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Newsletter

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Sneak Preview of The 38th Annual Meeting and Seminar at the Hyatt Regency Chesapeake Bay Resort

By: Jim Morelewicz, Palm Coast, FL

Just about the time we celebrate the longest day of the year, we will be packing our bags for the annual Surety & Fidelity Claim Institute meeting at the Hyatt Regency Chesapeake Bay Resort in Cambridge Maryland. The annual meeting will be held June 26 -28, 2013.

This year's venue is about an hour and a half drive from the Baltimore Washington (BWI) Airport and an hour and three quarters from Reagan National Airport in Washington, DC. For most of our East Coast members, the Hyatt is less than a half day's drive away.

We are in the process of finalizing this year's education program and speakers. Here is what you can expect. Thursday morning's program will be focused on multiple phase construction projects and *(continued on pg. 3)*

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Comments From The Editor

It seems as though 2012 was, for me, the year of the retirement party. It started with Gregg O'Mahony retiring from The Guarantee Company of North America, followed by Jim Carpenter retiring from North American Specialty Insurance Company, Ron Goetsch retiring from Liberty Mutual Insurance Company, Ken Givens retiring from Arch Insurance Company and concluded with Stan McCormack retiring from Merchants Bonding. Too many already!

With four kids on the permanent education plan, my retirement is a long way off; and I am somewhat taken aback when longtime friends announce their retirement. With each of these retirements, I have thought that our industry will be the poorer for it; we are losing not only the great experience and judgment brought by these individuals to our industry, but as individuals, we are also losing the frequency of contact, making friendships formed over the course of many years more difficult to maintain due to distance and diminished opportunities to get together and catch up.

I regard each of these retirements as a personal loss, as well as a loss for the industry. I wish each of them well and a long, healthy and happy retirement. I also hope they will return to visit us all on occasion, as our friendships go beyond the professional. The reality is that for each of us, our business relationships are like a second family, which we would like to have remain intact forever.

I realize that, with each retirement, a new opportunity is presented for someone else to "step up to the plate," assume a leadership position in our industry, and make their own mark on the continuing development of professionalism, efficiency and fairness in the conduct of our business. Each of the folks whose retirement parties I attended in 2012 leave big shoes to fill, but each of them is being replaced by someone up to the task.

I look forward to working with their successors, and hope that they each recognize the importance to the industry of organizations like the Surety & Fidelity Claims Institute. The SFCI is important to each of their respective companies in creating both high quality CLE opportunities and networking opportunities, each of which save their respective companies a lot of money. With high quality CLE and CE, research by outside counsel need not be started from scratch, reducing billable hours paid by their respective companies. In addition, surety and fidelity claims professionals' ability to spot issues is increased, the ability to remain alert to developing trends in the law is facilitated, and the ability to recognize potential pitfalls is augmented. At least equally important, relationships between claims managers in different companies may be developed which will facilitate frank, fair and balanced inter-surety claims resolutions, as so many projects have multiple sureties involved. The result is cooperative relationships and more reasonable negotiations in situations involving multiple sureties, whether in a co-surety context, multiple prime contractor context, or involving bonds for general contractors and subcontractors, payment bonds versus discharge of lien bonds or otherwise. The development of relationships and trust and the ability to speak frankly, but in a collegial manner, inures to the benefit of each of the companies represented by our organization.

With each of this past year's retirements, an opportunity is presented for someone else to step into leadership positions in our industry. Our organizations need constant renewal at all seniority levels, and the Surety & Fidelity Claims Institute is no exception. I encourage each of you to think about who might be an appropriate candidate for membership in our organization and to encourage their attendance and participation in our activities.

And to my friends who have retired, enjoy your retirement, but please keep in touch. All the best.

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Sneak Preview of The 38th Annual Meeting and Seminar at the Hyatt Regency Chesapeake Bay Resort

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potential bond stacking. We will begin with a presentation covering the obligee's duty to disclose information that presents a risk to the surety. We have all encountered multiple contracts designed to accommodate a principal's limited bonding capacity. Speakers will also

address issues such as the agent's liability when incomplete or potentially misleading information is supplied by it, phased contract issues and their interplay with standard bond provisions. Speakers will review both claim handling and potential salvage options that are available to the surety in this scenario. Surety program speakers will include Jim Ferrucci of Wolff & Samson PC in West Orange, New Jersey; Dennis Bartlett of Brosseau Bartlett Seserman, LLC in Denver, Colorado; Scott Spearing of Hermes, Netburn, O'Connor & Spearing, P.C. in Boston, Massachusetts; and Pat Hustead of The Hustead Law Firm in Denver, Colorado.

The second part of Thursday's program will be a panel discussion among surety claims managers which will be moderated by Bruce Shreves of Simon Peragine Smith & Redfearn, LLP in New Orleans, Louisiana. The panel will be faced with fact scenarios likely to be encountered in a phased construction surety bond claim and will discuss options available to the surety.

When you attend this year's annual meeting, you will see some changes. One of them will be in the format of the education programs. Instead of beginning each day with the law update – surety on Thursday and fidelity on Friday - at this year's meeting we will open Friday morning's program with the fidelity update, followed by several fidelity topics. After the break on Friday, we will present the surety law update and conclude the program with an ethics topic.

As always, we anticipate that the education program will qualify for CLE and CE credits from the states in which all attendees are licensed.

In recent years, we have listened to the feedback from our members and have arranged for the meetings to take place at a different venue each year. Last year we held the meeting in Colorado Springs and this year we are back on the East Coast. The 2014 meeting will move farther south to The Grove Park Inn in Asheville, North Carolina followed by the 2015 meeting, which likely will be held out west, possibly in the Albuquerque or Santa Fe, New Mexico area. We are hoping that this will allow SFCI members in each of these regions to more easily and affordably attend the Annual Meetings close to their workplaces. We also hope to provide a variety of attractive locations so that all of us might consider planning a family vacation around our Annual Meeting.

So what kinds of activities and amenities can we expect this year in Cambridge, Maryland? The hotel is located on the Choptank River on the Eastern Shore of Maryland. The property is spread over 400 acres and is an ideal location for family activities and a variety of water sports. There is a spa and salon, golf, sailing, fishing and swimming. The hotel is located within reasonable travel distance of the Naval Academy and historic Annapolis as well as quaint towns such as St. Michael's and Oxford. Check out the hotel's website for further information: chesapeakebay.hyatt.com.
Keep an eye out for your registration package, which will be mailed to you in early March 2013. A schedule of events, details on the education program and other important information for the upcoming annual meeting will be in that package. Don't miss the opportunity to spend three days learning and socializing in a friendly, relaxed, collegial environment in one of the most beautiful regions of our country.

WHEN YOUR PRINCIPAL IS A FEDERAL CONTRACTOR: KNOW THE FEDERAL ACQUISITION REGULATIONS

By: Jennifer Fiore and John Dunlap, Dunlap Fiore, LLC, Baton Rouge, LA

When your Principal is a federal contractor, navigating the Federal Acquisition Regulations ("FAR") and determining potential impacts that federal law may have on the surety can be daunting. This article is will highlight the significant FAR requirements that every surety should know with respect to the business dealings of their principal. This article also deals with issues that may arise for the surety under the FAR when dealing with a troubled federal contractor.

I.
The Requirements Of The FAR That Every Surety Should Know

When the federal government is the obligee, the surety should be aware of the standards to which its principal will be held. In instances where a surety has taken over a federal project and selected a completion contractor, these standards, depending upon how the completion agreement is structured, may apply to the completion contractor as well. It is important that the surety understand these requirements and be knowledgeable about whether its principal is in compliance. There are many costly pitfalls for contractors and subsequently sureties who do not take the time to review and understand the provisions of the FAR. A contractor's failure to comply with the FAR can result in contract termination as well as debarment and potential civil and/or criminal liability. For the surety this can only spell bond liability.

The FAR is the principal set of rules in the Federal Acquisition Regulation System. This system is a series of regulations issued by federal agencies which govern the process through which the federal government purchases, or acquires, goods and services. That process consists of three phases: (1) need recognition and acquisition planning, (2) contract formation, and (3) contract administration.

The FAR is codified in Title 48 of the U.S. Code of Federal Regulations and although not statutory, the U.S. Court of Federal Claims held that the FAR has the force of law and is binding on the government.[1] The purpose of the FAR is to provide "uniform policies and procedures for acquisition". Among its guiding principles is to have an acquisition system that satisfies customer's needs in terms of cost, quality, and timeliness; minimize administrative operating costs; conduct business with integrity, fairness, and openness; and fulfill other public policy objectives.

Among others, the FAR includes policies and procedures related to contractor code of business ethics and conduct that apply to all Government contractors when the value of the contracts is in excess of $5 million and the performance period is 120 days or more. The provisions require Government contractors to conduct themselves with the highest degree of integrity and honesty. In addition, contractors should have a written code of business ethics and conduct, an employee business ethics and compliance training program, and an internal control system.

II.
Significant Requirements Of The FAR

A. Code of Business Ethics and Conduct (FAR 52.203-13(b)(1)(i))

Government contractors must now have a written code of business ethics published within 30 days after a Federal contract award, if the contract is $5 Million or more and lasts beyond 120 days.

Although the FAR does not detail the specific areas that should be covered, the contractor's written code of conduct should generally address ethical business practices and expected standards of ethical and moral behavior. This code of conduct should cover dealings with customers, suppliers, employees, and other parties. In evaluating the adequacy of the contractor's written code of conduct, consider whether the code provisions:

(a) address conflicts of interest, illegal or other improper payments, anticompetitive guidelines, and insider trading.

(b) cover compliance with Government contracting requirements for procurement integrity, classified information, and recruiting and employing current or former Government personnel.

(c) are periodically acknowledged by all employees.

(d) clearly establish what behavior is acceptable or unacceptable, and what to do if employees encounter improper behavior.

(e) cite consequences for violations.

[1] *Davies Precision Machining, Inc. v. U.S.*, 35 Fed. Cl. 651 (1995).

B. Training (FAR 52.203-13(c)(1))

The FAR also requires Federal contractors to institute a Business Ethics Awareness and Compliance Program shortly after they are awarded a Federal contract. This program is required to include training programs relating to the contractor's standards and internal control system. The contractor is required to train its principals and employees, and as appropriate, its agents and subcontractors.

Contractors should make sure that their ethics awareness and compliance training materials cover their code of business ethics and conduct. The program should include periodically communication of the contractor's standards and procedures by providing effective training and otherwise disseminating information appropriate to an individual's respective roles and responsibilities.

C. Periodic Reviews (FAR 52.203-13(c)(2)(ii)(C))

Contractors should establish and maintain an effective system of internal controls and self-governance and should not condone inappropriate practices. Management must continually communicate the importance of a strong internal control system. The contractor's business ethics awareness and compliance program should have policies and procedures to facilitate timely discovery of improper conduct and ensure corrective measures are promptly instituted and carried out for any cases of improper conduct disclosed.

The FAR contains specific requirements for contractors to perform periodic reviews of company business practices, procedures, policies and internal controls, including:

(a) Monitoring and auditing to detect criminal conduct;

(b) Periodic evaluation of the effectiveness of the business ethics awareness and compliance program and internal control system (especially if criminal conduct has been detected); and

(c) Periodic assessment of the risk of criminal conduct, with appropriate steps to design, implement, or modify the business ethics awareness and compliance program and the internal control system as necessary to reduce the risk of criminal conduct identified through this process.

D. Internal Reporting Mechanism (FAR 52.203-13(c)(2)(ii)(D))

The FAR requires the contractor's internal control system to provide for an internal reporting mechanism, such as a hotline, which allows for anonymity or confidentiality, by which employees may report suspected instances of improper conduct, and instructions for employees to make such reports.

E. Display of Hotline Posters (FAR 52.203-14)

Requires, for contracts performed in the United States, display of:

(a) Department of Homeland Security fraud hotline poster(s) identified by the contracting officer in the contract clause at FAR 52.203-14;

(b) Agency hotline poster (unless the contractor has implemented a business ethics and conduct awareness program, including a reporting mechanism); and

(c) The hotline poster(s) on the company website for employees (if a website is maintained).

F, Disciplinary Action (FAR 52.203-13(c)(2)(ii)(E))

The contractor's internal control system must provide for disciplinary action for improper conduct or for failing to take reasonable steps to prevent or detect improper conduct.

G. Disclosure of Improper Conduct (FAR 52.203-13(c)(2)(ii)(F))

The FAR provides detailed requirements for making timely disclosure of improper conduct. This provision requires contractors to disclose, in writing, to the client-agency Office of the Inspector General, with a copy to the contracting officer, whenever the contractor has credible evidence that a principal, employee, agent, or subcontractor has violated Federal

criminal law involving fraud, conflict of interest, bribery, or violations with the gratuities regulations or the False Claims Act.

Contractors should insure that their policies and procedures include a reasonable definition of credible evidence, and a reasonable timeframe for disclosure once credible evidence is obtained. Credible evidence implies a somewhat higher standard than "reasonable grounds to believe". Contractors are allowed to take time for preliminary examination of the evidence to determine its credibility prior to disclosure. Until a determination is made that evidence is credible, then there is no "knowing failure to timely disclose."[2]

However, once the contractor has had sufficient time to take reasonable steps to determine that the evidence is credible, the contractor should disclose the violation in a timely manner. The FAR does not, however, define "timely", nor does it prescribe a specified time period.

When reviewing a disclosure and determining the disposition thereof, the Government takes into consideration, the promptness and timeliness of the disclosure, the contractor's full cooperation, the contractor's allowance to the government of complete access to necessary records (inclusive of internal investigation report), the contractor's restitution and the institution of adequate corrective actions.

The FAR defines full cooperation as "…disclosure to the Government of the information sufficient for law enforcement to identify the nature and extent of the offense and the individuals responsible for the conduct. It includes providing timely and complete responses to Government auditors' and investigators' request for documents and access to employees with information."

However, cooperation as defined in 52.20313(a)(2) does not foreclose rights arising in law, the FAR or contract and does not require waiver of attorney-client privilege, work product doctrine or Fifth Amendment rights.

A contractor's failure to comply with the ethics requirements of the FAR can subject the contractor to termination, suspension or even debarment. The surety, as part of its own underwriting processes for Federal contracts, should requests copies of its principal's Code of Conduct and Business Ethics and periodically discuss with its principal, its compliance with the FAR.

If a contractor is in violation of the disclosure requirements mandated by the FAR, bigger issues are implicated. Consequently, liability for the Surety can increase. The next section of this article will examine potential liability for the contractor and surety when violations of the FAR occur.

III.
Liability Under The Civil False Claims Act

If a Contractor obtains creditable evidence of a violation of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity, any violation of Civil False Claims Act, or any "Significant Overpayment", the FAR requires the contractor to disclose such to the Office of Inspector General with a copy provided to the contracting officer.[3]

A violation of the Civil False Claims Act, 31 U.S.C. § 3729 *et seq*. ("FCA") can have serious consequences for not only the contractor but the surety as well. The FCA provides generally that any person who "knowingly" presents, or causes to be presented, to the Government a false or fraudulent claim for payment or approval will be liable to the United States Government for certain civil penalties. Once a contractor obtains creditable evidence of any violation of the FCA, the contractor shall make timely disclosures of such in writing to the Office of Inspector General with a copy provided to the contracting officer.[4] Such disclosure requirement extends for three years after final payment and the disclosures are made with no advance agreement regarding potential civil or criminal actions by the Department of Justice.

When prosecuting a false claim action, the government must prove, by a preponderance of the evidence, that (1) the contractor presented to the United States a claim for payment; (2) the claim was false or fraudulent; (3) the contractor knew the claim was false or fraudulent; and (4)

[2] 73 Fed. Reg. 67073 (2008).

[3] 48 C.F.R. 52.203-13

[4] *Id*.

the United States suffered damages as a result of the false or fraudulent claim.[5]

A "claim" is defined to include "any request or demand …. for money or property" from the Government.[6] The term "false or fraudulent claim" has been construed broadly and is intended to reach all types of fraud without qualification, that might result in financial loss to the Government; and the act reaches beyond claims which might be legally enforced to all fraudulent attempts to cause the Government to pay out sums of money.[7] A person is deemed to have "knowingly" presented a false claim within the meaning of the FCA when the individual has actual knowledge that the claim is false, or acted in "deliberate ignorance" or "reckless disregard" of the truth or falsity of the claim.[8] The Government is not required to prove specific intent to defraud.

In order to avoid a reckless disregard allegation a contractor should, at a minimum, examine records to ensure they are consistent with the claim submitted. Case law has indicated that the failure to make at least a minimal examination of records constitutes deliberate ignorance or reckless disregard.[9]

The falsity of a claim is determined at the time of submission. If a contractor has submitted a claim (i.e., a payment application) to the Government and the contractor knows that he or she is not actually entitled to the funds or property in question, the contractor has asserted a false claim. Fortuities in the government's subsequent decision-making process have no effect on the objective truth or falsity of the claimant's asserted entitlement, and should have no effect on the claimant's potential liability under the Act.[10]

In addition to actions related to false claims, FCA suits may be brought under theories of liability, including "false certification." A false certification can create liability when the compliance certification is a prerequisite to obtaining a government benefit. Recently, the United States Court of Appeals for the Sixth Circuit reaffirmed a broad reading of the False Claims Act in *United States ex rel. Brian Wall v. Circle C Construction, LLC*.[11] In its opinion, the Sixth Circuit held that qui tam relators (whistleblowers) bringing a civil action under the FCA may base their claim upon violations of the Davis-Bacon Act, which requires a contractor to certify that each laborer or mechanic has been paid not less than the applicable wage rates.

While not all breaches of contract or regulatory violations automatically give rise to liability under the FCA, "the false certification of compliance ... creates liability when certification is a prerequisite to obtaining a government benefit."[12] When the government has conditioned payment of a claim upon a claimant's certification of compliance with a provision of a contract entered into pursuant to a regulation, a claimant submits a false claim as a matter of law when he or she falsely certifies compliance with that provision.[13]

A contractor can be in violation of the FCA by making false certifications due to financial pressure. This can occur when the contractor certifies on its payment application that all subcontractors and material suppliers listed on the schedule of values on the last application for payment have been paid when, in fact, they have not. For example, if the contractor invoices the government every 30 days and "floats" the subcontractors for 60 days, it has violated the Civil False Claims Act.

Claims can be impliedly false or fraudulent under the FCA where they "represent[] compliance with a material condition of payment that was in fact not met," even if the precondition of payment is not expressly stated in a statute or regulation. Moreover, non-submitting third parties may be liable if they knowingly cause submitting

[5] *United States v. Basin Elec. Power Coop.*, 248 F.3d 781, 803 (8th Cir. 2001).
[6] 31 U.S.C. § 3729(c)
[7] *United States v. Neifert-White Co.*, 390 U.S. 228, 232-233 (1968).
[8] 31 U.S.C. § 3729(b)
[9] *United States v. TDC Mgmt. Corp.*, 24 F.3d 292, 298 (D.C. Cir. 1994).
[10] *United States v. Krizek*, 111 F.3d 934, 939-40 (D.C. Cir. 1997).
[11] 697 F.3d 345 (6th Cir. 2012).
[12] *United States ex rel. Hopper v. Anton,* 91 F.3d 1261, 1266 (9th Cir.1996).
[13] *United States ex rel. Thompson v. Columbia/HCA Healthcare Corp.*, 125 F.3d 899, 902 (5th Cir.1997).

entities to present a materially false or fraudulent claim through their submissions.[14]

Further, claims can be fraudulent even without an express certification of compliance, so long as compliance with the particular statute or regulation is a condition of government payment.[15]

A violation of the FCA can result in termination, suspension or debarment of the contractor as well as statutory penalties.[16] These penalties include fines of not less than $5,500 and not more than $11,000, plus three (3) times the amount of damages sustained by the government.[17] A person violating the FCA is also liable to the Government for the costs of a civil action brought to recover any such penalty or damages.[18] Damages for false claims act violations can be reduced to two times the amount of damages which the Government sustains if:

(a) The person responsible for committing the violation furnishes the Government with all information known about the violation within thirty days after the date on which the information was first obtained;

(b) Such person fully cooperates with any Government investigation of such violation; and

(c) At the time such person furnished the government with the information about the violation, no criminal prosecution, civil action, or administrative action had commenced, and the person did not have actual knowledge of the existence of an investigation into such violation.[19]

IV.
Potential Liability For The Surety

When the surety takes over a project, it must be careful not to create liability for itself by unknowingly violating the FCA. For instance, when claims are assigned to the surety as part of a takeover, the surety will then submit the principal's claims to the Government in an effort to offset losses. The surety can find itself submitting applications for payment in connection with the work performed by the principal who maintains that it is entitled to payment but who improperly certified the application.

A surety which submits its principal's claim or makes a certification to the government, has a duty to review the claims and certifications independently and verify the information to be submitted to the Government. Further, the surety has an obligation to disclose errors with prior claims or certifications if they are discovered during the surety's review. Failure to do so could subject the surety to exposure based upon the principal's prior bad act. In instances where claims have been assigned under subrogation rights, it can be difficult for the surety to conduct an independent examination due to lack of documentation, access to evidence and witnesses. Diligence is key.

V.
Conclusion

When your Principal is a federal contractor, understanding the provisions of the FAR that can impact a surety's liability is critical. The consequences for contractors who fail to comply with the FAR ultimately create liability for the surety. Awareness of the standards to which its principal will be held and verifying that its principal is in compliance are safeguards that the surety should implement.

[14] *United State ex rel. Hutcheson v. Blackstone Medical, Inc.* 647 F.3d 377, 387 (1st Cir. 2011).
[15] *United States ex rel. Wilkins v. United Health Group,* 659 F.3d 295 (3rd Cir. 2011).
[16] FAR 9.406.
[17] 31 U.S.C. § 3729(a)(1)
[18] 31 U.S.C. § 3729(a)(3)
[19] 31 U.S.C. § 3729(a)(2)

DON'T GET STRIPPED: THE SUBDIVISION BOND SURETY, THE SUCCESSOR OWNER, AND OBLIGATIONS THAT RUN WITH THE LAND

By: Michael J. Dudek and T. Scott Leo, Leo & Weber, P.C., Chicago, IL

I. Introduction

As a result of the housing crisis and resulting subdivision developer defaults and bankruptcies, many local municipal or county authorities are confronted with large tracts of land left mostly undeveloped by the once ambitious and now insolvent developers. Generally, a developer is required under local ordinance or statute to obtain a surety bond (referred to as a "subdivision bond") guaranteeing the completion of public improvements which include items such as streets, sewers, lighting, drains, grading, pavement, gutters, curbs, shade trees, water mains and utilities. Often, a third-party successor will obtain the land following the original debtor's insolvency either through a foreclosure sale or through the developer's bankruptcy. The successor, maybe a savvy subdivision developer who survived the housing crisis or an investment group, may see an opportunity in obtaining an undeveloped subdivision previously owned by an insolvent developer at a discount through either a foreclosure sale or through the original owner's bankruptcy case. The successor, with or without the cooperation of the municipality, will often look to the original developer's surety to install the public improvements on the surety's dime. As explained below, public improvements covered by a subdivision bond are interests that run with the land that cannot be avoided by the successor even though the property was sold "free and clear" of all liens and interests through the foreclosure or bankruptcy. Instead, the successor is obligated to perform the bonded obligations as they are *in rem* and run with the land and cannot be stripped via foreclosure or bankruptcy.

II. Background

A. Subdivision Bonds[1]

Generally, when a subdivision developer seeks to develop an unimproved tract of land, the developer will enter into a subdivision or annexation agreement with the municipality.[2] Local statute or ordinance typically governs the scheme, control and design under which the subdivision shall be developed.[3] The municipality's power to regulate land use, through subdivision agreements, plats, and other land use regulations, is delegated by the state legislature.[4] Accordingly, the subdivision agreement and the obligations regarding construction of public improvements it provides are legislative acts enacted under the

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[1] For a comprehensive analysis of subdivision bonds and different issues raised by subdivision bonds, see Susan M. Moore, et al., *Law of Developers or Subdivision Bonds*, *in* THE LAW OF COMMERCIAL SURETY AND MISCELLANEOUS BONDS 33 (Bruce C. King, et al. eds., 2d ed. 2012).

[2] *Id.* at 36.

[3] *Id.* at 35-36; *see also Assoc. Home Builders, Inc. v. City of Walnut Creek*, 484 P.2d 606, 609 (Cal. 1971) (discussing local ordinance requiring dedication of open space for recreational use); *City of Urbana v. Cnty. of Champaign*, 389 N.E.2d 1185, 1186 (Ill. 1979) (recognizing under Illinois statute that local municipalities empowered to regulate subdivision planning); *Vill. of Orland Park v. First Fed. Sav. & Loan Ass'n of Chi.*, 481 N.E.2d 946, 950 (Ill. App. Ct. 1985) (discussing legislative purpose and policy of ordinances regulating preannexation agreements).

[4] *See, e.g.,* 65 ILL. COMP. STAT. 5/11-12-5(1) (eff. Jul. 24, 2003); *see also Petterson v. City of Naperville*, 137 N.E.2d 371, 379 (Ill. 1956) ("The privilege of the individual to use his property as he pleases is subject always to a legitimate exercise of police power under which new burdens may be imposed upon property and new restrictions placed upon its use when the public welfare demands.").

municipality's police power because they incorporate local ordinances.[5]

The municipality's consideration for entering into the subdivision agreement is primarily the developer's promise to complete the public improvements.[6] The subdivision agreement sets forth the specific requirements for the public improvements and the time periods under which the developer is to complete them.[7] The municipality generally approves the subdivision agreement under its legislative function utilizing its police powers delegated by statute.[8]

The municipality usually requires the developer to post security guaranteeing the installation of the public improvements.[9] To meet this requirement, the developer obtains a subdivision bond requiring that the surety complete the public improvements in the event the developer defaults.[10] Subdivision bonds are creatures of statute because they directly or indirectly incorporate by reference the municipality's ordinances and statutes governing the development of the subdivision.

B. The successor owners argue that they have no obligation to install public improvements that are covered by the prior owner's bond

Some municipalities are looking to the subdivision bond as a means to complete the public improvements even though the property is now owned by a bank or subsequent developer. The bank or subsequent titleholder may assert that the foreclosure sale or bankruptcy proceeding stripped any obligation on its part to complete the public improvements. This leaves the municipality seeking completion of public improvements from the surety.

In some instances, the municipality will enter into a "sweetheart deal" with the subsequent titleholder. In a sweetheart deal, the municipality agrees with the subsequent titleholder that it will make a demand against the subdivision bonds for completion and reimburse the new titleholder for the costs incurred by it in installing the public improvements if successful.[11] Some courts are inclined to side with the municipality when such deals are challenged by the surety even though it results in the successor obtaining completion of the public improvements without cost and at the surety's expense.[12]

An example of a sweetheart deal is found in *City of Merced v. Am. Motorists Ins. Co.*[13] In *City of Merced*, a developer entered into a subdivision agreement with the city to participate in the development of a large subdivision with various developers.[14] The subdivision agreement obligated the developer to construct future additional public

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[5] *See, e.g., Vill. of Orland Park*, 481 N.E.2d at 950-51 (holding subsequent purchaser of development property through foreclosure sale bound to annexation agreement between municipality and prior owner); *Metro. Gov't of Nashville and Davidson Cnty. v. Barry Constr. Co.*, 240 S.W.3d 840, 851 (Tenn. Ct. App. 2007) (listing cases and holding that development plan is binding upon subsequent developers and owners of property); *see also Gen. Ins. Co. of Am. v. City of Colo. Springs*, 638 P.2d 752, 757-58 (Col. 1981) ("The reason for requiring the subdivider to install street improvements is directly related to the public health, safety and welfare. Such a requirement assures suitable access routes, advances the objectives of the community plan, and protects the municipality and taxpayers from the burden of constructing additional streets to accommodate new developments.") (*citing* 4 R. ANDERSON, AMERICAN LAW OF ZONING § 23.32 at 129 (1977)).

[6] Moore, et al., *supra* note 1, at 41.

[7] *Id.* at 36-37.

[8] *See, e.g., Petterson*, 137 N.E.2d at 380 (holding that subdivision developer may properly be required, as a condition for approval of a subdivision plat, to install curb, gutter, and drainage facilities").

[9] Moore, et al., *supra* note 1, at 37.

[10] *Id.*

[11] *See* David C. Veis & David L. Lynch, *Watching Out for Sweetheard Deals*, THE BRIEF 54 (Summer 2009) (defining sweetheart deal as "[a] sweetheart deal is an agreement between a third-party subsequent developer and the public agency whereby the third-party subsequent developer agrees to complete the public improvements and the public agency agrees to pursue a claim against the surety for the benefit of the third-party subsequent developer to recover the full cost of the public improvements").

[12] *See, e.g., City of Merced v. Am. Motorist Ins. Co.*, 24 Cal. Rptr. 3d 788 (Cal. Ct. App. 2005); *City of Sacramento v. Trans Pac. Indus.*, 159 Cal. Rptr. 514 (Cal. Ct. App. 1979).

[13] 24 Cal. Rptr. 3d 788.

[14] *Id.* at 789.

improvements called "deferred work."[15] The developer obtained performance bonds guaranteeing performance of its *pro rata* share of the deferred work on each part.[16] Before completing the deferred work for the second part of the project, the developer became insolvent and was unable to finish its remaining deferred work.[17] The remaining undeveloped property was sold to a successor developer through a foreclosure sale.[18] Prior to the foreclosure sale, the city informed the successor that it would be responsible for the remaining deferred work.[19] The city and the successor then entered into an agreement whereby the city would pursue recovery from the initial developer's bonds for the remaining work and reimburse the successor out of the proceeds if it agreed to complete the remaining work.[20] The city then authorized the successor's attorney to file suit against the bonds on its behalf.[21] The successor stated that it would not have purchased the property if not for the agreement with the city.[22] The court ruled for the city, disagreeing with the surety that the city suffered no damages because the successor agreed to complete the work and holding that there was no illegal assignment of the city's bond claim.[23]

What the *City of Merced* decision failed to consider was whether the public improvements at issue were obligations that ran with the land.[24] Because the deferred work in *City of Merced* should have constituted *in rem* property interests that run with the land, the deferred work should have been the successor's obligation. A more thorough analysis of an owner's obligations under municipal law and a consideration of what are the obligations that run with the land are found in the decisions discussed below holding that the subsequent developer must bear the burdens of developing properties as required by local ordinances.

III.
Subdivision Public Improvements Are Property Interests That Run With The Land and Cannot Be Stripped In Foreclosure or Bankruptcy Proceedings

A. Successors of property through a foreclosure sale of a subdivision development should be obligated to complete remaining public improvements

State foreclosure laws provide a means for a purchaser to obtain real property extinguished of foreclosed liens and interests of the previous owner's creditors whose interests attach, if at all, to the proceeds of the foreclosure sale. In the case of an insolvent subdivision developer, it is usually either the developer's bank which obtains the property by bidding the amount of the developer's indebtedness or another party wishing to develop the land which successfully bids on the property at a foreclosure sale.[25]

A recent case finding that completion of bonded subdivision agreements falls upon the successor developer who purchased the property through a foreclosure sale is *Fox Gate LLC v. Town of Millbury*.[26] In *Fox Gate*, a successor subdivision developer obtained unimproved land platted for subdivision development through a foreclosure sale.[27] The successor sought to have the town assert a claim against the subdivision bond issued on behalf of the former owner.[28] Interestingly, the surety disclaimed liability under the bond, claiming that "when [the bank] became owner of the subject property … it also became responsible for any obligations in

[15] *Id.* at 790.
[16] *Id.*
[17] *Id.*
[18] *Id.*
[19] *Id.* at 790-91.
[20] *Id.* at 791.
[21] *Id.*
[22] *Id.*
[23] *Id.* at 797-98.
[24] The surety attempted to argue that the original developer's obligation was relieved because the successor became obligated to the original subdivision agreement. *Id.* at 796. However, the surety did not provide any authority for this argument and the court declined to consider the issue. *Id.*

[25] A secured lender's bidding the debt it is owed to offset the purchase price at a foreclosure or bankruptcy auction is often referred to as "credit bidding." *See RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065, 2069 (2012).
[26] *Fox Gate LLC v. Town of Millbury*, No. 09 MISC 395474, 09 MISC 402987, 2011 WL 6016246 (Mass. Land Ct. Dec. 1, 2011).
[27] *Id.* at *3.
[28] *Id.* at **3-4.

connection with the property, including the improvements covered by the subject bond . . . . *The subject [b]ond is non-assignable and does not cover the obligations of the new parties* . . . . The posting of new bonds by the new developer will ensure that the entity benefitting from the improvements will bear the cost thereof . . . ."[29] The town apparently agreed with the surety and refused to proceed further against the bond.[30] The court sided with the town in the successor's action to compel the town to pursue the bond. The court noted:

> The responsibility to complete the mandated improvements, including municipal services, while initially vested in [original developer], passed seriatum through its successors to [original developer] where it vests presently in [successor]. This court rejects the notion that while the plaintiff acquired the Subdivision together with the rights to develop same, it managed to shed the concomitant obligation to complete the Subdivision improvements.[31]

The court held that the town could not be mandated to pursue the bond.[32] The *Fox Gate* court required that the successor who obtains a subdivision development through foreclosure to bear the responsibility for completion of public improvements.

B. Bankruptcy law does not permit successors to escape completion of public improvements

Federal bankruptcy law provides a similar means of transferring property "free and clear" of all interests and liens in the property. Debtor-developers and successors may try to use the United States Bankruptcy Code to change their obligations under subdivision agreement relying upon 11 U.S.C. § 363(f). Section 363(f) of the Bankruptcy Code allows the debtor (or trustee) to sell property of the bankruptcy estate "free and clear" of any interests. Specifically, Section 363(f) provides:

> The trustee [or debtor-in-possession under 11 U.S.C. § 1107(a)] may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate only if –
> (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
> (2) such entity consents;
> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
> (4) such interest is in bona fide dispute; or
> (5) such entity could be compelled, in a legal or equitable proceeding, to accept money satisfaction of such interest.[33]

Section 363(f) is disjunctive, meaning that a sale is free and clear of the interest concerned so long as any condition set forth in Section 363(f)(1)-(5) is met.[34]

Relying upon Section 363(f), a successor may assert that the property that it obtained through a Section 363 sale stripped the property of any obligations to install public improvements. The logical inference from this argument is that the obligation to install the public improvements remains with the original developer and should thus be borne by the surety because the original developer is unable to complete them. The subdivision agreement, however, is not an ordinary contract. It is a

[29] *Id.* at *3 (emphasis in original).
[30] *Id.*
[31] *Id.* at *5; *cf. Town of Carolina Shores v. Cont'l Ins. Co.*, No. 7:10-CV-13-D, 2010 WL 4338437, at *4 (E.D.N.C. Oct. 26, 2010) (rejecting surety's argument that bank purchaser of subdivision property in foreclosure was successor principal under the subdivision bond).
[32] *Fox Gate*, 2011 WL 6016246 at *9.
[33] 11 U.S.C. § 363(f) (2012).
[34] *In re Dundee Equity Corp.*, No. 89-B-10233, 1992 WL 53743, at *4 (Bankr. S.D.N.Y. Mar. 6, 1992).

creature of ordinance that incorporates the subdivision plat. Recorded plats and annexation agreements are legislative acts of a public body in the exercise of police powers and cannot be altered by any application of the Bankruptcy Code. When a trustee or debtor sells the property "as is," the obligations to improve the property as required by ordinance are transferred with the property. Obligations that run with the land cannot be stripped away in a Section 363 sale.[35]

In *In re Oyster Bay Cove, Ltd.*, a purchaser bought real property sold "as is" composed of twelve individual lots from the Chapter 7 bankruptcy trustee.[36] The property was subject to easements for dedication of a road and storm basin to the local municipality.[37] The purchaser sought to back out of the sale and argued that the dedication destroyed marketability of title.[38] The purchaser argued that the sale of the property "as is" subject to the dedication was at odds with Section 363(f) of the Bankruptcy Code which provides for the sale of property free and clear of interests.[39] Disagreeing with the purchaser and affirming the bankruptcy court's holding against the purchaser, the court explained as follows:

> As the Bankruptcy Court correctly points out, a sale "free and clear of liens and other interests" has no impact on restrictions of record that run with the land. "Free and clear" should be interpreted as speaking of interests *against the property,* such as liens or mortgages, which now attach to the proceeds of the sale. … Therefore, the order to sell "free and clear" has no affect [sic] on the dedication of the road and the storm drain, which are easements that run *with* the land. Clearly, 11 U.S.C. § 363(f) and Bankruptcy Rule 6004, which refer to the sale of land "free and clear" from these "interests," are not intended to sever easements and other nonmonetary property interests that are created by substantive State law. Indeed, absent the consent of the owner of the easement or the easement being in bona fide dispute, the Bankruptcy Code does not even allow the Bankruptcy Court to authorize a sale of the property "free and clear" of an easement. Therefore, the terms "as is" and "subject to … any covenants, restrictions and easements of record" do not contradict the order and hence are valid.[40]

The *Oyster Bay* Court noted the "five instances" listed under Section 363(f) where a party may sell a property free of some interest that runs with land.[41] Of those instances, the court held that three would "never, by law, apply" and property subject to an easement could only be transferred through consent or if it were subject to dispute.[42]

Similarly, in *Gouveia v. Tazbir*, the Seventh Circuit Court of Appeals, found that the property sold under Section 363(f) could not be sold free of a restrictive covenant that ran with

[35] *See, e.g., Gouveia v. Tazbir*, 37 F.3d 295 (7th Cir. 1994); *In re Oyster Bay Cove, Ltd.*, 196 B.R. 251 (E.D.N.Y. 1996); *Skyline Woods Homeowners Ass'n v. Broekemeier*, 758 N.W.2d 376 (Neb. 2008); *In re Southcreek Dev.*, No. 10-90327, 2011 WL 44703 (Bankr. C.D. Ill. Jan. 6, 2011). Moreover, the filing of a bankruptcy petition does not affect local laws impacting ownership of the property. *See, e.g.,* 28 U.S.C. § 959(b) (requiring trustee to manage or operate property in accordance with state law); *In re Nease*, 391 B.R. 470 (Bankr. M.D. Fla. 2008) (holding that municipal fines imposed upon debtor postpetition for failure to maintain property did not violate the automatic stay under 11 U.S.C. § 362); *In re Phillips*, 368 B.R. 733 (Bankr. N.D. Ind. 2007) (same); *In re Lauriat's Inc*., 219 B.R. 648 (Bankr. D. Mass. 1998) ("[a] debtor in possession *shall* manage the property of the estate in accordance with state law; there is no exception for convenience or monetary gain.") (emphasis in original).

[36] *Oyster Bay*, 196 B.R. at 253.

[37] *Id.*

[38] *Id.*

[39] *Id.* at 255.

[40] *Id.* at 255-56 (emphasis in original).

[41] *See id.* at 256 nn. 7 & 9.

[42] *Id.* at 256 n. 9.

the land and that the holder of the *in rem* interest could not be compelled to accept money damages in under Section 363(f)(5) in lieu of enforcement of the covenant.[43] The Seventh Circuit also held that the restrictive covenant at issue could not be rejected as an executory contract under Section 365 because it was an interest in real property that ran with the land.[44] The Seventh Circuit specifically held that "[a]s such, § 365 of the bankruptcy code is inapplicable."[45]

A recent case involving the bankruptcy of a developer interpreted how Section 363(f) applied to the sale of development land subject to an annexation agreement. In *In re Southcreek Development, LLC*, a municipality moved under Section 363(e) to protect its interest in the amended annexation agreement it entered into prepetition with the debtor, a bankrupt developer.[46] The debtor's secured lender objected and the bankruptcy court held that the bankruptcy trustee could sell the property free and clear of the municipality's interest because it was subject to a bona fide dispute under Section 363(f)(4).[47] On appeal, the district court reversed, finding that Section 363(f)(4) did not apply because the statute of limitations in a state statute governing challenges to an annexation plan barred dispute of the annexation agreement.[48] On remand, the court examined each remaining subsection of Section 363(f) and held that any sale order cannot strip the obligations imposed by a municipal annexation agreement.[49]

[43] 37 F.3d 295, 299 (7th Cir. 1994); *see also In re 523 E. Fifth St. Hous. Pres. Dev. Fund Corp.* 79 B.R. 568 (Bankr. S.D.N.Y. 1987) (holding that a municipality could not be compelled to accept money satisfaction under § 363(f)(5) to satisfy restrictive covenant regarding low income housing requirement in deed to debtor).
[44] *Gouveia*, 37 F.3d at 299.
[45] *Id.*
[46] No. 10-90327, 2011 WL 44703, at *1 (Bankr. C.D. Ill. Jan. 6, 2011). Section 363(e) allows any party with an interest in property to be sold or proposed to be sold to request that the court "prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest." 11 U.S.C. § 363(e).
[47] *Southcreek*, 2011 WL 44703, at *1.
[48] *Id.*
[49] *Id.* at *3.

The cases discussed above firmly establish that obligations that run with the land, such as public improvements established under the municipality's police powers, cannot be stripped or avoided in foreclosure and bankruptcy.[50] Because the obligations survive the foreclosure process or the developer's bankruptcy, they belong to the successor.

IV.
Steps The Surety Can Take To Avoid Liability

A. It is essential that the surety monitor its developer-principal's bankruptcy case

An example of why it is important for the subdivision bond surety to monitor its principal's bankruptcy case is *Travelers Casualty and Surety Company of America v. Morgan Acquisitions, LLC*.[51] In *Travelers*, the developer entered into an agreement with a township to construct a condominium development.[52] The agreement contained an obligation to install screening improvements bordering the development.[53] In its bankruptcy case, the developer sought to sell the development property free and clear of all liens, claims, encumbrances, and interests under Section 363(f).[54] The developer failed to complete installation of the screening improvements before its bankruptcy.[55] The developer's surety did not raise an objection to the sale.[56] On the date of the sale, the township demanded that the surety install the screening.[57] The surety installed the screening in exchange for an assignment of the township's claims against the successor.[58] The surety, as subrogee

[50] *See In re Union Golf of Florida, Inc.*, 242 B.R. 51 (Bankr. M.D. Fla. 1998) (recognizing "an overriding congressional intent that the Bankruptcy Court not interfere with the valid exercise of a state's police power").
[51] No. 10-10965, 2010 WL 2474631 (E.D. Mich. June 14, 2010).
[52] *Id.* at *1.
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.* at *2.
[57] *Id.*
[58] *Id.* at **2-3.

and assignee of the township, filed suit against the successor for reimbursement.[59] In ruling for the successor, the court held that surety's "sole opportunity to pursue its claims was during the bankruptcy proceeding."[60] The case was dismissed as barred as an impermissible collateral attack on the sale order and barred by *res judicata*.[61] An important consideration for the court was that the surety appeared in the bankruptcy case, had notice of the sale motion, and did not object.[62]

Although the surety believed that the successor would be ultimately responsible for the screening, *Travelers* demonstrates why it is important for the surety to monitor the bankruptcy case and seek to preserve its rights if necessary.[63] In *Travelers*, neither the township nor the surety objected to the Section 363 sale. In the court's view, this was the critical time to assert the issue. Therefore, since neither the township nor the surety objected, the surety was precluded from raising any of the township's rights in the later proceeding.[64] Accordingly, with no objection, the property was sold stripped of the screening improvement obligations. The surety or the township should have raised a conditional objection to the sale in the bankruptcy proceeding to preserve the issue. It did not matter to the court that the screening obligations likely run with the land and should not have been stripped off in the bankruptcy sale.

B. Communicate

It is important to communicate with all concerned parties where possible. *Fox Gate* suggests that early communication between the surety and the municipality regarding the public improvement obligations may provide the surety with a powerful ally in rightfully placing the obligations with the successor.[65] Communication early with the foreclosing lender, debtor, and bankruptcy trustee is also important so that each party fully understand that the obligations run with the land so that the sale requires that the buyer provide its own security. Discussion with a debtor-in-possession could be particularly useful in the situation where the debtor's principal officer, shareholder, or member is party to an indemnity agreement with the surety and may wish to avoid personal liability in the future. This could be powerful leverage in obtaining cooperation with a debtor-in-possession.

V.
Conclusion

There are some simple steps to take and issues the subdivision bond surety should remember in order to enhance the prospects that the successor owner will bear or share the costs of installing subdivision improvements:

1. Remember that a sale "as is" whether conducted in a foreclosure sale or through a bankruptcy proceeding does not

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[59] *Id.* at *3.

[60] *Id.* at *9; *contra Union Golf*, 242 B.R. at 58 ("In fact, even if an action to enforce a governmental unit's police power is commenced against a debtor in another forum, the debtor is prohibited from removing the action to the bankruptcy court.") (citing 28 U.S.C. § 1452(a)).

[61] *Travelers*, 2010 WL 2474631 at **6-9; *but see Skyline Woods Homeowners Ass'n v. Broekemeier*, 758 N.W.2d 376, 393 (Neb. 2008) (holding that suit brought to enforce restrictive covenant was not a collateral attack on the bankruptcy sale order selling the subject property free and clear of interests under Section 363); *Union Golf*, 242 B.R. at 59-60 (holding that municipality was not a "creditor" or other party bound by plan that sought to strip zoning regulation requiring debtor's golf course to be run as a private course only even though the municipality received notice of plan and failing to object to plan confirmation).

[62] *Travelers*, 2010 WL 2474631, at *7.

[63] *See id.* at *2 n. 2 (quoting the surety, that the surety believed that "any eventual purchaser would be obligated to complete the, as yet, uncompleted governmentally mandated work").

[64] An objection might be required to preserve a surety's claim against a successor purchaser when the subdivision bond claim arose before the sale of the property. For an interesting discussion of the liability of successor developers, see Marilyn Klinger & Kenneth C. Ryken, *Successor Developers: Untapped Opportunities for Subdivision Bond Sureties*, 62 DEF. COUNS. J. 577 (Oct. 1995).

[65] *See Fox Gate LLC v. Town of Millbury*, No. 09 MISC 395474, 09 MISC 402987, 2011 WL 6016246, at *3 (Mass. Land Ct. Dec. 1, 2011) (discussing correspondence between municipality and subdivision bond surety regarding surety's responsibility for bonded improvements).

strip the obligation of the successor to comply with municipal ordinances that include the plans and subdivision agreements for the development of the property.

2. The surety might be able to recover from the successor for improvements that unjustly enrich the successor by enhancing the value of the property.

3. The subdivision agreement itself often requires that the successor replace the bonds and sometimes provides for the release or discharge of the prior owner (the principal).

4. Follow any proceeding involving the principal and the disposition of property closely, and raise all of the issues discussed above as soon as possible (communicate with the municipality that the successor is responsible for installation of the public improvements, raise an objection in any § 363 or at a foreclosure sale proceeding).

Surety Casenotes

By: Kenneth W. Rockenbach, Ed., Liberty Mutual Surety, Richardson, TX

Kansas Court Reads Reasonable Investigation Requirement into Indemnity Agreement

Westfield Ins. Co. v. Harvest Constr. Gen. Contracting, Inc., 288 P.3d 159 (Kan. Ct. App. 2012).

Contractor suffered financial setbacks which necessitated Surety's involvement in completion of bonded project. From facts of the case, the contract balances were forwarded to the Surety while the Principal attempted to complete the project. Disputes arose between Principal and Surety over payments to be made to subcontractors. The Surety ultimately closed out the project after Principal failed to respond to the Surety's requests.

After close out and incurring a loss, Surety brought suit against the indemnitors to recover the loss. Surety filed a motion for summary judgment on March 26, 2010. On that same date, indemnitors' counsel filed a motion to withdraw from the case. The motion was granted five days after it was filed. Indemnitors new counsel entered an appearance on the day the summary judgment response was due. New counsel requested that the motion be pushed off until discovery could be undertaken, or for at least 60 days, to permit him to get up to speed. Surety did not object to a limited delay of the response date. The trial court set a hearing on the motion for extension, but ultimately decided to grant the summary judgment at that hearing without the filing of a responsive pleading. At a subsequent hearing, the amount of damages was determined by the Court. Indemnitors then appealed.

The appellate court overturned the summary judgment order on several points. First, the court found that a surety seeking indemnification must show that its conduct was reasonable. The court noted that none of the summary judgment evidence submitted by the Surety provided any proof that the conduct was reasonable. The court felt that the summary judgment evidence should have included proof of the thoroughness of the investigation, the cooperation (or lack of cooperation) of the indemnitors, and attempts made to mitigate the claims. The court rejected the Surety's point on appeal that its good faith in making payments was established in the later damages hearing.

Second, the court found that the trial court should have granted the indemnitors a reasonable amount of time to file a response based on the retention of new counsel and the Surety's lack of objection to an extension.

Court Rejects Enforcement of Venue Selection Clause and Stay of Miller Act Suit

U. S. ex. rel. Trinity Indus. Servs., LLC v. Fed. Ins. Co., 2012 WL 4928907 (M.D. Ga. October 16, 2012).

Subcontractor brought suit against Surety and Principal in the United States District Court for the Middle District of Georgia. Surety issued a payment bond under the Miller Act for work to be performed at an Air Force Base in Georgia. Subcontractor's suit alleged Miller Act claims and state law breach of contract claims. Surety and Principal filed a motion to transfer venue based on the subcontract's venue selection clause.

The venue selection clause provided that any suit between the parties was required to be brought in state district court in Oklahoma City, Oklahoma. The clause also provided Principal with the sole discretion to file a suit in a state court near the project site. This second clause also specified that there was no waiver of the right to remove the suit should the Principal file an action itself.

Subcontractor challenged the venue selection clause due to the fact that its Miller Act claim against the Surety was required to be filed in federal court. Surety and Principal countered that, at a minimum, the Miller Act claim should be stayed until such time as the state law causes of action were transferred to Oklahoma and a trial was had on those counts. This argument was based on the line of authority related to staying Miller Act claims when there is a binding arbitration clause between Principal and its subcontractor.

The court ultimately refused to enforce the forum selection clause because it "attempts to divest the federal courts of their exclusive jurisdiction." The court found that the clause would prohibit the subcontractor from ever filing a Miller Act claim and could not be enforced. The Court also rejected the argument that the Miller Act claim should be stayed while the state law causes of action were transferred and tried. The Court noted that a claimant need not bring any state law claims along with its Miller Act claim and that the Principal is not a necessary party to the Miller Act suit. Further, the Court found the line of cases addressing arbitration as inapplicable to the analysis of this forum selection clause.

Court Rejects Equitable Subrogation Due to "Voluntary" Payment

Developers Sur. & Indem. Co. v. Populous, Inc., --- F.Supp.2d ----, 2012 WL 4858607 (W.D. Mo. October 11, 2012).

The Kansas City Chiefs entered into a contract with Ghostfire Design for work to be performed at Arrowhead Stadium. The contract between the Chiefs and Ghostfire provided for periodic payments, so long as Principal progressed the work as required. Ghostfire entered into a subcontract with L&L Group for a portion of the work and Surety issued a subcontractor performance bond. The contract between L&L Group and Ghostfire provided for one deposit payment and four subsequent payments to be based on services performed and expenses incurred.

The Chiefs also retained the services of an architect, Populous, Inc., that was required to review and inspect the work of contractors on the project and certify that the payment applications were accurate and correct. The Chiefs also contracted with a program management firm, Konrath, to provide oversight of the architect and other design professionals' work.

L&L Group submitted five payment applications on the project and the first four were paid by the Chiefs. All but the second pay application had been approved by the architect. L&L Group subsequently ceased operations and Ghostfire declared a default and made a demand on the Surety to perform. Surety ultimately decided to waive its right to perform under the bond and issued a check for the penal sum of the bond, with a reservation of rights. This decision was made after assessing the potential costs of performing the obligation, which far exceeded the penal sum.

Surety alleged that the Chiefs significantly overpaid L&L and that Ghostfire, the architect and the program manager failed to properly supervise payments to L&L. Surety subsequently brought suit against the Chiefs, the Jackson County Sports Authority, Jackson County, Missouri, Populous, Konrath and Ghostfire. The claims against the owners were settled leaving the Surety's equitable subrogation claims against the architect, contractor and program manager.

Surety alleged that it was subrogated to the claims of the Chiefs against those defendants because it fully performed under the performance bond by making payment. Defendants alleged that the subrogation claim should fail because Surety knew about the alleged overpayments when it paid the penal sum and did not withhold the allegedly discharged portion of the penal sum. Defendants alleged that the Surety was a volunteer and could not recover that amount from them through equitable subrogation.

The trial court ultimately agreed with the defendants' argument. The court noted that at the time of the default, the Surety had the choice between completing the contract itself or paying the bond up to a stated amount. Surety alleged that performance was not financially feasible given all of the facts surrounding the completion of the contract. The court noted that "an informed choice is not rendered involuntary simply because it reflects a calculated decision to avoid a more difficult or injurious outcome." The court noted that the Surety was well within its rights to pay the penal sum in lieu of performing, but that decision impacted the equities in this case. The court found that the equities weighed in favor of finding the payment to be a voluntary one. The court found that "despite the alleged overpayment, the actual completion of the underlying contract cost the Chiefs considerably more than the amount [Surety] paid under the bond. . . . Because the Chiefs bore the cost of completion in excess of the amount [Surety] paid under the bond, it would be inequitable to permit [Surety] to subsume the Chiefs' causes of action."

Surety Successfully Argues for Non-dischargeability of Bankruptcy Debt due to Breach by Indemnitor of Trust Fund Provision of Indemnity Agreement

Poynter v. Great Am. Ins. Co., 482 B.R. 557 (W.D. Ky. 2012).

Surety issued bonds on behalf of Poynter Construction. Prior to bonds being issued, the owner of Poynter Construction, Dewayne Poynter, executed an Agreement of Indemnity that contained a trust provision. Under that section of the indemnity agreement, the indemnitors agreed that any contract funds received on bonded projects would be considered as trust funds.

Surety mandated that Principal maintain capital of no less than $1 million in order for Surety to issue bonds. Poynter wrote a check for $1 million to his company which was funded by a loan to him from PBI Bank. Poynter ultimately used contract funds to repay the loan before its maturity date without notifying the Surety. Principal was subsequently unable to complete three construction projects which caused Surety to incur a loss.

Poynter then filed a voluntary petition seeking relief under Chapter 7 of the Bankruptcy Code. Surety then instituted a proceeding against Poynter to have his debt to Surety declared non-dischargeable under 11 U.S.C. § 523(a)(4). The Bankruptcy Court granted the Surety a summary judgment on this issue. Poynter appealed to the District Court.

The District Court upheld the Bankruptcy Court's decision. The Court noted that under 523(a)(4), a discharge under Section 727 does not discharge an individual debtor from any debt for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny. Poynter challenged the existence of a trust that would create fiduciary duties. The Court found that the indemnity agreement's trust language was enough to create a trust in that it set forth the express intent to create a trust, the ascertainable res, a sufficiently certain beneficiary and a trustee. The Court held that "the res was ascertainable and clearly stated as 'all funds received by them, or due under any contract covered by any Bond.' The beneficiaries are the subcontractors, materialmen and [Surety]." Poynter was to act as the trustee and his failure to properly handle the funds provided a basis to challenge the discharge of his debt to the Surety.

Surety's Claim Against Government Survives Motion to Dismiss

Hartford Fire Ins. Co. v. U.S., --- Fed.Cl. ----, 2012 WL 5194055 (Fed. Cl. October 22, 2012).

Surety brought suit against the United States for allegedly wrongfully disbursed funds to Surety's bond principal. The United States filed a motion to dismiss the causes of action for failure to state a claim, and the Court issued an

opinion addressing the causes of action as initially filed.

At issue in the case were two Miller Act performance bonds issued by Surety in favor of its Principal. One of the projects was for work in Lake County, Indiana and the second project was located in Savannah, Georgia. The projects were occurring concurrently; however, the Obligee terminated Principal for default on the Savannah project. Principal submitted its own claim under the Contract Disputes Act on the Savannah Project alleging damages and delay in performance due to defective specifications. A lawsuit was eventually filed by Principal based on this claim.

While the claim process was moving forward, the Obligee became concerned with the progress of the work on the Indiana project. The Obligee began copying Surety on correspondence related to the Indiana project and, in March, 2005, threatened a termination if the work did not progress.

In April, 2005, a settlement conference was held in the Savannah litigation. That settlement conference resulted in an agreement between the Obligee and Principal that changed the default termination into a termination for convenience. Additionally, the Obligee agreed to pay Principal $700,000. In June, 2005, Surety wrote a letter to the contracting officer on the Indiana project requesting that the Obligee exercise its rights to offset funds that may be due to Principal. The June notice specifically referred to the upcoming $700,000 payment on the Savannah project. The Department of Justice approved the settlement in early July, 2005 and the funds were released to Principal in late July, 2005. The Obligee terminated the Indiana contract due to Principal's default in February, 2006. Surety completed work on the project with a loss of $1.6 million.

Surety then filed suit based on the Government's failure to offset the funds from the Settlement Agreement against the default on the Indiana project. The Government filed a motion to dismiss the suit for failure to state a claim as it believed it had no duty to offset the funds from the settlement agreement against the later default on the Indiana project.

The trial court decided that the Surety's suit could survive the motion to dismiss as it had alleged sufficient facts respecting all material elements necessary to sustain recovery under some viable legal theory. In surviving the motion to dismiss, the Surety overcame the Government's argument that it had no legal duty to offset the funds.

The open issues to be decided by the trial court as the case moves forward appear to be whether the notice in June to offset the funds was sufficient as it was sent to the Indiana office instead of the Savannah office. Additionally, the government raised the issue of whether there was any duty to offset the money in July, 2005 when the Indiana contract was not terminated until February, 2006. The Court at this early stage found that there were sufficient facts alleged to survive a motion to dismiss.

Fidelity Casenotes

By: Ben Zviti, Ed., Travelers Bond, New York, NY

Salvage/Restitution/Retirement Plan

State v. Burns, 976 N.E.2d 969 (Ohio Ct. App. 2012).

Former business manager of a school district was indicted and charged with theft from the school district resulting in a loss of approximately $650,000 over a four-year period. The former manager pled guilty and agreed to make restitution on all counts, including those dismissed. At sentencing, the court ordered restitution in the following amounts: $52,429 to the school district, $180,613 to one bond company, and $425,386 to another bond company. The aforesaid insurers provided surety bonds to the defendant during his employment with the school district as required by law. No objection to the restitution order was made at the time of sentencing. After the sentencing hearing, the school district moved to withhold the full restitution award from any funds held in the responsible party's name by the Ohio School Employees Retirement System. The trial court granted the motion and issued its judgment ordering the $658,428 restitution amount to be withheld. On appeal, the

defendant challenged the order of restitution to the insurance companies as well as the amount withheld from the retirement plan.

The court held that applicable law "does not prohibit an award of restitution to an insurance company when the award is made pursuant to the express plea agreement between the State and the defendant" and therefore that portion of the defendant's sentence complied with applicable law. However, the court reversed that portion of the restitution order directing the Ohio School Employees Retirement System to withhold $605,999.00 from the defendant's pension plan for the insurers based on its reading of the relevant statute. The court interpreted the law to allow only a political subdivision that suffered an actual loss and has been awarded restitution in the amount of its actual loss to seek to withhold that restitution award from the offender's pension payments. The court determined that the insurance companies are "non-political-subdivisions" and "non-victims." As such, the court reversed that portion of the trial court's order, holding that withholding retirement funds to pay insurance companies is not provided in the statute.

<u>Direct Loss/Vicarious Liability of Insured Not a Direct Financial Loss</u>

Abady v. Certain Underwriters at Lloyd's London Subscribing to Mortg. Bankers Bond-No. MBB-06-0009, --- P.3d ----, 2012 WL 4829601 (Colo. App. October 11, 2012).

The insured, Commercial Capital, Inc. (CCI), was a real estate lending company providing short-term financing for commercial construction projects with a focus on providing commercial real estate loans to borrowers who could not otherwise obtain loans from lenders with more restrictive lending criteria. The insured carried a Mortgage Bankers Bond which provided coverage for, *inter alia*, direct financial loss sustained by the insured arising out of employee dishonesty. Disgruntled investors, believing that CCI and its officers made misrepresentations during the solicitation process, obtained an assignment of rights, title and interest in the bond from bankrupt CCI's trustee. The investors filed a suit naming, among others, the insurer, asserting a claim as assignee of the bond and a garnishment claim asserting a right to garnish the insurer after obtaining a judgment against CCI. The trial court granted summary judgment to the insurer, concluding that: (1) the bond is a fidelity bond and not a surety bond; (2) the bond terms were unambiguous; (3) the plain language of the bond protects only CCI; (4) the assignment of CCI's rights to investors did not convert their third-party claims into first party claims; and, therefore, (5) investors' claims were not recoverable under the bond. The investors appealed.

With respect to the investors' claims as assignee, the court of appeals noted that an assignee stands in the assignor's shoes and takes "only as good a claim as his assignor had." The investors' losses (i.e., third-party claims) do not, therefore, become first-party claims because they have received an assignment from the insured; they only stand to recover the losses that CCI could have recovered. The court of appeals determined that the question presented was simply whether the insurer would be liable to CCI for the damages suffered by investors out of the wrongful acts of its officers and employees in marketing interests in CCI to investors. The court of appeals affirmed the judgment of the trial court, concluding that the insurer would not be liable because the losses asserted by the investors do not constitute direct losses to CCI as contemplated by the bond. The court of appeals highlighted the distinction between fidelity bonds and liability policies in its analysis, noting that the distinction was of import because liability coverage was available under the policy, but not purchased by CCI. Although "direct financial loss" was not defined in the policy, the court ruled that based upon the plain and ordinary meaning of the phrase, and the purpose of the policy, as well as its assessment of the policy as a whole, 'direct financial loss' sustained by CCI unambiguously refers only to the immediate loss of CCI's property through the dishonesty of its own officers and employees; not to damages to third parties, including investors. Since, here, CCI is liable for losses suffered by investors, if at all, under a theory of vicarious liability, the court held that to accept investors' definition of "direct financial loss" would create the potential that any loss would be deemed a direct loss. Such an

interpretation "would eliminate the distinction between a direct loss and an indirect loss and would transform the [bond] into a liability policy."

Employee Dishonesty/Padded Payroll Scheme

Amerisure Ins. Co. v. Debruyn Produce Co., --- N.W.2d ----, 2012 WL 4897946 (Mich. Ct. App. October 16, 2012).

The insured's former controller issued herself unauthorized checks from the insured's payroll account. The insurer declined coverage under the employee dishonesty portion of the commercial insurance policy on the grounds that the loss "did not constitute the type of employee dishonesty covered by the policy" according the policy's exclusionary language excluding from coverage financial benefit to the employee, including employee benefits earned in the normal course of employment, including salaries. The insurer filed a declaratory judgment action seeking a ruling that it was not liable to indemnify the insured for the claim. Both parties filed motions for summary judgment and the trial court granted summary judgment in favor of the insured, holding that the misconduct at issue did constitute employee dishonesty under the policy. On appeal, the Court of Appeals of Michigan affirmed the trial court's ruling. The court distinguished the instant matter from cases where the employer accidentally inflates a paycheck and the employee refuses to return the excess funds. The controlling question for the court was whether the money taken by the former employee constituted salary or not. The court found that it was clear that the money taken by former employee was not salary. Unlike the other cases where the courts upheld the application of the similar exclusion, in the instant matter, the insured did not intend to write her multiple checks. The former employee simply helped herself to money under her control. It was not included in her regular paycheck and she did not pay income tax or other withholding on the money. As the court concluded, "[t]he money should not be considered salary simply because she stole it from the payroll account instead of a cash register."

Employee Theft/Termination/Motion to Dismiss

First Nat. Bank of Ely v. Progressive Cas. Ins. Co., 2012 WL 5944847 (D. Nev. Nov. 27, 2012).

Insured bank became aware that an employee was embezzling depositors' money and/or money belonging to the bank itself. The former employee pled guilty to embezzlement and was sentenced to prison and ordered to pay $5,897,234.98 in restitution. The bank notified its Fidelity Bond/D&O insurer of the loss for which the bank was legally liable and requested coverage and indemnification. Upon completion of its claim investigation, the insurer paid the bank $1,547,318.08 of the $1,675,000 available under the Bond, explaining that the bank made a material misrepresentation on its renewal application and because a bank employee discovered the defalcating employee's activities but did nothing about them. Therefore, the insurer determined that the loss suffered after the discovery was not covered by the Bond. The insurer advised the bank that no payment would be made under the D&O policy because no suits had been filed or demands made against the bank. The insurer reserved all rights to assert additional defenses in the future in both coverage letters. The bank filed an action against its insurer alleging 1) breach of contract; (2) breach of the covenant of good faith and fair dealing; (3) violation of the Nevada Unfair Claims Settlement Practices Act; (4) fraud and concealment; and (5) negligence. After removing the case to federal court, the insurer filed a motion to dismiss and in the alternative to strike the bank's request for punitive damages. The bank filed a motion to strike new defenses and for leave to file a second amended complaint, claiming that the insurer asserted new defenses that were not asserted in its denial letters.

The court denied the insurer's motion to dismiss the bank's breach of contract claim because the insurer had not shown that it was legally justified in denying the full amount available under the Bond in its motion to dismiss. The court did hold that the insured has failed to state a claim for breach of the D&O Policy because the bank failed to properly plead facts indicating that the insurer breached the

insurance contract. The bank did not plead that it indemnified anyone for the employee's wrongful conduct, nor did it plead that it was legally obligated to pay due to the wrongful acts. The court also concluded that the D&O policy does not compensate the bank for the loss suffered from fraudulent and criminal conduct per the policy's Fraud/Violation of Law Exclusion. The court denied the insurer's motion to dismiss the bank's breach of the Nevada Fair Claims Settlement and Practices Act because the adjuster may have misstated the terms of the policy (i.e., the definition of "claim") on more than one occasion prior to correctly stating it in a subsequent letter. The bank's fraud claims against the insurer as well as its claims for negligent misrepresentation were dismissed because the claims were insufficiently pled. The court also dismissed the bank's request for punitive damages because "First National has not sufficiently pled that [the insurer] was guilty of oppression, fraud, or malice to support a claim for punitive damages." The court denied the bank's motion to strike certain defense raised by the insurer in its motion to dismiss, doubting the application of the "mend the hold" doctrine in Nevada, and nevertheless disposing of the issue because the insurer expressly reserved all rights to raise additional defenses, and thus the bank was on notice that additional policy defenses may be raised by the insurer. Lastly, the court rejected the bank's argument for the application of the equitable doctrines of waiver and estoppel to prohibit the insurer's defenses, referencing a general proposition under Nevada law that "does not allow a litigant to use waiver to extend the coverage or scope of an insurance policy to include claims expressly excluded from the contract.".

<u>Employee Dishonesty/Improper Financial Gain</u>

K2 Settlement, LLC v. Certain Underwriters at Lloyd's, London, 2012 WL 5990038 (W.D. Pa. November 30, 2012).

The insured, K2 Settlement, LLC ("K2") filed a breach of contract action, including alleged violations of Pennsylvania's Bad Faith insurance statute, against its Special Mortgage Bankers Bond insurer, arising out of a denial of a $482,963.28 employee dishonesty claim. The insured was a newly formed title insurance business. Its day-to-day operations were run by the defalcating employee, Kandi Jablonski, who at all times was the president and sole shareholder of an entity called PA Settlement Services, Inc. ("PASS"). Jablonski was hired and named the president of the insured while remaining sole owner of PASS. Soon thereafter, the insured and PASS entered into an Asset Purchase Agreement under which, the insured assumed specifically identified liabilities of PASS for the purposes of obtaining PASS' workforce, operating systems, furniture, equipment and office. Jablonski continued to operate PASS in order to wind down its existing business and to conduct title business in those jurisdictions where K2 had not yet acquired the required licensure, title underwriter approvals, bonding, or certifications needed to begin operations there. Jablonski was responsible for accessing and managing K2's escrow accounts, and for authorizing transactions from K2's escrow accounts due to her status as a K2 employee and authorized signer on the accounts. The discovery of a discrepancy in the accounting of K2's and PASS' escrow accounts lead to an investigation revealing that Jablonski misappropriated funds and engaged in unauthorized disbursements to cover shortages in the PASS account.

K2 submitted a claim for employee dishonesty to its insurer for its direct financial loss. The bond provided for coverage for direct financial loss sustained by the insured directly caused by dishonest acts by an Employee which were committed with the manifest intent to obtain and resulted in the receipt of Improper Financial Gain for the Employee or for others. The definition of Improper Financial Gain expressly excluded salary, fees, commissions, bonuses, salary increases, promotions, profit sharing and other emoluments or similar benefits. Condition B of the bond provided conditions limiting coverage under certain circumstances in the event of a merger or consolidation with or a purchase of another institution. The insurer denied the claim on the grounds that (a) the Bond does not cover losses caused by employees of an acquired institution; and (b) Jablonski did not receive an "Improper Personal Financial Gain."

The court rejected the insurer's argument that Condition B precluded coverage. The terms 'merge', 'consolidate', and 'purchase' are not defined in the bond so the court looked to *Black's Law Dictionary* noting that the terms uniformly indicate a total acquisition of a company which ceases to exist after the transaction. In the instant matter, PASS did not cease to exist and was operating while winding down. The Asset Purchase Agreement did not achieve a total acquisition of PASS by K2, or a termination of PASS' operations; therefore, Condition B did not operate to bar coverage. However, the insured's claim failed because that court concluded that no reasonable juror could find that Jablonski received an Improper Personal Financial Gain as a result of her misconduct. The insured argued that because Jablonski was "president and 100% shareholder of PASS, Jablonski *could* be held personally liable if the funds in her PASS Escrow Account were not sufficient enough to allow PASS to meet its obligations on the loan transactions closed by PASS." The only evidence the insured provided with respect to the above averment is the speculative statement in the affidavit of Dan Egan, a K2 manager. The court held that "[e]ven assuming that avoiding personal liability for losses constitutes personal financial gain, Egan's testimony is too speculative to support a reasonable jury inference that Jablonski would have been personally liable for insufficient funds in PASS accounts." The insurer was accordingly granted summary judgment on bank's bad faith claim.

FI Bond/Clause E/Actual Physical Possession by Authorized representative

BancInsure, Inc. v. Highland Bank, 2012 WL 6217375 (D. Minn. December 4, 2012).

The insured bank entered into an Assignment Agreement with an entity called First Premier, which, in turn, entered into a lease agreement with Equipment Acquisitions Resources, Inc. ("EAR"). First Premier was to provide certain semiconductor equipment to EAR and assist EAR in obtaining financing for the lease of this equipment. EAR's principals executed personal guaranties with First Premier unconditionally guaranteeing payment to First Premier of all obligations under the lease. On behalf of EAR, First Premier went to the insured bank seeking to borrow $3,000,000 to finance the lease of equipment. First Premier sent various financial documents to Highland Bank prior to entering into any agreement and also sent a certified copy of the original guaranty documents. The document sent to the bank bore a stamp stating, "THIS IS A CERTIFIED COPY OF THE ORIGINAL," next to which the lessor wrote the date and his initials. As such, the original document was in First Premier's possession at all relevant times. The bank issued about $4,000,000 in loans.

After about 20 months, EAR stop making lease payments. The bank investigated the default and learned, among other things, that the leased equipment did not actually exist, and that the equipment purportedly purchased was pledged to multiple lenders. In addition, the bank discovered that the guaranty provided by one of EAR's principals was a forged instrument. The bank submitted a Proof of Loss to its insurer, claiming that Insuring Agreements D and E of the Fidelity bond covered Highland Bank's $2,011,618.30 in losses related to the First Premier/EAR equipment lease financing. The insurer denied coverage, contending as to Insuring Agreement E, that because Highland Bank did not have actual physical possession of the document, it failed to satisfy the insuring bond's condition precedent. That same day, the insurer filed a declaratory judgment action. The critical precondition to coverage at issue was whether the insured could demonstrate actual physical possession of the guaranty by the insured or an authorized representative to establish that it relied on the faith of the guaranty. The bank sought partial summary judgment on the limited issue of whether First Premier was the "authorized representative" to satisfy the condition precedent to coverage. Thus, the court did not reach the ultimate issue of coverage.

Noting that the bond does not define "authorized representative", the court looked to principles of agency to determine whether First Premier was the bank's authorized representative. The necessary elements of an agency relationship are: (1) consent to the agency; (2) action by the agent on behalf of the principal; and (3) exercise of control by the principal over the agent which may be

established through a course of dealing even though the parties did not call it an agency relationship. Since the Assignment Agreement between the bank and First Premier did not use the term 'agent', the court searched the record to determine whether an agency relationship existed. The court found that the evidence in the record established the elements of an agency relationship: (1) the bank consented to First Premier acting as its agent for purposes of the transactions at issue, and specifically for purposes of First Premier maintaining possession of the original guaranty; (2) First Premier acted on the bank's behalf by performing the following tasks: collecting and remitting loan payments, paying sales and use tax, providing additional financial documentation, updating insurance, inspecting collateral and acting as the primary contact with EAR; (3) with respect to control, the court determined that the bank possessed "control" over the location of the original documents, and over the transaction in general, because the bank held the funds and determined whether or not to fund the First Premier/EAR transactions based on the elements in the entire package, including the guaranties. The record demonstrated that the bank permitted First Premier to retain the originals with the understanding that the bank would receive certified copies.

Loss means Actual Loss, Not Failure to Realize Fictitious Gains

Jacobson Family Invs., Inc. v. Nat'l Union Fire Ins. Co. of Pitt., PA, 955 N.Y.S.2d 338 (N.Y. App. Div. 1st Dep't. 2012).

The insureds were a family-related investment management office and various investing entities. The insureds claimed that they suffered $107,619,369.33 in losses arising out of the Madoff fraud. However, some investing entities withdrew more money than was put in, and were thus deemed "net winners". Other investing entities withdrew less money than was put in, and were thus deemed "net losers". As a whole, the entities netted a win, but the proof of loss nevertheless claimed a loss of $107,619,369.33 based on the final fraudulent account statements prior to discovery of the Madoff fraud. The policy was modified by endorsement to cover dishonest acts of outside investment advisors and had a $3 million deductible. The insurers declined coverage and the ensuing action was commenced, including a claim for breach of the implied covenant of good faith and fair dealing.

The Supreme Court, Appellate Division, First Department affirmed the trial court's order holding that 'loss' (an undefined term in the bond) could have only reasonably meant money invested less money received and did not include "phantom" assets that never actually existed. The Court rejected the insurers' argument that the investors' claims constitute one single loss and therefore, in reality, no loss at all, because the net result was a net win in excess of $3,000.000.00. Instead, the Court treated each investing entity separately, so the net losers could pursue claims, but, in turn, then applied the $3 million deductible separately to each net loser investing entity. The Court rejected the insureds' arguments that the calculation of premium and the terms of a prior bond somehow evidenced the intent to provide coverage for phantom assets. The Court did conclude that $2,500,000 in cash received by the net loser entities from the trustee for the Securities Investor Protection Corporation was a recovery and, thus, an offset for the net loser entities' claims. However, the Court thought there were issues of fact as to whether money paid by two winner entities to loser entities was a recovery as that term was used in the policy because, according to the Court, it was "unclear for what purpose these payments were made and whether they were intended to compensate the two net losers for their loss". The Court affirmed dismissal of the insureds' breach of the implied covenant of good faith and fair dealing claims because there were reasonable grounds to decline coverage for phantom assets.

Property Held for Others/On Premises/Direct Loss

Sperling & Slater, P.C. v. Hartford Cas. Ins. Co., 2012 WL 6720611 (N.D. Ill. Dec. 27, 2012).

The insured hired a secretary who worked for a name partner and founder of the insured law firm. Among her duties, the secretary administered Mr. Sperling's personal bank account. Other members of the firm

discovered that the secretary embezzled approximately $880,000 from Mr. Sperling's personal account by writing checks on the account that were payable to herself. The secretary was charged and pled guilty to federal bank fraud. Mr. Sperling recovered roughly $360,000 of the missing funds. The insured firm reimbursed him the remaining $525,000 in unrecovered losses. The insured submitted its claim to its insurer for the loss of $525,000. The insured purchased several coverages, including, on premises loss; loss of personal property of others in the insured's care custody or control under a blanket limit of $250,000; loss from employee dishonesty under a sub-limit of $55,000; and a "Super Stretch for Law Offices" coverage which creates a blanket coverage limit for the additional coverages not part of the base policy. The insurer denied the claim and the insured firm commenced a declaratory judgment action seeking a declaration that the claim is covered by both the Super Stretch for Law Offices endorsement and the Employee Dishonesty Endorsement. The district court dismissed the action with prejudice because it found that:

> Mr. Sperling's personal losses, and any corresponding reimbursement by the Firm, were not covered by the Personal Property of Others endorsement because: (1) Sperling's personal bank account was not in the care, custody or control of the Firm; (2) the loss of the funds did not occur at the Firm's premises; and (3) the Personal Property of Others endorsement does not cover acts of employee dishonesty.

The Court found that Sperling's personal losses were not covered by the Employee Dishonesty endorsement because: (1) the firm did not suffer a direct loss from the secretary's acts; and (2) the loss of the funds did not occur at the firm's premises. The firm filed a motion for reconsideration. The court denied the firm's motion because it did not identify a clear manifest error of law or present a significant change in the controlling law since the issues were present to the Court. Attacking the court's reasoning does not meet the reconsideration threshold as it is improper to use such motions to relitigate arguments the court has previously rejected; the court noted that the insured's recourse, if any, lies with the Seventh Circuit Court of Appeals.

The insured requested relief to amend its complaint to allege that it had custody over the personal account, together with a duty to reimburse the partner, under an undertaking/assumption of duty theory. In its initial opinion, the court found that the law firm failed to establish that it had any duty to protect the partner's personal property because law firms do not ordinarily exercise fiduciary control over the personal bank accounts of their partners. The purported amended complaint failed to allege facts describing how it acquired such a duty but simply contained the conclusory allegation that it possessed a duty to protect the partner's bank account. Relying on analogous cases, the court held that the firm did not suffer a direct loss and therefore coverage was not afforded under the Employee Dishonesty endorsement to the policy. Lastly, the court held that the loss did not occur at the insured's premises and the Personal Property of Others endorsement does not cover acts of employee dishonesty.

<u>Insuring Clause D2 - Fraudulent Instructions / Definition of "Customer"</u>

First Nat. Bank of N. Cal. v. St. Paul Mercury Ins. Co., 2013 WL 61026 (N.D. Cal. Jan. 3, 2013).

Husband and wife ("trustees" or "account holders") opened a trust account with the insured bank in 2009. Sixteen months later, over the course of back-to-back days, the insured received phone calls from someone purporting to be the account holder requesting two wire transfers. On day one, the caller requested that $412,876.18 be transferred from the Trust to a bank in Bangkok. On day two, the caller requested a transfer for $98,876.13 to a bank in Shanghai. The caller provided some verification information at the request of the insured employee who took the calls. Five days later, the trustee contacted the insured to advise that he had not authorized the wire transfers. The

authorities investigating the matter uncovered a criminal operation involving a pattern of fraudulent wire transfers from banks across the US to banks in Europe and Asia. The trustees demanded reimbursement. The insured reimbursed the account holders $514,193.00, which included the total amount transferred ($511,752.31) plus interest and service charges. The insured submitted a claim to its insurer for coverage pursuant to its Financial Institution Bond under Insuring Clause D2 – Fraudulent Telefacsimile and Voice Instruction Transactions, which provides that the insured bank will be indemnified for a losses directly from having in good faith transferred funds on deposit in a Customer's account in reliance upon a fraudulent telephonic voice instructions which purports to be from an individual person who is a Customer of the bank. The term "Customer" is defined by the Bond as an entity or natural person that meets the three following conditions: (i) has a Written agreement with the Insured authorizing the Insured to rely on telephonic voice or Telefacsimile Device instructions to make transfers; (ii) has provided the Insured with the names of persons authorized to initiate such transfers; and (iii) with whom the Insured has established an instruction verification procedure other than voice recognition.

The insurer denied coverage because the insured bank did not establish that the account holders satisfied the definition of "Customers" under the Bond, as the bank had not produced a Written agreement authorizing the bank to rely on telephonic voice or fax instructions to make transfers. Counsel for the bank replied to the declination letter claiming that the bank was "entitled to coverage under the Bond because Travelers cannot meet its burden to prove that Coverage D2 is inapplicable to this claim[,]" and that "Travelers' denial of coverage is not supported by the facts applicable to [First National's] claim, and accordingly is not made in good faith." A few weeks later, the bank filed a declaratory judgment action alleging causes of action for breach of contract and allegation of bad faith. The bank filed a motion for partial summary judgment on its breach of contract claim, arguing that the account holders were "Customers" under the definition in the Bond because they signed a Signature Card on the day they opened the account, which indicated their intent to acquiesce to the terms of the Deposit Account Agreement and Disclosure, which document itself required that the trustees agreed to enter into and comply with the bank's wire transfer agreement and to comply with the bank's Security Procedures. The insurer filed a motion summary judgment on the breach of contract claim arguing that the bank has not met the Bond's tripartite conditions for coverage under the requirements set forth in the Bond's definition of the term "Customer" as used in Insuring Clause D2. The court granted the insurer's motion for summary judgment and denied the insured bank's motion for partial summary judgment holding that the bank failed to meet each of the three requisite conditions to demonstrate that the account holders qualified as "Customers" under the bond. With respect to the requirement that the insured must demonstrate a Written agreement with the Insured authorizing the Insured to rely on telephonic voice or Telefacsimile Device instructions to make transfers, the court rejected the insured's incorporation by reference argument on the basis that:

> a generic signature card, read with an account agreement and a section from a bank's Operations Manual, does not constitute a "Written agreement" under the definition in the Bond agreement. Further, as an "agreement," it is indefinite as it is not accompanied by any draft of the wire transfer agreement or any document setting forth the provisions of such an agreement, and is nothing more than an agreement to agree, which is not enforceable under California law.

The court noted that the Security Procedures were not even given to the account holders nor were they even described sufficiently to enable them to determine where they were located and what they say. In reviewing the Signature Card that was signed on the day the account was opened, the court held that the bank had not established that the account holders provided the bank with "the

names of persons authorized to initiate such transfers", thus failing to meeting condition (ii) of the definition of Customer. Lastly, the court concluded that the bank did not provide any evidence of an established "instruction verification procedure other than voice recognition" with the account holders, thus failing to meet condition (iii) set forth in the definition of Customer.

Computer Systems Fraud/No Coverage for entry by Authorized User

Universal Am. Corp. v. Nat'l Union Fire Ins. Co. of Pitt., PA, --- N.Y.S.2d ----, 2013 WL 69241 (N.Y. Sup. Ct. Jan. 7, 2013).

The insured health insurance company suffered a net $7,764,211 loss at the hands of thieves that obtained National Provider Identifiers (NPIs) from the Centers for Medicare and Medicaid Services and used the NPIs to submit fraudulent claims directly into the insured's computer system. The insured argued that the losses were covered by the Computer Systems Fraud Rider of its Financial Institution Bond and filed a motion for summary judgment. The insurer denied liability and filed a cross motion for summary judgment. Neither party cited to New York cases interpreting the coverage at issue. The insured cited to a Connecticut decision, but the court distinguished that case from the matter before it. On the other hand, the court found two New Jersey decisions to be instructive in that each court found that coverage was limited to situations in which the data was input by an unauthorized user. There was no coverage where the user was authorized to input the data, supporting the argument that the overall thrust of the coverage is to insure against computer hackers or imposters. The court found support in the title of the Rider, which indicated it was to cover "misuse or manipulation of the computer system" itself, rather than "situations where the fraud arose from the content of the claim, and the system was otherwise properly utilized." The court granted the insurer's cross motion for summary judgment and concluded, "[n]othing in this clause indicates that coverage was intended where an authorized user utilized the system as intended, i.e. to submit claims, but where the claims themselves were fraudulent."

LEGISLATIVE UPDATE

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

Due to the elections and prior adjournment of most legislatures, there are few enactments to report on in this article; however, below is a sampling of surety legislation recently adopted by California and Pennsylvania. For complete details see the statutory section or bill number identified in the text and footnotes below.

California

Construction Manager/General Contractor Bond

The California legislature adopted an alternative procurement procedure for certain transportation projects performed by the Department of Transportation (DOT).[1] Their pilot project will allow for a construction manager/general contractor method for construction when the DOT determines that this method will reduce project costs or expedite project completion in a manner that is not achievable through the design-bid-build method. Among other requirements, a construction manager will be required to provide evidence that it has the capacity to obtain all required payment and performance bonds. The bond must be in an amount sufficient to cover the contract amount for construction services and shall be on a form developed by the DOT.

Funeral Establishment License Bond

A.B. 374[2] amends the funeral establishment license law to allow a license applicant that cannot submit an audit report due to estate matters or litigation for which the funeral director or his or her designee is a party

[1] Cal. Pub. Cont. Code §§ 6700 - 6708 (A.B. 2498, adopted - 9/29/2012).

[2] Cal. Bus. & Prof. Code § 7630 (Adopted - 9/19/2012).

to request permission to provide a surety bond. The surety bond shall be in an amount equal to fifty percent greater than the corpus of the trust and will guarantee the payment to each account of any shortages in the trust funds.

Information Technology Contractor

An information technology contractor providing services to California will no longer be required to provide a faithful performance bond.[3] Prior to the these amendments, a bond was required in the amount of at least fifty-percent of the total amount payable under the contract and secured the faithful performance of the contract by the contractor.

Pennsylvania

Township Treasurer Bond

The Pennsylvania legislature redrafted their law on appointed township treasurers.[4] While the bonding requirement remains a fidelity bond for fifty percent of the amount of township funds estimated by the board of township commissioners to be available to the township at any time in the given year, it appears that some of the duties upon which the bond shall be conditioned have been further defined. Prior to the adoption of this new law, the bond was only conditioned upon a just accounting for and paying over of all moneys belonging to township funds in the manner prescribed by law and for the delivery of these funds and any papers, books or documents to his/her successors. Under the new law, the duties of the township treasurer include: receiving moneys and depositing them in designated depository accounts; keeping distinct and accurate accounts; annually stating the accounts and making the books and vouchers available for audit; paying out all moneys on orders signed by township president or vice president and attested to by secretary; preserving accounts to hand over to his/her successor; and paying over any remaining balance to his/her successor.

Surface and Reclamation Act Bond Alternative

In October, the Pennsylvania legislature adopted legislation that allows the Department of Environmental Protection (Department)" to establish a land reclamation financial guarantee program.[5] Mine operators may use the financial guarantee program as an alternative to bonding obligations. One of the criteria the Department will review when determining eligibility in the program includes the operator's prior denial of coverage, if any, by a surety company. The financial guarantee program shall be discontinued when 25% or greater of the outstanding bond obligation for the land reclamation financial guarantee program is subject to forfeiture.

[3] Cal. Pub. Con. Code § 12112 (A.B. 1517, adopted - 8/27/2012).

[4] 53 Pa. Cons. Stat. § 55101 (S.B.1185, adopted - 10/24/2012)

[5] 52 Pa. Cons. Stat. § 1396.4 (H.B. 1813, adopted - 10/24/2012)

SUGGESTIONS & COMMENTS??

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