

COMMITTEE NEWS

Fidelity & Surety Law

Dealing With The Construction Impacts Of COVID-19

During this time of global pandemic, contractors and their sureties are facing familiar challenges, such as material shortages and labor inefficiency, but at levels unprecedented in scope and duration, as well as unique challenges in the form of stay-at-home orders and government shutdowns of construction work deemed “non-essential” business. This article addresses some of the issues that the surety industry will need to consider in order to navigate the inevitable contractor failures and increased bond claims arising from the impacts of COVID-19 on the construction industry.

I. KEY CONTRACT TERMS ADDRESSING ENTITLEMENT TO SCHEDULE RELIEF AND DELAY AND OTHER DAMAGES

A. Introduction

Given the small profit margin of many construction contracts, a significant number of contractors may not be able to withstand the financial impact of COVID-19.

[Read more on page 19](#)



Michael A. Stover,
Cynthia E. Rodgers-Waire
Thomas J. Moran

Wright, Constable & Skeen

Michael A. Stover and Cynthia E. Rodgers-Waire are partners of Wright, Constable & Skeen’s Baltimore, Maryland office; and Thomas J. Moran is a partner in its Richmond, Virginia office.



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Chair Message

Dear FSLC Members,

I want to thank the editors and authors who have made this newsletter possible. They have done a tremendous job and I know you will find the articles included herein to be of great interest to you.

This spring has brought difficulties to us all, and unfortunately much grief to some. What has helped me carry on through these dark times are the relationships I have with my friends and colleagues in this organization. Within hours of the shelter in place orders, emails began flying across the country. Friends and colleagues were sending notes checking on one another's wellbeing, information regarding orders in places where one may have business commitments and summaries of FAR provisions, state statutes and case law on the impact of an events such as this. Maps, compasses, deck hands and oars providing whatever assistance available in these uncharted waters. No one could witness the way our members responded and continue to respond and not be amazed.

Unfortunately, the pandemic has prevented us from holding our Spring Meeting this year. I know we were all looking forward to both Lake Tahoe and the program "Surety Aspects of Bankruptcy Law and Practice". While we cannot do anything about Lake Tahoe, we can assure you that you will have the opportunity to attend the wonderful program put together by Chad Schexnayder and Michael Collins next spring in Scottsdale, AZ!

Finally, I would like to take this opportunity to thank all of you for allowing me the wonderful experience of chairing this committee. It has truly been an honor and a pleasure. ➤

Regards,
Darrell Leonard



Darrell Leonard

*Zurich American Insurance
Company*

*Chair, ABA TIPS Fidelity and Surety
Law Committee*

Staff Editors

Jonathon C. Burwood

Jeffrey Grossman

Krysta K. Gumbiner

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Member Roster

Chair

Darrell Leonard
Zurich
11074 Inspiration Cir
Dublin, CA 94568-5530
(800) 654-5155 EXT 2
Fax: (800) 329-6105
darrell.leonard@zurichna.com

Chair-Elect

Chad Schexnayder
Jennings Haug & Cunningham LLP
2800 N Central Ave, Ste 1800
Phoenix, AZ 85004-1049
(602) 234-7830
Fax: (602) 277-5595
CLS@JHC.Law

Immediate Past Chair

Brett Divers
Mills Paskert Divers
100 N Tampa St, Ste 3700
Tampa, FL 33602-5835
(813) 2293500
Fax: (813) 229-3502
bdivers@mpdlegal.com

Diversity Vice-Chair

David Bresel
Zurich
1205 Pierce St
Omaha, NE 68108
dbresel@gmail.com

Membership Vice-Chair

Carol Smith
Dysart Taylor
4420 Madison, Ste 200
Kansas City, MO 64111
(816) 931-2700
Fax: (913) 317-9100
csmith@dysarttaylor.com

Technology Vice-Chairs

James Breckenridge
Levy Craig Law Firm
4520 Main Street, Ste 1600
Kansas City, MO 64111
(816) 460-1839
jbreckenridge@levycraig.com

Brian Rice
45-18 Court Square, Ste 60
Long Island City, NY 11101
(646) 553-3500
brice@optistartech.com

Council Representative

Sam Poteet
Manier & Herod
1201 Demonbreun St, Ste 900
Nashville, TN 37203--3140
(615) 742-9321
Fax: (615) 242-4203
spoteet@manierherod.com

Scope Liaison

Ronald Richman
Bullivant Houser Bailey PC
101 Montgomery St, Ste 2600
San Francisco, CA 94104
(415) 352-2722
Fax: (415) 352-2701
ron.richman@bullivant.com

Newsletter Editors-in-Chiefs

Omar Harb
Lipson Neilson P.C.
3910 Telegraph Road, Ste 200
Bloomfield Hills, MI 48302
(248) 282-8111
Fax: (248) 593-5040
oharb@lipsonneilson.com

Todd Braggins
Ernstrom & Dreeste LLP
925 Clinton Sq
Rochester, NY 14604-1708
(585) 473-3100
Fax: (585) 473-3113
tbraggins@ed-llp.com

Beth Rotenberg
Crum & Forster
305 Madison Ave
Morristown, NJ 07960
(973) 490-6574
Beth.Rotenberg@cfins.com

John Sebastian
Watt Tieder Hoffer & Fitzgerald LLP
10 S Wacker Dr, Ste 2935
Chicago, IL 60606-7411
(312) 219-6900
Fax: (312) 559-2758
jsebastian@watttieder.com

Newsletter Executive Editor

Christopher Ward
Clark Hill Strasburger
2600 Dallas Parkway, Ste 600
Frisco, TX 75034-1872
(214) 651-4722
Fax: (214) 659-4108
christopher.ward@strasburger.com

Vice-Chairs

Christina Craddock
Liberty Mutual Group
2055 Sugarloaf Cir, Ste 300
Duluth, GA 30097-4363
(678) 4173913
Fax: (855) 318-4099
Christina.Craddock@LibertyMutual.com

Jennifer Fiore
Dunlap Fiore LLC
6700 Jefferson Highway, Building 2
Baton Rouge, LA 70806
(225) 282-0652
Fax: (225) 282-0680
jfiore@dunlapfiore.com

David Harris
Bovis, Kyle, Burch & Medlin, LLC
200 Ashford Center North, Ste 500
Atlanta, GA 30338
(678) 3383931
dah@boviskyle.com

John McDevitt
Liberty Mutual Group
175 Berkeley St
Boston, MA 02116-5066
(617) 243-7918
Fax: (866) 547-4882
john.mcdevitt@libertymutual.com

Patricia Wager
Torre Lentz Gamell Gary & Rittmaster LLP
100 Jericho Quadrangle, Ste 309
Jericho, NY 11753-2702
(516) 240-8969
Fax: (516) 240-8950
pwager@tlggr.com

James Keating
Allied World Insurance Company
30 South 17th St, 16th Fl
Philadelphia, PA 19103
(267) 800-1819
jamesandrewkeating@hotmail.com

Leigh Henican
Gray Casualty & Surety Company
1225 West Causeway Approach
Mandeville, LA 70471
(504) 780-7440
lhenican@graysurety.com

James Knox
Zurich Insurance Group
369 Panorama Circle
Pottsboro, TX 75076
(708) 4042170
Fax: (312) 627-1717
james.knox@zurichna.com

Rebecca Farina
Zurich North America
1299 Zurich Way
Schaumburg, IL 60196-1056
(213) 952-6645
becky.farina@zurichna.com

Ryan Delaune
Clark Hill Strasburger
901 Main St, Ste 6000
Dallas, TX 75202-3729
(214) 651-2115
ryan.delaune@strasburger.com

Todd Kazlow
Kazlow & Fields LLC
8100 Sandpiper Cir, Ste 204
Baltimore, MD 21236-4999
(410) 8259644
Fax: (410) 825-6466
todd@kazlowfields.com

Justin Wear
Manier & Herod
1201 Demonbreun St, Ste 900
Nashville, TN 37203
(615) 244-0030
Fax: (615) 242-4203
jwear@manierherod.com

Cynthia Rodgers-Waire
Wright Constable & Skeen LLP
7 St Paul St, Fl 18
Baltimore, MD 21202
(410) 659-1310
Fax: (410) 659-1350
crodgers-waire@wclsaw.com

John Sebastian
Watt Tieder Hoffer & Fitzgerald LLP
10 S Wacker Dr, Ste 1100
Chicago, IL 60606-7485
(312) 2196900
Fax: (312) 559-2758
jsebastian@watttieder.com



Member Roster | continued

Richard Towle

20 Locktown Sergeantsville Rd
Stockton, NJ 08559-1119
(908) 605-3010
Fax: (908) 903-3030
rtowle@chubb.com

Amy Bentz

Bentz Law Firm PC
680 Washington Rd, Ste 200
Pittsburgh, PA 15228
(412) 563-4500
Fax: (412) 563-4480
aebentz@bentzlaw.com

Richard Baudouin

Krebs Farley PLLC
400 Poydras St, Ste 2500
New Orleans, LA 70130-3224
(504) 299-3570
Fax: (504) 299-3582
rbaudouin@kfplaw.com

Ty Thompson

Mills Paskert Divers
100 N Tampa St, Ste 3700
Tampa, FL 33602-5835
(813) 229-3500
Fax: (813) 229-3502
tthompson@mpdlegal.com

Shannon Briglia

Smith Currie & Hancock LLP
1950 Old Gallows Rd, Ste 750
Tysons, VA 22182-4014
(703) 506-1990
Fax: (703) 506-1140
sjbriglia@smithcurrie.com

Luke Busam

Frost Brown Todd LLC
301 E 4th St, Ste 3300
Cincinnati, OH 45202-4257
(513) 651-6157
Fax: (513) 651-6981
lbusam@fbtlaw.com

Thomas Vollbrecht

333 S Seventh St, Ste 2600
Minneapolis, MN 55402
(612) 359-7659
tvollbrecht@fwhlta.com

Douglas Wills

Chubb
436 Walnut Street, WA10A
Philadelphia, PA 19106
(215) 6401835
Fax: (908) 903-5537
dwills@chubb.com

Melissa Lee

Manier & Herod
1201 Demonbreun St, Ste 900
Nashville, TN 37203-3140
(615) 742-9372
Fax: (615) 242-4203
mlee@manierherod.com

Michael Weber

Dinsmore & Shohl LLP
222 W Adams St, Ste 3400
Chicago, IL 60606
(312) 775-1742
Fax: (312) 372-6085
michael.weber@dinsmore.com

Michael Hurley

Berkley Surety
412 Mount Kemble Ave, Ste 310N
Morristown, NJ 07960-6669
(973) 775-5040
Fax: (973) 775-5204
mhurley@berkleysurety.com

Susan Karlan

ICW Group - OPRS
15025 Innovation Dr
San Diego, CA 92128
(858) 3507213
Fax: (858) 350-2640
skarlan@icwgroup.com

Marc Domres

2349 S Summit Cir Glen
Escondido, CA 92026
(760) 310-5456
domres@gmail.com

Amy Bernadas

1339 East Second St
Pass Christian, MS 39571
(504) 299-3570
Fax: (504) 299-3582
amy.bernadas@zurichna.com

JoAnne Bonacci

Dreifuss Bonacci & Parker PC
26 Columbia Tpke, Ste 101
Florham Park, NJ 07932
(973) 514-1414
Fax: (973) 514-5959
jbonacci@dbplawfirm.com

Lee Brewer

Bryan & Brewer LLC
355 E Campus View Blvd
Ste 100
Columbus, OH 43235-5616
(614) 228-6131 EXT 203
Fax: (614) 890-5638
lbrewer@bryanandbrewer.com

Jeffrey Frank

Lipson Neilson P.C.
3910 Telegraph Road, Ste 200
Bloomfield Hills, MI 48302
(248) 593-5000 Ext 168
Fax: (248) 593-5040
jfrank@lipsonneilson.com

Frederick Zauderer

AXIS Capital
1211 Ave of The Americas, 24th Fl
New York, NY 10036
(908) 508-4370
Fax: (908) 508-4389
fred.zauderer@axiscapital.com

Bogda Clarke

Nationwide Insurance
250 Greenwich St, Fl 37
New York, NY 10007-2140
(732) 759-1011
Fax: (732) 805-2395
bogda.clarke@nationwide.com

Gregory Weinstein

Weinstein Radcliff Pipkin LLP
8350 North Central Expy, Ste 1550
Dallas, TX 75206
(214) 865-6126
Fax: (214) 865-6140
gweinstein@weinrad.com

Kyle Murphy

IAT Insurance
5 Park Center Ct, Ste 300
Owings Mills, MD 21117-4203
(443) 660-7377
Fax: (732) 559-7171
kyle.murphy@iatinsurance.com

Patrick Hustead

The Hustead Law Firm
4643 S Ulster St, Ste 1250
Denver, CO 80237-4307
(303) 721-5000
Fax: (303) 721-5001
pqh@thlf.com

Christopher Ward

Clark Hill Strasburger PLC
2600 Dallas Parkway, Ste 600
Frisco, TX 75034-1872
(214) 651-4722
Fax: (214) 659-4108
christopher.ward@clarkhillstrasburger.com

Hilary Hoffman

Chubb
150 Allen Road, Ste 101
Basking Ridge, NJ 07920
(908) 605-3117
hhoffman@chubb.com

Bruce Echigoshima

Liberty Mutual Group
23281 NE 17th St
Sammamish, WA 98074-4447
(206) 545-5000
Fax: (866) 548-6837
bruech@safeco.com

Scott Spearing

Hermes Netburn O'Connor & Spearing PC
265 Franklin St, Fl 7
Boston, MA 02110-3113
(617) 728-0050
Fax: (617) 728-0052
sspearing@hermesnetburn.com

Michael Spinelli

Cashin Spinelli & Ferretti LLC
801 Motor Pkwy, Ste 103
Hauppauge, NY 11788-5256
(631) 680-3100
Fax: (631) 737-9171
mwspinelli@csfllc.com

Virginia Boyle

1425 Kershaw Drive
Raleigh, NC 27609
(610) 8582433
Fax: (610) 828-4684
virginia.boyle@libertymutual.com

Ryan Dry

Krebs Farley & Dry PLLC
909 18th St
Plano, TX 75074
(972) 737-2530
rdry@kfplaw.com

Robert Flowers

Travelers
1 Tower Sq, Ste S202A
Hartford, CT 06183-0001
(860) 277-7150
Fax: (860) 277-5722
rflowers@travelers.com

Melissa Gardner

Liberty Mutual Group
7900 Windrose Ave,
Mail Stop S19-0375
Plano, TX 75024
(469) 997-6756
Fax: (469) 227-8004
Melissa.Gardner01@LibertyMutual.com



Member Roster | continued

Stephanie Geer

Liberty Mutual Group
3471 Miller Farms Ln
Peachtree Corners, GA 30096
(515) 490-9127
scanfiel@gmail.com

Jeffrey Goldberg

SWISSRE
1450 American Lane, Ste 1100
Schaumburg, IL 60173-2276
(847) 273-1268
Fax: (847) 273-1260
jeff_goldberg@swissre.com

Ivette Gualdron

Zurich
236 Rue Landry Rd
Saint Rose, LA 70087-3666
(504) 471-2676
Fax: (504) 712-3507
ivette.gualdron@zurichna.com

Stacy Hipsak Goetz

Liberty Mutual Group
2815 Forbs Ave, Ste 102
Hoffman Estates, IL 60192-3702
(847) 396-7140
Fax: (866) 548-7309
stacy.hipsakgoetz@libertymutual.com

Brian Kantar

*Chiesa Shahinian
& Giantomasi PC*
Eleven Times Square
New York, NY 10036
(973) 530-2112
Fax: (973) 530-2312
bkantar@csglaw.com

Christina Kocke

Zurich North America
215 Savanna Drive
Luling, LA 70070
(504) 258-8509
tina.kocke@zurichna.com

Rosa Martinez-Genzon

Anderson McPharlin & Connors LLP
707 Wilshire Blvd, Ste 4000
Los Angeles, CA 90017-3623
(213) 236-1653
Fax: (213) 622-7594
rmg@amclaw.com

Robert O'Brien

Liberty Mutual Group
9450 Seward Rd
Fairfield, OH 45014-5412
(513) 867-3718
Fax: (866) 442-4060
robert.obrien@libertymutual.com

Scott Olson

Markel Surety
9737 Great Hills Trl, Ste 320
Austin, TX 78759-6418
(512) 732-0099
Fax: (512) 732-8398
scott.olson@markel.com

Mary Jean Pethick

Zurich North America
600 Red Brook Blvd, Ste 600
Owings Mills, MD 21117
(610) 209-9794
mary.jean.pethick@zurichna.com

Derek Popeil

Chubb
150 Allen Road, Ste 101
Basking Ridge, NJ 07920
(908) 605-3009
Fax: (908) 903-5537
dpopeil@chubb.com

Denise Puente

*Simon Peragine Smith
& Redfearn LLP*
1100 Poydras St, Ste 3000
New Orleans, LA 70163-1129
(504) 569-2030
Fax: (504) 569-2999
denisep@spsr-law.com

Fred Rettig

State Farm Insurance
One State Farm Plaza, A-3
Bloomington, IL 61710-0001
(309) 766-5051
fred.rettig.c8f1@statefarm.com

Kenneth Rockenbach

Liberty Mutual Group
1001 4th Ave, 37th Fl
Seattle, WA 98154
1 (206) 4733350
Fax: (855) 318-4099
kenneth.rockenbach@libertymutual.com

Edward Rubacha

Jennings Haug & Cunningham LLP
2800 N Central Ave, Ste 1800
Phoenix, AZ 85004-1049
(602) 234-7800
Fax: (602) 277-5595
er@jhc-law.com

Shashauna Szczechowicz

Wolkin Curran LLP
402 West Broadway, Ste 400
San Diego, CA 92101
(415) 982-9390
Fax: (415) 982-4328
sszczechowicz@wolkincurran.com

Blake Wilcox

Liberty Mutual Group
1001 Fourth Ave, Fl 38
Seattle, WA 98154
(206) 473-3264
Fax: (425) 376-6533
blake.wilcox@libertymutual.com

Grace Winkler Cranley

Dinsmore & Shohl LLP
222 W Adams St, Ste 3400
Chicago, IL 60606
(312) 775-1744
Fax: (312) 372-6085
grace.cranley@dinsmore.com

Kimberly Zanotta

*Travelers Casualty & Surety
Company of America*
111 Schilling Rd
Hunt Valley, MD 21031
1 (443) 3532121
Fax: (410) 205-0605
kimz1@gmail.com

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THE BRIEF



Federal Circuit Determines Whether a Surety Has the Right to Settle its Principal's Affirmative Claims on Miller Act Contracts

A surety's indemnity agreement typically contains clauses providing that the principal assigns all of its rights and claims under a bonded contract to the surety and that the surety may act as the principal's attorney-in-fact in settling those claims. These assignment and attorney-in-fact provisions are often instrumental to a surety in its resolution of a disputed performance bond claim. Courts have long recognized the surety's right to its principal's assigned claims, applying traditional concepts of contract law.¹ However, in a recent case, *Guarantee Co. of North America v. Ikhana, LLC*, the Federal Circuit affirmed a limit to this long-held right under the surety's indemnity agreement when the surety has bonded a Miller Act contract.²

Although the Federal Circuit's decision in *Ikhana* precludes a surety, in particular circumstances, from settling out its principal's affirmative claims against the federal government, a well-reasoned concurring opinion—along with a petition for an *en banc* rehearing—provided the surety industry with reason to believe that the *Ikhana* decision may not be the final word on this issue.³ However, the Federal Circuit denied the surety's petition for an *en banc* rehearing.⁴

I. General Principles Governing a Surety's Right to Settle its Principal's Claims

Indemnity agreements typically contain, among other things, assignment and attorney-in-fact clauses. In the event of default, the surety may exercise its rights under these provisions to secure its entitlement to indemnification. The surety may also utilize these provisions to unilaterally settle any claims the principal may have against the obligee in order to mitigate its losses under the bonds.

A typical assignment clause relates back to the date the bond was executed and broadly assigns to the surety all rights, interests, and claims the principal may have

[Read more on page 33](#)

¹ See, e.g., *Bell BCI Co. v. Old Dominion Demolition Corp.*, 294 F. Supp. 2d 807, 812 (E.D. Va. 2003) (applying general contract law principles in interpreting the surety's assignment and attorney-in-fact rights).

² *Guarantee Co. of N. Am. v. Ikhana, LLC*, 941 F.3d 1140, 1143-44 (Fed. Cir. 2019), *reh'g denied*, 2020 WL 2781655 (Fed. Cir. May 29, 2020).

³ See *id.* at 1144-49 (Wallach, J., concurring).

⁴ *Guarantee Co. of N. Am. v. Ikhana, LLC*, No. 2018-1394, 2020 WL 2781655 (Fed. Cir. May 29, 2020).



Kevin S. Brotspies

McElroy, Deutsch, Mulvaney & Carpenter, LLP

Kevin S. Brotspies is a partner with McElroy, Deutsch, Mulvaney & Carpenter, LLP in the firm's Morristown, New Jersey office.



Laura M. Garcia

McElroy, Deutsch, Mulvaney & Carpenter, LLP

Laura M. Garcia is an associate with McElroy, Deutsch, Mulvaney & Carpenter, LLP in the firm's Morristown, New Jersey office.



A Mississippi Federal Court Gets It Right: Social Engineering Fraud, Computer Fraud, And Funds Transfer Fraud Each Stand Alone

In a summary judgment decision issued in February 2020, the U.S. District Court for the Northern District of Mississippi got all the issues right: social engineering fraud coverage is not the same as computer fraud coverage and direct means direct.¹ Additionally, the court issued one of the first decisions actually addressing a policy that included social engineering coverage.

The case involved an AXIS Privatus Platinum Policy, which included insuring agreements for Social Engineering Fraud, Computer Transfer Fraud, and Funds Transfer Fraud coverage. The insured, Mississippi Silicon, sustained a loss of its money when its CFO sent two separate wire transfers to a Bulgarian bank, which the CFO assumed was a bank for a legitimate vendor but was not.

The Policy

In the Policy, the Social Engineering Fraud coverage provided:

The Insurer will pay for loss of **Money** . . . resulting directly from the transfer, payment, or delivery of **Money** . . . from the **Premises** or a **Transfer Account** to a person, place, or account beyond the **Insured Entity's** control by:

- a. An **Employee** acting in good faith reliance upon a telephone, written, or electronic instruction that purported to be a **Transfer Instruction** but, in fact, was not issued by a **Client, Employee** or **Vendor**²

The Funds Transfer Fraud coverage provided:

The Insurer will pay for loss of **Money** . . . resulting directly from the transfer of **Money** . . . from a **Transfer Account** to a person, place, or account beyond the **Insured Entity's** control, by a **Financial Institution** that relied upon a written, electronic, telegraphic, cable, or teletype instruction that purported to be a **Transfer Instruction** but, in fact, was issued without the **Insured Entity's** knowledge or consent.³

[Read more on page 38](#)



Toni Scott Reed
Clark Hill Strasburger PLC

Toni Scott Reed is a partner of Clark Hill Strasburger PLC in the firm's Dallas, Texas office.

¹ Miss. Silicon Holdings, LLC v. AXIS Ins. Co., No. 1:18-CV-231-SA-DAS, 2020 U.S. Dist. LEXIS 29967 (N.D. Miss. Feb. 21, 2020).

² *Id.* at *5.

³ *Id.* at *6.



The Principal's Defenses Are The Surety's Defenses, But Is Setoff One Of Them?

It is axiomatic that under general suretyship law, the surety is entitled to assert the defenses of its principal. However, sureties have run into difficulty in asserting their principals' setoff claims for a variety of reasons. This article examines what constitutes a set-off claim, whether the surety has its principal's setoff defense, and arguments the surety may face in asserting the defense.

As a preliminary matter, it is important to understand the difference between setoff and recoupment. Courts often use those terms interchangeably, which can also complicate the analysis.¹ In *Citizens Bank of Maryland v. Strumpf*,² the United States Supreme Court defined the right of setoff as a right which "allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.'"³ Black's Law Dictionary defines "setoff" as a "counter-claim demand which defendant holds against plaintiff, arising out of a transaction *extrinsic of plaintiff's cause of action*."⁴ For example, if Stevenson sues Cromwell for \$10,000 for lumber that Stevenson supplied, and Cromwell seeks to reduce the judgment by \$5,000 representing Stevenson's (unrelated) unpaid rental of Cromwell's excavator, which Stevenson used on another project, then Cromwell is seeking a setoff.

Recoupment, on the other hand, is "a reduction or rebate by the defendant of part of the plaintiff's claim because of a right in the defendant *arising out of the same transaction*."⁵ Thus, if Stevenson sues Cromwell for \$10,000 for lumber that Stevenson supplied, and Cromwell seeks to reduce the judgment by \$5,000

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Ashley L. West

Dysart Taylor Cotter McMonigle
& Montemore, PC

Ashley L. West is an Associate Attorney with Dysart Taylor Cotter McMonigle & Montemore, PC in Kansas City, Missouri.

1 *ITV Direct, Inc. v. Healthy Sols., LLC*, 445 F.3d 66, 72 (1st Cir. 2006) ("To modern ears, the distinctions between recoupment, setoff and modern statutory variations are hoary and largely arbitrary."); *Westinghouse Credit Corp. v. D'Urso*, 278 F.3d 138, 145 n.2 (2d Cir. 2002) (observing that "the distinction between a recoupment and a setoff retains little significance under the modern rules for asserting counterclaims in pleading") (internal quotation marks omitted). The distinction makes a difference. See *United States ex rel. Martin Steel Constructors, Inc. v. Avanti Constructors, Inc.*, 750 F.2d 759, 762-63 (9th Cir. 1984) (holding that the general contractor's defense of "setoff" was unenforceable against its subcontractor's supplier). The claim in *Avanti*, however, was not a setoff, as the Ninth Circuit categorized it but was actually a claim in recoupment. *Id.* See also *United States ex rel. Fed. Roofing & Painting, Inc. v. Foster Constr. (Panama) S.A.*, 456 F.2d 250, 251 (5th Cir. 1972) ("[P]ayments due subcontractor [on a government project] would be subject to offset for reasonable claims arising out of performance of the subcontract work [and the] prime contractor was entitled to withhold from payment to its subcontractor provable damages which prime contractor had incurred under the subcontract"); [https://www.westlaw.com/Document/179a713f4540611d9a99c85a9e6023ffa/View/FullText.html?transitionType=Default&contextData=\(sc.Default\)&VR=3.0&RS=da3.0&fragmentIdentifier=co_pp_sp_999_18](https://www.westlaw.com/Document/179a713f4540611d9a99c85a9e6023ffa/View/FullText.html?transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=da3.0&fragmentIdentifier=co_pp_sp_999_18) *United States ex rel. Ascher Bros. v. Am. Home Assur. Co.*, No. 98 C 0995 2003 WL 1338020, at *18-21 (N.D. Ill. March 18, 2003) (recognizing "setoff" as a defense under the Miller Act, but the court was actually addressing a recoupment claim).

2 516 U.S. 16 (1995).

3 *Id.* at 18 (quoting *Studley v. Boylston Nat. Bank*, 229 U.S. 523, 528 (1913)).

4 *Setoff*, BLACK'S LAW DICTIONARY (6th ed. 1990) (emphasis added).

5 *Recoupment*, BLACK'S LAW DICTIONARY (6th ed. 1990) (emphasis added).



Contractor And Surety Considerations For Davis Bacon Act Compliance

On federal and federally funded projects, contractors and sureties face a multitude of potential wage-related liabilities. However, contractors and sureties may limit this potential exposure by developing a thorough understanding of the Davis Bacon Act¹ (the “DBA” or the “Act”) and its requirements. The Act, which applies to federal or federally-assisted contracts in excess of \$2,000 for construction, alteration, or repairs, requires contractors and subcontractors to pay laborers who are “employed directly on the site of the work” locally prevailing wages and fringe benefits for corresponding work on similar projects in the area.²

One critical question that must be answered in determining whether prevailing wages must be paid under the DBA is whether the contractor’s or subcontractor’s laborers are working “adjacent or virtually adjacent” to the site. The Federal Regulations governing the DBA defines “site of the work” as follows:

- (1) The site of the work is the physical place or places where the building or work called for in the contract will remain; and any other site where a significant portion of the building or work is constructed, provided that such site is established specifically for the performance of the contract or project;
- (2) Except as provided in paragraph (1)(3) of this section, job headquarters, tool yards, batch plants, borrow pits, etc., are part of the site of the work, provided they are dedicated exclusively, or nearly so, to performance of the contract or project, and provided they are **adjacent or virtually adjacent** to the site of the work as defined in paragraph (1) (1) of this section;
- (3) Not included in the site of the work are permanent home offices, branch plant establishments, fabrication plants, tool yards, etc., of a contractor or subcontractor whose location and continuance in operation are determined wholly without regard to a particular Federal or federally assisted contract or project. In addition, fabrication plants, batch plants, borrow pits, job headquarters, tool yards, etc., of a commercial or material supplier, which are established by a supplier of materials for the project before opening of bids and not on the site of the

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Sarah K. Carpenter

Smith, Currie & Hancock LLP

Sarah K. Carpenter is an attorney with Smith, Currie & Hancock LLP in the firm’s Washington, D.C. office.

¹ 40 U.S.C.A. § 3141-3148 (West 2020) (West).

² 40 U.S.C.A. § 3142(a)-(c) (West).



Fifteen Years Of Chapter 15 For The Surety

Chapter 15¹ —the “international” chapter of the United States Bankruptcy Code— turns fifteen this year. In essence, Chapter 15 is an attempt to codify a more standardized set of procedures for recognition of foreign insolvency actions in United States bankruptcy courts. Enacted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Chapter 15 is patterned after the United Nations Commission on International Trade Law Model Law on Cross-Border Insolvency.² 11 U.S.C.A. § 1501 proclaims the Chapter’s lofty aims: (1) to promote cross-border cooperation; (2) to establish legal certainty for trade and investment; (3) to foster fair and efficient processes; (4) to afford protection to the debtor’s assets; and (5) to help rescue financially troubled businesses.³ For the surety, procedural standardization in cross-border bankruptcy cases represents a welcome development,⁴ and while Chapter 15 preserves the importance of discretionary principles like comity and cooperation,⁵ bankruptcies with international dimensions remain anything but predictable.

Chapter 15 is still considered “new.” Relatively few published decisions have emanated from the bankruptcy, district, and circuit courts concerning cross-border cases under Chapter 15. Until 2010, no federal circuit court of appeal had interpreted Chapter 15. At once scant and rapidly changing, the precedent in this arena offers little fixed guidance to a surety seeking to protect its interests in a principal’s cross-border bankruptcy. The inherent variations among foreign states’ laws likewise do not lend themselves to many “one-size-fits-all” solutions for the surety seeking to best vindicate its indemnity and equitable subrogation rights in United States and foreign courts. However, as a side note, sureties

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Alana L. Porrazzo

Jennings, Haug & Cunningham, LLP

Alana L. Porrazzo is an associate at Jennings, Haug & Cunningham, LLP’s Phoenix, Arizona office.



Saloni Shah

CNA

Saloni Shah is Claims Counsel at CNA Surety in Chicago, Illinois.

Disclaimer: The material provided is not intended or designed to provide legal or business advice. Rather, it is intended to bring to your attention many, but not all, issues that should be considered regarding Chapter 15 bankruptcies. Readers should contact their attorney to obtain advice with respect to any particular legal matter.

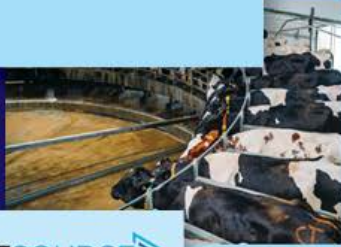
1 11 U.S.C.A. § 1501-1532 (2005) (West).

2 11 U.S.C.A. § 1501(a); see also MODEL LAW ON CROSS-BORDER INSOLVENCY (U.N. COMM’N ON INT’L TRADE L. 1997). Legislation based on the Model Law on Cross-Border Insolvency has been adopted in 46 states in a total of 48 jurisdictions worldwide. U.N. COMM’N ON INT’L TRADE L., https://uncitral.un.org/en/texts/insolvency/modellaw/cross-border_insolvency/status (last visited Feb. 4, 2020).

3 11 U.S.C.A. § 1501.

4 Essential reading is Robert Miller’s “Chapter 15 Proceedings” chapter in the forthcoming *Surety Aspects of Bankruptcy Law and Practice*, which comprehensively traces the theory and development of international bankruptcy for surety practitioners and discusses pre-Chapter 15 inconsistencies. Robert Miller, *Chapter 15 Proceedings*, in SURETY ASPECTS OF BANKRUPTCY LAW AND PRACTICE (M. Collins & C. Schexnayder, eds., A.B.A. Fid. & Sur. L. COMM. forthcoming 2020).

5 “Comity” is “the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws.” *Hilton v. Guyot*, 159 U.S. 113, 164, 16 S. Ct. 139, 40 L. Ed. 95 (1895). See also *In re Atlas Shipping A/S*, 404 B.R. 726, 738 (Bankr. S.D.N.Y. 2009) (“[C]hapter 15 specifically contemplates that the court should be guided by principles of comity and cooperation with foreign courts in deciding whether to grant the foreign representative additional post-recognition relief.”); Allan L. Gropper, *Current Devs. In Int’l Insolvency Law: A United States Perspective*, 15 J. BANKR. L. & PRAC. 2, Art. 3, 3-5 (Apr. 2006).



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How To Handle A Principal In Receivership

For many lawyers, surety and receivership are just two of those topics that we had to learn a little bit about to pass the bar exam. Some of us have gone on to devote our careers to surety law, but what happens when suretyship careens into that other insular area of the law—receivership? What happens to an otherwise orderly surety claim when a principal goes into receivership? It is a likely scenario. Bond claims often arise because principals are facing the sort of broader financial changes that could land them in receivership. If that happens, don't blow the dust off a decades-old Bar Bri book. Use this article as a helpful starting point instead.

Receivership Basics

Receivership is a judicial proceeding in which a court appoints a neutral to take control over the assets and operations of a commercial entity and its property. The appointment of a receiver is typically requested by a secured creditor seeking to protect and preserve its collateral until the assets are liquidated through foreclosure. The receiver takes exclusive possession and control of the debtor's property and displaces the debtor for purposes of management and control of the property placed into receivership. The receiver usually has the power and authority to collect all revenues owed to the debtor and to pursue any cause of action the debtor may have against third parties. The receiver is an arm or an officer of the court, subject only to the control and direction of the court. The appointment of a receiver does not alter or impair anyone's rights or the obligations of a contract. The overall guiding principle for a receiver's actions is to act in good faith and in the best interests of the receivership estate and its creditors.

Each state or jurisdiction has its own laws concerning receivership. In some states, the receivership statute is relatively abbreviated, allowing the court substantial discretion to exercise its equitable powers.¹ In other states, the receivership statute resembles a mini-bankruptcy code containing considerable due process features and structure for the receivership process.² There might also be state-wide or local rules of civil procedure specific to receiverships. The applicable state statute (and most court orders appointing the receiver) may also provide for a stay or prohibition against any acts to assert a claim against the debtor or property of the debtor

Nancy Gomez Tamayo

Tokio Marine, HCC

Nancy Gomez Tamayo is a senior bond claims attorney for Tokio Marine, HCC, in Los Angeles, CA.



Michael M. Tamburini

Shane C. Mecham

Levy Craig Law Firm

Michael M. Tamburini and Shane C. Mecham, are shareholders at the Levy Craig Law Firm in its Kansas City, MO office.

¹ For example, the Kansas receivership statute consists of five relatively short provisions that simply authorize the court to appoint a receiver to "keep, preserve, and manage all property and protect any business or business interest entrusted to the receiver ...", and provide that the receiver's powers are to "perform such acts respecting the property or business as the judge may authorize." *Kan. Stat. Ann. § 60-1301, et seq.* (West 2020).

² See, e.g., the Missouri Commercial Receivership Act, *Mo. Rev. Stat. § 515.500, et seq.* (West 2020), which went into effect in 2016. This relatively new Act provides a comprehensive statutory structure for the appointment of a receiver and administration of the receivership estate.



or to obtain possession of such property for a limited period of time or until the receivership is terminated. Thus, practitioners are advised to research the specific provisions of that state's receivership statute(s).

The Receivership Estate

Once a receiver is appointed, the receivership court's role is generally limited to addressing and disposing of matters brought before the court by the receiver or other parties in interest. Such matters typically involve authorizing the sale of receivership property, adjudicating claims made against the receivership estate, providing guidance and direction to the receiver, and determining whether certain assets are property of the receivership estate and thus protected by the receivership.

Property of the receivership estate is usually defined in the order of appointment and, in some states, by the applicable statute. As in the bankruptcy context, property of the receivership is often broadly defined to consist of any legal or equitable right, title, or interest the debtor has in property as of the appointment of the receiver.³ Because the definition is often modeled after the United States Bankruptcy Code's definition and the bankruptcy case law interpreting that definition is far more developed, it is instructive to refer to that line of authority.

Receivership and the Bond

In the event a receiver is appointed while a bond claim is pending, the question becomes: what is the effect of the receivership and the stay on the bond claim? The analysis should begin with determining what type of bond is at issue followed by an evaluation of whether the defendant in receivership has any protectable interest in that bond.

Courts are split on whether payment and performance bonds are property of the receivership estate. Some courts have found that the bonding agreement is a valid contract for which the debtor bargained and paid valuable consideration.⁴ Those courts have concluded that those contractual rights are intangible property that are within the definition of property of the estate. Other courts, with little to no analysis, have summarily found that the debtor has no interest in the bond.⁵ Thus, in the

³ See e.g., *Ali v. CIT Tech. Fin. Servs.*, 188 Md. App. 269, 294 (Ct. Spec. App. Md. 2009) (noting that Section 541(a) of the Bankruptcy Code, which defines "property of the estate" as all legal and equitable interests of the party filing bankruptcy, has been interpreted as "all-inclusive and "sweeping" such that it includes whatever contract rights the debtor holds when the bankruptcy petition is filed).

⁴ See, e.g., *In re Chateaugay Corp.*, 116 B.R. 887, 898 (Bankr. S.D. N.Y. 1990) (holding that bonding agreements are valid contracts for which the debtors bargained and paid valuable consideration; such contractual rights are intangible property which is included within the definition of the debtor's estate).

⁵ See, e.g., *In re Bluff City Sheet Metal*, 2016 Bankr. LEXIS 3119, at *5 (Bankr. W.D. Tenn. 2016) (finding that creditor with claim against a bond arising out of a debt owed by the debtor was not seeking a claim against the debtor, but rather was pursuing a claim against property in which the debtor had no interest).



view of those courts, a statutory or court-ordered stay does not apply to the claim against the surety on the bond arising out of the debt owed by the debtor. Notably, the authority behind such split with respect to contract surety bonds is rather scant. For other types of surety bonds, the authority is virtually non-existent.

An important practical consideration is that receivership courts, like bankruptcy courts, are courts of equity.⁶ As such, they have fairly wide latitude when it comes to establishing the boundaries of concepts such as “property of the estate.” The combination of the limited authority available on this issue and the broad equitable powers of the receivership court do not permit any bright line rules. Consequently, how the surety proceeds regarding a bond claim pending at the time of the order of appointment may largely depend on the receiver’s position. The receiver may have no objection to the surety paying the bond claim as it does not dilute the receivership estate and it is one less claim that could potentially be made against the receivership estate. If possible, written confirmation of the receiver’s position is recommended. If such confirmation cannot be obtained, the surety may consider seeking protective relief from the stay (assuming one is in place) from the court so that it may pay the bond claim and avoid any challenge to such payment. Such stay relief should also be considered in the event the receiver opposes payment of the bond claim.

If the bond at issue is a supersedeas bond that a judgment debtor obtained to stay enforcement of a judgment against the debtor pending appeal and to secure the judgment, the answer to whether the bond is property of the estate is a little clearer and appears to turn on whether the appeals process is complete and the outcome of the appeal. Turning again to the bankruptcy context, the majority view on this issue is that if the appeals process is not complete at the time of the bankruptcy filing, the debtor still has a contingent reversionary interest in the supersedeas bond, subject to being divested if the debtor is unsuccessful on appeal.⁷ Once divested of such interest, the supersedeas bond is no longer property of the estate.

Receivership and the Indemnitors

In the event of a receivership, the question also arises whether the surety may pursue its indemnity rights against the principal. Presuming a stay is in place, the surety is likely stayed from pursuing its claim against the debtor principal. Such

⁶ *Ito v. Investors Equity Life Holding Co.*, 346 P.3d 118, 131 (Haw. 2015) (explaining that the receivership court has broad discretionary power to appoint receivers and craft remedies to preserve equity).

⁷ *In re Celotex Corp.*, 128 B.R. 478, 482 (Bankr. M.D. Fla. 1991); *In re Snap Line Servs., Inc.*, 594 B.R. 502, 507 (Bankr. N.D. Ga. 2018) (concluding that debtor’s contingent unvested interest in supersedeas cash deposit terminated upon date appellate process concluded in favor of judgment creditor, which the stay dissolved by operation of law); *In re Koksai*, 424 B.R. 470, 477 (Bankr. D. Kan. 2010) (stating that debtor had an interest in the cash bond on the date of the bankruptcy filing, subject to being divested if judgment of the state court in favor of the judgment creditor was affirmed).



claim would be an action against the assets of the receivership estate. One step the surety would be advised to take to protect its interests is to file a proof of claim in the receivership. Although it is generally not required, the surety may consider attaching a claim summary to the proof of claim that identifies the bond and any applicable indemnity agreement and provides a current accounting of the amount claimed. As soon as the surety learns of the receivership, it should investigate the applicable rules and deadlines for filing such claims.

Non-debtor indemnitors, on the other hand, are not protected by any stay imposed by the order of appointment involving the principal. Accordingly, the commencement of a receivership does not prevent the surety from pursuing its right of indemnity against the non-defendant indemnitors.

Other Potential Risks in Navigating Receivership Waters

A number of unexpected and unique risks may come up for the surety during a receivership that are worth mentioning. In *In re Missouri Professionals Mutual-Physicians Professional Indemnity Association*,⁸ for example, the receiver and a claimant in the receivership took the position that the bond transaction was void as a fraudulent transfer under the Uniform Fraudulent Transfer Act.⁹ Their argument was that the principal was insolvent when it bought the appeal bond and did not receive “reasonably equivalent value” for the bond, and, therefore, the surety should return the premium.¹⁰

Meanwhile, the bond claimant continued to demand payment.¹¹ This combination of events left the surety in the difficult position of handling a claim on a bond that might subsequently be held to be void.¹² To increase pressure on the surety, the bond claimant filed enforcement motions in the case in which the appeal bond was filed and a separate bad-faith action.¹³ Neither of those actions were brought in the same court as the receivership, so the surety faced the risk of being subject to conflicting rulings from different judges.¹⁴

⁸ Case No. 18AB-CC00267 (Franklin Cnty. Ct., Mo. filed Dec. 31, 2018).

⁹ *Id.* Petition to Avoid Fraudulent Transfers p. 2 (May 10, 2019).

¹⁰ *Id.* p. 3.

¹¹ Bell v. Redjal, et al, Case No. 1522-CC10079, Judgment p. 1 (Cir. Ct of the City of St. Louis, Missouri April 8, 2019).

¹² In re Missouri Professionals Mutual-Physicians Professional Indemnity Association, Case No. 18AB-CC00267, Motion to Compel Receiver to Refile Petition to Avoid Fraudulent Transfers p. 1 (June 18, 2019).

¹³ Bell v. Redjal, et al, Case No. 1522-CC10079, Judgment p. 1 (Cir. Ct of the City of St. Louis, Missouri April 8, 2019); Bell v. Am. Contractors Indem. Co., Case No. 1922-CC10541, Petition p. 1 (Cir. Ct of the City of St. Louis, Missouri June 19, 2019).

¹⁴ *Id.*



The surety defended itself in the bond claimant's actions by making clear that the delay in payment was due to another court considering the validity of the bond.¹⁵ That pending motion in another court justified the surety's conduct and proved that the delay in payment was not arbitrary.¹⁶ At the same time, the surety was able to broker a deal with the receiver for the receiver to withdraw his motion to void the bond in exchange for the surety paying the bond claim, thereby discharging that claimant's overlapping receivership claim.¹⁷ This example illustrates that a surety has several additional factors to consider when its principal is in receivership.

In the event of a bad-faith complaint, the surety should consider immediately filing a motion to dismiss. The threat of a receivership court setting aside a bond as a fraudulent transfer is certainly reasonable grounds for a surety not to pay any claims until after that threat is resolved. Compounding this difficulty are the facts that: (1) the lawyers and judge working on the bond claim may not be familiar with the finer points of receiverships; (2) the lawyers and judge working on the receivership may not be familiar with the finer points of suretyship; and (3) the bond claim and receivership may be brought by different lawyers and may be pending before different judges in different courts. Accordingly, the surety might find itself subject to conflicting orders, *e.g.*, the bond claim court directing the surety to pay and the receivership court holding that the bond is void. Practitioners faced with this dilemma should not assume that one side knows what the other is doing and should bring the filings and findings in one court to the attention of the other court.

Conclusion

The rules and procedures in receivership are often foreign and sometimes unclear. Where bond claims are pending at the time of the receivership, the surety is advised to work promptly and closely with the receiver to determine the receiver's position on whether a bond will be considered a part of the receivership estate. At the same time, the surety should reserve its indemnity rights by filing a proof of claim in the receivership. ➤

¹⁵ Bell v. Am. Contractors Indem. Co., Case No. 1922-CC10541, Motion to Dismiss p. 7 (Cir. Ct of the City of St. Louis, Missouri July 31, 2019).

¹⁶ *Id.*

¹⁷ Case No. 18AB-CC00267, Receiver's Withdrawal of Motion to Allow Payment of Secured Claim p. 1 (November 22, 2019).



Dealing... continued from page 1

Contractors are experiencing increased costs for a variety of reasons. For example, there is a need for more thorough and frequent cleaning of offices and job sites, a greater supply of hand-washing facilities, and additional staffing requirements to learn new safety guidelines and to perform temperature checks, and other activities required or recommended to maintain a healthy work environment.¹ Contractors are experiencing diminished labor productivity caused by a number of factors, including increased employee absenteeism triggered by illness, quarantine, issues with public transportation, lack of available childcare; the general effects of telecommuting; and the necessity of reduced on-site staffing or additional shift work mandated by new federal or local social distancing requirements. Materials may be more expensive to timely procure as a result of global manufacturing shutdowns (e.g., goods made in China), closure of ports, and general material transportation delays within the United States. Even if a bonded principal is weathering the storm, a bonded project may still suffer because lower-tier subcontractors and suppliers are simultaneously facing the same issues.

While operating costs are increasing, revenue streams are declining. Government or owner-imposed shutdowns have suspended some private and public construction work, curtailing anticipated progress payments needed to fund overall operations. While other projects are continuing, some nervous or financially-distressed upstream owners/general contractors are slowing down payment processing or declaring bankruptcy, affecting the contractor's ability to adequately staff its own operations and pay lower-tier vendors. In addition to increased operating costs and payment delays, contractors may be subjected to delay damage claims from obligees when projects cannot be completed on schedule. The first place for principals and their sureties to look for some relief is in the underlying construction contract.

B. Contract Performance Obligations and Delay Clauses

Almost every construction contract has a "time is of the essence" provision and a completion deadline. Absent a justifiable excuse, the consequences for failure to meet the completion deadline may include termination of the contract for default (usually accompanied by a demand on the performance bond surety to complete

¹ Under the Occupational Safety and Health Act ("OSHA"), there is a general duty to provide workplaces that are "free from recognized hazards." OSHA has released advisory guidance giving recommendations to employers on how they may provide safe and healthful working conditions during the pandemic. The Centers for Disease Control and Prevention, the World Health Organization, and the Equal Employment Opportunity Commission have also weighed in on best practices for avoiding or mitigating the spread of COVID-19. These guidelines, along with states and localities' executive orders, mean contractors (especially those working in multiple jurisdictions) and takeover sureties must be familiar with a patchwork of rapidly evolving rules regarding the pandemic. In addition, industry groups like the Associated General Contractors of America have also issued their own guidance and recommendations. Sureties should be closely monitoring developments to safely and lawfully maintain operations.



the work), payment of the obligee's costs to supplement the principal's labor force to mitigate delays, and/or the assessment of liquidated damages or actual delay damages for failure to timely complete the work. Significant project delays increase the surety's risk of receiving both a performance bond claim from the obligee and payment bond claims from lower-tier vendors seeking progress payments and delay/impact costs.

The vast majority of construction contracts also contain provisions allocating the responsibility for the impacts of various delays. Provisions addressing delays that are caused by forces outside of either party's control are typically referred to as "force majeure" clauses. Although their specific terms vary widely, there are two primary types of force majeure clauses: one type contains a non-exclusive list of examples of force majeure delays along with a "catch-all" provision containing language such as "or anything outside of either party's control;" and the other type specifically spells out every calamity that will qualify as a force majeure delay. For those clauses containing a "catch-all" provision, a global pandemic very well may fall within the provisions of the clause. Clauses with ambiguous or narrower language may be subject to future litigation as to whether current circumstances meet the criteria.

After determining whether a global pandemic falls within a specific clause's coverage, a further assessment must be made to determine what relief triggering the clause may provide. In some cases, the contractor may be entitled to a time extension only, negating any effort by the obligee to legitimately declare a contract default or assess delay damages, but not providing any relief in the form of compensation for the contractor's additional costs attributable to the pandemic and extended performance duration. Other clauses may allow the contractor to seek additional compensation for costs that it can prove were caused by the force majeure event.

One of the most widely-utilized sets of industry construction documents is the American Institute of Architects ("AIA") series of contract forms. The current AIA contract language addressing delay is found in the A201–2017 General Conditions, which state:

§ 8.3 Delays and Extensions of Time

§ 8.3.1 If the Contractor is delayed at any time in the commencement or progress of the Work by . . . unusual delay in deliveries, unavoidable casualties . . . or other causes beyond the Contractor's control . . . or (5) by other causes that the Contractor asserts, and the Architect determines, justify delay, then the Contract Time shall be extended.

§ 8.3.3 This Section 8.3 does not preclude recovery of damages for delay by either party under other provisions of the Contract Documents.



This language is sufficiently broad to entitle a contractor to relief for delays caused by the current COVID-19 crisis and the potential recovery of provable delay costs. Similarly, Section 6.3.1 of the ConsensusDocs 200 contains a list of excusable delays that includes both epidemics and transportation delays that are not reasonably foreseeable and references the contractor's right to an equitable adjustment in the contract price. Each contract must be read carefully though, as parties often modify the standard industry contract provisions, including the obligee eliminating the contractor's right to recover delay damages. In addition, many parties use their own contract forms rather than using the common industry forms and obligees routinely seek to avoid liability for a contractor's delay-related costs regardless of cause.

Most federal government contracts address the issue of delay by incorporating provisions of the Federal Acquisition Regulations ("FAR"). [FAR 52.249-10](#) addresses what constitutes a default under a fixed-price construction contract and [FAR 52.349-14](#) addresses excusable delays. Both epidemics and quarantine restrictions are grounds for excusable delay.

C. Suspension of Work and Termination for Convenience Clauses

Rather than deal with the cost of ongoing project delays caused by COVID-19's impacts, obligees may elect to suspend work on a bonded project until the severity of such impacts have passed. In other cases, obligees may have no choice but to suspend work due to local government shutdown orders, which are now starting to ease but could recur if the fears of a "second surge" are realized. Typical suspension for convenience language is found in the AIA A201:

§ 14.3 Suspension by the Owner for Convenience

§ 14.3.1 The Owner may, without cause, order the Contractor in writing to suspend, delay or interrupt the Work, in whole or in part for such period of time as the Owner may determine.

§ 14.3.2 The Contract Sum and Contract Time shall be adjusted for increases in the cost and time caused by suspension, delay, or interruption under Section 14.3.1. Adjustment of the Contract Sum shall include profit. No adjustment shall be made to the extent

- .1 that performance is, was, or would have been, so suspended, delayed, or interrupted, by another cause for which the Contractor is responsible; or
- .2 that an equitable adjustment is made or denied under another provision of the Contract.



ConsensusDocs Section 11.1.1 specifically references the contractor's right to an equitable adjustment in the contract price for cost and delay arising from an owner's suspension of the work. Under federal contracts, FAR 52.242-14, a suspension of work clause provides that the contractor is entitled to compensation for increased costs if the project is suspended for an "unreasonable" amount of time, the delay is caused by the government and the contractor is not responsible for any concurrent cause of delay, and the contractor has provided proof of an injury.

Manuscripted contracts take a variety of forms and may contain language that the contractor only receives a price adjustment if work is suspended for more than a stated duration of time. Suspension provisions may also allow one or both parties the option to terminate the contract if the suspension lasts beyond a stated duration.

In the private sector, where hospitality and retail sectors have been hit particularly hard by the impacts of COVID-19 and government-imposed shutdowns, contractors may see contracts for the construction or renovation of hotels, or construction related to restaurants or other retail spaces, terminated for the obligee's convenience. The termination language of the particular contract governs the contractor's rights to compensation for work not performed and anticipated profits. While a termination for convenience eliminates any threat of a performance bond claim due to performance delays, the risk of payment bond claims remains if the contractor cannot successfully negotiate termination claim settlements with its lower-tier vendors.

D. The Need to Protect and Preserve Both the Project Site and Notice and Claim Deadlines

As COVID-19 shutdowns, stay-at-home orders, slowdowns in the supply chain, and/or lack of labor begin to affect bonded projects, it is important to keep in mind that just because the project might be shut down does not mean that the deadlines applicable to certain aspects of the project have stopped running. Deadlines and other time periods will continue to run, limitations will continue to run (unless the government steps in), and mechanic's lien rights and bond claim rights will continue to run. Accordingly, it is critical to determine and preserve applicable deadlines for notices of claims, lien rights, delays and impacts, requests for equitable adjustments, change orders, and insurance claims. The same is true for dispute resolution rights.

The contractor and its surety must be mindful of the fact that an integral part of preserving rights and claims involves properly documenting the impacts. Special attention must be paid to keeping track of COVID-19-related costs and impacts in a clearly identifiable way so that the claims, notices, and requests are supported by sufficient evidence when the time comes. It does no good to preserve the claim through a notice if the claim cannot be proven with sufficient evidence and documentation.



Finally, if there is a project shutdown, the contractor must make an effort to determine the applicable contract requirements for protecting the site, work, materials, equipment, work of others, etc., as it is better to protect now, than pay later for damage, spoliation, or theft. The contract documents should also provide insight into who bears the risk of loss or damage if injury occurs despite the contractor taking the required steps to protect the work in place.

II. RELIEF FROM PERFORMANCE OBLIGATIONS ARISING OUTSIDE THE CONTRACT TERMS

A. The Common Law Defense of Impossibility of Performance

When dealing with an impatient obligee, whether in a takeover or when advising a principal having difficulties, a surety in the age of COVID-19 will need to be aware of the impossibility defense. Familiarity with the factors of this defense can be useful not only in defending a claim, but avoiding termination and assertion of a claim.

Whereas a force majeure defense is dependent on the particular language of the bonded contract and jurisdiction-specific case law addressing that clause, impossibility is a common law defense. This means that even if the principal did not comply with notice requirements or other conditions precedent, an impossibility defense may still be available. However, it should be kept in mind that if the contract specifically allocates risk for non-performance in the case of pandemic, the terms of the contract will control over common law concepts such as impossibility.²

In early American jurisprudence, the law of contracts essentially swallowed up the impossibility defense. The courts believed that if performance of a contract became impossible, this was a risk borne by the non-performing party.³ As commercial activity flourished and construction increased, this framework became unworkable and a more realistic rule had to be applied. The courts came to recognize the unfairness of pinning the risk of performance solely on one party when a basic assumption implied in the contract fails through no fault of that party.⁴ Over time, this doctrine has expanded beyond literal impossibility to include situations of commercial impracticability; i.e., where performance is technically possible, but only at unreasonable and excessive cost.

Most jurisdictions apply factors similar to the following in determining whether contractual performance is excused due to impossibility:

1. The unexpected occurrence of an intervening act;

² See *U.S. v. Winstar Corp.*, 518 U.S. 839, 907-08 (1996) (citing Restatement (2d) Contracts § 261).

³ See *Dermott v. Jones*, 69 U.S. 1, 8 (1864).

⁴ See *Tex. Co. v. Hogarth Shipping Co.*, 256 U.S. 619, 629-30 (1921).



2. The occurrence was of such a character that non-occurrence was a basic assumption of the parties when entering into the agreement; or
3. The occurrence made performance impracticable.⁵

1. “Unexpected Occurrence”

With COVID-19, most courts are going to agree that a pandemic on this scale was unexpected; however, that will change as time goes on. For contracts signed before February 2020, this part of the defense will likely be satisfied. But due to the widespread nature of the pandemic, future contracts should address disease specifically. Entering into a contract that does not allocate the risk of nonperformance in the case of disease or pandemic could well be at the risk of the party who cannot perform.

This is particularly relevant to takeover and tender agreements. Sureties should ensure that they are protected from risk if COVID-19 or some other pandemic prevents a contract from being completed. The agreement can address the availability of labor or materials, and the effect of government shutdowns and stay-at-home orders, separately. Now that everyone is keenly aware of the threat posed by pandemics, the impossibility defense is going to be much tougher to establish for contracts entered into going forward.

2. “Non-Occurrence Was a Basic Assumption”

In some jurisdictions, the test for whether the non-occurrence of an intervening event was a basic assumption of the parties relates to foreseeability.⁶ Other jurisdictions, such as the Fourth Circuit, have moved away from the foreseeability test because the human mind can conjure just about any possibility. The test in the Fourth Circuit, therefore, is whether the non-occurrence of the event was sufficiently unlikely or unreasonable at the time of contracting to constitute a reason for setting aside the contractual obligations.⁷ This will depend on the scope and purpose of the contract, the timing, and the interests of the parties at stake.

When seeking to rely on an impossibility defense, a simple citation of the virus and attendant hardships is not going to be sufficient. The “event” has to be something more than simply the virus. There has to be an impact that specifically affects the project in some way. This impact should be documented with contemporaneous communications wherever possible.

⁵ See, e.g., *Opera Co. of Boston, Inc. v. Wolf Trap Found. for Performing Arts*, 817 F.2d 1094, 1102 (4th Cir. 1987).

⁶ See, e.g., *Heat Exchangers, Inc. v. Map Constr. Corp.*, 368 A.2d 1088, 1093 (Md. App. 1977).

⁷ See, e.g., *Opera Co. of Boston, Inc.*, 817 F.2d at 1101-02.



3. Impracticability of Performance

In the majority of cases involving sureties, impracticability of performance will be the most heavily contested. Impracticability includes not just obvious circumstances such as a government shutdown, but also changed circumstances where the costs arising as a result of the virus would be excessive and unreasonable.⁸ This does not mean that a simple increase in costs will relieve a party from its obligations. To support an impossibility defense, the costs and burden have to increase so much that they are not fairly to be regarded as within the risks the obligor assumed under the contract.⁹

An important point to keep in mind is that the party relying on an impossibility defense must exhaust all alternatives for performance.¹⁰ For example, if the project is in a phase that (1) specifically relies on a particular type of skilled labor; (2) there are limited companies in the region that do this type of work; and (3) none of them are available because of the virus; the contractor or surety must document these facts and ask the companies to confirm their status or unavailability in writing. The information should be shared with the obligee so it can adjust its expectations accordingly. Depending on the circumstances, it may be necessary to explore the possibility of using a subcontractor from a different part of the country.

Similarly, if a certain material specified in the contract is unavailable and it can only be obtained from a particular geographic or proprietary source, the efforts to agree on and obtain suitable replacements should be documented. If it costs 100 times the agreed amount to get material from an alternative source than what was assumed in the bid, this will likely excuse performance. On the other hand, if the difference is much smaller but still significant, performance may not be excused. Substitutions should be evaluated wherever possible.

4. Duration

In most construction matters, particularly those involving delay damages, an impossibility defense will likely be a temporary one. If a contract is only temporarily impossible, the performing party will be expected to resume performance once the event preventing performance ceases.¹¹ Accordingly, a surety working with a principal on a project that is currently on hiatus should be sure that the principal has the resources in place to resume work as smoothly as possible once the obligee gives the instruction to resume. This includes not only ordinary remobilization measures,

⁸ *Transatlantic Fin. Corp. v. U.S.*, 363 F.2d 312, 315 (D.C. Cir. 1966).

⁹ Restatement (Second) of Contracts § 265 cmt. a (1981).

¹⁰ See *Blue Cross Blue Shield of Tenn. v. BCS Ins.*, 517 F. Supp. 2d 1050, 1056 (N.D. Ill. 2007).

¹¹ See *Com. Edison Co. v. Allied-General Nuclear Servs.*, 731 F. Supp. 850, 861 (N.D. Ill. 1990).



but also ensuring any government-mandated social distancing guidelines and other health precautions, such as testing protocols, are implemented.

An excuse from performance can be permanent where it would be materially more burdensome to resume performance than it would have been had there been no frustration. The classic example would be if there was a dramatic increase in price of a necessary commodity that arose in conjunction with the pandemic. At this time, it cannot be predicted whether this will happen, or to which commodities, so the assumption should always be that the delay arising from COVID-19 is temporary and a contractor or takeover surety should expect to return to the job once the problem has eased.

B. Use of Frustration of Purpose Principals During COVID-19 Work Restrictions and Shutdowns

The surety's options for defending obligee delay claims and performance under a reservation of rights will be heavily dependent on factors such as the nature of any shutdowns or restrictions imposed on the project, the state or locality where the project is located, and in some places, the character of the project (for example, defense or medical-related jobs).

The goal when faced with a total shutdown should be apparent. If construction work is subject to a complete government shutdown, the project cannot proceed, workers and consultants cannot be on site and there should be a time extension coextensive with the amount of time that work is not allowed on the project. When the contract was formed, it was under the expectation that it would not become illegal to perform the work. Neither the principal nor the surety can be expected to break the law in order to perform the contract, and this applies even if a regulation or order is later found to be unconstitutional or unenforceable.

But what if work is allowed, but only under restrictions that affect the ability to timely perform? Requirements such as social distancing and caps on the number of employees active on a jobsite may slow down performance even if they do not completely prevent construction. The principle of frustration of purpose could prevent the imposition of delay damages by the obligee in light of the challenges these restrictions place on principals and takeover sureties. "Frustration of purpose," a concept very similar to the impossibility defense, applies where "a party's principal purpose is substantially frustrated without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made[.]"¹²

¹² *Chase Precast Corp. v. John J. Paonessa Co.*, 566 N.E.2d 603, 606 (Mass. 1991) (quoting Restatement (Second) of Contracts § 265 (1981)).



The first consideration is always to check the bonded contract for provisions on work stoppages, government-ordered shutdowns, and instructions not to proceed. Equitable and common law doctrines can be useful in situations not contemplated by the contract, but they generally cannot be used if they contradict the contract's plain language.¹³ If a claim has been asserted, or if restrictions are causing delays that may result in a claim, the most important step is to document the reasons for the delay. Ideally there should be detailed records of the manpower and time needed to perform certain tasks before restrictions came into place. If not, consultants may be required to approximate delay impacts using estimating tools and industry standards. If the claim ends up in litigation, expert testimony on the reasonableness of the delay in light of the restrictions in place will be very important in determining liability as well as damages.

In addition, the bond form may provide additional nuances affecting the viability of a common law defense. Consider the scenario where the principal closes its doors during the course of a government-ordered shutdown, and the obligee asserts a claim seeking immediate payment. To use a familiar example, the AIA A312-2010 performance bond gives the surety four options once the conditions precedent for assertion of a claim are met. Under Section 5, once the surety has received notice that the obligee is considering a declaration of default, the principal has been terminated, the surety has been notified, and the obligee agrees to pay the balance of the contract price to the surety or a contractor selected to perform, the surety has four options, paraphrased below:

- 5.1: Arrange for the principal to complete the contract;
- 5.2: Take over and perform the contract itself;
- 5.3: Obtain bids and tender a completing contractor, paying the damages in excess of the balance incurred as a result of the default;
or
- 5.4: Waive the right to take any of the above options and either pay the obligee the amount for which it is liable, or deny the claim.

Clearly, if a shutdown is in place, the surety cannot comply with Sections 5.1, 5.2 or 5.3 – at least not immediately. However, an obligee may argue that, while the first three options may be unavailable, the last is not. It may ask the surety to rely on the documents it provides and ask the surety to write a check for the full amount of the claim.

¹³ See *In re Conneaut Lake Park, Inc.*, 564 B.R. 495, 509-10 (Bankr. W.D. Pa. 2017).



There is some case law, albeit arising from other contexts, suggesting that where a contract gives multiple options for performance and some are unavailable, the performing party must choose from the options that are available.¹⁴

The key to responding to such an argument is in the plain language of the bond. The surety on an A312-2010 bond has the right to choose its method of performance. If it cannot exercise any of its options except one due to circumstances beyond its control, there is no choice. Therefore, the surety's obligation under the bond cannot be performed until the shutdown is over and the options for performance become reasonably practicable. When dealing with other bond forms, it is always advisable to check to see if the bond guarantees the surety the right to choose its method of performance.

C. Additional Guidance on Relief Available under Federal Government Construction Contracts

Recently, the Office of Management and Budget ("OMB") issued Memorandum No. M-20-18 (the "Memorandum") to the heads of all federal executive departments and agencies entitled "Managing Federal Contract Performance Issues Associated with the Novel Coronavirus." In the Memorandum, OMB states that:

agencies should be flexible in providing extensions to performance dates . . . if a contractor is unable to perform in a timely manner due to quarantining, social distancing, or other COVID19 related interruptions.¹⁵

OMB provided additional guidance in frequently asked questions ("FAQs") attached to the Memorandum. The FAQs provide that the government should be as flexible as possible in finding solutions when a contractor is unable to meet project schedules due to COVID-19 quarantine restrictions or exposure. The government agencies are encouraged to look for other solutions if completion with the existing contractor is not feasible including termination for convenience. OMB emphasized that such actions should be taken without negatively affecting a contractor's performance rating.

OMB further stated that requests for equitable adjustment associated with increased costs related to safety measures undertaken by contractors to protect employees from COVID-19—including costs for performance disruption—should be considered on a case-by-case basis, taking into account whether the contractor was attempting to comply with the Centers for Disease Control and Prevention ("CDC") guidance.¹⁶

¹⁴ See, e.g., *Yankton Sioux Tribe of Indians v. U.S.*, 272 U.S. 351, 359 (1926) ("where one part of an alternative promise, originally possible, has subsequently become impossible of fulfillment, the other part of the alternative must nevertheless be performed.").

¹⁵ Memorandum No. M-20-18 from the Office of Mgmt. & Budget, at p. 1.

¹⁶ *Id.* at p. 4.



Sureties may be able to use the OMB guidance to structure a reduction or elimination of scope of work, termination for convenience, or buy-out of a bonded contract as a means of resolving a performance bond claim. If a surety is in a takeover situation, it may be able to use the OMB guidance to justify a request for equitable adjustment to recover increased costs for COVID-19 impacts, obtain schedule extensions, or mitigate liquidated damages.

III. LOOKING FOR FINANCIAL RELIEF FOR THE PRINCIPAL OUTSIDE OF THE CONSTRUCTION CONTRACT

As many contracts limit recovery to non-compensable time extensions or contain high burdens of proof to seek delay damage recoveries, contractors need to look to other sources of recovery for COVID-19 related financial impacts.

A. Insurance Coverage

Contractors typically have a variety of insurance policies that may apply to a bonded project and, under certain circumstances, the surety may be able to assert a claim against such policies to recover costs incurred. One such policy that might come into play through the surety's subrogation rights is "business interruption." In theory, this coverage is supposed to reimburse an insured for losses in business revenue caused by an interruption in business operations.¹⁷ Obviously, with COVID-19 impacts, such as shutdowns, quarantines, and decontamination, many bonded contractors may experience lost revenue from the interruption of their business. The problem with this type of insurance is that it is written on a property loss policy format and typically requires physical loss or damage to trigger coverage.¹⁸

In a recent Pennsylvania Supreme Court opinion, *DeVito v. Wolf*, unrelated to insurance coverage, the court held that the COVID-19 pandemic qualifies as a "natural disaster" under the Pennsylvania Emergency Code because it involves "substantial damage to property, hardship, suffering or possible loss of life."¹⁹ In addressing the nature of the virus and the manner in which it is transmitted, the court observed that "[t]he virus spreads primarily through person-to-person contact, has an incubation period of up to fourteen days, one in four carriers of the virus are asymptomatic, and the virus can live on surfaces for up to four days. Thus, any location (including Petitioners' businesses) where two or more people can congregate is within the disaster area."²⁰

The court in *DeVito* further rejected the argument that the virus had to be actually present at a specific location before a shutdown could occur and held that all



properties were damaged because of the manner in which the disease spreads.²¹ This could have important implications in policy interpretation regarding physical damage. The court concluded that the “COVID-19 pandemic is, by all definitions, a natural disaster and a catastrophe of massive proportions.”²² A surety should also carefully examine executive orders and disaster declarations issued in the relevant jurisdictions for statements and “findings” that the presence of the virus constitutes damage to property. Such findings could be used to support a claim.

Prior to the COVID 19 pandemic, there have been cases across the country holding that occurrences such as mold, fumes, and contamination can constitute physical damage or loss for purposes of business interruption coverage.²³ Further, several state governments, such as New Jersey, Pennsylvania, Ohio, Massachusetts, New York, and Louisiana, have introduced legislation to retroactively mandate coverage for business interruption caused by COVID-19.²⁴ In addition, over thirty lawsuits have been filed around the country challenging the denial of coverage for COVID-19 impacts under business interruption policies.²⁵ Thus, sureties will need to review the business interruption policy language and stay in touch with developments in the law regarding such coverages.

B. Coronavirus Aid, Relief and Economic Security Act (the “CARES Act”)

If a surety is concerned about the financial health of one of its bonded principals or is already financing or working with the principal to complete bonded projects, the surety should be pushing the principal to apply for certain loans that are being

²¹ *Id.* at *13.

²² *Id.* at *12.

²³ *W. Fire Ins. v. First Presbyterian Church*, 437 P.2d 52, 55 (Colo. 1968) (gasoline in soil); *Sentinel Mgmt. Co. v. New Hampshire Ins.*, 563 N.W.2d 296, 300 (Minn. Ct. App. 1997) (asbestos); *Cooper v. Travelers Indem. Co. of Ill.*, No. C-01-2400-VRW, 2002 WL 32775680, at *3 (N.D. Cal. Nov. 4, 2002) (e-coli in water); *Motorists Mut. Ins. v. Hardinger*, 131 F. App'x 823, 828 (3d Cir. 2005) (bacteria in water); *Matzner v. Seaco Ins.*, 9 Mass. L. Rptr. 41 (Mass. Supp. 1998) (carbon monoxide); *Mellin v. N. Sec. Ins.*, 115 A.3d 799, 807-09 (N.H. 2015); *Gregory Packaging, Inc. v. Travelers Prop. Cas. Co. of Am.*, Civ No. 2:12-cv-04418 (WHW)(CLW), 2014 WL 6675934, at *2-3, 8 (D.N.J. Nov. 25, 2014) (ammonia smell); *Sullivan v. Standard Fire Ins.*, 956 A.2d 643, at *3 (Del. 2008) (table op.) (mold).

²⁴ See H.B. 589, 133rd Gen. Assemb., 2019-2020 Sess. (Ohio 2020) (introduced); S.D. 2888, 191st Gen. Ct. (Mass. 2020) (draft); Assemb. B. 3844, 290th Leg., 1st Ann. Sess. (N.J. 2020) (introduced); S.B. 477, 2020 Reg. Sess. (La. 2020) (engrossed); H. B. 858, 2020 Reg. Sess. (La. 2020) (introduced); H.B. 2372, 204th Gen. Assemb., 2019-2020 Sess. (Pa. 2020) (introduced); Assemb. B. 10226, 243rd Leg. Sess. (amended/substituted).

²⁵ See Stephanie Zimmerman, *Coronavirus Pandemic Prompts Wave of “Business Interruption” Lawsuits by Restaurants*, A.B.A. J. PUB. HEALTH (March 26, 2020), <https://www.abajournal.com/web/article/coronavirus-pandemic-prompts-wave-of-business-interruption-lawsuits-by-restaurants>; Ed Treleven, *Class-Action Lawsuit Joins Growing Number Over Business Interruption Insurance Denials Amid COVID-19 Pandemic*, WIS. ST. J. (Apr. 30, 2020), https://madison.com/wsj/news/local/crime-and-courts/class-action-lawsuit-joins-growing-number-over-business-interruption-insurance-denials-amid-covid-19-pandemic/article_e9f48697-6a31-54fd-bd72-1c2d7a8b1f0d.html; Jennifer M. Oliver, *Contractual Distancing: Pandemic Insurance Litigation Spreads with Business Interruption Claim Denials*, N. L. REV. (April 19, 2020), <https://www.natlawreview.com/article/contractual-distancing-pandemic-insurance-litigation-spreads-business-interruption>.



offered by the federal government as a result of the COVID-19 pandemic. The CARES Act is now law and provides businesses with much-needed relief in the form of tax payment deferrals and loan programs. While the initial funding of the CARES Act program was depleted, Congress has authorized additional funding.

The CARES Act expands the Paycheck Protection Program (“PPP”) of the Small Business Act (the “SBA”) and applies to qualifying businesses that have fewer than 500 employees or that meet the SBA’s size requirements under the industry-based standards.²⁶ CARES Act loans are available through lenders that administer SBA loans and are available for up to 250% of average monthly payroll costs, up to \$10 million.²⁷ This amount is for the purpose of covering up to eight weeks of payroll and other business operation expenses.²⁸

Standardized loan terms have been developed with loans having a maximum term of ten years and interest rates are capped at 4%. The loans are limited to use for:

- payroll costs
- group healthcare benefits during periods of sick leave
- employee salaries and other compensations
- payments of mortgage interest
- rent payments
- interest on other debt, and
- utility payments²⁹

No personal guarantee or collateral is required, and the recipient is not required to certify that it is otherwise unable to obtain credit.³⁰ Another feature of the loans is that they can be forgivable.³¹ This loan essentially covers what a surety might otherwise have funded in a traditional financing situation.

C. The Disaster Loan Program

The federal government has also expanded the Economic Injury Disaster Loan Program (the “EIDL”) under the SBA. This expansion allows more businesses to obtain disaster loans in light of the COVID-19 pandemic. Such loans are available to small businesses in amounts up to \$2 million for economic injury caused by the pandemic.³² Originally, the loans were only available to small businesses in states

²⁶ See *Paycheck Protection Program Loans, Frequently Asked Questions (FAQs)* (May 27, 2020), <https://home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf>.

²⁷ *Id.*

²⁸ *Id.* The government has recently increased the period during which the loan can be used.

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.*

³² *Disaster Loan Assistance, Frequently Asked Questions*, U.S. SMALL BUS. ADMIN <https://disasterloanassistance.sba.gov/s/faq> (last visited June 15, 2020).



that have made a disaster declaration. If a business qualifies, the SBA's goal is to reach a decision on applications within 2-3 weeks. Payback terms can extend up to 30 years and for private, for profit businesses, the interest rate is 3.75%.³³

IV. TYPICAL SURETY LEGAL TOOLS TO PURSUE INDEMNITY MAY NOT WORK

As a result of the COVID-19 pandemic, many court systems have shut down or implemented emergency procedures or protocols that modify, limit, or postpone the normal operations of the courts. The extent of the emergency actions varies from jurisdiction to jurisdiction. The effect of the new emergency operations procedures may be to take away many of the bread-and-butter tools that sureties typically rely on. For example, it may be difficult or impossible to get a temporary restraining order for a books and records review or injunctive relief to enforce a collateral demand. In some instances, injunctive relief or declaratory relief may be necessary to protect other rights, stop certain actions, or preserve the status quo, but many courts have cancelled hearings and trials for all but limited emergency matters. Actions like default judgments, summary judgments, or even confessed judgments may all languish with courts closed or court staff reduced to skeleton crews.

In certain circumstances, it may be possible to petition the court for an emergency electronic or other remote hearing. The status of local courts and government offices may also affect a surety's ability to secure various collateral. For example, it might not be possible to record a deed of trust or file a UCC-1 financing statement. Sureties may need to consider using the assignment clauses and power of attorney rights often found in indemnity agreements to seek self-help remedies and enforce indemnity rights. ➤

³³ *Id.*



Federal... continued from page 8

under the bonded contract or growing out of the bonded contract.⁵ The following is an example of an assignment clause that has been enforced by the courts:

The Indemnitors hereby consenting do assign, transfer, pledge and convey to the Surety . . . as collateral security for the performance of the covenants and agreements herein contained, contained in Other Agreements and for the payment of any other indebtedness or liability of the Indemnitors and/or Principals to the Surety, whether therefore or hereafter incurred, the assignment in the case of each contract being effective as of the date of the Bond covering such contract the following: (a) all of the right, title and interest of the Indemnitors and/or Principals in, and growing in any manner out of, all contracts referred to in the Bonds, or in, or growing in any matter out of the Bonds; . . . (d) all actions, causes of action, claims and demands whatsoever which the Indemnitors and/or Principals may have or acquire against any subcontractor, laborer or materialman, or any person furnishing or agreeing to furnish or supply labor, material, supplies, machinery, tools or other equipment in connection with or on account of any and all contracts referred to in the Bonds[.]⁶

Many assignment clauses include even broader language, providing that, in addition to all rights arising out of the bonded contract, the principal assigns to the surety all rights under *any* contract, agreement, or undertaking in which the principal has an interest, regardless of whether such a contract is bonded or unbonded.⁷

An attorney-in-fact clause further protects the surety by irrevocably appointing the surety as the principal's attorney-in-fact, authorizing the surety to settle any of the assigned claims on behalf of the principal, including any affirmative claims the principal may have in connection with the bonded contract.⁸ These claims include any affirmative claims for non-payment the principal may have against the obligee, or certain counterclaims the principal may have against payment bond claimants.⁹ The following is an example of an attorney-in-fact clause that has been enforced by the courts:

5 See *Handex of Md., Inc. v. Waste Mgmt. Disposal Servs. of Md., Inc.*, 458 F. Supp. 2d 266, 273-74 (D. Md. 2006) (recognizing that courts have determined that assignment clauses are "deemed effective as of the time the surety's bond was executed.").

6 *Liberty Mut. Ins. Co. v. Aventura Eng'g & Constr. Corp.*, 534 F. Supp. 2d 1290, 1294-95 (S.D. Fla. 2008).

7 See *Amwest Sur. Ins. Co. v. Szabo*, No. 00 C 2716, 2002 WL 1559688, at *5 (N.D. Ill. July 16, 2002) (upholding an assignment clause which assigned to the surety "all rights in connection with any Contract' and subcontracts, '[a]ny and all sums due or which may thereafter become due under any Contract[.]' and '[a]ll rights arising out of insurance policies, notes and accounts receivable, and choses in action").

8 *Id.*; see also *Hutton Constr. Co. v. Cty. of Rockland*, 52 F.3d 1191, 1192 (2d Cir. 1995) (upholding the enforcement of the indemnity agreement's assignment and attorney-in-fact clauses and holding that the surety had the authority to "settle all claims on behalf of" the principal, "including not only claims against the Sureties 'upon the bonds,' but also [the principal's] affirmative claims growing out of its insured contracts").

9 See *Hutton*, 52 F.3d at 1192.



The Indemnitors and Principals hereby irrevocably nominate, constitute, appoint and designate the Surety as their attorney-in-fact with the full right and authority, but not the obligation, to exercise all the rights of the Indemnitors and Principals assigned, transferred and set over to the Surety in this Agreement, with full power and authority to execute on behalf of and sign any Indemnitor or Principal to any . . . release, . . . or any other document or papers deemed necessary and proper by the Surety in order to give full effect not only to the intent and meaning of the within assignments, but also to the full protection intended to be herein given to the Surety under all other provisions of this Agreement. The Indemnitors and Principals hereby ratify and confirm all acts and actions taken and done by the Surety as such attorney-in-fact and agree to protect and hold harmless the Surety for acts herein granted as attorney-in-fact.¹⁰

Pursuant to the assignment and attorney-in-fact clauses in the indemnity agreement, the surety may make, execute, and deliver any documents, instruments, or papers the surety may deem necessary to give full effect to the protections afforded to it under the indemnity agreement. These clauses also give the surety broad discretion to settle any claims the principal may have in order to avoid the unnecessary expense and uncertainty of litigation, as well as limit its exposure to additional losses in the event the principal does not prevail. Courts throughout the country have routinely upheld such clauses.¹¹ Therefore, assignment and attorney-in-fact clauses are critical in protecting the surety's interest in mitigating potential losses in the event of its principal's default under a bonded contract.

II. *Ikhana* Addresses a Surety's Right to its Principal's Assigned Claims in the Federal Contracting Context

Neither the basic factual scenario nor the court's rationale for its decision in *Ikhana* are unfamiliar to sureties. What is noteworthy, however, is the concurring opinion, which opened the door for the Federal Circuit to revisit its earlier holdings, which have precluded a surety from settling its principal's affirmative claims against the Federal Government.

¹⁰ *Aventura*, 534 F. Supp. 2d at 1294.

¹¹ See, e.g., *id.* at 1306 (recognizing that a "right-to-settle clause provides a surety with wide discretion in settling claims, even where the principal is not liable for the underlying claim" and that it is a "well settled principle that a surety may settle claims regardless of whether liability for the claim actually existed, and for the sole purposes of avoiding the cost of litigation"); *James McKinney & Son, Inc. v. Lake Placid 1980 Olympic Games, Inc.*, 462 N.E.2d 137, 138-39 (N.Y. 1984) (dismissing the principal's suit against the obligee because the surety had previously settled the claim with the obligee pursuant to the surety's assignment rights and thus the principal was "no longer the real party in interest with respect to claims against [the obligee] by virtue of [the] assignment"); *Old Dominion*, 294 F. Supp. 2d at 808 (finding that the indemnity agreement's assignment and attorney-in-fact clauses gave the surety authority to settle the principal's claims against the obligee).



The fundamental facts of *Ikhana* are rather unremarkable. The principal was awarded a public construction contract and the surety issued a payment and performance bond in connection therewith.¹² The principal executed an indemnity agreement, which provided that the principal assigned to the surety all of the principal's rights under the bonded contract in the event of default.¹³ During the performance of the contract, the principal submitted delay and extra work claims to the obligee.¹⁴ The principal was ultimately terminated for cause, and the obligee made demand under the performance bond.¹⁵ The principal failed to deposit collateral, and the surety engaged in settlement negotiations with the obligee.¹⁶ The surety and obligee entered into a settlement agreement, whereby the surety tendered a completion contractor to the obligee to complete the remaining work under the bonded contract.¹⁷ The settlement agreement also provided that the surety agreed to settle its principal's affirmative claims against the obligee.¹⁸

The identity of the obligee – the Federal Government – along with the fact that the principal had filed an appeal with the Armed Services Board of Contract Appeals (“ASBCA”)¹⁹ prior to the surety's settlement agreement with the obligee, is what separates *Ikhana* from a run-of-the-mill performance bond claim.²⁰

Given that the principal had pending ASBCA appeals, the surety moved to intervene and withdraw the principal's appeals in order to effectuate the terms of the settlement agreement.²¹ The Government also moved to dismiss the appeals on the basis of the settlement agreement with the surety.²² The ASBCA denied the surety's motion to intervene and withdraw, along with the Government's motion to dismiss, and held that the surety lacked standing to withdraw the principal's appeals.²³ The Federal Circuit, on direct appeal, affirmed the ASBCA's decision, reasoning that the Contract Disputes Act prohibits the surety from asserting its principal's pre-takeover affirmative claims.²⁴

¹² *Ikhana*, 941 F.3d at 1141-42.

¹³ *Id.* at 1142.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.* The principal appealed the propriety of the Government's termination, along with the principal's four claims for additional compensation. *Id.*

²⁰ See *id.* It bears note that, according to the parties' briefs, the Government waived protections under the Anti-Assignment Act, 31 U.S.C.A. § 3727 (Westlaw through Pub. L. No. 116-135); 41 U.S.C.A. § 6305 (Westlaw through Pub. L. No. 116-135). Thus, the Anti-Assignment Act did not play a factor in *Ikhana*. See generally *Ikhana*, 941 F.3d 1140.

²¹ *Ikhana*, 941 F.3d at 1142.

²² *Id.*

²³ *Id.*

²⁴ *Id.* at 1143-44.



The *Ikhana* court, relying heavily on its earlier decisions in *Admiralty*²⁵ and *Fireman's Fund*,²⁶ held that a surety cannot commandeer its principal's appeal to the ASBCA if the surety itself could not appeal the contracting officer's decisions to the ASBCA under the Contract Disputes Act.²⁷ Recognizing that the Contract Disputes Act provides that only a "contractor" can appeal a contracting officer's decision to the ASBCA, the court held that the surety is not considered a "contractor" under the Contract Disputes Act with respect to its principal's affirmative claims arising prior to the surety's takeover of the bonded contract.²⁸ Rather, the surety only has standing as a "contractor" under the Contract Disputes Act to assert claims to the ASBCA arising under a takeover agreement.²⁹

Two members of the three-judge *Ikhana* panel issued a concurring opinion, agreeing with the outcome of the decision, but taking issue with the rationale underlying the precedent upon which the court relied. The concurrence argued that the Federal Circuit wrongly decided *Admiralty* and *Fireman's Fund* by disregarding the principal's contractual assignment of its rights to the surety in the indemnity agreement.³⁰ The concurring opinion observed that the Contract Disputes Act's limitation of the right to bring appeals to a single "contractor" was not intended to address a surety's right to assert (or, presumably, dismiss) its principal's appeals, but rather was intended to preclude *subcontractors* from participating in the remedies provided for under the Contract Disputes Act.³¹ By ignoring the true purpose of the Contract Disputes Act, the concurrence argued, the *Admiralty* and *Fireman's Fund* courts misapplied the statute without support.³²

Discussing the fundamentals of suretyship, the concurring opinion pointedly observed that, in the indemnity agreement, the principal assigned the surety all of the principal's rights and claims under the bonded contract.³³ The concurrence recognized that the court's earlier decisions in *Admiralty* and *Fireman's Fund* have tied the hands of sureties in the federal contracting context. Outside of the federal contracting context, a surety has the right to address claims and litigation involving its principal – including the principal's claims against the obligee. When the surety has bonded a federal project, however, *Admiralty* and *Fireman's Fund*

25 See *Admiralty Constr., Inc. v. Dalton*, 156 F.3d 1217 (Fed. Cir. 1998).

26 See *Fireman's Fund Ins. v. England*, 313 F.3d 1344 (Fed. Cir. 2002).

27 *Ikhana*, 941 F.3d at 1143-44.

28 *Id.*

29 *Id.*

30 *Id.* at 1146 (Wallach, J., concurring).

31 *Id.* at 1146-47.

32 *Id.*

33 *Id.*



have precluded sureties from efficiently resolving performance bond claims in which the principal has asserted its own claims against the federal government.³⁴ The concurring opinion astutely addressed the importance of enforcing a surety's right to its principal's affirmative claims:

The facts of this case are representative of the nature of a surety's work – bringing efficient resolution to contract disagreements, assuming financial risk, and ensuring execution – and of the necessity for granting sureties the legal rights they need to ensure speedy resolutions. The significance of this negotiating tool should not be understated. Lengthy delays in public projects could be problematic, expensive, and even dangerous. Moreover, sureties for government contracts may recognize the downstream problems of our precedent and either opt out of providing the service or, in recognizing the potential for heightened financial risk, charge a higher rate for their services. Whatever the overall cost of doing business will be higher for all parties and U.S. taxpayers will be left paying the tab.³⁵

The concurrence openly invited a review of the Federal Circuit's precedent “to resolve a question of exceptional importance.”³⁶

In identifying the disconnect between basic suretyship and common law principles, on one hand, and the state of the law with respect to a surety's rights to its principal's affirmative claims against the Federal Government, on the other, the concurring opinion gave hope that these two inconsistent bodies of law would soon be harmonized. That hope was short-lived, however, with the Federal Circuit denying the surety's petition for an *en banc* rehearing.³⁷ As observed by Judge Wallach in his concurring opinion in *Ikhana* and his dissenting opinion on the surety's petition for rehearing, the Federal Circuit's decisions in *Admiralty*, *Fireman's Fund*, and, now, *Ikhana* will continue to tie the hands of sureties that have bonded federal contracts. >

³⁴ *Id.* at 1147-49.

³⁵ *Id.* at 1149.

³⁶ *Id.*

³⁷ *Ikhana*, 2020 WL 2781655, at *1.



Mississippi... continued from page 9

Finally, the Computer Transfer Fraud coverage provided:

The Insurer will pay for loss of . . . **Covered Property** resulting directly from **Computer Transfer Fraud** that causes the transfer, payment, or delivery of **Covered Property** from the **Premises** or **Transfer Account** to a person, place, or account beyond the **Insured Entity's** control, without the **Insured Entity's** knowledge or consent.⁴

Computer Transfer Fraud was defined as “the fraudulent entry of **Information** into or the fraudulent alteration of any **Information** [Electronic Data] within a **Computer System**.”⁵

Computer System was defined as “computer hardware, software and all components thereof linked together through a network or devices accessible through the internet, or the **Insured Entity's** intranet or connected with data storage or other peripheral devices that are operated by and either owned by or leased to the **Insured Entity** and used to collect, transmit, process, maintain, store and retrieve **Electronic Data**.”⁶

The Computer Transfer Fraud insuring agreement included a specific term that specified that the transfer had to occur without the insured's knowledge or consent for coverage to exist, and its own title signaled a similar concept: a computer transfer, not a human transfer was required.

The Business Process

Mississippi Silicon (“MS”) was a manufacturer of silicon metal and it used Russian company Energoprom as its supplier of graphitized carbon electrodes.⁷ MS incurred a loss of money after it paid invoices it owed to Energoprom by sending two separate wire transfers (three weeks apart) to a Bulgarian bank that MS believed was a bank for Energoprom.⁸

On October 23, 2017, John Lalley, CFO of MS, received an email that stated “Olga Rozina,” an Energoprom employee, in the “from” line.⁹ The October 23, 2017, email had an attachment with bank information on it.¹⁰ MS contended that the October 23,

⁴ *Id.*

⁵ *Id.* at *12.

⁶ Note that the opinion did not quote this definition but is provided based on the author's personal knowledge of the policy language at issue.

⁷ *Miss. Silicon Holdings*, 2020 U.S. Dist. LEXIS 29967, at *1-2.

⁸ *Id.* at *1-4.

⁹ *Id.* at *2.

¹⁰ *Id.*



2017, email with the attachment (the “October Email”) was not from the real “Olga Rozina” and was a spoofing email. When the October Email was received into the MS email system (Microsoft Office 365 email system), it sat in the email system.¹¹ The email and the attachment to it had no functionality that permitted the MS email system to make any further use of the October Email.¹²

After receiving the October Email, John Lalley made the affirmative decision to issue a payment in the amount of \$250,030.00 by sending that amount by wire transfer to the bank noted on the Attachment to the October Email that John Lalley received.¹³ A wire transfer of that size required a three-step approval process by MS employees; accordingly, John Lalley along with two other employees provided separate approvals to the Bank.¹⁴ Without all three authorizations, the October Wire Transfer would not have been sent out by the Bank. The October Wire Transfer was transmitted in accordance with the instructions physically typed into the Trustmark Bank system by John Lalley.¹⁵

John Lalley received an email on November 17, 2017, where the “from” line indicated “Olga Rozina,” stating that she was sending “shipping documents and invoice attached for Lot#7” and also requested information regarding “the estimated date of payment for 2 invoices left due in October/November,” and to which were attached (a) delivery instructions for electrodes sent to MS; and (b) an invoice reflecting the amount owed to Energoprom for those electrodes, including bank information for use in the payment.¹⁶ This initial November 17, 2017, email, with attachments of delivery instructions and an invoice, was a legitimate email from the real “Olga Rozina.”¹⁷ The original banking information for Energoprom was stated.

John Lalley then received two separate (but identical content) emails on November 17, 2017, at 2:42 a.m., and on November 17, 2017, at 5:28 a.m., where the “from” line indicated “Olga Rozina,” which stated that John Lalley should ignore the banking information on the invoice just sent as “we cannot include our agent collectors account on our invoice.”(the “November Disregard Emails”).¹⁸ MS contends that the second two emails received on November 17, 2017, were spoofing emails. When the two separate but identical emails of November 17, 2017, (stating John Lalley should

¹¹ Note that some of these details were not included in the court’s opinion but are based on the author’s knowledge of the lawsuit and the underlying facts.

¹² *Id.*

¹³ *Miss. Silicon Holdings*, 2020 U.S. Dist. LEXIS 29967, at *2-3.

¹⁴ *Id.* at *3.

¹⁵ *Id.* at *2-3.

¹⁶ *Id.* at *3; *supra* n.11.

¹⁷ *Miss. Silicon Holdings*, 2020 U.S. Dist. LEXIS 29967, at *3.

¹⁸ *Id.* at *3-4; *supra* n.11.



ignore the invoice's bank information just received) (the "November Disregard Emails") were received into the MS email system, each sat in the email system.¹⁹ The November Disregard Emails had no functionality that permitted the MS email system to make any further use of the November Disregard Emails.²⁰

Following receipt of all of the various November 17 emails, John Lalley made the affirmative decision to issue a payment for \$775,851.13, by sending that amount by wire transfer to the Bulgarian bank noted on the Attachment to the October Email that John Lalley received back on October 23. On November 17, John Lalley logged into the Trustmark Bank computer system and physically entered the details to send a second wire transfer (this time in the amount of \$775,851.13) to the Bulgarian bank identified on the Attachment to the October Email (the "November Wire Transfer").²¹ The three-person verification process was completed as well.²² John Lalley received a confirmation from Trustmark Bank that the November Wire Transfer was successfully transmitted to the Bulgarian bank.²³ John Lalley compared the information and determined that the wire was sent as instructed.²⁴ No fraudster contacted Trustmark Bank pretending to be MS and no one other than MS tried to initiate wire transfers at Trustmark Bank from the MS bank account.²⁵

On December 11, 2017, Energoprom alerted John Lalley that Energoprom had not received any recent payments for outstanding invoices for electrodes.²⁶ MS provided notice of a claim to AXIS.²⁷

AXIS issued a claim decision granting coverage under the Social Engineering Fraud insuring agreement.²⁸ MS rejected the claim payment, arguing that the loss was also covered under the Computer Transfer Fraud and Funds Transfer Fraud insuring agreements.²⁹

The Court's Analysis

The United States District Court for the Northern District of Mississippi entered summary judgment in favor of AXIS on all issues in the case, holding that the policy

¹⁹ *Supra* n.11.

²⁰ *Supra* n.11.

²¹ *Id.* at *4.

²² *Id.*

²³ *Supra* n.11.

²⁴ *Id.*

²⁵ *Supra* n.11.

²⁶ *Miss. Silicon Holdings*, 2020 U.S. Dist. LEXIS 29967, at *4.

²⁷ *Id.* at *6-7.

²⁸ *Id.* at *7.

²⁹ *Id.* at *7-8.



itself was unambiguous and must be construed according to its plain meaning.³⁰ The court noted that a policy must be considered as a whole, with all relevant clauses together, and noted that a disagreement of the parties over how to interpret policy language does not mean the policy is ambiguous.³¹ The court noted that AXIS conceded coverage under the Social Engineering Fraud insuring agreement and focused on the distinctions between that insuring agreement and both the Computer Transfer Fraud and Funds Transfer Fraud insuring agreements.³²

The court spent little time analyzing the Funds Transfer Fraud insuring agreement, concluding quickly that no facts indicated that the insuring agreement could possibly be applicable.³³ The court properly focused on the elements of the insuring agreement, including the fact that it was the insured's bank that had to be tricked into acting and that MS could not satisfy the "no knowledge or consent" provision there since three employees took affirmative steps to transfer the money.³⁴

The court carefully walked through the elements of the Computer Transfer Fraud insuring agreement with detailed attention to the unauthorized access, direct causation, and "without the knowledge or consent" elements.³⁵ The court stated that it "[found] telling the inclusion of the word 'directly' in the provision" and applied a "direct means direct" causation standard.³⁶ The court noted that while the October Email set in motion a series of events which ultimately led to the loss, the emails did not themselves manipulate MS's computer system and automatically transfer the funds.³⁷ Rather, the emails requested that MS engage in an affirmative act (initiating a wire transfer) and that such a distinction was critical in light of the policy language.³⁸ Rejecting MS's argument to apply a proximate loss standard, the court declined to ignore the plain language of the policy, concluding: "If a proximate cause standard or some other more expansive coverage was intended, that language undoubtedly could have been included in the Policy. However, it was not."³⁹

The court additionally included a discussion of the "knowledge or consent" provision, which appeared at the end of the insuring agreement: "In the court's view, the inclusion of the 'knowledge or consent' requirement is telling as to the coverage that

³⁰ *Id.* at *27.

³¹ *Id.* at *10-11.

³² *Id.* at *9-10.

³³ *Id.* at *20-24.

³⁴ *Id.*

³⁵ *Id.* at *12-20.

³⁶ *Id.* at *13-15.

³⁷ *Id.* at *12-13.

³⁸ *Id.* at *13-14.


³⁹ *Id.* at *14-15.



was intended.⁴⁰ The court concluded that the provision and plain language meant the coverage applied only to losses that occur without MS's knowledge or consent.⁴¹

As a further point on the phrase, the court made reference to the actual Social Engineering Fraud insuring agreement, which it noted provided additional helpful guidance.⁴² The court stated that had the Computer Transfer Fraud insuring agreement been intended to cover a loss occurring when a funds transfer was effectuated by an employee acting in good faith reliance upon an electronic instruction that turned out to be fraudulent, the same language used in the Social Engineering Fraud insuring agreement could have been used in the Computer Transfer Fraud provision.⁴³ The court found the absence of the language in the Computer Transfer Fraud provision to be instructive.⁴⁴

The court spent its time and attention analyzing the language of the policy and its plain meaning. However, as part of its final discussion, the court did refer to and cite with approval *Apache Corp. v. Great American Ins. Co.*, noting the Fifth Circuit's analysis and treatment of the policy in that decision.⁴⁵ The court also noted Ninth Circuit decisions reaching similar conclusions.⁴⁶ Although decisions from the Second, Sixth, and Eleventh Circuits were cited in MS's briefing to the court, the court did not adopt any of the approaches taken by those courts.

The Northern District of Mississippi's analysis stands in stark contrast to the approaches taken recently in some very result-oriented cases. It reflects an important discussion of the distinction between social engineering coverage and computer fraud coverage, as well as a serious emphasis on the direct causation element. Its focus on the plain language of the policy—and its intellectually honest treatment of the actual terms of the policy—provide a strong example of arguments that should prevail on these coverages. 

40 *Id.* at *16-17.

41 *Id.* at *17.

42 *Id.* at *18-20.

43 *Id.* at *19-20.

44 *Id.*

45 *Id.* at *24-26 (citing *Apache Corp. v. Great Am. Ins. Co.*, 662 F. App'x 252 (5th Cir. 2016)).

46 *Id.* at *26 n.8 (citing *Pestmaster Servs., Inc. v. Travelers Cas. & Sur. Co. of Am.*, 656 F. App'x 332 (9th Cir. 2016)).



Principal's... continued from page 10

representing Cromwell's expenditure to buy replacement lumber because the lumber Stevenson supplied was defective due to wood rot, then Cromwell is seeking a recoupment. Recoupment is akin to a back charge or a compulsory counterclaim.

It is also important to evaluate whether the principal has a valid set-off claim. Often there is a contractual setoff provision that would permit the principal to deduct from the amount owed the claimant on the bonded project an amount equal to the sum owed by the claimant to the principal under any other contract or agreement between the two parties. If there is not a contractual provision, the applicable common law must be considered to determine whether there is a common law right of setoff.⁶ Typically, for setoff to apply, the parties' demands must be mutual (between the same parties) and the claim being setoff must be liquidated.⁷

In addition to general principles of surety law, the surety's utilization of its principal's setoff defense is addressed in the Restatement (Third) of Suretyship and Guaranty (the "Restatement").⁸ [Section 35 of the Restatement](#) provides:

When the principal obligor [principal] has a claim against the obligee [claimant] that is unrelated to the underlying obligation and, under the law governing setoffs, the principal obligor [principal] could set off that claim against the underlying obligation, the secondary obligor [surety] may utilize that claim to reduce its duty under the secondary obligation [bond]:

- a. to the extent that the claim is uncontested by the obligee [claimant] or there is no genuine issue as to the obligee's [claimant's] liability to the principal obligor [principal];
- b. if the principal obligor [principal] consents to the use of its claim by the secondary obligor [surety];
- c. if the principal obligor [principal] is made a party to the obligee's [claimant's] action to enforce the secondary obligation [bond]; or
- d. if the principal obligor [principal] is charged with notice of the secondary obligation [bond] and the secondary obligor [surety] gives the principal obligor [principal] reasonable notice of the obligee's [claimant's] action

⁶ *Boatmen's Nat. Bank of St. Louis v. Sears, Roebuck & Co.*, 106 F.3d 227, 230-31 (8th Cir. 1997) (concluding there was no contractual right of setoff and analyzing whether there was a common law right of setoff).

⁷ For example, in *Montello Oil Corp. v. Apex Oil Co.*, the court held a petroleum trader could not set off its intentional tort claim against the amount it owed the other trader because an intentional tort claim did not constitute a liquidated debt. Whether the debt is liquidated will be determined under the applicable law. 571 F. Supp. 389, 391-92 (E.D. Mo. 1983).

⁸ Restatement (Third) of Sur. & Guar. § 35 (AM. LAW INST. 1996).



and of the secondary obligor's [surety's] intent to assert the claim and an opportunity to join its assertion, unless the court, based on considerations of the appropriate administration of justice, determines that it would be inappropriate to litigate the claim in that court.

Thus, Section 35 of the Restatement provides authority for the surety's use of its principal's setoff claim.

Although the surety should be able to use its principal's setoff defense, sureties have faced an additional hurdle in the Miller Act context. The Miller Act requires the general (or prime) contractor on a federal project to provide a surety bond "for the protection of all persons supplying labor and material."⁹ The Miller Act is "highly remedial in nature . . . [and] is entitled to a liberal construction and application in order properly to effectuate the congressional intent to protect those whose labor and materials go into public projects."¹⁰ The Miller Act creates a cause of action in favor of "every person who has furnished labor or material in the prosecution of the work provided for in the contract."¹¹ Under the Act, a person "who has not been paid in full [for the labor or material for which claim is made] shall have the right to sue on [the] payment bond...for the sum or sums justly due him."¹²

Although courts have held that the surety has its principal's defense of recoupment,¹³ some courts have relied on what they have concluded to be the purposes of the Miller Act to limit the surety's ability to use its principal's defenses, when the defense

9 *United States ex rel. Walton Tech., Inc. v. Weststar Eng'r, Inc.*, 290 F.3d 1199, 1204 (9th Cir. 2002) (quoting 40 U.S.C.A. § 270a(a)(2)(current version 40 U.S.C.A. §§ 3131-32 (Westlaw through [https://www.westlaw.com/Document/ID447E62064C811EAA701EB8FBFEFA7B6/View/FullText.html?transitionType=Default&contextData=\(sc.Default\)&VR=3.0&RS=da3.0](https://www.westlaw.com/Document/ID447E62064C811EAA701EB8FBFEFA7B6/View/FullText.html?transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=da3.0) Pub. L. No. 116-135)).

10 *Walton Tech.*, 290 F.3d at 1204 (quoting [https://www.westlaw.com/Document/I582bf3129bed11d9bdd1cfdd544ca3a4/View/FullText.html?transitionType=Default&contextData=\(sc.Default\)&VR=3.0&RS=da3.0&fragmentIdentifier=co_pp_sp_780_216](https://www.westlaw.com/Document/I582bf3129bed11d9bdd1cfdd544ca3a4/View/FullText.html?transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=da3.0&fragmentIdentifier=co_pp_sp_780_216) *United States ex rel. Sherman v. Carter*, 353 U.S. 210, 216 (1957)).

11 40 U.S.C.A. § 270b(a)(current version 40 U.S.C.A. § 3133 (Westlaw through Pub. L. No. 116-135)).

12 *Id.*

13 In *United Structures of America, Inc. v. G.R.G Eng'g, S.E.*, 9 F.3d 996, 999 (1st Cir. 1993), the court found "the [aim of recoupment,] doing justice in view of one transaction as a whole...would seem to match the [Miller Act's] requirement of determining the sums 'justly due' a supplier, making recoupment an appropriate defense in Miller Act cases." The court added, "we do not see how the full contract price of goods supplied can possibly be 'justly due' a person who supplied defective goods...the policies underlying the Miller Act seem to permit recoupment." *Id.* See also *United States ex rel. Andrews Marine Servs., Inc. v. United Sur. & Indem. Co.*, No. Civ. 04-1135 (HL), 2005 WL 1308919, at *5-7 (D.P.R. 2005) (noting that "disallowing recoupment would seem to give the supplier 'rights' to which his contract does not entitle him" and holding that "a surety company standing in the shoes of the contractor is entitled to recoup the value of any defective or incomplete performance."); *United States ex rel. Hussmann Corp., v. Fid. & Deposit Co. of Md.*, 999 F. Supp. 734, 747-48 (D. N.J. 1998) (holding the surety was entitled to raise a claim of recoupment as a defense to subcontractor's Miller Act claim); *United States ex rel. Tenn. Valley Marble Holding Co. v. Grunley Constr.*, 433 F.Supp. 2d 104, 114 (D.D.C. 2006); (holding "defendant's claim arises out of the same transaction as plaintiff's Miller Act claim. Accordingly, defendant's claim is in recoupment and may be asserted as a defense to plaintiff's Miller Act claim."); *Finish Line v. J.F. Pate & Assoc. Contractors, Inc.*, 90 So.3d 749, 754-55 (Ala. Ct. App. 2012) (concluding the setoff defense asserted by the general contractor and surety was actually a counterclaim in the nature of recoupment and such defense may be asserted against a supplier).



affects the timing and right of recovery.¹⁴ At least one court has concluded that the surety cannot use its principal's setoff defense based on its belief that such use would be at odds with the purpose of the Miller Act.

In *United States ex rel. Acoustical Concepts, Inc. v. Travelers Casualty and Surety Co. of America*,¹⁵ a general contractor entered into subcontracts with the same subcontractor on three projects, two federal projects and a third private-nonbonded project. The bonded subcontracts contained a setoff provision that allowed the general contractor to set off any claims it had against the subcontractor against any amount owed on any other project.¹⁶ The subcontractor successfully completed work on the two federal projects but breached the subcontract on the private project resulting in damages to the general contractor. In accordance with the setoff provision in the subcontracts, the general contractor withheld monies owed to the subcontractor on the federal projects to cover the general contractor's damages on the private project.

The subcontractor sued the Miller Act payment bond sureties seeking payment for the amounts owed on the federal projects and filed a motion for summary judgment on its Miller Act claims.¹⁷ The sureties defended, arguing that whether the subcontractor had been paid was in dispute because they were entitled to assert the general contractor's claim arising out of the private project pursuant to the setoff provision in the subcontracts. The court rejected the sureties' position and concluded that the setoff provisions were contradictory to the purposes of the Miller Act and therefore could not be used by the sureties as a defense. The basis for the court's holding was its conclusion that allowing the sureties to assert the setoff provisions would delay or complicate payment to the subcontractor, which supplied labor and materials on federal projects.¹⁸ The court focused on the purpose of the Miller Act, to ensure subcontractors are paid for labor and materials supplied to federal projects, and a surety's responsibility to investigate and pay the claim if its principal defaults. Interestingly, when determining the amount that was "justly

¹⁴ See *United States ex rel. T.M.S. Mech. Contractors v. Millers Mut. Fire Ins. Co. of Texas*, 942 F.2d 946, 951 (5th Cir. 1991) (holding a surety's liability depended on whether the claim fell within "the language of the [Miller Act], interpreted in light of its protective purpose."); *United States ex rel. Walton Tech., Inc. v. Weststar Eng'g, Inc.*, 290 F.3d 1199, 1207 (9th Cir. 2002) ("[W]here subcontract terms affect timing or the right of recovery under the Miller Act, enforcement of such term to preclude Miller Act liability contradict the express terms of the Miller Act."); *United States ex rel. U.S. Glass, Inc. v. Patterson*, No. 12-2634, 2014 WL 442853, and *3 (E.D. Penn. Feb. 4, 2014) (holding a pay-when-paid clause would contravene the Act's terms because "the liability of a Miller Act's surety and principal is coextensive with the contractual liability of the principal only to the extent that it is consistent with the rights and obligations created under the Act."); *United States ex rel. Kitchens To Go v. John C. Grimberg Co.*, 283 F. Supp. 3d 476, 481-82 (E.D. Va. 2017) (concluding a "no damages for delay" clause was unenforceable because it affected both the timing and the right of recovery under the Miller Act).

¹⁵ 635 F. Supp. 2d 434 (E.D. Va. 2009).

¹⁶ *Id.* at 435-436.

¹⁷ *Id.*

¹⁸ *Id.*



owed” to the subcontractor, the court looked to the provisions of the contract for the scope of work and measure of payment.¹⁹ However, it refused to consider the setoff provision in making the determination of what was justly owed, finding the provision to be separate and distinct from the provisions of the contract which defined the amount owed to the subcontractor for labor and materials.²⁰

The court also noted that neither the Miller Act nor the payment bonds at issue mentioned setoff, and as a result, that defense was not available to the sureties.²¹ However, the Miller Act and Miller Act payment bonds do not specifically delineate any of the principal’s contract defenses. The court’s holding essentially results in not only the surety being unable to raise the defense but the principal being unable to raise the defense and only able to litigate its claim against the subcontractor in another case. Given that the principal has a reimbursement or indemnity obligation to the surety, the result of not allowing the surety to use its principal’s setoff defense guts the principal’s defense because the principal must reimburse the surety for any payment, the very result which the setoff defense is designed to avoid—ultimately, requiring A to pay B when B owes A.

While the *Acoustical* case is not necessarily binding on other courts, other courts may find it persuasive. Thus, when faced with the principal’s setoff defense, the surety should ensure the defense is supported by applicable contract language and case law, make the appropriate arguments that the surety has its principal’s defenses, and be prepared to address any argument that there is an exception to the general rule articulated by the Restatement. ➤

¹⁹ *Id.* at 439.

²⁰ *Id.* at 440.

²¹ *Id.* at 438–41.



Contractor... continued from page 11

work as stated in paragraph (l)(1) of this section, are not included in the site of the work. Such permanent, previously established facilities are not part of the site of the work, even where the operations for a period of time may be dedicated exclusively, or nearly so, to the performance of a contract.³

The Department of Labor (“DOL”) has declined to define either “adjacent” or “virtually adjacent” under the DBA because it has decided that the only “fair and practical method for determining whether a temporary facility is virtually adjacent to the ‘site of the work’ is on a case-by-case basis.”⁴ More specifically, the DOL has chosen not to define “just how far such a facility can be from the actual construction site and still be considered part of the ‘site of the work.’”⁵ The DOL’s view is that any such definition would create an “artificial benchmark” that would enable contractors to avoid DBA coverage and defeat the purpose of the Act.⁶ Instead, the DOL expects contractors to perform a common sense, case-by-case analysis, based on the size and nature of the project, of whether facilities established nearby to serve a federal or federally assisted project are covered by the DBA.⁷

Although the DOL has not offered a geographic definition for either “adjacent” or “virtually adjacent,” some guidance regarding the potential geographic scope of these concepts is available. The DOL has favorably referred to the analysis set forth in the Administrative Review Board’s (the “Board”) decisions in *Bechtel I*⁸ and *Bechtel II*^{9,10}. *Bechtel I* and *Bechtel II* involved a project for the construction of 330 miles of aqueduct and pumping plants and a dispute over whether the DBA applied to work performed at three batch plants located less than one-half mile from various pumping stations (and often requiring concrete from the batch plants to be delivered to construction locations up to 15 miles away from the plants).¹¹ The Board in *Bechtel I* and *Bechtel II* analyzed the nature of the project and determined that because of the project’s narrow, linear nature, work performed in actual or virtual adjacency to “one portion of the long continuous project is to be considered adjacent to the entire project.”¹² Consequently, the Board held that the batch plants were located in virtual adjacency to the site of the work so that it would be reasonable to include them as the “site of the work.”¹³

The DOL considers the *Bechtel* matters persuasive because they illustrate the “difficulties inherent in establishing a specific distance for defining the terms, ‘virtually adjacent.’”¹⁴ Because temporary batch plants constructed for the purpose of supplying asphalt for a project are likely to be located somewhere near the project,

¹² *Bechtel I*, at *6; *Bechtel II*, at *2.

¹³ *Bechtel II*, at *5.

¹⁴ *Labor Standards Provisions*, *supra* note 4, at 80273.



instead of directly on the site and in the way of the project, the DOL believes such batch plants exemplify the necessity of performing a factually specific analysis based on the size and nature of the project in determining whether a work site is “virtually adjacent” for purposes of the DBA.¹⁵ In sum, the DOL has determined that “[w]here to locate a storage area or a batch plant along such a project is a matter of the contractor’s convenience and is not a basis for excluding the work from the DBA.”¹⁶

The Board has also provided guidance in its decisions since *Bechtel I*, *Bechtel II*, and the 2001 amendment to the definition of “site of the work” indicating that 1,000-1,500 yards from the project site is “arguably” “virtually adjacent” whereas three to five miles from the project site is not.¹⁷

Additional guidance regarding whether a work site is “adjacent” or “virtually adjacent” for purposes of the DBA may be found in state department of transportation (“DOT”) materials. For instance, several state DOTs have offered guidance regarding what is considered “virtually adjacent” with the general consensus being that any work areas located within one half mile to one mile (as the crow flies) of the closest point of the site of the work will be considered “virtually adjacent” for purposes of the DBA.¹⁸ On the other hand, a few state DOTs have declined placing a geographic limitation on the applications of “adjacent” or “virtually adjacent” and have instead defined “adjacent” as a “common boundary between the project and plant site” and “virtually adjacent” as a “plant site is separated from the project site by a narrow strip of land such as a local road between a project and a plant site.”¹⁹

It is important to remember that even where a work site is not considered “adjacent” or “virtually adjacent” under the DBA, the work site may still be considered what is known as a “secondary site” – any site other than the project’s final resting place where a significant portion of the building or work is constructed, provided that such site is established specifically for the performance of the contract or project.²⁰ Prior to award of a contract, an offeror may request a determination from the Contracting

¹⁵ *Id.* at 80270, 80275.

¹⁶ *Id.* at 80270.

¹⁷ *See e.g.*, IN THE MATTER OF: FORREST M. SANDERS, PETITIONER v. ADMINISTRATOR, WAGE & HOUR DIVISION, EMPLOYMENT STANDARDS ADMINISTRATION, U.S. DEPARTMENT OF LABOR, RESPONDENT, 2007 WL 4248530; IN THE MATTER OF: GARY J. WICKE DISPUTE CONCERNING PAYMENT OF PREVAILING WAGE RATE PAID TO A LABORER OR MECHANIC EMPLOYED BY A CONTRACTOR THAT IS A PARTY TO A CONTRACT WITH THE FOREST SERVICE, UNITED STATES DEPARTMENT OF, 2008 WL 4462982.

¹⁸ *See, e.g.*, NORTH DAKOTA DEP’T OF TRANSP., DAVIS-BACON WAGE AND PAYROLL REQUIREMENTS HANDBOOK 6 (2019); STATE OF OHIO DEP’T OF TRANSP., CONSTRUCTION ADMINISTRATION MANUAL OF PROCEDURES 36 (2017).

¹⁹ *See, e.g.*, NEVADA DEP’T OF TRANSP., CERTIFIED PAYROLL AND COMPLIANCE MANUAL 53 (2016); IOWA DEP’T OF CONSTR., CONSTRUCTION MANUAL: DAVIS-BACON WAGE REQUIREMENTS § 2.24 (2020).

²⁰ 29 C.F.R. § 5.2(l)(1).



Officer regarding whether a work site satisfies the criteria for a secondary site²¹. However, after award of a contract, a factually specific analysis of the work site will be necessary to determine whether the DBA applies.²²

If a contractor is found by the DOL to have violated the DBA, the contractor and its sureties may be liable not only for the difference between the applicable prevailing wage rate and the wages actually paid, but also for any excess costs incurred by the government to complete the work, in the event that the government chooses to terminate the work as a result of the alleged DBA violation.²³ Therefore, in relying upon any geographic guidance in determining whether a project site is “adjacent” or “virtually adjacent” under the DBA, it is important to remember the reason why the DOL refused to define the terms in the first place – to avoid giving contractors an arbitrary benchmark for circumventing DBA coverage. By declining to provide a geographic test for just how far such a facility can be from the actual construction site and still be considered part of the “site of the work,” the DOL sought to enable a practical, case-by-case application of the DBA requirements. Although prevailing wage determinations are generally made prior to contract award and, therefore, likely before a surety’s involvement with a project, sureties should promote DBA compliance by encouraging their principals to verify applicable DOT guidance and perform a factually specific analysis of “the site of the work” with the assistance of counsel, if necessary. The exercise of conducting such a good-faith, case-by-case analysis may be pivotal in the DOL’s determination of whether a DBA violation has occurred or, at a minimum, may provide support for a contractor and its surety to negotiate a settlement with the DOL regarding alleged DBA violations. ➤

²¹ 48 C.F.R. § 22.407(h); 48 C.F.R. § 52.222-5(a)(2).

²² Note that the FAR only provides for a contractor to request a determination from the Contracting Officer *prior to* award. *Id.*

²³ 40 U.S.C.A. § 3143-3144(a) (West).



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should endeavor to have foreign principals and indemnitors sign U.S.-law indemnity agreements, when possible!⁶

This article gives an overview of the recognition process under Chapter 15 and some of the specific challenges that the surety may face in global insolvency proceedings as compared to the more familiar issues encountered in domestic bankruptcy cases. Not the least of these challenges may be working with multiple teams of U.S. and foreign counsel. A sampling of the legal issues encountered in a bond principal's Chapter 15 case highlights the potential need for several sets of outside counsel—provided the surety's exposure justifies the complication and expense.

What Is a Chapter 15 Case, Anyway?

The foreign representative of a debtor commences a Chapter 15 case by filing a petition for recognition of a foreign proceeding in a U.S. bankruptcy court.⁷ For this article, we will use the hypothetical of a Canadian bond principal whose principal place of business is in Canada. In addition to its Canadian business, the principal conducts significant business in the United States and has assets based in the United States. The Canadian principal initiates a reorganization proceeding in Canada. A representative of the debtor then files a Chapter 15 petition in a United States bankruptcy court.

A foreign proceeding may be a “main” proceeding if that jurisdiction is where the debtor's “center of main interest” (“COMI”)—or principal place of business—lies.⁸ Alternatively, an insolvency proceeding can be categorized as “nonmain,” meaning it is pending in a jurisdiction where the debtor carries out some “nontransitory economic activity.”⁹ In our hypothetical, the debtor has a COMI in Canada. The Canadian reorganization case would more than likely qualify as a Main Proceeding and the Chapter 15 case as a Non-Main Proceeding.

Recognition of a Main Proceeding has two major impacts. First, the Main Proceeding has the authority to issue a global stay halting all proceedings and collection actions against the debtor. [11 U.S.C.A. § 361 \(West\)](#) (“Adequate protection”), [362](#) (“Automatic stay”), [363](#) (“Use, sale or lease of property”), [549](#) (“Postpetition transactions”) and [552](#) (“Postpetition effect of security interest”) automatically kick

⁶ A practice tip suggested to the authors by attorney T. Scott Leo of The Law Offices of T. Scott Leo, P.C.

⁷ See [11 U.S.C.A. § 1504, 1515\(a\) \(West\)](#). See also *In re PT Bakrie Telecom Tbk*, 601 B.R. 707, 713 (Bankr. S.D.N.Y. 2019).

⁸ See *In re Fairfield Sentry Ltd.*, 714 F.3d 127, 135–37 (2d Cir. 2013) (noting also that a debtor's COMI should be determined based on its activities at or around the time of the Chapter 15 filing); *In re Ran*, 607 F.3d 1017, 1025 (5th Cir. 2010).

⁹ [11 U.S.C.A. § 1502\(2\) \(West 2005\)](#).



in upon recognition.¹⁰ Second, the Main Proceeding may also request turnover of the debtor's United States-based assets for administration under, in our example, Canadian substantive law or request the Non-Main Proceeding's cooperation in enforcing a Canadian reorganization plan. Importantly, Chapter 15 does not compel United States bankruptcy courts to extend such post-recognition relief as a matter of course. With Chapter 15, Congress gave United States bankruptcy courts "broad latitude to mold relief to meet specific circumstances."¹¹ A United States court need not accede to a turnover or plan enforcement request if it deems that the interests of domestic creditors would be inadequately protected.¹²

Chapter 15 and the Model Law on which it is based thus strike a kind of balance between the Main Proceeding's goals of preserving and administering the debtor's assets on the one hand, and the Non-Main Proceeding's interests in ensuring adequate protection for creditors and preventing outcomes "manifestly contrary" to its own laws.¹³

Practically speaking, only a limited number of circumstances will cause Chapter 15 courts to refrain from extending comity to foreign Main Proceedings.¹⁴ In the case of our hypothetical Canadian reorganization, precedent strongly supports the conclusion that a United States bankruptcy court will extend comity and enter orders effectuating those of the Canadian bankruptcy tribunal.¹⁵ However, Chapter 15 fully empowers a United States bankruptcy court to condition or modify a recognition order—even when "sister" Canadian insolvency proceedings are concerned.¹⁶

10 11 U.S.C.A. § 1520(a) (West 2005). U.S. courts may defer to foreign insolvency proceedings on the grounds of comity even in the absence of a Chapter 15 case officially recognizing a foreign Main Proceeding. See *EMA GARP Fund v. Banro Corp.*, No. 18 CIV. 1986 (KPF), 2019 WL 773988, at *8 (S.D.N.Y. Feb. 21, 2019), *aff'd sub nom. EMA Garp Fund, L.P. v. Banro Corp.*, 783 F. App'x 82 (2d Cir. 2019) (dismissing district court case against Canadian debtor in light of pending Canadian reorganization proceeding, despite the lack of a bankruptcy court order granting recognition of the Canadian bankruptcy pursuant to Chapter 15). *But see Halo Creative & Design Ltd. v. Comptoir Des Indes Inc.*, No. 14 C 8196, 2018 WL 4742066, at *2 (N.D. Ill. Oct. 2, 2018) (denying stay of U.S. litigation in light of pending Canadian bankruptcy proceeding because a U.S. bankruptcy court had not recognized the Canadian bankruptcy under Chapter 15).

11 *In re Tri-Cont'l Exch. Ltd.*, 349 B.R. 627, 637 (Bankr. E.D. Cal. 2006).

12 *In re Sivec SRL*, 476 B.R. 310, 324 (Bankr. E.D. Okla. 2012) (refusing asset turnover to Italian Main Proceeding on grounds that U.S. creditors would be inadequately protected); *In re Vitro S.A.B. de CV*, 701 F.3d 1031, 1050–51 (5th Cir. 2012) (declining enforcement of Mexican reorganization plan on the basis of nonconsensual third-party releases contained therein).

13 The public policy exception is codified in Chapter 15 at 11 U.S.C.A. § 1506 (West 2005).

14 See *Miller*, *supra* note 4.

15 See, e.g., *In re Metcalfe & Mansfield Alternative Investments*, 421 B.R. 685, 698–99 (Bankr. S.D.N.Y. 2010); *E&L Consulting, Ltd. v. Doman Indus. Ltd.*, 360 F. Supp. 2d 465, 470 (E.D.N.Y. 2005), *aff'd sub nom. E & L Consulting, Ltd. v. Doman Indus. Ltd.*, 472 F.3d 23 (2d Cir. 2006); *Tradewell, Inc. v. Am. Sensors Elecs., Inc.*, No. 96 CIV. 2474 (DAB), 1997 WL 423075, at *4 (S.D.N.Y. July 29, 1997). "Canada is 'a sister common law jurisdiction with procedures akin to our own,' and thus there need be no concern over the adequacy of the procedural safeguards of Canadian proceedings." *Cornfeld v. Inv'rs Overseas Servs., Ltd.*, 471 F. Supp. 1255, 1259 (S.D.N.Y.), *aff'd*, 614 F.2d 1286 (2d Cir. 1979) (quoting *Clarkson Co. v. Shaheen*, 544 F.2d 624, 630 (2d Cir. 1976)).

16 11 U.S.C.A. § 1522(c) (West 2005). See, e.g., *In re Sanjel (USA) Inc.*, No. 16-50778-CAG, 2016 WL 4427075, at *6–7 (Bankr. W.D. Tex. July 29, 2016) (modifying order recognizing Canadian bankruptcy to permit U.S. creditors to assert Fair Labor Standards Act claims against the debtor's officers and directors because such claims would soon be time-barred under applicable statute of limitations).



Recognition Is Not Necessarily a “Rubber Stamp” Exercise

Recognition under Chapter 15 is made according to a list of statutory factors. However, it “is not to be rubber-stamped by the courts.”¹⁷ A foreign representative must satisfy each element of a three-part test to obtain recognition of the foreign insolvency proceeding under Chapter 15. First, the court must determine whether the relevant action is a “foreign proceeding.”¹⁸ Next, the court must determine whether the relevant action meets the requirements for recognition under section 1517(a), e.g., whether the petition checks certain procedural boxes, whether the foreign representative is duly authorized, and whether the COMI is located as alleged.¹⁹ Lastly, the court must consider whether recognition defies the public policy of the United States under [11 U.S.C.A. § 1506](#). Unfortunately for sureties and other creditors, United States courts apply the public policy exception to recognition only narrowly and infrequently.²⁰

The very nature of the foreign insolvency proceeding (e.g., Is it collective? Does it bring the debtor’s assets and affairs under the control or supervision of a foreign court?) may give the surety grounds to challenge recognition.²¹ Foreign counsel thus can play an essential role in advising the surety and domestic counsel about whether the foreign insolvency counts as a “foreign proceeding” under the United States Bankruptcy Code. Foreign counsel may also be integral to assessing the powers and limitations of the foreign representative and whether that individual makes a proper Chapter 15 representative. The surety’s own underwriters—with knowledge of the foreign debtor’s global operations and asset location—likewise may help assess any impermissible forum-shopping.

Foreign Law Outcomes Guide Chapter 15 Strategy and Vice Versa

Above all, how the surety’s claims will be treated and adjudicated under the law of the foreign Main Proceeding clarifies the stakes in a related Chapter 15 case. The

¹⁷ *In re Servicios de Petroleo Constellation S.A.*, 600 B.R. 237, 279 (Bankr. S.D.N.Y. 2019).

¹⁸ Seven criteria exist. See *In re Betcorp Ltd.*, 400 B.R. 266, 276–77 (Bankr. D. Nev. 2009).

¹⁹ For a more thorough discussion of recognition requirements, see Peter M. Gilhuly, Kimberly A. Posin, & Adam E. Malatesta, *Bankruptcy Without Borders: A Comprehensive Guide to the First Decade of Chapter 15*, 24 ABI L. REV. 47, 88–96 (2016).

²⁰ *In re ABC Learning Centres Ltd.*, 728 F.3d 301, 309 (3d Cir. 2013); *In re Qimonda AG*, 470 B.R. 374, 387 (E.D. Va. 2012) (“[T]hose courts that have addressed [11 U.S.C.A. § 1506] . . . have made one thing very clear: it should be invoked only in extremely narrow circumstances.”).

²¹ See *In re Gold & Honey, Ltd.*, 410 B.R. 357, 368 (Bankr. E.D.N.Y. 2009) (finding Israeli insolvency proceeding insufficiently collective because it was “more akin to a[n] individual creditor’s replevin or repossession action[.]”). However, in a short bench ruling in *In re Abengoa, SA*, 16-10765-KJC [Docket No. 71] (Bank. D. Del. Apr. 27, 2016), Judge Carey granted recognition over various sureties’ objections that Spanish *pre-insolvency* proceedings were not sufficiently collective and did not meet the requirements of section 101(23). The objecting sureties filed a notice of appeal in United States District Court for the District of Delaware, which was later dismissed by joint stipulation. *Fid. & Dep. Co. of Md. v. Abengoa, SA*, No. 16-00346 (LPS) [Docket Nos. 1 & 8] (D. Del. 2016).



scale of the battles to be faced in the foreign Main Proceeding informs the surety's legal (and business) decisions about whether to pursue a recognition challenge and/or post-recognition objections. In turn, the relief obtained in a Chapter 15 case can influence the surety's participation in the Main Proceeding and/or any global settlement negotiations. The following is but a shortlist of the surety's considerations:

1. Does the law of the foreign Main Proceeding recognize the surety's equitable subrogation rights?

In U.S. bankruptcy courts, it is well settled that a surety is entitled to rights of equitable subrogation and that these rights occur automatically by virtue of the principal's default (and not merely following the surety's discharge of its bond obligations).²² Supreme Court authority holds that the surety's subrogation rights relate back to the date the suretyship was created, which is to say the date of the bond's issuance.²³ U.S. bankruptcy courts have overwhelmingly recognized that the surety's equitable subrogation rights in bonded contract proceeds are senior to any lien of all other secured creditors in the proceeds of such contracts.²⁴

The extent to which foreign bankruptcy tribunals will recognize the surety's equitable subrogation rights—and the extent to which the surety's claim will trump those of other secured creditors—are essential questions for the surety weighing how vigorously to oppose recognition of the foreign Main Proceeding or post-recognition requests for comity.

2. Will the foreign Main Proceeding fully enforce the surety's indemnity agreement?

Take the all-too-common case in which the surety issues a bond for a subsidiary of an entity with which it has an indemnity agreement and assume that the indemnity agreement fails to name the subsidiary specifically. If the subsidiary initiates restructuring proceedings in a foreign state, the surety may not have a valid claim under the indemnity agreement. While most United States-law-based indemnity agreements elaborate on the term "principal" and include "successors and affiliates" language, such language may be insufficient to bind related companies under the law of the foreign Main Proceeding.

22 RESTATEMENT OF THE LAW (THIRD) SURETYSHIP & GUAR. § 31, cmt. a (1996).

23 *Prairie State Nat. Bank v. United States*, 164 U.S. 227, 232, 239–40, 17 S. Ct. 142, 41 L. Ed. 412 (1896); *Henningsen v. U.S. Fid. & Guar. Co.*, 143 F. 810, 814 (9th Cir. 1906), *aff'd*, 208 U.S. 404, 28 S. Ct. 389, 52 L. Ed. 547 (1908) (the "right of subrogation relates back . . . to the time the contract of suretyship was entered into.").

24 See, e.g., *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 83 S. Ct. 232, 9 L. Ed. 2d 190 (1962); *Prairie State Nat. Bank*, 164 U.S. 227 23; *In re Alcon Demolition, Inc.*, 204 B.R. 440 (Bankr. D.N.J. 1997); *Am. States Ins. Co. v. United States*, 324 B.R. 600 (N.D. Tex. 2005); *In re Kappa Dev. & Gen. Contracting Inc.*, No. 17-51155-KMS, 2019 WL 2867110 (Bankr. S.D. Miss. July 2, 2019).



Foreign counsel should be prepared to advise the surety about the enforceability of other key rights under the indemnity agreement, including those given under assignment, trust fund, and attorneys' fee provisions. For example, the United States Supreme Court has determined that contractual attorneys' fees are recoverable in bankruptcy, even when the fees are incurred litigating issues "peculiar to federal bankruptcy law."²⁵ The laws of the foreign Main Proceeding may not allow for a similar result.

3. Will the foreign Main Proceeding allow for unliquidated creditor claims?

In the case of a principal's bankruptcy, the surety's claim is often at least partially unliquidated, *i.e.*, the surety has either not received claims or its liability has not yet been conclusively determined. International insolvency laws vary as to whether creditors can assert unliquidated claims. If the law of the foreign Main Proceeding does not allow for the value of unliquidated claims to be reconsidered as in the United States Bankruptcy Code,²⁶ then the surety's unliquidated claims may be disallowed. Some good news if contending with a Canadian reorganization as in our example: Contingent and unliquidated claims may be allowed by a Canadian trustee or monitor.²⁷

4. Does foreign law allow for broad non-debtor releases?

The surety may be all too familiar with the problem of non-debtor protections and releases in United States bankruptcy cases. A Chapter 11 plan, for instance, might have provisions applicable to non-debtor affiliates that could jeopardize the surety's ability to pursue non-debtor indemnitors. Third-party releases, exculpation or injunction provisions,²⁸ if allowed by the law of the foreign Main Proceeding, pose the same risk.

Third-party releases are generally allowed in United Kingdom arrangement schemes and under the insolvency laws of other commonwealth countries like Australia and Canada.²⁹ That is bad news for the surety creditor in our Canada example, as the Chapter 15 case *In re Metcalfe & Mansfield Alternative Investments* confirmed.³⁰ The *Metcalfe* court found "no basis . . . to second-guess the decisions of the Canadian courts" and enforced a Canadian reorganization plan containing broad, third-party releases.³¹

²⁵ *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 127 S. Ct. 1199, 167 L. Ed. 2d 178 (2007).

²⁶ See 11 U.S.C.A. § 502(c)(1) (West 2005).

²⁷ Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3 § 121(2) (Can.); Companies' Creditors Arrangement Act, *Id.* at 694, 700. 2985 c. C-36 § 2(1) (Can.).

²⁸ *In re Aegean Marine Petroleum Network Inc.*, 599 B.R. 717, 720 (Bankr. S.D.N.Y. 2019).

²⁹ See Abhilash M. Raval, Lauren C. Dolye & Dennis C. O'Donnell, *Cross-border restructuring in the US: Chapter 15 approval of third-party releases granted in foreign proceedings*, INT'L INSOLVENCY & RESTRUCTURING REPORT 2019/20 12, 12 (May 2019).

³⁰ *Metcalfe*, *supra* note 16.

³¹ *Id.* at 694, 700.



France, Germany, and Italy, however, prohibit granting non-debtor releases under their respective insolvency laws.³² And at least one bankruptcy court (in a United States circuit that holds third-party releases invalid) declined to enforce foreign third-party releases contained in a Mexican reorganization plan.³³

In Praise of Creative Legal Solutions...and Concrete Billing Guidelines

The inherent interrelatedness between a Chapter 15 case and foreign Main Proceeding demands a strong working relationship between the surety and its teams of counsel—without language barriers and with a depth of shared experience in surety law and the nuances of the United States Bankruptcy Code. For the surety, clear fee agreements defining the respective roles and responsibilities of the multiple outside law firms are essential, as is limiting those who can bill their time to particular tasks and the development of litigation plans. But leave room to revel in the opportunity: the still-developing body of Chapter 15 case law leaves tremendous space for creative legal advocacy to shape the next fifteen years of international insolvency for the surety. ➤

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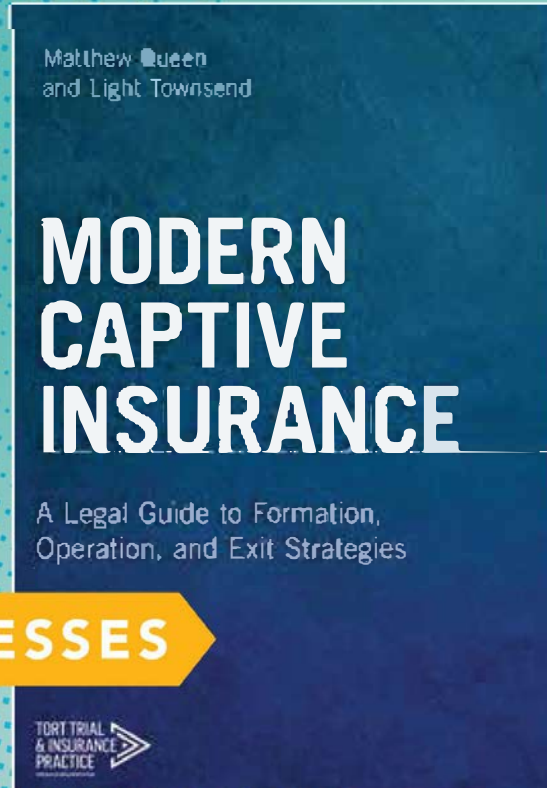
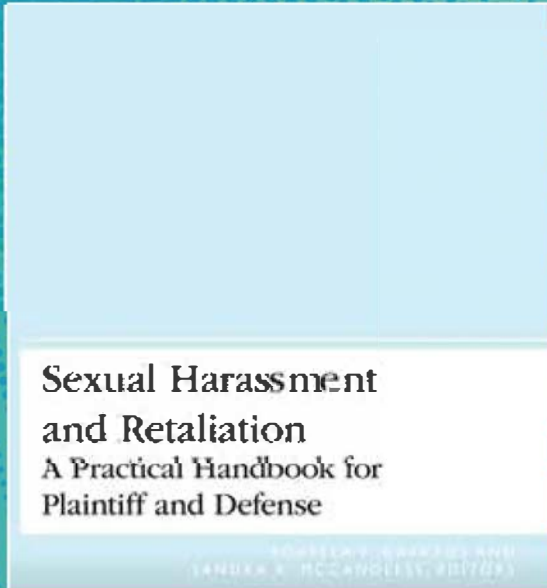
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