightly created." The court further noted that courts determine whether a trust exists based on the trust instrument as a whole and "not any alleged magic words". Mere formulaic recitation of trust language is not sufficient to create an express trust.

Considering the trust provision in the indemnity agreement, as well as case law, the court found that the language in the indemnity agreement was not sufficient to create an express trust. Specifically, the court noted that the indemnity agreement read much more like a security agreement, than a trust agreement. The court noted that there was no provision in the agreement regarding refraining from comingling of funds, which is common in trust agreements. Nor were the terms "beneficiary" or "grantor" located anywhere in the agreement. Nor was there any named trustee in the agreement, or imperative language imposing upon the trustee certain duties. The court found that, instead, the "talismanic" language "trust" and "trust funds" appeared to be used in the indemnity agreement in an effort to circumvent Origin's superior security interest.

FIDELITY CASENOTES

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

Ohio Supreme Court Holds Physical Damage Required to Cover Ransomware Associated Loss Under Business Owners Policy

EMOI Servs., L.L.C. v. Owners Ins. Co., --- N.E.3d ----, 2022 WL 17905839 (Ohio Dec. 7, 2022).

This matter involves a coverage dispute concerning loss suffered by the insured as a result of a ransomware incident. The insured is a software company that services the medical industry. The insured suffered a ransomware incident and eventually paid the ransom to obtain decryption keys. The decryption keys largely worked; however, the insured's automated phone system remained impacted even after attempts to restore the same were employed using the decryption keys. Per the court order, none of the insured's hardware or equipment suffered

damage as a result of the ransomware attack. The insured reported the matter to its carrier almost immediately following discovery of the ransomware issue.

The policy at issue is a businessowners insurance policy. The carrier determined that none of the insured's claimed loss – payment of the ransom, costs associated with investigating and remediating the attack and the costs to upgrade the insured's security – were covered. The carrier denied the claim the same day the insured provided notice. The carriers' denial letter pointed to an exclusion applicable to one potentially triggered insuring agreement ("Data Compromise") that precluded loss for "any threat, extortion or blackmail," which included "ransom payments." The carrier also noted that under another potential coverage ("Electronic Equipment"), there was no coverage because "there was no 'direct physical loss to the media.'" After the denial of the claim, the insured commenced litigation.

The carrier moved for summary judgment. The trial court granted the motion, finding that the situation involved a data compromise and not physical damage to electronic equipment, agreeing with the carrier's position in its denial letter. The trial court also leaned on the exclusion concerning costs arising out of threats, extortion and ransom payments. On appeal the appellate level court in Ohio reversed, finding potential genuine issues of material fact that prevented an award of summary judgment. The appellate level court noted that coverage could exist if the insured could show actual physical damage. That decision was then appealed to the highest court in Ohio.

Before the Ohio Supreme Court were three issues, putting aside the alleged bad faith claims: (1) whether a policy covering direct physical loss or damage covers losses arising out of a ransomware attack; (2) whether a court could find coverage for ransomware associated loss while simultaneously reading "key ransomware exclusions out"; and (3) whether experts are required to evaluate issues 1 or 2. In finding for the carrier, the Ohio Supreme Court was unequivocal in determining that the applicable coverage required a showing of "direct physical loss of, or direct physical damage to, electronic equipment or media." Here, because the software at issue was "an intangible item that cannot experience direct physical loss or direct physical damage," there could be no coverage. In so holding, the court rejected the insured's arguments that loss associated with damaged software should be covered because it is media, even where there has been no damage to hardware. The court's interpretation of the relevant insuring clauses and definitions made clear that there must be a showing of "physical existence" as it relates to the claimed damaged media and resulting loss. The upshot of the court's decision was that while the policy provides coverage for the damage to the physical vessel holding the electronic data, i.e., tapes, disks, cards, etc., there was no coverage for the intangible media on the same, at least not under this particular policy, because software and other information stored on physical electronic components do not have the requisite "physical existence" necessary under the policy.

California Federal Court Dismisses Suit by Payroll Company Seeking Coverage Under Forgery or Alteration, Computer Fraud and Funds Transfer Fraud Insuring Agreements

Cachet Fin. Servs. v. Berkley Ins. Co., 2023 WL 2558413 (C.D. Cal. Jan. 20, 2023).

The insured in this matter provides automated clearing house and payroll services, and works with other payroll servicers to process the payroll of its various clients. In short, the insured takes various payroll information from an intermediary

payroll processing company and effectuates the electronic payroll transfers for the employer. As part of this, the employer transfers funds to the insured and the insured transfers the payroll out to the individual employees. In addition, the insured reviews the batch of materials provided by the intermediary payroll processing entity to verify that amounts are balanced, i.e., the amounts drawn from the employer's account match the amounts sent to the insured and then out to the individual employees. Once this process is complete, the insured draws the specified amount from the employer and automatically processes the payroll payments out to the employees as directed by the information provided by the intermediary payroll processing entity.

The insured alleged a loss of approximately $40,000,000.00 was caused by the uploading of information to the insured by two intermediary payroll processing entities, the relevant clients in this instance (MyPayrollHR LLC and iGreen Payroll Services Inc.) As to the former, the plaintiff alleged that the principal of MyPayrollHR LLC engaged in a kiting scheme to steal approximately $26,000,000.00. The scheme apparently involved making it appear as if money was transferred to the insured to process payroll, which did not actually occur, and then inducing the insured to transfer the same out to the principal of MyPayrollHR LLC as part of the process described above. The scheme also involved the principal of MyPayrollHR LLC manipulating account numbers so that funds that were to be deposited with the insured never were, and were instead sent to accounts controlled by the principal. In essence, the principal of MyPayrollHR LLC is alleged to have caused the insured to send approximately $26,000,000.00 out without having actually received those funds. As to iGreen Payroll Services Inc., the insured allegedly lost over $21,000,000.00. Here, iGreen Payroll Services Inc. provided the insured with instructions to debit several accounts with insufficient funds, which it tried to do. The bank involved rejected the debits but not before the insured transferred out the corresponding funds as directed by iGreen Payroll Services Inc.

The insured submitted its loss to the carrier seeking coverage under forgery or alteration, computer fraud and funds transfer fraud insuring agreements. The coverage dispute between the insured and carrier resulted in litigation commenced by the insured. Before the court was the carrier's motion to dismiss. As more fully set forth below, the court sided with the carrier.

The court addressed coverage under the computer fraud and funds transfer fraud coverage first. As to computer fraud, the carrier's main contention was that there was no fraudulent entry to data, as required by the computer fraud portion of the coverage. The carrier argued that all entries of data were done by the insured's clients in an authorized fashion, i.e., the clients used the process of uploading data to the insured in an authorized manner. The insured's argument was essentially that the information provided to the insured was fraudulent both because they contained fraudulent data and were done to cause fraudulent transfers from the insured. The carrier's retort to this position was that while the clients perpetrated a fraud, the policy does not protect against all fraud, including where the clients use the process authorized by the insured, notwithstanding the validity of the data submitted. The court agreed, noting the fraudulent nature of the data did not "negate" the fact that the process employed by the clients was authorized. In this sense, the term fraudulent does not qualify the data; rather, it addresses the method by which the data arrived at the insured, namely, unauthorized access to the insured's computer system. With respect to the funds transfer fraud coverage, the court also agreed with the carrier, with little

analysis. The single paragraph dealing with this coverage agreed with the carrier, rejecting the insured's argument that the instructions to the insured were "altered," and noting that there was no fraudulent instruction to the insured's bank without its knowledge or consent by someone purporting to be the insured.

Lastly, the court addressed the forgery or alteration insuring agreement. Here, the court examined whether the information sent to the insured was altered, as that term is commonly understood. Again, the court sided with the carrier which argued that the files and information provided to the insured from its clients were not altered; rather, they were fraudulent from the start. Stated another way, there was no valid original that the bad actors then altered to induce the insured to transfer the funds. The fraudulent information from the bad actors provided to the insured was always fraudulent. In so finding, the court held that the fact that the clients had previously provided valid payroll information historically or that the payroll information was different than what was "expected" was of no import. Of note, the court did not explore whether the information provided to the insured even fell within the list of enumerated documents in the forgery or alteration insuring agreement.

Given the lack of trigger of any insuring agreement, the court dismissed the matter. It is now on appeal to the Ninth Circuit.

Indiana Federal Court Holds Electronic Transfers of Money Not Covered Under In Transit Coverage Due to Physical Property Requirement

Kem Krest LLC v. The Hanover Ins. Co., 2023 WL 1795879 (N.D. Ind. Feb. 6, 2023).

This matter concerns in transit coverage. In this instance, the insured contracted to purchase sterile gloves from a Malaysian seller. The transaction involved at least two suppliers, one of which directly contracted with the seller. To effectuate the purchase and sale, the parties employed an escrow agent. As part of the transaction, the insured would provide funds to the escrow agent. The escrow agent would then provide a down payment upon receipt of certain financial guarantees. Then, the seller would video conference with the insured and inspect the received gloves, after which the escrow agent would make necessary payments to the suppliers and logistics providers. Upon confirmation of the shipping of the gloves and then receipt of the gloves by the insured, the escrow agent was to release two more payments.

As it turns out, the transaction did not go as planned. The escrow agent, despite not receiving the appropriate financial guarantees, provided the down payment. Then, one of the suppliers requested funds to cover certain shipping costs, again, not part of the agreed-upon arrangement. The escrow agent provided these funds as requested. When the shipping company arrived to the factory to pick up the gloves, it was told that because no money had been paid, there were no gloves "allocated" to the insured and there would be none provided. All told, the insured provided over $3,200,000.00 as part of the deal and never received any gloves. The insured submitted its loss, reduced to $2,710,357.00 through recoveries, to its carrier. The carrier denied the claim, finding no coverage under the policy's in transit coverage, and citing two exclusions concerning exchanges and purchases and voluntary parting. This litigation ensued, and the insured moved for summary judgment.

The carrier argued that the in transit coverage provided for coverage of loss of physical property and not money that is electronically transferred, highlighting the notion that the insuring agreement speaks of messenger's living quarters and the insured's premises as physical places. Relatedly, the carrier argued

that electronically transferred funds do not physically exist inside or outside a building and, therefore, cannot move from inside a premises to outside. In this sense, the coverage would not address property that moves between two locations that are both outside of the insured's premises (or messenger's living quarters). The insured, in turn, argued that the carrier's interpretation of the insuring agreement was far too narrow, and that the insuring agreement is not uniformly limited to the loss of physical property. The insured also disputed the carrier's argument that the property, intangible or otherwise, must originate inside the insured's premises, as the coverage only refers to the property while it is outside of a premises.

On this latter issue, the court agreed with the insured, noting that when "carolers sing 'Oh the weather outside is frightful,' they certainly don't mean the weather that originated in their house moved outside.'" Notwithstanding this "win" for the insured, the court held that the policy's "definition of money only suggests that it covers physical money." The court found that electronic transfers do not fit within the definition of money, which contains several examples of *tangible* items. In so holding, the court used the insured's arguments against it, noting that the funds transfer fraud insuring agreement is worded in such a way to encompass electronic transfers, while the in transit coverage is plainly limited to physical transfers. The court also rejected the insured's attempts to bring electronic transfers within the coverage with a macro view of the way modern business is conducted, instead choosing to apply the words as written in the contract.

<u>Texas Federal Court Holds the That Texas Prompt Payment of Claims Act Is Inapplicable to Employee Theft Claims</u>

Blue Star Sports Holdings, Inc. v. Fed. Ins. Co., 2023 WL 2266128, United States District Court, Eastern District of Texas, Case No. 4:22-cv-098 (Feb. 28, 2023)

This matter involves a coverage dispute concerning an employee theft claim. The insured is a sports media company offering a range of services including league management, camp and event solutions, funding and payment options and various other services designed to assist professional, youth and amateur athletes, and their families. In this matter, the insured discovered that two of its employees embezzled over $6,000,000.00 via multiple wire transfers. After discovering and investigating the theft, the insured submitted a claim to its carrier seeking the $3,000,000.00 policy limit associated with employee theft. After the completion of the claim investigation, the carrier denied the claim. Eventually, the insured commenced litigation in order to obtain coverage.

Multiple counts in the insured's complaint (and amended complaint) alleged bad faith, with one count specifically alleging a violation of the Texas Prompt Payment of Claims Act. Before the court was a motion to dismiss concerning multiple counts, including the count under this statute. As to this particular count, the carrier's main contention was that the statute is inapplicable to disputes arising out of fidelity bonds.

Before addressing the Texas Prompt Payment of Claims Act, the court explored extra-contractual and bad faith claims in general. Texas has a framework where it uses five rules to govern these types of claims, four of which were applicable to this matter. First, the insured must show it is entitled to benefits under the policy. Second, the insured can recover its policy benefits as actual damages under the extra-contractual framework if the statutory violation caused the loss of the benefits. Third, an insured can receive damages under the statutes, independent of the policy benefits, even if the policy does not

entitle the insured to benefits if there is an independent injury caused by the alleged bad acts of the carrier. Fourth and finally, as a corollary to the third rule, an insured cannot recover under an extra-contractual statute if the insured is not entitled to benefits under the policy and there is no independent injury. Under this framework, the court noted that Texas law permits extra-contractual claims where the insured either bases its claim on an independent injury or where it flows from an alleged wrongful denial of benefits under the policy. The carrier sought to dismiss the extra-contractual claims on the grounds that the insured had not plead an independent injury; however, the court determined that the insured here had instead plead the extra-contractual claims as a corollary or linked to the alleged wrongful denial of benefits, permissible under Texas law. As such, the court refused to dismiss the insured's common and statutory bad faith claims, but will require the insured to show that it is entitled to benefits under the policy, as there was no allegation of independent injury.

With respect to the Texas Prompt Payment of Claims Act, however, the court agreed with the carrier. The parties obviously disagreed as to the application of this statute to a claim arising out of an employee theft provision in a policy, rather than a "fidelity bond," as that term is used in the statute. "Fidelity bond" is not defined in the statute; however, using the common and ordinary meaning of the terms, the court concluded that an employee theft insuring agreement is a "fidelity bond," as that undefined term is used in the statute. Citing recent case law from another district in Texas (*RealPage Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA*, 2020 WL 1550798 (N.D. Tex. April 1, 2020)), as well as other persuasive decisions from other Texas federal courts, the court held that where the claim arises out of the bad acts of employees and the insuring agreement under which the insured seeks coverage provides for coverage of the same, the statute does not apply because the claim involves a "fidelity bond." Of note, two of the three cases relied upon by the court in its decision concerned claims or insuring agreements not involving employee theft and rejecting the carrier's contention that the statute was inapplicable. The framework of decisions limiting the inapplicability of the statute to those claims, as opposed to those based entirely on employee theft and the corresponding insuring agreement, formed the basis for the court's determination here. In this case, the facts and the insuring agreement cited by the insured in its pleadings "unambiguously intended to provide coverage to [the insured] for specific types of losses caused by an employee or a fiduciary." This "clearly meets the ordinary definition of a fidelity bond," stated the court, ignoring that the dispute involved a self-described policy versus a "fidelity bond." The court looked beyond titles and headings to determine that the Texas Prompt Payment of Claims Act provides no relief in this instance and the count must be dismissed.

Fifth Circuit Affirms District Court's Decision to Cover Social Engineering Fraud Under Funds Transfer Fraud Insuring Agreement

Valero Title Inc. v. RLI Ins. Co., 2023 WL 1434270 (5th Cir. Feb. 1, 2023); *Valero Title Inc. v. RLI Ins. Co.*, 2021 WL 5154790 (S.D. Tex. Mar. 29, 2021).

This matter involves an insured seeking coverage for a social engineering fraud loss under its funds transfer fraud coverage. In this case, an insured employee was corresponding with a payoff lender about a loan payment transaction. Unbeknownst to the insured employee, a fraudster entered the conversation and posed as an employee of the payoff lender. As part of that, the fraudster provided fraudulent payoff instructions in an effort to misdirect the funds. It worked, and the insured employee transferred $250,945.31 in accordance with the

fraudster's directions. The insured eventually discovered the loss and sought coverage under its funds transfer fraud coverage. The carrier denied coverage, and this litigation ensued.

At the district court level, the parties agreed that the funds transfer fraud coverage provided two potential avenues to coverage. One, an insured could show a written instruction by an insured that was forged or altered by someone other than the insured and transmitted to the insured's bank. The other option involved a fraudster impersonating an insured and instructing the insured's bank to make a transfer. Both avenues of coverage required a showing that the fraudulent request to the insured's bank occurred without the insured's knowledge or consent. The insured sought coverage under the former. The main issue before the district court was whether the forgery or alteration had to occur before the insured issues the instruction to its bank or if it must be that the valid instructions issued by the insured must be then forged or altered before reaching the insured's bank. Of course, the carrier argued that the coverage provides that there must be a valid instruction to the insured's bank that is then forged or altered before it gets to the insured's bank, contending that any preceding forgery or alteration does not trigger coverage. The district court sided with the insured, finding that the carrier's interpretation could not be "harmonized" with the definition of forgery and the insuring agreement in general. The court's main point was that it felt that the carrier was conflating the two different avenues to coverage, and that for the two clauses to be able to separately provide coverage, they must cover two different scenarios without overlap. In so holding, the court determined that the carrier's interpretation of the first part of the insuring clause was really what the second part covered, so that the first part of the insuring clause had to cover some other scenario, i.e., what happened to the insured in this instance. As such, the only covered scenario the court could envision under the first part of the insuring clause was where there are "forged or altered instructions the insured issued without knowledge of the forgery or alteration."

The carrier appealed the decision to the Fifth Circuit, which affirmed the decision. Reviewing the matter de novo, the court of appeals succinctly agreed with the district court that there must be at least two different scenarios covered by the plain language of the fraudulent instruction definition, and that the district court's highlighting of the scenario before the court as one covered by the first part of the definition is correct. Otherwise, the court of appeals held, like the district court, the two different scenarios set forth in the definition of fraudulent instruction would be "redundant." The court found that each example provided by the carrier of covered loss scenarios under the first part of the definition of fraudulent instruction would either not meet the definition of fraudulent instruction or simply be covered under the second part of the definition. Again, seeking to find separation between the two acknowledged portions of the coverage, the court affirmed the district court's analysis and found coverage. Casting aside the various other scenarios proffered by the carrier, the court of appeals agreed with the district court that where the insured receives instructions that are forged or altered and passes those along to its bank to effectuate a transfer, it is in fact a fraudulent instruction by the plain language of the definition at hand.

<u>Eighth Circuit Affirms Coverage of Shipping Costs Lost In Employee Theft Claim</u>

Nat'l Union Fire Ins. Co. of Pittsburgh v. Cargill, Inc., 61 F.4th 615 (8th Cir. 2023).

This publication discussed the federal district court's decision in the January 2022 edition.

Please refer to that discussion for any specifics not discussed herein. In short, the insured discovered an embezzlement scheme involving one of its employees. Included among the job responsibilities of this former employee was negotiating sales contracts with customers for the purchase of corn and sorghum. During an internal audit, the insured discovered noticeably large accounts receivable balances. This discovery launched an internal investigation. Paired with the FBI, the insured discovered a large-scale scheme perpetrated between 2006-2016. According to the investigation, the former employee entered fraudulent (inflated) prices in the insured's system that customers were allegedly willing to pay for the commodities. The former employee also made fraudulent entries in the insured's accounting system to memorialize these fictitious prices. The employee's scheme allegedly caused the insured to sell the commodities at lower prices, which the insured claimed caused an approximately $32,000,000.00 loss, which included shipping costs and loss associated with the misrepresented pricing. With respect to the former employee, she pleaded guilty to various charges, and admitted to depositing at least $3,115,610.89 of customer payments into her personal bank accounts.

After the insured submitted the claim to its carrier, the insured and carrier jointly retained a vendor to investigate the matter and determine a quantum of loss. Under the policy, there is a provision that provides that a report created in this context (a Fidelity Research & Investigative Settlement Clause ("FRISC") report) issued by the vendor is "definitive as respects the facts and the quantum of loss …." In this instance, the FRISC report determined that the former employee's scheme caused the insured to purchase the commodities at prices above the insured's eventual sale price over the course of the scheme. Specifically, the FRISC report concluded the scheme adversely impacted the insured in the amount of $32,115,192.00, including the $3,115,611.00 the former employee stole. A large portion of that loss included the shipping costs that the insured would not have incurred but for the fidelity principal's scheme (after the scheme, new sales in the fidelity principal's area declined approximately 90%). The carrier denied coverage and filed a declaratory judgment action.

The district court awarded judgment on the pleadings to the insured. In doing so, the court construed the term "theft" and the phrase "resulting directly from" in a broad and favorable manner to the insured. The court identified a theft, which was relatively undisputed. The dispute was whether the alleged losses over and above the $3,115,611.00 constituted covered direct loss. The court sided with the insured and refused to separate the actual amount embezzled from the collateral loss as part of the scheme. In addition, the district found that the causal connection between the two types of losses involved here fell within the phrase "resulting directly from."

On appeal to the Eight Circuit, one of the main issues before the court was whether the fidelity principal's conduct was such that the policy covered the approximately $29,000,000.00 in shipping costs incurred by the insured as a result, according to the FRISC report, of the scheme. Reviewing the matter de novo, the court agreed with the district court, and affirmed the decision. In very similar fashion to the district court, the eighth circuit examined the word "theft," as defined, and the phrase "resulting directly from." The court rejected the carrier's arguments and found that the fidelity principal's "implicit" control and manipulation tactics amounted to an unlawful taking. While the court agreed that the fidelity principal never physically seized any of the commodities at issue, her actions amounted to an "implicit taking," as her control of pricing and shipping was so

significant that it caused the insured to send commodities at her behest that it otherwise would not have. For this court, that amounted to a taking sufficient to find a theft. Relatedly, the Eighth Circuit agreed with the district court that the insured's loss of millions of dollars in shipping costs resulted "directly from" the fidelity principal's acts. The court found that the FRISC report concluded that the insured would not have paid the millions of dollars in shipping costs without the fidelity principal's scheme, and found that no other "intervening cause" played a role. Taking a more macro approach, the court viewed the fidelity principal's scheme as a whole, and found coverage for all of the insured's loss which flowed from the fidelity principal's embezzlement acts, even those damages beyond the actual misappropriated amount.

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

Montachem Int'l Inc. v. Fed. Ins. Co., 2023 WL 2401510 (D.N.J. Mar. 8, 2023).

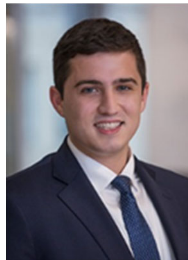
This matter concerns a misdirected payment from one of the insured's customers pursuant to banking instructions inserted into an existing transaction by a fraudster. Specifically, in 2019, the insured sent an invoice to one of its customers. At some point in the process, a fraudster gained unauthorized access to the email account of an insured employee. Using this access, the fraudster emailed an insured customer agent and provided alternate, fraudulent payment instructions related to the invoice. Thereafter, the customer agent provided the instructions to the customer. The customer, unaware of the fraud, remitted $213,056.67 to the account provided as part of the fraud. It seems that as part of its own investigation the insured concluded that the fraudster had accessed the insured's computer system and/or email software. For the customer's part, it refused to make a second payment. The insured submitted a claim to its carrier alleging a loss caused by computer fraud and forgery. The carrier denied the claim citing, among other things, that the property at issue did not fall within the policy's ownership of property provision.

After the denial, the insured commenced litigation. Before the court was the carrier's motion to dismiss on the grounds that the money at issue was not covered property under the policy. The ownership of property provision in this policy covered property "owned by [the insured] or for which [the insured] is legally liable, or held by [the insured] in any capacity whether or not the insured is liable… ." The carrier's argument was straightforward: the insured in this case did not own or hold the funds and it was not "legally liable for" the same. The insured's argument was that it held "the funds in its capacity as a holder of an account receivable," and thus held the funds in accordance with the policy's ownership of property provision, which it contended was broadly stated ("held…in any capacity"). Citing *Posco Daewoo Am. Corp. v. Allnex USA, Inc.*, Civ. No. 17-483, 2017 WL 4922014, (D.N.J. Oct. 31, 2017); *Posco Daewoo Am. Corp. v. Allnex USA, Inc.*, Civ. No. 17-483, 2018 WL 6077983 (D.N.J. Nov. 19, 2018), the carrier maintained that the insured had no interest in money that was owned and held by its customer, noting that the insured remained free to seek payment from its customer and that it was simply choosing not to. It was clear that the insured's argument to defeat the motion to dismiss was its argument that it held and owned a receivable.

The court held in favor of the insured, straining to distinguish the ownership of property provision at issue from the one involved in the *Posco Daewoo* matter. The court here, with little analysis, latched onto the phrase "in any capacity" as a modifier to the holding of property. The apparent

breadth of this phrase, and construing the matter in a light most favorable to the insured, provided the court with enough to allow the insured's complaint to survive the carrier's motion to dismiss.

LEGISLATIVE UPDATE



By: Matthew Vece, Manager, Financial & Tax Counsel, American Property Casualty Insurance Association, Washington, D.C.

State legislative sessions are in full swing. All 50 states and DC have now held legislative sessions in 2023, and a handful of states have enacted surety legislation so far. A sampling of those bills is provided below.

Kentucky

Public Adjuster License Bonds

Kentucky increased the minimum bond amount for a public adjuster license from $20,000 to $50,000.[85]

New Mexico

Public Adjuster License Bonds

New Mexico amended its license bond requirements for insurance adjusters.[86] Previously, all adjusters other than staff adjusters were required to obtain a license bond. This legislation narrows the license bond requirement to apply to only public adjusters. Additionally, this bill removed the provision that allowed an applicant or licensee to file a cash bond in lieu of a surety bond.

North Dakota

Motor Vehicle, RV, and Trailer Dealer License Bonds

North Dakota will allow licensed motor vehicle dealers to also buy, sell, or exchange recreational vehicles and trailers provided that the licensee maintains a surety bond that fulfills the respective bond requirements for recreational vehicle dealers (under N.D. Cent. Code § 39-22.3-05) and trailer dealers (under § 39-22.1-02).[87]

Residential Mortgage Lender License Bonds

North Dakota established new licensing requirements for residential mortgage lenders. Among the requirements is that each licensee must maintain a surety bond in an amount not less than $50,000.[88] When an

[85] Ky. Rev. Stat. Ann. § 304.9-430 (H.B. 232; effective 90 days after the end of the legislative session).
[86] N.M. Stat. Ann. § 59A-13-5 (H.B. 229; effective June 16, 2023).
[87] N.D. Cent. Code § 39-22-14 (S.B. 2193; effective August 1, 2023).
[88] N.D. Cent. Code § 13-12-07 (S.B. 2090; effective August 1, 2023).

action is commenced on a licensee's bond, the Commissioner of the Department of Financial Institutions may require the filing of a new bond. Immediately upon recovery in any action on the bond, the licensee must file a new bond.

Money Transmission License Bonds

North Dakota enacted a licensing regime for those engaged in the business of money transmission, which is defined to include payroll processing services as well as selling or issuing payment instruments or stored value.[89] An applicant for a money transmission license must provide, and a licensee at all times must maintain, security consisting of a surety bond. The bond must be in an amount equal to the greater of $100,000 or an amount equal to 100% of the licensee's average daily money transmission liability in the state calculated for the most recently completed 3-month period, up to a maximum of $500,000. In the event that the licensee's tangible net worth exceeds 10% of total assets, the licensee must maintain a surety bond of $100,000. The terms of or a copy of any bond filed by a licensee with the Department of Financial Institutions is not confidential and may be made available to the public upon written request, provided that confidential information, including prices and fees for the bond, is redacted.

Utah

Lawyer Referral Consultant Service Bonds

Utah created new regulatory requirements for lawyer referral consultants.[90] Lawyer referral consulting is defined as assisting a person to find an attorney or law firm that provides legal services in the legal field appropriate for the person's legal matter. This legislation requires lawyer referral consultants to post a cash bond or surety bond in the amount of $50,000. The bond must be payable to the Division of Consumer Protection for the benefit of any person damaged by any of the following acts that a lawyer referral consultant or the lawyer referral consultant's agent, representative, or employee commits: fraud, misstatement, misrepresentation, unlawful act, omission, or failure to provide lawyer referral services.

Virginia

Payment and Performance Bonds

Virginia revised its Little Miller Act regarding bond requirements for public construction projects.[91] The amended statute allows localities, by ordinance, to permit a contractor to furnish performance and payment bonds equal to the dollar amount of individual tasks identified in the contract instead of the sum of the entire contract amount. This exception to the Virginia Little Miller Act applies only to indefinite delivery or quantity contracts with a local public body.

[89] N.D. Cent. Code § 13-09.1-33 (S.B. 2119; effective August 1, 2023).
[90] Utah Code Ann. § 13-63-204 (S.B. 274; effective May 2, 2024).
[91] Va. Code Ann. § 2.2-4337 (H.B. 1490; effective July 1, 2023).

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