WELCOME TO

PEARLMAN 2023

Pearlman 2023

Building Relationships – Keeping Them Strong

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On behalf of the Board of Directors and Sustaining Members of the Pearlman Association, I want to express our sincere appreciation to you for choosing to attend the Pearlman events this year. Whether you traveled across the country or across town, whether this is your first visit or your 28th, we have worked hard to make your time with us a rewarding and memorable experience and we hope we surpass your every expectation.

Pearlman is an organization designed, built and managed exclusively by company-side surety professionals. Its close, continuous access to the collective heartbeat of a large number of surety companies makes for a unique, targeted perspective on the needs, goals and challenges facing the industry – a perspective available to no other similarly situated organization. Our annual events draw from this special vantage point as we design our curriculum, training and recreational events.

As you take part in our events this year, please keep in mind that Pearlman has but one mission; to strengthen and enhance the talent, professionalism and career prospects of the surety professional. We will accomplish this mission through our scholarship distribution, our educational programs and our commitment to building industry relationships and keeping them strong.

Thank you, again, for joining us this year.

All the best,

Luis Aragon, Chairman/Director, Pearlman Association

Special Recognition

The Pearlman would like to give special recognition to the folks who work tirelessly behind the scenes to make each Pearlman conference a reality.

Special thanks to **Lih Hudson** who truly does all the work. She spends hours upon hours making sure that every little detail is thought of and dealt with. Lih works tirelessly to make each conference the best in the industry and to ensure that everything runs smoothly. When you see her, please give her a heart-felt "thank you." She deserves it.

Special thanks also to **Christine Brakman**. Chris usually pulls all-nighters to put all the conference materials together, formatted correctly, and truly useable. We can't thank her enough for her hard work in preparing The Pearlman "packet" for printing. Thank you, Chris!

A big thanks to **David Stryjewski** for graciously volunteering his time to do the books and keeping the Pearlman finances in order.

A great big thanks to **Brenna Stuhlman** for obtaining CE credits for Florida, Texas, and Washington. She also has applied for CLE credits in California, Texas and Washington!

And lastly, a Thank You and Congratulations to **Jeff Olson**, who stepped down this year from his role as Chairman and Director of the Pearlman Association. Jeff took the helm of the Pearlman Association for the last seven years. Under Jeff's stewardship, Pearlman continued to grow, thrive, and evolve. Thank you for your work and dedication! Jeff can finally head down the street to the Hollywood Tavern for a relaxing drink during this year's program!

Schedule of Events

Wednesday, September 6th

4:30-7:30 **Hospitality Reception –** The Willows Lodge, Woodinville
Hosted by Langley LLP, Sage Associates, Inc., The Hustead Law Firm, and The Vertex Companies, Inc.

Live Music by Ernest Pumphrey
Hosted by Faux Law Group and Williams Kastner

Thursday, September 7th

7:00-8:15 **Registration and Breakfast –** Sparkman Cellars Winery, Woodinville
Hosted by Forcon International Corporation, SMTD Law LLP, and PCA Consulting Group

All Day Coffee/Beverage Service
Hosted by Sokol Larkin Wagner Storti LLC

Espresso Bar
Hosted by MPCS

8:15-8:30 **Welcome/Introductory Remarks**
Luis Aragon | *Liberty Mutual Surety*
Co-Chairs: Mike Pipkin | *Weinstein Radcliff Pipkin LLP*
Regina Gaebel | *Allianz Trade Surety*
Brent McSwain | *Sage, an Aperture Company*

The Cases That Shape the Industry
Regina Gaebel | *Allianz Trade Surety* – Segment Introductions

8:30-9:15 ***Pearlman v. Reliance Ins. Co.*****: Equitable Subrogation as the Foundation of Surety Law**
Panelists: Jacquelyn A. Klima | *Kerr Russell*
Ashlee Rudnik | *Intact*

9:15-10:00 ***U.S. ex rel. Scollick v. Narula*****: Sureties and the False Claims Act**
Panelists: Thomas Moran | *Wright, Constable & Skeen, LLP*
Jennifer Fiore | *Dunlap Fiore, LLC*
Jennifer Schildbach | *Liberty Mutual Surety*

10:00-10:15 **Break**

10:15-11:00 **E-Discovery, Document Management, and Discovery Issues**
Panelists: Megan Daily | *Krebs Farley*
Rebecca Thomas | *Arch*
Mike Gaudet | *J.S. Held*

11:00-11:45 **Advanced Alternative Dispute Resolution Ideas for Sureties**
Panelists: Andrew Ness | *JAMS*
Leslie O'Neal | *JAMS*
Barbara Reeves | *JAMS*

11:45-1:15 **Lunch**
Hosted by Sage, an Aperture Company, Weinstein Radcliff Pipkin, LLP, and Wolkin Curran, LLP

Welcome Back
Luis Aragon | *Liberty Mutual Surety*

The Surety's Options Under the A312 Performance Bond:
Persectives from the Surety and its Consultants and Counsel
Brent McSwain | *Sage, an Aperture Company* – Segment Introductions

1:15-2:00 **The Risks and Rewards for Financing the Principal**
Panelists: Brian Kantar | *Chiesa Shahinian Giantomasi, LLC*
Jonathan Bondy | *Chiesa Shahinian Giantomasi, LLC*
Price Jones | *Liberty Mutual Surety*
Jack Nicholson | *Nicholson Professional Consulting*

2:00-2:45 **The Risks and Rewards of Taking Over the Project**
Panelists: David Kash | *Koeller Nebeker Carlson & Haluck, LLP*
Bruce Kahn | *Berkley Surety*
Jack Costenbader | *PCA Consulting Group*

2:45-3:00 **Break**

Afternoon Snacks
Hosted by RJT Construction

3:00-3:45 **The Risks and Rewards of Tendering a Completion Contractor**
Panelists: Sunny Lee | *Bronster Fujichaku Robbins ALC*
Paul Harmon | *Travelers*
Jim Carlson | *MPCS*

3:45-4:30 **The Risks and … the Risks of "Doing Nothing": A Risky Option Under the A312 Performance Bond**
Panelists: Gregory Smith | *Booth, Mitchel & Strange, LLP*
Grant Margeson | *Sokol Larkin Wagner Storti LLC*
Patrick Toulouse | *Travelers*
Trey Felty | *Liberty Mutual Surety*
Todd Bauer | *Guardian Group*

5:15 **Welcome Reception/Dinner** – Sparkman Cellars Winery, Woodinville
Hors D'oeuvres Hosted by Jennings Haug Keleher McLeod, Nicholson Professional Consulting, Inc., and Sokol Larkin Wagner Storti LLC

6:00 **Dinner** – Sparkman Cellars Winery, Woodinville
Hosted by J.S. Held, LLC, RJT Construction, and Watt, Tieder, Hoffar & Fitzgerald, LLP

7:15 **Hold 'Em Tournament** – Sparkman Cellars Winery, Woodinville
Dealers Sponsored by J.S. Held LLC and Weinstein Radcliff Pipkin, LLP

Cocktails
Hosted by Krebs Farley, PLLC

Friday Morning, September 8th

7:00-8:00 **Registration and Breakfast** – Sparkman Cellars Winery, Woodinville
Hosted by Carney Badley Spellman P.S., Cashin Spinelli & Ferretti, LLC, and Snow, Christensen & Martineau

All Day Coffee/Beverage Service
Hosted by Guardian Group, Inc.

Bloody Mary Bar
Sponsored by Dry Law PLLC

Espresso Bar
Hosted by MPCS

8:00-8:10 **Welcome Back/Program Introduction**
Luis Aragon | *Liberty Mutual Surety*
Co-Chairs: Mike Pipkin | *Weinstein Radcliff Pipkin LLP*
Regina Gaebel | *Allianz Trade Surety*
Brent McSwain | *Sage, an Aperture Company*

Outside the Box:
The Things to Think About When Handling a Surety Case in Litigation
Mike Pipkin | *Weinstein Radcliff Pipkin LLP* – Segment Introductions

8:10-9:05 **Ethical and Good Faith Considerations When Coordinating Interests**
Panelists: Jeffrey D. Horowitz | *The Horowitz Law Firm*
Brian Bragg | *Hartford Financial Services Group*
Elizabeth Henderson | *Hartford Financial Services Group*

9:05-9:50 ***In re Falcon V, L.L.C. & In re Fieldwood Energy*:**
What to Do When Courts Get Creative
Panelists: Chad Schexnayder | *Jennings Haug Keleher McLeod*
Alana Porrazzo | *Jennings Haug Keleher McLeod*
Nina Durante | *Liberty Mutual Surety*

9:50-10:10 **Special Presentation to Rick Levesque**
Mary Lynn Kotansky | *Liberty Mutual Surety*
Mark Gamell | *Torre, Lentz, Gamell, Gary & Rittmaster*

10:10-10:25 **Break**

10:25-10:55 ***L&A Contracting Co. v. S. Concrete Servs., Inc.*:**
Breach vs. Default—Triggers Under the Performance Bond
Panelists: Adrian A. D'Arcy | *D'Arcy Vicknair, L.L.C.*
Paul Friedrich | *Williams Kastner*
Kourtni Mason | *Skyward Specialty Insurance*
Anna Frederick | *EMC Insurance Companies*

10:55-11:25 **Safeguarding Privilege in Surety Claims**
Panelists: Max Langley | *Langley LLP*
Will Beasley | *Merchants Bonding*
Rudy Dominguez | *Liberty Mutual Surety*
Michael Spinelli | *Cashin Spinelli & Ferretti, LLC*

11:25-11:30 **Closing Comments**
Luis Aragon | *Liberty Mutual Surety*

11:30 **Lunch – On Your Own**

Friday Afternoon, September 8th – Golf Tournament and Dinner at Harbour Pointe Golf Club

11:45 **Bus Service to/from Harbour Pointe Golf Club**
Hosted by Law Offices of Larry Rothstein
Bus leaves Willows Lodge at 11:45AM

1:00 **Sign In/Warm Up** – Harbour Pointe Golf Club
Golf Hats Provided by RJT Construction

1:30 **Scramble Tournament – Shotgun Start**
Harbour Pointe Golf Club, 11817 Harbour Pointe Blvd, Mukilteo, WA 98275

Beverage Cart
Hosted by Ernstrom & Dreste, LLP and Watt, Tieder, Hoffar & Fitzgerald, LLP

6:30 **Dinner** – Harbour Pointe Golf Club
Hosted by Chiesa Shahinian & Giantomasi PC, and Ward, Hocker & Thornton, PLLC

Cocktails
Hosted by Sokol Larkin Wagner Storti LLC

7:45 **Awards – Scholarships – Closing**

8:30 **Buses return to Sparkman Cellars Winery and Willows Lodge**

Friday Afternoon, September 8th – Sip 'N Putt

12:30-3:30 Sip 'N Putt at Rainbow Run Mini Golf at Willows Run,
10402 Willows Road, Redmond, WA 98052
Lunch and Beverages: Provided
Transportation: On your own
Hosted by Booth, Mitchel & Strange LLP, Guardian Group, Inc., Lewis Brisbois Bisgaard & Smith LLP, Liberty Mutual Surety, and Pondera Winery

Saturday, September 9th - "On Your Own"

We would like to extend our sincerest appreciation to our Sustaining Members and friends of Pearlman who graciously volunteered their time to coordinate and chaperone Saturday's "on your own" event.

For those of you who signed up for any of the elective event, you will have received by now an e-mail message from your respective "chaperone" alerting you to the logistics of your event.

Woodinville Wine Tour

Hosted by Law Offices of T. Scott Leo, P.C., Torre, Lentz, Gamell, Gary & Rittmaster, LLP, and SMTD Law LLP

Program Co-Chairs

REGINA GAEBEL

Regina Gaebel is the Head of Surety Claims at Allianz Trade, where she is brings nearly 20 years of Surety and Construction legal expertise to her role leading the Surety claims department and as lead surety counsel advising underwriting regarding the many facets of suretyship including indemnity, co-suretyship, compliance, bond and contract language, and assessment of risk. Prior to joining Allianz Trade, Regina was Assistant Vice President of Surety Claims at Argo Surety for over 5 years where she was brought on board to provide legal expertise in Surety & Construction to launch and develop Argo's Contract Surety line of business including drafting Argo's Contract Surety General Indemnity Agreement and numerous other indemnity related Contract and Commercial surety agreements as well as being instrumental in developing claims processes and procedures for commercial, contract, and international surety. Prior to joining Argo Surety, Regina spent over 5 years as in-house surety counsel at another surety and over 6 years in private practice at a boutique Surety & Construction law firm in Chicago. Regina earned a Bachelor of Arts in Political Science from Saint Mary's College, Notre Dame, IN and a Juris Doctor from DePaul University College of Law. When not discussing the general tenets of suretyship, Regina spends her free time cheering on her beloved Chicago Cubs and Notre Dame teams, as a Baseball Mom, life-long ballet dancer, Smarties connoisseur, and making balloon animals.

MIKE PIPKIN

Mike F. Pipkin is a Partner with Weinstein Radcliff Pipkin LLP, Dallas, Texas and is licensed to practice in Texas and Louisiana state and federal courts. He received his Bachelor's degree in Business Administration from Abilene Christian University in 1986 (with honors) and his J.D. from Southern Methodist University Dedman School of Law in 1989. He served as the 2014-2015 Chair of the ABA/TIPS Fidelity and Surety Law Committee and is a member of the Order of the Knights of Pearlman, "bestowed with boundless gratitude for [his] unwavering commitment and generosity to the betterment of the surety industry." Mike is a Co-Editor of The Surety's Indemnity Agreement: Law & Practice, 3rd Edition and Bond Default Manual, 4th Edition, both published by ABA Publishing, and has authored chapters in other ABA FSLC books and presented on numerous topics concerning the surety and construction industries.

BRENT MCSWAIN

Brent McSwain received his Bachelor of Science degree in Industrial-Construction Management from Colorado State University and has been in the construction business for

over 45 years. He has worked as both an owner representative and general contractor responsible for developing and constructing hundreds of projects. For the last 20+ years he has been a Vice-President and managing consultant for The Sage Group in Denver, which was recently acquired by Aperture Brent is a testifying expert and provides extensive experience in litigation support, preparing and defending claims, forensic schedule delay analysis, and labor productivity loss analysis.

Presenters/Biographies

We would like to thank each of our co-chairs and presenters for the significant time and talent that each of them have selflessly invested into the success of our educational programs.

TODD BAUER

Todd Bauer is President of Guardian Group and has more than 30 years of construction and general management experience. Todd received his Bachelor of Science degree from the University of Southern California and his graduate degree from the University of Texas at Austin. Todd assists clients with surety bond claims investigation and settlement as well as litigation support and expert witness services. Mr. Bauer is also the President of Completion Contractors, Inc. and holds a Commercial California Contractors "B" license. He is licensed by the U.S. Treasury as a U.S. Customs Broker and provides expertise in the investigation and resolution of U.S. Customs and FMC bond claims. Mr. Bauer manages Guardian's surety Claim Control™ outsourcing programs and claims runoff assignments for surety companies and Departments of Insurance. He is affiliated with numerous industry organizations and is a frequent speaker at industry conferences and events.

WILL BEASLEY

Will Beasley is a senior claims attorney and contract claims manager at Merchants Bonding Company. Mr. Beasley is a graduate of the University of Tennessee, Knoxville, B.A., and SMU Dedman School of Law. His practice focuses on finding creative solutions to complex issues in the construction and surety industries

JONATHAN BONDY

Jonathan Bondy is a Member, Litigation and Fidelity & Surety Groups, at Chiesa Shahinian & Giantomasi PC. His practice is concentrated in the field of commercial litigation, with a focus on construction, surety and contract issues in New York and New Jersey. Jon represents and advises sureties with respect to performance and payment bond claims, the defense of prevailing wage claims, affirmative surety claims, loss recovery, bankruptcy issues and contractor workouts. He represents developers, contractors and building material suppliers in litigation matters, such as claims for breach of contract, applications for injunctive relief, delay claims and payment claims.

BRIAN BRAGG

Brian Bragg is currently Consultant Claims—Bond with The Hartford's Bond Claim Department, where his responsibilities include claims handling and advising underwriters. Before its acquisition by the Hartford in May 2019, Mr. Bragg served in the same capacity for Navigators Insurance Co. for over two years. Prior to that, he was employed by International Fidelity Insurance Company for over fifteen years. After graduating from law school, Mr. Bragg practiced law for over nine years with several New Jersey law firms where he handled commercial litigation, land use and construction cases, among other matters. He obtained his J.D. from The University of Michigan and his B.A. in English from Wayne State University.

JIM CARLSON

Jim Carlson is the Managing Principal of Maximum Property Construction Services, sister company to Maximum Energy Professionals. Jim brings more than 20 years of experience in owner's representation, surety claims, litigation, mediation, productivity plans, expert testimony, strategic programs, and construction oversight. Notably, Mr. Carlson has performed a significant amount of work in the Middle East where he worked on construction and commissioning of pumping lifting forwarding stations, mechanical cooling for the primary pump motor systems, and substation connection and cooling systems. In addition, he was routinely relied upon to source difficult to find materials, and creatively expedited approvals and deliveries through multiple borders and customs processes.

JACK COSTENBADER

Jack Costenbader, president of PCA Consulting Group, a San Francisco based consulting firm and PCA Disbursements Inc. a California licensed Funds Control Agent. Jack has 44 years of direct experience in surety and insurance consulting throughout the country, handling surety and property claims. In addition, Jack has 11 years of hands-on, build for profit construction experience. Education includes accounting at St. Bernard College in Cullman, AL and civil engineering at Newark College of Engineering, Newark, NJ.

MEGAN DAILY

Megan Daily is an Associate Attorney at Krebs Farley, PLLC in New Orleans, Louisiana. Megan primarily focuses her practice on surety and construction litigation, assisting sureties with project takeovers, performance bond defaults, payment bond claims, bad faith claims and indemnity litigation. Megan received her Juris Doctorate cum laude from Louisiana State University. In law school, Megan was an extern for the Honorable Judge William J. "Will" Crain of the Louisiana First Circuit Court of Appeals, and teaching assistant to Professor Raymond Diamond.

ADRIAN A. D'ARCY

Adrian A. D'Arcy is a native of Ireland, who immigrated to the United States after obtaining his undergraduate degree in Economics from University College Dublin. Adrian graduated *cum laude* from Loyola Law School in 2004 and has spent the last 19 years primarily practicing in the areas of construction and surety law. Prior to launching D'Arcy Vicknair, Adrian was a partner at a boutique New Orleans construction law firm. Adrian has represented owners, contractors, sureties, and insurers throughout his career in multi-party, complex, construction disputes which have been litigated in a variety of forums including state and federal court, arbitration, and specialized courts. Adrian also teaches Construction and Surety Law at Loyola Law School in New Orleans as an adjunct professor. Adrian has been rated as a Super Lawyer and been recognized by Best Lawyers for many years. Finally, Adrian is a frequent speaker across the country on construction and surety issues.

RUDY A. DOMINGUEZ

Rudy A. Dominguez has been in the surety game for over 15 years, currently as Senior Surety Claims Counsel for Liberty Mutual Surety. Before joining Liberty, he worked at a surety law firm in Dallas and clerked for a bankruptcy judge. Rudy earned both his B.A. and J.D. from the University of Texas at Austin and thereafter obtained the AFSB, ARe, and CPCU designations. Some people collect stamps, Rudy collects insurance acronyms…and eyeglasses.

NINA M. DURANTE

Nina M. Durante is Senior Surety Claims Counsel with Liberty Mutual Surety Insurance Company in its Commercial Claims Department. She is based in Seattle, WA. For most of her professional career, Nina has worked in the surety industry handling a variety of claims, including contract, fidelity and miscellaneous matters. In 2013, Nina joined Liberty's newly created Commercial Claims Region where she handles a variety of large commercial claims, bankruptcies, and performance related claims. Nina received her B.A. in Political Science from Seattle University and her J.D. from the University of Puget Sound School of Law (now, Seattle University School of Law). After graduation from law school, Nina clerked for the Hon. Nancy Ann Holman of the King County Superior Court in Washington. She is an active member of the Washington State Bar Association and the American Bar Association - TIPS section.

JOE TREY FELTY

Joe Trey Felty is Claims Counsel for Liberty Mutual Surety. A native of Texas, Trey started out in as an Aggie engineer making cheaper, faster, and better widgets at a major defense contractor in Dallas. After trying and failing to make sense of contract disputes and FAR

regulations, he moved to Chicago, earned his law degree from Valparaiso University, and went to work as Claims Counsel for CNA Surety handling contract surety matters. Prior to Liberty Mutual Surety, Trey was also a consultant with the good folks and surety experts at Cashin, Spinelli & Ferretti LLC.

JENNIFER FIORE

Jennifer Fiore is a principal in Dunlap Fiore, LLC, and her practice focuses on surety and construction law, business law, litigation, as well as Federal and State regulatory and administrative law matters. Ms. Fiore's practice encompasses the full breadth of private and public construction and surety law. She represents clients in the drafting and negotiation of contracts; the administration of project obligations; and the preparation, prosecution and defense of claims. She also has extensive experience in performance and payment guaranty-related matters, bonding, and indemnity issues giving her an experienced, educated perspective on all aspects of construction, and surety law. Ms. Fiore is a Vice-Chair of the Fidelity and Surety Law Committee of the Tort Trial and Insurance Practice Section of the American Bar Association, the Louisiana Bar Association, the Pearlman Association and the National Bond Claims Association. She serves as a panel member for the American Arbitration Association in the areas of Commercial and Construction disputes. Ms. Fiore received her Mediation Certificate from the Harvard Law School Program on Negotiation Mediation Intensive and serves as a mediator in a wide variety of claims.

ANNA FREDERICK

Anna Frederick is a Bond Claims Attorney at EMC Insurance Companies in Des Moines, IA. Prior to joining EMC in 2022, Anna was an Assistant Public Defender for the County of Chester, West Chester, PA, for eleven years, where she gained substantial litigation experience. Ms. Frederick is a graduate of the Roger Williams University School of Law (J.D. 2010, *cum laude*) and Franklin & Marshall College (B.A. 2007).

PAUL K. FRIEDRICH

Paul K. Friedrich is a Member in the Seattle office of Williams Kastner, is a Co-Chair of the firm's Construction Litigation & Surety Practices Team, and is licensed to practice in both Washington and Oregon. His practice is focused on representing sureties and insurers in all aspects of contract, commercial, and fidelity bond claims, with a particular emphasis on construction law, including the representation of general contractors and subcontractors on a wide range of issues involving public and private projects. Mr. Friedrich has extensive experience defending against surety-related bad faith claims and is a frequent speaker and author on surety and construction related legal issues.

MIKE GAUDET

Mike Gaudet is a Managing Director in J.S. Held's Global Investigations Practice, specializing in Digital Investigations & eDiscovery. He has more than 20 years of experience providing solutions for corporations, legal teams, and government agencies related to data discovery and governance challenges. He is an expert eDiscovery practitioner and technologist, with a master's in Computer Science. Mike has proficiency in leveraging the right tools to quickly gain insight from data, and to efficiently achieve project goals on time and under budget. He has experience executing ad-hoc investigations, leading long-term compliance engagements, and implementing Software-as-a-Services (SaaS) solutions. Mike works directly with corporate clients and their counsel to navigate data governance/discovery challenges, either proactively or in response to an event. Mike leads an eDiscovery team that can bring to bear various tools for data analysis, forensics, review, and reporting.

PAUL C. HARMON

Paul C. Harmon is Senior Claim Counsel with Travelers Bond & Specialty Insurance. In December 2007, Paul Harmon joined the Federal Way, Washington Regional Claim Office having previously been admitted to the Washington State Bar. Paul is a 2007 graduate of the University of Oregon School of Law where he was the Executive Editor of the *Oregon Review of International Law*. Previously, Paul received his B.A. in Political Science with a Minor in Music from the University of California, San Diego.

ELIZABETH G. HENDERSON

Elizabeth G. Henderson, CPCU, AFSB is a Senior Representative in Bond Claims with The Hartford. She has been a surety claims handler for over ten years and currently lives in the Seattle, Washington area. She holds a bachelor's in philosophy, with a minor in microbiology, from Washington State University as well as CPCU and AFSB designations. In her free time, she enjoys snorkeling, scuba, and practically anything involving the ocean. When only dry land is available however, she can be found hiking in the Cascades with her two German Shepherd dogs.

JEFFREY D. HOROWITZ

Jeffrey D. Horowitz—Principal of The Horowitz Law Firm, A Professional Corporation, Sherman Oaks (Los Angeles), CA. Mr. Horowitz has been in private practice representing sureties, contractors, and subcontractors, since 2003. Prior to that, he was the Managing Attorney for Frontier Insurance Group, Inc.'s Los Angeles surety claims/legal department, from 1992-2002. He graduated with a B.S. degree in Business Administration from California State University, Northridge in 1986 and received his J.D. degree from Loyola Law School, Los Angeles in 1990. Mr. Horowitz was admitted to the California Bar in 1990 and is admitted to practice in all State and Federal Courts in California.

BRUCE KAHN

Bruce Kahn is a commercial litigation attorney whose practice focuses on the construction, surety, and real estate industries. He presently heads the claims department as a senior vice president at Berkley Surety, a Berkley Company. He is a graduate of Albany Law School, where he was managing editor of the Albany Law Review. He also holds a master of business administration degree from Cornell University's S. C. Johnson School of Business.

PRICE JONES

Price Jones joined Liberty Mutual Surety in 2011. He is a Surety Account Analyst in Liberty Mutual Surety's Surety Claims-Financial Services Department in Plymouth Meeting, PA. In his role, Price conducts account visits to review the books and records of contractors to assess their current financial condition and develop a loss forecast. He also supports the claim handlers in reviewing bond claims and monitoring contractor and project financing through various escrow accounts. Price is a Pennsylvania CPA who graduated from LeMoyne College (Syracuse, NY) in 1997, earning a Bachelors of Science in Accounting. After college he began his accounting career with a traditional public accounting firm in Syracuse, NY. In 2001 he began his surety career when he joined the Philadelphia, PA public accounting firm of Nihill & Riedley, PC, specializing in consulting with sureties on contractor loss and claim matters. He has recently completed his coursework to receive a Master of Accountancy with a Data Analytics degree through the University of Scranton.

BRIAN KANTAR

Brian Kantar is a partner with the law firm of Chiesa Shahinian Giantomasi. Brian's practice is concentrated in commercial litigation, with a focus on fidelity and surety, construction and bankruptcy matters. Brian regularly represents surety companies, contractors and developers in a wide variety of contract disputes, performance and payment bond claims, affirmative claims, loss recovery, bankruptcy issues and contractor workouts. While Brian's practice is primarily based in New York and New Jersey, Brian regularly collaborates with his surety clients on projects and claims both on a national and international basis. Brian served as co-chair of the Surety Program at the 2020 ABA FSLC Fidelity & Surety Law Committee's Mid-Winter Meeting and has been appointed to serve as program chair of the Surety Claims Institute's Annual Meeting in 2023 and 2024. Brian serves as Managing Editor of the Surety Claims Institute's Newsletter in which he also authors a highly regarded surety case update. Brian is a Vice-Chair of the ABA Fidelity & Surety Law Committee. In 2005-2006, Brian served as a law clerk to Judge Ross R. Anzaldi, presiding judge of the Civil Division, Superior Court of New Jersey, Union County. He graduated in 2001, summa cum laude, from Hofstra University, where he was elected to Phi Beta Kappa. He earned his J.D. magna cum laude from Seton Hall Law School, in 2005, where he was elected to the Order of the Coif. While in law school, Brian served as chairman of the Honor

Council and interned for Judge Mary C. Jacobson of the Superior Court of New Jersey, Civil Division, Essex County.

DAVID W. KASH

David W. Kash is a partner in the firm of Koeller Nebeker Carlson & Haluck, LLP in its Phoenix, Arizona office. Mr. Kash received his BSC with honors (Accounting) from DePaul University in 1977 and his JD from Chicago-Kent College of Law with honors in 1981. He is admitted to practice in both Arizona and Illinois, he is AV rated by Martindale Hubbell, he is a member of Arizona Finest Lawyers, is recognized as a Southwest Super Lawyer, and selected to The Best Lawyers in America. He is a trial attorney and his practice includes construction and surety law. He has authored a variety of legal articles and given several presentations. He has been a frequent speaker at Pearlman Association gatherings. Many of his articles can be accessed online or by request to david.kash@knchlaw.com.

JACKIE KLIMA

Jackie Klima is a member of Kerr Russell. She is experienced in the analysis of claims against performance bonds, payment bonds, and other commercial bond forms; pursuit of exoneration and indemnification from bond principals and indemnitors; recovery of contract balances; and all aspects of litigation from the receipt of a claim through the appeals process.

MAX LANGLEY

Max Langley is a Texas and Florida second-generation surety lawyer. Mr. Langley is a graduate of The University of Texas at Austin, B.A., and The University of Miami School of Law, *cum laude*. After practicing in Miami for a few years, he moved back to Dallas to be closer to family. During the Texas bar exam, he sat next to Will Beasley, and it is inconsequential who got the higher score. Max's practice focus includes eDiscovery and digital evidence.

SUNNY LEE

Sunny Lee is a partner with Bronster Fujichaku Robbins in Honolulu. He received his B.A. from the University of Hawaii in 1999 and his J.D. from Seattle University in 2003. Mr. Lee practiced in Seattle before returning home to Hawaii. Prior to joining Bronster Fujichaku Robbins, he was in-house counsel for a title company. Mr. Lee's practice is focused on construction, real estate, AOAO, surety, complex commercial and business litigation. He was a contributing author to The Electronic Payment Bond Deskbook.

GRANT N. MARGESON

Grant N. Margeson is a member at Sokol Larkin. He has extensive litigation experience, ranging from small contract or tort matters to large, complex commercial litigations. Grant has represented sureties, contractors, and other business entities, architects, and industry professionals in a variety of matters, including regarding bond claims, contractual claims, negligence, design defects, and termination issues, among others.

KOURTNI MASON

Kourtni Mason began her career in surety claims in 2015 and recently joined Skyward Specialty Insurance as Senior Surety Counsel. Prior to her career in surety, Kourtni was a maritime and insurance defense litigator, which made the transition to surety law seamless.

Kourtni is a native of Monroe, LA and graduate of Grambling State University, where she earned her Bachelor of Arts degree in Political Science. After briefly living in Atlanta, she returned to Louisiana to attend Southern University Law Center in Baton Rouge, LA, where she obtained her J.D. She currently lives in New Orleans, LA and spends her free time outdoors, buried in a book, or sharing her very own children's book, Little Miss Dancey Pants, with tiny dance enthusiasts.

THOMAS MORAN

Thomas Moran is a Partner based in the Richmond, Virginia office of Wright, Constable & Skeen, LLP. He graduated from Cornell University with a B.A. in Government in 2002 and received a J.D. from the University of Richmond School of Law in 2005. Before helping to open the Richmond office of Wright Constable in 2019, he was a partner at Setliff Law, PC, and was previously at Wallace Pledger, PLLC. In addition to Virginia, Tom is licensed to practice in West Virginia and the District of Columbia. His practice is focused on surety and construction litigation. He has previously presented at the Northeast Surety and Fidelity Claims Association, Surety Claims Institute, and the Eastern Bond Claims Review.

ANDREW NESS

Andrew Ness is an arbitrator and mediator with JAMS. In addition to mediation engagements, he has served as an arbitrator in both international and domestic U.S. arbitrations, as a Dispute Review Board Member, a Standing Neutral, and a Neutral Evaluator, all in relation to complex construction and U.S. Government contract disputes. Before becoming a full-time neutral, he was a practicing construction lawyer for 40 years, most recently as a partner in the Washington, D.C. office of Jones Day. In his practice, he served as lead counsel on a wide variety of large construction disputes resolved in federal and state courts and via domestic and international arbitrations. The projects with which

Mr. Ness has been substantially involved encompass a broad range of energy, industrial and process, government, institutional, commercial, and building projects. Mr. Ness has been recognized by Chambers USA and Best Lawyers in America since each publication commenced coverage of Construction Law, and is consistently named one of the Global Most Highly Regarded Individuals by International Who's Who of Construction Lawyers. He is a Fellow and former Board member of the American College of Construction Lawyers and was the 2012–2013 Chair of the ABA Forum on Construction Law, the world's largest organization of construction lawyers.

JACK NICHOLSON

Jack Nicholson, CPA, CFF, CGMA is a Certified Public Accountant and President of Nicholson Professional Consulting, Inc. Mr. Nicholson has over 35 years of experience in construction, banking, auditing, tax, management advisory services, and corporate financial and personnel management. Mr. Nicholson is NPCI's construction accounting and fidelity expert. He has accumulated considerable experience in the both the construction accounting and fidelity consulting role. He has appeared as an expert witness on numerous occasions in recent years on both construction and fidelity issues. Additionally, he has extensive experience in surety loss analysis and claims administration, while representing many of the major surety companies in the United States.

LESLIE KING O'NEAL

Leslie King O'Neal is a neutral with JAMS, handling disputes as a mediator, arbitrator, and project neutral. For 15 years she was associate general counsel for an ENR top 25 general contractor, where she managed various types of construction-related claims and litigation and worked with the company's sureties, Travelers, and Chubb. Before going in house, she was in private practice with several law firms, including Holland & Knight, LLP, and Greenberg Traurig, where she litigated a variety of construction and surety disputes. She was chair of the ABA Forum on Construction Law and was a vice-chair of the TIPS Fidelity & Surety Law Committee. She is a Fellow in the American College of Construction Lawyers. She has written numerous articles and has been a contributing author and editor for several books, including "Managing and Litigating the Complex Surety Case" (Second Edition) and "Construction Technology and Law: A Legal Guide." She received her B.A. from the University of Florida and her J.D. from the University of Florida College of Law.

ALANA L. PORRAZZO

Alana L. Porrazzo is a partner in the Phoenix, Arizona office of Jennings Haug Keleher McLeod LLP and licensed to practice in the state and federal courts of Arizona, New Mexico, and Louisiana. She is a co-chair of the FSLC Law Division Bankruptcy Subcommittee and a member of the Arizona State Bar Association Construction Section Executive counsel. Ms.

Porrazzo studied at Yale University (B.A., 2009) and Tulane University School of Law (J.D., *cum laude*, 2016).

BARBARA A. REEVES

Barbara A. Reeves is an arbitrator, mediator, and court-appointed neutral with JAMS in Los Angeles, California. She has more than 17 years' experience as a full-time arbitrator and mediator, handling the range of international and domestic commercial business disputes including construction and surety, intellectual property, antitrust, employment, insurance coverage, and entertainment. A graduate of Harvard Law School, she clerked for the Ninth Circuit, was a trial attorney and section chief with the Department of Justice, Antitrust Division, a partner in major law firms (Morrison & Foerster, Fried Frank, Paul Hastings) and associate general counsel at a major electric utility holding company.

ASHLEE RUDNICK

Ashlee Rudnick is a surety claims manager at Intact Insurance Surety Group. She graduated from Michigan State University Law School and previously practiced real estate and property transactions in the Metro Detroit area. Ashlee worked in the pipeline industry focusing on easement acquisitions and property restoration settlements before joining Intact.

CHAD L. SCHEXNAYDER

Chad L. Schexnayder is a partner in the Phoenix office of Jennings Haug Keleher McLeod, LLP. For more than 39 years, his practice has focused principally on the surety and construction industry, representing builders, public and private owners, design professionals, suppliers, sureties and insurers. He represents clients before agencies, mediators, arbitrators, and in state and federal courts, including U.S. bankruptcy courts, throughout the country. He is a Past Chair of the Fidelity and Surety Law Committee of the American Bar Association, Tort & Insurance Practice Section. Mr. Schexnayder is an editor and author in numerous industry publications, including *Surety Aspects of Bankruptcy Law and Practice*, American Bar Association (2021) (ed.), and Chapter 145 in the *New Appleman on Insurance Law Library Edition*, and *Intersections of Bankruptcy and Construction: Treatment of Executory Construction Contracts.* He has spoken before the American College of Construction Lawyers, Surety Claims Institute, American Bar Association, Pearlman Association, Mid-South Commercial Law Institute, National Association of Surety Bond Producers, West Coast Casualty Construction Defect Seminar, the Surety and Fidelity Association of America, and the Arizona State Bar Construction Law Section on bankruptcy, surety and construction law subjects. He is a cum laude graduate of Arizona State University Sandra Day O'Connor College of Law, and a cum laude graduate of Washington University at St. Louis.

JENNIFER SCHILDBACH

Ms. Schildbach is Surety Claims Counsel at Liberty Mutual Surety. Jennifer previously served as surety counsel for AmTrust Financial Services, Inc., prior to Liberty's 2019 acquisition of AmTrust's surety business. At Liberty, she handles contract bond claims across the country. Before going in-house, Ms. Schildbach was a principal attorney at Lanak & Hanna, P.C., in Orange, California, where for nearly fourteen years she represented sureties, prime contractors, subcontractors, owners, lenders, suppliers and commercial enterprises, before state and federal courts and administrative agencies, in all areas of surety, construction, commercial and prevailing wage law. Ms. Schildbach has a J.D. from Whittier Law School and a B.A. from the University of Louisville.

GREGORY H. SMITH

Gregory H. Smith is a partner in the Orange County office of Booth, Mitchel & Strange LLP. Mr. Smith's practice focuses on business litigation matters and surety law matters in state and federal courts. Mr. Smith graduated from the University of California Berkeley in 2003 and obtained his law degree from Whittier Law School in 2005. He joined Booth, Mitchel & Strange LLP in 2012. Prior to joining the firm, Mr. Smith worked as an Equal Justice Works/AmeriCorps Attorney and later as a Staff Attorney at the Public Counsel Law Center where his practice focused on consumer litigation.

MICHAEL W. SPINELLI

Michael W. Spinelli, AIA – Principal at Cashin Spinelli & Ferretti, LLC, a nationwide surety consulting and construction management firm headquartered in New York. Mr. Spinelli is a registered architect and attorney. He received his B.S. in Architectural Technology from the New York Institute of Technology, and his Juris Doctor, *summa cum laude*, from the Touro Law Center. He is past president of the Long Island Chapter of the American Institute of Architects, and past vice-chair of the Fidelity & Surety Law Committee. Over his 30-year career, Mr. Spinelli has been a graduate school professor, frequent lecturer, and author on surety and construction claims. He has been recognized as an expert in these areas in numerous state and federal jurisdictions.

REBECCA THOMAS

Rebecca Thomas joined Arch in June of 2023, where she is currently a Senior Claims Examiner for Arch Insurance's Subcontractor Default Insurance. Prior to joining Arch, Rebecca spent 19 years in private practice defending and advising insurance companies on various commercial insurance products, including subcontractor default insurance, general liability coverage with a focus on construction defect claims, professional liability coverage, and first party coverage. Rebecca obtained her law degree from Tulane Law School and holds a Bachelor of Arts Degree in English from the University of Georgia.

PATRICK TOULOUSE

Patrick Toulouse earned a B.A. in Economics from Pomona College in Claremont, California in 1983. He received a J.D. from Cornell University in 1986 and a M.B.A. from the University of Washington in 1999. Prior to joining Travelers in 2002, Patrick was in private practice in Seattle for 16 years working on general business, bankruptcy, commercial, real estate, construction, and estate planning matters. He is currently a Technical Director & Counsel in Travelers's office in Federal Way, Washington where he manages and resolves complex performance and payment bond matters.

Sustaining Members

Bains Law is a boutique business litigation and construction/surety firm, serving clients in Texas, Florida, Arkansas, and bankruptcy courts throughout the nation. Bains Law prides itself on focusing on the client and its goals, which may range from an early, cost-effective settlement to “all hands on deck” litigation through trial and appeal. As a small firm, Brandon is intimately involved in all facets of each case. This oversight ensures that the case is progressing in accordance with client's desires, costs are monitored and budgets kept, and clients remain continually informed and updated. Originally born in DeSoto, Texas, Brandon has spent most of his life in Texas, with the exception of a stretch in Miami as part of opening a law office for his prior firm. Brandon misses Cuban coffee more than can be expressed in words. Luckily, Bains Law is active in Florida, which provides a good excuse to return from time to time to enjoy a cortadito. Brandon has been married to Allison since 2008 and they have three beautiful (and sometimes crazy) children: Sailor, Saxon, and Cannon. At any given time, there are also dogs, cats, rabbits, and lizards running around. Brandon is thankful that his HOA does not allow chickens, donkeys, and the like, or he would come home one day to find Allison running a small farm. Finally, all rumors are true – Brandon is superb at karaoke.

Please visit our website at https://bainslaw.com/.

Since 1955, Booth, Mitchel & Strange LLP has provided exemplary legal service to businesses and individuals throughout California. With offices in Los Angeles, Orange County and San Diego, we are positioned to efficiently handle litigation and transactions throughout Southern California. In addition, over half of the firm’s practicing lawyers are partners who have a personal stake in the quality of our work, the satisfaction of our clients in the results obtained and in the professionalism with which we represent them.

Rated AV by Martindale-Hubbell, Booth, Mitchel & Strange LLP handles private and commercial lawsuits and arbitrations involving tort, contract, environmental, construction, surety, commercial, employment, professional liability, landlord-tenant and real estate disputes. We represent both plaintiffs and defendants and have thereby developed a breath of insight that facilitates prompt and accurate analysis of our client's problem and an ability to obtain the most favorable resolution in the most efficient and cost effective way.

We are also available to consult in the areas of commercial and construction contracting, real estate transactions, leasing, surety and employment.

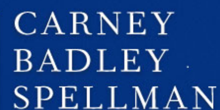
Please visit our website at www.boothmitchel.com.

Bronster Fujichaku Robbins is recognized as one of the premier trial law firms in Hawaii, handling cases on all of the islands. We are an experienced litigation firm with an established track record of successful settlements, work outs, and trial verdicts in a wide variety of complex litigation, arbitrations and mediations. Our firm is strongly committed to serving the community through significant public and private *pro bono* work.

Our philosophy is to obtain the best results possible for our clients through aggressive advocacy and efficient management practices.

Our areas of practice include commercial, business, surety and real property litigation; consumer protection law involving financial fraud, unfair or deceptive business practices; antitrust and competition law; litigation and advice to trustees and trust beneficiaries, including claims of breach of fiduciary duties; regulatory and administrative law before state and county agencies; environmental litigation; civil rights employment cases including discrimination, harassment, and wrongful discharge; and arbitration, mediation and other dispute resolution services.

Please visit our website at www.bfrhawaii.com.



Carney Badley Spellman works with a wide range of clients including, individuals, professionals, entrepreneurs, educators, closely-held or family businesses, franchises, as well as insurance companies, Fortune 500 companies and global industry leaders. They are in the private sector, public sector and governments. Our clients are forward thinkers, creative, collaborative and deliver high-quality products and business services to their markets. Our clients markets extend into almost every industry including, food and beverage, retail, professional services, arts, health care, education, manufacturing, technology, construction, surety, real estate and more. We partner with them so they can drive their journeys.

Please visit our website at www.carneylaw.com.

Cashin Spinelli & Ferretti, LLC is a multi-disciplinary firm providing consulting and construction management services to the Surety and construction industries. Since 2000, Cashin Spinelli & Ferretti has been providing expert advice and analysis to the nation's leading Surety companies. Drawing on the expertise of its staff of Professional Engineers, Architects, Attorneys, Certified Public Accounts, Field Inspectors and Claims experts, Cashin Spinelli & Ferretti is well poised to offer Surety consulting and litigation support services to the industry. Cashin Spinelli & Ferretti's workforce is large enough to handle any surety matter, but still maintain the client contact that is so important in our industry.

Operating from offices in: Hauppauge, New York (Long Island); Southampton, Pennsylvania (Philadelphia area); Avon, Connecticut (Hartford area); Crystal Lake, Illinois (Chicago area); Bend, Oregon; and Miami, Florida; Cashin Spinelli & Ferretti provides its services to all areas of the United States, and the Caribbean.

Please visit our website at www.csfllc.com.

Chiesa Shahinian & Giantomasi PC, with offices in New York, NY, West Orange, NJ and Trenton, NJ, is committed to teaming with our clients to achieve their objectives in an increasingly complex business environment. This goal is as important to us today as it was when our firm was founded in 1972.

Over the past four decades, CSG has expanded from eight to more than 130 members and associates, all of whom are dedicated to the legal profession and to the clients they serve. As our firm has grown, we have steadfastly maintained our commitment to excellence, offering businesses and individuals comprehensive legal representation in a cost-effective, efficient manner.

Our firm provides the high level of service found in the largest firms while fostering the type of personal relationships with the firm's clients often characteristic of small firms. We take pride in our reputation for excellence in all our areas of practice, including banking, bankruptcy and creditors' rights, construction, corporate and securities, employment, environmental law, ERISA and employee benefits, fidelity and surety, government and regulatory affairs, health law, intellectual property, internal investigations and monitoring, litigation, media and technology, private equity, product liability and toxic tort, public finance, real estate, renewable energy & sustainability, tax, trusts & estates, and white collar criminal investigations.

Please visit our website at www.csglaw.com.

Clark Hill has been at the forefront of the fidelity and surety industry for over fifty years. From the quiet days of the 1960's to the mercurial 1980's dealing with the banking and real estate crisis throughout the country, to the advent of electronic banking and mega-construction projects of the 1990's and 2000's, the lawyers in Clark Hill's Fidelity & Surety group have worked in partnership with our clients in every aspect of the industry.

Clark Hill's surety lawyers provide experienced representation in all facets of the surety industry. The group's lawyers have significant experience representing sureties in connection with all types of bonds, including performance, payment, probate, public officials, subdivision, and various other miscellaneous commercial surety bonds. Our lawyers have successfully handled countless complex contract surety claims, expertly guiding sureties through pre-default investigations and negotiations and completion of construction projects after default, including drafting and negotiating completion contracts, takeover agreements, ratification agreements, financing agreements, and other pertinent surety agreements. Our lawyers likewise have extensive experience handling complicated and varied commercial surety bond claims, from the initial investigation and analysis to conclusion. Our expertise and experience extends to protecting the surety's interests in bankruptcy proceedings, including pre-bankruptcy and post-filing negotiations of reorganization plans, conflicts regarding unpaid proceeds of bonded contracts, negotiations regarding assumption of bonded obligations, and other issues affecting the surety in bankruptcy.

Please visit our website at www.clarkhill.com.

D'Arcy | Vicknair LLC is a law firm that primarily focuses on Construction Law and Surety Law. The firm is a group of attorneys with records of successful litigation outcomes. Many of our attorneys are named in Super Lawyers, Best Lawyers, and many of the firm's attorneys also participate in bar associations and other professional organizations, frequently serving in leadership roles. Our attorneys also have degrees in other areas related to the practices of the firm, such as Electrical Engineering, Economics and Civil Engineering. In addition, two of our attorneys (including Mr. D'Arcy) teach at Loyola Law School New Orleans as adjunct law professors. As regards surety work, all aspects of construction performance and construction claims are handled by D'Arcy Vicknair. The firm tackles each phase of bond work from assessing claims through working out settlements, and, when appropriate and necessary, through detailed discovery, trial of the claim and handling any appeals, and associated indemnity actions. The firm provides a full range of surety-related legal services including, but not limited to, defaults, claim analysis, management and coordination, project takeovers, indemnity issues, subrogation issues,

workouts, and mediation, arbitration, and litigation. Headquartered in New Orleans, Louisiana, the firm has attorneys licensed to practice in Louisiana, Texas, Mississippi, and New York. Please visit our website at www.darcyvicknair.com.

At Dry Law, with a team of attorneys licensed in Texas, Oklahoma, Arkansas, and New Mexico, our services extend across the country, catering to clients from all corners of the nation. We pride ourselves on understanding how each client defines a successful resolution of their dispute, and work with them to achieve those results whether that occurs before, during, or at the conclusion of trial. Our goal is to provide our clients with efficient and cost-effective solutions that protect their interests. We realize that "legal victories" and "business victories" are not always synonymous and we are committed to achieving the best possible outcome for our clients, whether it is through creative and efficient pre-litigation solutions or, if necessary, tenacious advocacy in the courtroom. We understand that trust is essential in our field, and we work hard to earn our clients' trust and respect. Our clients trust us to handle their complex disputes, and we take that trust seriously. We are committed to finding the best solutions for our clients and providing them with the high-quality representation they deserve.

Over the years, the firm's attorneys have successfully obtained over $60 million in collateral orders through injunctions filed all over the South, including Texas, Oklahoma, Arkansas, Alabama, and Georgia.

Finally, our practice impacts lives not only in Texas, but across the United States and around the globe. That impact is not lost on our team and we are proud to be a part of this greater community. For 2023, Dry Law has committed to fund Eden's planting of over 33,000 mangroves and other native trees in Madagascar and Haiti.

Please visit our website at: https://drylaw.com/.

DUNLAP • FIORE

ATTORNEYS AT LAW

The attorneys at Dunlap Fiore, LLC, represent surety clients throughout the United States and have extensive experience in all aspects of the construction industry including: default, project completion, disputes involving payment, defective work, defective design, delay claims, and claims for additional work. Our attorneys are actively involved in negotiations with project owners, creditors and financially troubled contractors during all stages of the construction process.

Our firm has a particular focus in federal contracting and issues involving the Federal Acquisition Regulation. Representing sureties for government contractors, we draw on decades of experience in resolving government contract controversies. Our approach to legal representation involves fully understanding the needs of our clients, followed by personalizing our representation to obtain quick, positive results.

Please visit our website at: www.dunlapfiore.com.

ERNSTROM & DRESTE LLP

The Ernstrom & Dreste, LLP law firm is proud to focus its practice on the surety and construction industries. Our experience and in-depth knowledge of surety and construction law is recognized locally, across New York State and even nationally. We serve clients across the country and around the globe. We are more than just a law firm; our industry knowledge helps us understand what is important to our clients. As leaders in surety and construction law, we are a team of accomplished professionals who understand the nature of both industries and the forces which shape those industries. Because the industries we serve are intertwined, our understanding of the surety industry means we can better serve our construction clients, and our knowledge of the construction industry means we can better serve our surety clients. We go the extra mile to make sure our clients are satisfied with the legal services we provide.

Please visit our website at www.ed-llp.com.

Fasano Acchione & Associates provides consulting services for a variety of clients in the construction and surety industries. The individuals at Fasano Acchione & Associates are accomplished professionals with expertise in surety, construction, engineering, project management, and dispute resolution including litigation support.

FA&A maintains offices in New York, NY, Philadelphia, PA, Mount Laurel, NJ, Seattle, WA, and Baltimore, MD. If you would like more information, please contact Vince Fasano at (856) 273-0777 or Tom Acchione at (212) 244-9588.

Please visit our website at www.fasanoacchione.com.

The Wild-Wild West is the home of Faux Law Group. Faux Law Group represents sureties in Nevada, Idaho and Utah regarding claims on public and private payment and performance bonds, subdivision bonds, commercial bonds, license bonds, DMV bonds, and miscellaneous bonds. Faux Law Group represents sureties in the recovery of losses through indemnity and subrogation actions. Our attorneys are actively involved in the local communities in order to better represent the interests of our surety clients.

Please visit our website at www.fauxlaw.com.

Forcon International is a multi-dimensional consulting and outsourcing firm that has provided services to the surety, fidelity, insurance and construction services industry for more than twenty-nine years. Our surety and construction services include books and records review, claim analysis, third party claims administration for sureties, bid procurement, estimating, project administration, scheduling and funds control. We are able to offer these broad ranges of services because FORCON is composed of senior claim management professionals, accountants, professional engineers and construction management executives. Forcon has acted as third party administrator dealing with bond claims and runoff services since its inception. The firm operates from six (6) offices located throughout the United States [FL, GA, MI, MD, PA, VA].

Please visit our website at www.forcon.com.

Global Construction Services, Inc.

Global Construction Services, Inc., located in Redmond, Washington, has provided project management, claims consulting services and surety loss consulting to virtually the entire spectrum of the construction industry since 1972. Our construction experts have assisted owners and contractors alike with the preparation and updating of project schedules, change order pricing and negotiation, and time extension calculations. We have prepared and/or defended claims on behalf of general contractors, subcontractors, sureties, public owners, private owners, architects and engineers. We have extensive experience providing expert testimony at deposition, arbitration and trial. We have deftly handled surety losses through all phases of project completion as well as the resolution of related claims both asserted by and defended by the surety.

Please visit our website at www.consultgcsi.com.

Guardian Group, Inc. is a full-service consulting firm with offices nationwide specializing in surety claims, property and casualty claims, construction management and claims, construction defect claims, fidelity claims, construction risk management, expert witnessing and litigation support.

When you need expert construction and surety claims support, our distinguished twenty-five year track record yields confidence, unprecedented efficiency and results.

Guardian's management and staff consists of a unique combination of highly qualified engineers, architects, schedulers, project estimators, accountants, claims personnel and other professionals with expertise in all types of construction and surety bond claims. This knowledge, together with fully automated systems, provides our clients with expedient and cost effective claims resolutions.

Call on the one company engineered to exceed your expectations. Please learn more about Guardian Group, Inc.'s successful approach to consulting by visiting our website at www.guardiangroup.com.

Founded in 1979, JAMS is the largest private provider of mediation and arbitration services worldwide. With Resolution Centers nationwide and abroad, JAMS and its nearly 300 exclusive neutrals are responsible for resolving thousands of the world's important cases. JAMS may be reached at 800-352-5267.

JAMS neutrals are responsible for resolving a wide array of disputes in the construction industry, including matters involving breach of contract, defect, cost overrun, delay, disruption, acceleration, insurance coverage, surety, and engineering and design issues. The JAMS Global Engineering and Construction Group consists of neutrals who serve the industry through traditional ADR options such as mediation and arbitration, and through several innovative approaches to ADR such as Rapid Resolution, Initial Decision Maker, and Project Neutral functions. Further, JAMS neutrals understand the complexity of project financing and the demands of large infrastructure and other mega-projects and are

uniquely qualified to serve on Dispute Review Boards and other institutional approaches to conflict resolution.

Please visit our website at www.jamsadr.com.

The surety, construction, and litigation firm of Jennings Haug Keleher McLeod delivers effective courtroom representation, capable legal advice, and superior personal service to our clients in the construction and surety industries. Our experienced lawyers provide representation in a broad array of practice areas including construction law, surety/fidelity law, bankruptcy, Indian law, business law, and insurance defense.

What distinguishes our Firm is the quality of service and the consistent follow-through clients can expect from our attorneys and staff. We pride ourselves in providing timely, effective, and efficient legal services to our surety and contractor clients.

The firm serves businesses and individual clients throughout the state of Arizona, and we can accept cases in the southwest United States, California, New Mexico, Nevada and in select bankruptcy actions nationwide.

Please visit our website at www.jhkm.law.

Jermain Dunnagan & Owens, P.C. has represented sureties in the last frontier of Alaska for more than forty years. From rebids and completion of defaulted contracts in remote locations, to bonded but busted roads, schools, hospitals, and dams, we solve problems with local knowledge and expertise. We know the environment. Our firm has a proven track record of limiting surety exposure and quickly capturing repayment for our clients. We combine personal service with innovative tech solutions and big firm capabilities to achieve results anywhere in Alaska.

Please visit our website at www.jdolaw.com.

J.S. Held is a leading consulting firm specializing in construction consulting, property damage assessment, surety services, project and program management, and environmental, health & safety services. Our organization is built upon three fundamental pillars: to provide high quality technical expertise; to deliver an unparalleled client experience; and to be a catalyst for change in our industry. Our commitment to these pillars positions us as a leading global consulting firm, respected for our exceptional success addressing complex construction and environmental matters in the world. Our team is a group of multi-talented professionals, bringing together years of technical field experience among all facets of projects including commercial, industrial, high rise, special structures, governmental, residential, and infrastructure. Our uncompromising commitment to our clients ensures our position as one of the most prominent consulting firms in our industry.

Please visit our website at www.jsheld.com.

Established in 1874, Kerr, Russell and Weber, PLC has evolved from a small practice in Detroit into a firm of committed, resourceful and respected lawyers with many talents and specialties. Our areas of practice include fidelity and surety. Kerr Russell represents sureties in a wide range of matters, including the handling of defaults; claims against performance bonds, payment bonds, probate bonds and other commercial bond forms; performance takeovers, tenders and subcontract ratifications; pursuit of indemnification; and all aspects of litigation. Our attorneys also include those whose specialties afford our surety practice access to a wide array of disciplines which are often beneficial to our services for surety clients, including corporate, tax, real estate, bankruptcy, and employment practices.

Please visit our website at www.kerr-russell.com.

Koeller, Nebeker, Carlson, Haluck, LLP (KNCH) prides itself in its handling of complex litigation matters. Our broad spectrum of practice areas includes litigation defense, business law, employment law, insurance coverage and bad faith, environmental law, and most types of general practice areas. Our clients range from small business owners and their insurance companies; to mid-sized commercial contractors, landlords and tenants; to large nationwide homebuilders and commercial builders.

Over the 30 years of our existence, we have also become a recognized authority in all areas of construction litigation and transactions, with a particular specialty in representing builders, developers and general contractors. From real estate acquisition, development and financing, to construction and business litigation for both residential and commercial projects, our breadth of experience and geographical coverage ensures that our clients' personal business and financial concerns are being represented every step of the way.

As a direct result of the faithful support of our clients and the dedicated service of our attorneys and staff, the firm has grown to over 80 attorneys, 200 employees, with offices in Irvine, San Diego, Sacramento, Las Vegas, Phoenix, Orlando and Austin. Indeed, since its inception in 1986, KNCH has formed a dynamic presence throughout the states of California, Arizona, Nevada and Florida and has recently extended its reach into Texas. We look forward to developing new client relationships while continuing to excel at serving the needs of existing clients by achieving the highest level of excellence.

Dedicated to service, and driving ahead with integrity and courage, we are the law firm you want on your side.

Please visit our website at www.knchlaw.com.

The nationally recognized attorneys of Krebs Farley have litigated cases all over the United States. Our attorneys' skills show not only in the courtroom, but also in negotiation. The personal commitment and dedicated effort that our attorneys put forth make a difference in every case we handle. We are smart, pragmatic, and diligent. And we are dedicated to creatively pursuing the best solutions for our clients.

We understand the importance of prompt, correct, and concise responses; foreseeing and accounting for future contingencies in contract drafting; resolving disputes that can be amicably resolved; and positioning those matters that cannot be settled for a successful outcome in litigation. We do this while remaining cognizant that litigation often impacts business considerations beyond the case at hand. We also work closely with our clients in developing and operating within a litigation budget. Whether it be in negotiation, in mediation, in arbitration, in trial or on appeal, the attorneys at Krebs Farley seek pragmatic solutions for our clients.

Please visit our website at https://krebsfarley.com.

Langley LLP is a Texas civil trial, commercial bankruptcy, and appellate firm that represents Fortune 500 and middle- market industry leaders in disputes throughout the United States. Our firm is made up of ambitious and smart lawyers who demonstrate passion and zeal in representation of the firm's clients. We help our clients solve their legal challenges through aggressive negotiation or litigation. Our areas of specialty include surety and construction, property insurance claims, commercial litigation, and commercial bankruptcy.

Our attorneys try cases, handle arbitrations, litigate, negotiate, analyze, and communicate. At the heart of the matter, for us it is all about understanding our clients' business and keeping our clients informed. We are strong believers in creating a plan for each matter designed to arrive at an efficient and effective resolution. Most cases in the United States settle, as do most of ours. When a case must be tried, our trial lawyers relish the opportunity – whether it is a two day trial to the bench or a sixteen week jury trial. Whether the amount in controversy is hundreds of millions of dollars or a small sum,

our experience, communication skills, and use of cutting edge technology position us to achieve the winning result.

Please visit our website at www.l-llp.com.

The Law Offices of
John L. Fallat

Our firm has been representing fidelity and surety companies for over 20 years. We focus on problem solving, always attempting to resolve conflicts efficiently in a good-faith effort to avoid expensive, protracted litigation. However, we are certainly prepared to defend claims through the entire judicial process, including appeals. The size of our firm enables us to give personal attention to our clients' needs.

Please visit our website at www.fallat.com.

Lewis Brisbois offers its clients counsel experienced in handling all facets of surety practice from its offices throughout the United States. Our attorneys have successfully represented clients in resolving contract and commercial surety, and issues ranging from simple license bonds to complex multi-state contract surety defaults. Our attorneys have extensive experience handling surety matters in mediation, arbitration, state, and federal courts, as well as appellate courts, including United States Circuit Courts.

Please visit our website at www.lewisbrisbois.com.

Our attorneys have successfully represented clients in complex performance and payment bond cases ranging from major contractor defaults to bond fraud to bad faith allegations. Such experience includes negotiating takeover and tender agreements, and performance bond buybacks, as well as the assertion and litigation of affirmative claims against owners, design professionals, or subcontractors.

Our proficiency extends beyond contract surety to bonds of all types: fidelity, probate and many other commercial lines, including notary bonds, mortgage broker bonds, motor vehicle dealer bonds, bankruptcy trustee bonds, and license bonds, among others. Our work with fidelity bonds includes employee dishonesty bonds, commercial crime policies, and other similar products.

We bring substantial experience in matters involving loss recovery, including indemnification and subrogation. This includes asserting various indemnity agreement rights such as the right to review books and records, and the entitlement to collateral security.

We have also successfully represented sureties in various subrogation matters, including disputes with lenders, the IRS, bankruptcy trustees, and other creditors.

Our attorneys have served as authors and editors of books, periodicals, articles, and newsletters in the surety and fidelity fields. They are regularly asked to speak at ABA/Surety and Fidelity Law Committee functions and other national surety industry conferences and seminars, and have held leadership positions in industry groups.

Please visit our website at https://lipsonneilson.com/.

The Loewke Brill Consulting Group was formed in 1992 by Peter J. Brill. Peter had a wealth of construction and claim knowledge from his 40+ years of service to the industry. In 1998 Mike Loewke and Peter joined forces. The company expanded its capability in 2003 when Jim Loewke joined the team. Peter Brill passed away in the summer of 2003. Today,

partners Mike and Jim Loewke continue to provide quality service as "The Best Defense in the Construction Industry." They are supported by a staff of talented, highly trained professionals that attend to each project with attention to detail. We service all levels of surety and construction including litigation support projects.

The Loewke Brill Consulting Group professionals are Construction Specialists with three generations of experience and service in the industry. Our company's commitment to its core values of integrity, trust, and reliability has resulted in exceptional client satisfaction for many years.

The Loewke Brill Consulting Group has offices located in Rochester, NY, Hudson Valley, NY, Jensen Beach, FL, Charlotte,NC and our newest location in Ontario, Canada.

Please visit our website at www.loewkebrill.com.

Manier & Herod, P.C. is located in Nashville, Tennessee and provides representation, counsel, and advocacy on behalf of sureties and fidelity insurers throughout the United States. Manier & Herod's attorneys are actively involved in the Fidelity and Surety Committee of the American Bar Association (ABA) and frequently address the ABA and other professional organizations on topics relevant to the fidelity and surety industries. Manier & Herod represents fidelity insurers and sureties in underwriting, pre-claim workouts, coverage analysis and litigation, contractor defaults including performance bond and payment bond claims, contractor bankruptcies, surety litigation, indemnity actions, and other matters and forums.

Please visit our website at www.manierherod.com.

Markel Surety is proud to be a Sustaining Member of Pearlman, one of the finest networking and continuing surety claims education organizations for our industry. Markel Surety builds long-term, mutually beneficial relationships to help our partners grow their business through all market cycles. We are a Fortune 500 Company with superior capitalization. We pride ourselves on being responsive, consistent in our approach to surety credit, and committed to our clients for the long term. Our claims team strives to be responsive, creative in our approach to dispute resolution and avoidance, and a resource to our underwriters, producing partners, and accounts.

Please visit our website at www.markel.com.

Matson, Driscoll & Damico LLP is a world-class forensic accounting firm that specializes in economic damage quantification assessments. We have deep rooted and comprehensive expertise in matters related to the surety and construction industry.

Our experts speak over 30 languages and we have 42 offices on 4 continents. Our work spans more than 130 countries and 800 industries, and we frequently work with law firms,

government entities, multi-national corporations, small businesses, insurance companies and independent adjustment firms.

For more information please contact David Stryjewski or Peter Fascia at 215.238.1919 or visit us at mdd.com.

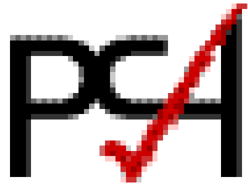
Maximum Property Construction's mission is to provide expertise in the unique practices of Construction Defect Evaluations, Expert Witness Services, Owner's Representative Services, and Surety Claims Investigations. We apply core values of rapid response to all inquiries, personal integrity in our business relationships, impeccable customer service, and excellence of our work product at all times.

Our services include:

- Expert Witness services in the fields of mechanical-HVAC, plumbing, and general construction
- Construction Defect Evaluation, Analysis, and Litigation Support
- Construction Surety Claims Investigations
- Owner's Representative
- Commercial Construction License

Please visit our website at www.mpcs-llc.com.

Nicholson Professional Consulting, Inc. – a time-tested accounting and construction consultancy based in Atlanta, Georgia, with various other office locations throughout the United States. NPCI provides Accounting, Engineering, Construction Management and litigation support expertise, primarily to the surety/fidelity industry, as well as, construction clients and owners. In response to our client's needs, NPCI has also developed a project completion unit, known as Nicholson Management, and has continued to expand its own expert testimony and reporting in the areas of litigation support. NPCI is vertically integrated, providing clients with a range of services that span from early-phase performance review to full-scale Surety intervention, from prime takeover and project completion to litigation support in the resolution of construction claims. NPCI leverages its experience at all phases of contract administration to provide greater peace of mind and confidence to its various clients.



PCA Consulting Group was formed in January 1989 for the purpose of providing the surety, insurance, legal and financial industries with cost effective technical services. With over 80 years of aggregate experience, the construction and engineering professionals of the PCA Consulting Group have served the surety and insurance industries throughout the majority of the continental United States and have been involved in matters requiring knowledge of every construction specialty.

PCA has adapted its experience and systems to meet the Surety's requirements. From evaluating the status and cost-to- complete projection for an individual project, to analyzing the fiscal and operating point-in-time cash position of an entire construction company, PCA has developed the systems, acquired the expertise, and retained the personnel to provide results in a timely and cost effective manner.

Please visit our website at www.pcacg.com.

Companies with business interests across the South turn to Phelps Dunbar for counsel on their legal needs. With 13 office locations in the U.S. and in London, we serve clients in the region's major commercial centers. Our 350-plus lawyers serve clients in several core practice areas, including labor and employment, litigation, business, admiralty, insurance coverage, and healthcare, and have a substantial construction and surety law focus in our Louisiana, Florida, Texas, Alabama, and Mississippi offices. But it's more than our casework that sets our firm apart.

We spend time with you off the clock, so we can learn everything from your strategic goals to challenging operational issues. We are known for asking questions, not just about what is, but about what should be. And we make sure that you access our experience seamlessly, with every lawyer in every office available to be part of your team. We do this because anything can make the difference in a business-critical deal or lawsuit.

We embrace the future, not just of your industry but of our own. We are constantly looking for how to improve services and outcomes through technology. Through our Phelps

Analytics Lab, we partner with Tulane University to pilot programs that use AI to identify business trends, develop litigation strategies and improve efficiency.

We are proud to offer national talent with local pricing to companies working throughout the Gulf South. We welcome the chance to work with you. Please visit our website at https://www.phelps.com/.

For over 30 years, RJT Construction, Inc. has been dedicated to providing exceptional quality, experience, and professional services to the construction, surety, and legal industries. RJT operates as a full service consulting firm specializing in construction, surety, and related claims and litigation. RJT's typical services include: surety claims investigation and default analysis, completion obligations and oversight on behalf of surety, reporting, monitoring, payment bond analysis, claims preparation, claims analysis including support and defense, construction defect claims and litigation support, forensic investigation, scheduling analysis, and expert designation and testimony.

Please visit our website at www.rjtconstruction.com.

Robins Kaplan LLP is among the nation's premier trial law firms, with more than 250 attorneys in eight major cities. Our attorneys litigate, mediate, and arbitrate client disputes, always at-the-ready for an ultimate courtroom battle. When huge forces are at play, major money is at stake, or rights are being trampled, we help clients cut through complexity, get to the heart of the problem, and win what matters most.

Our surety attorneys have combined over 100 years of experience in the evaluation, resolution and litigation of bond claims. This includes the handling of multi-project defaults to achieve a timely completion of open projects while mitigating losses and maximizing recovery efforts. Our surety attorneys also counsel clients on matters arising out of fiduciary bonds, litigation bonds, license and permit bonds, and other miscellaneous bond matters, as well as provide necessary training and counsel on state regulations and Department of Insurance requirements.

Please visit our website at www.robinskaplan.com.

Robinson+Cole

Robinson+Cole is an Am Law 200 firm serving regional, national, and international clients from nine offices throughout the Northeast, Florida, and California. Our 200-plus lawyers and other professionals provide legal solutions to businesses, from start-ups to Fortune 100 companies and from nonprofits and educational institutions to municipalities and state government.

Through an understanding of our clients' industry, the nature and structure of their business, their level of risk tolerance, and their budget considerations, we tailor our legal strategy to align with their overall business needs. Where appropriate, alternative billing arrangements are made to provide clients with a greater degree of certainty about their legal costs. Robinson+Cole's varied practice areas include construction and surety; insurance and business litigation; land use, environmental and real estate; labor, employment and benefits; tax; and intellectual property and technology.

Please visit our website at www.rc.com.

Sage Associates is very pleased to be among the sponsoring firms of Pearlman. We have provided high quality, high value consulting services in the surety industry, as well as construction, banking, and insurance industries, for more than 30 years and our contacts within the construction community and with attorneys and mediators within the construction field is unmatched in the western United States.

The firm's employees and associates offer a broad mix of expertise and skills. Surety claims work is facilitated by knowledge, patience, focus, and relationships. We focus on our client's business and objectives, working hard to assist sureties "deliver on the promise"

and resolve claims. Cost to benefit is always a paramount consideration at Sage Associates as is a long term focus both in the assignment and with our relationship with our clients.

Please visit our website at www.sage-associates.com.

Sage, an Aperture Company, provides consulting and expert witness services to the surety and construction industry on projects throughout the United States and Canada. Our expertise is focused on the heart of construction projects: time and money. The background of Sage, an Aperture Company's team makes rapid and precise evaluation of costs to complete and project status possible. Sage, an Aperture Company's extensive background in construction claims and litigation is an asset when reviewing actual or potential defaults since troubled projects often have significant construction disputes. Favorable resolution of those disputes can be a significant source of salvage and reduce losses. Construction disputes arise out of the need by one of the parties to recover monetary damages. Sage, an Aperture Company focuses on first the areas of damage and then focuses on causation to narrow the research effort to the relevant areas of performance, resulting in a more cost-effective approach to claims assessment, development, and defense.

Please visit our website at www.sageconsulting.com.

SALAMIRAD, MORROW, TIMPANE & DUNN LLP
ATTORNEYS AT LAW

SMTD Law LLP is a boutique law firm specializing in construction, surety and business litigation. The Firm's attorneys are highly experienced in handling disputes unique to the construction and surety industries and they understand the rigors and challenges of litigation. The Firm handles matters for many of the world's leading sureties in all types of commercial and contract surety matters. Our attorneys frequently assist our surety clients with: defense of contract and commercial bond claims; analysis and prosecution of affirmative claims; preparation of transactional documents, including loan and financing agreements; subdivision workouts with lenders and local entities; and handling complex indemnity and other salvage actions.

Please visit our website at www.smtdlaw.com.

Simon, Peragine, Smith & Redfearn, LLP has extensive experience in handling fidelity and surety related matters and litigation. Over the years, the firm's attorneys have handled numerous fidelity, contract surety, financial guarantee and miscellaneous bond and commercial surety matters.

The firm's attorneys who practice in the surety law field have been active participants in many professional associations, such as the Fidelity & Surety Committee of the Tort Trial Insurance Practice Section of the American Bar Association; the DRI Surety Committee; National Bond Claims Institute; Surety Claims Institute; and Louisiana Surety Association.

H. Bruce Shreves is the former Chair of the American Bar Association Fidelity & Surety Committee and the DRI Surety Committee; Jay Kern has served as a Vice-Chair of the American Bar Association Fidelity and Surety Committee; Mr. Shreves, Mr. Kern and Denise Puente have delivered numerous papers and lectures before various ABA Committees, as well as DRI, National Bond Claims and Surety Claims Institute.

Mr. Shreves is currently the Chair of the Louisiana Fidelity, Surety & Construction Law Section of the Louisiana Bar Association. Mr. Shreves, Mr. Kern and Ms. Puente have been named by New Orleans Magazine as Best Lawyers in New Orleans in the area of construction/surety, and have been named as Louisiana Super Lawyers in the areas of construction and surety. They are contributing authors or editors to various ABA publications, including the Law of Payment Bonds; the Law of Performance Bond; and the Law of Suretyship.

Please visit our website at www.spsr-law.com.

Snow Christensen & Martineau traces its roots to Provo, Utah, and 1886, ten years before Utah became a state. One of its founders, George Sutherland, later became the only Utahan to serve on the United States Supreme Court. The firm now enjoys a complement of more than 55 attorneys (including a recently retired but still energetic federal magistrate judge) and a strong staff including more than 15 paralegals. With physical offices in Salt Lake City and St. George and virtual offices wherever needed, the Firm serves some of the Intermountain West's most vital and influential businesses and institutions. Snow, Christensen & Martineau benefits from an impressive history of service, growth and innovation in the legal community, and continues to build toward an equally impressive and significant future. The Firm is recognized for its preeminent trial work, but its attorneys are experienced in a broad spectrum of legal specialties, including complicated business transactions, patents, trademarks and other intellectual property. Many are recognized as among the best in their fields of practice, combining national expertise with personal service. The firm is committed to providing timely, superior legal services at a fair price. Its commitment to the practice of law is manifest in the general lackluster performance of most of its members on the golf course.

Please visit our website at www.scmlaw.com.

Sokol Larkin, a boutique law firm located in Portland, Oregon, has earned its reputation as one of the Pacific Northwest's premier firms in the areas of construction and design law, surety and fidelity law, and business, commercial and real estate matters. The firm's clients range from individuals and small businesses to large multi-national companies.

Jan Sokol and Tom Larkin established the firm to create a team of excellent attorneys. With principle, passion and purpose, our mission is to provide the highest level of legal service in an aggressive, though pragmatic and cost-effective, manner to help clients achieve the best possible results. The firm's success has helped the firm develop long-standing trust and relationships with its clients. At Sokol Larkin our attorneys and support staff each contribute their individual expertise to provide our clients with exceptional service and personal attention in all matters. The firm has attorneys admitted to practice in Oregon, Washington, Idaho, Alaska, California, the District of Columbia and other jurisdictions.

Please visit our website at www.sokol-larkin.com.

The Horowitz Law Firm
A Professional Corporation

Our principal lawyer, Jeffrey D. Horowitz, who has more than 30 years of surety law experience, spent 10 years as in-house counsel for a national surety bond company, has since been in private practice for more than 20 years, and currently represents sureties with their bond claims and litigation needs all over California.

We have experience handling many types of surety bonds, including Performance Bonds, Payment Bonds, Subdivision Bonds, License and Permit Bonds including Contractor's License Bonds, Mechanics Lien and Stop Payment Notice Release Bonds, Bid Bonds, Motor Vehicle Dealer Bonds, Notary Bonds, and Insurance Broker Bonds.

With more than three decades of experience working specifically on issues related to surety bonds, and handling a wide range of surety bond litigation, including trials, appeals, mediations and negotiation, our office has built a reputation of successful and effective representation. For strong representation on issues related to surety bonds, including surety defense, indemnity and subrogation, we are ready to represent your interests. Mr. Horowitz also practices construction and real estate law.

The Horowitz Law Firm, APC is based in Sherman Oaks, a suburb in the City of Los Angeles, California. Please visit our website at www.jdhorowitzlaw.com.

The Hustead Law Firm
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The Hustead Law Firm, A Professional Corporation, launched in 1996 when Patrick Q. Hustead left the partnership of one of Denver's largest law firms to create a dedicated litigation practice focused on the surety and insurance industry. Since that time, the Firm has grown into a dynamic mix of attorneys and technology that produces the results its clients deserve and expect. From complex surety matters to nuanced bad faith claims, the Firm delivers the firepower of a large firm with the personal attention of a small one.

Please visit our website at www.thlf.com.

Torre, Lentz, Gamell, Gary & Rittmaster, LLP is a boutique New York based law firm specializing in surety, fidelity and construction law and providing clients with the best features of small and large firms. TLGGR is able to provide this service by combining the seasoned legal talent and modern technology of a large firm with the personal attention, expertise and congeniality of a small firm. Our office is located in Jericho, Long Island, New York, which is within 30 minutes of Manhattan. While the firm's practice is located primarily in New York and New Jersey, TLGGR also has recently handled substantial matters in Connecticut, Pennsylvania, Delaware and Washington, D.C.

TLGGR handles all manner of commercial and business problems but in large measure specializes in counseling and litigation relating to (1) construction bonds, commercial surety bonds and other forms of suretyship, (2) construction contract and engineering disputes, (3) claims against project owners for wrongful termination and additional compensation, (4) financial institution bonds and other forms of fidelity or crime insurance, and (5) creditors' rights in bankruptcy. These matters involve us in a broad range of commercial problems, including workouts, bankruptcy proceedings, and insurance coverage analysis and litigation.

Please visit our website at www.tlggr.com.

Scott M. Palatucci regularly prosecutes and defends claims in Federal and State courts, as well as arbitration tribunals. In his litigation practice, Mr. Palatucci represents contract and commercial sureties, owners (public and private), general contractors, subcontractors and utility and heavy highway contractors in all aspects of litigation including, but not limited to, matters involving contract claims, liens and lien foreclosure, performance and payment bonds, construction defect, equitable adjustment claims, subrogation claims and "bad faith" claims.

In addition to the above, Mr. Palatucci routinely counsels contract and commercial surety underwriters in connection with, among other things, rules and regulations governing mono/multi-line sureties and the drafting/negotiation of various underwriting documents (i.e., indemnity agreements, bond forms, etc.). Mr. Palatucci also has extensive experience auditing third-party claim handlers for his contract and commercial surety clients and for general liability, property, and builders' risk underwriters facing construction disputes and project completion issues.

Mr. Palatucci is admitted to the bars of the Commonwealth of Pennsylvania, the State of New Jersey, the State of New York, the District of Columbia, the United States District Court – District of New Jersey, and the United States Court of Federal Claims.

Mr. Palatucci has been identified as a "Super Lawyer" in the area of Surety (2022 & 2023) in Super Lawyers® (2022 & 2023), a Thomson Reuters publication.

Prior to entering private practice, Mr. Palatucci served as Law Clerk to The Honorable Joseph F. Scancarella (Ret.), Presiding Judge, Superior Court of New Jersey, Passaic County, Law Division, and as Law Clerk to The Honorable Philip H. Mizzone, Jr., Superior Court of New Jersey, Passaic County, Chancery Division.

Please visit our website at www.tm-firm.com.

VERTEX is an international technical services firm that operates with urgency and produces exceptional value for our clients. VERTEX provides construction, environmental, energy, air quality, and engineering solutions. With over 20 domestic and international offices, along with unique teaming arrangements worldwide, we have the reach and relevant expertise to approach projects with remarkable efficiency gained through local knowledge. Our reputation for excellence, both in terms of timely results and quality service, spans the globe. It has earned us the trust of a prestigious client base that includes Fortune 100 companies and esteemed boutique firms in virtually every line of business.

Please visit our website at www.vertexeng.com.

For over a quarter of a century, the attorneys at Ward, Hocker & Thornton, PLLC (WHT) have diligently and competently served their clients and have provided them with the highest quality legal representation. With offices in Lexington and Louisville, WHT serves the entire state of Kentucky and has litigated cases in nearly all of its 120 counties.

Additionally, WHT often handles cases in the adjoining states of Indiana, Ohio, Tennessee and West Virginia.

WHT is a firm which generally represents the insurance industry and its insureds, the surety and fidelity industry, and the trucking industry. We also directly represent self-insured corporations (many of which are Fortune 500 companies) and various hospitals, health care providers and financial institutions. The net result is that our team of 30 lawyers has tremendous negotiation and litigation experience, having collectively handled thousands of cases encompassing several different areas of law, including: appellate practice, automobile/motor vehicle litigation, construction law, commercial and business litigation, extra-contractual/coverage issues, financial institution law, fire & casualty, governmental liability, healthcare professional liability, insurance defense, large loss subrogation, products liability defense, premises liability, surety & fidelity law, trucking & transportation litigation, and workers' compensation defense.

Our attorneys are licensed to practice in all courts in Kentucky, and in addition have attorneys licensed to practice in the states of Indiana, Ohio and Tennessee. WHT has been awarded the prestigious AV rating offered by LEXISNEXIS Martindale-Hubbell, and we are listed in the Best Directory of Recommended Insurance Attorneys and Adjustors.

Our goal is to provide you and your business with result-oriented legal services in an effective, cost-efficient manner. We at WHT welcome the opportunity to be of service to you and will aggressively work to achieve a successful outcome.

Please visit our website at www.whtlaw.com.

Watt, Tieder has one of the largest construction and surety law firms in the world, with practices that encompass all aspects of construction contracting and public procurement. Our practice groups include: domestic construction law, government contracts, international construction law and surety law. Watt, Tieder's work characteristically relates to major development and construction projects involving highways, airports and seaports, rail and subway systems, military bases, industrial plants, petrochemical facilities, electric generating plants, communication systems, and commercial and public facilities of all types in the United States and globally.

Watt, Tieder is one of the premier surety law firms in the country. We represent more than a dozen sureties in North America, acting as national, regional or public contract counsel for them. Our surety clients include industry leaders like Arch Insurance Company, Cincinnati Insurance Company, Hartford Fire Insurance Company, Liberty Mutual Surety Insurance Company, RLI Corp., SureTec Insurance Company, Travelers Casualty and Surety Company and Zurich North America. In our thirty years of practicing surety law, Watt, Tieder has gained particular expertise in default terminations, affirmative construction claims, surety "abuse of discretion" cases, government contract disputes, surety bad faith claims and all forms of contract bond defaults.

With offices in Washington DC Metro; Irvine, California; Las Vegas, Nevada; Seattle, Washington; Chicago, Illinois; and Miami, Florida, we have a staff of over 50 legal professionals working throughout the United States, Canada, Europe, the Middle East, Asia, South America, Australia and Africa.

Watt, Tieder and its attorneys are annually recognized for accomplishments in construction and surety law, including top tier rankings in Chambers USA, the Legal 500 and US News-Best Lawyers.

Please visit our website at www.WattTieder.com.

Weinstein Radcliff Pipkin LLP is a Dallas, Texas–based commercial litigation law firm with extensive experience in commercial construction, surety, fidelity and professional liability coverage and defense, and labor and employment. As advocates, clients nationwide look to us as their go–to firm for litigation in Texas, Oklahoma, Arkansas, and elsewhere. As advisers, we provide an early, honest case assessment, offering creative solutions and establishing reasoned expectations that save time, money, and headaches. Our attorneys have extensive experience handling construction and surety cases involving contractor defaults, construction and design defects, impact and delay claims, and catastrophic loss. We also have considerable trial and litigation experience for fidelity and professional liability insurers, as well handling labor and employment cases involving corporate management, employee benefits, and non-compete agreements.

Please visit our website at www.weinrad.com.

Williams Kastner has been serving clients in the Northwest since 1929. With more than 90 attorneys in offices located throughout Washington and Oregon and affiliated offices in Shanghai, Beijing and Hong Kong, we offer global capabilities and vision with a local sensibility.

We are well known for our vast trial and litigation successes. Our deep bench of seasoned litigators have extensive trial experience in federal and state courts. In fact, over the course of the last three decades, Williams Kastner has tried (and won) more cases to jury verdict than any other firm in Washington.

The Construction Litigation & Surety Practice Team at Williams Kastner serves clients involved in all aspects of the construction industry, including general contractors, specialty subcontractors, owner/developers, architects, engineers, lending institutions, sureties and insurers. In the surety context, the Team handles the entire spectrum of issues, such as: analyzing and responding to default terminations and other performance bond claims; providing advice regarding complex bond claim investigations; addressing various project completion scenarios, including tenders, takeovers and financing the bond principal; defense of performance and payment bond claims under the Miller Act and

state law, including discharge, exoneration and other surety-specific defenses; defense of extra-contractual claims by claimants, bond principals and indemnitors involving claims brought under the Washington Insurance Fair Conduct Act, the Consumer Protection Act and common law bad faith; prosecution of affirmative construction claims to mitigate surety losses; prosecution of indemnity and other salvage actions on behalf of sureties; resolving priority disputes between sureties, banks, trustees and public agencies; and defense of claims on miscellaneous bonds, including license bonds and public official bonds. When the situation warrants, the Team draws upon other practice areas within the firm to serve the needs of our construction industry clients. These practice areas often include: labor and employment, collections, bankruptcy, land use and real estate.

Please visit our website at www.williamskastner.com.

WOLKIN • CURRAN, LLP

Wolkin Curran specializes in surety, construction and insurance coverage litigation. With offices in both San Francisco and San Diego, Wolkin Curran's primary practice areas are in California and Nevada.

Wolkin Curran's surety and construction practice emphasizes the representation of sureties, general contractors, and public entities. Wolkin Curran investigates, negotiates, settles and litigates bond claims in trial, bankruptcy, and appellate courts. Wolkin Curran represents sureties in all aspects of commercial and contract suretyship, including takeover, completion, payment and creditor issues.

Please visit our website at www.wolkincurran.com.

Wright, Constable & Skeen's Fidelity and Surety Law Group has over 100 years of combined surety and fidelity experience. WC&S lawyers represent sureties in federal and state courts at both the trial and appellate levels, before regulatory bodies, as well as in various forms of alternative dispute resolution, including mediation and arbitration. WC&S lawyers draw on experiences gained both from working within, and for, surety companies.

WC&S' experience and knowledge provide efficient representation for its clients throughout the Mid-Atlantic region, including handling complex surety cases with the federal government. WC&S' practice encompasses all aspects of performance bond claims, payment bond claims, bankruptcy, indemnity/subrogation, and commercial surety bonds. WC&S is an active participant in various legal and industry groups and associations, and its lawyers are leaders and speakers on a wide variety of important topics to the surety and fidelity industry. In addition, WC&S' lawyers are contributing authors or editors to various ABA and industry publications and books. WC&S has developed a national reputation in representing sureties in bankruptcy, authoring various papers and texts on the subject, and speaking at numerous conferences.

Wright, Constable & Skeen has been named to the "2012 Top Ranked Law Firms™ in the U.S." by Lexis Nexis® Martindale-Hubbell®, as published in Fortune magazine. WC&S was recognized as a U.S. law firm of 21 or more attorneys where at least one out of every three lawyers, including associates, achieved the AV®Preeminent™ Peer Review Rating℠.

Please visit our website at www.wcslaw.com.

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Driving Directions

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1.	Go right out of the parking lot onto NE 145th St/WA-202	1.7 mi
2.	Turn right onto NE 175th St/WA-202	0.2 mi
3.	Turn left onto 131st Ave NE/WA-202	0.3 mi
4.	Merge onto WA-522 W via the ramp on the left	0.8 mi
5.	Merge onto I-405 N toward Everett	6.7 mi
6.	Stay straight to go onto WA-525 N	4.3 mi
7.	Turn left onto Harbour Pointe Boulevard SW	1.7 mi
8.	End at 11817 Harbour Pointe Boulevard SW	

Harbour Pointe Golf Club to Willows Lodge - 14580 Northeast 145th Street, Woodinville, WA

1.	Start out going south on Harbour Pointe Blvd toward S Grove Dr	1.7 mi
2.	Turn right onto Mukilteo Speedway/WA-525	4.1 mi
3.	Take I-405 S toward I-405 S/Bellevue/Renton	6.8 mi
4.	Merge onto WA-522 E toward WA-202E/Monroe/Wenatchee	1.0 mi
5.	Take the WA-202 E exit toward Woodinville/Redmond	0.1 mi
6.	Merge onto 131st Ave NE/WA-202S toward Woodinville/Redmond	0.2 mi
7.	Take the 2nd right onto NE 175th St/WA-202	0.2 mi
8.	Turn left onto Woodinville Redmond Rd NE/WA-202	1.9 mi
9.	End at 14580 NE 145th St. Destination will be on the left.	

Harbour Pointe Golf Club to Marriott Redmond Town Center – 7401 164th Avenue NE, Redmond

1.	Start out going south on Harbour Pointe Blvd toward S Grove Dr	1.7 mi
2.	Turn right onto Mukilteo Speedway/WA-525	4.1 mi
3.	Take I-405 S toward I-405 S/Bellevue/Renton	11.9
4.	Take WA-908 E exit, exit 18, toward Redmond	0.7 mi
5.	Merge onto NE 85th Street	1.0 mi
6.	NE 85th St becomes Redmond Way	1.9 mi
7.	Turn right onto Cleveland Street	0.3 mi
8.	Turn right onto 164th Ave NE	0.05
9.	Enter next round-about and take the 3rd exit onto NE 76th St	0.09
10.	End at 7401 164th Avenue NE	

Harbour Pointe Golf Club to SeaTac Airport

1.	Start out going south on Harbour Pointe Blvd toward S Grove Dr	1.7 mi
2.	Turn right onto Mukilteo Speedway/WA 525	4.1 mi
3.	Merge onto I-5 S toward Seattle	30.1 mi
4.	Take the S 188th St exit, exit 152, toward Orillia Rd	0.2 mi
5.	Keep right to take the S 188th Street ramp	0.2 mi
6.	Turn right onto S 188th St	1.1 mi
7.	Turn right onto International Blvd/WA 99	1.0 mi
8.	End at Seattle-Tacoma International Airport. Airport is on the left.	0.8 mi

Willows Lodge to SeaTac Airport

1.	Head east on NE 145th St toward Sammamish River Trail.	0.1 mi
2.	At the traffic circle, continue straight to stay on NE 145th St	449 ft
3.	At the traffic circle, take the 1st exit onto Woodinville Redmond Rd NE	0.1 mi
4.	At the traffic circle, continue straight onto WA-202 E/Woodinville Redmond Rd NE	1.5 mi
5.	Turn right onto NE 124th St	2.5 mi
6.	Merge onto I-405 S via the ramp to Renton	20.5 mi
7.	Continue onto WA-518 W	0.9 mi
8.	Take the exit toward Sea-Tac Airport	0.8 mi
9.	Merge onto Airport Expressway	0.9 mi
10.	Slight right onto Departures Dr. Destination will be on the right	0.4 mi

Notes

Notes

Papers

PANEL 1

PEARLMAN V. RELIANCE INS. CO.

EQUITABLE SUBROGATION AS THE FOUNDATION OF SURETY LAW

Ashlee Rudnick | Intact Insurance Surety Group | Southfield, MI

Jacquelyn A. Klima | Kerr, Russell & Weber, PLC | Detroit, NY

PEARLMAN 2023

September 7-8, 2023

Sparkman Cellars Winery | Woodinville, WA

Pearlman v. Reliance Ins. Co.: Equitable Subrogation as the Foundation of Surety Law

Ashlee Rudnick, Intact Insurance Surety Group
Jacquelyn A. Klima, Kerr, Russell and Weber, PLC

A. INTRODUCTION.

A surety on bonded construction projects has equitable subrogation rights when it is asked to perform under its performance or payment bonds. This doctrine allows the surety to step into the shoes of the entity whose claim has been paid and assert the same rights to the contract funds that such entity would have had. Where the surety completes performance of the contract, it steps into the shoes of the owner, and where the surety pays subcontractors and suppliers, it steps into the shoes not only of those subcontractors and suppliers, but also of the owner, which had a right to retain funds to pay for labor and materials, and the contractor, who had a right to use those funds to pay for labor and materials. The superior rights of a surety to contract proceeds have been recognized by courts throughout the country, with the foundation being a series of United States Supreme Court cases: *Prairie State Bank, Henningsen and Pearlman.*

B. THE PEARLMAN TRILOGY

In *Prairie State Bank v. United States*, 164 U.S. 227, 230; 17 S. Ct. 142; 41 L. Ed. 412 (1896), the principal contractor defaulted, and the bank claimed a superior right to the funds retained by the government because it advanced money for the completion of the building. The United States Supreme Court held that the surety was subrogated to the rights of the government when it fulfilled the principal's obligation, and the bank was not entitled to subrogation because it was a mere volunteer. *Id*. at 232-233. The *Prairie State Bank* court held that had the surety not completed the contract, the government would have had the right to keep the retained funds and apply them to the completion of the project. *Id*. at 232. The surety was subrogated to these same rights. The court held that the surety's subrogation rights related back to the date of the original suretyship contract, and therefore, the bank's rights to the balance of the contract were subordinate to the surety's rights. *Id*. at 240.

The court later extended the doctrine to claims on payment bonds. In *Henningsen v. United States Fid. and Guaranty Co. of Baltimore*, 208 U.S. 404, 410; 28 S. Ct. 389; 52 L. Ed. 547 (1908), the contractor failed to pay its laborers and materialmen, and the surety was compelled to do so. The United States Supreme Court, following *Prairie State Bank*, held that the bank's rights to the balance of the contract were subordinate to the surety's rights because the bank was a mere volunteer and could not assert the equitable doctrine of subordination. *Id*. at 411-412. The court stated that the surety was subrogated to the rights of the laborers and materialmen as well as the owner, because as a result of having made payments to laborers and materialmen, the surety had released the government from all equitable obligations to see that the laborers and materialmen were paid. *Id*. at 410. In concluding, the court stated:

> Whatever equity, if any, the bank had to the fund in question, arose solely by reason of the loans it made to Henningsen. Henningsen's surety was, upon elementary principles, entitled to assert the equitable doctrine of subrogation; but it is equally clear that the bank was not, for it was a mere volunteer, and under no legal obligation to loan its money.

Id. at 411-412 (quoting and adopting Court of Appeals Opinion (citations omitted).

The doctrine was clarified in the third case of the trilogy, *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132; 83 S. Ct. 232; 9 L. Ed. 2d 190 (1962). In *Pearlman,* 371 U.S. at 133, the surety executed payment and performance bonds under the Miller Act. The government terminated the contract with the principal contractor after it began having financial difficulty, and the surety paid $350,000 in claims by laborers and materials suppliers. *Id*. at 134. The contractor went into bankruptcy, and the government turned over the balance of $87,737.35 to the trustee in bankruptcy. *Id*. The United States Supreme Court stated that if the surety had an equitable lien or prior right to the fund before the bankruptcy adjudication, then the fund never became part of the bankruptcy estate. *Id*. at 135-136. The court also stated that the right of subrogation was a well-established doctrine and noted that *Prairie State Bank* held that the surety

had a security interest in such a fund when it completed performance of the contract, and *Henningsen* held that the surety had a security interest in such a fund when it paid the contractors laborers and materialmen. *Id*. at 136-139. The court held that the surety's rights to the balance of the contract were superior to the rights of the trustee in bankruptcy:

> We therefore hold in accord with the established legal principles stated above that the Government had a right to use the retained fund to pay laborers and materialmen; that the laborers and materialmen had a right to be paid out of the fund; that the contractor, had he completed his job and paid his laborers and materialmen, would have become entitled to the fund; and that the surety, having paid the laborers and materialmen, is entitled to the benefit of all these rights to the extent necessary to reimburse it.

Id. at 141.

Together, these cases establish the following key concepts:

- Equitable subrogation applies to both performance and payment bond obligations;
- A surety that is compelled to fulfill its bond obligations has priority over a bank that has loaned money to the principal, such bank being considered a mere volunteer;
- Retained contract funds never become the property of the defaulting principal;
- Upon performance of its performance bond obligations, the surety steps into the shoes of the owner, and upon performance of its payment bond obligations, the surety steps into the shoes of the owner, contractor, and the subcontractors, suppliers, and/or laborers it paid;
- The surety's equitable subrogation rights relate back to the date of the bond.

For decades, this line of case law has served as the starting point for equitable subrogation analyses throughout the country and constitutes the foundation for surety law.

C. THE SURETY'S PRIORITY OVER THE LENDER

Equitable subrogation is only available to one who is compelled to pay the debt to a third party and not to one who acts as a mere volunteer. *Prairie State Bank*, 164 U.S. at 231. Typically, the surety's subrogation rights relate back to the date of the bond and give it priority over any later creditors. *W. Cas. and Sur. Co. v. Brooks*, 362 F.2d 486, 490 (4th Cir. 1966). Because subrogation rights are equitable and not contractual, they are not subject to the Uniform Commercial Code ("UCC"). *City Bank and Tr. Co. of Portage v. Don's Elec., Inc. (In re Don's Electric, Inc.)*, 65 B.R. 399, 403-404 (Bankr. W.D. Wis. 1986). The surety is entitled to contract funds over competing claimants with respect to any contract funds that remain in the owner's possession and have yet to be disbursed to the defaulting contractor. *See, e.g.*, *Fidelity & Deposit Co. of Maryland v. Scott Bros. Constr. Co.*, 461 F.2d 640, 642 (5th Cir. 1972) (concluding that although progress payments paid to the contractor could not be recovered from the contractor's assignee absent a showing that the contractor was in default when the payment was made, "the surety enjoys a claim superior to that of an assignee bank" with respect to contract funds that have not been disbursed).

Courts have held that a bank cannot question a surety's equitable entitlement to the contract funds on the basis of prejudice, unfairness, or surprise. The surety's superior entitlement to bonded contract funds in the hands of the owner/obligee to offset losses caused by the defaulting bond principal and fulfill the surety's bond obligations to the owner/obligee arises from "equitable principles … deeply imbedded in our commercial practices, our economy, and our law." *Pearlman*, 371 U.S. at 140. Thus, lenders providing financing to construction contractors know that upon the contractor's default, the surety's rights to contract funds are inherently superior and that a lender's ability to obtain such funds is tenuous. The court in *Don's Electric*, 65 B.R. at 404 , succinctly explained why a construction lender cannot claim surprise or prejudice when the surety

makes a claim against bonded contract funds, even when the surety did not file a UCC financing statement:

> All construction lenders act in full awareness that the borrowers[‘] accounts are highly contingent in the event of default. Similarly, banks are fully aware that all major projects are covered by surety bonds. There is no element of surprise if the non-filing surety asserts its inherent right to use contract proceeds to offset the cost of rectifying the contractor's default.

Because construction lenders are commercially savvy and well aware of the surety's equitable entitlement to contract funds, any claim of unfairness, surprise, or prejudice in awarding these funds to the surety would be disingenuous.

D. PERFORMANCE VERSUS PAYMENT BOND OBLIGATIONS

Despite the holdings in *Henningsen* and *Pearlman*, some courts have differentiated equitable subrogation rights on the basis of performance bond versus payment bond obligations, especially where the competing creditor is the government. The confusion started with a case decided after *Henningsen* and before *Pearlman, United States v. Munsey Tr. Co.*, 332 U.S. 234; 67 S. Ct. 1599; 91 L. Ed. 2022 (1947). In *Munsey*, 332 U.S. at 236-237, the principal entered into six contracts with the government and failed to pay laborers and material suppliers on five of the contracts. The surety paid the labor and materials claims and asserted a right to the retained percentages of the contracts. *Id*. at 237. The court distinguished prior equitable subrogation cases on the ground that the government had been a mere stakeholder in the retained funds and was not asserting its own rights. *Id*. at 240 The court held that the government had the right to offset an independent claim it had against the principal on a separate project because the surety was subrogated to the rights of the laborers and materialmen who did not have enforceable rights against the government for their payment. *Id*. at 241, 244. The court declined to subrogate the surety to the rights of the government to retain funds to assure performance of the contractor's obligations, reasoning that the more likely motive is to

ensure completion of the work on time rather than the payment of laborers and materialmen. *Id*. at 243.

The three concurring justices in *Pearlman* disagreed that the surety was entitled to the retained funds on the theory that the surety was subrogated to the claims of the laborers and materialmen, citing the holding in *Munsey* that laborers and materialmen have no rights to funds in the government's hands. *Pearlman*, 371 US at 142. Those justices agreed that the surety was entitled to the funds but based their concurrence on the ground that in the event of default, all sums becoming due were assigned to the surety by the contract. *Id*. at 143-144. But this position lost. The majority of the justices held that the surety succeeded against the trustee in bankruptcy on the ground that the surety was subrogated to the rights of the government to use the retained funds to pay laborers and material men, to the rights of the laborers and materialmen to be paid from the retained funds, and to the rights of the contractor who would have been entitled to the funds had he completed the job and paid the laborers and materialmen. *Pearlman*, 371 US at 141. The court specifically addressed *Munsey*, holding that "*Munsey* left the rule in *Prairie Bank* and *Henningsen* undisturbed." *Id*. at 140-141.

Despite the holdings in *Pearlman* fifteen years after *Munsey*, some courts continued to use the reasoning in *Munsey* to deprive sureties of their equitable subrogation rights. For example, in *United States Fidelity & Guar. Co. v. United States*, 475 F.2d 1377, 1378-1379 (Ct. Cl. 1973), the principal served as the prime contractor on a project for the United States Navy and encountered financial difficulties during its performance of the contract. The surety received notices of nonpayment from subcontractors and demanded that the government refrain from making further progress payments, but the government refused. *Id*. at 1379. Eventually, the government deleted the remaining work through a change order, contracted with subcontractors to finish the work, and still had contract funds remaining. *Id*. at 1379-1380. The government used a portion of those funds to pay taxes owed by the principal to the Internal Revenue Service. *Id*. The surety filed a suit for interpleader and deposited the penal sum of the payment bond, which was used to pay the subcontractors on a pro tanto

basis. *Id*. at 1379. The surety and subcontractors also asserted claims against the government for the progress payment made after the surety's notice, for the payment made to the IRS, and for the remaining contract funds. *Id*. at 1380.

The court held that the surety had no claim to the remaining funds on the contract until all claims of the subcontractors were paid in full, and the payment bond had been insufficient to cover those claims. *United States Fidelity & Guaranty Co.*, 475 F.2d at 1381. The court further held that the government had an equitable obligation to pay the remaining funds to the subcontractors, and the subcontractors were entitled to these funds, but they did not have standing to sue the government. *Id*. at 1381-1382. The reconciled *Munsey* with *Pearlman*, noting that under *Pearlman*, the payment bond surety was subrogated to the rights of the subcontractors who may have superior rights to the retained funds but no right to sue the government, but it was also subrogated to the rights of the contractor with privity that could sue the government. *Id*. at 1382. As for the tax payment, the court held that the surety did not have priority over the IRS:

> A surety that pays on a performance bond in order to complete the subject contract has priority over the United States to the retainages in its hands. A surety that pays on its payment bond, however, does not have priority when the United States is asserting a tax or other obligation owed by the prime contractor. Since the surety in this case paid only on its payment bond, it falls in the latter category, and must claim the retainage subject to the tax claim of the United States.

Id. at 1383 (citations omitted). The court added that the subcontractors had an equitable right to the funds paid to the IRS, but that right was subservient to the tax lien. *Id*. at 1384. Finally, the court found that it was unclear whether the government abused its discretion in making the progress payment after the surety's notice, but even if it did, the government could not be required to pay that amount to the surety where it had not paid the subcontractors in full. *Id*. at 1385.

On the other hand, in *Aetna Cas. & Sur. Co. v. United States*, 845 F.2d 971, 973 (Fed. Cir. 1988), the principal was the prime contractor on three federal projects. When the principal was unable to meet its obligations, the surety financed its operations and made payments to subcontractors and suppliers. *Id*. The government rejected the surety's request to pay the remaining contract funds to the surety and released a large portion of the retained funds to the IRS pursuant to a tax levy. *Id*. Citing *United States Fid. & Guar. Co.*, the court stated that "[t]he surety has different rights under a performance bond than it has under a payment bond," and that the surety's right to recover the tax payment and retainage depended on whether it was acting as a performing surety. *Id*. at 974. The court stated that a surety need not complete the work to qualify as a performing surety because it also has the option to assume liability for any excess costs expended by the government to complete the project or to provide funds to an insolvent principle to complete performance. *Id*. at 975. The court held that the surety was acting as a performing surety when it financed the principal and paid subcontractors and suppliers because the amount it expended exceeded its maximum payment bond liability, most of the payments were made directly to the principal, and typically, payment bond claims are one time payments to subcontractors and suppliers rather than periodic payments. *Id*. at 975-976.

In *Dependable Ins. Co. v. United States*, 846 F.2d 65, 66 (Fed. Cir. 1988), the surety paid payment bond claims on a federal project and sought the retainage held by the Navy. The IRS claimed the retained funds for the principal's failure to pay withholding, social security, and unemployment taxes. *Id*. The court held that the government's right to retained contract funds were superior to those of a payment bond surety. *Id*. at 67. The court further held that the surety's status as a performance bond surety for the same contractor on other federal projects did not give it a right to the retained proceeds on this project. *Id*. The surety could only defeat the government's setoff rights on the specific contracts on which it completed performance. *Id*.

Yet in *Nat'l Am. Ins. Co. v. United States*, 498 F.3d 1301, 1303 (Fed. Cir. 2007), the payment bond surety filed suit against the government

for the final payment made to its principal after the surety notified the government of the payment bond claim. The court attempted to reconcile *United States Fidelity & Guaranty Co.* and its progeny with *Munsey* and *Pearlman*. *Id*. at 1305. The court noted the discussion in *United States Fidelity & Guaranty Co.* that the surety was subrogated not only to the rights of the laborers and materialmen, but also to the contractor, and that subsequent cases have reaffirmed. *Id*. The court stated that "[a]ccordingly, it has been well-established that a payment bond surety that discharges a contractor's obligation to pay a subcontractor is equitably subrogated to the rights of both the contractor and subcontractor." *Id*. at 1306. The court also noted that in *Munsey*, the surety had only asserted subrogation to the rights of the subcontractor and the government, and the court "never addressed the surety's ability to be equitably subrogated to the rights of the contractor whose debt it discharged." *Id*. The court affirmed the trial court's holding that the surety was equitably subrogated to the rights of the contractor, and the government violated its duty by making the final payment after receiving notice of the surety's assertion of rights in the contract funds. *Id*. at 1303, 1307.

Subsequent cases have cited *Nat'l American* for the proposition that the payment bond surety's subrogation to the rights of the contractor entitle it to recover retained contract funds as well as wrongfully disbursed payments. *See, e.g.*, *Colonial Sur. Co. v. United States*, 108 Fed. Cl. 622, 633 (2013) (discussing that a surety can establish a right of subrogation by paying payment bond claims and recover contract funds retained or disbursed after notification by surety); *Ins. Co. of W. v. United States*, 83 Fed. Cl. 535, 538 (2008) (noting that under *Pearlman* and *Nat'l American*, a payment bond surety is subrogated to the rights of the contractor and can seek to recover contract funds from the government). Other cases continue to look directly to *Pearlman* for the equitable subrogation rights of a payment bond surety. *See Transamerica Premier Ins. Co. v. United States*, 32 Fed. Cl. 308, 312 (1994) (citing *Pearlman* in stating that when the surety pays off materialmen, it "is subrogated not only to the rights of the materialmen to retained contract funds, but also to the right of the Government to use retained contract funds to pay materialmen, and the

right of the contractor to these funds in the event he has paid his materialmen”).

These are just some examples of cases in which this issue was considered. While some courts simply stray from *Pearlman*, many at least attempt to reconcile the different holdings. Some courts only subrogate the payment bond surety to the rights of subcontractors and suppliers that may not be permitted to assert claims directly against the government. Some justifications are based on the type of entity competing with the surety for funds, especially government entities rather than private creditors. Other courts are able to differentiate *Pearlman* on particular facts and circumstances, such as the assertion of rights to funds outside of remaining contract funds. Despite a few departures from *Pearlman*, it remains a fundamental basis for equitable subrogation law, and courts regularly cite its holding that a payment bond surety is subrogated to the rights of the payment bond claimants, the government, and the contractor.

E. THE SURETY’S CROSSOVER RIGHTS TO CONTRACT FUNDS ON OTHER PROJECTS

An owner will sometimes assert the right to use contract proceeds to set off claims it has against the prime contractor, for the prime contractor to do the same with its subcontractors, and for subcontractors to do the same down the line. It is a “well-established common-law right of debtors to offset claims of their own against their creditors.” *Pearlman*, 371 U.S. at 140. Logically, these setoff rights can be acquired by the surety through equitable subrogation.

In general, a surety’s subrogation rights can cross over to the proceeds of another job where there is a common owner. In *United States Fidelity & Guar. Co. v. Housing Auth. of Berwick*, 557 F.2d 482, 483 (5th Cir. 1977), the surety issued payment and performance bonds for two companion public construction projects. The surety paid claims asserted by subcontractors and suppliers and advanced funds to its principal to finish both projects. *Id*. The surety’s losses on the first project were less than the retained contract funds on that project, but its losses on the second project far exceeded the retained contract funds on that project. *Id*. at 483-484. The

trial court held that the contractor's assignee had a superior right to the proceeds on the first project. *Id*. at 484. The Fifth Circuit reversed, holding that the surety was subrogated to the position of the public owner. *Id*. at 484-485. The principal's contract with the owner entitled the owner to backcharge the retainage on the first project to pay claims by material and labor suppliers on both projects, and therefore, the remaining funds on the first project never became due to the principal. *Id*.

As another example, in *District of Columbia v. Aetna Ins. Co.*, 462 A.2d 428, 429 (D.C. App. 1983), the surety provided payment and performance bonds for the construction of a firehouse. Its principal also contracted with the same government owner for the construction of a water pumping station, but a different surety provided the payment and performance bonds on that project. *Id*. The principal defaulted on the firehouse project, and the surety asserted its right to the contract proceeds remaining on the fully completed water station project to offset its losses in completing performance of the firehouse project and paying payment bond claims. *Id*. In determining whether the surety could assert such cross-project rights of offset, the court stated:

> Fairness would dictate that the surety be accorded the owner's rights and remedies with respect to the contractor. In circumstances, like the present, where the same contractor is engaged in more than one project, it becomes clearer that it is the reach or scope of the remedy rather than the equitable right itself which is at issue. Finding no persuasive reasons to the contrary, we adopt the view that the right of subrogation is not founded on contract. It is a creature of equity; is enforced solely for the purpose of accomplishing the ends of substantial justice; and is independent of any contractual relations between the parties.

Id. at 431 (citations omitted). The court held that, upon satisfying its obligations, the surety was subrogated to all the rights and remedies of the owner, including the common law right of setoff. *Id*. at 432.

Again, some courts have distinguished performance and payment bond obligations and found that the owner's setoff rights have priority over the surety's subrogation rights where the surety has only payment bond losses and did not complete the project.

For example, in *The Aetna Casualty & Sur. Co. v. United States*, 208 Ct. Cl. 515, 517-518; 526 F.2d 1127 (Ct. Cl. 1975), the surety provided payment and performance bonds for ten contracts that its principal entered into with the United States Postal Service ("USPS"). The surety paid payment bond claims on eight of the projects and sought the remaining contract funds to reduce its losses. *Id*. at 518. The government claimed a right to offset a judgment against it by one of the principal's subcontractors on an unrelated, unbonded project against the contract balances. *Id*. at 519. The surety argued that the government should be unable to recoup its losses on the unbonded contract where it failed to comply with the Miller Act. *Id*. at 520. The court found that the surety was not subrogated to the rights of the material suppliers and laborers under the unbonded project, so it could not challenge the government's failure to comply with the Miller Act. *Id*. at 520-521. The court held that the government had a right to offset its losses on the unbonded project with the contract balances remaining on the bonded projects. *Id*. at 521.

In *Hartford Fire Ins. Co. v. United States*, 108 Fed. Cl. 525, 528-529 (2012), the principal served as the general contractor on two federal projects for the Army Corps of Engineers and was ultimately terminated on both projects. The principal sued the government on the first project, claiming defective specifications and differing site conditions, and the parties settled for $700,000. *Id*. at 529. The surety completed the second project and sent a letter to the government, asserting its equitable subrogation rights and requesting that the government withhold payments to the principal, including settlement payment. *Id*. The government paid the principal, and surety filed suit against the government. *Id*. at 529-530. The court stated that a performing surety has more expansive rights than a payment bond surety and can recover completion costs from retained contract funds free from setoff for taxes owed by the principal. *Id*. at 532. The court noted that if the government had completed project, it could have

offset the costs against the settlement payment. *Id*. at 533. The court held that upon receipt of the notice from the surety, the government became a stakeholder to the sum with duties to the surety, and the only claimants were the surety and the principal. *Hartford*, 108 Fed. Cl. at 533-535. The surety was subrogated to the setoff rights of the government, and the government paid the principal at its own risk. *Id*. at 534, 536. Ultimately, the court found that there was a question of fact related to whether the government failed to promptly terminate the principal on the second project, whether the government used reasonable discretion in distributing the funds where the surety had not yet completed performance, and the court denied the government's motion to dismiss. *Id*. at 537-538.

There are some jurisdictions that have held that a payment bond surety's rights are superior to the owner's setoff rights. In *Teamsters Health and Welfare Fund v. Net Constr., Inc.*, 334 F. Supp. 2d 751, 752 (E.D. Pa. 2004), the Teamsters health and welfare and pension funds obtained a default judgment against the principal on a construction project for unpaid employee benefits and sought the contract balance from the city to satisfy the judgment. The principal owed the city unpaid taxes, and the city asserted the right to use the contract balance to offset that delinquency. *Id*. at 753. The surety that had paid several payment bond claims also sought the contract balance under its subrogation rights. *Id*. The court stated that under the bond, the surety had a direct contractual obligation to the city to pay subcontractors and suppliers, and the city could not withhold money from the surety because the principal did not pay its taxes. *Id*. at 754. The court held that the surety's claim to the funds was superior to that of both the city and the Teamsters. *Id*. *See also United States v. Pennsylvania Dep't. of Highways*, 349 F. Supp. 1370, 1381-1382, 1384, 1387-1388 (E.D. Pa. 1972) (holding that payment bond sureties' equitable subrogation to funds held by the state were superior to the claims of the bankrupt principal's creditors, the trustee in bankruptcy, any assignee of the principal, and the federal government).

In *Transamerica Ins. Co. v. United States*, 989 F.2d 1188, 1189 (Fed. Cir. 1993), the surety provided payment and performance bonds for two contracts that its principal entered into with the United States. The

principal completed one contract but defaulted on the second, and the surety completed performance of the second. *Id*. The surety notified the government owner that it sought the funds owed to the principal for the first contract under its equitable subrogation rights, but the government disbursed those funds to the principal. *Id*. The court stated that had the government chosen to finish the second contract, it could have offset any losses or expenses against the funds it owed the principal on the first contract. *Id*. at 1194. Therefore, the court held that the surety was subrogated to the owner's setoff rights. *Id*. at 1194-1195.

A surety is subrogated not only to the rights of the owner, but also to the rights of all obligees, where the principal enters into multiple contracts concerning the same common owner. In *Kentucky Central Ins. Co. v Brown (in re Larbar),* 177 F.3d 439, 442 (Bankr. 6th Cir. 1999), the principal, Larbar Corporation, informed the surety that it would be unable to complete thirteen of its twenty-nine bonded projects to erect highway guardrails, and the principal later filed for bankruptcy. The surety completed the projects with another contractor, incurring substantial losses on most of the projects. *Id*. The principal had entered into most of the contracts directly with the government owner, but it had entered into two of the contracts as a subcontractor to a general contractor named Incisa. *Id*. at 445. Complicating matters further, while Incisa was the only general contractor on one of its projects, the Kenton County project, it was one of two general contractors on its other project, the Harlan County project. *Id*. at 446.

The Harlan County project was the only one that created a significant profit, and the surety sought the right to offset its losses on the other projects—including the projects in which Incisa was not a general contractor—with those available contract proceeds from the Harlan County project. *Larbar*, 177 F.3d at 441-443.[1] The structure of the thirteen projects at issue was as follows:

[1] Because Larbar was in bankruptcy, the court analyzed the surety's setoff rights under Section 553 of the Bankruptcy Code, which states, "'this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case. . . .'" *Larbar*, 177

Project	Harlan County	Kenton County	Various (5 Projects)	Various (6 Projects)
Owner	Commonwealth of Kentucky	Commonwealth of Kentucky	Commonwealth of Kentucky	Commonwealth of Kentucky
General Contractor	Incisa/Grassetto	Incisa	Larbar	Larbar
Subcontractor	Larbar	Larbar	N/A	N/A
Proceeds/Losses	$24,944.89	($18,829.31)	$3,107.45	($139,000)

The Sixth Circuit held that the surety stepped into the shoes of the Commonwealth of Kentucky and Incisa and could offset the mutual profits and losses on all of the contracts with *Larbar*. *Id*. at 446. Along with the common law right of setoff, the court explained the policy considerations in support of allowing the setoffs across the projects:

> A surety is obligated to complete any remaining contracts after its principal defaults. If, however, it is denied the right of setoff, then the surety might be tempted to 'cut corners' rather than promptly and properly complete the losing contracts. The opportunity to setoff any profits against its losses on multiple-bonded projects thus serves as a practical incentive for the surety to fulfill all of its obligations.

Id. at 447. Even though there were different contractors involved on behalf of the common owner on the various projects, the *Larbar* court held that the surety could offset the losses from the Kenton County project and the other projects not involving Incisa, with the remaining proceeds from the Harlan County project. *Id*. at 446.

Thus, where the surety bonds multiple projects with a common owner, the surety should look to the remaining contract funds across all projects as a potential source of recovery for losses on bond claims.

F.3d at 445. It has been held that Section 553 merely "preserves state law setoff rights." *Roberds, Inc. v. Lumbermen's Mut. Casualty Co. (In re Roberds)*, 285 B.R. 651, 656 (Bankr. S.D. Ohio 2002).

F. THE SURETY'S PRIORITY OVER THE BANKRUPTCY ESTATE.

The filing of a bankruptcy petition creates a bankruptcy estate that consists of "all legal or equitable interests of the debtor in property" as of that date. 11 U.S.C. § 541(a)(1). Property in which the debtor only holds legal title becomes property of the bankruptcy estate only to the extent of the debtor's legal title and not to the extent of any equitable interest that he does not hold. 11 U.S.C. § 541(d). In general, courts have recognized the surety's superior right to contract funds when its defaulting principal files for bankruptcy:

> The law is clear that the surety enjoys a special place with respect to retained contract funds which become available because the surety completes a construction project. Several courts have held that the surety has an equitable lien upon the contract funds and that by virtue of this lien the surety takes precedence over the trustee in bankruptcy of a bankrupt contractor.…
>
> . . . .
>
> The equitable rights of the surety in these cases is founded upon the common sense proposition that the contract retainage funds would never become available to any creditor unless the surety completed the project. Stated differently, the contract funds were never really in the possession of the contractor, either as an asset for his general creditors or as collateral for the secured creditor, because the payment of the funds is conditioned upon the completion of the construction project:
>
> This is not an interest in or lien upon, property or funds in the possession or control of the bankrupt [contractor]. Until the obligation to the city [owner] was fulfilled the bankrupt had no claim upon the retained funds.
>
> Thus, the surety who completes the project is given first chance at the contract funds even if other creditors of the

> bankrupt contractor have previously secured their interest in the funds. The consequence of this equitable lien or equitable subrogation doctrine is that an exception is created to the general rule that only those creditors who perfect a security interest by following the U.C.C. or by obtaining a lien judgment can prevail over the trustee in bankruptcy, who, as of the day of the filing of the petition, stands in the position of a judgment creditor.

United States Fidelity and Guar. Co. v. J.L. Leach (In re Merts Equipment Co.), 438 F. Supp. 295, 297 (M.D. Ga. 1977) (internal citations omitted).

The surety's subrogation rights relate back to the date of the bond and give it priority over any later creditors. *Western Casualty*, 362 F.2d at 490; *see also Amwest Surety Ins. Co. United States*, 870 F. Supp. 432, 434 (D. Conn. 1994) ("A tax lien has a priority interest if filed before execution of a bond, but would not prevail against an unrecorded equitable surety interest from a bond executed before a noticed tax lien.") (citations omitted); *First Alabama Bank of Birmingham v. Hartford Accident & Indem. Co.*, 430 F. Supp. 907, 911 (N.D. Ala. 1977) (holding that the surety's subrogation rights attached to the construction contract at the time the performance and payment bonds were posted); *The Home Indem. Co. v. United States*, 180 Ct. Cl. 173, 177 (1967) (holding that although the surety's subrogation rights do not become an actuality until it satisfies the principal's debt, those rights relate back to the date of the execution of the bonds).

The *Pearlman* Court stated that if the surety had an equitable lien or prior right to contract funds before the bankruptcy adjudication, then the funds were not part of the bankruptcy estate:

> Ownership of property rights before bankruptcy is one thing; priority of distribution in bankruptcy of property that has passed unencumbered into a bankrupt's estate is quite another. Property interests in a fund not owned by a bankrupt at the time of adjudication, whether complete or partial, legal, or equitable, mortgages, liens, or simple priority of rights, are

> of course not a part of the bankrupt's property and do not vest in the trustee. The Bankruptcy Act simply does not authorize a trustee to distribute other people's property among a bankrupt's creditors. So here if the surety at the time of adjudication was, as it claimed, either the outright legal or equitable owner of this fund, or had an equitable lien or prior right to it, this property interest of the surety never became a part of the bankruptcy estate to be administered, liquidated, and distributed to general creditors of the bankrupt. * * *

Pearlman, 371 U.S. at 135-136. Some courts have questioned whether *Pearlman* survived the enactment of the Bankruptcy Code in 1978. Two of the provisions that have been the common subject of this question are Sections 541, "Property of the estate," and 509, "Claims of codebtors."

Section 541 sets forth in detail property that belongs to the bankruptcy estate and property that is excluded. In particular, 11 U.S.C. § 541(a)(1) includes in the estate "all legal or equitable interests of the debtor in property as of the commencement of the case," and 11 U.S.C. § 541(d) provides:

> Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.[2]

In *In re Glenbrook Group, Inc.*, 552 B.R. 735, 740 (Bankr. N.D. Ill. 2016), the court stated that *Pearlman* was no longer precedential because "the very

[2] Although Section 541 has been amended multiple times, the language in subsections (a)(1) and (d) remains the same as the 1978 version. *See* Pub.L. 95-598, Nov. 6, 1978, 92 Stat. 2594.

things the Court states are not property of the estate in *Pearlman*, property subject to equitable interests, mortgages, liens, etc., are now included as property of the estate under § 541(d), albeit subject to any equitable interest." The court later found that even if *Pearlman* took property out of the estate, it was a case that involved federal funds and thus did not apply to that case, which involved a municipality. *Id*.

That said, in *In re QC Piping Installations, Inc.*, 225 B.R. 553, 560 (Bankr. E.D.N.Y. 1998), the principal was terminated before the bankruptcy filing, and the surety completed the project and paid payment bond claims. The court stated that under the long recognized doctrine of subrogation, the surety stands in three sets of shoes—those of the contractor to the extent it is due receivables, to the laborers and materialmen paid who may have had liens, and to the owner for whom the project was completed. *Id*. at 562. The court then considered "whether *Pearlman's* holding emerges unscathed after consideration of Section 541 of the Bankruptcy Code." *Id*. at 564. The court found that most bankruptcy courts "have concluded that retainage is not property of the debtor-contractor's estate where there has been a pre-petition default and a surety has stepped in under its bonds." *Id*. at 566. The court cited these cases:

- *In re Pacific Marine Dredging & Constr.*, 79 B.R. 924, 929 (Bankr. D. Or. 1987) (holding that where the debtor failed to pay subcontractors and the owner exercised its right to withhold payment, the debtor did not have any legal or equitable interest in the fund, and the fund was not property of the estate);

- *In re Ward Land Clearing & Drainage, Inc.*, 73 B.R. 313, 316 (Bankr. N.D. Fla. 1987) (holding that upon default, the contractor forfeited its rights to the construction contract, the bank could not acquire by assignment a right superior to the contractor's, and the completing surety was entitled to the funds as a subrogee);

- *In re Modular Structures, Inc.*, 27 F.3d 72, 78, n.1 (3rd Cir. 1994) (stating that "the adoption of the Bankruptcy Code in 1978 has not undercut Pearlman's vitality");

- *In re Four Star Construction Co.*, 151 B.R. 817, 823 (Bankr. N.D. Ohio 1993) (holding that under principles of subrogation and Section 509, the undistributed contract funds were not property of the estate to the extent of the payment bond surety's subrogation rights);

- *In re John's Insulation, Inc*., 221 B.R. 683, 688 (Bankr. E.D.N.Y. 1998) (holding that the surety was subrogated to the owner's and the contractor's rights and was entitled to contract payments of retainage, earned but unpaid funds, and unearned proceeds);

- *In re ADL Contracting Corp.*, 184 B.R. 436, 444-445 (Bankr. S.D.N.Y.1995) (finding that the surety's claim to settlement proceeds was superior to that of a judicial lien creditor, but not to the claim of an unpaid subcontractor);

- *In re Wingspread Corp.*, 116 B.R. 915, 931-932 (Bankr. S.D.N.Y.1990) (citing *Pearlman* and holding that, under the doctrine of subrogation, the guarantor of leases who paid post-petition rent to lessors could assert the lessor's rights, including the right to an administrative priority).

QC Piping, 225 B.R. at 566-568.

Other courts have followed suit. *See, e.g., In re Baltimore Marine Indus.*, 476 F.3d 238, 241 (4th Cir. 2007) ("[T]he Supreme Court has cited *Pearlman* since enactment of the Bankruptcy Code, without questioning its validity. *See Dep't of the Army v. Blue Fox, Inc.*, 525 U.S. 255, 264, 119 S.Ct. 687, 142 L.Ed.2d 718 (1999)."); *In re Colt Engineering, Inc.*, 288 B.R. 861, 868 (Bankr. C.D. Cal. 2003) (finding that *Pearlman* is still applied by bankruptcy courts, has been extended beyond the Miller Act to private contracts, and applies to more than just retained funds); *In re Cone Constructors, Inc.*, 265 B.R. 302, 308-309 (Bankr. M.D. Fla. 2001) (stating that the "holding set forth in *Pearlman* remains controlling law" and holding that the surety's equitable subrogation rights were superior to the trustee's interest to the extent of the surety's performance under the bond).

Another Section often discussed is 11 U.S.C. § 509:

(a) Except as provided in subsection (b) or (c) of this section, an entity that is liable with the debtor on, or that has secured, a claim of a creditor against the debtor, and that pays such claim, is subrogated to the rights of such creditor to the extent of such payment.

(b) Such entity is not subrogated to the rights of such creditor to the extent that--

(1) a claim of such entity for reimbursement or contribution on account of such payment of such creditor's claim is--

(A) allowed under section 502 of this title;

(B) disallowed other than under section 502(e) of this title; or

(C) subordinated under section 510 of this title; or

(2) as between the debtor and such entity, such entity received the consideration for the claim held by such creditor.

(c) The court shall subordinate to the claim of a creditor and for the benefit of such creditor an allowed claim, by way of subrogation under this section, or for reimbursement or contribution, of an entity that is liable with the debtor on, or that has secured, such creditor's claim, until such creditor's claim is paid in full, either through payments under this title or otherwise.[3]

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[3] The 1978 version of this provision differed slightly:

(a) Except as provided in subsections (b) and (c) of this section, an entity that is liable with the debtor on, or that has secured, a claim of a creditor, and that pays such claim, is subrogated to the rights of such creditor to the extent of such payment.

(b) Such entity is not subrogated to the rights of such creditor to the extent that—,

(1) a claim of such entity for reimbursement or contribution on account of a payment of such creditor's claim is—,

There has been some debate among courts regarding whether Section 509 codifies equitable subrogation as stated in *Pearlman* or is a separate type of subrogation. In *In re Celotex Corp.*, 289 B.R. 460, 469 (Bankr. M.D. Fla. 2003), the court stated that "[s]ubrogation under § 509 suggests the claimant need only be liable with the debtor and pay the common debt and thus be subrogated to creditors' rights." The court noted cases in which courts debate whether Section 509 preempts other forms of subrogation, whether the criteria is the same, whether equitable subrogation is an alternative to Section 509, and those that simply do not acknowledge Section 509. In *In re Pihl, Inc.*, 560 B.R. 1, 8-9 (Bankr. D. Mass. 2016), the court listed the various cases and determined that a "decisive majority of courts hold … that equitable subrogation principles remain applicable in bankruptcy." (citations omitted). The court found that as soon as the sureties had a legal obligation to pay, their subrogation rights were triggered, and they were entitled retainages and progress payments earned but not paid. *Id*. at 10. That obligation arose when the principal ceased performing work on the bonded projects. *Id*. at 10-11.

In *In re Four Star Const. Co.*, 151 B.R. 817, 819 (Bankr. N.D. Ohio 1993), the surety that paid payment bond claims sought the release of undistributed contract funds being held by the owner. The court stated that "Section 509(a) provides for the subrogation of the surety to the rights of the creditor to the extent of any payment made by the surety to the creditor," and citing *Pearlman*, continued that it "is applicable to both

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(A) allowed under section 502 of this title;

(B) disallowed other than under section 502(e) of this title; or

(C) subordinated under section 510 of this title; or

(2) as between the debtor and such entity, such entity received the consideration for the claim held by such creditor.

(c) The court shall subordinate to the claim of a creditor and for the benefit of such creditor an allowed claim, by way of subrogation under section 509 of this title, or for reimbursement or contribution, of an entity that is liable with the debtor on, or that has secured, such creditor's claim, until such creditor's claim is paid in full, either through payments under this title or otherwise.

Pub.L. 95-598, Nov. 6, 1978, 92 Stat. 2585.

partial and full payments of the principal debt made by the surety." *Id*. at 820. The court also stated that Section 509(a) applies only where the surety pays the principal debt in full after commencement of the bankruptcy and is inapplicable if paid before the petition was filed. *Id*. Because the surety paid each of the subcontractors' claims after the petition was filed, Section 509(a) applied. *Id*. The court held that the surety made the payments with respect to its obligations under the bonds and indemnity agreement, did not act as a volunteer, and was secondarily liable for the claims paid. *Id*. at 823. Thus, the contract funds in the owner's possession were not estate property to the extent of the surety's subrogation rights. *Id*.

In *In re LTC Holdings, Inc.*, 10 F.4th 177, 180-181 (3d Cir. 2021), the principal filed bankruptcy, and the surety tendered a completion contractor to the United States to finish the project and agreed to pay any amount due beyond the remaining contract funds. The surety claimed subrogation to the government's right to set off a tax refund owed to the principal. *Id*. at 180. The trustee and the government reached a settlement in which the principal released pending litigation against the government, including requests for equitable adjustments, and the government released the full amount of the tax refund to the trustee and waived its setoff rights. *Id*. at 182-183. The court stated that "Section 509 of the Bankruptcy Code 'is the statutory enactment of the long-standing doctrine of equitable subrogation.'" *Id*. at 185. The court stated that under Section 509, the surety is partially subrogated to a creditor's rights to the extent of any payments made, but the surety's subrogation rights are subordinated to the creditor's claim until it has been paid in full. *Id*. at 186. The court found that the government was "paid in full" either when the surety made the final payment to the completion contractor or when the government gave the surety a release, both of which occurred after the settlement agreement. *Id*. at 187. The court held that the tender agreement itself did not satisfy the surety's obligations because the bonds remained in effect during the performance of the work, and the agreement merely set forth actions that would satisfy the surety's obligations once completed. *LTC Holdings*, 10 F.4th at 188. Thus, the surety's subrogation rights were subordinate to the government's claim at the time of the settlement, the government could waive its right to set off the tax refund to settle its claim, and that waiver

extinguished the surety's ability to be subrogated to those setoff rights. *Id*. at 189.

Pearlman remains a fundamental basis for equitable subrogation law in bankruptcy cases despite the expanded definition of estate property in Section 541 and the statutory subrogation provisions in Section 509. The reconciliation of these provisions with the holdings of *Pearlman* will likely be the subject of continued debate. Given that *Pearlman* has survived for over sixty years, it appears likely to continue.

G. CONCLUSION

The holdings of *Prairie State Bank, Henningsen,* and *Pearlman have* withstood the test of time and the passage of various statutes, including the Miller Act and the Bankruptcy Code. Under this precedent, the surety has equitable subrogation rights to, at a minimum, any contract balances on the projects it bonded, and these rights relate back to the dates of the bonds. Where the surety completes performance of the contract, it steps into the shoes of the owner, and where the surety pays subcontractors, suppliers, and laborers, it steps into the shoes not only of those subcontractors, suppliers, and laborers, but also of the owner and the contractor.

The surety's equitable subrogation rights are superior to the rights of other creditors because the owner has the absolute right from the bonded contract and/or the bond to withhold payment of contract funds upon the contractor's default and to apply these funds to offset amounts expended by the owner to complete the project and pay subcontractors and suppliers. Once the surety performs under its bonds, it is subrogated to the owner's rights and, by stepping into the shoes of the owner, is entitled to directly offset the contract balances against amounts the surety has paid to complete the project and/or satisfy subcontractor claims. The defaulting contractor is not entitled to, nor does it ever acquire any interest in the contract funds. Rather, the funds flow directly from the owner to the surety through its subrogation rights, and therefore never become an asset of the contractor. Where the surety bonds multiple projects with a common owner, the surety should look to the remaining contract funds across all projects as a potential source of recovery for losses on bond claims.

PANEL 2

U.S. EX REL. SCOLLICK V. NARULA

SURETIES AND THE FALSE CLAIMS ACT: CAN SURETIES BREATHE A SIGH OF RELIEF?

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U.S. ex rel. Scollick v. Narula: Sureties and the False Claims Act: Can Sureties Breathe a Sigh of Relief?

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I. INTRODUCTION

The civil False Claims Act (FCA) imposes liability on anyone who commits fraud against the federal government and provides civil and criminal penalties for violating the FCA. The FCA applies to any industry that deals with the federal government, including construction and surety. In the past, sureties were rarely parties to FCA lawsuits.

Yet the expansion of the *qui tam* remedy and the increasing awareness by the plaintiff's bar of the potential for fraud in the construction industry has increased claims and risks of FCA exposure for bonded contractors, subcontractors, and their sureties. Post-Covid, there has been an onslaught in False Claims litigation, some of which involved the construction and surety industry. In fiscal year 2021, the Department of Justice reported recoveries of more than $5.6 billion in settlements and judgments from civil cases, the second-largest figure ever and the highest since 2014.[2] Of these recoveries, the amount paid by the federal government to relators, or whistleblowers, exceeded $200 million.[3]

This paper focuses on the recent ruling in *U.S. ex rel. Scollick v. Narula* as well as other recent cases involving FCA claims asserted against sureties and the lessons to take away from them. But first, a short refresher on the FCA.

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[1] The authors wish to thank Dennis P. O'Neill of Beacon Consulting Group, Inc., and Cynthia Rodgers-Waire of Wright, Constable & Skeen, LLP, who prepared previous papers and material on this topic from which the current authors drew from.

[2] *Justice Department's False Claims Act Settlements and Judgments Exceed $5.6 Billion in Fiscal Year 2021*, Department of Justice, Feb. 1, 2022, *available at* https://www.justice.gov/opa/pr/justice-department-s-false-claims-act-settlements-and-judgments-exceed-56-billion-fiscal-year (last accessed June 8, 2022).

[3] *Fraud Statistics – Overview*, Civil Division, U.S. Department of Justice, *available at* https://www.justice.gov/opa/press-release/file/1467811/download (last accessed June 8, 2022).

II. HISTORY

The False Claims Act was passed in 1863 during the Lincoln Administration,[4] to prevent wrongdoing by dishonest government contractors during the Civil War. The Act establishes a *qui tam* cause of action which allows a "relator," or whistleblower, to sue the party committing fraud and recover part of the government's damages, plus attorneys' fees and costs. The basic justification for this scheme is that the person best suited to uncover fraud is often someone who was involved; in other words, "it takes a rogue to catch a rogue."[5]

Certain amendments over time weakened the *qui tam* cause of action by removing the relator's guaranteed share of a successful recovery and barred *qui tam* relief if the Government had prior knowledge of the fraud.[6] But rampant fraud perpetrated on the government during the Cold War[7] brought new life to the *qui tam* remedy when President Reagan signed new amendments in 1986,[8] restoring the relator's right to recover a share of the recovery, entitling the relator to their attorneys' fees, providing employment protection, and increasing penalties.[9] In 2009 and 2010 President Obama enacted additional amendments which brings the Act to its current language.[10]

III. FRAMEWORK OF FCA

A. FEDERAL FCA

The civil False Claims Act[11] prohibits any person from:

1. Knowingly presenting, or causing to be presented, a false or fraudulent claim for payment ("presentment claim");[12]

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[4] 12 Stat. 696.
[5] Cong Globe, 37th Cong., 3d Sess. 955-56 (statement of Sen. Howard).
[6] 31 U.S.C. § 232(c) (1943).
[7] *Id.* at 1271-72.
[8] False Claims Amendments Act of 1986, Pub. L. No. 99-562, 100 Stat. 3153.
[9] Helmer, *supra*, at 1273-74 (citing 31 U.S.C. §§ 3729-30) (1986).
[10] Fraud Enforcement and Recovery Act, Pub. L. No. 111-21 § 4, 123 Stat. 1617, 1621-25 (2009).
[11] The FCA also has a criminal counterpart, codified at 18 U.S.C. §§ 286 & 287.
[12] 31 U.S.C. § 3729(a)(1)(A).

2. Knowingly making a false statement or record in order to have a claim paid ("false statements claim");[13]
3. Conspiring with others to defraud in order to have a claim paid ("conspiracy claim");[14] and
4. Making or using a false record or statement to avoid an obligation to pay money to the federal government ("reverse false claim").[15]

Each violation is punishable by treble damages and a civil penalty.[16] The statute of limitations for *qui tam* actions is 6 years from the violation, or 3 years after the facts underlying the right of action were or should have been known by the appropriate government official, whichever comes last.

There are two possible paths for an FCA action. First, the Department of Justice may file its own lawsuit.[17] Second, a relator may file a *qui tam* action in "the name of the Government."[18] A *qui tam* action is filed under seal, with notice to the federal government.[19] The federal government then has 60 days to intervene or decline, though extensions are common.[20] The federal government has full civil discovery power during this period.[21]

If the federal government elects to intervene, it undertakes primary responsibility for the litigation moving forward.[22] The federal government has the authority to settle, although final discretion lies with the court upon notice and opportunity for a hearing.[23] If the government achieves a favorable result, either by judgment or settlement, the relator may recover 15 to 25 percent of the proceeds, plus reasonable attorneys' fees and costs.[24]

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[13] 31 U.S.C. § 3729(a)(1)(B).
[14] 31 U.S.C. § 3729(a)(1)(C).
[15] 31 U.S.C. § 3729(a)(1)(G).
[16] 31 U.S.C. § 3729(a)(1); 28 C.F.R. § 85.5.
[17] 31 U.S.C. § 3730(a).
[18] 31 U.S.C. § 3730(b)(1).
[19] 31 U.S.C. § 3730(b)(2).
[20] *Id.*
[21] 31 U.S.C. § 3733(a).
[22] 31 U.S.C. § 3730(c)(1).
[23] 31 U.S.C. § 3730(c)(2)(A)-(B).
[24] 31 U.S.C. § 3730(d)(1).

If there is no intervention, the relator may proceed with the case as long as it will not interfere with a criminal investigation or prosecution arising from the same facts.[25] A successful relator in a case with no intervention will be entitled to 25 to 30 percent of the proceeds, plus reasonable attorneys' fees and costs.[26] On the other hand, a defendant who avoids liability will only receive an award of attorneys' fees if the case was frivolous, vexatious, or brought mainly to harass.[27]

A potential relator has an incentive to act quickly. If the subject matter of the action was previously publicly disclosed by someone other than the whistleblower, no *qui tam* action may be filed.[28] This rule is strictly enforced to avoid "parasitic suits by opportunistic late-comers[.]"[29]

B. ELEMENTS OF FCA CLAIM

The general elements of an FCA violation are:

1. A **false** statement or fraudulent course of conduct;
2. Made or carried out with **knowledge** of the falsity;[30]
3. That was **material**; and
4. That involved a **claim**.

Courts have held that the heightened pleading standard for fraud in Rule 9(b) of the Federal Rules of Civil Procedure applies to FCA claims.[31] The relator plaintiff must therefore provide a detailed description of the time, place and contents of the supposedly false representation, the identity of the person making the representation, and to whom it was made.[32] A plaintiff may also satisfy the pleading standard by showing the existence of a pattern of conduct that necessarily would result in the submission of a false claim to the government, but this is not likely to impact a surety

[25] 31 U.S.C. § 3730(c)(4).
[26] 31 U.S.C. § 3730(d)(2).
[27] 31 U.S.C. § 3730(d)(4).
[28] 31 U.S.C. § 3730(e)(4)(A).
[29] *United States ex rel. Branch Consultants, L.L.C. v. Allstate Ins. Co.*, 782 F. Supp. 2d 248, 257 (E.D. La. 2011).
[30] This is sometimes referred to as the "scienter" requirement. *See, e.g.*, *United States ex rel. Campie v. Gilead Scis., Inc.*, 862 F.3d 890, 902 (9th Cir. 2017).
[31] *United States ex rel. Grant v. United Airlines, Inc.*, 912 F.3d 190, 196 (4th Cir. 2018).
[32] *United States ex rel. Nathan v. Takeda Pharms. N. Am., Inc.*, 707 F.3d 451, 455-56 (4th Cir. 2013).

defendant that issues bonds on specific projects.[33] The heightened pleading standard for fraud is a difficult hurdle for relators, and can often result in one or more rounds of amended initial pleadings and motion(s) to dismiss before the trial court ultimately decides whether to allow the case to move past the pleading stage.

i. Falsity

Because it is rooted in fraud, an FCA claim cannot survive unless it involves some type of false representation to the government. The concept of falsity has been applied broadly as FCA jurisprudence has evolved. Courts recognize three general types of falsity: (1) factual falsity, (2) legal falsity, and (3) fraudulent inducement.[34]

Factual falsity is the most straightforward; it occurs where a claimant misrepresents the goods or services it provided to the government.[35] For example, when a contractor (or a takeover surety stepping into its principal's shoes) seeks payment for materials that are different from the ones installed, or submits a change order seeking to be paid for work it did not perform, the factual falsity prong will be met.

Legal falsity deals not with the quality of the work performed but compliance with government requirements, such as statutes, regulations, or contractual provisions. If compliance with such a requirement is a condition for receipt of payment from the government, a false certification that this requirement is met will be grounds for legal falsity.[36] There are two types of false certification: express and implied. An express false certification is an explicit representation that the claimant complied with a contractual or legal condition to payment, but in truth it has not complied.[37] An implied false certification occurs where a claimant must comply with certain requirements to be paid, but fails to do so.[38] The implied false certification

[33] *See Grant*, 912 F.3d at 197.

[34] *See United States v. Honeywell Int'l Inc.*, No. 08-0961(PLF), 2020 WL 6940028, at *13 (D.D.C. Nov. 25, 2020).

[35] *United States ex rel. Wilkins v. United Health Group, Inc.*, 659 F.3d 295, 305 (3d Cir. 2011).

[36] *Id.*

[37] *United States v. Kellogg Brown & Root Servs., Inc.*, 800 F. Supp. 2d 143, 154 (D.D.C 2011).

[38] *Id.*

concept is based in the theory that when a government contractor submits a claim for payment, it implies compliance with all contractual or legal conditions to payment. To qualify as an implied false certification, an application for payment must make specific representations about the goods or services provided, and fail to disclose noncompliance with material requirements such that the representations are "misleading half-truths."[39]

Finally, a claimant can violate the falsity requirement even when there is no defect in its pay applications under the fraudulent inducement theory. "Fraudulent inducement exists where a contract was procured by fraud or when a party to a contract makes promises at the time of contracting that it intends to break."[40] Where a claimant knowingly makes a false representation to the government, and the government was induced by or relied on that representation in awarding the contract, the initial fraud taints every payment under the contract.[41] Accordingly, when a contract was fraudulently induced, each application for payment is a false claim and can be punished independently, with the attendant damages and penalties.[42]

ii. *Knowledge*

Under the FCA, a person acts "knowingly" when he or she "(i) has actual knowledge of the information; (ii) acts in deliberate ignorance of the truth or falsity of the information; or (iii) acts in reckless disregard of the truth or falsity of the information[.]"[43] This definition is broad enough to cover willful ignorance of obvious deficiencies, but mere negligence, innocent mistakes and technical violations do not qualify as "knowledge."[44] A reasonable dispute over the interpretation of a key regulation or statute is not a false claim.[45] As discussed in § IV below, the Supreme Court has

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[39] *Universal Health Servs., Inc. v. United States ex rel. Escobar*, 579 U.S. 176, 190 (2016).

[40] *United States ex rel. Westrick v. Second Chance Body Armor, Inc.*, 266 F. Supp. 3d 110, 125 (D.D.C. 2017).

[41] *Honeywell*, 2020 WL 6940028, at *18 (citing *Second Chance*, 266 F. Supp. 3d at 125 & 129; *United States v. DynCorp Int'l, LLC*, 253 F. Supp. 3d 89, 108 (D.D.C. 2017)).

[42] *United States ex rel. Bettis v. Odebrecht Contractors of California, Inc.*, 393 F.3d 1321, 1326 (D.C. Cir. 2005).

[43] 31 U.S.C. § 3729(b)(1)(A)(i)-(iii).

[44] *See United States ex rel. Burlbaw v. Orenduff*, 400 F. Supp. 2d 1276, 1285-86 (D.N.M. 2005), *aff'd*, 548 F.3d 931 (10th Cir. 2008); *United States ex rel. Lamers v. City of Green Bay*, 168 F.3d 1013, 1020 (7th Cir. 1999).

[45] *United States ex rel. Phalp v. Lincare Holdings, Inc.*, 116 F. Supp. 3d 1326, 1360 (S.D. Fla. 2015).

recently ruled for a holistic subjective approach to the knowledge prong rather than a bright-line objective approach.

iii. Materiality

A "material" act is one "having a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property."[46] The focus of the inquiry is the government's likely action based on the information it receives from the claimant. The Supreme Court recently rejected a mechanical test for materiality, finding that the trial court must decide, "whether the defendant knowingly violated a requirement that the defendant knows is material to the Government's payment decision."[47]

What the government *actually* does with information of the type received, *and* the claimant's actual knowledge of what the government does, are the key questions. It is not enough that the government designates a particular requirement as a condition of payment, or that the government *may* withhold payment if the requirement is not met.[48] If the defendant, for example, can show that the government routinely approves payments when it knows that a technical requirement has not been met, the requirement is not material whether or not it is statutory, regulatory or contractual.[49]

It is not clear that the materiality requirement applies in the context of fraudulent inducement claims. Statements made to the government may be sufficiently material if they induce the government to award the contract, and need not be material to the government's decision to pay once the contract has been executed.

C. DISTINGUISHING BETWEEN TRADITIONAL CLAIMS AND REVERSE FALSE CLAIMS

As used in this paper and generally in FCA jurisprudence, a "claim" can be a direct request to the government for money, or a reimbursement request made to a recipient of federal funds, such as a university or general

[46] 31 U.S.C. § 3729(b)(4).
[47] *Escobar*, 579 U.S. at 181.
[48] *Id.* at 193.
[49] *Id.* at 195.

contractor.[50] In the construction context, either a general contractor's submission of a pay application to the government, or a subcontractor's submission to the general contractor, can constitute a traditional claim.

A "reverse false claim" is a false statement intended to avoid or minimize a duty to the government, no matter how or in what form that duty arises.[51] If decrease in scope would ordinarily result in a credit to the government, but a contractor conceals relevant information to avoid recognizing the credit, a reverse false claim could exist. A false representation intended to avoid liability for a liquidated damages claim could also constitute a reverse false claim.

IV. RECENT FCA CASES INVOLVING SURETIES

A. UNITED STATES EX REL. SCOLLICK V. NARULA

Perhaps the best-known case involving a surety's rights and obligations with respect to the FCA is *United States ex rel. Scollick v. Narula*. In *Scollick*, the plaintiff-relator filed suit against several large contractors who allegedly fraudulently obtained federal contracts worth millions of dollars that were set aside for HUBZone and Service-Disabled Veteran Owned Small Business ("SDVOSB"). Scollick also sued two sureties that issued bid, performance, and payment bonds on the theory that the sureties knew, or should have known, that the SDVOSB contractor was being controlled by a large contractor and that the sureties issued bonds based on the strength of the large contractor's bonding capacity. The plaintiff-realtor argued that without that bonding, the contractor would not have been able to compete and obtain the contracts set aside for SDVOSB contractors.

The plaintiff-realtor claimed that the sureties knew that the large contractors were neither small business concerns as defined by the Small Business Administration (SBA) regulations, nor SDVOSBs as defined by the Department of Veterans Affairs (VA) and that the large contractor would perform the work. The plaintiff-realtor alleged that the sureties were

[50] *Escobar*, 579 U.S. at 182.
[51] 31 U.S.C. § 3729(b)(3).

liable for issuing the bonds despite ostensibly having that knowledge to further the fraud.

The plaintiff-relator alleged that the principal actors established two companies, Centurion Solutions Group ("CSG") and Citibuilders Solutions Group ("Citibuilders"), falsely identified as SDVOSB in order to improperly qualify for SDVOSB set-aside construction contracts, while the work would be performed by a larger parent company, Optimal Solutions and Technologies ("OST").[52] Along with the various individuals and companies who had direct involvement in the alleged scheme, the two sureties that issued bid and performance bonds, the insurance broker and its president were also made defendants.[53] The federal government declined to intervene.[54]

i. The Amended Complaint

After his initial complaint against the sureties was dismissed, the plaintiff-relator moved to amend and cure his pleading deficiencies.[55] The surety defendants opposed the motion on the grounds of futility.[56] In the amended complaint, plaintiff-relator relied on a theory of indirect presentment, a theory by which the FCA imposes liability on those who knowingly cause the presentation of false claims or statements to the government, not just those who directly present the false claim or statement.[57] Under this theory, the relator argued that the sureties' actions directly led to the submission of false claims and, importantly, that the sureties continued to do business with Citibuilders and CSG even after learning about the false claims.[58]

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[52] *United States ex rel. Scollick v. Narula*, 215 F. Supp. 3d 26, 31 (D.D.C. 2016) (*Scollick I*).
[53] *Id.* at 33-34.
[54] *Id.* at 30.
[55] *United States ex rel. Scollick v. Narula*, No. 14-cv-01339-RCL, 2017 WL 3268857, at *1 (D.D.C. July 31, 2017) (*Scollick II*).
[56] *Scollick II*, 2017 WL 3268857, at *1; *see also, e.g.*, *Stripling v. Jordan Production Co.*, 234 F.3d 863, 872-73 (5th Cir. 2000) (a motion to amend may be denied if the proposed amendment would be futile, or fails to state a claim upon which relief could be granted).
[57] 31 U.S.C.A. 3729(a)(1).
[58] *Id.* at *14.

The Court found the new facts, as pled, were sufficient to grant the motion for leave to amend.[59] The plaintiff-relator alleged that during the underwriting process, the sureties visited OST, the alleged parent company's, offices, where CSG and Citibuilders were nominally located.[60] The facts were enough to infer that the sureties knew that CSG was a mere shell company dependent on the resources of a larger entity.[61] Further, the plaintiff-realtor claimed the underwriting process would have uncovered that CSG lacked the necessary experience to carry out the project.[62] The Court made similar findings with respect to the allegations related to Citibuilders.[63]

The amended complaint also alleged that the sureties continued to do business with CSG and Citibuilders even though they knew that CSG and Citibuilders were committing fraud.[64] The plaintiff-relator argued that the sureties' alleged knowledge that their principals did not qualify as SDVOSBs rendered them liable under the FCA because CSG and Citibuilders would not have been able to obtain the contracts and perpetuate their alleged fraud without bonding.[65] The court further held that a reverse false claim, which is where an entity submits a false claim or statement to avoid obligations owed to the government, existed as pled because the sureties allegedly avoided their obligation to compensate the government for loss each time a payment was made to CSG or Citibuilders. The court accepted this theory, explaining that the bonds created an obligation to repay the government independent of the obligation arising as a result of the fraud.[66]

Responding to one surety's argument that the SDVOSB requirement was not explicitly referenced in the bond forms, the court found that the performance bonds incorporated all terms of the bonded contract, which necessarily required that the contract be awarded to and performed by an

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[59] *Id.*
[60] *Id.*
[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] *Id.* at *15.
[65] *Id.*
[66] *Id.*

SDVOSB.[67] The court further held that the plaintiff-relator had sufficiently alleged that the government received nothing of value because actual SDVOSBs are the intended beneficiaries of federal set-asides.[68] Accordingly, the court permitted the reverse false claims count to stand.[69] The Court further found that because the amended complaint sufficiently pled an underlying FCA claim, the plaintiff-relator adequately alleged the existence of a conspiracy under 31 U.S.C. § 3729(a)(1)(C).[70]

In a subsequent ruling addressing another defendant's motion to dismiss, the court defined Scollick's claim as one arising under the theory of fraud in the inducement, as opposed to one of implied false certification.[71]

ii. Surety released in Motion for Summary Judgment Ruling

In response, the defendants filed extensive Motions for Summary Judgment, all of which were denied except for those filed by the sureties. In granting the sureties' Motions the Court found that no evidence suggested that the sureties had actual knowledge that the bids were fraudulent, but they only knew the details of the bid proposals and certain details of company ownership.

The court further held that there was no deliberate ignorance or reckless disregard under the facts—to create such a standard that would "impose a significant duty on third party insurers to familiarize themselves with VA regulations before bonding companies."[72] With this pronouncement, the Court found that sureties are not on the hook to know of the specific SDVOSB requirements and "double-check the government's verification" of the same.[73] Such a requirement would be a "significant leap

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[67] *Id.*
[68] *Id.* (citing *United States v. Sci. Applications Int'l Corp.*, 626 F.3d 1257, 1279 (D.C. Cir. 2010)).
[69] *Id.* at *17.
[70] *Scollick II*, 2017 WL 3268857, at *17.
[71] *See Scollick ex rel. United States v. Narula*, No. 14-cv-1339, 2020 WL 6544734, at *8 ("*Scollick III*").
[72] *Scollick ex rel. United States v. Narula,* No. 1:14-cv-01339-RCL, 2022 WL 3020936, at*13.
[73] *Id.*

in terms of liability."[74] Rather, the court held that contractor defendants are required to learn about the SDVOSB regulations, as they are the ones ultimately seeking payment from the federal government.

While the holding in *Scollick* is favorable for the surety industry, it does not allow the sureties to be relieved. In *Scollick,* the specific facts related to the sureties' lack of knowledge- actual or constructive, allowed them to escape liability under the FCA. The case is a good example of the expansive application of the FCA, and sureties should remain vigilant in its underwriting, communications, and interactions with its principals. A different set of facts could have produced different results.

B. HANOVER INS. CO. V. UNITED STATES

In *Hanover*,[75] the principal contracted with the Army Corps of Engineers (Corps) to perform various construction activities relating to an "Everglades Upgrade" project in Florida.[76] The Corps terminated the principal for default and submitted a claim on the performance bond, in response to which the surety tendered a new contractor and paid the Corps nearly $24 million, the difference between the value of the completion agreement and the contract funds remaining on the bonded contract.[77] The surety and principal sued in the Court of Federal Claims challenging the validity of the default termination and seeking damages.[78] The principal also filed a separate suit appealing the denial of certain related claims for extra work as well as a claim of 154 days of government delays.[79] The original suit challenging the default termination was dismissed on a technicality, but the surety corrected the error by giving notice of its claim and refiled, including a request for an equitable lien on any recovery by the principal by virtue of the indemnity agreement.[80] The cases were consolidated.

[74] *Id.*
[75] *Hanover Ins. Co. v. United States*, 134 Fed. Cl. 51 (2017) ("*Hanover I*").
[76] *Id.* at 56-57.
[77] *Id.* at 57.
[78] *Id.*
[79] *Id.*
[80] *Hanover I*, 134 Fed. Cl. at 57.

At first, the government only filed answers to these suits without asserting any affirmative defenses or counterclaims.[81] In discovery, the principal obtained leave to amend the complaint in its separate suit to delete its "wall breach claim," and to refine and re-allege its other claims.[82] In response to the amended complaint, the government attempted to obtain leave to assert fraud counterclaims against the surety and principal under several statutes, including the FCA.[83] As for the FCA counterclaim, the government asserted that the principal had included in its certified claim false and unsupportable overcharges for costs not incurred, double billing, and inflated costs.[84] The government alleged that the surety was liable for the fraud by virtue of its status as surety.[85] It also claimed that the surety had submitted a false claim in its own right by pursuing the principal's entire claim, which included a $1.1 million pass-through claim from a subcontractor, whose payment bond claim the surety had settled in full for $370,000.[86]

The surety and principal opposed the government's motion for leave to amend on several grounds, including futility.[87] The court held that the allegations below by the government were adequate under the heightened Rule 9(b) pleading standard to allege that the principal submitted various false claims:

1. The principal claimed a delay of 115 days due to differing site conditions when 55 of those days occurred after completion of the work;
2. The principal claimed delay days for which it had been compensated by the Corps;
3. The principal double-billed for the costs of pumps;
4. The principal included claims for damage for which it had been compensated;
5. The principal claimed false depreciation costs for dump trucks;

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[81] *Id.*
[82] *Id.* at 58.
[83] *Hanover I*, 134 Fed. Cl. at 58
[84] *Id.*
[85] *Id.*
[86] *Id.*
[87] *Id.* at 59, 63.

6. The principal attempted to pass through a subcontractor claim with exaggerated costs; and
7. The principal was not entitled to further reimbursement for the subcontractor claim because the subcontractor had settled its payment bond claim with the surety.[88]

As for the surety's "direct actions" constituting fraud, the court concentrated on the pass-through subcontractor claim that had been settled. Surprisingly, it found that Hanover's attempt to assert a lien on funds that might be due to the *principal* pursuant to its indemnity rights was potentially a fraudulent claim against the *government*.[89] The court also reasoned that the surety "facilitated or allowed" the principal to present the entire pass-through claim despite its knowledge that the principal had no liability to the subcontractor and that the subcontractor had assigned its claim to the surety under its settlement agreement.[90] Therefore it believed that the government had sufficiently pled facts that the surety had "acted to allow a false claim to be presented" to the court itself when it neglected to mention the settlement agreement.[91] The court was also evidently convinced that the *surety's* settlement of the *subcontractor's* payment bond claim extinguished all obligations between the *principal* and the subcontractor.[92] Finally, the court found that the tender and release agreement entered into by the surety and the government did not apply to allegations of fraud against the surety because the contracting officer who signed the agreement was not authorized to release fraud claims.[93] The government could amend its counterclaims to include FCA claims against the surety.[94]

After the decision examined above, the FCA claims involving the surety were severed and transferred to the United States District Court for

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[88] *Id.* at 66.
[89] *Id.*
[90] *Id.*
[91] *Id.* at 66-67.
[92] *Hanover I* at 67 (citing *Metric Constructors, Inc. v. United States*, 314 F.3d 578, 581 (Fed. Cir. 2002). The *Severin* doctrine holds that if a subcontractor on a federal contract has released the general contractor from any liability on a claim, the general contractor cannot pursue that claim against the Government. *See Severin v. United States*, 99 Ct. Cl. 435 (1943).
[93] *Id.* at 70.
[94] *Id.* at 72.

the District of Massachusetts.[95] Hanover and the government cross-moved for summary judgment. The court declined to hold that an "initially valid claim can be rendered fraudulent by subsequent events."[96] Because nothing suggested that the principal's claim for additional expenses was false when first presented and ruled on by the government, Hanover could not be liable for submitting or causing its principal to submit those claims.[97] The court then clarified that claims appearing for the first time in a complaint filed in federal court could not be considered a "claim" as a matter of law, and therefore could not be the basis for an FCA violation.[98] Summary judgment was granted to Hanover on the government's counterclaims, although the court remained "troubled" by its purported failure to report the payment bond claim settlement to the government.[99]

C. HANOVER INS. CO. V. DUNBAR MECH. CONTRACTORS, LLC

Another recent appellate case, *Dunbar Mechanical*[100] casts doubt on a surety's ability to plead potential FCA exposure as a reason to avoid its obligations under a performance bond. The obligee, a SDVOSB, won a bid for a federal set-aside project in Arkansas for $2,047,455.74.[101] The Small Business Administration regulations prohibit an SDVOSB prime contractor from subcontracting more than 85% of "the amount paid by the government to it" to non-SDVOSB firms.[102] On the same day it was awarded the prime contract, the obligee entered into a subcontract with the principal, a non-SDVOSB, for substantially all the work included in the prime contract for $1,794,136.00.[103] The subcontract contained a provision permitting the obligee to add to or reduce the principal's work without notice to the surety.[104] The obligee also entered into a separate agreement with the

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[95] *Hanover Ins. Co. v. United States*, No. 1:20-cv-11989-PBS (D. Mass.) ("*Hanover II*").
[96] *Id.*, Dkt. No. 248, p. 12.
[97] *Id.*
[98] *Id.*
[99] *Id.* at 13.
[100] *Hanover Ins. Co. v. Dunbar Mech. Contractors, LLC*, 964 F.3d 763 (8th Cir. 2020) ("*Dunbar Mech. II"*).
[101] *Id.* at 764-65.
[102] 13 C.F.R. § 125.6(a)(3).
[103] *Dunbar Mech. II*, 964 F.3d at 765.
[104] *Id.*

principal's sole member, who agreed to serve as the project manager for an additional fee of $62,000.00.[105]

The obligee terminated the subcontract and the project manager contract, and submitted a performance bond claim.[106] Upon investigation, the surety concluded that because the obligee had subcontracted over 85% of the work under the prime contract to the principal, the subcontract was illegal and the performance bond was void.[107] The district court granted the surety's motion for summary judgment, because 90.66 percent of the original contract price would be paid by the SDVOSB obligee to the non-SDVOSB principal.[108]

On appeal, the Eighth Circuit began its analysis with the plain language of the SBA regulations.[109] It found that the actual cost of contract performance, rather than the original contract amount, was the benchmark for determining whether the 85% threshold for non-SDVOSB participation had been exceeded.[110] While the subcontract appeared to contemplate excessive payment to a non-SDVOSB subcontractor, the obligee retained the unilateral ability throughout the project to reduce the principal's scope of work and drop payments to the principal below the 85% threshold.[111] The court therefore could not conclude that the subcontract violated the regulations.[112]

Turning to the surety's argument that it could face FCA liability if it performed a bonded obligation that turned out to be illegal, the court found that the specter of FCA liability did not justify rescinding the subcontract and discharging the bond.[113] First, the court reasoned that the allegations in *Scollick* painted a picture of a "concerted scheme to defraud" involving

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[105] *Id.*

[106] *Dunbar Mech. II*, 964 F.3d at 765-66.

[107] *Id.* at 766.

[108] *Hanover Ins. Co. v. Dunbar Mech. Contractors, LLC*, No. 3:18CV00054 JM, 2019 WL 2353046, at *2 (E.D. Ark. June 3, 2019). ("*Dunbar Mech. I*").

[109] As it explained in footnote 1 of its opinion, the Eighth Circuit applied 13 C.F.R. § 125.6(b)(2) as it was in effect when the general contract was awarded. *Dunbar Mech. II*, 964 F.3d at 767 n. 1. The relevant provision now appears at 13 C.F.R. § 125.6(a)(3).

[110] *Dunbar Mech. II*, 964 F.3d at 767.

[111] *Id.*

[112] *Id.* at 767-68.

[113] *Dunbar Mech. II*, 964 F.3d at 768.

false certifications, false claims of past performance, and concealment of records.[114] The allegations in the two cases were dissimilar enough that it was unclear whether the surety in *Dunbar Mechanical* could face FCA liability.[115] And secondly, even if the surety did have a reasonable fear of exposure, the Eighth Circuit ruled that it had recourse because it could simply pay the obligee and avoid further involvement, *or* perform under the bond upon giving notice to the government of the potential for false claims.[116] The latter option would eliminate any potential liability under the "continues to do business" theory.[117] The Eighth Circuit accordingly reversed the summary judgment ruling and remanded to the district court.[118]

As the only reported federal appellate decision to consider the surety's potential FCA liability, *Dunbar Mechanical* is likely to have considerable influence over future surety cases in which a principal's qualification for set-aside contracts is in doubt. The most immediate fallout from *Dunbar Mechanical* is that a surety is unlikely to be successful in avoiding its performance bond obligations when it pleads that compliance will open it up to FCA liability. But more reassuringly, *Dunbar Mechanical* appears to confirm that disclosure to the government creates a safe harbor for a surety who discovers compliance issues upon being presented with a claim. Where a surety learns of such issues and seasonably informs the contracting officer, it should be able to avoid FCA exposure when it chooses among its options for performance.

D. U.S. EX REL. SCHUTTE V. SUPERVALU INC. & U.S. EX REL. PROCTOR V. SAFEWAY[119]

On June 1, 2023, a unanimous Supreme Court issued rulings in two consolidated cases on the False Claims Act (FCA), *United States ex rel. Schutte et al. v. SuperValu Inc. et al.*, Case No. 21-1326, and *United States ex rel. Proctor v. Safeway*, Case No. 22-111. The Court's opinion has broad implications for government contractors including the construction

[114] *Id.* While *Dunbar Mech. II* refers to "concealment of records" being at issue in *Scollick*, none of the claims in *Scollick* related to record concealment.
[115] *Id.*
[116] *Id.*
[117] *Id.*
[118] *Id.*
[119] 143 S. Ct. 1391 (2023).

industry. Writing for the unanimous court, Justice Clarence Thomas underscored the importance of a defendant's subjective beliefs about compliance in applying the FCA's knowledge requirement. Essentially, the rulings maintain the status quo and affirm that "[w]hat matters for an FCA case is whether the defendant knew the claim was false." The Court made clear the focus is on what the defendant thought when it submitted the false claims, noting "[t]he FCA's scienter element refers to [the defendants'] knowledge and subjective beliefs—not to what an objectively reasonable person may have known or believed."

In the Surety context, this case may be helpful because, in large part, a Surety does not know that its principal has made a false claim. Even so, it does not relieve the Surety from the need to self-report once it become knowledgeable of a possible false claim.

V. PRESUMPTION OF LOSS RULE

As touched upon in *Scollick*, one area of concern for sureties seeking to avoid false claims liability is the Small Business Jobs Act. A contractor's false certification of its compliance with set asides like SDVOSBs has always been illegal, but until relatively recently, the government was often unable to show its actual economic loss flowing from a contractor's false certification of its own qualifications or its improper use of noncompliant subcontractors.

In 2010, the Small Business Jobs Act created a presumption in favor of loss as a result of circumventing set-aside requirements:

> In every contract, subcontract, [or] cooperative agreement…which is set aside, reserved, or otherwise classified as intended for award to small business concerns, there shall be a presumption of loss to the United States based on the total amount expended on the contract, subcontract, [or] cooperative agreement…whenever it is established that a business concern other than a small business concern

> willfully sought and received the award by misrepresentation.[120]

This "Presumption of Loss Rule" discourages "business and experience being improperly shifted away from small business and women-owned small businesses."[121] It applies to a company making representations about its own status to the government, as well as a third party certifying the company's status to the government.[122] This includes general contractors making representations about their subcontractors, although the Federal Acquisition Regulations provide a safe harbor for a general contractor relying solely on the subcontractor's representations about its compliance.[123] This safe harbor is unavailable where the general contractor knows the representations are fraudulent.

The presumption of loss is rebuttable only by proof that the misrepresentation was not affirmative, intentional or willful.[124] Coupled with the FCA's treble damages provision, this means that a false certification or statement leading to a bid being improperly awarded to a nonqualifying business could result in an liability exceeding three times the amount of the value of the contract, even if the government received a completed project.

This rule was recently applied in the settlement of a *qui tam* action brought against Hensel Phelps, a large general contractor on a project to build an armed forces retirement home in Washington, D.C. As many federal contracts do, the general contract required Hensel Phelps to implement a subcontracting plan to ensure opportunities for SDVOSBs. Rather than carry out the plan as intended, Hensel Phelps negotiated a classic "pass-through" arrangement with respect to kitchen and food service equipment. The work and materials would be provided by a large non-compliant business, while the subcontract was signed by a SDVOSB which

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[120] 15 U.S.C. § 632(w)(1).

[121] *United States ex rel. Savage v. Washington Closure Hanford LLC*, No. 2:10-CV-05051-SMJ, 2017 WL 3667709, at *3 (E.D. Wash. Aug. 24, 2017).

[122] *Savage*, 2017 WL 3667709, at *4.

[123] 48 C.F.R. § 52.219-9(c)(2).

[124] *See United States v. Singh*, 195 F. Supp. 3d 25, 30 (D.D.C. 2016).

received a 1.5% fee for doing no actual work. The *qui tam* action resulted in an early settlement and a loss of over $2.8 million to Hensel Phelps.[125]

VI. ACTIONS BY THE SURETY

Under the Federal Acquisition Regulation ("FAR"), the Mandatory Disclosure Rule ("Rule"), requires Government contractors to disclose to the Government certain potential violations of criminal and civil law as well as instances of significant overpayment. FAR 52.203-13; 9.406-2; and 9.407-2. Noncompliance with this disclosure obligation is grounds for suspension/debarment. Further, Federal Acquisition Rule 52.203-13 requires a government contractor to timely disclose to the Government whenever the contractor has credible evidence that a principal, employee, agent, or subcontractor of the contractor has violated the Civil False Claims Act or a violation of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity in connection with the award, performance, or closeout of a government contract or any related subcontract. Therefore, if a surety has solid suspicion, or actual knowledge, that a false claim has been made by the principal, the safest action would be to disclose this information to the government in detail and to immediately stop conducting business with the principal. Failure by the surety to inform the government or continue supporting the principal could lead to claims of indirect support of any FUTURE false claims that the principal may submit to the government.

Sureties must also be careful when filing pleadings and/or taking other affirmative actions based on the claims and positions of their principals. If a principal claims something that a surety knew or should have known was false, *Hanover* suggests that the surety could face FCA liability and treble damages simply for incorporating that claim by reference. Affirmative defenses, contract dispute acts, or claims to the contracting officer need to be fully investigated by the surety and supported before being asserted to or against the government. If not, there is real concern that if the principal's actions are found to be fraudulent, and any

[125] *Construction Company Agrees to Pay $2.8 Million to Resolve Allegations of Small Business Subcontracting Fraud*, Department of Justice, May 12, 2022, *available at* http://www.justice.gov/usao-ndny/pr/construction-company-agrees-pay-28-million-resolve-allegations-small-business (last accessed June 8, 2022).

valid claims which the surety could make on behalf of the principal after takeover or subrogation could be waived under the forfeiture act.

VII. CONCLUSION

While the *Scollick* result will be reassuring to surety professionals who fear liability for unwittingly writing a bond for a noncompliant principal, the door is still open for exposure to False Claims Act liability. As concepts such as indirect presentment, implied false certification and the Presumption of Loss Rule have taken hold, the FCA has become more of a concern for peripheral stakeholders in government-adjacent industries, and construction is no exception. As *qui tam* plaintiffs' lawyers continue to become familiar with federal construction procurement, it is to be expected that more sureties will be forced to defend FCA suits as a result of knowledge obtained during the claims or underwriting processes. A working knowledge of the FCA is recommended to avoid even the possibility of liability.

PANEL 3

E-DISCOVERY, DOCUMENT MANAGEMENT, AND DISCOVERY ISSUES

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PEARLMAN 2023

September 7-8, 2023

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E-Discovery, Document Management, and Discovery Issues

By: Megan Daily, Mike Gaudet, and Rebecca Thomas

I. INTRODUCTION

To quote Stewart Brand, "[o]nce a new technology rolls over you, if you're not part of the steamroller, you're part of the road." How sureties and other businesses maintain records has changed from storing paper copies in file rooms. This has forced law firms to adapt because litigation largely requires gathering tons of information and using it to one's advantage. The traditional method of manually reviewing and processing mountains of paperwork is too tedious and, at times, may not even be possible. Rampant digitization has become the norm and e-discovery has evolved from a nice addition to a necessary component of litigation. This paper will highlight some issues that may arise when dealing with e-discovery, document management and discovery.

II. E-DISCOVERY

In the most colloquial of terms, e-discovery, is discovery in which information is sought in an electronic format. This data is typically called electronically stored information ("ESI"). This could include emails, voicemails, audio, digital data, video, social media posts, and so on. According to the American Records Management Association, more than 90% of records created nowadays are in electronic form.[1] Below are some rising trends and potential complications concerning e-discovery.

A. PRESERVATION OF ESI

i. Duty to Preserve

There is no general duty to preserve evidence before litigation is filed, threatened, or reasonably foreseeable, unless the duty is voluntarily assumed or imposed by a statute, regulation, contract, or another special circumstance.[2] But courts generally require that a party begin preservation efforts once it knows or should know that the evidence is likely to be

[1] "The Digital Universe in 2020: Big Data, Bigger Digital Shadows, and Biggest Growth in the Far East," IDC, December 2012.

[2] *Victor Stanley, Inc. v. Creative Pipe Inc.*, 269 F.R.D. 497, 521 (D. Md. 2010).

relevant to pending or future litigation.[3] Although a party's duty to preserve may often be triggered before litigation, courts have emphasized that the mere possibility of litigation cannot by itself trigger the duty because "[t]he undeniable reality is that litigation 'is an ever-present possibility' in our society."[4]

ii. When to Preserve

Case law has recognized certain "triggering events" which notify the parties to preserve evidence in various contexts. In *Asher Assocs., LLC v. Baker Hughes Oilfield Operations, Inc.*, the court found that a letter from plaintiff's counsel that stated that the plaintiff had been "significantly damaged" was enough to alert the recipient that litigation may be forthcoming, so preservation should begin.[5] The court emphasized the content of the letter, listing certain elements as necessary to alert the defendant. The letter provided the defendant with the following: 1) an "interim damage calculation;" 2) a claim that "damages continue to accrue;" 3) a demand for immediate payment, including a 5-day deadline; and 6) the letter identified specific claims that the plaintiff "would assert if it initiated 'such legal or other action to enforce its rights."[6] The court concluded that these elements were sufficient to trigger a duty to preserve because the defendant "should have understood that future litigation was reasonably foreseeable and substantially 'more than a possibility.'"[7] Or in *MeccaTech, Inc. v. Kiser*, the court found that the duty to preserve evidence was triggered when the defendants jointly retained counsel and requested a legal opinion on their potential exposure.[8] In short, when the duty to preserve is triggered seems to depend on the facts and circumstances of the particular case.

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[3] See, e.g., *Consol. Edison Co. of N.Y., Inc. v. United States*, 90 Fed. Cl. 228, 256–57 (2009) ("The duty to preserve material evidence arises not only during litigation but also extends to that period before the litigation when a party reasonably should know that the evidence may be relevant to anticipated litigation." (quoting *Dong Ah Tire & Rubber Co. v. Glasforms, Inc.*, No. 06-3359, 2008 WL 4298331, at *3 (N.D. Cal. Sept. 19, 2008))).

[4] *Cache La Poudre Feeds, LLC v. Land O'Lakes, Inc.*, 244 F.R.D. 614, 621 (D. Colo. 2007).

[5] No. 07-cv-01379-WYDCBS, 2009 WL 1328483, at *8 (D. Colo. May 12, 2009).

[6] *Id.*

[7] *Id.*

[8] No. 8:05CV570, 2008, at *8 (D. Neb. Apr. 2, 2008).

iii. Scope of Preservation

Once it is determined that the duty to preserve has begun, then the next issue is to determine the scope of the duty to preserve. "The scope of the duty to preserve is a broad one, commensurate with the breadth of discovery permissible under Federal Rule of Civil Procedure 26."[9] It "includes an obligation to identify, locate, and maintain, information that is relevant to specific, predictable, and identifiable litigation."[10] The duty applies only to relevant data, documents and things.[11]

Courts have summarized the scope of "relevant" documents as:

> [A]ny documents or tangible things (as defined by [Fed. R. Civ. P. 34(a))] made by individuals "likely to have discoverable information that the disclosing party may use to support its claims or defenses." The duty also includes documents prepared for those individuals, to the extent those documents can be readily identified (e.g., from the "to" field in e-mails). The duty also extends to information that is relevant to the claims or defenses of any party, or which is "relevant to the subject matter involved in the action." Thus, the duty to preserve extends to those employees likely to have relevant information—the "key players" in the case.[12]

iv. How to Preserve

With respect as to the format in which documents must be preserved, the *Zubulake IV* court noted that "[i]n recognition of the fact that there are many ways to manage electronic data, litigants are free to choose how this

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[9] *Danis v. USN Commc'ns, Inc.*, No. 98 C 7482, 2000 WL 1694325, at *32 (N.D. Ill. Oct. 23, 2000).

[10] THE SEDONA CONFERENCE, THE SEDONA CONFERENCE COMMENTARY ON LEGAL HOLDS: THE TRIGGER AND THE PROCESS 3 (public cmt. ed. Aug. 2007), available at http://www.thesedonaconference.org/content/miscFiles/Legal_holds.pdf).

[11] *Pension Comm. of Univ. of Montreal Pension Plan v. Banc of Am. Sec.*, 685 F. Supp. 2d 456, 464 (S.D.N.Y. 2010).

[12] *Goodman v. Praxair Servs., Inc.*, 632 F. Supp. 2d 494, 511-12 (D. Md. 2009); (quoting *Zubulake v. UBS Warburg, LLC* (*Zubulake IV*), (S.D.N.Y. 2003) IV, 220 F.R.D. at 217-18 (footnotes omitted));see also *Victor Stanley, Inc. v. Creative Pipe, Inc.*, No. MJG-06-2662, 2010 WL 3530097, at *23 (D. Md. Sept. 9, 2010) (quoting *Zubulake IV*, 220 F.R.D. at 217–18); *Crown Castle USA Inc. v. Fred A. Nudd Corp.*, No. 05-CV-6163T, 2010 WL 1286366, at *10 (W.D.N.Y. Mar. 31, 2010) (stating a similar holding) (quoting *Zubulake IV*, 220 F.R.D. at 217–18).

task [of retaining relevant documents (but not multiple identical copies)] is accomplished."[13] And there are differing opinions among the circuits if the electronic data needs to be stored in an "accessible format," it is probably a best practice to have the documents stored in a form which can be readily retrieved and viewed.[14] While not every circuit has taken this stance, the Second Circuit, has routinely found that conduct that hinders access to relevant information is sanctionable, even if it does not result in the loss or destruction of evidence.[15]

v. Additional Obligations

Another obligation courts impose on counsel is understanding a client's data storage and retrieval systems, since remaining ignorant to the workings of those systems and practices can result in unanticipated consequences for the client.[16] Not only is a complete understanding of a client's record and data storage system essential to satisfy Rule 26 disclosure obligations, it is critical to be able to respond to arguments

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[13] The court explained:

> For example, a litigant could choose to retain all then-existing backup tapes for the relevant personnel (if such tapes store data by individual or the contents can be identified in good faith and through reasonable effort), and to catalog any later-created documents in a separate electronic file. That, along with a mirror-image of the computer system taken at the time the duty to preserve attaches (to preserve documents in the state they existed at that time), creates a complete set of relevant documents. Presumably there are a multitude of other ways to achieve the same result.

Zubulake IV, 220 F.R.D. at 218

[14] *Quinby v. WestLB AG,* No. 07Civ-7406(WHP)(HBP), 2005 WL 3453908, at *8 n.10 (S.D.N.Y. Dec. 15, 2005) (the judge declined to sanction the defendant for not keeping his data in an accessible format.); *Best Buy Stores, L.P. v. Developers Diversified Realty Corp.*, DDR GLH, LLC, 247 F.R.D. 567, 570 (D. Minn. 2007) (the court concluded that the plaintiff did not have to maintain a database at a monthly cost of over $27,000, absent specific discovery requests or additional facts suggesting that the database was of particular relevance to the litigation, even though the plaintiff should have been on notice that some of the information in the database would be sought in discovery, explaining that "by downgrading the database, the plaintiff did not destroy the information it contained but rather removed it from a searchable format.");

[15] See *Residential Funding Corp. v. DeGeorge Financial Corp.*, 306 F.3d 99, 110 (2d Cir. 2002); see also *Treppel v. Biovail Corp.*, 233 F.R.D. 363, (S.D.N.Y. 2006).

[16] For example, failure to accurately represent these issues can result in courts allowing on-site inspections of computer systems or the imposition of sanctions. See, e.g., *Simon Property Group L.P. v. mySimon, Inc.*, 194 F.R.D. 639 (requiring inspection of hard drive after finding "some troubling discrepancies" in discovery responses); *Playboy Enters., Inc. v. Welles*, 60 F. Supp. 2d 1050 (S.D. Cal. 1999) (granting access where party testified that relevant emails had been deleted and could not be restored).

related to the burdens and costs associated with complying with discovery requests.[17]

An illustrative case of this concept is *GTFM, Inc. v. Wal-Mart Stores, Inc.*[18] There, plaintiffs sought electronic data regarding local sales. Without consulting a representative from the information technology group, defense counsel stated that the data was no longer available and producing it would be unduly burdensome because there was no centralized computer capacity to track it.[19] A year later, plaintiffs deposed a vice-president from the company's management information systems group who testified the sales data could be tracked for up to one year. That meant the information had been available at the time of plaintiffs' initial request. But because of the delay caused by counsel's misrepresentation, it was no longer available.

The *GTFM* court criticized defense counsel for failure to consult the appropriate personnel observing "whether or not defendant's counsel intentionally misled plaintiffs, counsel's inquiries about defendants' computer capacity were certainly deficient. . . . As a vice president in [defendant's management information systems] department, she was an obvious person with whom defendant's counsel should have reviewed the computer capabilities."[20] As a result, the court ordered an on-site inspection at the company's expense and required the company to pay over $100,000 toward plaintiffs' legal fees.[21]

vi. Failure to Preserve

A breach of the duty to preserve relevant evidence with a culpable state of mind gives rise to spoliation. Potential sanctions for spoliation include "from least harsh to most harsh—further discovery, cost-shifting,

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[17] Virginia Llewellyn, Planning with Clients for Effective Electronic Discovery, THE PRAC. LITIGATOR, 7, 10 (July 2003) ("The best electronic discovery response requires work well in advance of litigation.").
[18] No. 98 Civ. 7724, 2000 U.S. Dist. LEXIS 3804 (S.D.N.Y. Mar. 30, 2000).
[19] *Id.* at *5.
[20] *Id.* at *6.
[21] *Id.*

fines, special jury instructions, preclusion, and the entry of default judgment or dismissal."[22]

B. METADATA

ESI is distinct from paper information because of its intangible form, persistence, transience, and volume. Another key and noteworthy difference between ESI and paper documents is that metadata[23] typically accompanies ESI and can play a critical evidentiary role. Preserving metadata from electronic documents to prevent spoliation creates special e-discovery challenges.

Different file formats have different metadata and while some metadata is readily viewable, other metadata may be hidden or even encrypted, making it difficult to retrieve. There are three general categories of metadata: (1) Embedded Metadata, (2) System Metadata, and (3) Application Metadata. Embedded Metadata is data entered into a file that is not normally visible, such as formulas in an Excel spreadsheet.[24] This data may only be available in a file's original or native format, meaning it may not be included in the file if it is copied or converted to a different format such as a PDF. System Metadata refers to a computer's storage system and is used to identify where files are located on the hard drive as well as the file's name, size, and usage.[25] Application Metadata is data created by a specific application and is located within the file itself.[26] This type of metadata is generally the most useful because it can include information such as the author's name; the date and time it was created, edited and/or accessed; and whether any previous versions of the file exist.[27]

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[22] *Pension Comm.*, 685 F. Supp. 2d 456, 469 (S.D.N.Y. 2010).

[23] Metadata is defined as the information that describes and explains data. It provides context with details such as the source, type, owner, and relationship to other data sets. Metadata is the contextual information that helps you understand raw data. https://guides.lib.unc.edu/metadata/definition

[24] 126 Am. Jur. Proof of Facts 3d 281 (Originally published in 2012).

[25] *Id.*; Jeffrey L. Masor, Electronic Medical Records and E-Discovery: With New Technology Come New Challenges, 5 Hastings Sci. & Tech. L.J. 245, 252 (2013).

[26] *Id.*

[27] *Id.*

C. THE RISE OF ARTIFICIAL INTELLIGENCE

Using Artificial Intelligence ("AI") is no longer a "new" frontier. AI has been used in the review phase of e-discovery for approximately a decade. Yet AI's current integration has become more accessible. Modern AI uses data mining techniques that can not only drastically reduce the documents sent for review, but AI can also extract new keywords and search terms and even identify additional custodians who should be interviewed or placed on legal hold.

AI's deep learning algorithms can also observe human attorneys reviewing documents and learn the criteria that make a document relevant to a particular matter. Once the AI has reached a threshold of confidence in its ability to predict document relevance (or privilege), it can then automatically work to speed up human review by suggesting document codes or prioritizing documents for review—or it can simply apply those labels to the remaining sets of ESI. That said, a March 2023 survey of law firms conducted by the Thompson Reuters Institute stated that while a vast majority of law firms were aware of AI's capabilities, only 3% of those surveyed were using AI or had plans to use the technology.[28]

Another reason not to fear the takeover of robot lawyers just yet, is that the technology cannot write a legal document. In 2023, two lawyers exclusively used ChatGPT, a chatbox developed by OpenAI, to prepare a brief and it led to disastrous results.[29] In *Mata v. Avianca, Inc.*, the legal team asked ChatGPT to locate cases involving a similar fact pattern as their client. They then cited, without verifying the accuracy, the cases suggested by the chatbox. Unfortunately, the lawyers were unaware that ChatGPT could provide information that *seems* reasonable or plausible, but in reality, is not true at all. The lawyers have since been fined the maximum amount allowed under statute and are facing additional disciplinary action. Worse still, their client's legal action was also dismissed.

[28] https://www.thomsonreuters.com/en-us/posts/technology/chatgpt-generative-ai-law-firms-2023/

[29] *Mata v. Avianca, Inc.*, No. 22-cv-1461, (S.D. NY. June 22, 2023).

III. DOCUMENT MANAGEMENT

As the name suggests, document management involves the storage and handling of documents. The importance of storing and organizing data efficiently cannot be overstated, for the tiniest bit of detail improves administration, reduces legal costs, and reduces errors.

Document management should not be confused with document storage, which is merely the saving and ordering of documents within folders either stored locally or in a file server. Document management is a more comprehensive overview of how an organization stores, manages, and tracks its electronic documents.

There are many digital document management tools, but document management practices for legal often differ greatly compared to standards in other industries. As a result, dedicated legal document management software began to emerge in the 1990s to support law firms and in-house legal teams. Below are some potential issues that may arise concerning document management.

A. DATA BREACH

The biggest privacy and security threats come from cybersecurity attacks. Phishing scams, hacked email accounts, and ransomware attacks can seriously jeopardize stored documents. The best protection from these types of attacks is a technologically informed workplace. It is recommended for every person to undergo regular training to recognize scams and red flags. Other ways to reduce the potential data leaks may consist of regular maintenance such as performing regular backups. Other ways to minimize risk may be company specific, such as storing less data or only saving data that is relevant. This could be as simple as storing human resource information on a separate server than business records.

B. IMPROPER REDACTIONS

When you lose control of your documents, you risk violating attorney-client privilege or disclosing confidential information. One way this can happen is through insufficient redaction. The public has made hay with high-profile filings that were badly redacted. In 2011, Freedom to

Tinker produced a study evaluating the frequency of redaction failures in PACER that concluded there were thousands, and probably tens of thousands, of documents in PACER containing redaction failures.[30]

In 2019, attorneys for former Trump campaign chair Paul Manafort failed to properly redact pleadings they filed in federal court.[31] The redaction failures disclosed information to the public that was previously confidential or unknown. The actual pleadings filed by Manafort's lawyers were PDF documents that *appeared* to contain redactions because the documents contained blacked-out passages (i.e., rectangular black boxes). Even so, if someone was so inclined, it was possible to copy the PDF content and paste it into a Word document and all of the “hidden” text was visible. Fortunately, this issue is easily avoidable; all PDF software includes tools that permanently alter/redact a document.

C. BAD/OLD PLATFORMS

While the adage “move fast, break things” may provide guidance in some areas, it should not be strictly adhered to when sticking with software. If a software system is not meeting expectations or needs, it would be better to cut costs and invest in a solution. The upfront costs might seem like a barrier but the investment may lead to increased productivity or more security which could save money on the backend.

D. UNSEARCHABLE CONTENT

Documents may exist on servers that have a large amount of content that is completely unsearchable. This might come in the form of paper files, mail, or faxes that have not been digitized. But a huge proportion of dark content lives in PDFs that have never been indexed for full-text search. Unfindable content leads to a massive waste of time and effort. To address this issue, it is highly recommended to invest in an optical character recognition (“OCR”) tool, which will read through PDFs and other formats of files and create a fully searchable index.

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[30] T.B. Lee, *Studying the Frequency of Redaction Failures in PACER*, Freedom to Tinker (May 25, 2011), https://freedom-to-tinker.com/2011/05/25/studying-frequency-redaction-failures-pacer/.

[31] *United States v. Manafort*, 321 F. Supp. 3d 640 (E.D. Va. 2018).

E. MULTIPLE REPOSITORIES

While not technically a new or digital concept, proper organization such as having a singular document storage system can save time and money. Important documents and records may become scattered across several repositories. There could be paper files, files on a local server, documents stored on individual computers, emails in individual accounts, text messages, handwritten notes, etc. This may lead to lost files, missed deadlines, and a tremendous waste of time as you search for the information you need. An easy solution is to invest and commit to a central repository where all information can be found in an organized space.

IV. DISCOVERY ISSUES

While e-discovery follows many of the same rules as traditional discovery, it also raises new issues, such as preserving relevant ESI, preparing appropriate document requests and responses, and privilege concerns. Below are some specific discovery issues that may arise when dealing with ESI.

A. FEDERAL RULE OF CIVIL PROCEDURE 26(F)

Rule 26(f) specifically requires parties to meet early and confer about discovery, including ESI production and discovery issues.[32] At a Rule 26(f) conference, the parties should be prepared to address the form(s) in which ESI will be produced, the anticipated schedule for production and preservation responsibilities. Parties may also consider identifying data from sources that the parties believe could contain relevant information but under the proportionality factors should not be preserved.[33]

B. EMAILS

Sending emails has become so central and simple that email use has crept into areas that the technology cannot handle or manage. One problem

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[32] Fed. R. Civ. P. 26.

[33] Fed. R. Civ. P. 26 (b)(1) lists six factors that courts should weigh in making a proportionality ruling. They are: 1) Importance of the issues at stake in the action; 2) Amount in controversy; 3) Parties' relative access to relevant information; 4) Parties' resources; 5) Importance of the discovery in resolving the issues; and 6) Whether the burden or expense of the proposed discovery outweighs its likely benefit.

with email is that it "silos" key information into individual email accounts. Every email user can reply to a specific person, to forward other email chains or even alter the information in the previous email. Even if you try to carbon copy others into the conversation, one person could always reply only to the sender, which effectively shuts off the information into a silo. This leads to a disorganized and incomplete document record.

But even worse, email can introduce new threats to attorney-client privilege. This might come through lack of encryption, or through mistakes like the improper use of "reply all" or sending something to the wrong contact (bob@opposingcounsel.com instead of bob@client.com). One way to avoid or minimize this risk is to look for tools that allow communication without these pitfalls, like client portals or secure document sharing.

C. METADATA DISCOVERABILITY

Metadata is both discoverable and admissible, however whether it may be admitted into a particular case is subject to analysis case-by-case. The Federal Rules of Civil Procedure recognize the discoverability of metadata, as do many states, and parties to litigation can request that their opponent produce certain metadata.[34]

A party must demonstrate the relevancy and proportionality of their requests for metadata.[35] Metadata is generally relevant when the process by which a file was created is at issue in the case or if there are questions about a file's authenticity. When assessing proportionality, courts will determine whether the metadata is essential to the issues in the case and will consider the time and the costs associated with its production, which can be burdensome at times. So, even if a party's request for production of metadata is granted, the court may require the requesting party to cover the costs associated with such production.[36]

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[34] *See* Fed. R. Civ. P. 34(a).

[35] *See* Fed. R. Civ. P. 26(b)–(c).

[36] For example, in *Aguilar v. Immigr. and Customs Enf. Div. of U.S. Dep't of Homeland Sec.*, the court required supplemental production of certain non-email documents with metadata but ordered the moving party to bear the costs because the documents had previously been produced in a searchable format. 255 F.R.D. 350, 360–62 (S.D.N.Y. 2008)

The most common challenge that a party will encounter in the admissibility of metadata involves authentication (i.e., producing evidence that the data is what the party claims it to be).[37] In rare instances, metadata may be self-authenticating, meaning that no more evidence is required for it to be admitted.[38] But the most common ways to authenticate metadata include (a) presenting lay or expert witness testimony, (b) identifying unique characteristics of the metadata, or (c) producing evidence that the application or system output is known to be reliable, such as a time-stamp. Still, even when "date and time stamps are deemed authentic, [a party] may still elicit and present evidence regarding metadata reliability and accuracy."[39]

V. CONCLUSION

This paper outlines several issues that have arisen with the increased reliance on electronic documents. While the issues may be ever evolving, hopefully this paper will provide a framework to address current problems, mitigate potential missteps and prepare for future complications.

[37] Under Rule 901(a) of the Federal Rules of Evidence, "[t]o satisfy the requirement of authenticating or identifying an item of evidence, the proponent must produce evidence sufficient to support a finding that the item is what the proponent claims it is."

[38] See Fed. R. of Evid. 902(11). Rule 902(11) is based upon proof that the evidence has resulted from a regularly conducted business activity, such as recordkeeping. This is limited to situations where the metadata is offered to prove the existence of an electronic record, not its content. See *United States v. Hunt*, 534 F.Supp.3d 233, 254 (E.D.N.Y. 2021).

[39] *Tamares Las Vegas Properties, LLC v. Travelers Indem. Co.*, 586 F. Supp. 3d 1022, 1030(D. Nev. 2022).

PANEL 4

ADVANCED ALTERNATIVE DISPUTE RESOLUTION IDEAS FOR SURETIES

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PEARLMAN 2023

September 7-8, 2023

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OUTSIDE THE BOX: THE THINGS TO THINK ABOUT WHEN HANDLING A SURETY CASE IN LITIGATION

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Introduction

Most surety claims professionals are familiar with the common alternative dispute resolution (ADR) methods: mediation, and arbitration. These have been around for decades, resulting in certain standard practices becoming the norm. But sometimes the standard practices aren't sufficient for a complex surety and construction case. Reaching resolution requires going beyond the standard practice and using ADR tools different and creative ways. In this paper, the authors, all neutrals at JAMS, describe three ways that common ADR techniques can be used to resolve surety and construction cases. These techniques can be combined or used sequentially to help parties settle more efficiently and cost effectively.

I. MIXED-MODE ARBITRATION AND MEDIATION

By Barbara A. Reeves

Construction arbitration involving sureties continues to grow, a testament to its advantages over litigation: knowledgeable decision-makers, flexibility to structure the process, speed, and efficiency. As larger and more complex disputes are submitted to arbitration, the concern is that arbitration is losing some of these advantages. This article describes how counsel can structure their arbitration to incorporate the full range of dispute resolution processes using the same neutral as arbitrator, mediator, and evaluator throughout. The focus is on measures the surety can take to control its costs, to use mixed-mode dispute resolution effectively to resolve disputes and to minimize the risk of an adverse decision.

Thirty years ago, a seminal article explored matching the dispute to a settlement process (the forum) by noting that it can be looked at from two

ends: the fuss and the forum.[1] The thesis of that article is that rather than fitting/structuring the dispute into a particular forum, the focus should be on analyzing the dispute and designing or selecting an appropriate process: "fitting the forum to the fuss."

Since then, there has been a great deal of academic literature developing that idea, and exploring not only the various processes, but also mixing modes, arbitration and mediation, in the same case. [2] This article provides a practical analysis of how to use a mixture of mediation and arbitration in the same case with the same neutral, combining settlement-focused mediation and arbitrator adjudication, where the parties agree that a mediator can shift to the role of arbitrator or an arbitrator can shift to the role of mediator. Just as drivers on a highway shift from lane to lane and backpackers adjust their wardrobe as the day progresses, disputants can move from arbitration to mediation, and back again, as circumstances warrant.

Known as arb-med, or arb-med-arb, and med-arb, these multi-mode processes have resulted, in my experience, in a very high rate of settlement. This article explains why to do it, how to do it, when to do it and how to manage and avoid the risks in having the same neutral serve as arbitrator and mediator.

Historically, judges in common law countries viewed their role as decision-makers, leaving it to the lawyers to question witnesses and present evidence. Civil law judges, on the other hand, were expected to take a more inquisitorial role and question witnesses and assist the parties in reaching resolution. Not surprisingly, arbitrators followed these models in their respective jurisdictions.

In China, for example, arbitrators are expected to facilitate settlement discussions if the parties consent. In Germany and Switzerland,

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[1] Frank E.A. Sander & Stephen B. Goldberg, Fitting the Forum to the Fuss: A User-Friendly Guide to Selecting an ADR Procedure, 10 Negotiation J. 49 (1994).

[2] *See*, Thomas Stipanowich, Arbitration, Mediation and Mixed Modes: Seeking Workable Solutions and Common Ground on Med-Arb, Arb-Med and Settlement-Oriented Activities by Arbitrators, 26 Harv. Negotiation Law Review 265 (2021), for a thorough review of the literature in the field.

it is appropriate for arbitrators to provide the parties with an indication of their preliminary views on the issues in the case. In the United States, while parties often use mixed-mode dispute resolution, first mediating with a mediator, then arbitrating with a different neutral if the mediation did not resolve the matter, arbitrators were traditionally expected to stay in their lane as decision-makers and not engage directly in settlement discussions or mediation with the parties to their arbitration.

With the increase of international commercial arbitration in recent decades as the world became flatter, these models have clashed, and much has been written about how to harmonize the common law and civil law approaches to arbitration.

In 2001, the International Institute for Conflict Prevention & Resolution (CPR) issued its Final Report of the CPR Institute for Dispute Resolution Commission on the Future of Arbitration and stated that the commission generally discouraged parties from entering into med-arb and arbitrators from engaging in settlement discussions, but it recognized that with the informed written consent of the parties, in some cases it may be appropriate.

In 2009, on the other side of the Atlantic, the Centre for Effective Dispute Resolution (CEDR) Commission on Settlement in International Arbitration issued arbitration rules and guidelines, the CEDR Rules for the Facilitation of Settlement in International Arbitration, to encourage and improve the promotion of settlement by international arbitral tribunals, recognizing that parties generally want their cases solved cost-effectively and efficiently, and negotiating settlement may accomplish that result. The commission concluded that unless otherwise agreed by the parties, the arbitral tribunal should take steps to help the parties achieve a negotiated settlement of all or part of their dispute. These rules give arbitrators the discretion to indicate to the parties the key issues identified in the case and what evidence may be required for each party to prevail on the key issues, to provide parties with preliminary findings of fact and conclusions of law, and to hold settlement conferences with the parties' consent.

However, both the CPR and the CEDR commission discourage arbitrators from having private caucuses in mediation when conducting arb-med or arb-med-arb, out of concern that such *ex parte* caucuses with the parties would make their awards susceptible to challenge and vacatur.

Fast forward to 2018 and the promulgation of The Rules on the Efficient Conduct of Proceedings in International Arbitration (Prague Rules), guidelines "intended to provide a framework and/or guidance for arbitral tribunals and parties on how to increase the efficiency of arbitration by encouraging a more active role for arbitral tribunals in managing proceedings." Some viewed these rules as a pushback against the U.S. style of arbitration, encouraging a proactive role for arbitrators in hearings, indicating to the parties their preliminary views on the case, and helping reach "an amicable settlement of the dispute at any stage of the arbitration," including by acting as a mediator with the parties' consent.

Meanwhile, over the past decade, some experienced neutrals in the United States have at times played dual roles in med-arb, arb-med, or arb-med-arb.

With this background, let's examine how to use these approaches to accomplish the goal set forth at the beginning of this article: to resolve arbitrations efficiently, guided by what the parties want, and the intricacies of the case require. In my experience, med-arb, arb-med, and arb-med-arb have served as efficient processes for achieving this goal.

A. Where to Start

Arb-med and arb-med-arb: You're in an arbitration, but you think now is a good time to mediate. Should you ask your arbitrator to shift to the role of mediator or otherwise directly engage with the parties with respect to settlement? And, if you don't reach settlement (at this time), are you prepared to return to the arbitration with your former arbitrator, who also served as your mediator? This is **arb-med** and **arb-med-arb**, dispute resolution processes in which the parties agree that the arbitrator takes on the role of mediator during the arbitration process. If mediation resolves the dispute, the settlement agreement may be converted into a consent arbitration award. If, on the other hand, mediation does not succeed in fully

resolving the dispute, the arbitrator-turned-mediator will return to being an arbitrator, and the arbitration will continue.

Med-arb: You're in a mediation but not reaching settlement after a long day or two. Would it be useful if the mediator switched to the role of arbitrator and gave a ruling on the entire case or at least some of the issues? This is **med-arb**, a dispute resolution process in which the parties agree that the mediator first attempts to mediate the dispute and, if mediation does not succeed in fully resolving the dispute, then switches to the role of arbitrator.

B. When and How

Arb-med and arb-med-arb: An arbitrator who is also an experienced mediator and who has experience in the mixed-mode arb-med process may raise the opportunity to mediate during the preliminary arbitration conference between counsel and the neutral. Or it may arise during arbitration proceedings, or at the end of testimony, or even after the arbitrator has written an award but before it is issued. Whenever it happens, it is likely the result of the parties concluding that a negotiated resolution via mediation by the arbitrator, who is already familiar with the case, is more beneficial in terms of cost savings and familiarity with the case than reaching out to another mediator.

At this point, we need a med-arb or an arb-med-arb agreement (JAMS case managers can provide one) that describes the process and confirms the parties' understanding that the neutral will be functioning in both roles. The neutral will be in caucus with each party and may learn confidential information, which one party may not authorize the mediator to share with the other. The parties will agree that the mediator may have these confidential caucuses with each party—an important step in learning each party's position to advance the mediation—and that they waive their right to object to *ex parte* communications. And if the matter returns to arbitration, they agree not to move to vacate any arbitral award or later disqualify the neutral solely on the ground that the arbitrator also served as a mediator. This enables the neutral to conduct a mediation using caucuses with each party—a highly effective part of mediation—and still be able to

return to the role of arbitrator if the mediation fails to resolve the entire case.

Med-arb: The opportunity for combining mediation with arbitration may arise during the pre-mediation calls with the mediator when one party or the other identifies an issue that is an obstacle to settlement but on which they would like a ruling by having the mediator hear some evidence and decide. More often, it arises during a mediation day when the mediator and the parties recognize that the matter simply won't settle until there is a ruling on an issue. Sometimes this is an issue that the parties have already submitted or intend to submit to the court in a motion. If the court is backlogged and the motion is not likely to be heard for quite a while, the parties may consider asking the mediator to switch hats to become an arbitrator, issue an enforceable order on the issue and then return to mediation.

Assuming the parties agree, they will need to sign a med-arb agreement, similar in purpose and scope to the arb-med-arb agreement discussed above.

C. WHY

Now that you know how to combine mediation with arbitration in the same case with the same neutral, why would you do it?

Having a single neutral serve in both roles—i.e., having an arbitrator engage in settlement discussions—avoids having to educate two separate neutrals, with resulting savings of time and cost. It may lead to a more creative business solution than could be ordered in an arbitration, and it may be appropriate given the parties' ongoing business relationship. There may be circumstances, for example, in an arbitration in which the parties wish to get a final resolution immediately, whether for financial reasons or because of a business situation that needs resolution. In those cases, having their arbitrator transition to a mediator role, or vice versa, may be the simplest and best solution and one that can be accomplished with one conference call. This is especially the case when an arbitrator has heard evidence or is otherwise well acquainted with the issues in dispute through prior motions, and may be able to shift to a mediator role immediately.

Likewise, if the parties have been engaged in mediating, and the parties have a rapport with and trust in the mediator, the mediator may be an ideal candidate to adjudicate the dispute if the parties cannot reach a negotiated settlement.

In this neutral's experience, there is another, even more important consideration: When one person is wearing both hats, counsel and the parties are inclined to listen to and take more seriously the mediator's efforts and evaluations. At least one study supports the notion that a settlement is more likely to be achieved if the same neutral serves as both the mediator and the arbitrator in the med-arb process.[3] That makes sense: When the mediator looks the lawyer in the eye and discusses a potentially weak point in the case, a typical response from an aggressive counsel in the usual mediation is to brush it aside. Usually, it is something that counsel in fact recognizes as a problem but has determined to try to push past the mediator, arguing that the arbitrator will not focus on that point or won't agree that it is an issue, even though counsel knows it is a weak point. This is a form of "spinning" the mediator, which may or may not work, but does interfere with reaching a settlement. When the mediator is also the arbitrator, one cannot so easily spin the mediator by arguing that the arbitrator will see things differently. Truth telling in mediation increases when counsel know that misrepresentations to the mediator will come back to haunt them if the case proceeds to arbitration in front of the same neutral.

What about the concern that the mediator may learn information in *ex parte* caucuses that would affect the arbitration process, should the parties return to arbitration? How can a mediator-turned-arbitrator purge his or her mind from what was heard in caucus? And how can the other side respond to confidential communications to which it was not privy?

In none of the cases that I have handled in an arb-med setting did the parties share any relevant facts during the mediation related to the merits that they were not willing to share with the other party.[4] In general, if the

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[3] Neil B. McGillicuddy, et al., Third-Party Intervention: A Field Experiment Comparing Three Different Models, 53 J. PERS. SOC. PSYCHOL. 104 (1987).

[4] In one mediation, a client principal disclosed that he was having an affair with the spouse of a principal of the other party. This interesting information, not disclosed to the other party, was

facts are relevant, they are either already known by the other party or will be by the time of the arbitration. If they are irrelevant, the neutral knows how to disregard irrelevant facts, unlike a concern that one might have when a witness blurts out something irrelevant in front of a jury.

Parties usually share with the mediator all the relevant facts, hoping to convince the mediator of the soundness of their position, and usually ask the mediator to make sure the other party understands the significance of all those facts. There are, of course, a few occasions when a party may choose to withhold facts or a legal argument in the belief that it is more advantageous to spring those facts or that argument at the hearing. But hiding facts or legal arguments at mediation is not a recommended approach if one truly wishes to settle at the mediation. Thus, it has not generally been the case that material facts or legal arguments were discussed with the mediator without the party agreeing that they may be shared with the other party. Counsel usually recognize the importance of presenting their best facts and legal theories to the other party at mediation to persuade that party.

What *is* shared in mediation that does not come out at arbitration are the parties' interests in settlement that are unrelated to the merits or their belief in the strength of their case but that have to do with their risk tolerance and their desire to control the resolution and to avoid the cost, time and expense of further arbitration. There are myriad other interests that may be discussed, such as a party's need for money and a quick settlement, or a party's financial distress and inability to pay, or a party's ongoing business situation, such as a merger or the need to raise investor funding, which may be hampered by continuing with the dispute. These are all of value in resolving the case but may not be relevant to the merits of the case and the decision to be made by the arbitrator after the hearing.

D. THE CONSENT AWARD

Once a settlement in an arbitration-turned-mediation has been reached, it may be documented as a settlement agreement, as in any other

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totally irrelevant to the merits of the arbitration but rendered the need for settlement more urgent so that the parties could conclude their business dealings before things became messier.

mediation. However, having a pending arbitration also provides the option to convert the settlement into an award, in the form of a consent award, should the parties need a formal award for some purpose.[5] This is a useful tool if an award might be needed for settlement enforcement purposes later or as evidence in another proceeding.

Med-arb, arb-med and active involvement by arbitrators in settlement discussions are not process options that have been widely embraced by parties, counsel, or dispute resolution professionals in the U.S. Given the size and complexity of construction and surety arbitrations, however, it is time to search for more efficient and effective ways of handling arbitrations. I hope this article has provided useful guidance to attorneys and their clients to experiment with what works and what doesn't as we develop new procedures for dispute resolution.

II. NEUTRAL EVALUATION: THE MOST UNDERUTILIZED ADR TOOL

By Andrew D. Ness

While mediation is not a panacea, it is a powerful and effective tool for settling various disputes involving sureties cost-effectively. But, of course, not all mediations result in a settlement.

Analyzing why mediations fail is tricky business - every dispute and set of parties is different, and different parties have different motivations. While the motivations on the surety side fall within a narrow range, the motivation of the claimants vary much more widely. Business considerations having nothing to do with the project at hand can be an overriding factor. The personality of the decisionmaker can either greatly aid resolution or be a substantial hindrance.

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[5] JAMS Comprehensive Arbitration Rules, Rule 28 (Settlement and Consent Award) provides: "(b) The Parties may agree to seek the assistance of the Arbitrator in reaching settlement. By their written agreement to submit the matter to the Arbitrator for settlement assistance, the Parties will be deemed to have agreed that the assistance of the Arbitrator in such settlement efforts will not disqualify the Arbitrator from continuing to serve as Arbitrator if settlement is not reached; nor shall such assistance be argued to a reviewing court as the basis for vacating or modifying an Award."

But one obstacle that prevents settlement stands out, is often encountered, and can be readily identified, at least by the mediator. This is the situation where both sides feel strongly and sincerely that they have a very strong case. This mutual, but opposite, high degree of confidence in the merits of their case keeps the parties from making the kind of concessions needed to get to a mutually acceptable settlement figure.

The inescapable reality, of course, is that they cannot both be right. For one reason or another, at least one of the parties (and often both parties to greater or lesser degree), has misread the actual strength of its case. This does not mean that the party (or its counsel or experts) are incompetent or lazy; there are lots of complex reasons why a case evaluation can be stray far from the mark. The mediation process of "reality testing," or asking probing questions about the merits to reveal weaknesses in the facts or law supporting each party's position, is expressly to help parties think through their case evaluation from a fresh perspective, and perhaps see flaws that had previously been overlooked or minimized. But sometimes parties are so entrenched that this process does not budge them much.

If the case then goes to trial or arbitration hearing, one side will be very disappointed, while the other will be proven to have been closer to the mark in its case evaluation. But which party is off the mark? The reaction of the parties after an unsuccessful mediation in this situation is generally like: "well, some cases just need to go to trial." And historically there have not been many ways to avoid doing just that.

Is there a better alternative besides proceeding to trial or an arbitration hearing in those cases ? A way to shortcut all that expense and time? Both trials and arbitration hearings generally result in a reasonable decision on the merits and assessment of the damages, but only after a very time-and-resource-intensive process. Is there an easier way to answer the basic question that precluded settlement: Which party is being overly optimistic about the strength of its case?

Neutral evaluation is just that tool and is starting to come into its own. It is a way to obtain the answer to that key question in a much faster and more cost-effective manner than a trial or hearing. A well-designed

neutral evaluation process will yield highly practical, realistic feedback respecting the relative strength of both sides' positions and arguments, at a small fraction of the cost of a trial or arbitration hearing. If the views of the neutral evaluator are clear and persuasive and are well grounded in the facts and law applicable to the dispute, then the chances are quite high that both sides will be substantially influenced by the evaluation. The path to settlement becomes much clearer and easier. Sometimes a resumed mediation is needed to close the deal, but many times the evaluation alone will be sufficient to enable the parties to reach an agreement.

Choosing neutral evaluation requires a basic tradeoff assessment—is the cost of the evaluation likely to be worthwhile in terms of how much it moves the needle in favor of settlement? Assessing how much it is likely to move the needle also involves forecasting how persuasive the evaluation is likely to be, and whether the opposing party is likely to be sufficiently influenced by a negative evaluation of its arguments and positions.

Answering the last question is inherently a subjective judgment—if the real obstacle to settlement is rooted in a critical business concern and not actually about the claimant's assessment of the merits (such as where a negative case result is likely to lead to bankruptcy of the firm), then it is not a situation where neutral evaluation is likely to be effective. The mediator can generally provide important insight on this issue, however. But situations where a solid neutral evaluation fails to move the party significantly are rare, unless there is an overriding outside factor (like looming bankruptcy) that is the real governing factor (something the mediator can usually smoke out during the mediation). The great majority of bond claimants are not so driven by emotion or other non-objective factors that they can just blithely discard an unfavorable neutral evaluation. It may not be determinative, but it will likely carry substantial weight.

When judging the likely cost vs. the likely quality and persuasiveness of the evaluation, these factors can be controlled by how the evaluation is designed and implemented, to maximize the bang for the buck in the circumstances of the dispute. Just how to accomplish this is the focus of the next two sections.

A. STRUCTURING A NEUTRAL EVALUATION

A hallmark of neutral evaluation is its almost unlimited flexibility—the process can be shaped to meet the needs of a very wide variety of construction disputes, from very simple to extremely complex, and from modest in size to very large claims. The three elements to maximizing its cost effectiveness (the bang for the buck), however, are selecting the right evaluator (discussed further in the next section), agreeing on an efficient process to get the relevant facts and positions before the evaluator, and then agreeing on what issues the desired evaluation will address and how detailed it will be.

In all but the most straightforward situations, these three elements should be addressed in an agreed document, often called an evaluation agreement, signed by all parties participating. Such agreements need not be lengthy—most are only a page or two long—but they establish the agreed mutual expectations for the process. They also help guide the evaluator in producing an evaluation that best meets the parties' needs. Allocation of the evaluator's fees and costs should also be addressed in this agreement, and are typically split equally among the participating parties.

The evaluation itself should be a written document, which can be as detailed or summary as the dispute requires. Putting the evaluation in writing serves several purposes. It reduces miscommunication as to the substance of the evaluation; it sets out in greater or lesser degree the logic behind the evaluator's views about the dispute, and it allows the substance of the evaluation to be communicated accurately to those who were not present to hear an oral evaluation (such as supervisors or upper management who must by consulted on or approve a settlement). Finally, it provides a written record to have in the file to help justify the decision to settle. Neutral evaluations are by their nature nonbinding, a point typically confirmed in the evaluation agreement. And in most cases the resulting evaluation is made expressly non-admissible in any subsequent proceeding. Typically, the evaluation is intended to be used for settlement purposes only.

For a dispute involving a smaller amount, an inexpensive neutral evaluation may be limited to submission of written summaries and key documentary exhibits to the evaluator. The resulting evaluation might be three to ten pages summarizing the evaluator's views on the key issues presented. The whole process in such instances, from agreeing to use a neutral evaluation to receiving the written evaluation, can often be completed in thirty days or less.

What is most important in using such a low-cost approach is that the evaluator be given enough information to evaluate the conflicting contentions in context, and not just as abstract issues of law or fact. A summary of the applicable law is not likely to be a useful neutral evaluation, nor is a simple recitation of the facts. Sufficient context is important to permit the evaluator to understand and address accurately the factual situation presented, and how the relevant contract provisions and legal principles are likely to be applied in that situation. But that does not mean the submissions have to be lengthy, or that the legal arguments need to be elaborate, or that the documentary exhibits need to be extensive. In fact, many times the submissions of the parties can be based on a previously prepared mediation position statement, with some additions and modification, and perhaps a few additional exhibits. In this situation, much of the work previously done in preparing for a mediation can be recycled, with little added cost.

A well-chosen evaluator, like a skilled mediator, will have sufficient experience with similar disputes so he or she does not need detailed explanations, and will focus quickly on the key facts and legal issues that are important to the outcome, taking guidance from the parties' submissions. If there are unanswered questions that the evaluator needs to ask, this should be accommodated.

Also, important to keep in mind is that many times there is one specific issue, or at most a handful of specific issues, at the heart of the dispute and at the root of the inability to reach settlement. If not known previously, these will have generally been identified in the mediation process. A neutral evaluation can easily be structured to be limited to those issues. The rationale is that with expert input on the most important issues,

the parties and counsel can sort out the rest themselves (or assisted by a mediator). This is another avenue for benefiting from neutral evaluation with minimum time and expense that works well in a range of situations. Be careful, however, not to circumscribe the information made available to the evaluator so closely that the evaluation is of limited value because it is not well grounded in the context of the contract and project history.

Adding a presentation element is often deemed to be a valuable part the process, although it is an additional expense. Each party has an agreed time to make a presentation to the evaluator regarding the dispute. The evaluator can ask questions of the parties, an important mechanism for assuring that the evaluator can clarify the parties' positions as well as the relevant background and context.

Typical ground rules for such presentations are the following:

1. Each party has the right to make its presentation without interruptions from other parties.
2. All participating parties may attend all presentations.
3. Each party can use its allotted time however it chooses. Some may choose to focus on presentations by counsel, while others will emphasize hearing directly from the individuals who would be the key witnesses in a trial or hearing setting. Experts may also be used as desired.
4. Presentation aids (like PowerPoint slides) are optional but often encouraged by the evaluator as an aid to recalling the key points.
5. The evaluator can ask questions at any time, but the time utilized for asking and responding to those questions does not count against the party's allotted presentation time.
6. Some limited opportunity for rebuttal presentations is allowed, either by reserving some of the allotted time of each party or by agreeing in advance to a designated amount of rebuttal time for each party.

In most cases, these presentations can be completed in something between a half day and a full day. They are not intended to be, nor do they need to be, an extended process. Additionally, in the age of Zoom, they are

often done virtually to avoid the need for travel, and the presentation format is well suited to a video meeting. In short, the added value of presentations is often well worth the marginal added cost, which amounts to another half or full day of video mediation.

For larger disputes, this basic structure—submission before written summaries of each party's positions and arguments, accompanied by a limited set of the most relevant documents, and followed by party presentations and opportunity for rebuttal—can be expanded and revised as appropriate, depending on the number and complexity of the issues and the amount in dispute.

A key goal in any neutral evaluation is that each participating party believes it has had a fair and equal opportunity to present its side of the issues. This is generally the governing consideration in deciding how elaborate a process is necessary. To assure a level playing field, instill a sense of procedural fairness, and for reasons of cost control, agreements on page limits for written submissions, the approach to including exhibits, and the dates for exchanging submissions, exhibits, and presentation slides are recommended. These details are often not included in the evaluation agreement but left to be worked out in an initial call with the evaluator, where his or her experience and preferences can be factored in as well.

The final element that is important to address in structuring a neutral evaluation is having a reasonable advance understanding of the general scope and detail expected in the written evaluation. There are several reasons for this – it helps set the expectations of the parties as to what they will receive from the evaluator, informs the evaluator as to the level of detail that the parties feel is appropriate, and is another factor in controlling the cost of the process. There is often some attempt, in a few words, to address this in the evaluation agreement (such as asking for "an assessment of the key issues [whether these are defined or left to the evaluator] with concise reasons for the evaluator's conclusions"), but this topic should be developed with the evaluator in the initial call to clarify the expectations of all concerned.

In the most complex and highest value disputes, it can be appropriate and still cost-effective to specify a more elaborate neutral evaluation process. That said, the cost of the neutral evaluation should be kept at a modest fraction, generally 5% to 15%, of what a full arbitration hearing would involve. Keeping this in mind sets a natural upper limit on how extensive a process might be appropriate. A nonbinding process such as a neutral evaluation should not be allowed to become so elaborate as to effectively be a "pre-arbitration" that potentially (if not successful) must still be followed by a full arbitration or court trial. That risks significantly magnifying the cost and time required to achieve a binding resolution, just the opposite of the intended result.

The following outlines the neutral evaluation process recently used in a complex, multiclaim, highly technical and high-value design and construction dispute. While appropriate for that dispute and those parties, it should be understood as an approximation of the upper end of the range in terms of a reasonable neutral evaluation process.

1. Each party submitted initial position statements a month before the date for presentations. Position statements stated the reasons and basis for all claims and defenses, and discussed contract, technical, and legal references the party relied upon. Exhibits included documents the party relied on in support of its positions. There were no page limits, and each party submitted one to two notebooks of exhibits.
2. Rebuttal position statements, with additional exhibits, were submitted fifteen days before the presentations.
3. Expert reports were submitted with the initial position statements, and rebuttal reports with the rebuttal submissions. Each party utilized multiple experts.
4. Presentations were scheduled for two days, with each side allowed six hours for its initial presentation and two hours for rebuttal (plus time for evaluator questions). This was later modified to give each side three and one-half hours for rebuttal, with rebuttals conducted on a third day.

5. Both parties were expressly required to have persons with full decision-making authority to settle the dispute present to hear the presentations.
6. Both parties chose to devote 85 to 90% of their presentation time to persons directly involved in the disputed issues and experts, and only 10 to 15% on presentations by counsel, generally limited to legal and contractual issues. Given the complexity of the issues and length of presentations, a court reporter generated a transcript of the presentations.
7. Both parties used PowerPoint slides extensively, which were exchanged before the presentations, and the evaluator was provided with a hard copy of the slides for reference during the presentations.
8. The evaluation agreement specifically required that the evaluation include "detailed findings of fact and conclusions of law on entitlement and quantum." So this resulted in a very exhaustive evaluation (considerably more than the norm for most evaluations).
9. A short period for requesting reconsideration was provided to address any mistakes, errors, misunderstandings, or miscommunications that might have found their way into the evaluation.

This was expensive, as should be clear from this description. But it resulted in a settlement, and avoided a court proceeding that likely would have required a three-to-five-week trial. It likely still amounted to no more than 10 to 15% of the cost of full discovery and going to trial. Moreover, had it been unsuccessful, both parties learned a great deal about the other side's case, including both what the key fact witnesses had to say and what the experts would opine. This would have both made discovery more efficient and reduced trial preparation time, offsetting a good fraction of the neutral evaluation's cost.

B. CHOOSING THE EVALUATOR

Probably the most important decision in formulating an effective neutral evaluation process is selecting an appropriate evaluator. The

evaluator should be selected by an agreement of the parties and should be an individual in whom the parties have confidence as to both ability and neutrality. The selection criteria are generally aligned with what would be appropriate in selecting a sole arbitrator. The value of the process as a settlement tool is closely tied to all parties having confidence that the evaluation has been impartial, fair, and well-reasoned, coming from an evaluator of integrity and sound judgment.

Since what is sought in a neutral evaluation is usually a prediction of what the parties should expect the outcome of a full trial or arbitration hearing to be, the evaluator should be well matched to the nature of the binding dispute resolution process that will occur. If that process is arbitration, then experience as an arbitrator should be a requisite, along with deep knowledge of construction disputes and the relevant legal and contractual principles.

If the dispute will be heard by a state or federal court judge or jury, familiarity with the relevant court system or jury pool is often a more important factor than deep construction law experience. The best evaluator for a dispute that would be heard by a jury in Cook County, Illinois, for example, might be an experienced Chicago trial lawyer or former judge.

Finally, decisiveness is a necessary quality for a neutral evaluator that is often overlooked. Having gone through the exercise, the parties deserve and presumably want an evaluation that pulls no punches and calls the issues clearly as the evaluator sees them. An evaluation styled as a "maybe this, maybe that" identification of the litigation risks of each party can be better and more quickly obtained from the mediator in a mediation setting. In a neutral evaluation, the parties are usually more interested in hearing in a clear and decisive manner just how the neutral evaluator assesses the parties' positions, for better or worse.

Requiring disclosures from the neutral evaluator of past engagements and connections to the parties and counsel is also appropriate before finalizing the evaluator selection. That said, as is the case with a mediator, past relationships need not be disqualifying, and can even be a positive. In one recent case, the neutral evaluator was acceptable to both

parties precisely because both parties had used him as a lawyer in prior, unrelated matters, and thus had great confidence in his perceptiveness, analytic abilities, and integrity.

C. CONCLUSION

No brief paper can fully do justice to the almost endless possibilities for productively utilizing neutral evaluation to break an apparent impasse precluding resolution of a construction and surety dispute. The usefulness of the technique is limited only by counsel's imagination and what can be agreed upon to advance the goal of reaching an agreed settlement. Presently this tool is underutilized, but given its utility and cost effectiveness, it is likely to be adopted more often as counsel and clients gain further experience and confidence with it.

III. BLURRED LINES: "MEDIATED CASE MANAGEMENT" IS NOT AN OXYMORON

By Leslie King O'Neal

If the parties can't settle the case at mediation, is that the end of the mediator's role? Conventional practice says yes, but impasse at mediation may not be "all she wrote" for the mediator. Alternative dispute resolution is not a one-way, one lane highway. There are alternatives within alternative dispute resolution methods. Combining mediation with litigation (or arbitration) through mediated case management can provide a quicker and more cost-effective outcome for sureties, while preserving their legal defenses and allowing case preparation to proceed concurrent with dispute resolution.

In the last thirty years, mediation has become a standard part of civil trial practice in most jurisdictions. Either the parties go to mediation voluntarily, or the court orders them to mediation. Whether the mediation is successful depends on multiple factors, including the parties' relationships, the cost of proceeding with litigation, the parties' financial situations, the information available regarding disputed issues, the applicable law, and the talent of the mediator. Frequently, party representatives claim they lack sufficient information to make an informed decision on settlement. The

result is that the mediation fails, and the parties proceed to spend months or years and thousands of dollars in attorney's fees for discovery to learn the crucial facts. What if there were a way for parties to obtain the information needed without going through full-blown discovery? This could lead to settlement while saving the parties considerable time and expense. Mediated case management is such a process.[6]

A. WHAT IS "MEDIATED CASE MANAGEMENT?"

"Mediated case management" is a blend of facilitated case resolution process with adjudicatory process.[7] It allows the parties to litigate (or arbitrate) their dispute in a cost-effective and organized manner. "The program features a facilitated, cooperative implementation of dual tracks toward resolution of the case - a reconciliation track that parallels, intersects, or merges with a concurrent adjudicatory track. In simple terms, Mediated Case Management involves mediating the conduct of the litigation to expand and include reconciliation processes."[8] This process allows the parties to control the litigation process (and related costs) and to work toward settlement, while continuing to prepare for a trial or a final hearing.

B. STARTING THE MEDIATED CASE MANAGEMENT PROCESS.

The mediated case management process begins with the parties entering into a case management agreement stating they will conduct the litigation and prepare for trial in a cost effective, timely and efficient manner. The parties and counsel meet with a mediator shortly after the complaint or arbitration demand is filed. The mediator (and perhaps a co-

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[6] "Mediated Case Management" is akin to, but different from, "Guided Choice Mediation." Guided Choice is a mediation process in which a mediator is appointed to initially focus on process issues to help the parties identify and address proactively potential impediments to settlement." The mediator works with the parties to facilitate a discussion on procedural and potential impasse issues and helps them analyze the causes of the dispute and determine their information needs for settlement. Lurie and Lack, *Guided Choice Dispute Resolution Processes: Reducing the Time and Expense to Settlement*, 8 DISPUTE RES. INT'L 167, 168 (October 2014). The difference between "Mediated Case Management" and "Guided Choice" is that "Mediated Case Management" uses a dual track of case preparation and reconciliation, while "Guided Choice" focuses on settlement.

[7] Watson, *The Case for Mediated Case Management*, 1 AM. J. MEDIATION 1 (2007) (https://heinonline.org/HOL/LandingPage?handle=hein.journals/amjm1&div=5&id=&page=)

[8] *Id.*

mediator for backup) is engaged. The parties, with the mediator's assistance, negotiate an agreement regarding how the litigation or arbitration will be conducted, creating the dual tracks for trial preparation and potential reconciliation. The stated intent is to conduct the litigation cost-effectively, avoiding unproductive procedural or process disputes. At the same time, the parties and counsel agree to develop opportunities for settlement of issues.

Lead and alternate counsel and party representatives are selected. Counsel and the party representatives agree to attend periodic case management meetings, where they will discuss, negotiate, and agree on how discovery and other matters will be handled. The parties commit to use best efforts to litigate the case in a way to minimize time and expense. The agreement allows the mediator to work with the parties and the judge or arbitrator to facilitate processes and procedures to focus on creating opportunities to settle some or all the substantive disputes in the case before final hearing. The mediator organizes and conducts the case management meetings and, as appropriate, having meetings with parties and counsel to discuss settlement opportunities and structuring ADR processes. With the parties' permission, the mediator may act as a spokesperson to the court or the arbitrator regarding requests for support, such as interim rulings on issues or suggestions for the litigation. The parties share the mediator's expenses equally.

C. CONFIDENTIALITY

All concessions, admissions, representations, communications, and discussions arising out of the Mediated Case Management Program are confidential and inadmissible under the "umbrella of mediation," except written case management commitments submitted to the tribunal as stipulations and discovery provided under oath. Agreements reached during case management meetings regarding discovery or other matters are filed with the court as supplementary case management orders.

D. WITHDRAWAL

Any party may withdraw from the program upon ten days' written notice to all parties. However, all stipulations related to case management

orders remain in effect after a party's withdrawal, as does all sworn discovery.

E. HOW DOES "MEDIATED CASE MANAGEMENT" WORK?

After committing to the process, the parties agree on a "working statement" of key issues of fact, which becomes the basis for a mutually agreeable discovery or joint investigative program to obtain facts needed to resolve the fundamental issues. Discovery is done cooperatively through voluntary document exchanges, focused depositions and possible joint interviews or site visits.

i. Discovery

A Stipulated Case Management discovery program might typically call for some or all of the following:

1. A voluntary exchange of documents.
2. A defined "rifle shot' deposition program using "Rule 30(b)(6)" format depositions in which the parties identify and present for examination corporate representatives having the most knowledge about the relevant subject. The purpose is to share information – not to search for information randomly, practice cross-examination, impeach or test interrogation skills.
3. A joint interview session, site visit, or product inspection.
4. A voluntary exchange of summary expert reports.

The goal is that all discovery will aid in an eventual trial or final hearing and will focus on the primary facts in dispute. In some cases, the parties may agree on a single neutral expert to perform certain functions, such as auditing financial information. Where there are specific factual questions, such as whether rebar was installed or whether the windows met the specifications, a joint investigation conducted by a mutually agreed neutral expert can establish the facts quickly and efficiently.

The mediator will meet with the parties to resolve any discovery disputes that arise.[9] Mediation of discovery disputes is another area of ADR that is underutilized because it is not widely known. This is unfortunate. "For many reasons, using ADR during discovery just makes sense. First, ADR should be considered as a tool for resolving discovery disputes because of its proven effectiveness in resolving cases. Second, parties are familiar and comfortable with the ADR process, because of its virtual ubiquity in civil litigation. Third, mediating early in the litigation makes ultimate settlement more likely. [citations omitted]."

If the discovery dispute cannot be resolved through mediation, it will be submitted to the judge or to the arbitrator for decision. All discovery materials generated should be stipulated to be admissible in a later proceeding. Further, if the matter is not resolved, parties reserve their rights to take more comprehensive depositions of the corporate representatives and to request additional documents.

ii. Resolving legal issues

The parties create an agreed statement of key legal issues and define a mutually agreeable method to resolve those preliminary matters. This process focuses on which legal issues must be resolved before the substantive issues of the case can be settled. The goal is to have the case ready for trial or for settlement sooner rather than later. Collateral issues are set aside and preserved for later resolution, if necessary.

> A range of options is available to develop and resolve these issue-oriented programs. If key facts are unconfirmed, joint discovery or investigative programs may be defined and implemented to develop that information. Using the mediator as spokesperson with the Court, a prompt hearing might be set to get a final and binding judicial determination on any the key preliminary issues. A Special Master might be utilized as alternative to waiting for judicial attention if that becomes a problem. Another tact might be to simply get evaluative input

[9] Riedy and Greenwald, *Mediating Discovery Disputes: When "Meet and Confer" Alone Is Not Enough*, 17 CARDOZO J. OF CONFLICT RES. 307, 308 (2016).

> in a non-binding adjudicatory process, by staging an abbreviated hearing before a mutually respected authority to receive an advisory opinion on the issue.[10]

Obtaining a neutral evaluation[11] on specific legal issues may be particularly attractive to sureties, who often have technical legal defenses based on the bond language or case law. The parties present their positions on select issues and the neutral then provides non-binding advisory input that gives insight into a probable outcome in court or arbitration. With that information, negotiations continue. Even a non-binding opinion from a respected neutral on issues such as timely notice, overpayment or running of the statute of limitations may be sufficient to move a case toward settlement.

None of these concepts is cast in stone, since one of the major benefits of the program is its flexibility. Counsel, the parties, and the mediator can customize a plan suited to the specific case.

F. GOING BACK TO MEDIATION

Based on what has been discovered or developed on the stipulated issues, follow-up mediations can be developed. In construction cases, these "mini-mediations" most often relate to a sub-set of trade issues involving lower tier subcontractors or vendors. Scheduling such mini-mediations requires careful thought and planning at the beginning of the case management process. This will depend on various factors, which will differ in each case. Some considerations are: (1) the dollar size of the claims; (2) the relative difficulty in settling the claims and (3) construction sequence issues (*e.g., foundation* pour problems cannot be resolved before the soil condition issues).

Mini-mediation sessions could also be used to define and price necessary repairs without regard to liability. Expert presentations could be used to reach agreement on the cost of an appropriate fix for a particular problem. In addition, the parties could agree on what the contract plans and

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[10] Watson, *supra*, note 2 at 11.
[11] Neutral evaluations are discussed in more detail in section II of this paper.

specifications required and what constitutes a betterment to the project. These decisions are put on a conditional "hold" until liability issues are negotiated and resolved in other parts of the case. Knowing the cost of repair sometimes makes decisions on accepting partial or complete liability easier.

G. CHALLENGES AND BENEFITS OF MEDIATED CASE MANAGEMENT

Using mediated case management in litigation presents some challenges. It requires greater cooperation among counsel than is often present in highly contested litigation. It requires mediators to have case management skills together with dispute resolution skills. Finally, it requires the court or arbitrator to take a different approach to mediation than is typical. However, these challenges can be overcome. Sophisticated clients understand that most cases settle eventually. Therefore, they should be receptive to an approach that paves the way for settlement without preventing trial preparation from proceeding. Most judges and arbitrators applaud efforts to manage cases efficiently, especially with an eye toward settlement. Many mediators, especially those who are also arbitrators, have the case management skills needed for this approach. Sophisticated and experienced counsel recognize that "scorched earth" and "Rambo" type litigation is costly and often not beneficial to the client's interests. They understand that cooperation does not mean capitulation.

There are many benefits to mediated case management, including: (1) it is proactive and allows clients to be involved in the case. (2) it does not increase (and may significantly decrease) litigation costs. Nothing is done that would not have been done to prepare the case for trial. If the case does not settle, the parties are prepared for trial. (3) it helps maintain relationships despite litigation, which is important to many businesses. (4) even unsuccessful mediation has been shown to have a beneficial effect on ultimately resolving a case.[12] Using a process such as mediated case management can shape the case in many positive ways.

[12] It is generally acknowledged that even unsuccessful mediation of the dispute can have a significant, positive effect on shaping and ultimately resolving a case. "Even when mediation does not immediately produce a settlement it can give parties enhanced understanding and the confidence to simplify proceedings, paring legal theories or damage claims." David Burt, The

H. CONCLUSION

Mediated case management provides opportunities to manage litigation cost effectively and possibly to reach resolution of some or all issues without a trial. Even if the case goes to trial, after focused discovery through mediated case management, its presentation will likely be more streamlined. From the surety's perspective, this approach allows the claims attorney to obtain the necessary information to document the file more easily while maintaining the surety's legal defenses. Mediated case management is a tool that parties to complex surety and construction cases should consider using.

DuPont Company's Development of ADR Usage: From Theory to Practice, DISPUTE RESOL. MAG., Spring 2014, at 6.

PANEL 5

THE RISKS AND REWARDS FOR FINANCING THE PRINCIPAL

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PEARLMAN 2023

September 7-8, 2023

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THE RISKS AND REWARDS FOR FINANCING THE PRINCIPAL

By: Jonathan Bondy, Price Jones, Brian Kantar, and Jack Nicholson

I. <u>INTRODUCTION</u>

Other papers submitted in connection with this year's Pearlman program will discuss the surety's various options under the AIA A312 Performance Bond (the "Bond"). The surety's options under Section 5 the Bond[1] are well-known to those reading this paper:

> 5.1 Arrange for the Contractor, with the consent of the Owner, to perform and complete the Construction Contract;
>
> 5.2 Undertake to perform and complete the Construction Contract itself, through its agents or independent contractors;
>
> 5.3 Obtain bids or negotiated proposals from contractors acceptable to the Owner for a contract for performance and completion of the Construction Contract, arrange for a contract to be prepared for execution by the Owner and a contractor selected with the Owner's concurrence, to be secured with performance and payment bonds executed by a qualified surety equivalent to the bonds issued on the Construction Contract, and pay to the Owner the amount of damages as described in Section 7 in excess of the Balance of the Contract Price incurred by the Owner as a result of the Contractor Default; or

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[1] The surety's obligation to perform at all assumes that the conditions precedent to triggering the surety's liability under the Bond are met, and that the bond obligee is itself not in default under the Construction Contract. *See Archstone v. Tocci Bldg. Corp. of N.J., Inc.*, 990 N.Y.S.2d 44 (N.Y. App. Div. 2014) ("…[P]aragraph 3 of the subject AIA A312 performance bond contains express conditions precedent to the liability of the surety under the bond").

> 5.4 Waive its right to perform and complete, arrange for completion, or obtain a new contractor and with reasonable promptness under the circumstances:
>
> .1 After investigation, determine the amount for which it may be liable to the Owner and, as soon as practicable after the amount is determined, make payment to the Owner; or
>
> 2. Deny liability in whole or in part and notify the Owner, citing the reasons for denial.

This paper addresses an option that is only partially apparent from the face of the Bond – financing the principal. At first blush, a surety's decision to finance a principal should be construed as an election to perform under Section 5.1.[2] While, of course, a surety that completes a project with its principal is often financing its principal by funding the shortfall between the remaining contract balance and the cost of completion, this does not tell the entire story. Sometimes, sureties elect to "perform" under a bond and finance their principal even before a claim has been asserted.

This paper will evaluate the surety's considerations in deciding to finance, the mechanics of financing, as well as the risks and rewards of financing. There is no right or wrong approach here. The decision to finance is highly fact sensitive. And even when two sureties are faced with an identical set of facts, business considerations, and a given surety's approach to financing generally, may dictate whether financing is advisable. To be clear, a surety is *never* under an obligation to finance. The applicable indemnity agreement usually makes clear that a surety does not owe its principal or indemnitors any obligation to act in a particular manner. The contrary is also true – the indemnity agreement

[2] Some courts have held that a surety has a right to complete with its principal, without the obligee's consent, pursuant to Section 5.2 of the Bond. *See, e.g., Seawatch at Marathon Condo. Ass'n, Inc. v. The Guar. Co. of N. Am., USA,* 286 So.3d 823, 827-828 (Fla. Dist. Ct. App. 2019); *Lexon Ins. Co. v. Borough of Union Beach*, 2023 WL 3727791, *6 (D.N.J. May 30, 2023). Accordingly, an argument can be made that a surety also has a right to "finance" under Section 5.2 of the Bond.

gives the surety the right to make business decisions in the surety's sole (and often absolute) discretion, and in the surety's self-interest. Similarly, bond forms rarely (if ever) require a surety to finance its principal.

II. WHY IS FINANCING SO REVILED?

Some sureties refer to financing as an "f" word. Many dismiss financing out of hand, and for good reason. They are being asked to consider additional financial exposure for a principal that has already demonstrated an inability to perform its contractual obligations. Why would a reasonable person simply throw money at a problem? But, the name of the game is loss mitigation. The surety has a bonded obligation to fulfill. The surety claims professional's charge to select the most cost-effective means to satisfy that bonded obligation.

A decision to finance can become a serious time and financial commitment. Financing often involves reviewing and approving numerous payment requests (sometimes, at the last minute), addressing unanticipated issues (usually right before the claims professional is scheduled to go on vacation), hiring, and paying for, consultants and outside counsel, and taking on risk that may increase over time despite a claims professional's best efforts to quantify that risk at the outset. In general terms, the surety becomes involved (though not responsible for) in its principal's day-to-day operations. If financing is so terrible, why do sureties ever agree to finance? Because, when a surety decides to finance, it has usually decided that financing will likely be a more cost-effective choice than are the surety's other options under the Bond.

A surety's agreement to finance is not a commitment – it's a decision. A surety can decide what it will finance and what it will not finance. A surety's decision to finance might range from funding only payroll and/or procuring materials to funding the principal's entire operation. And a surety can also change its mind about financing (and what the surety will or will not finance) at any time.

Financing can present the surety with very difficult choices. Depending on the nature of the principal's financial posture, deciding to

finance a principal might require funding the principal's home office and overhead costs. These costs do not always advance the completion of the bonded contract(s), but they can be a necessary predicate to ensuring the viability of the principal so that the principal can complete the project. For instance, principals do not generally procure their insurance coverage on a project-by-project basis. Instead, the principal procures insurance for the entirety of its operations. If a surety decides to pay for its principal to maintain insurance that is a requirement of the bonded contract, the surety's financing may also inure to the benefit of the principal's unbonded projects or those bonded by other sureties (and those other sureties may not be willing to share in such "shared" costs).

Again, there is no right decision or playbook. A surety's decision to finance, including those in which a surety's financing inures to the benefit of unbonded work (or work bonded by other sureties) is going to depend on what makes sense to the financing surety under the given circumstances. A surety might agree to pay the insurance premium if doing so otherwise means savings hundreds of thousands of dollars.

III. THE INVESTIGATION PRIOR TO FINANCING

A decision to finance is generally preceded by either a notice of claim under the Bond or notice that the principal is struggling financially and requires financial assistance to complete its bonded work. Prior to considering financing, the surety will generally undertake an investigative process to determine the status of each potentially distressed project, as well as the principal's work program for projects not bonded by the potentially financing surety. This is not a commitment to act. It is simply a fact-finding exercise to determine the surety's options, which include the option to do nothing (which is sometimes the appropriate decision).

Perhaps, the principal is not underwater on every project, but only some. That said, the issues that give rise to a possible need to finance seem to spread like a contagion (an analogy to which we can all sadly relate). Maybe the principal is having issues because the obligees have been slow to pay. For example, public agencies in the City of New

York can be notoriously slow to approve and process progress payments and include draconian terms in their contracts that require continued performance even where payment is significantly delayed. Where the principal works almost exclusively for such an obligee (or a difficult general contractor), cash flow issues can snowball and have cascading effects on several projects, and perhaps all. Alternatively, the principal may be having cash flow issues because it underbid a number of projects. There are several reasons a principal may find itself in this unfortunate position.

There is no right way to obtain information. In large part, the approach will depend on how the surety's claims department is organized. Some sureties have extensive claims operations with in-house engineering, accounting and legal departments that can undertake such an investigation without outside assistance. Other sureties may not have these services within the claims department, in which case it may be necessary to retain the assistance of outside professionals. Either way, the key is to act quickly, and obtain as much information as possible. Ideally, the principal will reach out to the surety in the first instance and open its books and records (as is typically the surety's right under its indemnity agreement) for unfettered inspection. In a perfect world, the principal will also make its project management team and in-house and outside accountants available to the surety to review both the construction and financial status of open projects. Unfortunately, it does not always happen this way. Sometimes, having heard about the principal's potential financial issues, it is the surety that makes inquiry of its principal in the first instance. Although there can be reasons for a principal to delay in communicating with its surety (e.g., a sense of shame or guilt, fear of a collapse of the business, an overestimated ability to solve the issues without assistance, or simply being in a state of denial), it is ordinarily not a good sign where the principal is not proactively communicating with its surety.

Request Information & Meeting with Principal

The surety's communications with the principal and obligee should request information and documents relating to the status of the projects.

A surety almost always benefits from meeting with its principal in person. Besides obtaining the principal's view of the projects, an in-person meeting presents the surety with an opportunity to assess and identify the roles each person plays at the principal's organization and to determine whether working with the principal on a going-forward basis is a viable option. As a threshold matter, it is important to determine if the principal is even capable of completing some or all of the bonded projects. This involves an analysis of the principal's resources, finances, staff, and technical capabilities. Assuming the principal can complete the project, a surety should then determine whether the principal actually has the desire to do so. Some principals will provide as much assistance as is required in order to mitigate their indemnity obligations to the surety. Other principals may have different priorities. Most importantly, is the principal trustworthy? For example, if the principal has embezzled funds, it likely (but not always) makes no sense to finance the principal.

Where the surety is contemplating financing its principal, the in-person meeting may be an opportune time to begin working out the details and procedures that will be formalized in a subsequent financing agreement. If the individual indemnitors are solvent, a discussion of collateral and indemnity obligations may be appropriate. Although information about the principal's finances may have been disclosed to the surety's underwriters, such information may be outdated and/or drastically different due, in part, to the program default. It is critical to review and discuss the principal's current financial wherewithal. It is similarly important to develop an understanding of the principal's other creditors, such as banks and lenders. If the creditors' rights are secured by liens in contract proceeds, the surety may need to reach out to those creditors to discuss the surety's equitable subrogation rights in contract

proceeds. Some creditors may agree to enter into an inter-creditor agreement with respect to contract proceeds.

Beyond bank and trade creditors, it is important to evaluate the principal's tax liability. Existing tax liens may affect the surety's rights with respect to contract balances and the surety's projections. *See Fid & Deposit Co. of Md. v. Ohio Dept. of Transp.*, 806 F. App'x 364 (6th Cir. 2020). In addition, some bond forms (such as the Miller Act bond form) provide that the surety has liability for some of the principal's tax obligations with respect to the bonded project(s).

In addition, where the principal has one or more collective bargaining agreements, it is advisable to determine the status of the principal's compliance with its obligations under those agreements. For example, if the principal has failed to remit benefits, which are considered part of the laborers' wages in most jurisdictions, the surety may have additional exposure under its payment bonds or a bond specifically tied to the collective bargaining agreement. The financing surety might have to confront the reality of a union that is unwilling to allow its workers to return to a bonded project unless the principal's liability on all projects is also addressed.

Meeting with Subcontractors and Suppliers

Since a surety has not lived the projects on a day-to-day basis, the principal and its staff are often in the best position to provide information and feedback about the principal's subcontractors and suppliers. Although a surety may find such information to be helpful, the surety will ultimately have to make its own independent judgments about subcontractors and suppliers. After identifying critical subcontractors and suppliers, it can sometimes be helpful for the surety or its consultant to meet with them. Where there are disputes about, *inter alia*, amounts due, warranty obligations, or the cost to complete their work, it may be advisable for each party's respective counsel to assist in negotiating these issues.

Meeting with Obligee

The obligee may be at its most cooperative during its first meeting with the surety. The initial meeting with the obligee presents the surety with a significant opportunity to gather as much information as possible about the obligee's view of the project(s). It is important to document and confirm any representations made by the obligee (e.g., remaining scope of work, remaining contract balance, etc.) so that all parties are operating under the same set of assumptions. Confirming such representations in a letter offers the obligee the ability to clarify any misunderstandings before the surety makes decisions based upon incorrect or otherwise disputed information.

A meeting with the obligee may allow the surety and its team to identify and assess the individuals with whom the surety may be working over the next several months and possibly years. It is important for the surety to identify decision makers and to understand each person's role (from executive to administrative to field) with respect to the project(s). Where the surety's consultant is expected to work with the obligee's project team on a day-to-day basis, it may be advisable for the consultant to meet and establish relationships with such personnel from the inception. Where the obligee is not the actual owner, but rather a general contractor or construction manager, the surety should consider whether it is appropriate to ask that the actual project owner be present at the meeting with the obligee.[3]

Just as with the principal, it is equally important to obtain an understanding of the obligee's views with respect to the principal's prior performance as well as the performance of the principal's subcontractors and suppliers. Understanding the obligee's views may assist the surety in determining the reasons for the default and the surety's future course of action. Sometimes, the surety may be able to mediate what initially seems to be an impasse between the obligee and principal and the project may continue without the surety's continued involvement. For example, an obligee may feel more comfortable

[3] The surety may also consider requesting attendance of the obligee's design professionals and engineers, if appropriate.

releasing funds to the surety, which might defray some of the potential cash flow issues that put the principal in a default posture.

On occasion, it may be helpful for the principal to attend a meeting with the obligee. Where a default is due to a principal no longer being able to finance completion of the project, the principal and obligee may have a positive relationship and all parties may benefit from a meeting where each party's collective views and insights are shared. Of course, there are instances when having the principal at a meeting with the obligee may be counterproductive. The surety will determine on a case-by-case basis if it is advisable to include the principal in such meetings.

Although not every meeting is intended to serve the same purpose (there may be several meetings), and each obligee conducts itself differently, it is certainly appropriate (and advisable) to address whether the obligee will provide the surety with penal sum credit if it decides to finance the principal. If not, the surety may want to carefully consider the risk of the principal not completing the work and the surety having expended funds that are not credited against the penal sum.

Walkthrough of the Project Site

Assuming reasonable access is granted by the obligee, the surety should aim to inspect and photograph (and video, if necessary) the project sites as soon as possible in order to evaluate the sites in the condition they were left by the principal. This is especially important where the obligee is completing a project using its own or other forces (i.e., supplementing) and expects the surety to pay for any shortfalls between the contract balance and the cost of completion—in such situations, it is critical for the surety to establish what work was previously completed by the principal. Where possible, it is helpful to walk the site with both the obligee and the principal, albeit separately. More than one walkthrough may be necessary. Having both perspectives can assist the surety in developing a more thorough appreciation for the issues it may face should it determine it will

complete the project. In some instances, it may be advisable to have critical subcontractors participate in walkthroughs.

Walkthroughs and site inspections provide an opportunity to identify and assess actual and potential challenges. For example, between a review of drawings and the site, a surety can determine whether there are any design issues, scope gaps or site conditions that may impact the cost to complete the project. In the event such issues do arise, the surety may be able to address them with the obligee in a takeover or other type of agreement. Sometimes, the obligee will agree to provide a change order or to modify the scope in order to address problematic issues. For example, where expediency in completing the project is of paramount concern (e.g., the surrounding community is unhappy with the condition of the project), an obligee may agree to modify or even eliminate a potentially long term, non-critical element of a project.

Often, the obligee and principal disagree as to the status of the project or the reasons for delays in completion of the work, and the project documents (including specifications, bid documents, contract documents, daily reports, and correspondence) do not tell the entire story. Walking the site provides the surety with the ability to reach an independent conclusion as to where the project actually stands. The surety should compare the actual work completed to date to the approved schedule of values. Sometimes, the obligee overpaid because it paid too much payment relative to the work completed to date, and other times the obligee may have underpaid by acting unreasonably in failing to approve work in place (which is why the principal may be in its current position). Either way, it is important to understand where the project stands relative to the remaining contract balance in order to develop an accurate cost to complete. Where there are questions, the surety should not hesitate to seek clarification and/or submit requests for information.

Document Collection/Financial Records

Perhaps the most critical aspect of the surety's investigation, especially before it decides to finance, is the collection and analysis of project and financial records from the obligee and the principal, as well as the principal's subcontractors and any indemnitors. Set forth below is a list of documents,[4] which the surety should consider requesting from all relevant parties:

i. Complete set of contract documents, including:
    a. Bid documents
    b. Specifications
    c. Drawings
    d. General Conditions
    e. Special Conditions
    f. Supplemental Conditions
    g. Bulletins
    h. Change Orders
    i. schedules
    j. If outside documents are referenced, they too should be requested.
    k. Obviously – read the bond too.

ii. All requisitions:
    a. Submitted
    b. Approved
    c. Unapproved
    d. Pencil
    e. Schedule of Values
    f. Status of unit price items
        i. Some contracts prohibit payment if overruns exceed a certain percentage without advance agreement. Careful consideration should be given to this issue.

[4] This list simply provides examples and is not meant to delineate every document that should be requested. Every project is different. Some projects require a more exhaustive analysis of documents and others do not merit a review of all of the documents set forth on this list.

iii. Daily Reports/Monthly Reports
iv. Meeting Minutes
v. Project correspondence
vi. Formal/informal notices exchanges between the parties
vii. Requests for change orders (whether or not approved)
viii. Field notices/directives
ix. Shop drawings and as-built drawings (if submitted)
   a. Including rejected, approved and approved as noted
x. Information about allowances and owner-provided services
   a. Sometimes, the contract requires the principals to pay for these services after these allowances have been expended without additional allowances having been agreed upon.
xi. Liens/lien claims/lien dockets
xii. Notices from subcontractor claimants as pre-requisite to asserting payment bond claims.

There are certain types of documents that a surety should request directly from the principal. The following is a list of potential documents a surety may consider requesting from its principal:

i. Accounts receivable ledger
ii. Accounts payable ledger
   a. Assists with a determination of whether the principal has diverted contract funds for other purposes (including trust funds, if applicable).
iii. Bank account information
iv. Cash receipts
v. Status of other projects (this may assist with an analysis of the principal's liquidity and capacity)
vi. All subcontracts and purchase orders
vii. Communications with subcontractors and suppliers
viii. Information relating to warranty/guarantee obligations
ix. Financial statements
x. Overhead costs

a. It is important to determine what is necessary and what is not necessary, especially where the surety is considering financing its principal.

xi. Insurance information

xii. Equipment

Forecasting and Projections

Ultimately, a primary objective of the surety's investigation is to determine how much it will cost, and how long it will take, to complete the projects. This is why sureties often invest significant time and effort to meet with multiple parties and collect and analyze a wide range of documents and other information. This information also allows a surety to weigh the relative merits of the options available to it under the bonds and by law (including financing) and to make informed decisions about mitigation of damages. There are several ways in which a surety can forecast the cost to complete the project, the appropriateness of which depends on the facts, circumstances, and needs of a given project or claim. A discussion of the various approaches available to the surety is beyond the scope of this paper.

IV. THE DECISION TO FINANCE

To fulfil the charge of loss mitigation, sureties will always explore its options for completion of the bonded work. Generally, at the top of the list is to find another contractor to complete the bonded work. Unfortunately, in today's market, that has become a less attractive option. Many contractors are at, or close to, full capacity in today's market. Currently, that lack of capacity is driven by several factors, including:

1. Large volume of work released into the market due to previous Covid catch-up impacts;
2. Lack of subcontractors and labor available to perform the work;
3. Supply chain shortages for materials and specialty manufactured items needed to complete the work; and

4. Financial constraints due to the changing and uncertain costs of capital.

As a result, sureties are often receiving very few, if any, responses to inquiries for completion of bonded work. Those completion contractors that do respond are reluctant to offer a reasonable fixed price to complete the work. The current market experience has been in the 40 to 50 % range over the cost to complete estimates. Many contractors are instead offering to complete the work on a cost-plus basis, with no guarantee of a prospective bidder ever submitting a "hard" or final cost-to-complete estimate. That open-ended uncertainty does not fit well with the goal of loss mitigation.

As a result, and as distasteful as it may be, sureties are required to at least consider financing the contractor through the completion of the bonded work. Unfortunately, the process of deciding to use the principal to complete bonded work is not that simple. The decision process is more than financial considerations.

There is an old guideline known as the three C's of surety:

1. Capital – Sufficient financial capability to complete the work;
2. Capability – The ability to of the principal to perform the work; and
3. Character – Is the principal honest and forthcoming?

Capital is more than financial statements and work in process projections. The bottom line at this point in the loss mitigation process is the amount of cash needed to complete bonded work. How much cash does the principal really have? How much cash is the surety going to collect? How much cash is the surety going to spend, not just to complete the bonded work, but to support its principal?

Capability fully encompasses all aspects of the completing the bonded work. Does the principal have the tools, the manpower, the capable subcontractors, and the technical skill set to complete the bonded work? Is the surety dealing with a swimming pool contractor

trying to finish water treatment plants, or a school contractor trying to build a prison? In years past, skill sets were a primary completion problem. Now, there are additional issues with lack of manpower, lack of subcontractors, lack of materials, and the inability of specialty product manufacturers to meet delivery time frames.

These first two items, Capital and Capability, can be supplemented, but at what cost? The decision point is obtaining an understanding of the source and related cost of that supplementation. How much is the surety going to spend, over and above direct hard costs, to complete bonded work?

The third item, Character, or the lack thereof, is difficult to overcome. If the principal is dishonest and not forthcoming, it is unlikely those shortcomings will improve. The old saying of leopards do not change their spots is generally true. As a result, it is very likely the surety will spend considerable time and expense trying to manage the completion process and safeguarding its assets if the principal cannot be trusted. In many respects, a material lack of character trumps any hoped for mitigation expectations.

The analysis and periodic confirmation of all of these points will involve some level of continued costs, both for internal, and if necessary, external professionals. An understanding of the level of needed involvement of those professionals and the related costs will need to be quantified and periodically evaluated.

V. MECHANICS OF FINANCING

There is no "one size fits all" method to financing, but, more often than not, financing will begin with a series of agreements. First, if the surety is completing a project pursuant to Section 5.1 (or 5.2) of the Bond, the surety may enter into a takeover agreement with the owner. Takeover agreements can address, among other things:

1. The amount of the remaining contract balance;
2. The procedure for how the remaining contract balance will be paid;

3. The remaining scope of work;
4. Confirmation that the principal may continue to satisfy any contractual insurance requirements through its own insurance;
5. An agreement that the penal sum of the Bond is reduced dollar for dollar based upon the surety's financing and protection of the penal sum;[5] and
6. A mutual waiver or preservation of claims, liquidated damages and/or a reservation of rights.

What happens when there is no claim? Or what if an obligee reaches out to the surety prior to terminating the principal (a condition precedent under the Bond) and asks that the surety consider assisting its principal prior to their being a default termination. Obviously, Section 3 of the Bond is clear that "the Surety's obligation under th[e] Bond…arise[s] after" the obligee has complied with the conditions precedent set forth in Section 3. However, there might be occasions where it might be advisable to consider financing the principal prior to a default termination. Under those circumstances, the parties may not be able to utilize a traditional takeover agreement. However, the surety might still consider seeking a written agreement with the obligee to confirm it is acting as a performing surety so as to obtain penal sum credit for its financing and preserve its equitable subrogation rights.[6] It may also be advisable, in certain circumstances, to bypass some of the Bond's procedural requirements by way of an agreement that acknowledges the principal's default and waives some of the language mandated by the Bond.

[5] Unfortunately, the surety may not always be successful in securing this agreement. For instance, Section 8 of the Bond does not limit a surety's liability to the penal sum where a surety performs pursuant to Section 5.2. *See also Int'l Fid. Ins. Co. v. Cnty. of Rockland*, 98 F. Supp. 2d 400, 428 (S.D.N.Y. 2000). A surety might choose to finance its principal pursuant to Section 5.2, rather than 5.1, where the obligee will not affirmatively consent to the surety's utilizing the principal to complete the bonded project.

[6] Even without a formal agreement, some courts will view a financing surety as a performing surety. *See Aeta Cas. & Sur. Co. v. United States*, 845 F.2d 971, 975 (Fed. Cir. 1988) ("Neither formal termination of the contract by the Government nor execution of a take-over agreement by the surety is necessary in order for a surety to qualify as a performing surety… A performing surety may also satisfy its obligation by providing funds to an insolvent contractor to complete performance").

In addition to one or more agreements with the obligee, it is advisable for the surety to enter into a completion and/or financing agreement with its principal. Such agreements typically provide for, among other things:

1. The provision of collateral to secure the surety (in whole or in part), which might include a consent judgment, promissory notes, mortgages, letters of credit, liens, cash, etc.;
2. The indemnitors' reaffirmation and ratification of their obligations to the surety;
3. The indemnitors' acknowledgement that there is a default under the bonded contract and representations regarding the reasons for the surety's financing;
4. The provision of letter of direction and/or an express assignment of the remaining contract balance;
5. What the surety is willing to finance and not finance;
6. An acknowledgement that the surety may discontinue financing at any time and for any reason;
7. The process for requesting funds;
8. The procedures for submitting and approving of funding requests;
9. An agreement to provide the surety with unfettered access to the indemnitors' financial records;
10. Setting up one or more special accounts for purposes of administering the financing (a separate funds control agreement may be advisable) – preferably at an institution not associated with the principal;[7] and
11. A waiver of claims against the surety.

In addition to these agreements, the surety might also set up internal procedures and controls in connection with financing. These procedures and controls vary by surety.

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[7] The possibility of offset (i.e., "sweeping") by the principal's financial institution is real. *See, e.g., Arch Ins. Co. v. FVCBank*, 881 S.E.2d 785 (Va. 2022).

VI. RISKS AND REWARDS OF FINANCING

As noted at the outset of this paper, the decision to finance will depend on the facts and circumstances presented to a surety. After conducting its investigation, a surety will consider the risks and rewards of financing prior to deciding to finance.

Risks[8]

1. The principal is not an indemnitor, or the company's principals are not indemnitors.
    a. The surety may mitigate this risk by requiring additional indemnity. If such parties are unwilling to put skin in the game, the surety may not be inclined to finance.
2. Another lender has a pre-existing security interest in the principal's/ indemnitors' collateral (including in connection with the applicable contract balance(s))
    a. The surety's rights as performing surety should provide the surety with a superior right to the remaining contract balance, but there is some aberrant case law in this regard and/or the lender may not be sophisticated and understand the surety's superior rights.[9]
    b. A lender may consider negotiating an inter-creditor agreement with the surety in which the lender acknowledges the surety's subrogation rights. The lender may be incentivized to do so because the alternative might be the principal becoming insolvent with no chance of repaying its debt to the lender.
3. The surety's agreement to finance and/or the principal's financial struggles may give rise to a default under the terms of applicable loan documents.

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[8] The following list of risks is, by no means, meant to be exhaustive. There are several risks not addressed herein.

[9] *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132,137 (1962) ("And probably there are few doctrines better established than that a surety who pays the debt of another is entitled to all the rights of the person he paid to enforce his right to be reimbursed"); *but see In re Constr. Alts., Inc.*, 2 F.3d 670, 675 (6th Cir. 1993) (a minority view limiting surety's subrogation rights to retainage).

a. First, a default under the bonded contract might also lead to a default under the loan documents. A bank might be receptive to restructuring its loan, executing a forbearance agreement, or other workout.
b. Under certain circumstances, as distasteful as it may seem, a surety may consider allowing a principal to keep its loan obligations current in order to defer the lender from acting. While those funds could otherwise be used to complete the bonded contract(s), it might be more cost effective to avoid the fight while work is being completed.

4. If the surety decides to finance prior to a formal declaration of default, the obligee may not agree to provide penal sum credit to a financing surety.
    a. While a surety is often able to negotiate such an acknowledgment from an obligee, some obligees may not be willing to provide one.
    b. There are reasons to finance without a formal declaration of default, notwithstanding the risk that an obligee will not provide penal sum credit:
        i. The cost to complete is reasonably estimated to be appreciably below the penal sum;
        ii. Not publicizing financial difficulties could avoid potentially avoid the principal's subcontractors demanding assurances, suppliers revoking credit terms (thereby requiring additional liquidity), and/or suspension of the principal's lending facilities (which could have a catastrophic effect on the business or other projects (bonded or otherwise)).
5. Unbonded work:
    a. Typically, sureties will not provide financing for unbonded work because the surety cannot be liable for such work. However, there are scenarios where sureties might consider doing so, especially where the work is profitable and the proceeds from the bonded work could serve to offset the surety's losses (provided such proceeds

are assigned to the surety and the surety has a superior interest in such funds).

6. A principal that is bonded by multiple sureties.
    a. The financing surety will reach out to the other sureties to determine whether the other sureties are willing to share in overhead costs and other non-project specific costs. The financing surety will have to close evaluate its options where the other surety is unwilling to share in such costs.
        i. The other surety may have valid reasons for declining to participate. For instance, the principal might be close to completion on such surety's bonded work and payment of overhead is unnecessary to mitigate that surety's exposure.
7. The principal or indemnitors file for bankruptcy:
    a. Any collateral provided within the 90 days prior to a filing might be challenged as an avoidable preference. A surety may refute such challenge by arguing that the surety's agreement to provide funds constituted a contemporaneous exchange for new value given by the surety pursuant to 11 U.S.C. § 547(c)(1).
    b. The surety may find itself in a dispute with a bankruptcy trustee with respect to whether the contract balance constitutes property of the estate. While the surety's equitable subrogation rights pursuant to *Pearlman* and its progeny should prevail, not every trustee will agree without a decision from a court.
    c. The filing may limit the surety's assignment rights, pursuant to the applicable indemnity agreement, which may affect the surety's rights in claims that accrued prior to the bankruptcy petition date.
    d. Conversely, bankruptcy may provide the surety with an opportunity. To the extent the principal files under Chapter 11 and the surety is considering financing, the bankruptcy process offers the surety the opportunity to provide Debtor in Possession (DIP) financing which will often give the surety an administrative or other priority

vis-à-vis other creditors. This is in addition to the surety's subrogation rights with respect to unpaid contract balances and payment bond claims it has satisfied. The DIP financing agreement will usually be approved by the court, which gives it the force of a court order. A DIP financing agreement may also provide for collateral.

   e. The bankruptcy process may also afford the principal (and its surety) the opportunity to preserve and/or assert claims in the bankruptcy court that might otherwise might have had to proceed through some other process. A bankruptcy court can be a favorable forum for a principal, especially where the principal's affirmative claim will result in recovery of funds that will be distributed to the principal/debtor's creditors (including its surety).

8. The ultimate cost to finance exceeds what was originally projected.
   a. A cost to complete analysis cannot always anticipate certain intangibles, such as:
      i. Inflated pricing by subcontractors or suppliers
      ii. Latent defects
      iii. Unforeseen or differing site conditions
      iv. Design defects or issues
      v. Owner's failure to provide reasonable access or procure permits on a timely basis
      vi. Coordination issues with third party contractors over which the surety, principal and/or completion contractor have no control
      vii. Work that is dependent upon third parties entirely outside of the surety's, obligee's or principal's control.
   b. A surety is not always bound by its initial course of action. For example, where a surety first decides to finance its principal, but the cost to complete the work turns out to be well in excess of initial projections (e.g., home office overhead is higher than expected), a surety may re-evaluate the decision to finance its principal and

consider re-letting to a completion contractor on a lump sum basis. It may be less costly, in the long run, to change course, especially where the change occurs early on in the process. The takeaway is that forecasting and projections should occur continuously and the surety's costs evaluated on a regular basis.

Possible Rewards[10]

1. The most obvious reason to finance a principal is loss mitigation – especially where the cost to complete the bonded obligation by takeover with another contractor, tender, or buying back the bond will exceed the cost of financing (inclusive of financing overhead costs).
2. Preservation of warranties.
    a. A completion contractor will not always warrant the principal's work (requiring the surety to do so – leaving an open-ended risk) or charge an exorbitant price to do so.
    b. Some suppliers (e.g., roofing manufacturers) will not honor a warranty if their product is not installed by a qualified entity.
3. Mitigation against the prospect of delay costs and liquidated damages.[11]
4. Preservation of claims.
    a. Where a principal has not been terminated, a surety may finance its principal under a reservation of rights for purposes of loss mitigation and save for another day the right to assert a claim in connection with the project.
5. Avoiding cascading losses.
    a. A principal that is struggle on one project, may end up struggling on a number of projects. Stemming the tide by

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[10] The following list of potential rewards is provided for purposes of illustration only. Because no two projects, sureties, obligees, indemnitors, or claims scenarios are alike, certain potential rewards just may not be available.

[11] Section 7 of the Bond expressly provides that the surety may be liable for some delay costs and liquidated damages.

keeping one bad project from affecting another might make sense under certain circumstances.

   b. If a surety finances prior to a default termination by a public entity, the entity may not deem the principal as "not responsible" when considering future work. Whether or not the surety intends to continue to bond the principal, the ability to obtain future public work might be the only way the principal can repay the surety for its losses.

6. The opportunity to obtain collateral before incurring losses.
   a. At times, indemnitors will voluntarily provide the surety with collateral in consideration of the surety's agreement to finance.
7. Financing may provide the surety with additional control over completion costs and influence in resolving issues (such as payment disputes with subcontractors and suppliers) that have plagued a project.
   a. Unfortunately, the "cost" of such additional control is the commitment of time and resources required to finance a principal.

VII. CONCLUSION

Ultimately, whether or not to finance is not an easy decision, and there really is no "right" answer. Only when the file is closed, and the surety conducts a postmortem, will it know if it made the right decision. And even then, it may look back and decide that some decisions made along the way were not the right ones even if the overall decision to finance was correct. Gather as much information up front as you can, so that you can make the most informed decision possible, understanding that, even then, no one has a crystal ball. But an informed decision, which allows the surety to weigh the pros and cons of its financing options (including the decision to not finance), even if ultimately wrong, is the best decision.

PANEL 6

THE RISKS AND REWARDS OF TAKING OVER THE PROJECT

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GETTING TO ZERO THROUGH A GREAT TAKEOVER AGREEMENT[1]

By Bruce Kahn, Esq., and David W. Kash, Esq.

There are many forms of takeover agreement floating around our industry. Some are good starting points, but every job (even if you have the same obligee on more than one job) contains discernible differences which need review and attention. Your job as a surety lawyer is to make every effort to have the takeover agreement fit the unique circumstances of each project and attempt to anticipate and diffuse foreseeable problems to minimize the risk to the surety. The business goal of every surety faced with a defaulted principal is to resolve the claim at zero or as close to zero and as quickly as is possible. What does getting to zero mean? It means that the surety can satisfy its obligations in accordance with the underlying performance bond, while keeping in mind available collateral and its indemnitors' ability to perform their obligations under a general agreement of indemnity, to achieve at the end of the day, at or near a zero loss.

At a basic level, there are some who would tell you that a takeover agreement isn't necessary because the terms of the performance bond control the surety's obligations and rights. However, there are usually enough issues left open or subject to dispute by a principal's default that the bond itself, even to the extent it incorporates the entire underlying contract, will not provide a satisfactory answer. Thus there is a purpose for a negotiated takeover agreement between the surety and its obligee with these considerations evaluated. The surety should also consider the takeover agreement as the place where it can reserve rights or limit exposures under either the bond or the underlying contract and perhaps even rewrite part of the deal to its advantage if the underlying contract contains ambiguous or problematic terms and conditions. There may be tension with the obligee here since the obligee will likely want to consider its contract as the sacred text and to the extent the contract is integrated into the bond may resist any changes through a takeover agreement. However, where the surety has options other than takeover under its bond or applicable surety law there

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can be leverage enough to obtain concessions from even a difficult obligee, which in turn can help achieve the goal of coming in at zero.

You should first perform a thorough investigation of the project including obtaining all necessary contract documents and an accounting of comparative contract funds and percentages of completion, obtaining all construction schedules, assessing the amount of work needed to complete the project with a reliable estimate of the cost, in other words, performing the business and legal analysis required to determine the surety's appropriate strategy under the bond and in light of a surety's traditional "four options"—finance, tender, takeover, or pay. If the circumstances merit a takeover, the next step would be to retain a competent, independently bondable completion contractor and then prepare to draft and negotiate the takeover agreement with the obligee.

At a conceptual level, the takeover agreement should achieve three basic objectives: (1) it should establish who and what the surety is, why the surety is taking over the project, and what is the extent of the surety's exposure under its bond; (2) it should secure the surety's right to receive payment of the earned and unearned contract balances; and (3) it should insulate the surety from claims or other exposures during the project completion. What follows are some practice pointers that may help you craft a takeover agreement that will help achieve these objectives and help your surety client get to zero.

A. DETAILS ARE THE SURETY'S FRIEND:

Your takeover agreement should begin with detailed recitations memorializing all of the material facts, and summarizing and defining why the surety is entering into the agreement. This includes recitation of bond information, the contract, the participants, the default, the termination, necessary notices, and the agreement to procure the completion of the job. If there is litigation later, once memorialized as recitations these material facts cannot be disputed. Also, because many obligees (and unfortunately many judges) will likely have only the foggiest notion that a surety bond is anything other than another insurance policy, agreed-to recitations describing who and what the surety is, why it is taking the actions

embodied in the takeover agreement, and what the surety is or isn't obligated to do under its bond may prove to be very helpful.

Accordingly, the takeover agreement should recite that the surety has several alternatives to fulfill its financial obligations under the performance bond and that a takeover is only one of the surety's rights, and that the surety has relied on the representations and warranties provided by the obligee as to the project accounting and percentages of completion furnished in agreeing to take over the completion. The details of the project accounting should likewise be included in the agreement.

This means that the takeover agreement should contain the project's balance sheet as of the time of the takeover, establishing the contract value, the amounts previously paid, the amount of retention that is being withheld, the form of that retention (whether cash or securities instead of retention), and the location of any escrowed funds, in order to confirm the contract balance remaining. This accounting would necessarily include all approved change orders in establishing the contract value and may, as a practical matter, offer a chance to negotiate or finalize any open change orders.

The takeover agreement should limit the surety's liability to the outstanding penal sum of its performance bond. The agreement should also recite exactly what payments and costs go to reducing the penal sum. Among other things, any consultants' fees incurred by the surety in connection with the project should be included as reducing the penal sum under the theory that they are a completion cost, the same as if the surety hired a construction manager to supervise the completion of the work.

Detailing the remaining scope of work is also a material and essential element to be defined in the takeover agreement. You should know beforehand if the surety's completing contractor has agreed to a guaranteed price, lump sum, or other quantifiable scope and price. An undefined scope performed on a time and materials basis will guaranty that this is your last performance bond case.

The takeover agreement should contain a representation and warranty from the owner that the owner has preserved the work of the

defaulted principal at the site, and that it has paid the principal only those sums and percentages for work or materials furnished and installed at the site. This should bring to a head whether overpayments and claims exist. On Federal Miller Act jobs, for the surety to preserve an overpayment claim (Contract Dispute Act), it must catch the government in its wrongdoing and give notice of the principal's default to trigger the surety's equitable subrogation rights against the government. To preserve the claim, you must notify the federal government that it is breaking its own law (FARs) to benefit from equitable subrogation. *Lumbermans Mutual Cas. Co. v. U.S.*, 654 F.3d 1305 (Fed. Cir. 2011). Unlike state law, there is no Court of Claims jurisdiction for surety impairment of security claims. The surety must timely make a written claim to the contracting officer under the CDA. *Id.* at 1318; 41 USC § 602(a). Therefore, even if the takeover agreement contains a reservation of rights to claims against the federal government predating the takeover agreement, they are likely lost without the surety acting vigilantly and giving a prior default notice to the federal government. These sovereignty and jurisdictional problems are not issues against private obligees or on most state public projects. Takeover agreements should include a representation that since the default and termination, the owner has exercised due care to mitigate its damages, if any, and that no overpayments exist.

As for change orders going forward, the takeover agreement should identify the surety's representatives and their individual authority to approve and sign change orders. The takeover agreement should best contain a limitation requiring express surety consent to any additional work or change order beyond a certain sum.

While in the takeover agreement, the surety is agreeing to complete the contract, it should be expressly and clearly stated that this does not mean the surety becomes a contractor, but that it has elected as surety under its performance bond to fulfill its obligations by hiring a completing contractor. Allowing the takeover agreement to be construed as making the surety the contractor could theoretically and unintentionally expose the surety to complications like having to demonstrate compliance with prevailing wage laws or other compliance or integrity issues.

Along these lines, every effort should be made to have the obligee made aware of the identity of your completing contractor, and you should try to secure an acknowledgment, even from a public obligee, that the surety's completion contractor is acceptable to the obligee. The one time you may wish to consider keeping the exact identity of the completion contractor in the background is when the surety is completing by bringing back its previously defaulted principal, for reasons that should be obvious.

For the benefit of the obligee and to motivate the negotiation of other portions of the takeover agreement favorable to the surety, the agreement should include a recitation of the completing contractor's insurance requirements and that new performance and payment bonds will be provided, naming the surety and obligee as dual obligees. The takeover agreement should require the obligee to only assert any claims relating to the work of the completion contractor as against these new surety bonds from the date that the notice to proceed for the completion work is issued. This may be a tough sell since the obligee may not want to give up the completing surety as another pocket but should be tabled since the purpose of paying for and providing new bonds is to guarantee the completion work and it may make sense that the obligee should look to these bonds, at least first.

The completing contractor's insurance should name the surety, the surety's consultants, and the obligee as additional insureds. Make sure that you review the additional insured endorsement to determine any restrictions on the endorsement. The surety's counsel should also obtain copies of the principal's certificate of insurance and make sure that the completion contractor's coverage meets the requirements of the principal's contract. The surety's counsel should also make sure that the insurance is paid up, especially in light of requirements for completed operations coverage. It will be nearly impossible to replace that coverage if it is allowed to lapse. If the coverage has lapsed through inadvertence or otherwise, the surety's performance bond could then be transformed into insurance to cover the defaulted principal's contract indemnity obligations and insurance obligations. Also, as a practical matter you may be placed in a situation where the obligees will refuse to release payments if required insurance

policies are not in place or have lapsed and replacing these coverages can be both expensive and sometimes not that easy to arrange.

B. SECURE THE SURETY'S RIGHT TO GET PAID THE CONTRACT BALANCE

All other things being equal, you should expect the contract balances will probably constitute the most important and most available source of collateral to fund completion expenses. Therefore, you should do everything you can in the takeover agreement to secure the surety's right to be paid these balances. The obligee should remain expressly responsible to the surety under the bond and especially the payment terms and other obligations of the underlying contract. If there are preexisting disputes or if the principal has existing claims against the obligee, especially in cases of a public obligee, the takeover agreement makes it possible to negotiate and liquidate these claims. Otherwise, the dispute should be clearly described in the takeover agreement and include a clear reservation of rights and non-waiver of claims. The surety's basis for asserting the claim (through subrogation, through the indemnity agreement, or by assignment) should be specified as well. It will be this takeover agreement on which the surety may rely to have a legal basis, such as subject matter jurisdiction, to bring suit later on.

The effectiveness of the takeover agreement must be conditioned upon the release of all earned contract balance funds to the surety. The agreement should recite that any earned balances are the surety's security and that payment of these balances either at the execution of the agreement or by a date certain is an express condition precedent to the surety's obligation to perform completion of the work. Knowing the protocol for approval of the takeover agreement will be helpful especially since many public obligees like school boards require that agreements be expressly approved by the public body at a formal meeting. If the signing of the takeover agreement requires a formal vote, the surety may be asked to have its completion contractor on the job 30 days or more, which makes a condition precedent based on a date certain even more important since should the public entity fail to approve the takeover agreement, this potentially allows the surety the option of pulling its completion contractor

off the project or tendering the completion contractor to the public agency and considering its bond exonerated.

Every effort should be made to negotiate with the obligee a commitment to dedicate all remaining contract funds solely to payment for the completion of the work, in which the obligee expressly agrees not to withhold any contract funds, requiring instead that any claims including for impacts, delays, or liquidated damages must be made against the performance bond only.

This may be a hard-fought battle, since the obligee may want to preserve all the rights it had under its contract with principal, including any right to hold back payments. However, the surety's argument in favor of requiring claims be made only against the performance bond can be presented with the following points: (1) the bond is the surety's primary obligation to the obligee and all other things being equal, the bond remains in effect so to the extent any claims are valid they are secured by the bond; (2) the obligee's and the surety's priority should be the completion of the project and their commitment to dedicate all of the available contract funds to completing the work (including paying the completion contractor, subcontractors, and vendors) helps achieve this mutual goal; and (3) disputes over claims like change orders or owner holdbacks merely impede the process of completing the work or can even derail the project, disrupted before by the default of the principal, once again.

C. MITIGATE EXPOSURE TO DELAY CLAIMS:

The mere fact that there has been a default and termination, requiring the surety to act by itself, opens the door to possible owner/obligee allegations of delay. Construction delay claims—even meritless ones—are typically factually complex, often requiring expert schedule analysis and can be both difficult and expensive to litigate. So resolving issues of time in the takeover agreement is every bit as important as resolving issues about money and perhaps even more so since delay claims can be so pernicious.

The surety should request and the agreement should grant a non-compensatory time extension resetting the original substantial completion

date under the contract to a new takeover substantial completion date. The quid pro quo for the non-compensatory time extension is a reciprocal waiver of any right to claim any additional time extensions or damages as a result of any delays which may have resulted from the owner up to the date of the agreement. Any liquidated damages to be assessed against the surety through not achieving the takeover substantial completion date should not include any delays of the defaulted principal which occurred during his performance of the work. The calculation and assessment of any liquidated damages against the surety should include, however, the recognition of any excusable delays in the performance of the original contract.

It is best to incorporate a takeover substantial completion date as a date certain. That date may be extended through negotiation of other key issues that remain on the job. Having a takeover substantial completion date will empower the obligee's representatives to negotiate more tenable terms in the takeover agreement because the surety will then be exposed to liquidated damages if it fails to meet that date. After reviewing all prior schedules, including electronic schedules, the surety's completion contractor should prepare and expressly commit to a schedule (an added benefit is that this commitment will ensure that the surety can look to the completion contractor's bond if completion is not met), and that completion schedule should be offered to the obligee. Acknowledgment of that completion schedule and obligee's acceptance of the schedule should be included in the takeover agreement.

The surety should also secure a waiver of liquidated damages or make a vigilant effort to negotiate any claims, including pass-through claims, for delay damages or project impacts by the owner. The trade-off is the surety can always offer in return that the surety will accelerate the completion performance, pay additional start-up or staging costs, or agree to settle actual impacts with remaining retention or earned balance. If all else fails, because the surety has agreed to spend its own funds for the performance of the underlying contract, the assessment of liquidated damages, if any, should be made against retainages only.

What do you do with impact or delay claims or other affirmative claims of your completion contractor, its subcontractors, or vendors? The

takeover agreement should provide that if the owner causes damages or delays in the prosecution of the work, the surety retains the right to prosecute the claim or assign to the completion contractor the surety's rights under the contract so that the surety's completion contractor can prosecute the claim at its expense. If it is a private job, obviously, a completion contractor will have the right to serve a stop notice or record a mechanic's lien. The surety is best served if it can diffuse and liquidate pre-default claims before taking over and set forth how those claims are being treated and resolved in the takeover agreement, but then retain control over any claims from the completion contractor or its subcontractors as against the owner/obligee to leverage through settlement, completion of the project and finality.

D. ADDRESS WARRANTY EXPOSURE

The surety should agree to be responsible for all express warranty obligations set forth in the contract, and that the surety and its completing contractor will assign all warranties of all vendors, subcontractors, suppliers, and OEMs to the obligee. Those warranties should expressly run from the agreed substantial completion dates achieved by the principal or as agreed by the obligee in the context of the takeover agreement as the "Takeover Agreement Substantial Completion Date" negotiated by the surety after obtaining the completion contractor's final work schedule and completion dates.

E. ESTABLISH NEW OR MODIFY EXISTING ADR PROCEDURES:

The takeover agreement is a perfect opportunity to revisit any multi-step ADR provisions contained in the underlying contract. For example, some states require public bodies to follow set dispute resolution procedures. It may be possible to implement better procedures for the surety in the takeover agreement including circumventing or readjusting what otherwise would be unfavorable ADR provisions or onerous conditions precedent and notice requirements in the underlying contract. While the obligee may not agree to a complete rewriting of the dispute resolutions proceedings, depending on the circumstances you may be able to achieve things like adding mediation as another step, limiting all disputes

to ADR, or even identifying and pre-approving mediators or arbitrators to assure an expert and favorable panel.

F. A FEW OTHER POINTERS:

The takeover agreement should recite that it benefits only the obligee and the surety, and that no third party, who is not named in the agreement, has any rights whatsoever.

The takeover agreement should be modified only if it is done so in writing and signed by all parties.

Lastly, the takeover agreement should take precedence over any prior written or oral agreements. Should a conflict exist between the takeover agreement and the bond or the takeover agreement and the underlying contract, the takeover agreement will control.

G. CONCLUSION:

In summary, a well-crafted takeover agreement can serve the surety's interests in getting to zero by establishing who and what the surety is, why the surety is taking over the project and what is the extent of the surety's exposure under its bond, securing the surety's right to receive payment of the earned and unearned contract balances, and insulating the surety from claims or other exposures during the project completion.

Where the surety has options other than takeover under its bond or applicable surety law there can be leverage enough to obtain concessions from even a difficult obligee, which in turn can help achieve the goal of coming in at zero. As counsel for the surety, you should press as hard as the circumstances allow for every advantage that may be gained in the takeover agreement.

PANEL 7

THE RISKS AND REWARDS OF TENDERING A COMPLETION CONTRACTOR

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PEARLMAN 2023

September 7-8, 2023

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The Risks and Rewards for Tendering a Completion Contractor

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A contractor working on a bonded construction project has been defaulted by the Owner ("Obligee" under the Performance Bond"). The Owner has terminated the contractor ("Principal" under the Performance Bond) and has made a demand to the Surety pursuant to the American Institute of Architects A312 Performance Bond[1].

The Surety has retained the services of a consultant and is considering its options, including the option to finance the Principal, takeover, letting the Obligee perform the work, tendering, or denying the claim. This paper discussed the risk and rewards for the Surety in selecting the option of tendering of a completion contractor to complete the Project.

The reasons for tendering of a completion contractor are normally fact specific to each situation. The other options identified above may be appropriate under each circumstances. However, in circumstances that tendering is considered, there are some general considerations that a surety should consider if deciding to tender the project to a completing contractor. The Bond Default Manual, 4th Ed. (2015)[2] includes a chapter entitled *Tender* that discusses issues involving the tender of a completion contractor to the obligee.

The *Tender* Chapter identifies:

1. The surety's right to tender under the Performance Bond.
2. The advantages and disadvantages of tender.

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[1] The 2010 form of the AIA A312 is referenced in this paper.

[2] BOND DEFAULT MANUAL (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht and J. Blake Wilcox eds.) ABA, 4th Ed. (2015).

3. When tendering a completion contractor is appropriate
4. Negotiations with the obligee; and
5. Other factors to consider and the crucial issues to address in any tender.

The focus here will be on the risks and rewards of a surety selecting the option of tendering to a new completion contractor to complete the project.

I. REVIEW OF THE PERFORMANCE BOND

As always, the first place to look when considering whether to tender a completion contractor is the language of the Performance Bond. The following terms and conditions of the standard form A312 should be considered:

> 2. If the Contractor performs the Construction Contract, the Surety and the Contractor shall have no obligation under this Bond, except when applicable to participate in a conference as provided in Section 3.
>
> 3. If there is no Owner Default under the Construction Contract, the Surety's obligation under this Bond shall arise after:
>
> 3.1 The Owner first provides notice to the Contractor and the Surety that the Owner is considering declaring a Contractor Default. Such notice shall indicate whether the Owner is requesting a conference among the Owner, Contractor and Surety to discuss the Contractor's performance. If the Owner does not request a conference, the Surety may, within five (5) business days after receipt of the Owner's notice, request such a conference. If the Surety timely requests a conference, the Owner shall attend. Unless, the Owner agrees otherwise, any conference requested under this Section 3.1 shall be held within ten (10) business days of the Surety's receipt of the Owner's notice. If the Owner, the Contractor and the Surety agree, the Contractor shall be allowed a reasonable time to

perform the Construction Contract, but such an agreement shall not waive the Owner's right, if any, subsequently to declare a Contractor Default; and

3.2 The Owner declares a Contractor Default, terminates the Construction Contract and notifies the Surety.

3.3 The Owner has agreed to pay the Balance of the Contract Price in accordance with the terms of the Construction Contract to the Surety or to a contractor selected to perform the Construction Contract.

4. Failure on the part of the Owner to comply with the notice requirement in Section 3.1 shall not constitute a failure to comply with a condition precedent to the Surety’s obligations, or release the Surety from its obligations, except to the extent the Surety demonstrates actual prejudice.

5. When the Owner has satisfied the conditions of Section 3, the Surety shall promptly and at the Surety’s expense take one of the following actions:

5.1 Arrange for the Contractor, with the consent of the Owner, to perform and complete the Construction Contract;

5.2 Undertake to perform and complete the Construction Contract itself, through its agents or independent contractors;

5.3 Obtain bids or negotiated proposals from qualified contractors acceptable to the Owner for a contract for performance and completion of the Construction Contract, arrange for a contract to be prepared for execution by the Owner and a contractor selected with the Owner’s concurrence, to be secured with performance and payment bonds executed by a qualified surety equivalent to the bonds issued on the Construction Contract, and pay to the Owner the amount of damages as described in Section 7 in excess of the

Balance of the Contract Price incurred by the Owner as a result of the Contractor Default; or

5.4 Waive its right to perform and complete, arrange for completion, or obtain a new contractor and with reasonable promptness under the circumstances;

5.4.1 After investigation, determine the amount for which it may be liable to the Owner and, as soon as practicable after the amount is determined, make payment to the Owner; or

5.4.2 Deny liability in whole or in part and notify the Owner, citing reasons for denial.

7. If the Surety elects to act under Section 5.1, 5.2, or 5.3, then the responsibilities of the Surety to the Owner shall not be greater than those of the Contractor under the Construction Contract, and the responsibilities of the Owner to the Surety shall not be greater than those of the Owner under the Construction Contract. Subject to the commitment by the Owner to pay the Balance of the Contract Price, the Surety is obligated, without duplication, for

.1 the responsibilities of the Contractor for correction of defective work and completion of the Construction Contract;

.2 additional legal, design professional and delay costs resulting from the Contractor's Default, and resulting from the actions or failure to act of the Surety under Section 5; and

.3 liquidated damages, or if no liquidated damages are specified in the Construction Contract, actual damages caused by delayed performance or non-performance of the Contractor.

8. If the Surety elects to act under Section 5.1, 5.3 or 5.4, the Surety’s liability is limited to the amount of this Bond.

Under Section 5.3 of A312, the surety has the right to tender a completion contractor acceptable to the Owner.

When the project is a federal project, the Performance Bond, Standard Form 25 under the Miller Act is required. Performance Bond, Standard Form 25 does not reference any surety performance options. However, just because it is silent does not mean the surety is prohibited from tendering a completion contractor. Federal Acquisition Regulations ("FAR") § 49.4053 states that the contracting officer may arrange for the completion of the project by "any appropriate contracting method or procedure." Implicitly, if the surety proposes and the contracting office agrees, the surety may be allowed to tender a completion contractor to finish the project. *See Ins. Co. of the West v. United States,* 243 F.3d 1367, 1370 (Fed.Cir.2001); *Aetna Cas. & Sur. Co. v. United States,* 845 F.2d 971, 975 (Fed.Cir.1988).

Performance bonds typically contain provisions giving the surety the option to allow the (1) arrange for the Contractor, with consent of the Owner, to perform and complete the Construction Contract, (2) undertake the performance and complete the Construction Contract itself, through its agents or through independent contractors, or (3) obtain bids or negotiated proposals from qualified contractors acceptable to the Owner for performance and completion of the Construction Contract. *See St. Paul Fire & Marine Ins. Co. v. City of Green River, Wyo.*, 93 F.2upp.2d 1170 (USDC D. Wyoming 2000). Even if there are no provisions in the bond specifying the right to tender a completion contractor, the Surety would still likely have a right to tender a completion contractor. *See Granite Comput. Leasing Corp. v. Travelers Indem. Co.*, 894 F.2d 547, 551 (2d Cir. 1990).

II. TENDER AGREEMENT

The tender option can be formalized either by: (1) surety and the obligee entering into a tender agreement and the obligee and the completion contractor entering into a completion agreement; or (2) the surety, obligee and completion contractor entering into a tri-party agreement.

The tender agreement is an important piece of limiting the exposure for the surety and addressing those issues which were outstanding or may become issues in the future.

III. REWARDS OF TENDERING A COMPLETION CONTRACTOR

Now that we have analyzed the language of the Performance Bond and confirmed that the surety is allowed to tender a completion contractor to complete the project, we will examine the potential advantages of doing so, which may include:

1. Allows The Surety To Limit Its Losses;
2. The Risk Is Shifted From The Surety For The Principal To The Surety For The Completing Contractor;
3. The Risk Of Loss Will Not Exceed The Penal Sum Of The Bond;
4. A Qualified Contractor May Be Able To Complete The Project With The Remaining Contract Balance;
5. Ability To Negotiate Contract, Including Scope, Time Of Completion And Additional Contract Funds;

A. ALLOWS THE SURETY TO LIMIT ITS LOSSES

One of the main benefits of tendering a completion contractor is that it allows the Surety to limits it losses under the performance bond. Ideally, the tender agreement will have addressed all the outstanding issues between the Surety and the Obligee and allow for essentially a clean slate. The Surety's losses can be quantified at the time of tendering a completion contractor and entering into a completion agreement with the completion contractor. As an example, if the contract funds are insufficient to cover the completion contractor's bid, the Surety would know the additional funds it will need to cover the difference. Also, ideally, any issues with liquidated damages up to that point will be addressed and the Surety will know about its potential exposure. The Surety will be able to require that the completion contractor provide its own bonds for the remaining scope of work. In some cases, the Surety can negotiate to have its Performance Bond released. Finally, a loss for the Surety is not just delay damages or the difference in the remaining contract sum and the cost to complete the

project by the completion contractor, it is also the time spent on the Surety's outside counsel and consultants. A tendered completion contractor would limit the time the Surety would have to spent on administering the project.

B. RISK IS SHIFTED

Another reward for tendering a completion contractor is that if additional arise that are unrelated to the defaulted principal, the additional costs that may be incurred are the responsibility of the new completion contactor and their surety. While this may not eliminate all of the risk to the Surety, the future issues with the project become the liability of the completion contractor and the new surety. For example, if there are delays with procuring materials for the Project after tendering a completion contractor, the new surety and the new completion contractor would be responsible to address the new delays. The subsequent delays and associated liquidated damages would also be the responsibility of the new completion contractor and new surety.

C. THE RISK OF LOSS WILL NOT EXCEED THE PENAL SUM

One of the rewards of tendering a completion contractor is that the Surety's risk of loss will not exceed the penal sum of the Performance Bond. As it well known, a major concern for sureties is the potential for exposure beyond the penal sum of the bond. *Int'l Fid. Ins. Co. v. County of Rockland*, 98 F. Supp. 2d 400 (S.D.N.Y. 2000)[3].

The Tender Agreement will be the opportunity to reinforce that the maximum exposure for the Surety will be the penal sum of the Performance

[3] The performance bond in *Rockland* was the 1984 A312 bond which did not specifically limit the surety's liability to the penal sum when the delay damages are caused by the surety. The 2010 A312 bond was modified to exclude the takeover option from the protection of the penal sum of the bond. In *Rockland*, the surety did include a provision in its Takeover Agreement with the owner seeking to limit its liability to the penal sum. *Id.* However, the *Rockland* Court narrowly construed the provision stating that the dispute was not about funds advanced by the Surety to complete the contract; it was about loss of income to the owner caused by IFIC's breach, and the extent to which IFIC must reimburse them for that loss. *Id.* The court noted that the provision "did not include an absolute limitation on liability to the penal sum of the bond. Nor was there any limitation regarding liability for delay damages caused by the surety's delayed performance of the Takeover Agreement." *Id.* The court ruled that the reservation of rights in the takeover agreement was not specific enough to limit the surety's liability to the penal sum of the bond.

Bond and should include specific language that any damage or claims sought by the Obligee will not exceed the penal sum.

D. A QUALIFIED COMPLETION CONTRACTOR MAY BE ABLE TO COMPLETE THE PROJECT WITH THE REMAINING CONTRACT BALANCE.

A qualified completion contractor may be able to complete the project with the remaining contract balance. At times, the default of the principal has occurred early in the project such that there are substantial contract funds available to complete the project with no additional funds coming from the Surety. While this unicorn of a situation is rare, when it happens, the tendering option is a great advantage to the Surety.

In considering this option, a good practice point is to require prospective completion contractor bidders to provide bid bonds. The bid bonds weed out those potential completion contractors to those who are serious about their bids. A bid bond also protects the surety, who has spent time and money to prepare a bid package with its consultant. The premiums for a bid bond are nominal and most qualified completion contractors would be familiar with providing bid bonds for government projects.

One of the common misconceptions that a Surety might encounter when tendering to a governmental obligee is the belief that the governmental obligee must comply with the competitive bidding requirements before a completion contractor can begin work on a project. In *Mega Const. Co. v. U.S.*, 29 Fed. CL. 396 484 (1993), the United States Court of Federal Claims held that "[c]ompetitive reprocurement is not required after default although it is desirable since it offers firm evidence that the original contract price was reasonable." Essentially, the principle is that the Surety is not a contractor and is simply performing under the performance bond and tendering constitutes that performance and it is thus not a new procurement and not subject to the competitive bidding requirements.

E. Ability For The Surety To Negotiate Contract Terms, Including Scope, Time Of Completion And Additional Contract Funds.

Tendering a completion contractor gives the Surety an opportunity to negotiate contract terms. Often times the Surety has been on the peripheral of the discussions between the Obligee and Principal. The tender option gives the Surety a chance to establish a direct relationship with the Obligee and negotiate contract terms which include identifying the remaining scope of work, obtaining additional time to complete and even additional contract funds.

As discussed above, one of the greatest benefits to a Surety in tendering a completion contractor could be to obtain a release of its Performance Bond to be replaced with the completion contractor's new performance bond. This will most likely require discussions with the Obligee to explain the process of tendering, what documents will be required and how tendering a completion contractor can accomplish the obligee's goals, including getting the project completed as soon as possible. Again, the Surety having a good relationship with the Obligee, being transparent and having (documented) discussions with the Obligee's decisions makers can make the tender option a valuable tool for the Surety.

The remaining scope of work is often an important issue. First, it is important to understand the remaining scope under the existing contract in relation with the remaining contract balance. Often the Surety's consultant can help guide the discussions as to the remaining scope of work and narrow down what is left to be completed. An accurate description of the scope of work is critical for a tendering completion contractor and the Surety. Second, the bid price for the completion contractor will depend on the remaining scope of work. The completion contract cannot properly price its work or determine how much time it needs to complete the project unless it knows the scope of work to be performed.

A new completion date will be established with the completion contractor. This gives the Surety and the Obligee a date on which to negotiate any delay damages (liquidated damages) at the time of tendering. Instead of delay damages, the Surety can argue for time extension of the

original completion date based on delays that may be attributable to the Obligee or to no fault of the defaulted Principal. At the very least, the frame work for what time extensions could be considered should be discussed. As an example, the Obligee may be willing to establish a new completion date with an increase in the liquidated damages for failing to meet the date. This risk can then be passed onto the completion contractor and the new surety.

Any discussions with the Obligee should include consideration of any claims that the defaulted Principal may have against the Obligee. Nearly every single general agreements of indemnity gives the Surety the right to settle and release its principal's affirmative claims against the Obligee. However, if there is valid basis for the defaulted principal's claims against the Obligee, the surety should consider carving out the defaulted principal's claims, if possible. If the defaulted principal were to prevail against the obligee, the surety would want to make sure any recovery would be collected to reduce or eliminate the surety's losses on the project. If the obligee were at fault and becomes liable to the defaulted principal, the obligee should be required to first reimburse the surety for any losses before making payment to the defaulted principal.

IV. RISKS OF TENDERING A COMPLETION CONTRACTOR

Of course, tendering a completion contractor for an unfinished project does not come without risk to the Surety. The risks of tendering a completion contractor include: the obligee may refuse to consent to the completing, it is more costly for the Surety, and the cost of a bonded completion contractor usually exceeds the remaining contract balance resulting in a guaranteed loss for the Surety.

A. THE OBLIGEE MAY REFUSE TO ACCEPT A COMPLETION CONTRACTOR

Under the Section 5.3 of A312, the Obligee (Owner) has to consent to the completion contractor; "qualified contractors acceptable to the Owner". Further under Section 5.3, it requires that the contract with the completion contractor "be secured with performance and payment bonds executed by a qualified surety equivalent to the bonds issued on the Construction Contract[.]"

As such, the Obligee has the right to reject any completion contractor. There is no reasonableness language in Section 5.3. As a result, it is imperative that when considering the tender option, that the Surety engage as early as possible with the Obligee that it is considering a completion contactor. The Surety and Obligee can discuss those completion contractors that it is considering or soliciting bids from. Even so, the Surety runs the risk that the Obligee changes it minds and decides not to accept the tendered completion contractor at the very last minute.

B. THERE MAY BE SUBSTANTIAL UP-FRONT COSTS IN PUTTING TOGETHER BID PACKAGES AND OBTAINING BIDS

A lot of work and costs is required by the Surety in tendering a completion contractor to the Obligee. As discussed above, the Surety will likely want to put together a bid package to attempt to solicit multiple bids to complete the Project. In doing so, the Surety will likely have to pay a consultant to put together a bid package with a comprehensive scope of work already negotiated with the Obligee. A thorough and considered bid package with all the information and documents (original contract, plans, specifications, addendas, approved submittals, previous requests for information, change order requests, construction change directives, and other documents) avoids any issues and confusions by bids from completion contractors. Depending on the reasons for terminating the Principal, the bid package should include the documents related to any defective work that must be corrected by the completion contractor. Naturally, this also means that the Surety must understand the Obligee's allegations of defective work. Which in turns means spending time and resources to understand the defective work to accurately identify it in the bid package.

If multiple bids are received, the Surety now has to analyze each of the bids to determine that the contractors are qualified to do the work, that the bids accurately reflect the scope of work, and negotiate with those potential contractors. Again, this requires costs to the Surety and time spent by its inside counsel, engineers, and consultants.

Time is usually working against the Surety and it must quickly get up to speed on all of the issues before sending out the bid package. An experienced consultant can help limit the time spent on preparing bid packages and corresponding with potential completion contactor bidders.

C. THE COST OF A BONDED COMPLETION CONTRACTOR USUALLY EXCEEDS THE COST OF THE ORIGINAL CONTRACT

Another risk of selecting the tender option for a Surety is that the cost of a bonded completion contractor will usually exceed the cost of the original contact and the remaining contract sum. Setting aside the unicorn situations where there are sufficient contract sums to pay the entirety of the completion contractor, the Surety is guaranteed to have a loss[4] on the Project if the completion contractor's contract is more than the remaining contract sum. Unlike the options of takeover or financing the Principal, there is likely going to be a guaranteed loss for the Surety under the tender option.

D. THE PRINCIPAL CANNOT COMPLETE THE WORK

Unlike Sections 5.1 and 5.2 of the A312, Section 5.3 requires an Obligee to consent to the Completion Contractor. Normally, the relationship between Obligee and Principal has been broken to the point that the Obligee will not likely agree to have the defaulted Principal come back on the Project as the Completion Contractor. The Surety will have to pick a new contractor and go through the processes of bidding or selecting a new contractor.

E. LATENT DEFECTIVE WORK

Another disadvantage of tendering a completion contractor is that the Surety will likely remain liable for any latent defective work by the defaulted Principal. Latent defective work performed by the principal is that work that is unknown at the time of the Principal's termination and during the negotiations between the Obligee and the Surety. Latent defects

[4] Without consideration of the General Agreement of Indemnity upon which the Surety may recoup its losses from the Principal/Indemnitors.

usually are of serious concern to the Obligee, especially if termination of the principal was due to a known defective work.

The Obligee will usually be concerned with addressing latent defective work as part of the release to be given to the surety as part of the Tender Agreement. The Surety and Obligee can negotiate a set price for the risk to be paid as part of the tender or the Surety and Obligee can carve the latent defects out of the release in the Tender Agreement and add provisions to the Agreement to address latent defects as they arise in the future.

The Surety may want to consider a separate agreement with the completion contractor to address the latent defective work and warranty work performed by the terminated Principal. Often this agreement will be in the form of a "times and material, plus fee" contract or T&M Work. Under the contract documents including specified in the Tender Agreement, the Obligee will need to notify the Surety of any latent defective work or warranty work and the Surety will ask its consultant to confirm the existence of the latent defective work or warranty work. The Surety will have ongoing exposure due to the additional cost of the T&M Work and the expense of having its consultant remain involved on the Project.

PANEL 8

THE RISKS AND … THE RISKS OF "DOING NOTHING": A RISKY OPTION UNDER THE A312 PERFORMANCE BOND

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The Risks and…the Risks of Doing Nothing
A Risky Option Under the A312 Performance Bond

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Performance bonds are required on essentially all public projects and selectively included on many private projects to protect the owner/obligee against the potential that a contractor will fail to complete the work. Under the terms of a standard performance bond, such as the A312 bond, if a contractor fails to adhere to its contractual obligations, a surety may be required to step in and provide some options for completing the project. The surety's best course is not always clear—and the "option" of doing nothing comes with significant risks, thus making it at times not really an option at all. This paper discusses the surety's obligations under the A312 performance bond, the surety's defenses, scenarios where a surety may face the "option" of doing nothing, case examples where the surety chose to do nothing, or not enough, and suffered the consequences, and general recommendations of alternative options to doing nothing.

A. THE BASIC REQUIREMENTS OF THE A312 PERFORMANCE BOND

The A312 sets forth the conditions precedent to the surety's obligation to perform:

§ 3 If there is no Owner Default under the Construction Contract, the Surety's obligation under this Bond shall arise after:[1]

1. The owner has notified the contractor and the surety that the owner is considering declaring a contractor default and either the owner or the surety have requested/conducted a conference. If the owner, the contractor and the surety agree, the contractor

[1] Unless the Surety can demonstrate "actual prejudice" "[f]ailure on the part of the Owner to comply with the notice requirement in Section 3.1 shall not constitute a failure to comply with a condition precedent to the Surety's obligations, or release the Surety from its obligations…." § 4. But see *International Fidelity Insurance Co. v. Americaribe-Moriarty JV*, where the Eleventh Circuit Court of Appeals held that the general contractor's failure to comply with the notice requirements as set forth in the underlying contract and the bond invalidated the general contractor's claim against the bond for excess costs to complete its defaulting subcontractor's scope of work, 906 F.3d 1329, 1329 (11th Cir. 2018). Failure to follow notice requirements was a material breach of the performance bond. *Id*.

shall be allowed a reasonable time to perform the construction contract, but such agreement shall not waive the owner's right, if any, subsequently to declare a contractor default; and

2. The owner has declared a contractor default and formally terminated the contractor's right to complete the contract and notifies the surety of the same; and

3. The owner has agreed to pay the balance of the contract price to the surety in accordance with the terms of the construction contract or to a contractor selected to perform the construction contract in accordance with the terms of the contract with the owner.

Once the owner has satisfied these § 3 conditions, then the bond requires that the surety take one of these actions:

- Arrange for the contractor, with the consent of owner, to perform and complete (i.e., finance) (§ 5.1);

- Undertake to perform and complete with another contractor (i.e., takeover) (§ 5.2);

- Provide proposals from qualified contractors acceptable to the owner to complete with new performance and payments bonds and pay to the owner the costs of completion in excess of the terminated contractor's contract balance incurred by the owner as a result of the contractor default (i.e., tender) (§ 5.3); or

- Waive other performance options and either make payment to the obligee or deny liability § 5.4.

B. SURETY DEFENSES

Depending on the situation, a surety may raise various defenses to its obligations under the A312. Those defenses can be broadly categorized into (1) those that the principal may raise, which the surety can utilize and (2) those that the surety has, which are independent of the principal. In the first, the surety stands in the shoes of its principal having all possible defenses the bond principal may have.

Defenses of the principal include: lack of default or wrongful termination (e.g., failure to provide notice and opportunity to cure as required by the contract); failure to pay as required by contract; breach of implied covenant of good faith and fair dealing; interference with the principal's performance; defective design; impossibility of performance; and statute of limitations. Unreasonable delays by the obligee, as well as the obligee's failure to act, may also constitute a breach that will relieve the principal, and ultimately the surety from liability.

Some of the independent defenses that a surety may have include: material alteration of the underlying contract to surety's prejudice; prepayment or overpayment to principal; failure to mitigate damages; lack of notice of default; and release or discharge of principal.

The surety's overpayment defense is common and typically raised when the owner issues payment not due to the principal or releases retainage without consent of the surety. The surety's consent is generally required before a reduction in retainage or release of the final payment because the retainage protects the surety. Thus, payment without consent can discharge the surety's obligations. Improper payments include: 1) progress payments for work not completed, 2) payment for work the obligee/owner knew or should have known was defective; 3) premature release of the contract retainage, or 4) final payment without the required consent of the surety.[2]

Failure to mitigate damages is a defense most often applicable when the obligee takes over the arrangements for project completion without permitting the surety to complete. This "strips" the surety of its contractual right to minimize its liability under the performance bond, and render the bond null and void because of material breach. *Dragon Construction, Inc. v. Parkway Bank & Tr.*, 678 N.E. 2d 55 (Ill. Ct. App. 1997), appeal denied, 684 N.E. 2d 1355 (Ill. 1997).

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[2] But see *Argonaut Ins. Co. v. Town of Cloverdale, Ind.*, 699 F.2d 417 (7th Cir. 1983) (holding that the bond would not be discharged even though the obligee overpaid the contractor as a result of an improperly certified payment obligation because the obligee relied in good faith on an architect's certification.)

These defenses may become apparent at various points in the claim process. Many involve contractual defenses, where the surety and obligee must carefully assess whether the principal has actually defaulted. *Stonington*, 792 F.Supp.22d at 266. Typically, insignificant, or minor breaches do not rise to the level of a breach that warrants the decision to terminate a contractor. These issues are often fact specific and depend on the terms of the parties' contract.

C. Circumstances Where a Surety Must Carefully Weigh the Option of "Doing Nothing"

Although the A312 bond provides parameters for when a surety is required to take action, situations may arise where a surety faces the decision of whether to act or not.

One such situation is when an owner *attempts* to "make a claim" on the performance bond but does not comply with the formal claim process. This can be through a phone call or, more often, written correspondence to the surety stating that the owner/obligee is "making a claim" on the bond. The correspondence may include a request that the surety take some type of action, or in other cases the request merely states that the contractor/principal has breached the contract and so a claim is being made. Here, the request serves as a notification to the surety that there is a problem with the contractor/principal's performance, but it either does not comply with the bond requirements outlined in § 3 of the A312 bond, fails to terminate the principal, or both.

The owner/obligee has thus made the surety aware of a problem or potential problem with the contractor/principal's performance, but no bond conditions have yet been met to trigger the surety's obligation to act. In some cases, the owner/obligee is, in essence, treating the bond as an insurance policy, expecting the surety to jump into action, merely as a result of receiving notice of an issue. In other cases, the owner/obligee might employ an informal claim for tactical reasons— by notifying the surety without terminating the contractor/principal, the owner/obligee might be hedging a bet that notice to the surety justifies future claims for delay or liquidated damages.

In those cases, the surety may be tempted to deny the claim for failure to adhere to the bond requirements and close the file. But this strategy comes with risks. For example, by the time the owner/obligee does terminate the principal, the situation is worse than when the surety was first made aware of the problem. The project could be further behind schedule, the parties could be more entrenched in their positions and the potential costs to complete may surpass the remaining contract balances. Further, delay or liquidated damages can accumulate quickly and, if included into the contract, may be covered by the bond.[3] In addition, if the surety does not act, the contractor/principal's financial situation may change for the worse, leaving little available recovery for later, if the surety eventually has to get involved and there are insufficient contract funds. Some courts have awarded prejudgment interest to owners/obligees that have had to complete projects on their own when the surety has failed to act. *USF&G v. Braspetro Oil Serv. Co*., 369 F.3d 34 (2d Cir. 2004) (awarding compensatory damages and prejudgment interest to an obligee that completed a project with its own funds).

A surety may find itself in a similar predicament when an owner/obligee has terminated the contractor/principal after complying with the notice requirements outlined in § 3 of the A312 bond but is holding funds that exceed the remaining work and the contractor/principal disputes the claim. Here, by doing nothing, the surety is relying on (a) the obligee and principal to work out the issues and (b) on the contract funds to protect the surety from potential liability. Such a course may amount to the contractor/principal asking the surety to deny the claim pursuant to § 5.4 of the A312 bond. Even though that may ultimately be the correct choice, such determination is risky and must result from the surety's good faith investigation and understanding of the risks associated with denying the claim. *See Transamerica Premier Ins. Co. v. Brighton Sch. Dist*., 940 P.2d

[3] "A bond which is given for the faithful performance of a contract, to which it refers, binds the surety for labor performed and materials furnished thereunder as completely as though the surety were a party to the contract." *Continental Cas. Co. v. Hartford Acc. & Indem. Co*., 243 Cal. App. 2d 565 (1966). "As a general rule, a contract performance bond will be read with the contract." *Pacific Employers Ins. Co. v. City of Berkeley*, 158 Cal. App. 3d 145 (1984).

348 (Colo. 1997) (holding that a surety's failure to act constituted bad faith sufficient to justify punitive damages).

D. CASE EXAMPLES

Underlining the risk of doing nothing, some courts have allowed potential claims against a surety that may exceed the penal limits of the bond where the surety either did nothing or failed to do enough. A few examples of such decisions include:

- ***Colo. Structures, Inc. v. Ins. Co. of the W.*, 161 Wn.2d 577 (2007).** After a subcontractor failed to perform satisfactorily on a project to construct a store and breached the subcontract, the surety refused to attend onsite meetings to discuss performance issues related to the subcontractor's work or pay on a performance bond. *Id.* at 582-84. The Court held that the surety was liable on the performance bond and further held that sureties are liable for attorney fees when a surety wrongfully denies liability on a performance bond. *Id.* at 594, 606-07.

- ***Dodge v. Fid. & Deposit Co.*, 778 P.2d 1240 (Ariz. 1989).** After various performance issues arose with construction of a single-family residence, the Dodges declared the contractor in default and demanded the surety step in to finish the project. *Id.* at 1241. The Dodges alleged that the surety failed to investigate promptly or remedy the defaults of the principal and filed suit against the surety alleging breach of contract and a bad faith tort claim. *Id.* The lower court dismissed the bad faith claim against the surety. *Id.* On appeal, the Arizona Supreme Court reversed, holding that sureties have a duty to act in good faith as matter of policy because imposing potential tort damages on sureties deters bad faith conduct. *Id.* at 1242-44.

- ***Int'l Fid. Ins. Co. v. Delmarva Sys. Corp.*, No. 99C-10-065 WCC, 2001 Del. Super. LEXIS 165 (Del. Super. Ct. May 9, 2001).** A community college hired an electrical contractor for work in the construction of a new educational building and the contractor obtained a performance bond. *Id.* at *2. The contractor abandoned the job, and the college alleged the surety refused to perform its obligations under the bond. *Id.* at *3. The surety filed a declaratory judgment action and the community college filed counterclaims including one for "bad faith handling." *Id.* The surety moved to

dismiss the counterclaim asserting that Delaware does not recognize a cause of action for punitive damages in the surety context. *Id.* at *5. The court disagreed, holding that, although the relationship between surety and obligee is not the same as insurer and insured, enough similarities exist to extend the same types of claims including bad faith tort claims. *Id.* at *34.

- ***King County v. Vinci Constr. Grands Projets/Parsons RCI/Frontier-Kemper, JV*, 398 P.3d 1093 (Wash. 2017).** On a large public works project to expand a wastewater treatment system, it became clear that one of the contractors would not perform within the contract time and the project's owner declared the contractor in default. *Id.* at 1096. The sureties who had posted bonds on the project did not cure the alleged default or fund a replacement contractor based on the argument that the principal had not breached the contract. *Id.* The court found the sureties liable on the bond and for attorney fees. *Id.* On appeal, the court affirmed the judgment, holding that, under Washington law, sureties may owe attorney fees for denying liability on a performance bond along with statutory fees. *Id.* at 1101.

- ***Loyal Ord. of Moose, Lodge 1392 v. Int'l Fid. Ins. Co.*, 797 P.2d 622 (Alaska 1990)**. The Moose Lodge hired a contractor for the construction of a new facility and the contractor obtained a performance bond. *Id.* at 623. After numerous alleged defects and delays, the Moose Lodge declared the contractor in default and notified the surety that it would be completing the project. *Id.* at 625. After a claim against the contractor was dismissed, the Moose Lodge sued the surety for a bad faith tort claim. *Id.* at 626. On appeal of the trial court's entry of summary judgment for the surety on the bad faith claim, the Supreme Court of Alaska held that a surety owes a duty of good faith similar to the duty an insurer owes to its insured and that an obligee may maintain a tort action for bad faith against a surety. *Id.* at 626-628.

- ***Szarkowski v. Reliance Ins. Co.*, 404 N.W.2d 502 (N.D. 1987).** After the subcontractor defaulted on its contract with the prime contractor, the prime contractor filed a claim on the subcontractor's bond. *Id.* at 503. The surety refused to issue payment and the contractor filed suit to recover the debt under the bond, or alternatively obtain compensatory and punitive damages for bad faith. *Id.* On appeal, the court reversed the lower court's ruling dismissing both claims, holding, in part, that sureties owe a duty of

good faith to third-party beneficiaries and those third parties have a right to bring an independent tort action for breach of that duty. *Id.* at 505-07.

- ***Transamerica Premier Ins. Co. v. Brighton Sch. Dist. 27J*, 940 P.2d 348 (Colo. 1997).** Brighton School District hired a contractor to perform mechanical work on a construction project. *Id.* at 349. After the contractor defaulted on the contract, the school district obtained bids on remedial work and requested payment from the surety on the performance bond. *Id.* at 350. The surety contested the scope of the bid, argued for the principal to return to the project to complete the work, and refused to make payments. *Id.* Subsequently, the school district filed suit against the surety for breach of contract and a separate tort claim for bad faith denial of the bond claim. *Id.* The court held that the surety was liable on the bond claim and for the bad faith tort claim. *Id.* On review, the Colorado Supreme Court affirmed and held that an obligee may bring a bad faith tort claim against a surety on a performance bond. *Id.* at 353-54.

- ***Worldlogics Corp. v. Chatham Reinsurance Corp.*, 108 P.3d 5 (Ok. Civ. App. 2004).** After a contractor defaulted on the contract, Worldlogics made a demand on the performance bond and asked the surety to finish the project. *Id.* at 6. The surety failed to adequately investigate the claim and then refused to perform under the bond. *Id.* After securing an arbitration award against the bond, Worldlogics filed suit against the surety for breach of implied duty of good faith and fair dealing and the jury found the surety liable. *Id.* On appeal, the court affirmed the judgment, holding that a surety owes a duty of good faith and fair dealing to its obligee in Oklahoma, and a failure take action on a performance bond warrants a separate tort claim against a surety. *Id.* at 9-10.

As these examples suggest, and together with liability on a particular claim or project, a surety's decision to do nothing or not enough—and subsequent litigation of that issue—may lead to case law that impacts how a surety may need to address future claims and projects.

E. RECOMMENDATIONS

Although each situation is unique, there are some basic principles that should likely be applied in all situations where a surety faces the decision of whether to act. Although the actions below can be time

intensive and/or costly, their value in the end, especially if the contractor/principal is terminated, is worth the upfront time and expense.

i. Investigate

The A312 performance bond has specific pre-conditions that must be followed before the surety's obligations are triggered. A failure to comply with those pre-conditions may act as a defense. But once the surety learns of a potential problem with its principal's performance, it is in the surety's best interest to investigate thoroughly. The defense of the owner/obligee's failure to comply with the bond terms is not waived by the surety's investigation; rather, it gives the surety a head-start in understanding the issues, identifying potential defenses, and mitigating damages.

Timely communication and involvement with the surety is vital because, among other reasons, the surety can learn about any material changes, avoid overpayment, or release of collateral, and have the opportunity to timely investigate the facts and circumstances in the event of a contractor/principal's default.

An investigation can consist of several approaches, including at least the following common ones:

a. Read the Documents

The claim handler, counsel, and/or consultant should read the bond and the contract. It is necessary to know and understand the bond and contract terms and conditions in order to evaluate the claim (or potential claim), the principal's defenses—whether standing in the shoes as an obligee or principal— and the surety's obligations. Although the bond and contract are likely the first documents to review, other documents may come into play, including change orders, requests for information, schedules, pay applications, invoices, schedules, correspondence, meeting minutes etc. Additional documents incorporated by reference into the performance bond should also be considered, including the underlying

construction contract, which may provide additional basis for declaring default and terminating the contractor.[4]

b. Determine the Status of the Project

This is often done with help from a retained consultant who has the background and knowledge to understand the details of the project and claims. This includes understanding both the physical status of the project and the financial status. Another benefit to retaining a consultant for this task is that the consultant can often better understand the personalities and the history of the project. And, at times, the consultant can act as an independent voice to mediate the dispute between the owner and contractor; especially, where parties have dug-in on their position, more out of ego than substance.

c. Evaluate the Principal's Financial Status

Most General Indemnity Agreements allow the surety the right to access the principal's books and records. By analyzing the principal's records, the surety can not only get a better understanding of the financial condition of the project at issue, but also other projects that could impact the progress of the relevant project and the overall financial health of the contractor/principal. It is not uncommon that a contractor/principal in financial distress will divert funds to prop up one project at the cost of another, and in situations where a surety has bonded several projects for the same contractor, one problematic project can quickly turn into many problematic projects. Accordingly, a global assessment of the contractor/principal's finances is necessary to avoid a single claim having a snowball effect.

ii. Comply with the Insurance Regulations

State departments of insurance regulate the surety industry and include rules that may need to be followed as part of the claim process. The surety cannot ignore those regulations based merely on representations by

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[4] The A312 Performance Bond incorporates by reference the underlying construction contract.

their principal. Accordingly, the surety must be fluent in the laws of the state(s) where they have issued bonds.

iii. Create a Record in Writing

Upon learning that there may be an issue with a bonded project, the surety should immediately start creating a record. Creating a record includes acknowledging correspondence from the owner/obligee, informing the contractor/principal of the alleged issues, gathering information from the contractor/principal and owner/obligee, advising the owner/obligee of the parties (obligee/principal/surety) obligations, and advising the owner/obligee of potential defenses. On the flip side, an owner/obligee that terminates the contractor/principal hastily and without record that reflects the merits of the termination puts itself in a less favorable position to call on the surety.

F. CONCLUSION

A surety may be tempted to "do nothing" in response to a claim, especially where the preconditions of the surety's obligations under an A312 bond have not been satisfied. However, doing nothing—or not doing enough—carries great risk that a surety will experience a more expensive claim process, litigation, and potentially even bad faith claims. Thus, in response to a claim, a surety should undertake a thorough investigation into the claim, comply with applicable state law requirements, and create a written record of its evaluation and defenses. Not only may such actions lead to earlier resolution of the claim, but they also put the surety in a better position should the issue persist.

PANEL 9

ETHICAL AND GOOD FAITH CONSIDERATIONS WHEN COORDINATING INTERESTS

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Ethical and Good Faith Considerations When Coordinating Interests

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I. INTRODUCTION

Given the tripartite nature of the surety business[1], it is important for those working in the surety industry to be aware of the ethical issues that consistently arise in this line of work. There is a "balance of power between owner/obligees, contractor/principals and sureties"[2], and walking the tightrope of obligations between these parties often leads surety practitioners, whether they be surety claims personnel, surety counsel, or surety consultants, into an ethical minefield. "[S]ureties, by the nature of their business, may find themselves caught between Scylla and Charybdis[3]", the surety's "classic dilemma."[4]

A surety bond is a contract. [5] Whether or not the tort of bad faith applies to sureties in a particular state, "it is well established that a covenant of good faith and fair dealing is implicit in every contract….The essence of the implied covenant is that neither party to a contract will do anything to injure the right of the other to receive the benefits of the contract."[6] But in a surety bond, with whom is the surety contracting? With the bond principal or with the obligee, or with both? To whom does the surety owe a

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[1] *Cates Construction, Inc. v. Talbot Partners* (1999) 21 Cal.4th 28, 58. "The surety relationship is a tripartite one implicating the separate legal interests of the principal, the obligee and the surety."; *PSE Consulting, Inc. v. Frank Mercede & Sons, Inc.*, 267 Conn. 279, 316, 838 A.2d 135 (Conn. 2004).

[2] *Cates Construction, Inc. v. Talbot Partners* (1999) 21 Cal.4th 28, 61.

[3] According to worldhistory.org, in an article published by Mark Cartright on February 26, 2017, "Scylla and Charybdis were monsters from Greek mythology thought to inhabit the Straits of Messina, the narrow sea between Sicily and the Italian mainland. Preying on passing mariners, Scylla was a terrible creature with six heads and twelve feet, while Charybdis, living on the opposite side of the straits, was another monster who, over time, was transformed in the imagination of the ancients into a more rational, but no less lethal, whirlpool. Odysseus famously had to negotiate a passage through their deadly clutches in Homer's Odyssey." https://www.worldhistory.org/Scylla_and_Charybdis/

[4] *PSE Consulting, Inc. v. Frank Mercede & Sons, Inc.*, 267 Conn. 279, 316-17, 838 A.2d 135 (Conn. 2004).

[5] *Bloom v. Bender* (1957) 48 Cal.2d 793, 803. "…while a surety cannot be held beyond the express terms of his contract, the contract is to be interpreted by the same rules used in construing other types of contracts…." See also *Cates Construction, Inc. v. Talbot Partners* (1999) 21 Cal.4th 28, 39. "Performance bonds, like all contracts of surety, are construed with reference to the same rules that govern interpretation of other types of contracts."

[6] *Cates Construction, Inc. v. Talbot Partners* (1999) 21 Cal.4th 28, 43.

contractual covenant of good faith and fair dealing? And what ethical rules arise while navigating these issues?

California courts have treated the surety relationship as a contract between the surety and the bond principal.[7] While the obligee is an intended beneficiary of the bond, the obligee is not a party to the surety bond contract.[8] In addition, while a bond principal may be statutorily required to reimburse its surety for losses paid out of a bond[9], it is common for sureties to require a separate indemnity agreement to be signed, making the bond principal and personal indemnitors responsible to reimburse the surety in the event of losses, including for legal and investigative expenses. This may give rise to additional duties of good faith and fair dealing which spawn further ethical issues.

This article will address some of the common ethical issues that are faced by surety practitioners due to the inherent conflicts in the surety bond business. A distinction must be made between surety claims handlers that work for surety bond companies, and outside counsel or counsel employed in in-house litigation departments of surety bond companies. The duty of good faith, which will be discussed below, applies to surety claim handlers, but the Model Rules, also discussed below, do not. The Model Rules apply to active attorneys who represent clients. This includes outside counsel and counsel working in in-house litigation departments. While much of this article focuses on common issues faced by outside counsel or in-house litigators, this paper also raises issues of concern relevant to surety claims representatives.

[7] *Ehmcke Sheet Metal Works v. Wausau Ins. Co.*, 755 F. Supp. 906, 911 (USDC, ED Cal., 1991).

[8] *Cates Construction, Inc. v. Talbot Partners* (1999) 21 Cal.4th 28, 43.

[9] See for example, California Civil Code § 2847, which states, in relevant part, that "[I]f a surety satisfies the principal obligation, or any party thereof, whether with or without legal proceedings, the principal is bound to reimburse what he has disbursed,…."

II. KEEP IN MIND THE PREAMBLE AND SCOPE OF THE MODEL RULES

While states have their own rules of professional conduct for attorneys[10], "[F]or more than one hundred years, the American Bar Association has provided leadership in legal ethics and professional responsibility through the adoption of professional standards that serve as models of the regulatory law governing the legal profession."[11] Much of this paper will review the American Bar Association ("ABA") Model Rules of Professional Conduct ("Model Rule" or "Model Rules") as they apply to various situations that commonly arise in the surety field. However, a review of the Model Rules should include the overriding purpose of them, which is well expressed in the Preamble and Scope section:[12]

"A lawyer's conduct should conform to the requirements of the law…."[13] A lawyer should be mindful of deficiencies in the administration of justice and of the fact that…sometimes persons…cannot afford adequate legal assistance."[14] "In the nature of law practice, however, conflicting responsibilities are encountered."[15] "Within the framework of these Rules, however, many difficult issues of professional discretion can arise. Such issues must be resolved through the exercise of sensitive professional and moral judgment guided by the basic principles underlying the Rules. These principles include the lawyer's obligation zealously to protect and pursue a client's legitimate interests, within the bounds of the law, while maintaining a professional, courteous, and civil attitude toward all persons involved in the legal system."[16] "The Rules of Professional Conduct are rules of reason. They should be interpreted with reference to the purposes of legal representation and of the law itself."[17] "The Rules presuppose a larger legal context shaping the lawyer's role. That context includes court rules and

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[10] E.g., see the Rules of the State Bar of California, California Rules of Professional Conduct, Rules 1.0 – 8.5.

[11] Preface to the ABA Model Rules of Professional Conduct, 2023 Edition, page xi.

[12] ABA Model Rules of Professional Conduct, 2023 Edition, pages 1-5.

[13] ABA Model Rules of Professional Conduct, 2023 Edition, Preamble and Scope, [5], page 1.

[14] ABA Model Rules of Professional Conduct, 2023 Edition, Preamble and Scope, [6], page 2.

[15] ABA Model Rules of Professional Conduct, 2023 Edition, Preamble and Scope, [9], page 2.

[16] ABA Model Rules of Professional Conduct, 2023 Edition, Preamble and Scope, [9], pages 2-3.

[17] ABA Model Rules of Professional Conduct, 2023 Edition, Preamble and Scope, [14], page 3.

statutes relating to matters of licensure, laws defining specific obligations of lawyers and substantive and procedural law in general."[18] "The Rules do not, however, exhaust the moral and ethical considerations that should inform a lawyer, for no worthwhile human activity can be completely defined by legal rules. The Rules simply provide a framework for the ethical practice of law."[19]

Therefore, while some of the "Rules are imperatives, cast in the terms 'shall' or 'shall not'…other of the Rules which are "generally cast in the term 'may' are permissive and define areas under the Rules in which the lawyer has discretion to exercise professional judgment."[20] In exercising this discretion, the surety lawyer should keep in mind the Preamble and Scope part of the Model Rules, examples of which are set forth above. In doing so, the surety lawyer should adhere not only to the Model Rules, but also to concepts such as good faith, properly applying in each applicable jurisdiction the law of suretyship and contracts in general, as well as the applicable rules of civil procedure, state Department of Insurance Regulations,[21] and the Rules of Professional Conduct applicable to attorneys in the particular state where each attorney practices.

III. RELATIONSHIP BETWEEN THE SURETY AND ITS BOND PRINCIPAL

As parties who directly contract with each other, the surety and the bond principal are bound by the implied covenant of good faith and fair dealing inherent in every contract, meaning that both parties cannot do anything to injure the right of the other to receive the benefits of the contract.[22] The benefits of a surety bond contract for the surety are receipt of bond premium. For the bond principal, the benefits are the issuance of the bond, thereby allowing the bond principal to perform a contract in the case of a contract (payment and performance) bond, or allowing the bond

[18] ABA Model Rules of Professional Conduct, 2023 Edition, Preamble and Scope, [15], page 4.

[19] ABA Model Rules of Professional Conduct, 2023 Edition, Preamble and Scope, [16], page 4.

[20] ABA Model Rules of Professional Conduct, 2023 Edition, Preamble and Scope, [14], pages 3-4.

[21] E.g., California Code of Regulations, Title 10, Chapter 5, Subchapter 7.5, the Fair Claims Settlement Practices Regulations, Section 2695.1, et seq.

[22] *Cates Construction, Inc. v. Talbot Partners* (1999) 21 Cal.4th 28, 43.

principal to be in business, in the case of a license bond[23]. As explained below, good faith also means that the surety will only pay bond claims that either are reasonably considered to be valid, or when the claim payment is not made with an improper motive or a dishonest purpose, depending on the jurisdiction.

A. THE GENERAL AGREEMENT OF INDEMNITY.

Typically, in connection with the issuance of a surety bond, a surety will require the bond principal, along with individuals associated with the bond principal, to execute a written indemnity agreement, often known as a general agreement of indemnity, which further induces the surety to issue a bond or bonds for the principal. These indemnity agreements generally require the bond principal and individual indemnitors to pay premium, to indemnify and hold the surety harmless, to reimburse the surety for any losses suffered in connection with the bond(s) issued in reliance on the agreement, to post collateral in the event of claims against the bond(s), and give the surety the sole discretion to pay or settle bond claims.

B. THE DUTY OF GOOD FAITH SETTLEMENT OF CLAIMS.

Case law in California holds that to support a surety's claim for reimbursement of losses under the indemnity agreement, the surety must have made the claim payments in good faith. In *Arntz Contracting Co. v. St. Paul Fire & Marine Inc. Co.* (1996) 47 Cal.App.4th 464, 482, the California Court of Appeal deprived a surety of part of its claim for reimbursement for losses under the indemnity agreement because the court found that some losses were sustained by the surety even though there was "overwhelming proof that those expenses were unnecessary and unwarranted" and the "surety's authorization of those expenses were without rational justification and constituted economic waste." *Arntz Contracting Co.*, 47 Cal.App.4th at 483. The Court of Appeal found that the surety "did not in good faith believe it was either desirable or necessary to completely replace the stucco, sheet metal and roofing in order to protect its interests as surety, and

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[23] E.g., California Business and Professions Code § 7071.6 requires, as a condition of licensure by the state, that a contractor post a contractor's license bond, for the benefit of those within the state of California who may be damaged as a result of the bonded contractor's violation of the Contractors State License Law.

so indemnification for those expenses was properly denied." *Arntz Contracting Co.*, 47 Cal.App.4th at 483-484. The Court of Appeal held that "[A] Surety is not entitled to indemnification for amounts paid in settlement of claims upon its bonds if the settlement is not made in good faith." *Arntz Contracting Co.*, 47 Cal.App.4th at 485.

In *General Ins. Co. of America v. Singleton* (1974) 40 Cal.App.3d 439, 443-444, where a surety successfully enforced its right to demand a deposit of collateral security under an indemnity agreement, the California Court of Appeal held that "the terms of the indemnity agreement are binding in this case if the settlement was made in good faith." In *General Ins. Co. of America*, the Court of Appeal found that there was no evidence to indicate that the surety did not act in good faith in settling litigation. *General Ins. Co. of America*, 40 Cal.App.3d at 444. The Court of Appeal further noted, citing to a 6th Circuit federal case[24], that "[P]rovisions in indemnity agreements granting to the indemnitor [sic[25]] the right to compromise and settle claims, and providing that vouchers and other evidence of payment shall be prima facie evidence of the propriety thereof, have been upheld as not against public policy and enforced by the courts." *General Ins. Co. of America*, 40 Cal.App.3d at 443-444. These clauses in indemnity agreements will be upheld so long as the surety pays claims and settles litigation in good faith.

However, the Court of Appeal in *Arntz Contracting Co.* concluded that "indemnification of settlement costs is properly denied where, as here, the costs are attributable to an obligee's direct action against the surety containing colorable allegations that the surety's deliberate and willful malfeasance in managing the project damaged the obligee and the trier of fact finds, upon substantial evidence, that the alleged malfeasance and resulting damages are unrelated to any wrongdoing by the principal." *Arntz Contracting Co. v. St. Paul Fire & Marine Inc. Co.* (1996) 47 Cal.App.4th 464, 486.

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[24] *Transamerica Insurance Company v. Bloomfield*, (6th Cir. 1968) 401 F.2d 357, 362.

[25] The word "indemnitor" in this quote must be a typographical error. The surety in an indemnity agreement is the indemnitee. The bond principal and its principals who sign the indemnity agreement are the indemnitors.

Therefore, a surety, whether investigating payment or performance bond claims, must abide by the duty of good faith and fair dealing inherent in every contract. This should apply in connection with the investigation of license bond claims as well. Not only will this satisfy the ethical obligation to comply with the law, as stated in the Preamble and Scope section of the Model Rules,[26] but will also help the surety in its loss recovery efforts, under its indemnity agreements. It should be noted that the Model Rules only apply to actively practicing attorneys who represent clients, not to surety company claims representatives.

A bond principal's statutory obligation to reimburse its surety for losses is clear under the law. In California, "Civil Code, sections 2847 and 2848 give the surety on a bond a cause of action against the principal where the surety has satisfied the principal obligation." *Anchor Cas. Co. v. Gordon D. Strube*, 221 Cal.App.2d 29, 32. In addition, an indemnitor that fails to reimburse a surety after the surety has suffered a loss on a surety bond, breaches the indemnity agreement. *Amwest Sur. Ins. Co. v. Patriot Homes, Inc.* (2005) 135 Cal.App.4th 82, 87. As long as the surety handles claims in good faith, the law will support the surety's efforts to seek reimbursement from its principal and indemnitors for its losses.

While a surety is required to pay each claim in good faith in order satisfy its obligation of good faith and fair dealing to its principal and indemnitors, what does "good faith" mean in this regard? In California, it means that the surety must act reasonably, according to *Arntz Contracting Co.* which held that "the covenant of good faith can be breached for objectively unreasonable conduct, regardless of the actor's motive." *Arntz Contracting Co. v. St. Paul Fire & Marine Inc. Co.* (1996) 47 Cal.App.4th 464, 483.

However, in connection with an indemnity action brought by a surety under an indemnity agreement, the California Court of Appeal held: "[T]o require plaintiff to establish a case against the defendants [the indemnitors] in the same manner that a claimant against the indemnitee would have been obligated to do, would defeat the purpose of the clauses in

[26] ABA Model Rules of Professional Conduct, 2023 Edition, pages 1-5.

the indemnity agreement allowing the indemnitee to settle claims. 'The purpose of clauses in indemnity agreements of the type here involved is to facilitate the handling of settlements by sureties and obviate unnecessary and costly litigation.'" (*Transamerica Ins. Co. v. Bloomfield*, supra, 401 F.2d 357, 363.)" *General Ins. Co. of America v. Singleton* (1974) 40 Cal.App.3d 439, 444.

While California interprets good faith to mean reasonableness, it appears to fall within a minority of jurisdictions that analyze a surety's conduct in making claim decisions "under a less forgiving standard, namely, one that defines bad faith as conduct that was unreasonable or negligent." *PSE Consulting, Inc. v. Frank Mercede & Sons, Inc*., 267 Conn. 279, 302, f.n.12, 838 A.2d 135 (Conn. 2004). In *PSE Consulting, Inc.*, the Connecticut Supreme Court upheld a jury defense verdict for the bond principal in connection with the surety's cross-complaint for indemnity, based on the surety's breach of the covenant of good faith and fair dealing, due to its failure to investigate adequately and improperly settling claims solely out of self-interest. *PSE Consulting, Inc. v. Frank Mercede & Sons, Inc.*, 267 Conn. 279, 318, 838 A.2d 135 (Conn. 2004).

However, the Connecticut Supreme Court stated that in analyzing the case, it was joining "those jurisdictions that define bad faith as requiring an 'improper motive' or 'dishonest purpose' on the part of the surety." *PSE Consulting, Inc. v. Frank Mercede & Sons, Inc.*, 267 Conn. 279, 304-305, 838 A.2d 135 (Conn. 2004). The Connecticut Supreme Court held that "[T]he majority of courts agree that the principal must establish something more than mere negligence to prove bad faith. *PSE Consulting, Inc. v. Frank Mercede & Sons, Inc.*, 267 Conn. 279, 302-303, 838 A.2d 135 (Conn. 2004).

C. PAYING CONTRACTOR'S LICENSE BOND CLAIM OVER PRINCIPAL'S OBJECTION

Every state has at least one class of contractor that is required to be licensed[27]. Some of these states require contractors to post a contractor's

[27] Model Jury Instructions for Surety Cases, Robert C. Niesley, Editor, American Bar Association, Chapter 5 – Contractor's License Bonds, Pages 103-108 (Published in 2000.)

license bond[28]. In California, this author's home state, contractors are required to obtain a license bond under California Business and Professions Code § 7071.6, which states: "(a) The board shall require as a condition precedent to the issuance, reinstatement, reactivation, renewal, or continued maintenance of a license, that the applicant or licensee file or have on file a contractor's bond in the sum of twenty-five thousand dollars ($25,000)[29].

In connection with a California contractor's license bond surety's decision to pay a claim out of the proceeds of a license bond, the surety is statutorily required to make only good faith payments. California Business and Professions Code § 7071.11 states, in pertinent part:

> "(e) Whenever the surety makes payment on a claim against a bond required by this article, whether or not payment is made through a court action or otherwise, the surety shall, within 30 days of the payment, provide notice to the registrar. The notice required by this subdivision shall provide the following information by declaration on a form prescribed by the registrar:
>
> (1)The name and license number of the contractor.
> (2) The surety bond number.
> (3) The amount of payment.
> (4) The statutory basis upon which the claim is made.
> (5) The names of the person or persons to whom payments have been made.
> (6) Whether or not the payments were the result of a good faith action by the surety.
>
> The notice shall also clearly indicate whether or not the licensee filed a protest in accordance with this section.
>
> (f) Prior to the settlement of a claim through a good faith payment by the surety, a licensee shall have not less than 15

[28] Model Jury Instructions for Surety Cases, Robert C. Niesley, Editor, American Bar Association, Chapter 5 – Contractor's License Bonds, Pages 108-112 (Published in 2000.)
[29] The penal sum of the bond required by the statute was increased to $25,000 as of January 1, 2023. Prior to that, it was $15,000.

> days in which to provide a written protest. This protest shall instruct the surety not to make payment from the bond on the licensee's account upon the specific grounds that the claim is opposed by the licensee, and provide the surety a specific and reasonable basis for the licensee's opposition to payment." (Emphasis added.)

As set forth in the statute, a surety in California is specifically required in connection with contractor's license bonds to only make good faith payments. The statute also implies that the surety should provide notice to its principal before settling a claim, and wait 15 days before making the payment, in order to give the principal a chance to provide a written protest where the principal can instruct the surety not to pay the claim. However, the principal's written protest must provide the surety with a specific and reasonable basis for the principal's opposition to a payment. The principal should provide documentary evidence in support of its position. A principal's failure to provide documents in its defense could be seen as unreasonable. The initial notice letter to the principal advising of the claim and asking for a response and defenses, should be sufficient to satisfy the statute. Serving the principal and indemnitors with a cross-complaint for indemnity if the claim is in the form of a lawsuit can also serve as notification of the claim.

If the principal provides a reasonable basis for its defense, especially when supported by documents, and when there is a "genuine dispute over liability," the surety can properly suspend further investigation of the claim, and "await the outcome of the liability dispute" before paying on the bond. *Brinderson-Newberg Joint Venture v. Pacific Erectors, Inc.*, 971 F.2d 272, 283 (9th Cir. 1992.) <u>Business and Professions Code</u> § 7071.11(e) and (f) provides authority to a surety to deny a claim when there is a good faith dispute between a bond claimant and the bond principal. However, according to the California Attorney General, "where liability is 'possible,' even though denied by the principal, a surety's payment of a bond claim may be considered to be made in good faith." 65 Ops. Cal. Atty. Gen. 25 (1982).

A surety paying a license bond claim over the objections of its principal after the principal has provided its surety with a reasonable and good faith defense, could impair the surety's indemnity rights against its principal under the indemnity agreement. The failure of the principal to respond to the surety's written notification of claim, or the principal's failure to provide a defense that makes sense or is reasonable, could result in the surety making a good faith payment to the claimant when the claimant's claim is well supported, assuming no special surety defenses apply, such as the statute of limitations, alleged bad acts or omissions of the principal occurring outside the effective bond period or license period, etc. A surety acting this way, denying claims where there is a good faith dispute, and paying them when none can be reasonably discerned, should be able to successfully navigate between Scylla and Charybdis, namely, the demands of the claimant or obligee on one side, and the conflicting demands or protests of the bond principal or indemnitor, on the other.

D. ISSUES REGARDING TENDERING THE SURETY'S DEFENSE TO THE BOND PRINCIPAL'S ATTORNEY

Indemnity agreements signed by bond principals and indemnitors in favor of surety bond companies as part of the bond application and underwriting process typically require the reimbursement to the surety of legal fees and court costs incurred in handling lawsuits or claims made against the bond(s). When a surety is served with a lawsuit seeking to enforce a bond, the surety, in order to avoid incurring legal fees and costs, and to allow the principal and indemnitor an opportunity to mitigate their liability to the surety under the indemnity agreement, will often offer to tender the defense of the lawsuit to its principal and indemnitors. To comply with its obligation to act in good faith, as described above, the surety will generally do an initial investigation to make sure there is a genuine dispute over liability, that its principal has a reasonable basis for a defense, and that the proposed tender attorney is responsive and competent, before tendering. The surety and the tender attorney must know about the ethical issues that can arise in this relationship.

i. Communication.

In a tender of defense situation, it is a concern that the tender attorney may think of his contractor/bond principal client as his main client, and the surety as a secondary client. In fact, the surety is as much a client as the bond principal, and the surety should expect to receive regular communication from the tender attorney regarding case status.

Model Rule 1.4: Communication, states, in part:

> "(a) A lawyer shall:
>
> (1) promptly inform the client of any decision or circumstance with respect to which the client's informed consent, as defined in Rule 1.0(e), is required by these Rules;
>
> (2) reasonably consult with the client about the means by which the client's objectives are to be accomplished;
>
> (3) keep the client reasonably informed about the status of the matter;
>
> (4) promptly comply with reasonable requests for information; and….
>
> (b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."

To best understand Model Rule 1.4, one should read Model Rule 1.0(e) for the definition of "informed consent":

> "(e) "Informed consent" denotes the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct."

The tender attorney should give, and the surety should expect to receive, regular case updates. When the surety asks the tender attorney for

an update, the principal's attorney should respond as quickly as he would, presumably, had his bonded contractor client asked for the update. If the principal elects to waive a jury trial, participate in mediation, or stipulate to arbitration, the tender attorney should get prior approval from the surety, to make sure the contractor client and the surety both agree. The tender attorney should let the surety know before the court has a hearing to select a trial date, so that if the surety wants to send a representative to attend the trial, the representative's schedule can be kept in mind when counsel selects the trial date along with the court and other counsel in the case. As for settlement, the tender attorney must always convey offers to the surety[30]. The tender attorney should let the surety know when discovery is received in case the surety wishes to review it as part of a further case investigation. Comment [1] to Model Rule 1.4 states that "[R]easonable communication between the lawyer and the client is necessary for the client effectively to participate in the representation."

ii. Fees.

Model Rule 1.5: Fees, states, in pertinent part:

> "…(b) The scope of the representation and the basis or rate of the fee and expenses for which the client will be responsible shall be communicated to the client, preferably in writing, before or within a reasonable time after commencing the representation, except when the lawyer will charge a regularly represented client on the same basis or rate. Any changes in the basis or rate of the fee or expenses shall also be communicated to the client."

When a surety tenders its defense to its bond principal/indemnitors and their attorney, the surety will typically require the principal/indemnitors and the tender attorney to sign a tender agreement. These agreements need to make clear, among other things, that all attorney's fees and costs incurred in the case will be the sole and exclusive responsibility of the

[30] California Rule of Professional Conduct 1.4.1(a)(2) requires a lawyer to promptly communicate to the lawyer's client all amounts, terms, and conditions of any written offer of settlement. However, the Comment to this Rule states that even oral offers must be communicated to the client if it is a significant development in the case, pursuant to Rule 1.4.

principal/indemnitor. Legal fees for the representation of the surety being paid for by the principal/indemnitors brings into play Model Rule 1.8(f)[31].

Model Rule 1.8: Conflict of Interest: Current Clients: Specific Rules, states, in relevant part:

> "(f) A lawyer shall not accept compensation for representing a client from one other than the client unless:
>
> (1) the client gives informed consent;
>
> (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and
>
> (3) information relating to representation of a client is protected as required by Rule 1.6."

Under Model Rule 1.8(f), the surety is the client, and the tender attorney is accepting payment from "one other than the client," namely the bond principal/indemnitor. A proper tender agreement from the surety can help to ensure that the requirements of Model Rule 1.8(f) are adhered to in the tender attorney scenario.

Comment [14] to Model Rule 1.8 further expresses the problems that can arise when one party pays for the representation of another: "Because third-party payers frequently have interests that differ from those of the client, including interests in minimizing the amount spent on the representation and in learning how the representation is progressing, lawyers are prohibited from accepting or continuing such representations unless the lawyer determines that there will be no interference with the lawyer's independent professional judgment and there is informed consent from the client. See also Rule 5.4(c) (prohibiting interference with a

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[31] In California, see Rule of Professional Conduct 1.8.6. Comment [1] to this Rule states: "A lawyer's responsibilities in a matter are owed only to the client except where the lawyer also represents the payor in the same matter. With respect to the lawyer's additional duties when representing both the client and the payor in the same matter, see rule 1.7." (Emphasis added.) In a tender attorney situation, the tender attorney is representing the bond principal/indemnitor client (the payor), and the surety client in the same matter.

lawyer's professional judgment by one who recommends, employs, or pays the lawyer to render legal services for another)."

iii. Confidentiality.

Model Rule 1.6: Confidentiality of Information, states, in pertinent part:

> "(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b)[32]."

The tender attorney owes a duty of confidentiality to both his or her bond principal/indemnitor client and to the surety client. This can lead to conflicts of interest, if the tender attorney feels that it should disclose information or documents to the surety that the principal or indemnitor does not want to share with the surety. This can be dealt with in a properly drafted tender agreement, which should have a clause that says something like: "Principal/Indemnitor agrees to waive their attorney-client privilege to the extent necessary to enable the Tender Attorney to keep the Surety informed of not only the strengths and weaknesses of the parties to the instant Litigation, but also to any facts or circumstances that could bear on the Principal/Indemnitor's ability to honor their obligations to the Surety."

Comment [2] to Model Rule 1.6 states that "in the absence of the client's informed consent, the lawyer must not reveal information relating to the representation." Dealing with this issue in a signed Tender of Defense Agreement will provide the bond principal/indemnitor's informed consent so that the tender attorney can share information with his or her co-client, the surety.

iv. Conflict of Interest.

Model Rule 1.7: Conflict of Interest: Current Clients, states:

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[32] Subsection (b) of Model Rule 1.6 deals with information a lawyer may reveal to prevent certain crimes or injuries, among other things.

> "(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
>
> (1) the representation of one client will be directly adverse to another client; or
>
> (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.
>
> (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
>
> (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
>
> (2) the representation is not prohibited by law;
>
> (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
>
> (4) each affected client gives informed consent, confirmed in writing."

When a surety tenders its defense to the principal/indemnitor's lawyer, there is an inherent conflict of interest. The liability of a surety is commensurate with that of its principal[33], thereby causing the interests of the principal and the surety to be aligned, which tends to avoid conflict. However, because of the indemnity agreement and statutory law which

[33] California Civil Code § 2808.

states that a principal must reimburse a surety for losses[34], the principal/indemnitor and surety could be at odds at any time.

So long as it appears during the litigation that the principal has a good defense, the potential conflict will simmer on the back burner. But if it surfaces, usually through the discovery process, that the facts or law are starting to tip against the principal, the tender attorney has a duty to inform the surety. In that case, especially if the surety feels that the case should be settled, but the principal/indemnitor wants to continue to litigate, it may be time for the surety to bring in their own separate counsel. In the meantime, the tender attorney will have satisfied Model Rule 1.7 by signing, and having the principal and indemnitors also sign, the tender of defense agreement, which provides informed written consent, under Model Rule 1.7(b)(4).

If the case settles while the tender attorney is still representing the surety, the tender attorney should be aware of Model Rule 1.8(g), which states:

> "(g) A lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the clients, … unless each client gives informed consent, in a writing signed by the client. The lawyer's disclosure shall include the existence and nature of all the claims … involved and of the participation of each person in the settlement."

A tender attorney needs to make sure that he or she does not commit to a settlement without informing the surety, and obtaining its written consent. This can be further assured through language in the tender of defense agreement, such as: "You are not authorized to commit the surety to any settlement or to the entry of any judgment against the surety without the surety's express written consent."

Comment [16] to Model Rule 1.8 further expresses the concerns about settlements when a lawyer represents more than one client:

[34] California Civil Code § 2847.

"Differences in willingness to make or accept an offer of settlement are among the risks of common representation of multiple clients by a single lawyer. Under Rule 1.7, this is one of the risks that should be discussed before undertaking the representation, as part of the process of obtaining the clients' informed consent. In addition, Rule 1.2(a) protects each client's right to have the final say in deciding whether to accept or reject an offer of settlement…."

v. Competence.

Model Rule 1.1: Competence, states:

> "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness, and preparation reasonably necessary for the representation."

Comment [1] to Model Rule 1.1 states:

> "[1] In determining whether a lawyer employs the requisite knowledge and skill in a particular matter, relevant factors include the relative complexity and specialized nature of the matter, the lawyer's general experience, the lawyer's training and experience in the field in question, the preparation and study the lawyer is able to give the matter and whether it is feasible to refer the matter to, or associate or consult with, a lawyer of established competence in the field in question. In many instances, the required proficiency is that of a general practitioner. Expertise in a particular field of law may be required in some circumstances." (Emphasis added.)

In deciding whether to tender the surety's defense to the principal and its attorney, one factor the surety should look at is the proposed tender attorney's competence to handle the case. As noted in Comment [1] to Model Rule 1.1, the complexity and specialized nature of a matter, and the fact that expertise in a particular field of law may be required in some cases, bears on whether an attorney is competent to represent the surety under a tender of defense.

The surety business is complex, and not all attorneys are aware of or experienced in the issues that arise in the tripartite relationship inherent in surety bond cases. The surety claims handler should check the background of the proposed tender attorney and make sure that he or she is up to the task. If the surety decides to tender to an attorney that has little experience with surety cases, it may be wise to require more frequent updates from that counsel than usual, and/or require him or her to perhaps co-counsel with a local attorney who has more experience in surety bond law. A principal's attorney who is not comfortable with surety law may be better off declining the assignment, rather than violating Model Rule 1.1.

If a principal insists on having its attorney defend the surety, despite the surety's disapproval, the surety may need to bring in its own outside counsel. That could lead to issues later when the surety seeks to enforce its indemnity agreement against the principal and indemnitor in connection with legal fees incurred. Even so, that may be better than entrusting a complex surety case to a principal's lawyer who is not considered by the surety to be competent.

Another area where attorney competence can be an issue is with collections. After a surety incurs a loss, it often sends the account to an outside collection for loss recovery. Some outside collection agencies are inexperienced with surety and when their collection efforts fail, they will bring in their own counsel to sue the principal and indemnitors under the indemnity agreement. The lawyers hired by the collection agencies, who typically work on contingency, may not know about the surety business, and may treat the case as they would any other business debt, such as a debt owed to a credit card company. Before you know it, for example, the surety claims representative, years after a claim was closed, can get a call from the collection agency's litigator, saying discovery was served and the surety now has to turn over 5 years' worth of unrelated claim files. If the lawyer did not timely object to the overbroad discovery request, that can be a problem. Therefore, it is important that surety bond companies also investigate the competence of counsel handling surety loss recovery.

IV. RELATIONSHIP BETWEEN THE SURETY AND BOND CLAIMANTS/OBLIGEES.

A surety's investigation of a claim or litigation of a claim will bring the surety and its counsel and consultants not only in contact with the bond principal and indemnitors, but also with the bond claimants/obligees. While the surety must deal with its principal and indemnitors in good faith pursuant to the covenant of good faith and fair dealing inherent in all contracts, as explained above, the Model Rules help to govern a surety's counsel's interactions with bond claimants/obligees.

Model Rule 4.1: Truthfulness in Statements to Others, states, in relevant part, as follows:

> "In the course of representing a client a lawyer shall not knowingly:
>
> (a) make a false statement of material fact or law to a third person;…."

Comment [1] to Model Rule 4.1, discusses misrepresentation: "[1] A lawyer is required to be truthful when dealing with others on a client's behalf, but generally has no affirmative duty to inform an opposing party of relevant facts."

Not only do the Model Rules require truthfulness when dealing with bond claimants, but state insurance regulations may do so too. For example, Section 2695.4 of the California Fair Claims Settlement Practices Regulations[35] states that: "(b) No insurer[36] shall conceal benefits, coverages or other provisions of the bond which may apply to the claim presented under a surety bond." This applies to all surety claims personnel, not just attorneys.

For an example of how the truthfulness issue could arise in the surety context, take an interpleader[37] situation where the surety has decided

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[35] California Code of Regulations, Title 10, Chapter 5, Subchapter 7.5, Section 2695.4.

[36] Section 2695.2(i) of the California Code of Regulations includes an issuer of surety bonds within the meaning of "insurer" for the purposes of the Regulations.

[37] California Code of Civil Procedure § 386, et seq.

to deposit the penal sum of the bond with the court because the aggregate amount of the claims made by multiple claimants exceeds the amount of the bond[38]. These cases often settle before trial, with the claimants agreeing to a pro-rata distribution of the bond[39], based on a proposal by the surety. The claimants will usually submit documentation to the surety in support of their claims, in response to the surety asking them to provide proof of claim. The surety will review these documents to calculate damages, in order to come up with a pro-rata settlement distribution proposal.

During file review, the surety may determine that one or more of the claimants' claims may not be valid. Perhaps a statute of limitations defense was discovered, or the claim had a date of loss that occurred outside the effective date of the bond, or maybe there are sufficient contract funds held by the claimant so they have not suffered damages, etc. So long as the other valid claims, in total, exceed the penal sum of the bond, the surety will suffer the complete loss of the bond no matter if the invalid claims are included in a settlement. Does Rule 4.1 require the surety's litigation counsel to inform the claimants with valid claims that the pro-rata proposal includes claims from claimants whose claims may not be valid? The less claimants there are, the more bond funds are left to distribute to the remaining claimants, and the remaining claimants' pro-rata shares will be higher.

The danger to the surety of not including the possibly invalid claims in the pro-rata distribution is that if those claimants are left out of the settlement, they could sue the surety. If the bond funds have been depleted through settlement with the other claimants, the surety risks liability beyond the sum of the bond if a court finds, for some reason, that this claimant's claim was indeed valid after all.

Comment [1] to Model Rule 4.1 says that a lawyer has no affirmative duty to inform an opposing party of relevant facts. If the

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[38] A surety's liability is limited to the penal sum of the bond. California Code of Civil Procedure § 996.470(a); *T&R Painting Construction, Inc. v. St. Paul Fire and Marine Insurance Company* (1994) 23 Cal.App.4th 738, 746.

[39] For California contractor's license bonds, the applicable statute calls for a pro-rata distribution of the bond if the bond is insufficient to pay all claims in full. California Business and Professions Code § 7071.11(a).

surety's lawyer is asked by a claimant: "have you determined that all claims involved in the pro-rata settlement proposal are valid?", then Model Rule 4.1 requires a truthful answer of "no". But if nobody asks, a good argument can be made that it does not violate Model Rule 4.1 to keep silent about the status of the validity of each claim under this example. An interpleader is a litigated matter and claimants have the right and duty to conduct their own investigation of the validity of the competing claimants' claims, using the discovery process.

Another solution is to not propose a pro-rata settlement, and let the parties litigate their claims at trial, or try to settle among themselves, without the involvement of the surety. In an interpleader, a surety who deposits or seeks to deposit the bond funds with the court can apply for an order from the court discharging the surety from liability.

Model Rule 4.2: Communication with Person Represented by Counsel states:

> "In representing a client, a lawyer shall not communicate about the subject of the representation with a person the lawyer knows to be represented by another lawyer in the matter, unless the lawyer has the consent of the other lawyer or is authorized to do so by law or a court order."

When dealing with claimants, sometimes it does not come up until the middle of a phone call that the claimant has counsel. Comment [3] to Model Rule 4.2 states, in part: "…A lawyer must immediately terminate communication with a person if, after commencing communication, the lawyer learns that the person is one with whom communication is not permitted by this Rule." It is a good idea when receiving a call from a claimant, for surety litigation counsel's first question to be: "are you represented by counsel?" This problem can occur when surety counsel receives a call from a bond principal or indemnitor too.

Model Rule 4.3: Dealing with Unrepresented Person states:

"In dealing on behalf of a client with a person who is not represented by counsel, a lawyer shall not state or imply that the lawyer is

disinterested. When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding. The lawyer shall not give legal advice to an unrepresented person, other than the advice to secure counsel, if the lawyer knows or reasonably should know that the interests of such a person are or have a reasonable possibility of being in conflict with the interests of the client."

Dealing with unrepresented claimants, even in litigation, is a common occurrence, especially with interpleaders on contractor's license bonds where the penal sums of the bonds can be low. Unlike contract bonds which bond only one work of improvement, license bonds are responsible for damages caused by a licensed contractor on all the jobs he or she performs in a state. When a bond principal runs into trouble, he or she can default on multiple projects at once. As a result, the license bond surety can receive 5, 10 or more claims against the same limited bond. License bonds in California are in the sum of $25,000[40], only recently having been increased from $15,000.

Because of this, interpleaders[41] are often filed in license bond cases. Because of the low penal sums of these bonds, and given that the law, in California, calls for a pro-rata distribution of the bond proceeds when the bond is not enough to pay all claims in full[42], many claimants in this situation decide, probably wisely, to represent themselves. A pro-rata distribution of the bond often results in limited funds being distributed to each claimant. Between the court filing fees and legal fees, hiring a lawyer may not make economic sense in these interpleader situations. An interpleading party in California can retain its reasonable attorney's fees and costs out of the amount interplead[43], further depleting the amount available for claimants. This is more reason for an interpleader bond claimant/defendant or cross-defendant to do his or her best to keep down legal fees.

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[40] California Business and Professions Code § 7071.6(a).
[41] California Code of Civil Procedure § 386, et seq.
[42] California Business and Professions Code § 7071.11(a).
[43] California Code of Civil Procedure § 386.6.

The result of this is that surety counsel that handle California license bond interpleaders get flooded with calls from unrepresented persons, asking all sorts of questions, including questions about civil procedure, such as "how do I file an answer?", "what sort of form should I use in filing an answer?", and "what should I write in my answer?"

Comment [2] to Model Rule 4.3 states, in pertinent part:

> "[2] The Rule distinguishes between situations involving unrepresented persons whose interests may be adverse to those of the lawyer's client and those in which the person's interests are not in conflict with the client's. In the former situation, the possibility that the lawyer will compromise the unrepresented person's interests is so great that the Rule prohibits the giving of any advice, apart from the advice to obtain counsel. Whether a lawyer is giving impermissible advice may depend on the experience and sophistication of the unrepresented person, as well as the setting in which the behavior and comments occur…."

An argument can be made in the license bond interpleader situation described above, that because in an interpleader the goal of the surety is to distribute the bond proceeds, and the goal of the unrepresented claimant is to have an opportunity to receive its fair share of the bond proceeds, the interests of the two are not adverse. Given this setting, providing some basic information to the unrepresented claimant, in response to their request, as a courtesy, could be considered appropriate. "At the core of the interpleader procedure is the notion that a "claimant" is not a defendant from whom affirmative relief is sought. Interpleader actions impose no obligations on claimants. Claimants are simply offered the opportunity to assert a right to control of a stake." *Cantu v. Resolution Tr. Corp.* (1992) 4 Cal.App.4th 857, 875. However, even in this unique situation, surety counsel should always tell the unrepresented claimant that counsel only represents the surety, and that it is strongly recommended that the claimant obtain its own legal advice.

Model Rule 4.4: Respect for Rights of Third Persons, states, in pertinent part, as follows:

> "(a) In representing a client, a lawyer shall not use means that have no substantial purpose other than to embarrass, delay, or burden a third person, or use methods of obtaining evidence that violate the legal rights of such a person."

Comment [1] to Model Rule 4.4 states: "[1] Responsibility to a client requires a lawyer to subordinate the interests of others to those of the client, but that responsibility does not imply that a lawyer may disregard the rights of third persons. It is impractical to catalogue all such rights, but they include legal restrictions on methods of obtaining evidence from third persons and unwarranted intrusions into privileged relationships, such as the client-lawyer relationship."

When representing a surety, counsel, whether outside or in-house, must be careful to only use litigation and investigative techniques that serve a valid purpose.

V. CONCLUSION.

Being mindful of the ethical rules in this article can help keep outside surety counsel and surety counsel practicing in in-house litigation departments on track, helping to avoid the ethics pitfalls that naturally flow from the conflicts inherent in the tripartite relationships that form the essence of suretyship. The rules on good faith claims handling can likewise help to keep surety claims representatives on track and help them avoid similar pitfalls.

PANEL 10

IN RE FALCON V, L.L.C. & IN RE FIELDWOOD ENERGY: WHAT TO DO WHEN COURTS GET CREATIVE

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In re Falcon V, LLC & *In re Fieldwood Energy*: What to Do When Courts Get Creative

By: Chad L. Schexnayder and Alana L. Porrazzo[1]

I. INTRODUCTION

Have you ever heard of result-oriented jurisprudence? Certainly. Courts *do* get creative. Whether because unique factual circumstances resist analysis under the framework of existing law or defy its straightforward application; or because precedent is deemed to demand correction, extension, modification, or reversal; or because of still other reasons—American jurisprudence is not innovation-proof. Yet "only in law," wrote Judge Posner, "is 'innovative' a pejorative."[2]

United States bankruptcy forums are popularly associated with an exceedingly high level of "judicial sophistication, individualism, and [you guessed it!] creativity."[3] Why do we view bankruptcy courts as "creative," more so than their Article III counterparts?

Practitioners' comparatively lesser familiarity with the specialized realm of bankruptcy may be part of the answer. Meanwhile, decisional law and scholarship consistently go out of their way to emphasize the inherently "equitable" approach of the United States Bankruptcy Code ("Bankruptcy Code").[4] The Bankruptcy Code itself has a kind of built-in pragmatism.[5] Courts will acknowledge that instead of "stringent requirements," the Bankruptcy Code favors "flexible tests that increase the likelihood that a plan can be negotiated and confirmed."[6] (Talk about result-oriented!)

[1] The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or any affiliates of the foregoing. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[2] United States v. McKinney, 919 F.2d 405, 421 (7th Cir. 1990) (Posner, J., *dissenting*).

[3] Troy A. McKenzie*, Judicial Independence, Autonomy and the Bankruptcy Courts*, 62 STAN. L. REV. 747, 782 (2010).

[4] *See generally* Marcia S. Krieger, "*The Bankruptcy Court Is a Court of Equity": What Does That Mean?*, 50 S. C. L. REV. 275, 275–276 (1999).

[5] *See* 11 U.S.C. § 105(a) (providing that "the court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.").

[6] *In re* Tribune Co., 972 F.3d 228, 245 (3d Cir. 2020).

As one commentator put it, "For all the complexity of the Bankruptcy Code, bankruptcy is a realm of unwritten law. That means that 'much of what matters most' in understanding how bankruptcy judges decide cases 'still is not in print.'"[7] Your authors tend to agree. That does not mean that the project of understanding "how bankruptcy judges decide cases" is inscrutable. (The proverbial writing on the wall is often apparent long before a key bankruptcy decision issues.) Nor do bankruptcy courts commonly, or even typically, make path-breaking, radical departures from the Bankruptcy Code and past circuit precedent interpreting it.

So much for this extended prologue on judicial creativity, which is both conceptually ill-defined and not actually our focus. The title of this paper and associated presentation does not quite match the authors' views of two, much-discussed commercial surety bankruptcy sagas: *In re Falcon V, LLC*[8] and *In re Fieldwood Energy, LLC*.[9]

Do either of these cases through their respective trajectories typify bankruptcy court "creativity"? Probably not—though one case is arguably more results-driven than the other.

Is either one disastrous for the surety industry? No again, at least to our minds.

But we can certainly benefit from understanding these cases and their holdings, for both the substantive and procedural elements of the stories they tell. Our strategy is therefore to make these written materials extended case notes, guiding readers through the ins-and-outs of *Falcon V* and *Fieldwood*, as the issues developed in bankruptcy court, through appeal, and contextually.

II. OIL AND GAS SURETY BONDS

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[7] Jonathan M. Seymour, *Against Bankruptcy Exceptionalism*, 89 U. CHI. L. REV. 1925, 1930 (2022) (internal quotations and citations omitted).

[8] *In re* Falcon V, LLC, 620 B.R. 256, 2020 Bankr. LEXIS 2490 (Bankr. M.D. La. Sept. 22, 2020), *aff'd on appeal sub nom.* Argonaut Ins. Co. v. Falcon V, LLC (*In re* Falcon V, LLC), Civ. Action No. 20-00702-BAJ-SDJ, 2021 U.S. Dist. LEXIS 188686 (M.D. La. Sept. 29, 2021) *and aff'd sub nom. In re* Falcon V, LLC, 44 F.4th 348 (5th Cir. 2022).

[9] *In re* Fieldwood Energy, LLC, No. 20-33948, 2021 Bankr. LEXIS 1829 (Bankr. S.D. Tex. June 25, 2021) *aff'd sub. nom*. *In re* Fieldwood Energy III LLC, No. 4:21-CV-2201, 2023 U.S. Dist. LEXIS 38454 (S.D. Tex. Mar. 7, 2023).

Both *Falcon V* and *Fieldwood* debtors engaged in oil and gas (O&G) exploration and production (E&P), operating and providing services for O&G properties. While not key to understanding the results of either one of these cases, a brief description of surety bonding in this arena sets the stage.

United States environmental and regulatory law generally makes E&P operators liable for properly decommissioning wells when they reach the end of their useful lives. Decommissioning embraces well site "plugging and abandonment" (P&A) as well as the removal of platforms and other facilities, site clearance, and restoration.

Related financial assurance is mandated by both the state and federal regulatory regimes governing E&P operators.[10] In addition to securing all-important P&A and decommissioning obligations, surety bonds in the O&G sphere may also relate to licenses and permitting for E&P operations, conservation, rights-of-way, land use, taxes, and utilities. And because state and federal regulations impose decommissioning liability not just on current operators and lessees, but also predecessors in title, an O&G operator may need to procure bonds running in favor both governmental/public entity obligees as well as contractual counterparties under asset purchase, lease assignment, and similar agreements by reason of predecessor decommissioning obligations.

III. *FALCON V*: "TRUST BUT VERIFY"

The Falcon V debtors'[11] prepetition E&P activities focused on oil and natural gas properties located onshore in Louisiana. Together, they engaged in upstream operations as a "single business segment to explore,

[10] The U.S. Bureau of Ocean Energy Management (BOEM) and the U.S. Bureau of Safety and Environmental Enforcement (BSEE)—both organized under the U.S. Department of the Interior—regulate all offshore O&G operations in federal waters. Onshore O&G operations on federal and Tribal lands are managed and regulated by the Bureau of Land Management (BLM). E&P activities on state and private land (as well as in state territorial waters) are regulated by each of thirty-three oil- and gas-producing states. State regulations bear on, *inter alia*, seismic activities, leasing, drilling, hydraulic fracturing, production, well closure, and site restoration. *See* E. Allison and B. Mandler, "U.S. Regulation of Oil and Gas Operations" *in Petroleum and the Environment,* Part 21/24 (American Geosciences Institute 2018).

[11] Debtors included Falcon V, LLC and its affiliates ORX Resources, LLC and Falcon V Holdings, LLC (collectively, "Falcon V").

develop, and produce crude oil, natural gas and NGLs, and [sold] to customers in the USA."[12]

Argonaut Insurance Company ("Argonaut") wrote Falcon V's surety bond program. The combined value of the four bonds issued by Argonaut totaled $10,575,000.[13] As consideration for the surety bonds, Falcon V executed a general indemnity agreement that required Falcon V (among other things) to pay bond premiums, post collateral upon demand, and indemnify Argonaut for any payments made under the bonds.

In connection with acquiring certain exclusive rights in O&G leases west of Baton Rouge, Falcon V was required to post a $10 million performance bond in favor of Hilcorp Energy I LP as obligee "for the purpose of ensuring proper removal of all wells, pipelines and structures by Falcon," *i.e.*, generally securing environmental compliance obligations in connection with the purchase.[14] A second bond (in the amount of $350,000) was issued in favor of Chevron Corporation as obligee in connection with decommissioning obligations under another asset purchase agreement. So, two of the four total bonds at issue in the case—representing 97% of the surety's outstanding potential exposure—ran to Falcon V's contractual counterparties (and not governmental entities).

But Falcon V's onshore operations also made it subject to BLM statewide bonding requirements and Louisiana Department of Natural Resources, Office of Conservation (LDNR) requirements for P&A, the removal of all platforms, pilings, facilities, pits, and other surface restoration.[15] The remaining two bonds in Falcon V's surety bond program were written in favor of governmental obligees, *i.e.*, the State of Louisiana ($250,000 penal sum) and the United States ($25,000 penal sum).

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[12] First Amended Disclosure Statement at 6, *In re* Falcon V, LLC, 3:19-bk-10547 (Bankr. M.D. La. Aug. 19, 2019), ECF No. 349.

[13] *See* Argonaut Ins. Co. v. Falcon V, LLC (*In re* Falcon V, LLC) (hereinafter, "Fifth Circuit Opinion"), 44 F.4th 348, 350–51 (5th Cir. 2022).

[14] *Id.* at 7.

[15] *See generally* Title 43 of the Louisiana Administrative Code, "Natural Resources." Part XIX ("Office of Conservation – General Operations" contains Section 104, entitled "Financial Security." *And see* https://www.dnr.louisiana.gov/index.cfm/page/167 (last accessed July 30, 2023).

The bonds generally provided that in the event Falcon V failed to fulfill its obligations, Argonaut must either pay the obligee or perform the obligation itself, up to the applicable penal sum. The bonds also provided that "regardless of the payment or nonpayment by [Falcon V] of any premiums owing with respect to [the Bonds], [Argonaut's] obligations…are continuing obligations and shall not be affected or discharged by any failure by [Falcon V] to pay any such premiums."[16]

A. In the Bankruptcy Court

Despite a refinancing effort in 2018 and subsequent attempts to raise equity capital and further refinance debt—and plagued by depressed commodity prices and declining production and revenues—Falcon V defaulted on its prepetition loan agreement. Falcon V and its prepetition lenders set about negotiating an in-court restructuring. In May 2019, Falcon V filed for Chapter 11 bankruptcy. The *Falcon V* debtors' first proposed plan was filed contemporaneously with initiating their consolidated Chapter 11 cases.[17]

Among other first-day motions, the debtors sought approval to continue their surety bond program. In the debtors' surety bond motion, the debtors emphasized that the surety bond program was essential to their ongoing operations:

> [B]ecause state and local law require the Debtors to post surety bonds, a failure to provide, maintain, or timely replace its surety bonds may prevent the Debtors from undertaking essential activities related to its operations. Maintaining Surety Bonds is common in the oil and gas industry because surety bonds are generally statutorily required for exploration and production activities.[18]

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[16] Fifth Circuit Opinion, 44 F.4th at 351.

[17] *See* First Amended Disclosure Statement at 17–21, *In re* Falcon V, LLC, 3:19-bk-10547 (Bankr. M.D. La. Aug. 19, 2019), ECF No. 349; Proposed Plan of Reorganization at 28, *In re* Falcon V, LLC, 3:19-bk-10547 (Bankr. M.D. La. May 19, 2019), ECF No. 28 (and providing for assumption of each executory contract and unexpired lease unless expressly rejected).

[18] Bond Motion at ¶ 21, *In re* Falcon V, LLC, 3:19-bk-10547 (Bankr. M.D. La. May 19, 2019), ECF No. 9.

Falcon V's surety-bond motion was approved on a final basis on June 17, 2019.[19] As is typical of first-day surety bond orders, the order authorized, but did not direct, the *Falcon V* debtors to continue their surety bond program in the ordinary course. It further provided that "nothing in this Order or the Motion shall be deemed to constitute post-petition assumption or adoption of any agreement pursuant to Bankruptcy Code § 365."[20]

The *Falcon V* debtor's disclosure statement likewise stressed that "[t]he maintenance of certain…surety bonds is essential to the Debtors' operations and is required by laws, various regulations, financing agreements and contracts" and that "Debtors believe that satisfaction of …surety obligations, whether arising pre- or postpetition, is necessary to maintain the Debtors' relationships with third parties and the uninterrupted operation of the Debtors' business."[21]

In addition to these expressions lauding the importance of surety credit to Falcon V's ongoing operations, the disclosure statement "included language likely to comfort, if not lull, the bonding company" by stating that "*[t]he Reorganized Debtors shall maintain all bonding currently in place after the Effective Date*."[22]

Moreover, the disclosure statement—and also the proposed plan of reorganization—indicated that all executory contracts (more on these shortly) would each be assumed unless expressly rejected.[23] All such

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[19] Final Order Authorizing Debtors to Continue Surety Bond Program, *In re* Falcon V, LLC, 3:19-bk-10547 (Bankr. M.D. La. June 17, 2019), ECF No. 226.

[20] *Id.*

[21] First Amended Disclosure Statement at 25, *In re* Falcon V, LLC, 3:19-bk-10547 (Bankr. M.D. La. Aug. 19, 2019), ECF No. 349.

[22] *In re* Falcon V, LLC, 620 B.R. 256, 261 (Bankr. M.D. La. 2020) (emphasis added) (and quoting the First Amended Disclosure Statement).

[23] Brief of Appellant Argonaut Insurance Company at 7–8, *In re* Falcon V, LLC, No. 21-30668 (5th Cir. Jan. 11, 2022) (quoting relevant sections §§ 9.1, 9.3 of the Plan). Of interest, Argonaut had filed proofs of claim on July 18, 2019 stating that "[i]t is Argo's position that any General Indemnity Agreement between Argo and any Debtor or non-Debtor affiliate may not be assumed and assigned, for among other reasons, because such agreement constitutes a 'financial accommodation' under 11 U.S.C. § 365(c)(2)." This statement was followed by a reservation of rights with respect to whether the surety bond program could be classed as executory. On the basis of these proofs of claim, Falcon V would later contend that Argonaut itself had "made clear that [the] Surety Bond Program was not executory and was not assumable." *See generally* Brief for Appellee at 8–9, *In re* Falcon V, LLC, No. 21-30668 (5th Cir. Feb. 10, 2022).

contracts were to "revest in and be fully enforceable by the Reorganized Debtors" after the plan's effective date.[24] The surety did not object to the plan.

The bankruptcy court entered its order confirming Falcon V's plan on October 11, 2019.[25] This order contained nothing in the way of specific references to surety credit and echoed the plan itself by expressly stating that "all executory contracts and unexpired leases of the Debtors shall be deemed assumed to the extent assumable under Bankruptcy Code section 365." The plan went effective very shortly after confirmation.[26]

Even if currently unfamiliar with the *Falcon V* story, the reader may still be able to predict what transpired. Several months after the plan's effective date, Argonaut sent a letter requesting that now-reorganized Falcon V post an additional $7 million in collateral. Falcon V refused, arguing that Argonaut's claims and ability to demand collateral had been discharged under the plan and pursuant to the confirmation order.[27]

On April 15, 2020, Argonaut took up the matter with the bankruptcy court. The surety filed a motion "to Interpret and Affirm the Terms of the Confirmed Chapter 11 Plan by which Argonaut's Surety Bond Program was Deemed Assumed." In this motion, Argonaut contended that the surety bond program had been assumed by the debtors, citing plan/confirmation order provisions deeming all executory contracts assumed. Falcon V countered that the surety bond program was not executory and alternatively, even if executory, the program amounted to a nonassumable financial accommodation. The dispute therefore centered on whether a tripartite surety bond program could be classed as "executory" under Section 365 of the Bankruptcy Code.[28]

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[24] *Id.* at 7 (quoting Plan, § 9.1).

[25] Technically, this was Falcon V's second amended plan.

[26] *See* Brief for Appellee at 9–10, *In re* Falcon V, LLC, No. 21-30668 (5th Cir. Feb. 10, 2022) (quoting the Confirmation Order).

[27] *See In re* Falcon V, LLC, 620 B.R. 256, 262–63 (Bankr. M.D. La. 2020).

[28] 11 U.S.C. § 365(a) "sets forth the basic power of the trustee to assume or reject executory contracts and unexpired leases." 3 COLLIER ON BANKR. ¶ 365.02 (and noting the debtor has this power when operating as debtor-in-possession). This is an oversimplification, but "assumption" can be thought of as a declaration that the debtor(s) intend to perform under the contract, and "rejection" just the opposite. The limitations and qualifications of Section 365 about which

So, what is an "executory contract"? The Code does not define the term. Two primary schools of interpretation have developed—one the majority view, the other the minority[29]—each having their root in scholarly articles rather than explicit Code sections. The most widely accepted definition (and that adhered to in the Fifth Circuit) is known as the "Countryman Test." The test takes its name from an article published by Harvard Law School professor Vern Countryman in 1973.[30] To be "executory," and thus assumable, performance must be due on both sides of the contract, and the quality of the performance must be such that a failure to render the unperformed obligation(s) would amount to a material breach of the contract. There are thus two prongs to the test, focusing on (1) remaining performance owed, and (2) the quality of that performance. In Professor Countryman's words:

> Thus, by a process similar to one method of sculpting an elephant, we approach a definition of executory contract within the meaning of the Bankruptcy Act: a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.[31]

The Countryman Test speaks in terms of a bilateral contract with neatly reciprocal obligations.

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contracts can be assumed/rejected and under what circumstances toes a kind of balancing act: on the one hand, allowing debtors to shed unprofitable or onerous contractual obligations in service of maximizing their ability to reorganize, while recognizing the detrimental impacts to contractual counterparties. Section 365(a) "provides a way for a trustee to relieve the bankruptcy estate of burdensome agreements which have not been completely performed." *In re Provider Meds., L.L.C.*, 907 F.3d 845, 851 (5th Cir. 2018) (quotation marks omitted).

[29] Describing the contours of the minority "Westbrook View", sometimes dubbed the "functional analysis" or "modern contract analysis" test, is beyond the scope of our project here, but see "The *Westbrook View*," Chapter V: Case Administration, 184–185 *in* Chad L. Schexnayder & Michael E. Collins, eds., SURETY ASPECTS OF BANKRUPTCY LAW AND PRACTICE (Am Bar Ass'n. 2021).

[30] Vern Countryman, *Executory Contracts in Bankruptcy: Part I.*, 57 MINN. L. REV. 439 (1973).

[31] *Id.* at 460. Note this quotation's reference to the Bankruptcy Act, not the Bankruptcy Code, which had not yet been enacted.

But suretyship is always tripartite, and multiple contracts define the relationship: (1) a bonded contract; (2) the bond; (3) the surety's indemnity agreement; and/or (4) ancillary agreements like collateral agreements. What of the fact that one agreement might incorporate another, or cannot exist legally or factually without another? If one contract cannot be assumed, are they all incapable of being assumed? What of the multifaceted obligations owing between principal and obligee, surety and obligee, and principal and surety? It is plain to see how multiparty, multi-contract relationships resist straightforward application of the Countryman Test—suretyship among them, where its tripartite nature involves more than just narrow obligations running between debtor and surety creditor.

As of the time the executory contract issue in *Falcon V* first reached the bankruptcy court, only a smattering of reported decisions had addressed whether surety bonds are executory contracts. All referenced the Countryman Test. A few said "no, bonds are not executory"; a couple said "yes," but only before going on to conclude that bonds were financial accommodations that could not be assumed.[32]

So, what is a "financial accommodation"? Section 365(c) of the Bankruptcy Code provides that a trustee or debtor-in-possession cannot assume or assign certain kinds of executory contracts—no matter what the contracts themselves may say about assignments of rights or delegations of duties. Among these are contracts "to make a loan, or extend other debt financing or financial accommodations[.]"[33] The purpose of this exclusion is generally to prevent debtors from requiring unwilling creditors to

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[32] *In re* Maxon Eng'g Servs. Inc., 324 B.R. 429 (Bankr. D.P.R. 2005) (holding "no," in the context of surety's stay relief motion to permit cancellation of contract bonds for public construction); *In re* All Phase Elec. Contracting, Inc., 409 B.R. 272 (Bankr. D. Conn. 2009) (holding "no", in similar context to of surety stay relief to cancel bonds); *In re* Wegner Farms Co., 49 B.R. 440 (Bankr. N.D. Iowa 1985) (holding bond was a financial accommodation); *In re* Edwards Mobile Home Sales, Inc., 119 B.R. 857 (Bankr. M.D. Fla. 1990) (bond held to be financial accommodation incapable of being assumed by operation of § 365(c)(2)). *And see In re* Evans Prods. Co., 91 B.R. 1003 (Bankr. S.D. Fla. 1988) (holding indemnity agreement executory); *In re* Coal Stripping, Inc., 215 B.R. 500 (Bankr. W.D. Pa. 1997) (annual premium agreement held not to be executory); *In re* James River Coal Co., No. 306-0411, 2006 WL 2548456 (M.D. Tenn. Aug. 31, 2006) (denying administrative priority for unpaid premiums and rejecting surety's argument that its agreement to provide bonds amounted to executory contract).

[33] 11 U.S.C. § 365(c)(2).

advance money or credit.[34] The term "financial accommodation" is not defined by the Bankruptcy Code. However, it has been construed uniformly and narrowly (if rather tautologically) to mean an extension of money or credit to accommodate another.[35]

As applied to the surety relationship, the bond "obligate[s] [the surety] to make good on certain financial liabilities of the debtor in the event debtor does not or cannot pay"[36] and thus can be understood as the surety's commitment to extend its credit in the event of the debtor's default. That our industry speaks of bonds as "surety credit"—issued according to underwriting criteria of the proverbial three Cs (capital, character, and capacity)—typifies precisely why bankruptcy courts have held bond programs to be nonassumable financial accommodations.[37] In plain English: If a bank extends a line of credit based on the financial capacity of the debtor, so too does the surety extend its credit based on the financial capacity of the debtor–principal.

B. DECISION AND APPEAL

On the surety's motion to interpret, the United States Bankruptcy Court for the Middle District of Louisiana held that the Falcon V surety bond program was not an executory contract, and even if executory, the program qualified as a financial accommodation that could not be assumed

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[34] *And see* S. Rep. No. 989, 95th Cong., 2d Sess. 58–59 (1978) ("The purpose of this subsection is to make it clear that a party to a transaction which is based upon the financial strength of a debtor should not be required to extend new credit to the debtor[.]").

[35] *See, e.g., In re* Thomas B. Hamilton Co., 969 F.2d 1013, 1018–19 (11th Cir. 1992); *In re* Jonesboro Tractor Sales, Inc., 619 B.R. 223, 231 (Bankr. E.D. Ark. 2020).

[36] *In re* Wegner Farms Co., 49 B.R. 440, 444 (N.D. Iowa 1985); *and see In re* Edwards Mobile Home Sales, Inc., 119 B.R. 857, 858–59 (Bankr. M.D. Fla. 1990) (obligation to pay debts of another is a financial accommodation).

[37] *See id.*; *see also In re* Thomas B. Hamilton Co., Inc., 969 F.2d 1013, 1018–19 (11th Cir. 1992) (guaranty and surety contracts are financial accommodations). A comparatively more interesting question is whether financial accommodations may never be assumed/assigned, or whether assumption/assignment is possible with consent. *Compare* 11 U.S.C. § 365(c)(2) (reciting without exception that executory contracts that are financial accommodations cannot be assumed) *with* 11 U.S.C. § 365(c)(1)(B) (mentioning otherwise nonassumable agreements that may be assumed and assigned with consent) and thereby suggesting that financial accommodations are always nonassumable; *but see In re* TS Indus., Inc., 117 B.R. 682, 687–88 (Bankr. D. Utah 1990) (Section 365(c)(2) "will not prevent assumption if the parties to the financial accommodations contract consent to its assumption after the debtor files a bankruptcy petition."); *In re* Prime, Inc.,15 B.R. 216, 218 (Bankr. W.D. 1981) ("The court is satisfied that, read in context of the statutory powers given the trustee to operate a business, section 365(c)(2) does permit assumption of a debt financing arrangement [with creditor consent].").

regardless of the surety's consent.[38] To reach that holding, the bankruptcy court first concluded that the surety's indemnity agreement and bonds must be construed together.[39] So far so good. Next, the bankruptcy court explained that the Countryman Test required analysis of "whether any performance remains due by each party and whether failure to render that performance would constitute a material breach of the contract, excusing the counterparty from performance."[40] Again, no glaring issue there; the Fifth Circuit follows the Countryman Test to determine executory contract status, for all the interpretative difficulties that come with applying that test to the tripartite surety relationship. The court then analogized to *In re James River Coal Co.*[41] and concluded that Argonaut, by posting bonds prepetition, owed no further performance to Falcon V—regardless of any performance yet due from bond obligees.[42] On these grounds, the bankruptcy court deemed the bond program executory. The bankruptcy court went a step further by concluding that even if executory, the bond program was incapable of assumption because of its status as a Section 562(c)(2) financial accommodation. The bond program was not assumed by the reorganized *Falcon V* debtors on the other side of reorganization.

On the surety's appeal to the U.S. District Court for the Middle District of Louisiana, the bankruptcy court's holding was affirmed with marginally expanded discussion. The district court found that the bond program failed the Countryman Test because "as between the Reorganized Debtors and the surety, the parties' obligations under the surety bond program flow in one direction, from the Reorganized Debtors to the surety."[43] While acknowledging the surety's continuing obligation to the

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[38] See *In re* Falcon V, LLC, 620 B.R. 256, 270 (Bankr. M.D. La. 2020).

[39] *Id.* at 264 (citing *Safer v. Nelson Fin. Grp., Inc.*, 422 F.3d 289, 296 (5th Cir. 2005).

[40] *Id.*

[41] 2006 WL 2548456 (M.D. Tenn. Aug. 31, 2006) (where court denied surety's motion for payment of accrued workers' compensation bond premiums as administrative expense on grounds that bonds were not executory because the surety had performed its "only" obligation to the debtor by posting the bonds prepetition).

[42] In *James River Coal*, the surety had cancelled the surety bond program at issue and had done so prepetition. The *James River Coal* court specifically went out of its way to distinguish this particular factual setup from cases like *In re Evans*, which held that a surety program still in effect during the pendency of Chapter 11 proceedings was executory. *See* 2006 WL 2548456, at *4, n.3.

[43] Argonaut Ins. Co. v. Falcon V, LLC, 2021 U.S. Dist. LEXIS 188686, at *10–11 (M.D. La. Sept. 30, 2021) (emphasis original) (citing ongoing obligations to pay premiums, post collateral, indemnify against loss, etc. and further stating that "The *Countryman* test requires more for an executory contract: performance must remain due on *both* sides.") (internal citation omitted).

obligees under the bonds, the district court did not consider that factor in terms of analyzing the incomplete performance prong of the Countryman Test. Instead, the district court stressed the irrevocable nature of the surety's bonds, reasoning that if Falcon V materially breached its obligations to the surety, the surety would nonetheless still be required to honor its obligations to the obligees. In other words, the "quality of performance" prong of the Countryman Test was also not satisfied because the debtors' actions could not create a material breach excusing the surety's performance. The district court simply stated that it was not its province "to decide the applicable test" and emphasized that the Fifth Circuit "looks to the relationship between the debtor and the party seeking to enforce the contractual obligations–here the surety."[44]

The United States Court of Appeals for the Fifth Circuit issued its much-anticipated decision on the further appeal in August 2022. The surety and *amici* had persuasively argued that the Countryman Test should be applied such that "[w]here the surety and the principal continue to owe obligations to the obligee, and the principal has not fulfilled its indemnity obligations to the surety, that is an executory contract."[45] The Fifth Circuit agreed, at least partially, reasoning that the Countryman Test should be applied to multiparty contracts in a "flexible" manner, accounting for the various obligations owed among all parties, and not just the debtor and aggrieved creditor.[46] For the Fifth Circuit, the deciding blow to the surety's argument was not so much the first prong of the test, given ongoing contractual performances running to the obligees, but rather the second prong. The Fifth Circuit held that the irrevocable nature of the bond program meant that the surety could not and would not be excused from performing its obligations to the obligees despite a material breach of Falcon V under the indemnity agreement or otherwise. On this basis, the program could not be deemed executory.[47]

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[44] *Id.* at *12. Hearkening back to our title, is this holding an example court "creativity"? Perhaps just the opposite—*i.e.,* a stubborn application of existing circuit precedent without much creativity or flexibility in its analytical application to tripartite suretyship.

[45] *In re* Falcon V, LLC, 44 F.4th 348, 354 (5th Cir. 2021).

[46] *Id.*

[47] The Fifth Circuit did not provide any discussion of the bond program's status as a financial accommodation, having concluded that it was not executory in the first instance.

So, what does the surety practitioner do now? Although we reserve the bulk of the analysis for spoken remarks at the program, a few comments may serve to conclude this discussion. In the wake of *Falcon V*, fair attention has been paid to potential catastrophic, cascading effects across the industry, and a fair amount of criticism has been leveled at the bankruptcy, district, and Fifth Circuit courts' opinions as having perverted the age-old conceptualizations of the tripartite surety relationship and further confused executory contract doctrines.

Are the surety's options more constrained (or convoluted) now that an irrevocable bond program has been deemed non-executory by the Fifth Circuit? Perhaps, at least on the same facts, *i.e.*, with respect to irrevocable O&G bond programs in the Fifth Circuit. But the Fifth Circuit's willingness to consider a "flexible approach" to the Countryman Test's application invites considerable briefing leeway for surety practitioners—both in service of a functional interpretation of executory contracts, and certainly when confronted with distinguishable fact patterns.[48] Moreover, *Falcon V* fundamentally does not disturb the proposition that (at least) revocable surety bonds should be considered executory, nonassumable financial accommodations.

Perhaps the starkest reminder coming out of *Falcon V* is that, regardless of glowing representations (or even outright lulling) by debtors, surety creditors should trust but verify. If the surety expects the debtors' collateral and indemnity obligates to ride through a reorganization, the surety must actively confirm that express language reaffirming and ratifying the bond program makes its way into the "new contract" represented by the bankruptcy court's confirmation order.

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[48] Consider contract bonding. Courts have held that if the obligee defaults by, *e.g.,* its failure to pay the principal in accordance with the contract documents, or its failure to provide the required notice to the surety, the surety is excused from performance. Under the rationale of *Falcon V* (and courts preceding it), a future court should have little trouble concluding the performance bond is executory.

IV. ***FIELDWOOD*: THE CONFIRMATION JUGGERNAUT**

By scale alone, the *In re Fieldwood* consolidated bankruptcy cases are a different beast than *Falcon V*. Every (or very nearly every) surety writing O&G bonds was drawn into *In re Fieldwood* proceedings; a case discussion could span a full book given the breadth of the bankruptcy and surety issues involved. This paper focuses only on some surprise twists in the days immediately preceding the confirmation hearing. These twists resulted in authorization of the sale of offshore oil and gas leases free and clear of future surety subrogation rights—a result that has withstood subsequent appeal to the district court this year.[49]

Before its COVID-19-era bankruptcy filing, Fieldwood Energy, LLC and its affiliates ("FWE") operated as one of the largest E&P companies in the Gulf of Mexico. In the years leading up to its 2020 Chapter 11 case, FWE held significant shallow water assets—notably purchasing assets from Apache Corporation ("Apache") beginning in 2013, from subsidiaries of SandRidge Energy, Inc. beginning in 2014—together with a deepwater portfolio it first acquired from Noble Energy, Inc. in 2018.[50] FWE owned an interest in over 350 oil, gas, and mineral leases and was party to hundreds of joint operating, utilization, and farm-out agreements.[51] It operated 300 platforms across 1.5 million gross acres in the Gulf and, in Q1 2020, averaged 79,410 barrels of oil equivalent produced per day.[52]

FWE had borrowed heavily to acquire its Gulf of Mexico assets. At the time of FWE's 2020 bankruptcy filing, FWE had approximately $1.8 billion in secured debt, with collateral value intensely impaired by the then-

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[49] An appeal to the Fifth Circuit is pending, with oral argument tentatively set for October 2023. But this is not the only current legal proceeding involving the post-confirmation Fieldwood entities and their sureties. See *Zurich Am. Ins. Co. v. Apache* Corporation, No. 2023-38238 (Tex. Dist. Ct. Harris Cnty.) & Notice of Removal, *In re* Fieldwood Energy III LLC, No. 20-33948 (Bankr. S.D. Tex. July 26, 2023), ECF No. 2818. Inquiring readers may also wish to consult the Surety Claims Institute (SCI) September 2021 newsletter article authored by Duane Brescia, "The Fieldwood Energy Sage: Instant Impact and Long-Term Concerns for Sureties" for a helpful and much broader discussion of the bankruptcy proceedings and their import.

[50] Declaration of Michael Dane in Support of Debtors' Chapter 11 Petitions and First Day Relief at ¶ 5, *In re* Fieldwood Energy, LLC, 20-33948 (Bankr. S.D. Tex. Aug. 4, 2020), ECF No. 29.

[51] *Id.* at ¶ 23.

[52] *Id.* at ¶ 19.

current price of oil.[53] Perhaps more significantly, FWE's total P&A liability was estimated to be between >$2 billion (according to FWE itself) and >$12 billion (according to BOEM). Legacy Apache assets comprised an estimated $1.2 billion, or 60% of FWE's outstanding decommissioning obligations.

To satisfy its P&A and other decommissioning obligations, FWE maintained a large web of financial assurances: letters of credit, letters of credit backed by surety bonds, escrow accounts, and direct surety bonds. Some bonds were issued directly to BOEM; other bonds were issued on behalf of FWE to predecessors (*e.g.*, Chevron, BP, Shell, Eni Petroleum, etc.); still other bonds covered permitting and operating obligations required by the U.S. Government and the States of Texas and Louisiana. As of the petition date, FWE had procured $1.165 billion in surety bonds maintained to satisfy these various contractual and regulatory requirements.[54]

A. IN THE BANKRUPTCY COURT

In the summer of 2020—when oil was trading at less than $30/barrel and FWE could avoid financial covenant breaches with its lenders—FWE reached agreement with certain of its lenders and its largest creditor, Apache (a predecessor in interest), to pursue an in-court reorganization. The proposed plan was *complicated*.

In very general terms, the plan called for: (1) FWE to sell its most valuable deepwater properties to an affiliate ("NewCo") in a credit-bid transaction; (2) two divisive mergers after the Newco transaction[55]; (3) the cancellation of debt; (4) the transfer of certain O&G assets to prior interest owners in exchange for funding; and (5) the abandonment of certain O&G assets to predecessors.

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[53] *See id.* at ¶ 40.

[54] *Id.* at ¶ 50.

[55] Relevant here, FWE would sell its deepwater assets to NewCo via a Section 363 bankruptcy sale, and FWE would convert to a Texas LLC. Through Texas merger statutes, FWE would allocate its assets divisively to FWE I (existing to complete decommissioning obligations on Apache assets and containing only legacy Apache properties) and FWE III (consisting of remaining legacy FWE where all assets with remaining potential value would be placed). *See* Brescia, supra n. 49, at 16.

On January 1, 2021, FWE filed its original proposed plan. The success of the proposed plan hinged on the debtors' ability to bring the United States DOI on board and satisfy the Government that sale approval and asset abandonment would not result in P&A liabilities falling to taxpayers. Intensive negotiations ensued over the coming months of the case.

On June 2, 2021, numerous sureties filed objections to confirmation of what was, by that time, the Fourth Amended Chapter 11 Plan.[56] The sureties' arguments varied according to each surety's interest. Among other things, surety objections took issue with plan feasibility and the debtors' proposed abandonment of certain O&G leases and related evasion of statutory operator liability for decommissioning obligations.

This is where our particular story takes a turn. On June 16, 2021, just two days prior to the scheduled commencement of the confirmation hearing, FWE inserted language into a Fifth Amended Chapter 11 Plan which, for the first time, proposed to strip sureties of their subrogation rights:

> Notwithstanding anything herein to the contrary, co-lessees of the Debtors, predecessors in interest with respect to any of the Debtors' asset, and surety providers shall not be entitled, under any circumstances, to claim a right of subrogation, if any such right exists, against the Debtors, the Post-Effective Date Debtors, FWE I, any FWE Additional Entity or NewCo and its subsidiaries (including Credit Bid Purchaser, as to any Governmental Unit's rights, including, but not limited to, any rights provided to the United States under this Plan.[57]

This insertion prompted a flurry of last-minute email negotiations between the objecting sureties and debtors' counsel. Ultimately, the parties agreed to include certain reservation language in the confirmation order that would preserve subrogation rights arising after the plan's effective date.[58]

[56] *See* Appellants' Brief at 4, *In re* Fieldwood Energy III LLC, No. 4:21-cv-02201 (S.D. Tex. Dec. 1, 2022), ECF No. 36.
[57] *Id.* at 12 (quoting relevant section of Fifth Amended Chapter 11 Plan).
[58] *See id.* at 13.

On Day 3 of the week-long confirmation hearing, FWE confirmed on the record that the agreed-upon confirmation order language was intended to preserve the sureties' subrogation rights. Neither the debtors nor the credit bid purchaser intended to strip the sureties of their time-honored rights of subrogation.[59]

But the story gets stranger still. Completely unbidden and *sua sponte*, the bankruptcy court elected to alter the consensual agreement between FWE and the sureties. Ostensibly based on live testimony of FWE's CFO at the confirmation hearing, Judge Martin Isgur articulated the view that "[t]he evidentiary record that we have is that there will not be an acquirer of these entities if they will then be subject to subrogation by the surety."[60] The bankruptcy court further noted that if the plan was not confirmed, "there is a great likelihood that the [surety] bonds will...be called," but "bonding companies may have their bond obligations eliminated or minimized if [the] [P]lan is carried into action."[61]

These conclusions are telling. Once again, they do not appear to exemplify bankruptcy court "creativity" so much as bald pragmatism, placing ultimate (unasked-for) emphasis on not derailing the entire reorganization project. Preserving the path to confirmation was evidently paramount for the bankruptcy court. Thinking about the ultimate balance of harms (*i.e.*, looking to the sureties' ultimate fate in confirmation versus failed reorganized scenarios) took precedence over teasing out the nuances

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[59] *See* Pearlman v. Reliance Ins. Co., 371 U.S. 132, 136–37 (1962) ("[T]here are few doctrines better established than that a surety who pays the debt of another is entitled to all the rights of the person he paid to enforce his right to be reimbursed."); Am. Sur. Co. of New York v. Bethlehem Nat'l Bank, 314 U.S. 314, 317 (1941) (describing the surety's subrogation rights as "one of the[] oldest doctrines"); *In re* Tri-Union Dev. Corp., 314 B.R. 611, 622–23 (Bankr. S.D. Tex. 2004) (observing the surety is subrogated to the government for recovery of all monies the surety has paid).

[60] Appellants Brief at 13–14 (citing confirmation hearing record). As the sureties would argue on appeal, "there was nothing included in any of the actual sales documents that a waiver of future subrogation rights was ever even contemplated and the Bankruptcy Court's *sua sponte* waiver of all subrogation rights amounts to nothing more than a … non-consensual third-party release." *Id.* at 14.

[61] *Id.* at 17 (citing confirmation hearing record).

of what preserving surety subrogation rights might really entail in practice.[62]

The confirmation order approving the FWE debtors' Eighth Amended Chapter 11 Plan of Reorganization was entered over the sureties' objections on June 25, 2021, and the plan went effective on August 27, 2021. While select sureties sought to stay the portion of the confirmation order relating to their subrogation rights, their efforts were unsuccessful. The effective date having passed, many of the transactions contemplated in the plan and confirmation order were consummated while the subrogation issue was appealed.

B. On Appeal

Bankruptcy mootness doctrines dominated the appeal to the district court. FWE argued that the sureties' challenges were "statutorily moot" under the Bankruptcy Code[63] because sale of the debtors' assets "free and clear" of subrogation claims was integral to the sale and because the sureties had failed to obtain a stay of the confirmation order. Further, FWE contended that the appeal was equitably moot.[64] In response, the sureties maintained the challenged provisions were not integral to the sale of the

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[62] Surety practitioners have remarked that the bankruptcy court's conclusion "makes no sense." The only way sureties for predecessor FWE would earn subrogation rights would be if they paid claims. And surety liability would only result if the credit bid purchaser, as the primary obligor, did not do as promised by properly decommissioning the assets at the end of their useful lives. The purchaser had built decommissioning costs into its purchase price—some $350 million. It would make little practical difference if that sum was paid directly for decommissioning or the sureties called upon to perform/pay for the decommissioning. But with the elimination of the sureties' subrogation rights, the credit bid purchaser might be induced not to perform at all, leaving the government to call on the predecessor sureties to perform. *See* Armen Shahinian, Surety Claims Institute Newsletter 38:2 at 4 (May 2023); see also SFAA Amicus Brief at 21–26, *In re* Fieldwood III, LLC (S.D. Tex. Feb. 2, 2023), ECF No. 40.

[63] *See* 11 U.S.C. § 363(m) ("The reversal or modification on appeal of an authorization…of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.") Under Fifth Circuit precedent, Section 363(m) and the doctrine of statutory mootness only applies when the challenged provision is "integral to the sale" of the debtors' assets. *In re Enerytec, Inc.*, 739 F.3d 215, 220 (5th Cir. 2013).

[64] The Fifth Circuit applies a three-part test when evaluating equitable mootness: "(i) whether a stay has been obtained, (ii) whether the plan has ben 'substantially consummated,' and (iii) whether the relief requested would affect either the rights of parties not before the court or the success of the plan." *In re McCray*, 623 F. App'x 184, 185 (5th Cir. 2015) (internal quotation omitted).

assets to the credit bid purchaser and the purchaser was not a good-faith purchaser.[65]

In its March 2023 memorandum opinion, the district court cited the FWE CFO's confirmation hearing testimony that the subrogation provision was "paramount to [purchaser's] consideration of how they would be willing to proceed with purchasing [the debtor's] assets and contributing capital for all purposes of the plan." This testimony prompted the conclusion that the bankruptcy court had "good cause" to accept that surety subrogation claims could jeopardize the sale and related plan.[66] Further, because the bankruptcy court had denied the request for a stay (and alternatively set the required bond amount at $350 million pending appeal), the district court determined that the subrogation-eliminating provisions were "integral to the sale" of the debtors assets. It bears noting that the district court also bolstered its finding of statutory mootness by suggesting that the DOI would likely have objected to the plan had the sale not been consummated, thereby imperiling the plan of reorganization.[67]

Lastly, the district court agreed with FWE that the appeal was equitably moot because (1) a stay had not been obtained, (2) the plan had been substantially consummated, and (3) the requested relief on appeal would affect the rights of parties not before the district court.[68] As the district court reasoned:

> [T]he Bankruptcy Court made clear findings that modifying the Confirmation Order as requested by the Sureties would likely have jeopardized the sale of the Debtors' assets, which in turn could have caused the Government to exercise its "veto" of the Plan on environmental grounds…Thus, an attempt to modify the Plan at this stage would present a grave

[65] This latter argument was deemed waived by the sureties. *See In re* Fieldwood Energy III, LLC, 2023 U.S. Dist. LEXIS 38454, *9.

[66] *Id.* at *8.

[67] *Id.* at *9.

[68] *Id.* at *13.

> threat to the success of the Plan—indeed, it could unravel the Plan entirely.[69]

While practitioners less familiar with bankruptcy appeals may be taken aback by the district court's procedural focus on mootness doctrines over substance, post-confirmation bankruptcy appeals are notoriously challenging for this very reason. Consummation of a plan of reorganization tends to occur with alarming rapidity after confirmation, and once implemented, plans are disturbed only for the most compelling of reasons. (Read: Rarely.)

Perhaps the *Fieldwood* reorganization was, as others have suggested, "too big to fail."[70] The sureties certainly faced acute pressures from all sides and all actors—including the bankruptcy court—in what seemed like an inexorable push to confirming a plan supported by the Government. *Fieldwood* is the story of the confirmation juggernaut, one might say. But that is just a small part of the story.

V. <u>CONCLUSIONS: TO COME</u>

This paper will be unsatisfying. These pages merely supply the (somewhat complicated) background to *Falcon V* and *Fieldwood*. It is the accompanying conference presentation that tackles our view of the more important question: "So, now what?" Stay tuned for a discussion of these decisions' broader impacts and what we surety practitioners might do, strategically and practically, in the wake of these recent surety bankruptcy cases.

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[69] *Id.* at *12.
[70] See Brescia, *supra* n. 49, at 20.

PANEL 11

L&A CONTRACTING CO. V. S. CONCRETE SERVS., INC.:

BREACH VS. DEFAULT—TRIGGERS UNDER THE PERFORMANCE BOND

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PEARLMAN 2023

September 7-8, 2023

Sparkman Cellars Winery | Woodinville, WA

***L & A Contracting Co. v. Southern Concrete Services, Inc.*:**
Breach vs. Default—Triggers Under the Performance Bond

Adrian A D'Arcy, D'Arcy Vicknair LLC
Paul K. Friedrich, William Kastner
Anna C. Frederick, Bond Claims, EMC Insurance Companies
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I. INTRODUCTION

For nearly thirty years, courts have continuously been citing one particular case in the realm of surety law to distinguish between a breach and a default and to clarify the requirements needed for a declaration of default. That case is *L & A Contracting Company v. Southern Concrete Services, Inc*.[1] At the time of writing, *L & A Contracting has* been cited in nine hundred and ninety-nine court decisions, eight law review articles, and eleven legal treatises. And, of course, these numbers do not include the countless briefs and motions submitted to courts and articles written for the surety community such as this one. When it comes to whether a surety's performance obligations have been triggered, *L & A Contracting* is a giant case in the industry.

By providing a performance bond, a surety binds itself to act in certain alternative manners if the contractor defaults on the underlying contract. Usually, in the event of its principal's default, the surety will have the choice to either complete the work, arrange for another contractor to complete the work, or pay damages to the project owner.[2] But the surety can also deny liability if its principal was not in default of its obligations under the original contract. As a surety's responsibilities are not triggered until its principal is in default, determining whether a breach (or a series of breaches) have risen to the level of being considered a "default" and whether or not the communications from the obligee rise to the level of being a default notice are critical to determining whether a surety's duties have been triggered or not. *L & A Contracting* has been instructive on these issues for decades.

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1 L & A Contracting Co. v. Southern Concrete Servs.,17 F.3d 106 (5th Cir. 1994).
2 *See e.g.,* AIA A312 Performance Bond.

While the terms *breach* and *default* are sometimes used interchangeably, in the context of construction suretyship law, *L & A Contracting.* tells us that the terms are distinguishable.[3] Every default is a breach, but not every breach is a default sufficient to require the surety to step in and remedy it. A breach of contract consists of an act of breaking the terms set out in a contract, whereas to constitute a legal default there must be: (1) a material breach or series of material breaches; (2) of such magnitude that the oblige is justified in terminating the contract.[4]

Also, very importantly, *L & A Contracting* holds that a declaration of default sufficient to invoke the surety's obligations under the bond must be made in clear, direct, and unequivocal language.[5] The declaration must inform the surety that the principal has committed a material breach or series of material breaches of the subcontract, that the obligee regards the subcontract as terminated, and that the surety must immediately commence performing under the terms of its bond.[6]

Recognizing a contractor's default is no easy task. A surety is forced to navigate an uncertain landscape because not every jurisdiction interprets contracts the same, and liability determinations will differ within jurisdictions as contract language varies. Moreover, the analysis for determining what is a mere breach and what is a default varies greatly case to case because no two factual situations are the same. A study of *L & A Contracting* and the subsequent case law is an essential starting place for sureties to understand when a default may or may not have occurred and when an obligee has or has not issued a proper notice of default. Despite strong indemnity agreements and despite a surety's obligations to the obligee, a surety must be very careful about jumping in too early and performing when a default has not actually occurred. *L & A Contracting* and the later jurisprudence citing the case provide a roadmap to sureties on these issues. As will be seen in this paper, while some courts/jurisdictions have not been as accepting of *L & A Contracting* as others, for the most part the tenets of *L & A Contracting* still mostly hold true today.

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[3] *Id.* at 110.
[4] *Id.*
[5] *Id.* at 111.
[6] *Id.*

II. THE CASE

While *L & A Contracting* is consistently cited for the tenets of law noted above, how many of us know the details of the case? Here, we summarize the facts, the issues, and the pertinent rulings.

A. THE FACTS AND THE TRIAL COURT RULING

Southern Concrete Services Inc. ("Southern") contracted with a general contractor, L & A Construction Company ("L&A") on a bridge project ("Project") in Apalachicola, Florida. Southern was required to supply L & A with the required concrete for the Project. And as required by the subcontract with L&A, Southern was mandated to provide a performance bond to L&A. Fidelity & Deposit Company of Maryland ("F&D") provided the performance bond for Southern naming L&A as the obligee on the performance bond.

According to the 5th Circuit *L & A Contracting* opinion, business relations between L&A and Southern deteriorated and "Southern failed to provide sufficient concrete to L&A in a timely manner and breached the subcontract in numerous other particulars."[7] L&A apparently repeatedly complained to Southern about Southern's slow delivery rates and the poor quality of the concrete Southern supplied.[8]

Then, on May 29, 1987, L&A sent a letter to Southern demanding that Southern cure the deficiencies within five days, a copy of which was sent to the surety, F&D.[9] Apparently, Southern's performance improved after L&A's May 29 letter in response to a routine inquiry from F&D on August 3, 1987. In the response, L&A stated that Southern was performing satisfactorily.[10]

After the apparent improvement in performance for a time, Southern again fell behind on its deliveries, and L&A began its periodic complaints.[11] On January 12, 1988, L&A wrote Southern and F&D again demanding

[7] *Id.* at 106.
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] *Id.*

"that the Bonding Company take the necessary steps to fulfill this contract to prevent any further delays and costs."[12] F&D did not respond to the letter and took no action.[13]

Southern completed its obligations under the subcontract on May 27, 1988, with the Court noting that "[a]t no time did L & A refuse to accept Southern's performance."[14] On August 19, 1988, L&A sued Southern and F&D for breach of contract in Mississippi state court, however, Southern and F&D removed the case to the federal court based on diversity jurisdiction.[15]

After a six-day bench trial, the federal district court found that both Southern and L&A had breached the subcontract and, after offsetting the award from Southern's counterclaim, held that L&A was entitled to recover damages of $642,269 plus post-judgment interest from Southern and F&D.[16]

B. F&D'S APPEAL[17]

As noted by the Court, F&D's liability to L&A was governed by the terms of the performance bond.[18] The Court noted that while Southern was directly liable for its breach of contract, the bond imposed liability upon F&D for Southern's breach only if two conditions existed.[19] First, Southern must have been in default of its performance obligations under the subcontract.[20] Second, L&A must have declared Southern to be in default.[21] The Court's inquiry into these two issues and the Court's ruling on the standards on these two issues are what makes *L & A Contracting* so important to the surety industry.

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[12] *Id.*
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] *Id.* at 109.
[17] The Court ruled on both Southern's and F&D's appeals, but this paper only covers the F&D appeal.
[18] *Id.* at 109.
[19] *Id.*
[20] *Id.*
[21] *Id.*

The Court noted that the language of the F&D bond "provided that F & D would become liable to take certain actions to remedy Southern's breach 'whenever Principal shall be, and shall be declared by Obligee to be in default under the subcontract, the Obligee having performed Obligee's obligations thereunder.' "[22]

As for the default declaration requirement, L&A argued, apparently based only on Webster's Ninth New Collegiate Dictionary, that "any communication that '[made] it clear that [Southern] failed to fulfill a contract or duty' constituted a legal declaration of default."[23] The Court noted that three factors counseled towards the rejection of L&A's argument as to a broad definition of what constitutes a default.

The Court's first factor weighing against L&A's argument was that L&A's dictionary definition "misapprehends" the legal nature of the "default" required before the obligee's claim against the surety matures.[24] It is in this first factor against L&A's definition of a declaration of default where we get the Court's ruling on what constitutes a legal default. In opining on what constitutes a default, the Court held that "[a]lthough the terms 'breach' and 'default' are sometimes used interchangeably, their meanings are distinct in construction suretyship law."[25] The Court held that "[n]ot every breach of a construction contract constitutes a default sufficient to require the surety to step in and remedy it", holding, "[t]o constitute a legal default, there must be a (1) material breach or series of material breaches (2) of such magnitude that the obligee is justified in terminating the contract."[26] This is some of the most powerful language in the *L & A Contracting* opinion. Showing that writing authorities and treatises is important, this holding was drawn from articles written by the highly respected Texas surety attorney, James Knox.[27] This holding, as to what constitutes a breach or breaches to constitute legal default, is some of *L & A Contracting*'s most cited language.

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[22] *Id.* at footnote 6.
[23] *Id.* at 109.
[24] *Id.* at 109 & 110.
[25] *Id.* at 109 & 110.
[26] *Id.* at 110.
[27] *Id.* at footnote 11.

The Court's second basis for rejecting L&A's argument in regards to the overly broad definition of a "declaration of default" was that L&A's definition was impractical.[28] The Court noted that serious legal consequences are linked to a "declaration of default," particularly in cases involving multi-million-dollar construction projects.[29] The Court noted that "[b]efore a declaration of default, sureties face possible tort liability for meddling in the affairs of their principals"[30] "[b]ut after a declaration of default, the relationship changes dramatically, and the surety owes immediate duties to the obligee."[31] The Court then held that, "[g]iven the consequences that follow a declaration of default, it is vital that the declaration be made in terms sufficiently clear, direct, and unequivocal to inform the surety that the principal has defaulted on its obligations and the surety must immediately commence performing under the terms of its bond."[32] Otherwise, according to the Court, "[s]ureties deprived of a clear rule for notices of default would be reluctant to enter into otherwise profitable contracts."[33]

The Court's final basis for rejecting L&A's definitional argument was that L&A's argument would not promote the purpose for which the parties probably included a notice of default provision in F&D's bond.[34] That purpose, according to the Court, would be to avoid the common-law rule, as noted in the Restatement of Security § 13, that a secondary obligor such as F&D is not entitled to notice when the time for its performance is due.[35] The Court noted that this purpose could not be served if L & A could fulfill its duty to provide "notice of default" to F&D by sending letters which did not refer to a default.[36]

The Court concluded that F&D's argument as to what constituted a declaration of default to be the only reasonable view and expressly held "[a] declaration of default sufficient to invoke the surety's obligations

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28 *Id.* at 110.
29 *Id.* at 110.
30 *Id.* at 110.
31 *Id.* at 110.
32 *Id.* at 110.
33 *Id.* at 110.
34 *Id.*
35 *Id.*
36 *Id.*

under the bond must be made in clear, direct, and unequivocal language."[37] According to the Court, "[t]he declaration must inform the surety that the principal has committed a material breach or a series of material breaches of the subcontract, that the obligee regards the subcontract as terminated, and that the surety must immediately commence performing under the terms of its bond."[38]

The *L & A Contracting* court held that under the standard it articulated that "L & A's evidence is insufficient as a matter of law to establish a declaration of default."[39] The Court noted that none of the letters L&A sent to Southern and F&D even contained the word "default" and noted that it did not find an unequivocal declaration of default in the other items of correspondence pointed to by L&A.[40]

The *L & A Contracting* holding illustrates that not all breaches are defaults and that a declaration of default must be clear to trigger a surety's obligations. This leads to the conclusion that the determination of a legal default is a factual analysis that varies case-by-case. Thus, per *L & A Contracting,* letters complaining about the subcontractor's performance that do not mention the word "default," are not sufficient to establish a default. Also, L&A continuing to accept Southern's performance after the alleged notice of default was clearly a factor which the Court saw as weighing against L&A in considering the subcontract as terminated, and so weighing against an actual default having occurred.

In the years that followed *L & A Contracting*, a majority of courts across the country embraced *L & A Contracting's* holdings and rationale. For the most part, courts have only weighed in on particular circumstances that have arisen to apply the *L & A Contracting "*material breach" analysis to the case *sub judice*. Next, we will examine those subsequent cases of note to examine how courts have fine-tuned the determination between breach and default to fit special circumstances.

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[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.* at

III. SUBSEQUENT CASES OF NOTE

Cases decided after *L & A Contracting* continued to apply the 5th Circuit's rationale, but nuanced situations arose that required some expansion in the application. To start, courts needed to determine whether a "material breach" analysis is required at all. For instance, in *John A. Russell Corp. v. Fine Line Drywall, Inc.*, the court did not have to embark on a material breach analysis because default was defined in the underlying contract.[41] *John A. Russell Corp.* presented the issue of determining whether a materiality analysis is needed when "default" is already defined within the contract.

In *John A. Russell Corp.*, the preliminary question before the court was when the default contemplated by a statute occurred. The court held that as Title 8 did not provide an explicit definition of default, the broad language of the statute ("the occurrence of the loss, death, accident or default") that the definition is to be drawn from the specific language of the underlying bond or insurance contract itself.[42] The court reasoned that such contracts are to be interpreted according to the standard contract principles, "striving to give effect to the intent of the parties as expressed by the plain language of the instrument."[43] However, if the type of default alleged by the project owner is not expressly defined in the contract, a court must then determine the materiality of the breach.

A common theme in performance bond cases is that complaints to the surety regarding the contractor's performance are not going to establish a default. As shown by the letters sent to the surety in *L & A Contracting* communications ranging such as mere complaints or demands for performance should not establish a default.[44] Likewise, in *Seaboard Sur. Co. v. Town of Greenfield*, letters complaining about performance, financial status, and delay in performance did not rise to the level of a default.[45] In *Seaboard Sur. Co.*, the court stated that "[i]n the context of surety default,

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41 *John A. Russell Corp. v. Fine Line Drywall, Inc.*, No. 2:05-cv-321, 2007 U.S. Dist. LEXIS 72362, at *8-9 (D. Vt. Sep. 27, 2007)

42 *Id.* at 6.

43 *Id.* at 6.

44 *L & A Contracting Co.*, 17 F.3d 106 at 111.

45 *Seaboard Sur. Co. v. Town of Greenfield*, 370 F.3d 215, 223 (Ct. App. 1st Cir. 2004).

the notice provision similarly provides an opportunity for the surety to cure the breach and thus mitigate damages."[46] The court held that such a breach will limit the surety's liability if the damages could have been mitigated.[47] The court looked to jurisprudence in reasoning that the "[f]ailure to adhere to a performance bond notification requirement is a material breach, resulting in the loss of an obligee's rights under the bond."[48] Such action that would deprive the surety's ability to protect itself [mitigate] under the performance options granted under the performance bond would constitute a material breach, thus rendering the bond null and void.[49] But as the notice in *Seaboard Sur. Co. v. Town of Greenfield* was regarding the obligee's failure to give the preliminary notice under Article 3.1 of the AIA A312 (1984) Performance Bond, the changed language in the revised AIA 312, noting that a surety's liability is only reduced in the amount of actual prejudice if obligee fails to give surety notice of intent to declare default, may water down the precedential value of *Seaboard Sur. Co.*

Another issue left unresolved by *L & A Contracting* is whether a partial default on the contract is enough to trigger surety liability. That issue was addressed in the case of *Elm Haven Constr. Ltd. P'ship v. Neri Constr. LLC*.[50] In *Elm Haven*, the Second Circuit confronted the issue of what constituted a declaration of default in the context of a performance and payment bond and chose to adopt the 5th Circuit approach articulated in *L & A Contracting*.[51] The court held that partial defaults were not enough.[52] The subcontract agreement in the *Elm Haven* case was made a part of the performance bond outlining the procedures to follow in the event of a default.[53] Since the surety is not party to the subcontract, it plays a separate role that the bond defines.[54] Standard principles of contract interpretation applicable to surety bonds is that "before a surety's obligations under a bond can mature, the obligee must comply with any conditions

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46 *Id.* at 220.
47 *Id.*
48 *Id.* at 218.
49 *Id.* at 218.
50 *Elm Haven Constr. Ltd. P'ship v. Neri Constr. LLC*, 376 F.3d 96, 98 (Ct. App. 2nd Cir. 2004).
51 *Id.* at 99.
52 *Id.* at 98.
53 *Id.*
54 *Id.*

precedent."[55] Thus, if notice is required, failure to give notice will preclude surety liability.[56] Hiring a replacement without giving required notice is a breach of the contract by the owner.[57] Again, the analysis in *Elm Haven* also involves the obligee's failure to give the preliminary cure notice under Article 3.1 of the AIA A312 (1984) Performance Bond, so the changed language in the revised AIA 312, may also effect the precedential value of *Elm Haven*.

While *L & A Contracting* described a default as a "material breach … of such magnitude that the obligee is justified in terminating the contract,"[58] termination is not necessarily a prerequisite to surety liability. In fact, if termination is not a condition precedent enumerated in the performance bond, it is not actually required before the surety's liability is triggered.[59]

Even if the contractor is found to be in default of the underlying contract, there are some instances where surety liability will be precluded. One such instance is if the project owner is in default. In *Elm Haven*, the project owner defaulted on the performance bond when it hired a replacement contractor without allowing the surety the opportunity to perform its duties.[60]

Another common example of project owner default is if the performance bond contained a notice of default provision that the owner failed to follow. If there is no notice provision, a surety's liability is triggered as soon as the contractor is terminated whether or not the owner has informed them.[61] However, it is common for the surety bond to have a notice or declaration of default provision in the actual contract which would require notice be given to the surety as a preceding condition to

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55 *Id.* at 99.

56 *Id.*

57 *Id.* at 100.

58 *L & A Contracting Co.*, 17 F.3d 106 at 110.

59 *PCL Constr. Servs. v. Hanover Ins. Co.*, 2012 U.S. Dist. LEXIS 201204 at *14 (Fla. M.D. 2012).

60 *Elm Haven Constr. Ltd. P'ship v. Neri Constr. LLC*, 376 F.3d 96 (Ct. App. 2nd Cir. 2004). Again, the changed language in the A312 performance bond may effect this analysis.

61 *See American Surety Co. v. United States*, 317 F.2d 652, 656 (Ct. App. 8th Cir. 1963); *Dooley & Mack Constructors, Inc. v. Developers Sur. & Indem. Co.*, 972 so. 2d 893, 895 (Fla. Ct. App. 3rd Cir. 2007).

performance.[62] Furthermore, even if no notice is required under the bond, owners and general contractors often do provide notice of default to sureties to allow the surety opportunity to mitigate damages.[63]

Multiple courts have also regarded the default notice as not needed if the default notice requirement is not in the bond. In *Dooley & Mack Constructors, Inc. v. Developers Sur. Indem. Co.,* the court held that under Florida law, a surety is relieved of its obligation if the obligee [contractor] fails to give notice that the bond requires.[64] The court then held that where a general contractor had added a provision to the performance bond which explicitly allowed it to complete work that subcontractor did not finish, the notice of default to the surety was not required.[65] The court also applied this principle of incorporation to such notice requirements in termination provisions of the bonds and subcontracts to determine the requirement to which a contractor must comply.[66] *American Surety Co. v. United States* provided additional insight into the notice requirements.[67] The court reasoned that since the performance bond at issue in the case contained no provision requiring notice to the surety in the event of a default, notice was not necessary.[68]

IV. <u>CASES NOT FOLLOWING *L & A CONTRACTING*</u>

Despite general adherence across the country, a small subset of jurisdictions refuse to follow the *L & A Contracting* framework for determining a default. One of those jurisdictions is the 4th Circuit. In the unpublished case, *Siegfried Constr., Inc. v. Gulf Ins. Co.*, the 4th Circuit confronted whether a contractor had acted sufficiently to trigger the surety of the subcontractor's obligation to perform.[69] The project involved the construction of a hotel in Maryland.[70] As general contractor, Siegfried

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[62] 5 Construction Law P 17.07.
[63] 5 Construction Law P 17.07.
[64] *Dooley & Mack Constructors, Inc. v. Developers Sur. Indem. Co.* 972 So.2d 893, 894 (Fla. 3rd DCA 2008).
[65] *Id.* at 896.
[66] *Id.* at 893.
[67] *American Surety Co. v. United States,* 317 F.2 652 (8th Cir. 1963).
[68] *Id.*
[69] *Siegfried Constr., Inc. v. Gulf Ins. Co.*, 2000 U.S. App. LEXIS 1304 at *2 (4th Cir. 2000).
[70] *Id.*

Construction engaged several subcontractors to perform work on the hotel.[71] One of the subcontractors hired was Jennifer Builders, Inc. ("Jennifer"), who was hired to install drywall.[72] As part of the subcontract, Jennifer was required to obtain a performance bond, which was issued by Gulf Insurance Company ("Gulf").[73] Jennifer performed its work poorly, causing delays to the project, and was ultimately terminated by Siegfried.[74]

Eventually, Siegfried sued Jennifer for breach of contract and sued Gulf for liability under the bond.[75] The district court found that Gulf was not liable because Siegfried did not fulfill the conditions precedent under the bond to trigger the surety's liability.[76] Under the performance bond, there were two conditions precedent to Gulf's liability: (1) that the subcontractor is in default; and (2) that the contractor declare the subcontractor in default.[77] Siegfried appealed the district court's decision that Gulf was not liable.[78] On appeal, the 4th Circuit found for Siegfried.[79] The court found that the subcontractor's conduct was enough to deem a default and that Siegfried gave sufficient notice of the default to the surety.[80]

Important to our purposes is how the court determined whether a default had occurred. Instead of following the *L & A Contracting* "material breach" analysis, the court followed Supreme Court of Virginia precedent.[81] The court did this despite its apparent knowledge of the holding in the *L & A Contracting* case.[82] The standard employed by the 4TH Circuit provided that "[a] building contractor defaults in the performance of his contract if he furnishes defective materials or workmanship."[83] The court also held that as

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71 *Id.*
72 *Id.*
73 *Id.*
74 *Id.*
75 *Id.* at *7.
76 *See id.*
77 *Id.* at *9.
78 *Id.* at *7.
79 *Id.* at *20.
80 *Id.* at *11-12.
81 *Id.* at *10.
82 *See id.* at *13 (*citing* to the *L & A Contracting* decision in the context of declarations of default).
83 *Id.* at *10 (*quoting Clevert v. Jeff W. Soden, Inc.*, 400 S.E.2d 181, 183 (Va. 1991)).

little as a "defective performance" would also be considered a default.[84] The court noted that no definition of default was present in the subcontract, thus, the court considered the "failure to perform" provision instead.[85] The court also noted that the subcontractor's failure to perform "defeated an essential purpose of the contract."[86] Altogether, this standard is a far cry from the "material breach" standard the that *L & A Contracting* applied. The 4th Circuit's standard for default would suggest that smaller and possibly immaterial breaches would be enough to rise to the level of default. Sureties operating within the jurisdiction of the 4th Circuit would be wise to note this lower threshold to liability-triggering default.

While the 4th Circuit implicitly departed from the *L & A Contracting* court's materiality analysis, the Washington Supreme Court went a step further and openly rejected it in *Colo. Structures, Inc. v. Ins. Co. of the W.*[87] One of several key issues before the court was whether the principal had materially breached the contract as to the point of being in default of the contract.[88] The Washington Supreme Court agreed with the *L & A Contracting* court to the extent that a material breach renders a principal/contractor in default, but it differed in opinion as to what constitutes a "material breach."[89]

The underlying dispute in *Colo. Structures* was between the general contractor of a project to build a Wal-Mart store and a subcontractor hired to build the store's sewer system.[90] The general contractor, Structures, required the subcontractor, Action, to acquire a surety bond as a requisite to the contract.[91] Action obtained a bond from a surety, West.[92] Throughout the project, Action fell behind schedule in its work.[93] To try to complete the project, Structures supplemented Action's workforce by providing

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84 *Id.*
85 *Id.*
86 *Id.* at 11.
87 *Colo. Structures, Inc. v. Ins. Co. of the W.,* 167 P.3d 1125, 1132 (Wash. 2007).
88 *Id.*
89 *Id.*
90 *Id.* at 1127.
91 *Id.* at 1128.
92 *Id.* at 1127.
93 *Id.* at 1128.

additional labor to help get Action back on schedule.[94] Nevertheless, Action did not achieve timely completion of the scheduled work.[95]

The main issue in examining the surety's liability in *Colo. Structures* concerned whether notice of default was a required precedent condition.[96] However, what makes *Colo. Structures* relevant to our discussion is the Court's interpretation of what establishes surety liability. To understand the *Colo. Structures* court's rationale, we must first examine the bond language:

> [A] Action Excavating & Paving, Inc. … , hereinafter called Principal, and Insurance Company of the West … , hereinafter called Surety, are held and firmly bound unto CSI [Colorado Structures, Inc.] Construction Co. … , hereinafter called Obligee, in the amount of … $472,290 … .
>
> [B] WHEREAS, Principal has … entered into a subcontract with Obligee … , which subcontract is by reference made a part hereof, and is hereinafter referred to as the subcontract, NOW THEREFORE, THE CONDITION OF THIS OBLIGATION IS SUCH THAT, if Principal shall promptly and faithfully perform said [***11] subcontract, then this obligation [*587] shall be null and void; otherwise it shall remain in full force and effect.
>
> [C] Whenever Principal shall be, and declared by Obligee to be in default under the subcontract, the Obligee having performed Obligee's obligations thereunder:
>
> (1) Surety may promptly remedy the default, subject to the provisions of paragraph 3 herein, or;
>
> (2) Obligee after reasonable notice to Surety may, or Surety upon demand of Obligee may arrange for the performance of

94 *Id.*
95 *Id.*
96 *See id.* at 1129.

> Principal's obligation under the subcontract subject to the provisions of paragraph 3 herein;
>
> 3) The balance of the subcontract price, as defined below, shall be credited against the reasonable cost of completing performance of the subcontract. If completed by the Obligee, and the reasonable cost exceeds the balance of the subcontract price, the Surety shall pay to the Obligee such excess, but in no event shall the aggregate liability of the Surety exceed the amount of this bond. If the Surety arranges completion or remedies the default, that portion of the balance of the subcontract price as may be required to complete the subcontract or remedy the default and to reimburse the Surety for its outlays shall be paid to the Surety at the times and in the manner as said sums would have been payable to Principal had there been no default under the subcontract. The term "balance of the subcontract price," as used in this paragraph, shall mean the total amount payable by Obligee to Principal under the subcontract and any amendments thereto, less the amounts heretofore properly paid by Obligee under the subcontract.
>
> [D] Any suit under this bond must be instituted before the expiration of two (2) years from date on which final payment under the subcontract falls due.
>
> [E] No right of action shall accrue on this bond to or for the use of any person or corporation other than the Obligee named herein or the heirs, executors, administrators or successors of Obligee.

The *Colo. Structures* court felt as though *L & A Contracting* was wrongly decided and, beyond that, unilaterally expanded the nature and scope of the A311 performance bond.[97] The Court held that the "conditions precedent" listed in Paragraph C of the bond apply only to the specific

[97] *Id.* at 1134.

performance options outlined in the bond..[98] The Court also held that surety liability continues until the single listed condition in Paragraph B is fulfilled,[99] *i.e.*, the principal promptly and faithfully performs and that obligee may "sue for damages incurred when performance is finished."[100]

Thus, based on the Court's interpretation of the bond in *Colo. Structures*, Paragraphs A and B, govern the surety's ultimate liability to the obligee for damages should it choose to sue, while Paragraph C governs the surety's liability and/or duty to the obligee to arrange for the performance options outlined in the bond. Under Paragraph C, the surety's duty to arrange for the performance of the bond principal's obligations is expressly conditioned upon three things: (1) the bond principal must be in default under the bonded contract; (2) the obligee must declare the bond principal to be in default; and (3) the obligee must have performed its own contractual obligations to the bond principal under the bonded contract. As to Paragraph C of the bond, the Court stated:

> When Paragraph C applies, it provides for certain remedies and measures of damage. By its terms, however, it applies only when (1) the principal is in default under the subcontract; (2) the obligee declares the principal to be in default under the subcontract; and (3) the obligee has performed its own obligations under the subcontract.[101]

> The Court added:

> Paragraph C sets forth three events (the principal's default, the obligee's declaration of default, and the obligee's performance) that constitute conditions precedent to the use of the remedies and damages described in Paragraph C, *but not conditions precedent to the liability created in Paragraph A*.[102]

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98 *See id.* at 1132.
99 *See id.*
100 *See id. at 1133.*
101 *See id.* at 1132.
102 *See id. at 1133.*

This deviates from the *L & A Contracting* rationale that requires a legal default before surety liability is triggered. Under *Colo. Structures*, any mere delay or breach could expose the surety to a lawsuit for damages after the bonded project is complete irrespective of the conditions in Paragraph C. While this is a seemingly aberrational ruling, it is significant because it is handed down by a state supreme court and may play a role in performance bond interpretation for the state of Washington and beyond.

V. CONTINUED RELEVANCE OF L & A CONTRACTING

L & A Contracting continues to provide courts around the country with guidance as to the determination of a legal default as well as on the need for a clear declaration of default. But for a few select outliers, *L & A Contracting* remains good law around the country.

The tenet of law that *L & A Contracting* stands for *i.e.,* that for a legal default to occur (and thus trigger a surety's obligations), there must be a material breach or series of material breaches of such magnitude that the obligee is justified in terminating the contract is vital. It adds a seriousness and gravity to the idea of a legal default (and the declaration of default) that is appropriate to the gravity and seriousness to both the principal and surety when such a default is declared by an obligee. And the high standard required by L *& A Contracting* is a standard that practitioners in the field should fight to keep.

PANEL 12

SAFEGUARDING PRIVILEGE IN SURETY CLAIMS

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Safeguarding Privilege in Surety Claims

by: Max Langley, Will Beasley, Mike Spinelli, and Rudy Dominguez

A. INTRODUCTION

Our top ten best practices for preserving privilege are:

1. **Limit the non-lawyer recipients** on requests for or discussions about legal advice. With emails, include counsel on the "To" line. Warn recipients to avoid forwarding privileged communications to unnecessary parties. With particularly sensitive and confidential issues for which a privilege is intended to be maintained, it is often best to use separate parallel communications to discuss legal and non-legal issues.
2. Ensure the content of the email clearly **reflects the request for legal advice** (e.g., "so that you can provide legal advice" or "this responds to your request for legal advice"). Focus on the substance of the communication and remember that merely including an attorney in a meeting or on a communication does not necessarily mean that the communication is privileged.
3. Do not wait for litigation to begin marking documents as privileged. Write "**confidential & privileged**" in the subject line of emails. In real-time, "tag" the privileged documents and/or move them into a separate "privileged" folder. Planning will greatly assist in asserting and maintaining privilege in the event of litigation.
4. **Do not over-assert** privilege during discovery in litigation. While it is tempting (and easy) to mark everything with an attorney on it as "privileged," you must ensure each element of privilege exists before alleging privilege. Remember the party asserting privilege has the burden of proving privilege, and merely claiming privilege does not magically transform a non-privileged document into a privileged document. Properly prepared privilege logs should be a forethought, not an afterthought. Overzealous assertion of privilege can lead to greater skepticism and increase scrutiny of all privilege entries on a privilege log by opposing counsel, which, in turn, could lead to

in camera review by the court or the arbitrator(s). In our experience, over-asserting privilege can lead to broad rulings that the rest of the allegedly privileged documents are not privileged.

5. Use separate collaboration areas, document storage, messaging threads, and chat groups when seeking or contributing legal advice versus business advice. **Limit** or eliminate "**dual purpose**" communications that mix legal advice with business advice.
6. Ensure the only participants with access to privileged collaboration tool data include an **actively contributing attorney** and those who share a **privileged relationship** (officers, directors, or other "need to know" employees).
7. **Use encryption—**both in transit and at rest. Encrypting in transit protects against a common attack: the "man in the middle attack." Encrypting at rest defends against inadvertent disclosure. Also consider proper access controls and logging procedures. In a 2017 case in Virginia federal court, the plaintiff used an online file-sharing service to exchange files with multiple users, including its counsel. The plaintiff did not password protect the repository, leaving the files unprotected and accessible by opposing counsel. The plaintiff's failure to limit access to the files resulted in waiver of attorney-client privilege. *Harleysville Ins. Co. v. Holding Funeral Home, Inc. et al.*, No. 1:2015cv0057, Dkt. 96 (W.D. Va. 2017).
8. **Educate your team** about privilege—including how to create and preserve the privilege. This means understanding what constitutes a privileged communication and how the privilege is susceptible to waiver. Consider phone calls as potentially being a more prudent course rather than emails.
9. **Know when** an expert communication or document is **privileged** and when it is not. Different jurisdictions have different rules, and this is an ever-evolving area (e.g., Texas recently changed to protecting draft expert reports). Keep consulting experts separate from testifying experts to maintain the consulting expert's privilege.

10. **Know the timing** of when privilege or work product protection can arise. Different jurisdictions have different rules. In Florida, for example, certain types of privilege require litigation to have actually begun before the document can be privileged.

Identifying what is and is not privileged, and preserving its privileged status, is one of the most important elements of the modern American lawyer's professional functions. A dangerous and common misconception is that all communications involving a lawyer are protected by the attorney-client privilege. If company employees, experts, inhouse counsel, and outside counsel take a cavalier approach to privilege, they risk a court or an arbitrator strictly applying the elements of privilege, and potentially holding that any potential privilege is waived over all or part of the withheld documents.

Attorney-client privilege is a client's right to refuse to disclose and to prevent any other person from disclosing confidential communications between the client and the attorney. Similarly, the "consulting expert privilege" protects the identity, mental impressions, and opinions of a consulting expert whose mental impressions and opinions have not been reviewed by a testifying expert. Finally, the "attorney work product privilege" permits attorneys to withhold from production documents and other tangible things prepared in anticipation of litigation. This paper will discuss these privileges from the perspectives of:

1. Outside Counsel
2. Inhouse Counsel
3. The Testifying Expert
4. The Consulting (Non-Testifying) Expert
5. The Party Asserting Privilege
6. The Party Challenging the Assertion of Privilege

The attorney-client privilege is one of the oldest privileges for confidential communications. It began in the range of Elizabeth I in England. At that time, the attorney owned the privilege, rather than the client. It has survived in its current form in the United States since at least the 1880s. The privilege is controversial sometimes, and different

jurisdictions have different views of the elements and scope of privilege. Because people misunderstand the elements of the doctrine, it rests at the crux of two diametrically opposed legal principles: (a) full discovery, and (b) withholding confidential communications.

The United States Supreme Court has stated that by assuring confidentiality, the privilege encourages clients to make "full and frank" disclosures to their attorneys, who are then better able to provide candid advice and effective representation. *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981). In other words, the overall purpose of privilege is to encourage open dialogue and sharing of information to obtain legal advice without fear of disclosure to unintended parties.

The application of privilege is not a clear-cut process, particularly given jurisdiction considerations. Texas, for example, is a "minority state" in certain aspects of attorney-client privilege, including Texas intermediate courts holding that the "significant purpose" test controls, rather than the "primary purpose" test used by most courts. A "significant purpose" or a "dual purpose communication" is one between an attorney and her client made for purpose of receiving or providing legal advice, as well as non-legal advice. In our tips below, we note that it is a best practice to *not* have a dual purpose communication at all. But if a dual purpose communication happens, it is crucial to know the relevant rule in your jurisdiction.

2023 and beyond presents new and newly arriving challenges to maintaining privilege, including the proliferation of electronically stored information ("ESI"), the widespread use (and misuse) of email and text messages, the endless array of digital depositories, and the rise of online collaboration tools.

B. LEGAL BASIS OF ATTORNEY-CLIENT PRIVILEGE

Although there are minor variations across different jurisdictions, the key elements of attorney-client privilege are:

1. a communication;
2. made between privileged persons;
3. in confidence;

4. for the purpose of seeking, obtaining, or providing legal assistance to the client.

In most jurisdictions, the primary purpose of the communication must be to seek or to give legal advice. In the minority of jurisdictions, including Texas, legal advice only needs to be a "significant purpose" (which is a lower degree than "primary purpose"). Although you should ideally separate legal advice rather than mixing legal-and-business advice, when such mixed circumstances do exist, it is important to know the rule in the relevant jurisdiction.

Federal courts are split on the "primary purpose" versus "significant purpose" issue. The United States Supreme Court recently held oral arguments over what the federal rule should be as to communications mixing legal advice with business advice. Many amicus briefs were submitted arguing uniformly for adoption of the "significant purpose" test (as used in Texas), rather than the "primary purpose" test (as used in most jurisdictions). Despite having the opportunity to decide the proper test for federal common-law assertions of privilege, the Supreme Court dismissed the appeal as "improvidently granted."

i. Dual-Purpose Communications

In re Grand Jury, 598 U.S. ___, No. 21-1397 (2023). In its brief, the U.S. Chamber of Commerce argued the primary purpose test "does not reflect the modern role that lawyers play in advising businesses" because the line between the business purpose and the legal purpose (the "Dual Purpose) is often blurry. The Chamber argued, the primary purpose test is often "inherently impossible" to apply and therefore "bound to yield arbitrary and unpredictable results." Only the U.S. government argued for the "primary purpose" test.

Dual-purpose communications occur when a client and its counsel participate in communications in which a request for legal advice is mixed among communications that include multiple topics, such as business advice. This is particularly true where a company's in-house counsel engages in communications with non-lawyer company employees that involve both legal and non-legal information. There is a split in the Federal

Circuit Courts of Appeal as to how the attorney-client privilege protection should apply in those cases. The Ninth Circuit follows the "primary purpose" test, the Circuit for the District of Columbia follows the "significant purpose" test, and the Seventh Circuit has held that a dual-purpose communications involving both tax preparation advice and legal advice is never privileged.

When an attorney is not acting primarily as an attorney but, for instance, as a business advisor, member of the Board of Directors, or in another non-legal role, then the privilege generally does not apply. A few jurisdictions even rebuttably presume that an in-house counsel's communications are not privileged.

ii. The Primary Purpose Test

In *In re Grand Jury* the target of a criminal investigation received subpoenas from a grand jury to produce communications and documents related to the investigation. The company and its law firm produced only some documents requested claiming that other documents were protected under the attorney-client privilege and the work-product doctrine. The District Court and the Ninth Circuit on appeal ruled against the company and the law firm and directed the production of the withheld documents. Both courts found that the company and its law firm offered no persuasive reason for the court to deviate from the majority common-law rule regarding the protection of attorney-client communications when "the primary purpose" of the communication was to seek legal advice. The law firm appealed the decision by the Ninth Circuit to the United States Supreme Court arguing that "the primary purpose" test would impermissibly limit the availability of the attorney-client privilege. The Supreme Court granted certiorari and heard oral arguments on the issue.

iii. The Significant Purpose Test.

In In re Kellogg Brown & Root, Inc., 756 F.3d 754 (D.C. Cir. 2014), the party seeking document discovery, Harry Barko, was an employee of Kellogg Brown & Root Inc. ("KBR"). The documents he was seeking related to an internal investigation that had been conducted by KBR into an alleged fraud scheme. Barko claimed that the documents sought were not

privileged business records. In response, KBR claimed that its internal investigations were conducted to obtain legal advice, therefore, the documents generated during its investigations were protected by the attorney-client privilege. The lower court concluded that KBR's internal investigation was undertaken in furtherance of regulatory law and corporate policy rather than for obtaining legal advice. On appeal, the D.C. Circuit Court held that the documents retained by KBR were afforded protection by the attorney-client privilege because one of the significant purposes of the internal communications was to obtain or to provide legal advice. Thus, the nature of the legal advice in the multi-purpose communication had to be a significant—but not the primary—purpose of the communications to trigger attorney-client privilege protection.

iv. No Protection.

The Seventh Circuit has held that dual-purpose communications involving both legal and tax preparation advice are never privileged. U.S. v. Frederick, 182 F.3d 496 (7th Cir. 1999).

Ultimately, in *In re Grand Jury*, the Supreme Court dismissed certiorari without explanation after hearing oral argument. The High Court chose not to resolve the split in the federal circuits regarding what test to apply when considering the application of the attorney-client privilege to multi-purpose communications. Thus, the take aways from the above discussion are: (1) consider the jurisdiction in which you find yourself before determining which test will be applied; or (2) conform to the "primary purpose" test, the more stringent standard, for keeping communications protected.

v. The Crime-Fraud Exception

The crime–fraud exception can render the privilege moot when communications between an attorney and client are themselves used to further a crime, tort, or fraud. In *Clark v. United States*, the U.S. Supreme Court stated that "A client who consults an attorney for advice that will serve him in the commission of a fraud will have no help from the law. He must let the truth be told." The crime–fraud exception also does require that the crime or fraud discussed between client and attorney be carried out to

be triggered. U.S. courts have not yet conclusively ruled how little knowledge an attorney can have of the underlying crime or fraud before the privilege detaches and the attorney's communications or requisite testimony become admissible.

Privilege can be waived, such as by copying an email to individuals not recognized by the court as being within the privileged relationship for the particular communication. Although both intentional and inadvertent disclosures have been deemed to waive the privilege, not surprisingly, courts disagree over the effect of inadvertent disclosure. At one end of the spectrum is the "out-the-barn-door" rationale, which holds that any disclosure that destroys confidentiality irreparably destroys an element of the privilege. At the opposite end are courts that consider waiver to require an *intentional* relinquishment of a known right, and thus an inadvertent disclosure cannot waive the privilege. The middle-ground approach requires a balancing of facts and circumstances, including the number of documents produced, precautions taken to prevent disclosure of privileged communications, and promptness of measures to remedy the mistake, to determine whether the disclosure results in waiver. Courts also differ as to the scope of the waiver occasioned by an inadvertent disclosure, with some limiting the disclosure of the particular document and others extending it to all communications on the same subject.

In the surety context, the "at issue" waiver may result in a court or an arbitrator finding waiver of privilege in some cases. For example, in *Travelers Cas. & Sur. Co. of Am. v. Grace & Naeem Uddin, Inc.*, 2009 U.S. Dist. LEXIS 139014, *6 (S.D. Fla. Oct. 23, 2009), the court found that any privilege for time entries by the surety's outside counsel and the surety's consultant were "impliedly waived" by the "at issue" doctrine because the surety sought the attorney fees and expert fees as part of its damages against its principal/indemnitors, and because the surety relied on the attorney and consultant invoices as evidence of its alleged damages. The court rejected the surety's argument that "revealing the redacted, privileged portions of the time entries would threaten the resolution of the ongoing [Project] state case by placing privileged thoughts, opinions, and mental impressions into the public domain, making them accessible to non-party

[obligee].” The particular indemnity agreement at issue required the surety to have had “a good faith belief” that it was required to pay the invoices, and the court relied on this prerequisite in finding any privilege or work product protection waived.

Applying the attorney-client privilege and work product privileges to the surety context presents unique challenges, and few courts have addressed application of the privileges in the surety relationship. According to a 1999 paper on the topic:

> The application of the attorney-client and work product privileges in the insurance context has received extensive and conflicting treatments by courts and commentators; however, the intricacies of these doctrines as applied in surety cases have received far less attention. Although insurance cases offer some guidance in the surety setting, the nuances of the tripartite surety relationship among surety, principal, and obligee have not been specifically analyzed.
>
> . . .
>
> Application of the attorney-client and work product privileges in insurance cases has caused disagreement among courts because claims handling is inherently litigious and often the prelude to litigation. If insurers are often teetering on the edge of litigation, the surety faced with a performance claim walks a tightrope with the principal pulling on one side and the obligee tugging on the other, each threatening to topple the surety into the abyss of litigation. Just like insurers, prudent sureties anticipate litigation with everything they do (or do not do). In applying the privileges, courts must decide whether claims handling is more of an “ordinary business” function or “prelitigation preparation.” Courts disagree not so much with the elements of the privileges as with the definition of the claims adjustment process. This same philosophical conflict (or definitional ambiguity) exists in surety claims.

> In suretyship, this ambiguity is compounded by the inherently dualistic nature of the surety/principal relationship. While the insurer and insured may at certain stages be allies and at others antagonists, the surety and principal are at war and in alliance at the same time. Few courts have spoken directly to the common interest privilege (or lack thereof) between the surety and its principal, or the inherently adversarial aspects of the relationship that render the analogy to insurance inapplicable. This article uses insurance cases as a framework for determining how privilege issues could be analyzed in the surety context.

Amy L. Fischer, *The Attorney-Client/Work Product Privileges and Surety Investigative Information: Applying Old Rules to Turn New Tricks*, 34 TORT & INS. L.J. 1009 (1999).

The "ordinary business doctrine" in some jurisdictions may limit successful invocation of privilege by the surety at times. For example, consultants who perform the "ordinary business functions" of a surety, such as underwriting and perhaps initial claims adjusting and investigation, are not litigation consultants working on behalf of counsel, and thus their analyses may not be protected by attorney-work product privilege.

This ordinary business doctrine was applied to a surety consultant's files in *Levingston v. Allis-Chalmers Corp.*, 109 F.R.D. 456 (S.D. Miss. 1985). Documents that the surety withheld on the basis of attorney-client and/or attorney-work product privilege included documents generated during the surety's completion of projects that were authored or received by its attorneys, surety representatives, surety consultants and other attorneys involved in disputed claims against the surety arising from the bonded jobs. The court concluded that the surety consultants engaged to help complete the bonded projects and the investigations of payment bond claims were not hired by the surety "in anticipation of litigation"—particularly not the instant litigation. Rather, they were engaged to determine the status of the work to determine what had to be completed and project completion costs. Furthermore, because the consultants were not listed as trial experts, the court concluded that they were merely "actors" or "viewers to be treated as

ordinary witnesses from whom all facts known and opinions held are freely discoverable." The surety had also failed to show that the consultant documents were created "to aid in possible future litigation," as required to invoke a work-product privilege. Rather, the documents were created largely in connection with completing the bonded projects and the analysis of claims against the surety's bonds on the bonded projects.

Some courts have held that a surety's reserve numbers are "relevant and not protected by either the attorney-client privilege or the work-product doctrine." *Western Sur. Co. v. United States*, 2018 U.S. Dist. LEXIS 216174, *13 (D. Ariz. Dec. 21, 2018). In *Western Sur.*, the court reasoned that the reserve numbers were not protected by attorney-client privilege even though they were set by the surety's inhouse counsel because the surety failed to establish that its reserve information was anything but "business advice." The court also rejected the work product claim because "documents prepared in the ordinary course of business are not protected by the work product doctrine because they would have been created regardless of litigation" and the surety provided "no evidence that this information was prepared specifically in anticipation of litigation or for trial and, therefore, the work-product doctrine does not apply." *Id.*

C. JOINT REPRESENTATION AND COMMON INTEREST

A surety may successfully claim privilege where a "common interest" or "joint defense" exists as between the surety and the principal in an action against the obligee. Texas refers to this privilege as the "allied litigant" doctrine. Different jurisdictions have different variations of this idea.

The terms "joint defense privilege" and "common interest doctrine" have been used interchangeably. Some courts fail to draw a distinction:

> Where the third party shares a common interest with the disclosing party which is adverse to the party seeking discovery, an existing privilege is not waived. This is known as the common interest or joint defense doctrine.

Allendale Mut. Ins. Co. v. Bull Data Sys., Inc., 152 F.R.D. 132, 140 (N.D. Ill. 1993) (citations omitted). Courts that have distinguished between the two terms describe the joint defense privilege as "protecting communications between two or more parties and their respective counsel if they are engaged in a joint defense effort." *In re Sealed Case*, 29 F.3d 715, 719 n.5 (D.C. Cir. 1994). In contrast, the common interest doctrine "protects communications between a lawyer and two or more clients regarding a matter of common interest." *Id*. at 19. Both describe the concept of maintaining the attorney-client privilege in a joint defense situation.

Although a "joint defense agreement" is unnecessary in many jurisdictions, including Texas, it may be prudent for the surety to formalize its common interest with the principal to better secure the privilege.

The "joint defense privilege," "common interest doctrine," or "allied litigant doctrine" extends the privilege to communications between an individual and another's attorney when the communications are "part of an on-going and joint effort to set up a common defense strategy." Rather than create a "privilege," the doctrine only preserves an already existing privilege from waiver by disclosure; it does not make otherwise nonprivileged documents privileged. Thus, this "privilege" arises only when the matter communicated is itself privileged; no joint defense privilege can be claimed for documents or communications that are themselves not privileged.

At some point in the surety's investigation of an obligee's claim, the surety may decide to stand behind the principal, and thus create a common interest as long as the surety endorses the principal's position or is subrogated to the principal's rights and claims. In *Levingston v. Allis Chalmers Corp.*, 109 F.R.D. 546 (S.D. Miss. 1985), the court acknowledged the existence of a joint privilege between the surety's counsel and counsel for the principal arising from subrogation. A common interest privilege should likewise exist after the surety agrees to stand behind its principal and deny an obligee's claim.

Before the surety's decision to stand behind its principal, the existence of privilege may depend on whether the information is received

by the surety "in the ordinary course of the surety's business" of claims investigation or for creating/maintaining a joint defense with its principal. Again, different jurisdictions have different rules, and applying the "common interest' / "joint defense" / "allied litigant" doctrine to the surety context presents unique issues not present in non-surety cases. Having a "cooperation clause" in the indemnity agreement may strengthen arguments for privilege in the context of communications between the surety and its principal.

A unique situation may arise where multiple co-sureties defending the same claim hire the same expert, and where that shared expert is designated as a testifying expert by one of the sureties. In *In re Commer. Money Ctr., Inc.*, 248 F.R.D. 532 (N.D. Ohio 2008), co-sureties retained a forensic accounting expert, and the banks requested the sureties to produce all documents that the forensic accounting expert "received, obtained, generated, reviewed, considered and/or relied upon" in connection with his retention as the sureties' forensic accounting expert. The sureties withheld the documents on the basis of attorney-client privilege and work-product privileges. Central to the sureties' arguments was their contention that the withheld documents were reviewed or generated by the expert in his capacity as a consultant for all the sureties, and that "only one of the sureties" had named the expert as a testifying expert. The court held that the documents were not privileged because the sureties had not demonstrated that the documents identified in their privilege log were reviewed or generated by the expert uniquely in his role as consultant for the sureties and had no relation to the subject matter of his expert report for the other surety.

D. WHOSE HAT IS IT ANYWAY? - THE DUAL HAT ISSUE

An in-house attorney for a surety wears many hats. To name a few, they handle claims, assist the company through a host of legal issues, and provide insight for business decisions. The good news is that the attorney-client privilege doctrine still applies to in-house counsel. The bad news is that the web of daily tasks makes it difficult to determine where that privilege begins and ends.

The attorney-client relationship for an attorney working at a company is between the in-house counsel (the attorney) and the corporation (the client). Of course, the in-house attorney doesn't speak directly to the "corporation." They speak to and advise their co-workers in their roles as employees for the corporation. And as a rule of thumb, the higher up the employee that the attorney is speaking to, the more likely privilege will apply. As an example, in the Surety context, a communication with the Chief Underwriting Officer is more likely to be privileged than a discussion with an underwriting assistant.

Along with who the in-house attorney is speaking to, it is also important to look at the purpose of the communication. Only communications concerning legal advice can be protected. Accordingly, including in-house counsel in business decisions will not trigger the privilege. Things get more complicated when a communication (usually an email) is a hodge-podge of legal and business advice. In those situations, jurisdictions are split on what test to apply. The D.C. Circuit held in 2014 opinion, by then Judge Kavanaugh, that the privilege applies if "obtaining or providing legal advice was one of the significant purposes of the attorney-client communication. *In re Kellogg Brown & Root, Inc.*, 756 F.3d 754, 760 (D.C. Cir. 2014). On the other hand, the 9th Circuit has adopted the primary purpose test, which asks "whether the primary purpose of the communication is to give or receive legal advice, as opposed to business or tax advice." *In re Grand Jury*, 23 F.4th 1088, 1091 (9th Cir. 2021), *cert. granted sub nom. In re Jury*, 214 L. Ed. 2d 16, 143 S. Ct. 80 (2022), *and cert. dismissed as improvidently granted*, 214 L. Ed. 2d 329, 143 S. Ct. 543 (2023).

The Supreme Court seemed set to determine whether the appropriate standard was either the "primary purpose" or a "significant purpose" earlier this year. Instead, after hearing argument it dismissed the writ of certiorari "as improvidently granted." *In re Grand Jury*, 143 S. Ct. 543 (2023).

E. ASSERTING AND CHALLENGING PRIVILEGE

Properly asserting privilege is a time-intensive task which must be carefully performed. Challenging claims of privilege is also time-intensive,

and there must be a weighing of the pros and cons of such a challenge before undertaking the work. Many claims of privilege in litigation are under-supported, inviting the shrewd litigator to challenge whether the claimant has met its heavy burden of proving each element of privilege.

F. MAINTAINING PRIVILEGE

Once each element of privilege has been established, the next task is maintaining privilege. In the introduction and at the conclusion of this paper, we offer practical considerations for safeguarding privilege.

The attorney-client privilege is *fragile* and must be carefully guarded. As discussed further throughout this paper, some jurisdictions view privilege as something that can be relatively easily waived. For example, privilege may be subject to waiver when the content of a confidential communication is disclosed to a third party with no legitimate need to know the information, even in some cases in which the disclosure is inadvertent. Therefore, counsel should first be consulted before forwarding, copying, or including others in confidential communications containing or seeking legal advice.

Do not assume that merely cc'ing an attorney on an email will make it privileged. *Bruno v. Equifax Info. Serv.*, 2019 U.S. Dist. LEXIS 24502, *5 (E.D. Cal. Feb. 14, 2019) (citing precedent and holding that merely cc'ing an attorney on an email is not enough to invoke attorney-client privilege). Rather, address the email directly to legal counsel, and explicitly mention that the email either seeks or gives privileged legal advice. Add notations to signal a primary legal purpose, e.g. "attorney-client communication" or "privileged and confidential." These notations will have the added effect of making it easier to assemble a proper privilege log in the event of litigation.

Actively prevent potential waivers of privilege. A waiver can occur where the communication takes place, or lives in, a less-than-secure environment. *Harleysville Ins. Co. v. Holding Funeral Home, Inc. et al.*, No. 1:2015cv0057, Dkt. 96 (W.D. Va. 2017) (claim of privilege waived where claimant left the documents in an unsecured online repository without password protection, and later inadvertently sent the access link to

opposing counsel via email). This case is not an isolated incident. In practice, protecting privilege can be one of the most complicated tasks in many types of litigation. The introduction of electronic evidence in the 1990s complicated a lawyer's duty to protect privileged information, and that challenge has increased with the exponential rise of digital data. Because it is possible to share digital files with a single mouse click, many lawyers, paralegals, and litigants have upended their cases with the accidental dissemination of privileged materials. Therefore, it is prudent to protect against such disclosures, by limiting both access to the information and ability to share the information. Most modern digital repositories allow the administrator to make users have only "read-only" abilities, rather than openly having sharing powers.

Some courts have held that an inadequate privilege log can result in waiver of privilege. Accordingly, pay special attention to preparing a proper privilege log, demonstrating the existence of each element of privilege. The days of privilege log apathy are ending. Courts are increasingly exhibiting more scrutiny of privilege logs and imposing sanctions, including the significant sanction of waiver, for insufficient privilege log descriptions. "If a party falls substantially short of the well-established requirements" for properly asserting privilege and describing the material in a privilege log, "then waiver is an appropriate consequence that helps dissuade parties from engaging in dilatory tactics." *Mechel Bluestone, Inc. v. James C. Justice Cos., Inc.*, 2014 WL 7011195, at *6 (Del. Ch. Dec. 12, 2014). "An improperly asserted claim of privilege is no claim of privilege at all." *Int'l Paper v. Fibreboard Corp.*, 63 F.R.D. 88, at 94 (Del. Dist. Ct. 1974). A court can order production where the descriptions are so repetitive as to be meaningless. *In re Oxbow Carbon LLC Unitholder Litig.*, 2017 Del. Ch. LEXIS 43, 2017 WL 959396, at *6 (Del. Ch. Mar. 13, 2017) (ordering waiver where "repetitive descriptions fall substantially short of Delaware's well-established requirements")

i. Privilege vis-à-vis the Consulting and/or Testifying Expert

A Construction Consultant is often retained by a surety company or outside counsel to serve one of three primary functions: 1) claim

investigations; 2) consulting, non-testifying experts; and 3) testifying experts. The consultant may serve in more than one of these capacities throughout a claim depending on the nature of the claim and the needs of the surety client. Whether or not the work product of the consultant is subject to discovery by a party other than the surety client can depend on which capacity the consultant served, how that role may have evolved over the lifetime of the matter, or how the facts, data or assumptions relied upon by the consultant in forming its opinions was provided.

ii. The Consultant in the Surety Claim Investigation

In the situation involving a claim investigation, the consultant is not necessarily retained to render expert opinions, but to help the surety investigate the claim. The consultant may possess specific expertise the surety wants to utilize during the claim investigation (for example, using a registered architect to evaluate a building envelope or a licensed professional mechanical engineer to investigate a default involving mechanical engineering and construction issues), but the consultant is not necessarily retained by the surety as a testifying expert at the onset of the engagement. In this situation, the consultant is gathering facts to be used by the surety informing its decision whether the surety believes it has responsibility under the performance bond or whether it determines that the performance bond obligation was discharged because of the conduct of the bond obligee.

If after a thorough evaluation of the facts and circumstances surrounding the default or termination, the surety decides that it will satisfy its performance bond obligations by electing one of the options available to it under the bond, the consultant may assist the surety carrying out that performance in deciding what completion option under the bond to deploy. If the surety retains the consultant directly and not through an outside counsel, the work product of the consultant is very likely to be discoverable (depending on the jurisdiction). The consultant is merely helping the surety determine what method the surety will choose in executing a project completion option. Even if the consultant is reporting to an in-house surety bond claim representative who happens to be a licensed attorney, in some jurisdictions, it is unlikely that any attorney-client privilege or attorney

work-product doctrine can be asserted to shield the consultant's work from discovery where the protection extends to materials prepared by an attorney (and in some cases that attorney's agent) in the process of creating documents in anticipation of litigation or in representing a client.

iii. The Attorney-Client Privilege

The surety claim representative who may happen to be a licensed attorney is performing a duty pursuant to the surety's bond obligations and not as an attorney representing its client in a litigation matter or in anticipation of litigation. Consequently, the consultant's role is likely to be viewed not as an expert witness but as an extension of the surety so that the data, documents, and damage computations reviewed and developed by the consultant are likely subject to discovery.

iv. The Attorney Work-Product Doctrine

A question arises as to when the consultant's retention on behalf of the surety during the claim investigation is through outside counsel and whether this factor affects the discoverability of the consultant's work product. Surety counsel has frequently asserted that the consultant's work on behalf of and reported only to the outside counsel is protected work product under the attorney work-product doctrine. FED. R. CIV. P. 26(b)(3)(A) provides that "a party may not discover documents … that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party's attorney, consultant, surety … or agent)" The Attorney Work-Product doctrine protects a consultant's work product to outside counsel when litigation is underway or when litigation is anticipated. Could one assert that anytime a performance bond demand is lodged against a surety that litigation is anticipated? That is likely too broad of an interpretation to persuade the courts to protect the consultant's investigative efforts even where the consultant is retained by the surety's outside counsel and not by the surety directly.

v. Preparation of Notes, Reports and Opinions

Outside counsel also often asks the consultant not to (i) write anything down, (ii) take any notes, or (iii) produce any reports to avoid

providing a written investigatory record that may be subject to discovery. Although this request sounds innocuous enough on its face, it is unrealistic to believe that a consultant expert will remember all the issues they investigated and all the facts that were considered during the investigation when the consultant is sitting for its deposition years later and testifying at trial years after that. During the investigation, it is the role of the consultant to call balls and strikes—to provide objective opinions to its client. The consultant should provide objective, impartial opinions for the benefit of the surety based on the facts and documents reviewed and stand behind those opinions if litigation ensues. Nevertheless, it is advisable for the consultant to proceed with its investigation with the understanding that any document reviewed and any note taken is likely subject to discovery.

vi. The Consultant as a Non-Testifying Expert

Sometimes the surety's outside counsel will engage a consulting, non-testifying expert to help the attorney understand complex issues that are outside the attorney's knowledge and expertise. The consulting expert is retained in anticipation of litigation or in preparation for trial. This consulting expert is not expected to be called as a witness. Under FED. R. CIV. P. 26(b)(4)(D), a party may not ordinarily "discover facts or opinions held by an expert who has been retained … in anticipation of litigation or to prepare for trial and who is not expected to be called as a witness at trial." This would include the documents reviewed by the consultant, the notes taken by the consultant and the opinions and conclusions reached by the consultant. There are however exceptions to this rule, including a showing of exceptional circumstances under which it is impracticable for it to obtain facts or opinions on the same subject by other means. Even still, the investigatory team should exercise caution when asking the consultant to opine in writing on the good, bad and the ugly, in case the consultant's role morphs into that of a testifying expert, and the consultant's opinions become discoverable. Should the consultant's role transition into a testifying expert, the broad disclosures of Fed. R. Civ. P 26(a)(2)(B) may become operative, including furnishing a report containing the all the facts and data considered by the testifying-expert consultant in forming its opinions.

vii. The Consultant as the Testifying Expert

Unlike the privilege that can be asserted under Fed**.** R. Civ. P. 26(b)(4)(D) where a consulting expert is retained only for non-testimonial trial preparation and litigation assistance, the materials relied upon by the testifying expert will not be shielded from discovery. Along with preparing a written report, the testifying expert must disclose among other things all the facts, documents, data, and treatises relied on in forming its opinions. Fed. R. Civ. P. 26(a)(2)(B)**.** This rule may also apply when the consultant is initially retained to assist the surety or counsel in investigating the claim if that role grows into that of a testifying expert. Presumably, all the information and documentation reviewed during the consultant's initial investigation is likely subject to discovery at least to the extent that it helped form his or her opinions subsequently as a testifying expert.

Notwithstanding the foregoing, Fed. R. Civ. P. 26(b)(4)(B) protects the draft reports of an expert from disclosure under Rule 26(a)(2)

G. CONCLUSION AND PRACTICAL CONSIDERATIONS

Safeguarding privilege in the context of surety claims presents unique challenges and complex issues that have largely been unaddressed by courts. Applying non-surety case precedent to surety cases often presents a "square peg, round hole" problem.

Maintaining privilege in the modern digital era—including email and online collaboration platforms—introduces new difficulties and novel questions. Surety claims professionals should consider these tips for preserving privilege:

1. **Have a proactive plan for preserving privilege, and foresee making a proper privilege log.** Marking documents as privileged early on, and segregating them into a "privileged" folder, will be very helpful for the litigation team rather than waiting until discovery time to review whether documents are privileged. Outside counsel should receive a limited, precise set of documents to consider for the privilege log, rather than having to reinvent the wheel. Making a proper privilege log is a

challenging, time-intensive process that can be greatly helped by proactive actions to preserve privilege. With the explosion of ESI causing document production sets to exponentially increase in size, it can be considerably more arduous to create an appropriate privilege log. Planning towards a proper privilege log will pay dividends.

2. **Enter into a "joint defense" agreement with the principal early on and ensure the GIA has a "cooperation clause".**
3. **Do not mix business advice with legal advice.** Document the legal purpose for the advice, and remember that in the event of litigation, depending on your jurisdiction, you may need to establish that the "primary purpose" of the communication was to obtain legal advice.
4. **Encrypt and password protect your claim file and related communications.** Limit access to those who have a "need to know" basis, and limit users to having "read-only" abilities, rather than the power to share.
5. **Limit distribution of communications containing legal advice to those with a "need to know" basis.** Likewise, make it a policy that recipients of legal advice are prohibited from sharing the communication to third-parties.
6. **Limit the amount of documents you claim privilege over.** Before asserting privilege, think: do we *really* need to withhold this document? Judges and arbitrators look negatively upon voluminous privilege logs—especially if the privilege log has "holes" in it or contains tenuous claims of privilege—and may find privilege waived, in whole or in part, because of overzealous assertion of privilege and/or a subpar privilege log.
7. **Know your jurisdiction's rules on privilege.** Different jurisdictions have significantly different rules on types of privileges applicable to the surety context. There is no "one-size-fits-all" tip for establishing or maintaining privilege.
8. **Do not merely "cc" an attorney; direct the communication to the attorney and clearly seek or receive legal advice.** Many litigants wrongly presume that cc'ing an attorney makes the communication privileged.

9. **Consider whether a phone call might be preferable to an email or letter, and if a written communication is necessary, consider labeling it "for the purposes of legal advice."**
10. **Consider keeping consulting experts as non-testifying experts, and having a separate testifying expert.** Once a consulting expert is converted into a testifying expert, the scope of privilege often shrinks. When retaining a testifying expert, know your jurisdiction's rules on the discoverability of draft expert reports and related communications.