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Newsletter

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RECAP OF SCI'S 38TH ANNUAL MEETING

Outgoing SCI President Ron Goetsch

By: Kevin O'Connor, Hermes Netburn O'Connor & Spearing PC, Boston, MA

For its 38th Annual Meeting, the Surety Claims Institute gathered at the Hyatt Chesapeake Bay Resort in Cambridge Maryland from June 26 to 28, 2013. The meeting marked our return to the East Coast, but our first foray into the Chesapeake Bay region. I am not sure what we were waiting for. The Resort provided a tremendous location for top notch educational presentations from a talented panel of industry experts and for catching up with friends, colleagues and clients. The facility was first class, the golf was challenging, the company was great and the crab feast was awesome! By any measure, the meeting was an overwhelming success. We had over 120 registrants, including 40 fidelity and surety claim professionals representing nearly 2 dozen surety and fidelity companies.

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Comments From The Editor

We seem to be encountering more bad decisions in the areas of fidelity and surety law as time goes by. Part of the problem is the effort that some courts make to bend themselves into pretzels to justify a finding in favor of a claimant against an insurance company. In other cases, sureties have not remained sufficiently vigilant after tendering defense to a principal's counsel and find that a bad ruling has come down on an issue of surety law that was not adequately briefed by counsel having surety expertise.

In other instances, even where competent counsel have been engaged by the surety, there is a substantial amount of pressure on both in-house surety claims representatives and outside counsel to keep litigation expenses to a minimum. This sometimes results in shortcuts, especially when the amount in controversy is not particularly large. The problem is that a small case can often have large repercussions for the surety. When there is a risk that a small case will yield bad law, sureties are often wise enough to attempt to settle such a case. Conversely, sometimes the facts of the small case are good and a surety might be wise to invest in the litigation and ask their counsel to do a thorough job preparing arguments in hopes of a positive published result. This can be particularly attractive when the amount in controversy is relatively small, the principal at stake is of substantial interest to the surety industry, and the amount in question might result in counsel for the claimant not investing equivalent time in seeking to persuade the Court. Hopefully, surety claims management remains cognizant that more is often at stake than the amount in controversy in a particular litigation. While this sometimes will complicate the ability

to seek full indemnity or expenses might be disproportionate to the amount at stake in a given litigation, judgments have to be made regarding what investment may be worthwhile beyond the scope of particular litigation.

The challenge remains for counsel representing sureties and fidelity insurers to continue to educate the courts regarding not only what the law is or should be, but also why the result which is sought is fair. Judicial expansion of surety liability does not serve the public interest as surety bonds are paid for ultimately by the public.

As the challenges of practicing law and managing claims departments continue to confront us, we need to remain mindful of the larger picture and the need to invest in creating good law so as to avoid the erosion of the once favored status of sureties.

Armen Shahinian
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RECAP OF SCI'S 38TH ANNUAL MEETING

(continued from page 1)

Blake Wilcox

Cully and Jim Veal

Steve and Raquel Weinberg

Bob and Verna Prentice

Tina Noia and Jack Costenbader

Chris Clore, Sue Black and Jim Black

Sheila and Jim Rudnik

Denise Hayes, Laura O'Neill, Bill McConnell, Dennis O'Neill and Ben Lentz

Steve Weinberg

Casey Kennedy, Charlie Cloud and Diane Kennedy

Andy and Dick Wisner

Bob Babcock, Charlie Cloud and Keith Witten

Jim and Katie Case

Gary and Cindy Gresham

Mike and Janice Keeley

The seminar program leaders, Jerry Sunderland of Wright, Constable & Skeen and Keith Witten of Gilliland & Hayes, put together an outstanding educational program. Thursday's surety program, lead by Jerry Sunderland, addressed suretyship issues presented by construction projects that are phased or otherwise segmented to avoid bond underwriting limits. Wolff & Samson's Jim Ferrucci led off with the presentation of his paper regarding the fraud in the inducement defense to surety claims at a phased project. Jim was followed by Steve Watters (The United Fire Group) and Dennis Bartlett (Brosseau, Bartlett & Seserman) and their discussion of potential claims against a producing agent or broker who procures bonds on phased projects. Next up was a presentation about potential attacks on the penal sum of phased project bonds, presented by Patrick Hustead of The Hustead Law Firm, Steve Pand of Travelers and Jeff Olson of Liberty Mutual. Patrick, Steve and Jeff were followed by Scott Spearing's (of Hermes, Netburn, O'Connor & Spearing) presentation of his paper regarding defenses available to a performance bond surety in the phased project setting.

Thursday's program culminated with a lively and insightful panel discussion regarding phased construction projects. Bruce Shreves of Simon, Peragine, Smith & Redfearn moderated the discussion. Leading industry experts Frank Lanak (HCC Surety Group), Jack Mangan (ACE INA Claims), Steve Nelson (SureTec Insurance Group), Robert Riggs (Hanover) and R. David Taylor (Roberts, Taylor & Sensabaugh) presented a wide ranging discussion of the practical and legal considerations and challenges presented by phased construction projects.

Jason Potter and sons

Friday's seminar program addressed topics of interest to both surety and fidelity practitioners. Alvin Fredericks of Eccleston & Wolf, one of Maryland's leading experts in the representation of lawyers and law firms, presented his paper regarding ethical issues presented in surety and fidelity matters. Justin Melkus, from Strasburger & Price in Dallas, followed Mr. Fredericks with a thorough and tremendously informative discussion regarding the use and impact of protective orders and agreements on the investigation and litigation of fidelity and surety claims. Next up were two staples of SCI's annual meeting, the surety law update (presented by Dennis Cavanaugh of Robinson & Cole) and the fidelity law update (presented by Tressler's Jim Knox). Like always, these annual surveys of new case law are a tremendous resource to the membership regarding cutting edge developments affecting claims.

Keith Witten wrapped up the seminar program with a presentation of his paper regarding the use of quasi estoppel and judicial estoppel in fidelity and surety litigation. Keith's work in organizing and coordinating the Friday program, and Jerry Sunderland's work on the Thursday program cannot pass without comment. Both did a tremendous job, for which all are grateful.

Our Chesapeake Bay meeting marked the end of the tenure of our colleague and friend Ron Goetsch as President of the Surety Claims Institute. A report of the meeting would be grossly inadequate without some comment on Ron's tenure. There truly are no words to adequately express the debt of gratitude our organization owes to Ron. Over the past several years he provided tremendous leadership and direction as President. He and his organizations

(both Safeco and Liberty Mutual) provided unwavering and constant support for the mission and vision of the Surety Claims Institute. I am sure that I speak for the entire SCI membership in thanking Ron for his service and wishing him all the best in the future.

Speaking of the future, all members likely are aware that Dave Kitchin of Great American Insurance Company agreed to serve as our incoming President. Dave and Great American have been key supporters of SCI for many years. SCI looks forward to continued growth and success under Dave's leadership. Next year's annual meeting will be held June 25 to 27, 2014 at the Grove Park Inn Resort & Spa in Asheville, North Carolina. Grove Park is another new location for SCI and 2014's annual meeting promises to be a great event. Mark your calendars and look for additional information regarding SCI in 2014.

SURETY CLAIMS INSTITUTE RESUMES PRIOR NAME

In 2009, the Surety Claims Institute changed its name to the Surety & Fidelity Claims Institute in recognition of the fact that, for many years, the Surety Claims Institute included fidelity cases and articles in both its Newsletter and its Annual Meeting presentations. In fact, over time, the Surety Claims Institute's Annual Meeting had developed a routine in which the Thursday program concentrated on surety topics and the Friday program concentrated on fidelity topics.

At the June, 2013 meeting of the SFCI's Board of Directors, it was determined that our organization would revert to its prior name based upon an analysis of the practice areas of our attendees and the programming requests and suggestions being received from its membership. Specifically, substantially more of the members attending the Annual Meeting concentrated their practices and claims management activities in the area of surety claims rather than fidelity claims. Having said that, a significant portion of the membership continues to handle both surety and fidelity claims and membership remains interested in topics relating to both practice areas. It was ultimately decided that the organization would continue to serve both the surety and fidelity claims industries but that it would not be tied to providing equal programming for both fidelity and surety claims. Rather, there was a recognition that being slavishly tied to equal program content was not the preference of the majority of members attending the Annual Meeting. On a going-forward basis, our Annual Meeting programs will include topics covering contract surety claims, commercial surety claims *and* fidelity coverage, with the Thursday program typically concentrating on contract surety matters and the Friday program concentrating on both fidelity and surety content, together with ethics programming. With these changes, the Institute has decided to shorten its name and resume the use of the name that served it well for over thirty years even while it covered both surety and fidelity topics in its programs and Newsletter. The Surety Claims Institute continues to welcome among its members those who handle surety claims, those who handle fidelity claims, and those who handle both. We look forward to continuing to offer value in our Newsletter and programs for each of these constituencies for many years to come.

CAN AN OBLIGEE'S DELAYED TERMINATION OF A PRINCIPAL UNDER AN A312 PERFORMANCE BOND DISCHARGE THE SURETY?

By: Bradford R. Carver and Jonathan C. Burwood, Hinshaw & Culbertson LLP, Boston, MA

I. INTRODUCTION

It is well settled that the AIA A312 Performance Bond (1984 ed.) sets forth conditions that an obligee must strictly fulfill before a surety has any obligation to perform. Failure to expressly comply with these conditions will discharge the surety. In that

context, when an owner unilaterally arranges for completion of a project, without first providing the surety with an opportunity to exercise its Paragraph 4 options, that act renders the bond null and void. In the vast majority of those cases, the obligee has removed the bond principal from the project, and completes with replacement forces. In doing so, the obligee improperly denies the surety its right to perform under the bond.

What happens, however, when the principal is in material breach of its contract but the obligee, for any number of reasons, allows the principal to complete the project, and only then terminates the contract and seeks damages from the surety under the bond? Paragraph 3 of the A312 Performance Bond does not contain any timing mechanism tied to the requirement that the obligee must terminate the principal prior to asserting a claim for performance against the surety. Nonetheless, does such a "termination after the fact" violate the bond's conditions precedent sufficient to discharge the surety? Several courts have held that, under certain circumstances, such a delayed termination can, in fact, discharge a surety. When investigating claims for performance under an A312 Performance Bond, surety practitioners should keep in mind this potential "delayed termination" defense.[1]

II. SUMMARY OF A312 CASE LAW

Prior to addressing the "delayed termination" defense, it is necessary to briefly review the structure of the bond and the manner in which courts have consistently construed its provisions, particularly the conditions precedent set forth in Paragraphs 3, 4 and 5.

Over the past 13 years, a significant body of case law has developed with respect to the conditions precedent set forth in the A312 Performance Bond. Courts throughout the country have consistently held that its unambiguous terms, particularly Paragraphs 3, 4 and 5, create conditions precedent to recovery by an obligee.[2] Paragraph 3 details the obligee's express default and termination obligations. Paragraph 4 identifies the surety's completion options. Paragraph 5 sets forth the procedure, if

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[1] The following discussion relates to the AIA A312 Performance Bond (1984 ed.) As most practitioners are aware, the American Institute of Architect promulgated a revised A312 Performance Bond in 2010. None of the cases discussed in this article address the revised bond form. Although the 2010 edition expressly states that certain obligee requirements are not conditions precedent, many of the concepts discussed in this article are applicable to the revised bond form.

[2] **A312 Paragraph 3:** *See Enter. Capital, Inc. v. San-Gra Corp.*, 284 F. Supp. 2d 166, 179 (D.Mass. 2003); *Bank of Brewton, Inc. v. Int'l Fid. Ins. Co.*, 827 So.2d 747, 753 (Ala. 2002); *120 Greenwich Dev. Assoc., LLC v. Reliance Ins. Co.*, No. 01 CIV.8219, 2004 WL 1277998 (S.D.N.Y. June 8, 2004); *Ag Grow Oils, L.L.C. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa*, 276 F.Supp.2d 999 (D.N.D. 2003); *Platinum Mech. LLC v. U.S. Surety Co.*, No. 07 Cv. 03318(CLB), 2007 WL 4547849 (S.D.N.Y. Dec. 21, 2007); *153 Hudson Dev., LLC v. Thomsen Constr. Co., Inc.*, 778 N.Y.S.2d 482 (2004); *Breath of Life Christian Church v. Travelers Ins. Co.*, No. W2009-00284-COA-R3-CV, 2010 WL 1172080 (Tenn. Ct. App. Mar. 26, 2010); *Travelers Cas. & Sur, Co. of Am, v. Crystal Towers, LLC*, No. 08-0518-KD-C, 2009 WL 5068823 (S.D. Ala. Dec. 17, 2009); *Podsiadlo v. W. Ins. Co.*, No. C056936, 2009 WL 2901950 (Cal. Dist. Ct. App. Sep. 10, 2009); *Old Colony Constr., LLC v. Town of Southington*, No. HHBCV095013418S, 2010 WL 4352934 (Conn. Super. Ct. Oct. 7, 2010); *LaSalle Grp., Inc. v. JST Prop., L.L.C.*, No. 10-14380, 2011 WL 3268099 (E.D. Mich. July 29, 2011); *Town of Plainfield v. Paden Eng'g Co., Inc.*, 943 N.E.2d 904, 909-912 (Ind. Ct. App. 2011); **A312 Paragraph 4:** *See Seaboard Sur. Co. v. Greenfield*, 266 F. Supp. 2d 189, 196 (D. Mass. 2003); *St. Paul Fire & Marine Ins. Co. v. Green River*, 93 F. Supp. 2d 1170, 1177 (D. Wy. 2000), *Solai & Cameron, Inc. v. Plainfield Comm. Consol. Sch. Dist. No. 202*, 871 N.E.2d 944 (Ill. Ct. App. 2007); *Enter. Cap., Inc. v. San-Gra Corp.*, 284 F. Supp. 2d 166, 179 (D. Mass. 2003); *Breath of Life Christian Church v. Travelers Ins. Co.*, No. W2009-00284-COA-R3-CV, 2010 WL 1172080 (Tenn. Ct. App. Mar. 26, 2010); *Fid. & Deposit Co. of Md. v. Jefferson Cnty. Comm'n*, 756 F. Supp. 2d 1329, 1336 (N.D. Ala. 2010); *St. Paul Fire & Marine Ins. Co. v. VDE Corp.*, 603 F.3d 119, 123-126 (1st Cir. 2010); *Town of Plainfield v. Paden Eng'g Co., Inc.*, 943 N.E.2d 904 (Ind. 2011); **A312 Paragraph 5:** *See Seaboard Sur. Co. v. Greenfield*, 370 F.3d 215, 219, fn.1 (1st Cir. 2004); *St. Paul Fire & Marine Ins. Co. v. Green River*, 93 F.Supp.2d 1170, 1175 (D.Wy. 2000), *Sleeper Village, LLC v. NGM Ins. Co.*, No. 09-cv-44-PB, 2010 WL 3860373 (D. N.H. Oct. 1, 2010)

necessary, for the obligee to declare the surety in default and elect its own completion remedy.

The obligations set forth in Paragraphs 3, 4 and 5 require sequential compliance.[3] The provisions of the bond balance the rights of the obligee and the surety.[4] That is, the obligee's strict compliance with Paragraph 3 is required before a surety is required to act under Paragraph 4. Paragraph 5 cannot be invoked by the obligee until the surety is given a reasonable opportunity to comply with Paragraph 4. An obligee's failure of strict and sequential compliance with each paragraph renders the bond null and void, and results in a complete discharge of the surety.

The structure and sequential nature of the conditions precedent set forth in the bond are critical to an understanding of the "delayed termination" defense. In *Solai*, an Illinois case, the court aptly stated:

> The structure of the performance bonds distinguish the act of termination from the act of replacement. Accordingly, these issues are treated in different paragraphs of the performance bonds, which specifically require that termination, as set forth in ¶ 3.2 of the bonds, must precede the option of replacement, as set forth in ¶ 4.3 of the same performance bonds. It is of vital importance to recognize that termination is a right available only to [the obligee] under ¶ 3 of the Bonds. Similarly, replacement is a form of mitigation available only to [the surety] under the provisions of ¶ 4. The performance bonds balance the rights of both owner and surety.[5]

Of equal significance to the sequential nature of the obligations in the bond, is the importance courts place on a surety's right to control completion under Paragraph 4. In fact, courts consistently hold, in cases involving both A312 and A311 performance bonds, that depriving a surety of its completion options renders the bond void.[6] In *Green River,* the court held that the obligee's refusal to allow the surety to exercise its Paragraph 4 rights constituted a wrongful termination under the terms of the bond, and thereby excused the surety from further performance, observing:

> Courts have consistently held that an obligee's action that deprives a surety of its ability to protect itself pursuant to performance options granted under a performance Bond constitutes a material breach, which renders the Bond null and void.[7]

Addressing these same issues, the United States District Court for the District of Massachusetts (affirmed by the First Circuit Court of Appeals) in *Seaboard Surety Co. v. Town of Greenfield*,[8] granted summary judgment to the surety, holding:

> Under the Bond, the obligee is clearly required to let the surety attempt to complete the Project, regardless of any questions it may have had about the surety's time frame for completion. Thus, [the obligee] absolutely deprived [the surety] of its rights under the Bond when it contracted with [the replacement contractor] to complete the Project, because [the obligee] did not allow [the surety] to fulfill its completion option … [The obligee] can only be found to have committed material breach when it foreclosed [the surety's]

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[3] *See Solai & Cameron, Inc. v. Plainfield Comm. Consol. Sch. Dist. No. 202*, 871 N.E.2d 944 (Ill Ct. App. 2007) (bond requires a "specific sequence" of conditions that must take place before the surety is required to perform).

[4] *Id*.

[5] *Solai*, 871 N.E. 2d at 953-954.

[6] *See e.g., St. Paul Fire & Marine Ins. Co. v. Green River*, 93 F.Supp.2d 1170 (D.Wy. 2000).

[7] *Id*. at 1178.

[8] 266 F. Supp. 2d 189, 196 (D. Mass. 2003).

> opportunity to complete the Project.[9]

Similarly, in *Solai & Cameron,* the court held that an obligee's decision to replace the contractor before termination violated Paragraph 4, nullifying the bond.[10] The court noted that this conduct:

> served to "strip [the surety] of its options, [sic] to mitigate. [The obligee's] decision to hire [a replacement contractor] before declaring [the principal] in default and terminating [the principal] from the project extinguished the options available to [the surety] under paragraphs 4.1, 4.2 and 4.3 of the performance bond, effectively forcing [the surety] to forgo these options."[11]

This failure, standing on its own, nullified the surety's duty to perform.[12]

In *Dragon Construction*, another Illinois case involving the A311 performance bond form, the obligee unilaterally hired a replacement contractor. The *Dragon* court held that the obligee's actions stripped the surety of its contractual right to minimize its liability under a performance bond by ensuring that the lowest responsible bidder was selected to complete the job.[13] As a result, the performance bond was rendered null and void.[14]

Each of these cases stand for the proposition that, under the bond, an obligee must afford a surety the right to exercise its Paragraph 4 completion options. Intruding upon, or foreclosing the exercise of these rights, can prove fatal to an obligee's claim.

[9] *See also Enter. Capital, Inc. v. San-Gra Corp., supra*. (obligee began finishing bonded work weeks prior to any effort to terminate the contractor and satisfy Paragraph 3.2 which relieved the surety of its obligations under the Bond.)

[10] *Solai*, 871 N.E. 2d at 957.

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] *Id.*

III.
DELAYED TERMINATION CAN DISCHARGE THE SURETY

The majority of A312 cases involve situations where an obligee replaces a principal during a job, and either fails to notify the surety or fails to properly terminate the principal as required by the bond. In those instances, it is clear that the action of replacing the principal with another contractor expressly violates the provisions of Paragraph 3 and Paragraph 4 of the bond, resulting in the surety's discharge. Circumstances can arise, however, in which an obligee chooses not to replace a principal that is in material breach of its contract. Instead, the obligee may allow the principal to "limp across the finish line" by providing some type of direct or indirect financial support. In so doing, the obligee may incur significant damages. After the project is complete, or essentially complete, the obligee may attempt to invoke the provisions of Paragraph 3, terminate the principal, and then demand that the surety reimburse the obligee for its damages. The question is whether an obligee can delay the termination of a principal that is in material breach of its contract, for the sole purpose of completing the work, and still demand damages from a surety. In other words, is a postponed termination fatal to an owner's A312 performance bond claim? The answer is, quite arguably, "yes."

The essence of the defense is that, given the precise structure of the A312 performance bond, and in particular, the conditions precedent set forth in Paragraphs 3, 4 and 5, an obligee that wishes to avail itself of the protection of the bond must invoke the default and termination provisions of Paragraph 3 with reasonable promptness after it becomes aware of a "Contractor Default," as that term is defined in the bond. Any delayed termination that prevents a surety from exercising its rights under Paragraph 4 of the bond, and availing itself of the protections under Paragraph 5, constitutes a violation of the bond's conditions precedent, resulting in a complete discharge of the surety.

In response to the assertion of this defense an obligee will invariably assert that Paragraph 3 of the bond does not specify when an obligee is required to declare a Contractor Default and terminate the contract. Paragraph

3.1 merely states that an obligee must notify the contractor and surety if it "is considering declaring a Contractor Default," but there is no requirement that such a declaration must occur within a specified period of time after an obligee becomes aware of a Contractor Default. Going back to the structure and sequence of the bond, however, and in particular the importance that courts place on a surety's right to arrange for completion of a terminated contract, a declaration of default and termination must occur with reasonable promptness. Otherwise, a surety's Paragraph 4 completion options may be compromised, eliminated or controlled at the whim of an obligee, even if those actions prejudice the surety. In other words, the requirement of a reasonably prompt declaration of default and termination is an implicit requirement of Paragraph 3.

Several courts have, either directly or indirectly, recognized the "delayed termination" defense. For example, in *Hunt Const. Group, Inc. v. National Wrecking Corp.*,[15] the general contractor/obligee Hunt Construction Group ("Hunt") hired National Wrecking Corp. ("NWC") to provide excavation services. NWC provided A311 payment and performance bonds. Three months after NWC completed its work and was no longer on site, Hunt sent default letters to NWC and the sureties and demanded performance. The sureties sought summary judgment on the basis that Hunt's notification, delayed until after the job was completed, foreclosed the surety's from exercising any of their rights to arrange for completion of the work.

The *Hunt* court's analysis of the structure of the A311 bond and the importance of allowing a surety to exercise completion options is directly applicable to an A312 bond. The court divided the A311 bond into paragraphs it denominated as "A," "B," and "C." The court explained that Paragraphs A and B are the prefatory paragraphs that provide that the underlying construction contract is incorporated into the bond and that the principal will faithfully perform. Paragraph C in the A311 bond requires the default of the principal and sets forth the surety's completion options. In rejecting Hunt's arguments, the court stated:

> Rendering a 'surety' absolutely liable for all costs and expenses, without notice, under paragraphs A and B would also read paragraph C out of the performance bond, and allow an obligee to wait for indefinite periods before demanding 'performance.'[16]

The court noted that Hunt's argument "failed to appreciate the inter-relationships among the subparagraphs."[17] The court then held:

> When an obligee fails to provide **timely notice** to a surety so it can exercise its options under paragraph C, the obligee has breached the contract and the surety is without liability.[18]

In a lengthy passage the court then recited various facts that highlight the need for a prompt termination:

> As soon as Hunt knew that NWC would not complete the job on time, it had an obligation to decide whether to declare NWC in default and notify the Sureties (who might have done something to aid NWC in speeding up the work, whether by hiring more trucks, more workers, more oversight, or whatever, in its judgment, would assist the obligor). Hunt sat on its hands and let NWC finish the excavation on its own. Hunt thereafter sat on its hands and failed to declare NWC in default until mid-Summer 2004, when NWC was long since off site.…Under the express terms of the Performance Bond and the law, Hunt was required to give the sureties "reasonable notice" of NWC's default to trigger the sureties' liability.

[15] 2008 WL 928 305 (D.D.C. Apr. 8, 2008).

[16] *Hunt*, 2008 WL 928305 at *7.

[17] *Id*.

[18] *Id*. (emphasis added).

Hunt failed to do so and, thus, never triggered that liability.

> **Where the obligee fails to notify a surety of an obligor's default in a timely fashion, so that the surety can exercise its options under the controlling performance bond, the obligee renders the bond null and void.**[19]

In another frequently cited A312 case, *Bank of Brewton, Inc. v. Int. Fidelity Ins. Co.*,[20] the bank/obligee complained to the surety several times about the principal's alleged failure to timely perform its work. The notifications, however, were insufficient and ultimately the principal completed the project. Four years after the project was completed, the bank/obligee sued the surety seeking damages. The trial court granted summary judgment for the surety which the Supreme Court of Alabama upheld. In doing so, the court discussed the specific structure of the A312 performance bond and its sequential requirements. In a rather intriguing holding, the court stated:

> The clear intent of the performance bond, taken as a whole, is for IFIC to serve as an insurer for the *completion* of the project as a whole. The project architect certified the project as substantially complete as of November 10, 1992. IFIC's obligations to the Bank concluded upon completion of the project.[21]

In essence, the *Brewton* court held that the purpose of the bond was to protect an owner from incomplete work, and to avail itself of the protections of the bond notice had to be provided during the actual construction phase.

In another A312 case, ` *Surety & Indemnity Co. v. Dismal River Club, LLC*,[22] Developers Surety provided a bond to Milroy Golf Systems, Inc. ("Milroy"), as principal, for the benefit of Dismal River, as obligee. Disputes arose between Dismal River and Milroy. Ultimately, Dismal River demanded that the bulk of Milroy's personnel leave the project and Dismal River employed several members of Milroy to complete remaining work on the project. Milroy's remaining personnel achieved substantial completion of the work. Only after substantial completion was achieved did Dismal River demand damages from Milroy and Developers Surety. Developers Surety filed a declaratory judgment action seeking an order that Dismal River failed to comply with the terms of the bond. The court held in favor of Developers Surety. The court first noted that Paragraph 3 imposes conditions precedent to the surety's obligation to perform under Paragraph 4.[23] The court further noted that Dismal River never made a Paragraph 5 demand which also constituted a breach of the bond.[24] Then, in an intriguing and pertinent discussion, the court discussed whether Dismal River could still satisfy the conditions precedent set forth in Paragraph 3 and Paragraph 5 by providing delayed notice to the surety.[25] The court noted that neither Paragraph 3 nor Paragraph 5 contain any express time limit for serving a demand on the surety. Nonetheless, the court ruled that it was too late. The court noted that Dismal River was dissatisfied with Milroy's work as early as July of 2005, that corrective work was taken by

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[19] *Id*. (emphasis added). *See also Balfour Beatty Constr. Inc. v. Colony Ornamental Ironworks, Inc.*, 986 F. Supp. 82 (D. Conn. 1997) (general contractor that allowed subcontractor to complete performance prior to defaulting subcontractor and demanding performance by surety under A311 Bond denied surety the opportunity to exercise options under the performance bond rendering the bond void); *C & I Steel LLC v. Peabody Constr. Co., Inc.*, 2007 WL 1540228 (Mass. Super. Feb. 7, 2007) (general contractor that permitted subcontractor to complete and provided insufficient notices to surety under A311 Bond prevented surety from investigating at a time when "adequate evidence is available, all parties are on site, and [the surety] could potentially correct the problem or limit its damages." The failure to provide adequate notice discharged the performance bond).

[20] 827 So. 2d 747 (2002).

[21] *Bank of Brewton*, 827 So. 2d at 753 (emphasis in original).

[22] 2008 WL 2223872 (D. Neb. May 22, 2008).

[23] *Id*. at *7.

[24] *Id*. at *9.

[25] *Id*.

Milroy's personnel during September of 2005, with substantial completion being achieved in November of 2005. The court then held:

> Had Developers been notified at that time, or even earlier, it might have pursued its first option under Paragraph 4 of the bond by attempting to arrange for Milroy Golf to complete the project with the consent of Dismal River. As a practical matter, that option is no longer available now that Dismal River has completed the work on its own. **I therefore find as a matter of law that Dismal River cannot give an effective demand notice under Paragraph 5 because Developers' ability to perform its obligations under Paragraph 4 had been impeded to a significant extent by Dismal River's delay.**[26]

In other words, the court held that by arranging for completion of the work utilizing Milroy, even after Milroy was in default, Dismal prevented Developers from exercising its Paragraph 4 options, resulting in a discharge of the bond.

Finally, a recent Second Circuit case lends further support to the delayed termination defense. In *Stonington Water Street Associates LLC v. National Fire Insurance Company of Hartford*,[27] National Fire issued a performance bond naming Hodess Builders, as principal, and Stonington Water Street Associates as obligee. National Fire and Stonington were notified of Hodess' financial difficulties and inability to complete the project. Eventually, and without the knowledge of National Fire, Hodess abandoned the project. Rather than notifying National Fire of the abandonment, and invoking Paragraph 3 at that time, and similar to the facts in *Dismal River*, Stonington hired several of Hodess' workers for several months to complete the project. Only after the project was complete did Stonington issue a Paragraph 3 demand on National Fire. National Fire contended that the late notice deprived it of its Paragraph 4 completion options, thereby rendering the bond null and void. National Fire obtained summary judgment on these grounds and the Second Circuit affirmed.

Several of the holdings of the District Court directly support the delayed termination defense. The District Court held that under the terms of the bond and contract, Stonington was obligated to notify National Fire under Paragraph 3 when reason to terminate became apparent. The court stated:

> On this record, **the date of Hodess' abandonment of the project is the date when reason to terminate became apparent**. There is no evidence that Stonington first complied with § 14.4.2 [of the A201 General Conditions] by obtaining certification from the Architect that cause for termination existed. Nor is there any evidence in the record that Stonington undertook the steps required by the construction contract to formally terminate Hodess at the time reason for termination arose. Put another way, there is no evidence that, when Hodess abandoned the project in August, 2006 that Stonington notified Hodess and National Fire that cause to terminate had arisen and that it was terminating Hodess' right to perform, and thereby giving National Fire seven days notice of its obligation to step into Hodess' shoes.[28]

The court then held, in language directly applicable to the defense:

> Stonington's failure to terminate Hodess **when reason to do so arose and then to properly comply with the notice**

[26] *Id.* at *13 (emphasis added).
[27] 792 F. Supp. 2d 253 (D.Conn. 2011).
[28] *Stonington*, 792 F. Supp. 2d at 265 (emphasis added).

> **procedure set forth in § 14.2.2 is a material breach of the Bond and underlying contract**. Furthermore, Stonington's failure to notify National Fire that Hodess abandoned the project and Stonington's unilateral decision to hire successor contractors to complete the project deprived National Fire of the opportunity to mitigate its damages and represent material breaches of the Bond.[29]

The Second Circuit agreed, stating:

> The District Court correctly determined that Stonington's **delayed notice** prejudiced National Fire because Stonington's hiring of replacement workers during the period of delay deprived National Fire of its contractual right under Paragraph 4 of the Bond to protect itself by participating in the selection of replacement workers.[30]

The *Stonington* court thus recognized and appreciated the importance of a prompt declaration of a default and termination. It is for this reason that the court held that the obligee's failure to terminate the principal "when reason to do so arose" constituted "a material breach of the bond and underlying contract."

There is an abundance of case law supporting the proposition that failure to comply with the conditions precedent in Paragraphs 3, 4 and 5 of the bond will result in a complete discharge of the surety. By contrast, there is only limited support for the proposition that a delayed termination by an obligee will likewise result in a discharge of the surety. Nonetheless, there is solid support for the defense in the few cases that have addressed the issue. Moreover, given the structure of the A312 performance bond, its sequential requirements, and the importance of allowing a surety to arrange for completion to mitigate its losses, the defense is entirely in accord with the purpose and intent of the bond. Simply verifying that an obligee took the steps required by Paragraph 3 is not enough. The timing of those actions is critical, and must be investigated.

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[29] *Id*. at 267 (emphasis added).
[30] *Id*.

Mechanic's Lien Discharge Bonds: An Introduction to Key Issues

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It is common knowledge that mechanic's liens play a crucial role in the context of private construction projects by providing a security interest in the real property of the construction project to those who have furnished labor or materials for improvements. Yet many practitioners are less familiar with mechanic's lien discharge bonds (also called lien release bonds). Although the laws governing both mechanic's liens and mechanic's lien discharge bonds are uniquely state-specific,[1] some general observations can be made.

This article will provide an analysis of several issues affecting the procedural and substantive aspects of claims against lien discharge bonds and tips for handling claims against such bonds.

I. Introduction

Once a valid mechanic's lien is asserted, there are two primary competing interests at hand. First is the interest of the owner whose property is encumbered by the lien. Second is the interest of the contractor, subcontractor, or supplier ("Lien Claimant" or "Claimant") who has benefited the property in some way but has not been paid. Other interests may also exist, such as the interest of a bank which is financing the owner's acquisition of the property. In light of these competing interests, a majority of states permit the posting of a bond to "discharge" or "release" the lien. The procedural requirements for posting the bond vary from state to state and are beyond the scope of this article. It should be noted, however, that the party posting the bond (the principal on the bond) might be the property owner, property owner's lender, a general contractor, a subcontractor, or a surety for a contractor or subcontractor.

Upon the proper posting of a lien discharge bond, the bond serves as a substitute for the real property. Thus, the bond serves the interests of both the property owner, and possibly the property owner's lender, and the Claimant. The owner can convey, mortgage, or otherwise encumber the property free and clear of the lien, and the Lien Claimant has a claim against the bond. Also, in some states, a lien discharge bond may discharge a claim of lien on the funds owed by the owner to the general contractor.[2]

The parties to a lien discharge bond may vary as to the principal, as explained above, but otherwise will be similar to other types of construction bonds. The party seeking to bond off the lien is the principal. The bonding company is the surety. The Lien Claimant is the obligee. If the primary debtor of the Lien Claimant does not pay, the surety faces potential liability to the Lien Claimant.

Conceptually, the process seems fairly straightforward. Yet there are several unique issues concerning claims on lien discharge bonds, the resolution of which has not been uniform among the courts.

II. Must the Claimant continue to comply with statutory lien perfection requirements after a lien discharge bond is posted?

Typically, the discharge of a lien through the filing of a bond does not create a separate action from the action to enforce the lien. However, courts are split on the issue of whether the Claimant must still perfect its lien as required by state law, such as by timely commencing an action against the primary debtor and obtaining a judgment against the primary debtor, prior to suing the surety on the bond. Other courts excuse compliance with

[1] All states and the District of Columbia provide by statute for some form of lien on private works projects, whereas most, but not all, states permit the posting of a bond to discharge the lien. For a compilation of and commentary on the states' laws in this area, see *Lien and Bond Claims in the 50 States* (2012 edition), published by the Foundation of the American Subcontractors Association, Inc., available at http://www.keglerbrown.com/File%20Library/Unassigned/2012-Lien-and-Bond-Manual.pdf (last accessed July 7, 2013).

[2] *See, e.g.* N.C. Gen. Stat. § 44A-20(f).

statutory lien perfection requirements entirely once the bond is posted.

A. Some states do not require compliance with statutory lien perfection requirements after a lien discharge bond is posted.

In *Bob Eldridge Constr. Co. v. Pioneer Materials, Inc.*, 235 Kan. 599, 684 P.2d 355 (1984), the Supreme Court of Kansas held that once the lien discharge bond is posted, the statutory lien perfection requirements are waived and need not be complied with. Thus, once the bond is posted, the Claimant is not required to take any further steps to perfect its lien prior to suing the surety on the bond. The court also held that because the bond excuses compliance with the statutory lien perfection requirements, any claim on the bond is governed by the five year statute of limitations applicable to bond claims, rather than the one year statute of limitations applicable to claims to enforce mechanic's liens.

B. Some states do require compliance with statutory lien perfection requirements after a lien discharge bond is posted.

In *Few v. Capitol Materials, Inc.*, 274 Ga. 784, 559 S.E.2d 429 (2002), a materials supplier, Capitol Materials, filed a lien against the improved property; the property owner, Few, posted a lien discharge bond, and Capitol Materials brought an action against Few to recover on the bond. The issue before the court was whether Capitol Materials must first pursue recovery from the general contractor with whom it had contracted prior to suing on the bond. The Supreme Court of Georgia held that Capitol Materials was required to pursue recovery from the general contractor before suing on the bond. In reaching its decision, the court reasoned that, because the lien discharge bond serves as a substitute security for the real property, no new cause of action is created by the posting of a lien discharge bond. According to the *Few* court, "[b]ecause no new action is created, the lien claimant must still comply with the statutory requirements for perfecting a lien, [except for the notice of suit requirement], and the principal and surety on the bond are entitled to raise any defense that would have been available as a defense to the lien foreclosure."[3]

Because Capitol Materials had not filed a claim against the general contractor within the applicable limitations period, the *Few* court held that it could not prevail as a matter of law in its action on the bond. Thus, in order to preserve its right to recover on the lien discharge bond in Georgia, a Claimant must comply with the statutory lien perfection requirements, which includes the timely commencement of an action against the primary debtor, which in the *Few* case was the general contractor. Although it was not explicit in its holding, *Few* suggests that Georgia law also requires a Claimant to pursue its claim of lien to entry of final judgment.[4]

In North Carolina, it is settled that a Claimant must not only perfect the lien by a lawsuit against the primary debtor, but must also pursue the claim of lien to entry of final judgment prior to seeking recovery against the surety on the bond. *See George v. Hartford Accident & Indem. Co.*, 330 N.C. 755, 412 S.E.2d 43 (1992). Because of this requirement, the *George* court also held that the statute of limitations applicable to a claim on the bond does not begin to run until the Claimant obtains a final judgment in his favor against the principal debtor.[5] However, the Claimant must bring the lawsuit against the principal debtor within the statute of limitations applicable to a claim against such debtor.

The foregoing cases illustrate the need for practitioners to carefully analyze the applicable state law for a lien discharge bond claim for possible lien perfection requirements and to determine the limitations period within which suit(s) must be commenced to assert recovery on the bond.

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[3] 274 Ga. at 786, 559 S.E.2d at 430-31.

[4] *Id.* at 786, 559 S.E.2d at 431 (noting that Capital Markets "did not file an action *or obtain a judgment against the contractor* before suing the property owner on the bond") (emphasis added).

[5] *Id.* at 756, 412 S.E.2d 43.

III. In those states that require compliance with lien perfection requirements, what right does the surety have to contest its liability in the second lawsuit against the surety?

A major issue, which arises in those jurisdictions that do require compliance with statutory lien perfection requirements after a lien discharge bond is posted, is whether the surety may contest the validity of the claim, and therefore its obligation to pay, in the subsequent action against the surety on the bond. This issue is most pronounced where a default judgment is obtained against the principal debtor. This issue has received varying treatment by those states that have considered it.

In Oregon, once the Claimant obtains a judgment against the principal debtor, even if by default, and the Claimant commences a proceeding against the surety on the bond, the surety has no right to challenge the validity of the claim on the lien discharge bond. *See Valencich v. TMT Homes of Oregon, Inc.*, 193 Or. App. 47, 88 P.3d 300 (2004). In reaching this conclusion, the *Valencich* court defined the lien discharge bond as a "litigation bond," conditioned only on the entry of a judgment against the principal debtor and the failure of the principal debtor to pay it; and not on the principal debtor's actual liability for the claim.[6] Citing "the traditional rule followed by a majority of jurisdictions," the court stated that "a judgment against the principal is binding and conclusive on the surety, who may not interpose defenses which should have been set up in the action in which the judgment was recovered."[7] Thus, in Oregon, absent a claim of fraud or collusion, the surety is not entitled re-litigate the principal debtor's actual liability to the Claimant. Notwithstanding the dicta in *Valencich*, it is unclear whether the holding in *Valencich* actually represents the majority rule nationally. Unfortunately, a complete review of the law on this issue in all fifty states is beyond the scope of this article, and therefore must be left for another day.

In contrast to Oregon, other states adhere to the rule that if the lien discharge bond surety is not a party to the underlying action to establish the validity and amount of the Claimant's claim, then the surety, in the Claimant's subsequent action against the surety on the bond, may contest the validity of the claim and whether the same is chargeable against the surety. *See Sette-Juliano Contracting, Inc. v. Aetna Cas. & Sur. Co.*, 246 A.D.2d 142, 674 N.Y.2d 654 (N.Y. App. Div. 1998). It does not matter whether the judgment against the principal debtor was on the merits or by default. Interestingly, the *Sette-Juliano* court further concluded that a surety did not forfeit the right to contest the validity of the claim by virtue of being deemed a party to the initial action. In *Sette-Juliano,* the surety slightly participated in the arbitration proceeding between the contractor and the subcontractor which formed the basis for the judgment against the contractor. Nevertheless, this did not prevent the surety's later contesting the claim.

In both *Valencich* and *Sette-Juliano,* the lien discharge bond sureties were not made a party to, and did not intervene in, the underlying litigation against the principal debtor establishing the Claimant's claim. Even though the general rule is that a lien discharge bond surety need not be made a party to the underlying action against the principal debtor, sureties should consider intervening in such actions to protect their rights.

IV. Must the Claimant prove the amount that it would have recovered on its lien against the property in order to recover on the bond? In other words, does the relative priority of the Claimant's lien matter in a claim against the bond?

The starting point when dealing with any issue of relative lien priority is the general rule of "first in time, first in right." Statutory exceptions to the general rule are often provided to Lien Claimants. However, the rules vary greatly from state to state, so practitioners should consult their governing statutes.

If there is no lien discharge bond and the Claimant is pursuing foreclosure of its lien, the Claimant typically must prove the validity and amount of the lien, and that there are sufficient proceeds from the sale, after deductions for superior liens, from which Claimant can recover. This proof requirement raises the issue of

[6] 193 Or. App. at 54, 88 P.3d at 303.

[7] *Id*. at 55, 88 P.3d at 303 (quoting 74 Am.Jur.2d 115-116, *Suretyship* §§ 129, 130).

relative lien priority. This is often a major consideration, especially in larger scale developments, where there are often multiple secured parties and Lien Claimants. Lien Claimants who are lower in priority, despite uncontested proof as to the validity and amount of their claim, may never get paid if superior claims deplete the funds available. But does the posting of a lien discharge bond relieve the Claimant of its obligation to prove that it ultimately would have been able to recover and the amount of the recovery in foreclosing on a lien? There is a split of authority on this issue.

In *Gelder & Assocs., Inc. v. St. Paul Fire & Marine Ins. Co.*, 34 N.C. App. 731, 239 S.E.2d 604 (1977), the North Carolina Court of Appeals held that the Claimant was not required to prove that it would have recovered on its lien had the property been sold at a foreclosure sale. According to the *Gelder* court, absent contrary language in the bond, the Claimant is not required to prove the relative priority of its lien in order to recover on a lien discharge bond.[8]

At least one other state has followed North Carolina and stated that the language of the bond, rather than relative lien priority, is paramount in determining whether the Claimant must prove that it would have recovered on its lien against the property. In *Gesco, Inc. v. Edward L. Nezelek, Inc.*, 414 So.2d 535, 540 (Fla. Dist. Ct. App. 1982), the Fourth District Court of Appeal of Florida held that the trial court "did not err in allowing full recovery on the bond, notwithstanding that foreclosure of the mortgage might have extinguished the mechanic's lien had the bond not been issued."

Virginia takes a different approach. In *York Fed. Savings & Loan Assoc. v. William A. Hazel, Inc.*, 256 Va. 598, 599, 506 S.E.2d 315 (1998), the Supreme Court of Virginia explicitly addressed the issue of "whether the holder of a mechanic's lien that is 'bonded off' pursuant to [Va. Code Ann. § 43-70] must still establish the priority of the lien." The parties stipulated to the amount of the claim, that the lien had been perfected, and that the lien had properly been bonded off and released.[9] The parties only disputed whether the subcontractor, Hazel, had the added burden of proving that it could have recovered on its lien had the discharge bond not been posted.[10] Given the statutory language in Virginia that payment under the bond be "conditioned for the payment of such judgment adjudicating the lien or liens to be valid and determining the amount for which the same would have been enforceable against the real estate," the *York Federal* court held that proof of priority was still required.[11] The Court did not accept Hazel's argument that "no competing interests exist once the mechanic's lien was released under the bonding off statute," finding that "few prior lienors would be willing to bond off the real estate if, by doing so, the lienor would be relieved of the necessity of proving the priority of his lien."[12]

The foregoing cases illustrate the split of authority and differing rationale applied by courts on the issue of whether Claimants must prove that they would have recovered on their lien against the property had it not been discharged by the issuance of a lien discharge bond. Both lines of authority have some practical justification. On the one hand, requiring Claimants to prove their ability to recover in a hypothetical foreclosure sale can be problematic, particularly in uncertain economic times when property values are subject to large fluctuations or where multiple competing claimants exist. On the other hand, excusing the requirement of proving relative priority often affords Lien Claimants greater rights than they otherwise would have had. This result is contrary to the stated purpose of the bond serving as a substitute for the lien. The issue highlights the need for practitioners to be aware of the language of the applicable state statutes governing lien discharge bonds, as well as any case law interpreting those statutes.

V. Conclusion

Practitioners must remember that mechanic's liens, and mechanic's lien discharge bonds, are creatures of statute and therefore the law may vary greatly from state to state. This article identifies the issues that should be explored under state law and the language of the

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[8] 34 N.C. App. at 733, 239 S.E.2d at 605.

[9] 256 Va. at 600, 506 S.E.2d at 316.

[10] *Id*. at 601, 506 S.E.2d at 316.

[11] *Id*. at 600, 506 S.E.2d at 316 (quoting Va. Code Ann. § 43-70).

[12] 256 Va. at 602, 506 S.E.2d at 317.

lien discharge bond at issue when dealing with a claim against the bond. As in most bond matters, practitioners must read carefully the language of the lien discharge bond which conditions the surety's obligation to pay, the state's lien statute (specifically the lien discharge bond provision) and related judicial decisions.

THE MUNICIPAL BANKRUPTCY CHAPTER 9 ISSUES FOR SURETIES

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I. Introduction

The last several years have seen multiple municipal bankruptcies being filed, beginning with several in the State of California and most recently involving the largest municipal bankruptcy in the history of the United States by the City of Detroit. To date, municipal bankruptcies have been relatively rare. Since 2008, there have only been a little over a dozen filed.[1] This is in part because only twelve states actually authorize municipal filings under Chapter 9,[2] while twelve others permit bankruptcy filings only after certain actions are taken by government officials.[3] Three other states allow municipal bankruptcy in limited circumstances.[4] The remaining states do not specifically authorize Chapter 9 bankruptcies, making the possibility of filings in those states unclear.

A Chapter 9 bankruptcy raises interesting issues for all who deal with municipalities, including sureties. The existence of these bankruptcies and the rampant speculation of more to come, necessitate that sureties be keenly aware of the unique risks that they pose and that sureties may face in if they are associated with public works projects when a municipality files a Chapter 9 bankruptcy. Among the key concerns for a surety will be the effect of the bankruptcy on contract balances and the surety's subrogation rights, the assumption or rejection by the municipality of public works contracts that the surety bonded, and the effect of assumption or rejection on the surety.

II. Contract Balances – General Funds v. Special Funds

In a Chapter 9, key among the surety's concerns will be the effect upon contract balances and the surety's subrogation rights. In these circumstances, it is important for the surety to understand how the municipal debtor is holding the contract funds. This typically involves an examination of whether the surety's claim is ultimately one against the municipality's "general fund" or if the contract funds are segregated in a "special fund."

The municipality's "general fund" is its general operating fund from which it pays typical operating expenses. The municipality's "special funds" are those which are restricted, either by grant or by law.[5] In a Chapter 9, the difference is somewhat akin to the difference between a general unsecured creditor (general fund) and a secured creditor (special fund). If the surety is deemed to have a claim against the general fund, it may ultimately only be entitled to a pro rata recovery at best, of the amount of its claim. On the other hand, if the surety's subrogation rights are in a special fund, then that fund should be outside the reach of other creditors of the municipal debtor.

Potential sources of special funds include federal funding, which usually comes

[1]Gould, Arkansas (Dismissed); Vallejo, California; Westfall Township, Pennsylvania; Village of Washington Park (Dismissed); Town of Moffett, Oklahoma; Prichard, Alabama; Boise County (Dismissed); Central Falls, Rhode Island; Harrisburg, Pennsylvania (Dismissed); Jefferson County, Alabama; Stockton, California; Town of Mammoth Lakes California (Dismissed); San Bernardino, California; Detroit, Michigan.

[2] Washington, Montana, Idaho, Arizona, Texas, Oklahoma, Nebraska, Minnesota, Missouri, Arkansas, Alabama, South Carolina.

[3] California, Michigan, Ohio, Kentucky, Louisiana, Florida, North Carolina, New York, New Jersey, Pennsylvania, Rhode Island, Connecticut.

[4] Oregon, Colorado, Illinois.

[5]*In re City of Vallejo, California*, 408 B.R. 280, 291 (9th Cir. B.A.P. 2009).

with use restrictions imposed by statute or regulation, and municipal revenue bonds. In the case of municipal bonds, the municipal debtor specifically allocates money from a municipal bond offering to construction of a public works project. Ideally, this required the municipality to have earmarked those funds with the municipal bond indenture trustee (a bank) such that funds are released from the bank/indenture trustee almost like a construction loan. If the surety is going into the Chapter 9 bankruptcy with specially allocated funds held by an indenture trustee, depending on the use restrictions in the indenture trust, the surety may find that the Chapter 9 bankruptcy has no impact at all.

The surety may confirm special revenue bond funding allocations by review of the applicable municipality's meeting minutes (many of which are online) and a review of the Municipal Securities Rulemaking Board ("MSRB"), Electronic Municipal Market Access ("EMMA") system website which allows access to the official statement (like a prospectus) of most municipal bond offerings since municipal bonds are publicly and privately offered.[6]

The surety likely has a panoply of other special fund and restricted fund arguments available to it, depending upon the jurisdiction involved. These may derive from construction trust fund statutes, earmarking of funds (perhaps at the request of the surety), stop notice rights (including the foreclosure by the surety of existing stop notices), and retention escrow accounts (such as on public works projects in California for instance). The surety may also be able to negotiate for (such as in the underwriting phase) or litigate (pre-petition) for protection and ear-marking of its funds.

III.
Executory Contracts

When faced with a Chapter 9, the surety and principal should also consider immediate negotiation with the municipal debtor to assume (preferably) or reject the bonded contract. An incomplete contract is considered to be "executory."[7]Filing a Chapter 9 bankruptcy case does not automatically terminate executory contracts, even if the contract is in default. As in Chapter 11, the debtor entity may "assume" the obligation of the contract and keep such contract in force, or "reject" it and terminate it, pursuant to the general provisions of the Bankruptcy Code. Judicial guidance from Chapter 9-specific cases dealing with assumption and rejection is scarce, but general principles from Chapter 11 cases dealing with Section 365 should be applicable.

A municipal debtor may assume the contract only if it can promptly cure the default and otherwise satisfy the requirements of Section 365, including providing adequate assurance of future performance. Thus, even though the bankruptcy court is precluded from interfering with the function of the municipality, the court can, in fact, order the debtor to pay "adequate protection" in the context of assuming an executory contract. In the Orange County bankruptcy, the court indicated that by coming into the bankruptcy court for protection, the municipality "consented to [the court's] jurisdiction to order, if necessary, adequate protection [for creditors] in connection with [the] proceeding."[8]

If the debtor rejects a construction contract, Section 365(g) says the rejection is a breach of the contract as of the date of filing, giving rise to a claim by the non-debtor party for "rejection" damages.[9] Further, the debtor, in rejecting a contract, may have a number of

[6]*See*ELECTRONIC MUNICIPAL MARKET ACCESS SYSTEM, MSRB, http://www.emma.msrb.org.

[7] While a number of definitions exist for the concept of an "executory contract," a number of courts have relied on the "Countryman"test:

> a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.

In re Teligent, Inc., 268 B.R. 723, 730 (Bankr. S.D.N.Y. 2001)) (citing Vern Countryman, *Executory Contracts in Bankruptcy: Part 1,* 57 MINN. L. REV. 439, 460 (1973).

[8]Pommer & Friedman, *Municipal Bankruptcy and its Effect on Government Contractors*, 25 PUB. CONT. L.J. 249, 256 (Winter, 1996) (quoting *Alliance Capital Management, LP v. County of Orange*, 179 B.R. 185 (Bankr. C. D. Cal. 1995)). The concept of "adequate protection" appears in various provisions of the Bankruptcy Code and generally refers to the debtor's duty to ensure that certain creditors (generally secured creditors) are protected against the loss or diminution of the value of their collateral or claim.

[9]*See* 11 U.S.C. § 365(g).

options that negatively impact the contractor. Such impact generally transfers, in one way or another, to the sureties that have posted bonds securing the performance and payment on those public projects.

First, if the city rejects the construction contract, the contractor's "rejection damages" constitute an unsecured claim for all unpaid amounts due under the contract. That may count for little, however, since the municipality may, in its Chapter 9 plan, reduce or "adjust" that claim all the way down to zero if it chooses. In such circumstances, the contractor will receive nothing for the unpaid work performed on the project, and subcontractors will undoubtedly begin making claims against the payment bonds. The obligation is effectively discharged with no right by the contractor or its surety to any recourse against the city or undisbursed contract funds.[10]

If the contract includes provisions allowing the municipality to terminate for convenience, the city can assume the contract under Section 365 (particularly if the unpaid amount is not too large), then terminate it to reduce its ongoing liability, subject to the terms governing payments due to the contractor in light of such a termination. This whipsaw tactic potentially removes the contractor from the class of unsecured creditors and, since the contractor can no longer vote against the debtor's plan, improves the city's chances for confirming its plan.[11]

If the debtor rejects the contract, it can still make use of applicable procurement procedures to obtain a new contractor to finish the project, even for less money.[12] Under this scenario, again, original contractors go unpaid, creating exposure for sureties to those subcontractors and suppliers depending on the contractor for payment.

The most serious challenge relating to assumption or rejection of executory contracts lies in the timing of that election. A Chapter 9 debtor can wait until confirmation to decide whether to assume or reject an executory contract, risking leaving contracting parties literally in limbo for months until an election is made. But the non-debtor party to the contract may move the court to order the debtor to decide earlier whether it will assume or reject the contract.[13] In determining such a motion, the bankruptcy court must "balance the interests of the contracting party against the interests of the debtor and its estate" because "[i]t is vitally important to all interested parties that the debtor make a prudent assumption or rejection decision...."[14] What constitutes a reasonable time to assume or reject is left to the bankruptcy court's discretion, to be determined on a case-by-case basis in light of the broad purposes of the entire Bankruptcy Code. Relevant considerations include the damage that the non-debtor will suffer beyond the compensation available under the Bankruptcy Code, the importance of the contract to the debtor's business and reorganization, whether the debtor has had sufficient time to appraise its financial situation and the potential value of its assets in formulating a plan, and whether exclusivity has terminated. "Above all, the court should interpret reasonable time consistent with the broad purpose of Chapter 11, which is 'to permit successful rehabilitation of debtors.'"[15]

Because of the prejudice and exposure from delaying such a decision until confirmation, contractors and sureties would typically have compelling arguments to expedite the decision to assume or reject. Namely, they should not be required to either (a) work for free, or (b) hold off from seeking other paying work, while the debtor decides whether or not to finish the project or reduce its scope. At the same time, there is danger in assuming that a contractor will be paid for work it continues to perform, absent an election or attendant assurances of continuing payment for that work.

In addition to the right that a contractor (and those standing in its shoes) has to seek an expedited determination of assumption or rejection, some cases suggest that the debtor cannot compel the contractor to continue performing under the contract, pending the debtor's decision to assume or reject, without

[10] Pommer & Friedman, *supra* note 8, at 257.
[11] *Id.*
[12] *Id.* at 257-58.

[13] 11 U.S.C. § 365(d)(2); *see alsoIn re Physicians Health Corp.*, 262 B.R. 290, 292 (Bankr. D. Del. 2001)
[14] *In re Physicians Health Corp.,*290 B.R. at 292 (citations omitted).
[15] *In re Teligent, Inc.*, 268 B.R. at 738-39.

assurance of payment by the debtor.[16] In *Thomas Companies, Inc. v. United Fire & Casualty Co.,*[17] an HVAC contractor continued to perform work under a contract with a Chapter 11 debtor, post-petition. The debtor ultimately rejected the contract and sought recovery of payments for post-petition performance. The court ruled for the contractor, reasoning that "a Debtor should be responsible for any associated expense incurred while [the decision to assume or reject an executory contract] is being made."[18] Likewise, some courts have held that any work performed by the contractor post-petition (and pre-rejection) would be afforded the ultimate priority of administrative claim status.[19] Similar arguments might be forwarded that work done on a public works contract during the time a Chapter 9 debtor is deciding whether to assume or reject that contract, would be entitled to that same priority for payment.

These potential options for treatment of executory contracts raise an interesting issue for sureties seeking to control their exposures. If the debtor rejects the contract pursuant to Section 365, preventing the contractor from completing the project, it should act to exonerate the performance bond, as if the municipality had breached the contract. The difference is that there is no recourse against the debtor for contract rejection. But, since payment bond liability is usually statutory and not often conditioned on owner payment, a payment bond may remain exposed to claims of those suppliers and subcontractors whom a contractor may be unable to pay due to lack of payment from the municipal debtor. If the debtor rejects the contract and ultimately reduces the claims under its plan (at all, let alone to zero), the contractor and its surety will certainly face liability to unpaid suppliers and subcontractors without full recourse against the project owner.

IV.
Conclusion

Predictions for the future of Chapter 9 filings vary considerably. Some believe we will continue to see more, while others predict a trickle but no deluge. Still others have tried to review Moody's and Standard & Poor's ratings to gauge possible insolvency. Those rating systems, however, provided strong municipal bond ratings for the City of Stockton's municipal bonds even after its Chapter 9 filing, so such ratings may of limited use as a predictor of future filings. On the heels of the Detroit filing, cities as large as Los Angeles have been mentioned as possible Chapter 9 candidates in the near future.[20]Adding to the murkiness is the impossibility of quantifying the effect on municipalities considering bankruptcy of the ability, or lack thereof, of currently bankrupt municipalities to shed onerous pension obligations as they crowd out spending on current public services, as has happened in San Bernardino and Vallejo. In light of significant financial issues caused by the weak economy and budget crises seen in numerous states and cities, more municipal insolvencies are likely, whether they result in Chapter 9 filings or not. Recognizing Chapter 9 issues early will hopefully allow sureties to more effectively deal with and alleviate the associated risks

[16] Pommer & Friedman, *supra* note 8, at 257; *S.N.A. Nut Co. v. The Haagen-Dazs Co., Inc., (In re S.N.A. Nut Co.)*,191 B.R. 117 (Bankr. N.D. Ill. 1996).

[17] 166 B.R. 677 (Bankr.C.D.Ill.1994).

[18] *In re S.N.A. Nut Co.*, 191 B.R. at 119 (citing *Thomas*, 166 B.R. at 680).

[19] Pommer & Friedman, *supra* note 8, at 257 n.70 (citing *Stewart Foods Inc. v. Boecker*, 64 F.3d 141 (4th Cir.1995)).

[20] Marielle Wakim, *Going For Broke: Is Los Angeles Headed in the Same Direction as Detroit*, LOS ANGELES MAGAZINE (July 25, 2013), http://www.lamag.com/citythink/citythinkblog/2013/07/25/going-for-broke-is-los-angeles-headed-in-the-same-direction-as-detroit; *See alsoLos Angeles on the Brink of Bankruptcy*, WALL STREET JOURNAL (May 5, 2010),http://online.wsj.com/article/SB10001424052748704608104575218392603082622.html.

Surety Casenotes

By: Kenneth Rockenbach, Liberty Mutual Surety, Duluth, GA

Indemnitor's Challenge to Personal Jurisdiction Fails; Allows Federal Action Despite Prior State Court Action Against Indemnitors

Hartford Cas. Ins. Co. v. Farley Associates, Inc., 2013 WL 3746016 (D.S.C. July 15, 2013).

Surety brought indemnity action against bond principal and six individual indemnitors after suffering losses. The District Court issued an opinion upon consideration of motions to dismiss filed by the indemnitors.

The first motion to dismiss was brought by an individual indemnitor alleging that the South Carolina court lacked personal jurisdiction over her. She alleged in the motion that she never participated in the business or financial decisions of the bond principal. Surety defended the motion to dismiss based on the following: (1) the indemnitor was an officer of the bond principal and that company had its principal place of business in South Carolina; (2) the indemnitor signed the GIA in South Carolina; (3) the signing of the GIA made her party to a contract to be performed in South Carolina; and (4) the indemnitor owns and receives income from a vacation home in South Carolina.

The Court rejected the motion to dismiss as it found that as a result of signing the GIA, the indemnitor "represented that she had a substantial interest in issuance of these bonds and in the underlying transactions guaranteed by the bonds." Additionally, the Court noted that the signing of the GIA in South Carolina provided further support for the finding of personal jurisdiction.

All of the indemnitors filed a second motion to dismiss that requested the Court to abstain from consideration of the case based on the *Colorado River* Abstention doctrine. The basis for this claim was that Surety had filed a prior state court action against the bond principal seeking injunctive and monetary relief under a single conversion claim. Ultimately, the Court rejected the second motion to dismiss as it found that the federal court action had "significantly greater breadth" which precluded a finding that the two actions address substantially the same parties and issues.

Attempted Delivery of Miller Act Notice Defeats Surety's Motion

U.S. ex rel. P-1 Contracting, Inc. v. Quandel Group, Inc., 2013 WL 2243960 (W.D. Oh. May 21, 2013).

Plaintiff brought suit under the Miller Act against Surety and Bond Principal. The Court issued an opinion on Surety's and Principal's motion for judgment on the pleadings under Fed. R. Civ. P. 12(c).

The Court noted that a motion for judgment on the pleadings can be granted "when, taking all well-pleaded allegations in the complaint as true, 'no material issue of fact exists and the party making the motion is entitled to judgment as a matter of law.'"

Plaintiff was a lower tier claimant as it provided demolition services to a subcontractor on the project. According to the allegations of the complaint, Plaintiff stopped working on the project on December 19, 2011 after not receiving payment from the subcontractor. Neither party disputed that Plaintiff was required to deliver notice on or before March 19, 2012. From the complaint, Plaintiff indicated that it sent notice via certified mail before the deadline. Additionally, the postal service left a notice of attempted delivery at the bond principal's office on March 15, 2012 (four days before the deadline) but the actual letter was not delivered until March 22, 2012 (three days after the deadline). Based on these facts, Bond Principal and Surety moved for judgment as the required notice was not delivered within the 90 day statutory window.

Defendants relied on the decision in *Pepper Burns Insulation, Inc. v. Artco Corp.*, 970 F.2d 1340 (4th Cir. 1992), which held that merely mailing the notice within the 90 day

window is not enough to preserve a lower tier claimant's claim against the bond.

The Court ultimately denied the motion for judgment on the pleadings as it found the *Pepper Burns* decision to be distinguishable. In the instant case, there was evidence that the postal service actually attempted delivery before the expiration of 90 days. The Court noted that "to that end, [Principal] had some control over whether it timely received [Plaintiff's] notice of its claim on the payment bond." The Court held that "the Miller Act's notice requirement was satisfied in light of the facts of this case. This finding comports with the Supreme Court's directive to give the Miller Act 'a reasonable construction in order to effect its remedial purpose.'"

Miller Act Statute of Limitations Ruled To Be a Claims-Processing Rule

U.S. ex rel. Air Control Technologies, Inc. v. Pre Con Industries, Inc., 720 F.3d 1174 (9th Cir. 2013).

The Ninth Circuit considered an appeal of a District Court's dismissal of Plaintiff's complaint on Surety's motion to dismiss. The District Court dismissed the complaint based on the Miller Act's one year statute of limitations.
From the facts of the complaint Plaintiff was fired from the project in November, 2009 by Principal. Subsequent to that, Principal rented Plaintiff's equipment for completion of the work. Plaintiff filed its suit on March 14, 2011 alleging: (1) breach of contract; (2) quantum meruit; and (3) a Miller Act claim. Plaintiff alleged federal question jurisdiction over the Miller Act claim and supplemental jurisdiction over the state law causes of action. Defendants moved for a motion to dismiss for lack of subject matter jurisdiction based on the Miller Act's one year statute of limitations. As is proper under a FRCP 12(b)(1) motion to dismiss, Defendants submitted supporting materials outside of the complaint which they asserted supported the jurisdictional defense. The District Court agreed with the Defendants and found that there was no demonstration by Plaintiff that it performed labor or provided materials within one year of filing its suit.

The Circuit Court overturned the District Court's granting of the motion to dismiss. The Court noted that there is currently an intra-Circuit split as to the effect of a plaintiff's failure to meet the Miller Act's one year statute of limitations. The Court also noted recent Supreme Court precedent which held that "unless Congress has 'clearly state[d]' that the statutory limitation is jurisdictional, 'courts should treat the restriction as nonjurisdictional in character.'"

The Court held that "a proper analysis of the Miller Act's statute of limitations makes clear that it is a claim-processing rule, not a jurisdictional requirement." In support of this finding, the Court noted that the Miller Act one year limitation does not speak in jurisdictional terms. "Neither the word 'courts' nor 'jurisdiction' appears in the section, which implies that §3133(b)(4) is a 'restriction on the rights of plaintiffs to bring suit, rather than a limitation on the power of the federal courts to hear the suit.'" Further, the Court noted that it was unlikely Congress intended the Miller Act's statute of limitations to be a jurisdictional requirement given the Act's highly remedial purpose.

The Court also noted that the District Court could not have granted the Motion to Dismiss under FRCP 12(b)(6) for failure to state a claim. That motion would force a different consideration as it could only be granted "when the running of the statute of limitations is apparent on the face of the complaint." The Court noted that the Complaint did not contain any information that would have allowed the District Court to make the timing determination.

Indemnitor Defeats Summary Judgment Through Challenge to GIA Signature

Hartford Fire Ins. Co. v. ABC Paving Co., 2013 WL 3213096 (S.D. Mich. June 26, 2013).

Surety filed indemnity complaint against ABC Paving Company, ABC Asphalt Paving Company, Inc., Michigan Road Maintenance Company, LLC, Thomas Morrison and Donna Morrison. The Court issued an opinion on Surety's Motion for Summary Judgment and Donna Morrison's cross-motion for summary judgment. Donna Morrison sought a summary judgment denying Surety's claims based on her allegation that she never signed the General Agreement of Indemnity.

The Court found that the GIA bore the purported signatures of both Mr. and Mrs. Morrison. The GIA signatures were notarized and indicated that both individuals signed the document on February 20, 2010. Mrs. Morrison disputed her liability under the GIA as she alleges that her signature was forged. She provided evidence that indicated she was out of the state on February 20, 2010 and sought to have the court consider expert testimony comparing her signature with the one on the GIA.

The Court granted Surety's summary judgment as to Mr. Morrison and the corporate entities. While the Court refused to consider Mrs. Morrison's expert's testimony due to a lack of timely designation, the Court found that there were questions of fact which precluded a summary judgment against Mrs. Morrison.

The Court noted that Mr. Morrison invoked his Fifth Amendment rights in refusing to testify regarding Mrs. Morrison's signature on the GIA. Additionally, while the notary seal is generally "presumptive evidence of the facts contained in the certificate," the presumption may be invalidated by the court when the notarial act was not performed as required by statute. Ultimately, the Court concluded that the issue of the validity of Mrs. Morrison's signature was one that had to be determined by a trier of fact.

Fidelity Casenotes

By: Adam Friedman, Wolff & Samson PC, New York, NY and West Orange, NJ

Direct Loss

New Hampshire Insurance Co. v. MF Global, Inc., 108 A.D.3d 463, 970 N.Y.S.2d 16 (N.Y.A.D. 1st Dep't 2013).

New York's appellate court examined whether a fidelity bond issued by plaintiff New Hampshire Insurance Company to the defendant (MF Global), a commodities futures broker, provided coverage for losses stemming from a commodities broker's conduct. The commodities broker, who was paid on a commission basis, began trading commodities futures from his personal trading account using his company's electronic trading system. The trades were not profitable and when the broker liquidated his positions, he sustained a loss of over $141 million. MF Global paid $150 million to the Chicago Mercantile Exchange Clearing House to cover the loss and submitted a claim under the bond. New Hampshire denied coverage, asserting that the company did not suffer a "direct financial loss" and that the broker was not an "employee".

The bond defines "loss" as "the direct financial loss sustained by [MF Global] as a result of any single act, single omission or single event, or a series of related or continuous acts, omissions or events." The court, without meaningful analysis, held that a "direct loss" for insurance purposes "has been analogized with proximate cause." The Court concluded that the broker's conduct was "the direct and proximate cause" of the company's loss. It further found, however, that issues of fact existed as to whether the broker was an employee under the language of the bond, which defined an employee as "(i) a person under an implied contract of employment or services with the insured; (ii) a person working under the direct control and supervision of the insured; or (iii) a person who is paid by the insured under their payroll system" and excluded an independent broker "remunerated on a sales or commission basis unless specifically agreed by the insurer and endorsed to this bond." The court granted partial summary judgment to MF Global to the extent of declaring that MF Global sustained a "direct financial loss" under the bond, but held that fact issues precluded summary judgment as to whether the broker was the insured's employee.

Employee Theft/Dishonesty

Guyan International, Inc. v. Professional Benefits Administrators, Inc., 2013 WL 1338194 (N.D. Ohio Mar. 29, 2013).

Permco retained third-party administrator PBA to administer Permco's self-funded employee benefit plan and to pay Permco's employees' health benefit claims. PBA was required to have a bond or insurance to

administrate ERISA plan funds, and so PBA obtained coverage from Federal Insurance Company to comply with the ERISA bonding requirements. Permco learned that PBA had not paid health benefit claims and could not account for Permco plan funds. Permco sought to recover its financial losses from the Federal policy. Federal denied the claim, and both parties ultimately sought summary judgment. Federal argued that no employee diverted the plan funds; rather, the losses were due to PBA's "general business practices" and, therefore, the losses did not constitute "theft" by an "employee." Federal also argued that the Board chairman, who directed PBA's diversion, did not qualify as an "employee" under the policy either. The Ohio federal court held that the plaintiffs' losses constituted "theft" under the Federal policy because the term included fraudulent, dishonest or criminal conduct. Further, the court found that acts of multiple PBA "employees" resulted in the theft and thus the fact that the chairman was not an employee was not determinative. Accordingly, the court denied Federal's motion for summary judgment and granted the plaintiffs' motion for summary judgment against Federal.

Exclusions

Seaway Community Bank v. Progressive Casualty Insurance Co., --- F. App'x ----, 2013 WL 4017128 (6th Cir. 2013).

Seaway's customer deposited checks drawn on a Canadian bank. Unbeknownst to Seaway, the checks had been altered to change the name of the payee to Seaway's customer. After Seaway's customer withdrew the proceeds of the checks, the Canadian bank declined to pay them and returned them to Seaway, causing Seaway a loss of approximately $375,000. Seaway asserted a claim against its Financial Institution Bond with Progressive. Progressive denied coverage under exclusion "(o)", which excluded from coverage losses resulting from checks that are not finally paid, for any reason, and Seaway sued. The lower court granted Seaway's motion for judgment on the pleadings. On appeal, the Sixth Circuit affirmed, stating that "finally paid" has a clear meaning in the banking industry consistent with the UCC's midnight deadline rule. Accordingly, the court held that the checks were "finally paid" since they were not returned by the Canadian bank before the UCC's midnight deadline, even though the UCC's midnight deadline did not apply to the Canadian bank. The court said that it had to consider the exclusion strictly, and that the exclusion did not contain any indication that "finally paid" should have a different meaning for checks drawn on Canadian banks.

LEGISLATIVE UPDATE

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

There was a significant amount of activity in the state legislatures this year relating to public private partnerships and commercial licensing bonds. For example, California, Florida, and Maryland all passed public private partnership laws that will require some form of surety bonds for the construction portions of the public private partnership agreement. In terms of commercial licensing bonds, Illinois and North Carolina amended their mortgage loan originator licensing bond requirements to reach individuals that may have been exempted under the previous law. Delaware passed an appraisal management license bond requirement and Minnesota passed a law requiring medical equipment suppliers to be bonded. Also, in the past few sessions, we have seen a decrease or elimination of public official bonds; however, this year Tennessee increased most of its public official bond amounts. Below you will find brief summary of the bills noted above as well as a sampling of additional surety legislation adopted during the 2013 legislative sessions. For complete details please see the statutory section or bill number identified in the text and footnotes below.

California

Public Private Partnership

A.B. 164[1] requires a lease agreement between a governmental agency undertaking an infrastructure project and a private entity to include performance and payment bonds. The payment bonds must conform to Cal. Civ. Code §§9550 – 9566 (Public Work Improvement/Payment Bonds). Prior to enactment of A.B. 164, Cal. Govt. Code §5956.6 generically required "security" to guarantee the completion of the project.

Delaware

Appraisal Management License Bond

Delaware passed a law requiring that any person that directly or indirectly engages in or attempts to engage or advertises or holds itself out as engaging in business as an appraisal management company, or to perform appraisal management services, must be registered by the Council on Real Estate Appraisers. Registration requires a written application that, among other items, includes proof of a $20,000 surety bond.[2]

Florida

Public Private Partnership

H.B. 85[3] allows a public private partnership (PPP) for qualifying projects. A qualifying project is "a project that (1) serves a public purpose including, but not limited to, any ferry or mass transit facility, vehicle parking facility, airport or seaport facility, rail facility or project, fuel supply facility, oil or gas pipeline, medical or nursing care facility, recreational facility, sporting or cultural facility, or education facility or other building or facility that is used or will be used by a public education institution, or any other public facility or infrastructure that is used or will be used by the public at large or in support of an accepted public purpose or activity; (2) is an improvement, including equipment, of a building that will be used by a public entity or the public at large or that supports a service delivery system in the public sector; (3) is a water, wastewater, or surface water management facility or other related infrastructure project; or (4) [is a project that the governing board designates as qualifying and involves] a facility owned or operated by the governing board of a county, district, or municipal hospital or health care system, or projects that involve a facility owned or operated by a municipal electric utility." The public entity responsible for the project must ensure that the PPP agreement provides for performance and payment security for subcontractors. This can be accomplished through surety bonds, letters of credit, parent company guarantees, and lender and equity partner guarantees. However, for those portions of the project that involve construction, performance and payment bonds are required and are subject to the requirements of Florida Stat. §255.05. The bill also creates the "Partnership for Public Facilities and Infrastructure Act Guidelines Task Force" (Task Force). This Task Force will recommend guidelines for the legislature to consider when creating a uniform process for establishing a PPP.

Georgia

Competitive/Sealed Bid Bonds

A new law[4] has been enacted in Georgia that will prevent a bidder from being disqualified from a bid or proposal or denied prequalification based upon a lack of previous experience with a job of the size for which the bid or proposal is being sought, so long as: (1) the bid or proposal is not more than 30% greater in scope or cost from the bidder's previous experience in jobs; (2) the bidder has experience in performing the work sought; and (3) the bidder is capable of being bonded by a surety which meets the qualifications of the bid document for a bid bond, a performance bond, and a payment bond as required by the public agency.

[1] Cal. Gov't. Code § 5956.6.

[2] Del. Code tit. 24, § 4022 (S.B. 38).

[3] Florida Stat. §§ 287.05712 and 336.71 (Effective – 07/01/2013).

[4] Ga. Code §§13-10-4 and 36-91-23 (S.B.168, effective – 04/24/2013).

Illinois

Mortgage Loan Originator

Under the Residential Mortgage License Act of 1987, a federally chartered savings bank is exempt from licensure to engage in the business of brokering, funding, originating, servicing or purchasing residential mortgage loans. S.B. 1667[5] allows an exempt federally chartered savings bank that is registered with the Nationwide Mortgage Loan Licensing System and Registry (NMLLSR) to apply for an exempt company registration to sponsor one or more individuals subject to the mortgage loan originator licensing requirements so long as certain requirements are met. Among those requirements such exempt federally chartered savings bank must provide is a blanket surety bond in a penal sum that reflects the amount of loans originated and shall cover the activities of all its sponsored mortgage loan originators.

Maine

Driver Education School License Bond

Licensed driver education schools will now be required to obtain a surety bond to guarantee the performance of the duties require under Subchapter 3 of Title 29-A. The amount of the bond is not specified.[6]

Maryland

Subcontractor Bonding

The Maryland legislature passed a law[7] that prohibits a prime contractor from implementing more stringent bonding requirements than required by Maryland law. Therefore, if a prime contractor requires a subcontractor to provide a bid, performance, or payment bond on a procurement contract for services, supplies or construction–related services, the prime contractor must accept the bond so long as the bond would be accepted by Maryland and is provided by a surety company authorized to do business or by the Maryland Small Business Development Financing Authority. In addition, in a solicitation or pre-bid conference for a procurement contract for services, supplies, or construction related services, the procurement agency must provide notice to all bidders that security should be: (a) a bond provided by a surety company authorized to do business in the state; (2) a bond provided by an individual surety that meets the requirements of Maryland law; (3) cash; or (4) another form of security authorized by federal or state regulation or that is satisfactory to the procurement agency.

Public Private Partnership

Maryland also passed a public private partnership (PPP) bill this year[8]. The bill requires performance and payment security in an amount and form to be determined by the public entity responsible for the public project. Requirements for the payment security for construction contracts must be in accordance with Title 17, Subtitle 1 of the State Government Article. This includes a requirement that payment security shall be established on the value of the construction elements of the PPP agreement and not on total value of the PPP partnership agreement.

Minnesota

Medical Equipment Supplier Bond

Upon initial enrollment, reenrollment, and revalidation, all durable medical equipment, prosthetics, orthotics, and supplies suppliers operating in Minnesota must obtain a surety bond. The amount of the performance bond for initial enrollment and reenrollment is $50,000. If the bond is for a revalidating provider, than the amount can vary depending on the amount of Medicaid revenue received by the supplier. So, if the Medicaid revenue for the previous calendar year is $300,000 or less, then the bond shall be for $50,000; however, if the Medicaid revenue exceeds $300,000, then the amount of the bond shall be $100,000. The performance bond must allow for recovery of costs and fees

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[5] 205 ILCS 635/1-3(a-1) (Effective – 8/16/13).

[6] Me. Rev. Stat tit. 29-A, § 1354(10) (S.P. 494).

[7] Md. Code State Fin & Proc. § 13-227 (H.B. 585/S.B. 599, effective – 07/01/2013).

[8] Md. Code State Fin & Proc. §§ 10A-101, 10A-102 through 10A-105, 10A-102, 11-203, 10A-201 through 10A-204, 10A-301, 10A-401 through 10A-403; Md. Code Transp. § 4-406 (H.B. 560/S.B. 538 effective – 07/01/2013).

in pursuing a claim on the bond and shall designate the Minnesota Department of Human Services as the obligee. The form of the bond shall be approved by the Governor. A provider may also be required to obtain a performance bond under certain enumerated instances.[9]

North Carolina

Transitional Mortgage Loan Originator License Bond

H.B. 616[10] amends the secure and fair enforcement mortgage licensing act to provide for the licensure of transitional mortgage loan originators. A transitional mortgage loan originator is authorized to act as a mortgage loan originator for a term of no more than 120 days and is not subject to license reapplication, renewal, or extension. A transitional mortgage loan originator will be subject to the same surety bond requirements as a mortgage loan originator. The amount of the bond is outlined in N.C. Gen. Stat. §53-244.103(b) and ranges from $75,000 to $500,000 depending on the amount of the mortgage loans the broker, lender or servicer have originated.

Tennessee

Good and Solvent Bond Definition

Existing Tennessee law requires contractors entering into public works contracts with city, county and state authorities to provide "good and solvent bonds." The legislature adopted S.B. 647/H.B. 219[11] to provide a definition for a "good and solvent bond." Such a "good and solvent bond" is a bond written by a surety or insurance company listed on the United States Treasury Department (Treasury) list of approved bonding companies and in an amount that does not exceed the approved amount indicated for the surety or insurance company. In addition, the surety or insurance company shall be licensed and authorized to do business in Tennessee. Any bond not in compliance with this definition shall be considered null and void as against public policy and shall be rejected by the building or bidding authority.

Public Official Bond

The Tennessee legislature amended many of its public official bond requirements this session. For instance, the tiered amount of the public official bond for county trustees is amended. If the bond is executed by an authorized surety company the bond shall be in the amount of 4% up to $3,000,000 of the funds collected by the office and 2% of the excess over $3,000,000. Prior to S.B.135/H.B.100[12] the amount of the bond started at a base of $5,000 and had a range between 2% and 10% depending on the amount of funds collected. If the bond is executed by a personal surety the bond shall be in the amount of 6% up to $3,000,000 of the funds collected by the office and 4% of the excess over $3,000,000 shall be added. Prior to these amendments the base bond was also at $5,000 and had a range between 4% and 10%. In addition, the amount of the public official bond for county mayors was amended by eliminating the tiered amount of the bond as determined by county population and replacing that with a flat $100,000 bond. The bond amount for county registrars is also increased. The registrar must provide a bond in the amount of $50,000 where the county population is less than 15,000 and $100,000 in counties where the population is 15,000 or more. Prior to these amendments the bonds amounts were $15,000 and $25,000 respectively. The minimum amount of the corporate surety bond required of the county director of accounts is increased from $10,000 to $100,000 and the amount for the county purchasing agent is changed from a range of $10,000-$25,000 to a flat $100,000. The blanket bond for the director of the county financial management committee is increased from $50,000 to $100,000. Every clerk of court except for the clerk of the Supreme Court and chief deputy clerks of the Supreme Court must

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[9] Minn. Stat. § 256B.04 (H.F. 1233/S.F. 1664).

[10] N.C. Stat. Gen. Stat. § 53-244.103 (Effective – 09/01/2013).

[11] Tenn. Code § 12-4-201(a) (Effective – 04/23/2013).

[12] This is an omnibus act, which revises several laws. *See* Tenn. Code §§ 8-19-102; 8-19-115; 8-11-102; 8-11-103; 5-6-109; 8-8-103; 8-13-102; 8-13-103; 5-13-103; 5-14-103; 5-21-109; 18-2-201; 18-2-205; 49-3-315; 9-3-301; 7-86-119; 7-86-119; 8-19-203; 8-19-208; 13-14-114; 13-14-114; 13-26-110; 8-19-122; 8-19-101.

provide either a $50,000 bond or $100,000 bond depending on the size of the county population. The bond amount for the county official vested with the authority to administer state-shared funds is increased from $50,000 to $100,000. The bond amounts were also increased for board members, executive committee members, employees, officers and any other authorized person of an emergency communications district, development district, or human resource agency who has the authority to make expenditures from or has access to public funds. The bonds issued required by Title 8 shall not be renewed, but instead a new bond shall be furnished. County governments are also now required to obtain and maintain blanket surety bonds for all county employees not covered by individual bonds referenced in the statue. The minimum for this blanket bond is $150,000.

Texas

Nursing Facility Medicaid Beds

The executive commissioner of the Health and Human Services Commission may, by rule, require an applicant for Medicaid beds in a nursing facility under a Medicaid bed waiver application to provide a performance bond in an amount of $500,000. The Department may allow other methods of financial security. The bond is intended to ensure that the applicant provides the Medicaid beds granted to the applicant under the waiver within the required time frame. The bond shall be executed by a corporate surety and be in a form approved by the department.[13]

[13] Tex. Health & Safety Code § 32.0213 (H.B. 3196, effective – 09/01/2013).

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