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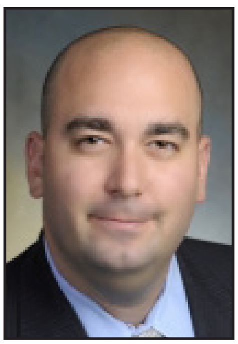
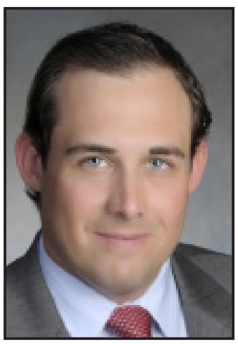
Committee News

Defending Liberty Pursuing Justice

Spring 2015

Fidelity & Surety Law Committee





OBLIGEES' BAD FAITH CLAIMS AGAINST SURETIES DISMISSED: TWO RECENT FEDERAL CASES PROVIDE ANALYSIS

By: Kevin S. Brotspies and Michael R. Morano

More than fifty years ago, the United States Supreme Court first declared that "suretyship is not insurance."[1] Despite this proclamation, courts have struggled to apply this principle consistently to obligees' bad faith claims against sureties. Recently, federal courts in Pennsylvania and Nevada both recognized this distinction in dismissing bad faith claims brought by obligees.

In *Upper Pottsgrove Township v. International Fidelity Insurance Co.*,[2] the Eastern District of Pennsylvania granted the surety's motion to dismiss an obligee's statutory bad faith claim brought under the state's bad faith statute.[3] In determining that "surety bonds are not insurance contracts" within the meaning of the statute, the court engaged in a three-part analysis.[4] First, the court looked at the language of the bad faith statute itself, focusing on "the ordinary meaning of the words used."[5] Second, the court analyzed the distinction between suretyship and insurance, as developed by the

Continued on page 11

1 Pearlman v. Reliance Ins. Co., 371 U.S. 132, 140 n.19 (1962).

2 976 F. Supp. 2d 598 (E.D. Pa. 2013).

3 Pennsylvania's bad faith statute, 42 Pa. C.S.A. § 8371, provides that "[i]n an action arising under an insurance policy, if the court finds that the insurer has acted in bad faith toward the insured, the court may" award interest and/or punitive damages against the insurer and/or "[a]ssess court costs and attorney fees against the insurer."

4 *Upper Pottsgrove*, 976 F. Supp. 2d at 601-02, 605.

5 *Id.* at 602-03 (quoting Am. Tobacco Co. v. Patterson, 456 U.S. 63, 68 (1982)).

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LETTER FROM THE CHAIR

As I write this, we are in the weeks leading up to the Spring CLE Meeting at the Estancia La Jolla Resort and Spa in beautiful La Jolla, California. Before we look forward to what that extraordinary week has in store, let us take a brief look back.

By all accounts, MWM 2015 was a phenomenal success! More than 700 attendees and guests enjoyed not only three days of outstanding programming and networking opportunities, but also the best weather for a Mid-Winter Meeting that we have had in years. Thanks so much to our Program Chairs—James Diwik of Sedgwick LLP, Darrell Leonard of Zurich North America, and Caryn Maxfield of The Walsh Group (Construction); Mike Hennigan of The Cincinnati Insurance Company and Jeff Price of Manier & Herod (Fidelity), and Eddy Etcheverry of Etcheverry Harrison and Bruce Corriveau of Travelers Bond and Specialty Insurance (Surety)—as well as all of our speakers for their vibrant and thoughtful presentations and papers.

However, what made MWM 2015 "look" the way that it did—crisp, professional, and modern—was due to the tireless, yet outstanding work of "SPEW"—the **S**ocial Media, **P**resentation Technology, **E**mail Communications, and **W**ebsite Subdivision of the Committee's Communications Division. Mark Krone, Luis Aragon, and Chris Cheatham worked to package all of the PowerPoints with promotional slides, so that each segment of all programs was seamless. They also worked to promote each presentation before and during MWM 2015 on Twitter, LinkedIn, and Facebook, as well as through email. Thanks so much to Mark, Luis, and Chris, who are setting high standards for cutting-edge Committee communications, a course that will be continued as we approach our Spring CLE and Leadership Meetings.

The brochure is out and registration is underway for the Spring CLE Meeting in La Jolla, California, so I will not repeat what is already set out in detail there. Program Chairs Carol Smith, Thomas Vollbrecht, and Blake Wilcox have put together an extraordinary program, titled "Performance Bond Claim Handling: Experiences with the Experts," containing not only plenary presentations, but also breakout sessions that will be geared toward engaging dialogue and learning opportunities for all levels of surety practitioners.

The Spring CLE Meeting will center on the substance contained in the Committee's seminal publication, the Fourth Edition of *Bond Default Manual*. Having shared editor responsibilities with Carol, Tom, and Blake, I can tell you that BDM4 will be a tremendous publication, one that is destined to be used, shared, highlighted, tabbed . . . you get the idea . . . for years to come by many in our industry.

A couple of final notes. Thanks again to thank our National Reception Sponsors who, at the Spring CLE Meeting, will support our Thursday night reception and dinner in the courtyard of the Estancia La Jolla. Our National Reception Sponsors' support of these events allows us to welcome all of our company attendees, as well as those more junior professionals. Thanks to:

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Finally, after the conclusion of the Spring CLE Meeting, we will take one more opportunity not only to enjoy what La Jolla has to offer, but also to raise awareness of the growing problem of human trafficking and what New Friends New Life, the Committee's community service focus for 2014-2015, is doing about it. Every year, millions of men, women, and children worldwide, including in the United States, are involved in human trafficking, but New Friends New Life restores and empowers formerly trafficked teen girls and sexually exploited women and their children, by providing access to education, job training, interim financial assistance, mental health, and spiritual support. For more information on how you can support New Friends New Life and its extraordinary mission, please visit its website, at newfriendsnewlife.org.

Thanks so much for your support and participation in the Committee! Finally, be sure to join our Group on LinkedIn, follow us on Twitter (@ABATIPSFSLC), and "like" us on Facebook. I look forward to seeing you in La Jolla!

Mike F. Pipkin
Sedgwick LLP
Chair, ABA TIPS Fidelity and Surety Law Committee

Volunteers Needed!

Laura Wheeler Waring Elementary School

Education Awareness Project

* April 30, 2015 * 11 AM - 1 PM *

Philadelphia, PA

Join the ABA TIPS Diversity Committee, Staff Counsel Committee and Law in Public Service Committee for a youth outreach program with Laura Wheeler Waring School students during the ABA TIPS Spring Section Conference. Volunteers will meet with students for the Committee's "A Day in the Life of an Attorney" program. Attorneys will discuss their professional experience in the legal industry and encourage students to explore the possibility of a law-related career.

Participants should meet in the lobby of the Philadelphia Ritz-Carlton on Thursday, April 30, 2015 at 10:15 AM for transportation to the school. Also, please contact Staff Liaison Jennifer LaChance at (312)988-5463 or jennifer.lachance@americanbar.org to sign-up for the project prior to the Spring Section Conference.

Laura Wheeler Waring School is located at 18th and Green Street in Philadelphia, PA.

ABA Defending Liberty Pursuing Justice

THE TIPS SECTION CONFERENCE APRIL 29 – MAY 1, 2015 THE RITZ-CARLTON | PHILADELPHIA, PA

TIPS DIVERSITY COMMITTEE

FEDERAL CONTRACTORS: THE BASICS OF BUSINESS ETHICS PROGRAMS, INTERNAL CONTROL SYSTEMS, AND MANDATORY DISCLOSURES

By: Darren Grzyb

Each year, the federal government and its state and local counterparts spend billions of dollars on construction projects, performed by contractors subject to regulation by public contracting entities. The sureties that execute bonds on behalf of these public contractors can benefit from a basic understanding of the ethics, prevention, and disclosure obligations imposed by the contracting agencies. The consequences of non-compliance to a bonded principal's business can be disastrous, including suspension or debarment of the principal from the public contracting market. Furthermore, an understanding of these regulations is important for a completing surety, as its completion contractors are likely required to adhere to these regulations as well. While this article focuses on the Federal Acquisition Regulation ("FAR") section 52.203-13, known as the Contractor Code of Business Ethics and Conduct,[1] there may be business ethics and reporting obligations imposed at the local and state level.[2]

In 2008, the Contractor Code was amended "to amplify the requirements for a contractor code of business ethics and conduct, an internal control system, and disclosure to the Government of certain violations of criminal law, violations of the civil False Claims Act, or significant overpayments."[3] Thus, the rule requires government contractors (a) to enact policies to prevent fraudulent or criminal activities; (b) to enact policies to detect fraudulent or criminal activities; and (c) to disclose violations of the criminal law, civil False Claims Act and "significant overpayments."

I. Prevention and Detection Obligations under the Contractor Code

Within thirty days of being awarded a federal contract, the contractor must establish a written code of business ethics and conduct, and make a copy of the code available to "each employee engaged in the performance of the contract."[4] Most contractors are required to "establish an ongoing business ethics awareness and compliance program" within 90 days of being awarded a contract, unless the contracting officer grants more time.[5] This provision essentially requires periodic training for, and dissemination of information to, "principals and employees, and as appropriate, the contractor's agents and subcontractors"[6] with respect to the contractor's ethics program and the "internal control system" ("ICS") that is required by 48 C.F.R. § 52.203-13(c)(2).

Under § 52.203-13(c)(2), contractors must establish an ICS to "facilitate timely discovery of improper conduct in connection with Government contracts" and ensure corrective measures are promptly carried out. Section 52.203-13(c)(2)(ii) sets forth the minimum standards for a compliant ICS, including: (a) assignment of responsibility at a sufficiently high level and adequate resources to ensure that the ethics program and ICS are effective; (b) avoiding individual conflicts of interest with respect to those administering the ethics program and ICS; (c) an ongoing responsibility to conduct periodic reviews as to the effectiveness of the ethics program and ICS and to assess the risk of criminal conduct; (d) an internal reporting mechanism, such as a hotline, allowing for anonymous reporting of improper conduct, and instructions that encourage employees to make such reports; (e) disciplinary action taken for improper conduct or failing to take reasonable steps to prevent or detect improper conduct; and (f) "full cooperation" with any government agencies responsible for audits, investigations or corrective actions. While the rule lacks more particularized

Continued on page 14

1 48 C.F.R. § 52.203-13 (2015), Contractor Code of Business Ethics and Conduct (hereinafter "the Contractor Code").

2 *See, e.g.*, N.J. Stat. Ann. § 52:32-47 (2015) (requiring contractors entering into contracts with the State of New Jersey to submit to the contracting agency a certification that the entity has read the state business ethics guide, understands its provisions and is in compliance with its provisions).

3 Contractor Business Ethics Compliance Program and Disclosure Requirements, 73 Fed. Reg. 67064-02 at B-1.

4 48 C.F.R. § 52.203-13(b)(1).

5 48 C.F.R. § 52.203-13(c)(1). Exempted from this requirement are small business concerns and contractors for the acquisition of "commercial items," as defined in 48 C.F.R. § 2.101. *Id.*

6 The definition of "subcontractor" includes suppliers or contractors that provide materials or services to the prime contractor or another subcontractor. 48 C.F.R. § 52.203-13(a).

PRACTICE POINTER

PRINCIPAL FILE BANKRUPTCY? ALL IS NOT LOST: THE SURETY'S ABILITY TO SUBROGATE TO SUPPLIERS' RECLAMATION AND ADMINISTRATIVE CLAIMS

By: Manju Gupta

For a surety, the bankruptcy filing of a principal raises a number of issues and several challenges, but it does not necessarily mean a loss. The surety can maximize its recovery by staying vigilant and timely asserting its subrogation rights.

When a principal files for bankruptcy, and the surety is called upon to perform under a performance or payment bond, the surety should determine which goods were supplied to the principal/debtor immediately prior to the filing. Under the Bankruptcy Code,[1] not all claims are treated the same. The Bankruptcy Code provides that certain unsecured claims have priority over general unsecured claims, and creates specific rights to recover goods supplied to the debtor immediately prior to the bankruptcy filing. This practice pointer addresses two types of rights to which a surety may be subrogated: (1) reclamation rights and (2) administrative priority claims under § 503(b)(9) of the Bankruptcy Code.

The principles of subrogation allow a surety to step into the shoes of the principal, owner, or a third party – such as a supplier – even in the context of a bankruptcy proceeding. For the surety to have these rights, it must first perform its bond obligations. For instance, when a principal defaults in the performance of a bonded contract, the surety may cure the default and thus become subrogated to the right of the owner, who holds the unpaid contract balances, to apply those balances to the surety's costs of curing the default. When a principal fails to pay for services, equipment, or material, the surety may cure the default under its payment bond by paying the unpaid subcontractors, materialmen, and laborers. The surety then becomes subrogated to the right of those entities to assert a lien against the property being improved, thereby entitling the surety to the contract balances held by the owner.

A bankruptcy proceeding, of course, is governed by its own set of rules regarding priority. As most sureties and their counsel are aware, there are certain types of claims for which a surety will not receive priority treatment. For example, a surety that pays the debtor's prepetition tax obligations or a debtor's prepetition custom duties under applicable bonds is not subrogated to the priority rights of governmental authorities. However, there is nothing in the Bankruptcy Code that precludes a surety from being subrogated to a supplier's right to reclaim goods and/or its claim for administrative priority under § 503(b)(9) of the Bankruptcy Code. Thus, while the surety does not generally have its own administrative claims or rights to reclamation, it may be subrogated to a supplier's right to assert such claims

One of the tools potentially available to the surety, but rarely used, is the supplier reclamation demand. That is, a supplier may have furnished supplies to the principal/debtor prepetition, and those supplies are now required to complete the bonded project. The supplier faces the dilemma of how it can most quickly obtain the return of these materials notwithstanding that the supplies are property of the debtor's estate under § 541 of the Bankruptcy Code. Meanwhile, the supplier may be making a claim against the payment bond for the cost of these materials. Under a reclamation demand, the supplier, or the surety subrogating to the supplier's rights, may make written demand to the debtor for the return of the materials within 45 days prior to the filing of the bankruptcy petition.[2] This remedy applies only to goods received during this small 45-day prepetition window, and it further requires that the supplier's or surety's written demand be made within 45 days of the debtor's receipt of the goods, or no later than 20 days after the bankruptcy petition filing date.[3]

A reclamation demand may prove to be successful, but it also may be challenging for the following reasons. First, under the Bankruptcy Code, reclamation rights

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1 11 U.S.C. §§ 101-1532 (2015).

2 11 U.S.C. § 546(c)(1).

3 *Id.*

PUMPING THE BRAKES ON AUTO DEALER BOND CLAIMS

By: Shane C. Mecham

The surety industry endeavors to pay legitimate claims promptly. While working quickly is often a good practice, when it comes to motor vehicle dealer ("MVD") bonds, speeding may put the surety at risk of crashing into excess liability. Whether selling lemons or failing to convey clear titles, auto dealers who have trouble with one sale often inspire a traffic jam of claims. A surety that merely pays MVD bond claims on a first-come, first-served basis could find itself defending additional claims beyond the penal sum of the bond. To avoid running out of gas, a wise surety should consider interpleading the bond proceeds to permit a court to dispense the funds to the competing claimants, thereby reducing the impact of any future claims on the surety.

I. Claims Against MVD Bonds Often Exceed the Penal Sum

In recent years, consumers have bought and sold cars more frequently and more quickly than in the past. "The opportunities for fraud are quite obvious, for as a rule from the time it is first bought until it is junked an automobile changes hands many times."[1] Complaints against motor vehicle dealers are the second-most common consumer complaint.[2] In response, all fifty states have passed legislation requiring motor vehicle dealers to carry bonds.

The statutorily required MVD bonds, however, usually are too small to cover all of the claims that arise from fraudulent dealer operations, and claimants compete for priority for payment of bond funds. "With most states' statutes setting bond amounts at relatively low dollar levels, handling MVD bond claims efficiently and effectively can be challenging."[3] "Challenges are also encountered with MVD bond claims because they often involve multiple claims on the same bond that exceed the bond penalty. Dealers whose financial condition is such that they perceive the need to engage in deceptive acts will often repeat such acts resulting in multiple claims."[4] These issues are compounded when claimants seek enhanced damages. "For instance, it is not uncommon to see claims for damages and fees under consumer protection and deceptive trade practices statutes."[5] While sureties likely will have special defenses to these claims under the MVD bonds, the presence of the enhanced claims alone makes the litigation more complicated, expensive, and difficult to resolve.

In these situations, the surety will be required to expend funds to defend against such claims, and is exposed to the risk of costs in excess of the penal sum. Knowing this, and that potential additional claims already may exist or might arise later, a prudent surety will consider the use of the interpleader action in response to MVD bond claims.

II. A Reasonable Effort to Locate All Claimants Yields Best Results

A unique challenge for sureties interpleading funds to resolve MVD bond claims is identifying all actual and potential claimants. Including all claimants as parties to the interpleader action is beneficial to an equitable distribution of bond proceeds and will best protect a surety from additional costs and excess liability.

The surety already will be aware of one or more claimants that spurred the surety to action in the first place. The difficulty is identifying other actual or potential claimants. First, of course, look to the language of the bond, which should reflect the statutory coverage and any preconditions, in order to narrow the pool of claimants. Second, review how the state's MVD bond statute defines those entitled to make a claim under the bond. "MVD bonds exist today because they are mandated by statute",[6] so an important source for determining the scope of coverage for an MVD bond is the authorizing statute. "Most statutes specifically identify who is covered under the bond."[7] Many MVD bond statutes provide coverage for anyone who suffers a loss as a result of the dealer's illegal actions.[8] State case

1 Bank of Atlanta v. Fretz, 226 S.W.2d 843, 847 (Tex. 1950).

2 Jean Chatzky, *Annual Consumer Complaint List*, Time, Feb. 21, 2005, at 65.

3 Lisa Jennings-Baroun, *General Overview of Motor Vehicle Dealer Bond Claims, in* The Law of Motor Vehicle Dealer Bonds 3 (William A. Downing, Lisa Jennings-Baroun, James S. Kreamer, & Aaron C. McKee eds., Am. Bar. Ass'n 2006).

4 *Id.*

5 *Id.*

6 James S. Kreamer, Aaron C. McKee, & Zachary M. Skinner, *Statutory Analysis, in* The Law of Motor Vehicle Dealer Bonds 15 (William A. Downing, Lisa Jennings-Baroun, James S. Kreamer, & Aaron C. McKee eds., Am. Bar. Ass'n 2006).

7 *Id.* at 16.

8 *See, e.g.*, Conn. Gen. Stat. § 52-400; KY. Rev. Stat. Ann. § 190.030; N.D. Cent. Code § 39-22-05; Tex. Transp. Code Ann. § 503.33(g)(3).

law may provide a more detailed interpretation of these statutes.[9]

Third, some states have approved MVD bond forms.[10] Such a form, if available, may shed light on who is eligible to make claims against MVD bonds in that state.

Fourth, review state court records to identify parties that have filed suit against the bonded dealer. It also might be prudent to check court records of nearby states. MVD bond statutes tend to be liberally construed, and some courts have held that MVD bond statutes should be presumed to apply to out-of-state transactions absent express language to the contrary.[11] Thus, an out-of-state purchaser of a vehicle from an in-state dealer might be protected by the statute.[12] This protection even could extend to a sale conducted outside the state.[13]

Fifth, a governmental agency may have records of claims asserted, even though no suit was filed. The statute mandating the MVD bond may also establish a procedure for parties to file claims with a governmental agency, such as the state's department of revenue. A surety may consider checking with that governmental agency as part of its investigation into actual and potential bond claimants.

Finally, consider the usual suspects. The most common claimants are vehicle purchasers and/or their retail lenders.[14] Other potential claimants include auto auctions, floor plan financers, and other creditors.[15] Once the surety has taken reasonable steps to identify all actual and potential claimants, each should be named in the interpleader action.

III. An Interpleader Action Protects Sureties From Additional Liability

Finding and serving all parties often poses challenges, but an effort to do so offers the surety its best protection against additional costs and excess liability. Once served, some parties may default or elect not to participate, which likely will cause the court to eliminate these parties from any distribution of the bond proceeds. In this context, important factors for the surety are that: (1) it cannot be accused of improperly distributing the funds, since the court is making the decision, and (2) parties who fail or decide not to participate in the interpleader action will probably be barred from subsequently pursuing claims against the MVD bond and the surety.

Each state has its own procedural requirements for interpleader actions. Sureties should review and follow those requirements.[16] In the interpleader action, the surety can ensure that any judgment entered does not exceed the penal sum of the bond. To the extent that claims exceed the limit of the bond, they typically will be reduced pro rata. The surety even may be able to recover its own fees and expenses out of the bond proceeds. "In a state in which the bond requirement creates continuous liability, the surety will have bond exposure for each license period the bond covers. However, the aggregate liability will be limited to the penal sum of the bond for each licensing period."[17] And significantly, most state statutes make clear that the "total aggregate liability on the bond to all persons making claims, regardless of the number of claimants . . . may not exceed the amount of the bond."[18]

Conclusion

Handling a single MVD bond claim might seem like a straightforward matter, but it is increasingly common that one claim will be followed by a long line of additional claimants honking and jostling for position. Some claimants may have filed lawsuits. Others may have filed claims with state governmental agencies. Each claimant likely will assert that the surety should pay the entire penal sum of the bond to him or her alone. A surety that simply pays valid claims as they are received risks exhausting the penal sum of the bond yet being forced to defend against additional claims.

Instead, when a surety receives an MVD bond claim, it should consider stepping back to look at the entire situation, endeavoring to treat all claimants fairly, while limiting liability to its penal sum obligation. One valuable tool the surety has to effectuate this plan is the interpleader action.

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9 Wooten v. G.M.H. Auto Sales, Inc., 370 S.E.2d 165, 167 (Ga. Ct. App. 1988); Minneapolis Auto Auction Ltd. v. Spicer Auto Sales, Inc., 439 N.W.2d 23 (Minn. 1989); Peoples Bank & Trust Co. v. W. Sur. Co., 456 So. 2d 766 (Miss. 1984); Mid-State Auto Auction v. Altman, 476 S.E.2d 690 (S.C. 1996).

10 *See, e.g.*, North Dakota Motor Vehicle Dealer Bond Form, *at* http://www.dot.nd.gov/forms/SFN02933.pdf (last visited Feb. 23, 2015).

11 *See, e.g.*, S. Seattle Auto Auction v. W. Cas. & Sur. Co., 598 P.2d 1269 (Or. Ct. App. 1979).

12 Idaho *ex rel.* Kidwell v. Master Distrib., 615 P.2d 116 (Idaho 1980).

13 Metro Milwaukee Auto Auction v. Coulson, 604 N.W.2d 111 (Minn. Ct. App. 2000); *but see* State Sur. Co. v. Lensing, 249 N.W.2d 608, 612 (Iowa 1977); Ore-Ida Potato Prods., Inc. v. United Pac. Ins. Co., 392 P.2d 191 (Idaho 1964) (presumption that MVD bonds only cover in-state activity unless the statute states otherwise).

14 Jennings-Baroun, *supra* note 3, at 7.

15 *Id*. at 8.

16 *See* Perkins v. Helms, 515 S.E.2d 906, 907 (N.C. Ct. App. 1999).

17 James S. Kreamer, Aaron C. McKee, & Zachary M. Skinner, *Damages and Remedies, in* The Law of Motor Vehicle Dealer Bonds 24-25 (William A. Downing, Lisa Jennings-Baroun, James S. Kreamer, & Aaron C. McKee eds., Am. Bar. Ass'n 2006).

18 *See, e.g.*, Utah Code Ann. § 41-3-205(d).

OBLIGEES' BAD FAITH...

Continued from page 1

common law and treatises. Third, the court considered whether other state statutes were persuasive.

The claim asserted by the obligee in *Clark County School District v. Travelers Casualty & Surety Co. of America*[6] was a common-law claim for tortious breach of the implied covenant of good faith and fair dealing. In *Clark County,* the District of Nevada held that an obligee cannot assert a claim against a surety for tortious bad faith.[7] The court rejected the obligee's reliance on out-of-jurisdiction case law permitting such a claim, but found persuasive the law of its neighboring state, California, which does not allow an obligee to assert a tortious bad faith claim against a surety.[8]

Although the import of both *Upper Pottsgrove* and *Clark County* is much greater within their respective jurisdictions than without, the analyses undertaken by those courts may be instructive in any jurisdiction, as they generally can be applied to obligees' bad faith claims across the country.

I. Statutory Bad Faith Claim: A Three-Part Analysis

The *Upper Pottsgrove* court's three-part inquiry provides a thorough analysis of an obligee's statutory bad faith claim, which can be utilized beyond Pennsylvania borders. Logically, the first step in the district court's analysis was to look to the plain language of the bad faith statute.[9] The *Upper Pottsgrove* court noted that, although "courts have repeatedly found that the statutory language of § 8371 is unambiguous", critically, the statute itself does not define "insurance policy."[10] Thus, the language of the statute alone was insufficient to resolve whether a surety bond falls within the scope of Pennsylvania's bad faith statute.[11]

With the language of the statute unambiguous but inconclusive, the *Upper Pottsgrove* court considered "the relationship between sureties and insurance contracts", and looked to common law and relevant treatises.[12] The court discerned that an insurance policy protects against certain insurable catastrophic losses, while a surety bond "answer[s] for the debt, default, or miscarriage of another and . . . creates a tripartite relationship between the [obligee], the principal obligor, and the surety."[13] The "fundamental differences" between bilateral insurance policies and tripartite surety bonds identified by the *Upper Pottsgrove* court included "the conclusion that . . . surety bonds are in the nature of commercial guarantee instruments rather than policies of insurance."[14] The district court stated that, given that courts and treatise authors "have routinely found that [the traditional, tripartite surety] relationship does *not* constitute an insurance contract, . . . [u]nder this approach a surety bond is not an insurance contract, and the bad faith provision of § 8371 would thus not apply to sureties."[15]

In the third part of its analysis, the district court concluded that other statutes were not persuasive.[16] The *Upper Pottsgrove* court rejected the obligee's argument that a surety bond should be considered an "insurance policy" under the bad faith statute because a different statute, the Unfair Insurance Practice Act ("UIPA"), defines an "insurance policy" to include "any contract of . . . suretyship."[17] The court explained that the UIPA has a different remedial purpose than the bad faith statute, as the UIPA was enacted to regulate the insurance industry and does not create a private right of action.[18] The *Upper Pottsgrove* court stated that, had there been an

6 No. 2:13-CV-01100-JCM-PAL, 2015 WL 139399 (D. Nev. Jan. 12, 2015), *recons. denied* 2015 WL 1578163 (D. Nev. Apr. 8, 2015).

7 *Id.* at *4.

8 *Id.* (citing Cates Constr., Inc. v. Talbot Partners, 980 P.2d 407 (Cal. 1999)).

9 *Upper Pottsgrove*, 976 F. Supp. 2d at 602-03; *see also* Fed. Ins. Co. v. Me. Yankee Atomic Power Co., 183 F. Supp. 2d 76, 90 (D. Me. 2001) (undertaking a "natural reading" of Maine's unfair claims settlement practices statute).

10 *Id.* at 603; *cf.* Dadeland Depot, Inc. v. St. Paul Fire & Marine Ins. Co., 945 So.2d 1216, 1224 (Fla. 2006) (holding that "Florida's Insurance Code is abundantly clear that a surety is included within the definition of an 'insurer' and is regulated as an 'insurer'").

11 The first prong of the *Upper Pottsgrove* three-part analysis may, in some cases, resolve the inquiry. For example, in *Fed. Ins. Co.*, the District of Maine held that, "[i]n Maine . . . the question [of whether a performance bond is subject to Maine's unfair claims settlement practices statute] must be asked and answered as a matter of statutory interpretation." 183 F. Supp. 2d at 88 (recognizing, but disregarding, the "spirited debate at common law over the similarities and differences between traditional insurance and suretyship").

12 *Upper Pottsgrove*, 976 F. Supp. 2d at 603.

13 *Id.* (quoting 74 Am. Jur. 2d *Suretyship* § 253 (1974)).

14 *Id.* (quoting Foster v. Mut. Fire, Marine & Inland Ins. Co., 614 A.2d 1086, 1099 (Pa. 1992)).

15 *Id.* at 604 (emphasis in original).

16 *Id.* at 604-05; *but see* *Dadeland Depot*, 945 So. 2d at 1225 (stating that statute governing attorneys' fees in a performance bond lawsuit was "persuasive, [but] not totally determinative" of whether an obligee should be considered an "insured" for purposes of Florida's bad faith statute).

17 *Id.* (citing 40 Pa. Cons. Stat. § 1171.3).

18 *Id.* at 604-05.

intention to subject a surety to liability under the bad faith statute, the legislature would have set forth an expansive definition of an "insurance policy", as it did in the UIPA.[19]

The *Upper Pottsgrove* court's three-part analysis led the court to conclude that "surety bonds are not insurance contracts within the meaning of" the Pennsylvania bad faith statute.[20]

II. Tortious Bad Faith Claim: The "Special Relationship" and Other Policy Considerations

The question of whether an obligee may maintain a tortious bad faith claim against a surety has become a rather divisive one, with different courts conducting similar analyses yet reaching divergent results.[21] The District of Nevada recently became the latest court to distinguish suretyship from insurance and decline to subject sureties to a claim by an obligee for tortious breach of the implied covenant of good faith and fair dealing.

Initially, the *Clark County* court recognized the widely-held view that a tortious bad faith claim may arise only where a "special relationship" exists between the parties.[22] The court observed that the Nevada Supreme Court has held that the suretyship relationship does not constitute a "special relationship".[23] The court noted that tort liability for bad faith is appropriate in the insurance industry, where an insurer maintains "vastly superior bargaining power" over its insured.[24] However, the district court joined the Nevada Supreme Court in rejecting the extension of this principle to suretyship, where the contracting parties are commercial entities that do not have "inherently unequal bargaining positions."[25] While the vast majority of insureds are forced to accept insurance policies on a "take-it-or-leave-it" basis, there is no unequal bargaining power between a surety and a performance bond obligee, as obligees frequently dictate the form of bond the principal must provide. [26] Additionally, "performance bonds typically incorporate the underlying construction contract, the terms and conditions of which have been negotiated by the principal and the obligee without any input from the surety."[27]

The District of Nevada distinguished an insured's claim from an obligee's performance bond claim by noting that the latter "do[es] not implicate the public policy or fiduciary responsibilities necessary for a tortious bad faith claim."[28] Indeed, absent tort liability for bad faith, exploitative insurers would be permitted to "take advantage of insureds' misfortunes in negotiating claim resolution."[29] On the other hand, sureties possess no such ability to take advantage of an obligee faced with a defaulting principal. Unlike an insurance policy, "in which the obligation of the insurer to the insured is the primary obligation of indemnity to the insured for loss," a surety's obligation under a performance bond is merely secondary to its principal's obligation under the underlying contract.[30] An obligee that properly manages its contract

19 *Id.* at 605 ("demanding a more explicit statement [from the legislature] before applying one Act's definitions to another Act is consistent with the canon of statutory interpretation whereby when a definition is present in one legislative act, but absent in a later act, the court should assume that the omission was intended by the legislature") (internal citation and quotations omitted).

20 *Id.* Significantly, *Upper Pottsgrove* clarified that the court's prior decision in Turner Constr. Co. v. First Indem. of Am. Ins. Co., 829 F. Supp. 752 (E.D. Pa. 1993), did not stand for the proposition that the bad faith statute has been extended to obligees' actions against sureties. *Upper Pottsgrove*, 976 F. Supp. 2d at 602. The *Upper Pottsgrove* decision, authored by the same judge as *Turner*, noted that no party in *Turner* argued that the bad faith statute did not apply to sureties, so the *Turner* court did not reach that issue. *Id.*

21 Courts in some jurisdictions have declined to extend tort liability to the suretyship context. *See, e.g.*, TolTest, Inc. v. Purcell P & C, LLC, No. 3:12-CV-01821, 2013 WL 1571714 (N.D. Ohio Apr. 12, 2013); Cincinnati Ins. Co. v. Centech Bldg. Corp., 286 F. Supp. 2d 669 (M.D.N.C. 2003); Blackfeet Tribe of Blackfeet Indian Reservation v. Blaze Constr., Inc., 108 F. Supp. 2d 1122 (D. Mont. 2000); Inst. of Mission Helpers of Baltimore City v. Reliance Ins. Co., 812 F. Supp. 72 (D. Md. 1992); *Cates*, 980 P.2d 407 (Cal. 1999); Masterclean, Inc. v. Star Ins. Co., 556 S.E.2d 371 (S.C. 2001); Great Am. Ins. Co. v. N. Austin Municipal Util. Dist. No. 1, 908 S.W.2d 415 (Tex. 1995). Numerous courts, however, have recognized a tortious bad faith claim by a performance bond obligee against a surety. *See, e.g.*, C & I Entertainment, LLC v. Fid. & Deposit Co. of Md., No. 1:08CV00016-DMB-DAS, 2014 WL 3640790 (N.D. Miss. July 22, 2014); Loyal Order of Moose, Lodge 1392 v. Int'l Fid. Ins. Co., 797 P.2d 622 (Alaska 1990); Dodge v. Fid. & Deposit Co. of Md., 778 P.2d 1240 (Ariz. 1989); Transamerica Premier Ins. Co. v. Brighton Sch. Dist. 27J, 940 P.2d 348 (Colo. 1997); Int'l Fid. Ins. Co. v. Delmarva Sys. Corp., 2001 WL 541469 (Del. Sup. Ct. May 9, 2001); *see also* Colo. Structures, Inc. v. Ins. Co. of the W., 167 P.3d 1125 (Wash. 2007) (disagreeing with *Cates* and awarding performance bond obligee attorneys' fees against surety for wrongful denial of performance bond claim).

22 *Clark Cnty.*, 2015 WL 139399 at *4.

23 *Id.* (citing Ins. Co. of the W. v. Gibson Tile Co., 134 P.2d 698, 702 (Nev. 2006)); *see also* *TolTest*, 2013 WL 151714 at *5 (stating that relationship between surety and obligee is not "marked by dependence"); *cf.* *Transamerica*, 940 P.2d at 352 (stating that a "special relationship exists between a commercial surety and an obligee that is nearly identical to that involving an insurer and an insured"); *Loyal Order of Moose*, 797 P.2d at 628 (opining that "the relationship of a surety to its obligee – an intended creditor third-party beneficiary – is more analogous to that of an insurer to its insured than to the relationship between an insurer and an incidental third-party beneficiary").

24 *Clark Cnty.*, 2015 WL 139399 at *4 (quoting *Gibson Tile Co.*, 134 P.2d at 461-62) (internal quotations omitted).

25 *Id.* at *4 (quoting *Gibson Tile Co.*, 134 P.2d at 461-62) (internal quotations omitted); *see also* *Masterclean*, 556 S.E.2d at 375 (stating that "[i]nequities in bargaining power are largely absent in the surety context").

26 *Cates*, 980 P.2d at 422; *see also* *Great Am.*, 908 S.W.2d at 418 (surety "had no control over the form of the bond used").

27 *Cates*, 980 P.2d at 422; *see also* *Great Am.*, 908 S.W.2d at 418 ("the bonds incorporated the terms of the contract" between the principal and obligee, and the obligee undisputedly "controlled the contract documents at issue").

28 *Clark Cnty.*, 2015 WL 139399 at *4.

29 *Great Am.*, 908 S.W.2d at 418; *see also* *Cates*, 980 P.2d at 422 (noting that insureds, in purchasing insurance policies, "seek protection against calamity").

30 *Great Am.*, 908 S.W.2d at 418-19; *see also* *Cates*, 980 P.2d at 423 (stating that "obligee also has a right of recovery against the principal").

funds throughout the performance of the contract should not find itself in the "economic dilemma that an insured faces after a catastrophic loss or accident," and thus not "particularly vulnerable to a surety's inaction."[31]

Although the *Clark County* court did not examine Nevada statutes in connection with its analysis, other courts have looked to state statutes to distinguish, or compare, suretyship and insurance.[32] However, in tortious bad faith cases, any statutory authority cited is, at most, persuasive, and not determinative.[33]

With the *Clark County* decision, Nevada joins California and several other jurisdictions in protecting sureties from performance bond obligees' tortious bad faith claims.[34] Although it would be a stretch to consider *Clark County* the harbinger of a groundswell of support for sureties against obligees' tortious bad faith claims, the *Clark County* decision builds on the foundation anchored by cases like *Cates Construction, Inc. v. Talbot Partners*[35] and *Great American Insurance Co. v. North Austin Municipal Utility District No. 1*.[36]

III. Conclusion

The viability of a performance bond obligee's bad faith claim against a surety is substantially dependent upon the jurisdiction in which that claim is brought, as well as the type of bad faith claim being asserted. The *Upper Pottsgrove* and *Clark County* decisions exemplify the analytical framework that courts employ to determine whether a surety will be subject to such claims. While the *Upper Pottsgrove* and *Clark County* cases are good news for sureties facing bad faith claims by obligees in Pennsylvania and Nevada, courts in other jurisdictions may well reach different conclusions.

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31 *Cates*, 980 P.2d at 424.

32 *See, e.g.*, *Delmarva*, 2001 WL 541469 at *8 (noting that "the presence of sureties in the insurance statutes is reflective of the Legislature's intent and deserves merit"); *Centech*, 286 F. Supp. 2d at 689-90 (observing that the "differences [between suretyship and insurance] are made clearer" by North Carolina's statutes).

33 *See, e.g.*, *Masterclean*, 556 S.E.2d at 374 (stating that "because South Carolina regulates surety companies under the insurance code does not mandate finding" that a surety may be liable for tortious bad faith).

34 The District of Nevada specifically looked to California law, and the *Cates* decision, in reaching its decision in *Clark County*. *Clark Cnty.*, 2015 WL 139399 at *4 (noting that "Nevada looked to California law in adopting the tortious bad faith cause of action" in the insurance context).

35 980 P.2d 407 (Cal. 1999).

36 908 S.W.2d 415 (Tex. 1995).

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guidance with respect to ethics programs and the ICS,[7] the Defense Contractors Audit Agency (an agency of the Department of Defense ("DoD")) publishes a checklist for its auditors to consult in reviewing compliance, which is a good source for contractors to utilize in establishing their programs.[8]

II. Affirmative Reporting Obligations Under FAR 52.203-13(b)(3) and (c)(2)

The most significant 2008 revision to the Contractor Code is the requirement of mandatory disclosure of criminal and fraudulent conduct in connection with the award, performance, or closeout of a contract. This revision places the burden on the contractor to report certain violations. The administrative comments indicate that the mandatory disclosure rule represents a "sea change" and "major departure" from the voluntary disclosure requirements previously in place. Proponents of the rule amendment, including the DoD and inspector generals, noted that the policy of voluntary disclosure was largely ignored by contractors for the previous ten years. During that same time period, mandatory disclosure was adopted for banks and public companies and has been stressed by the United States Sentencing Commission and Department of Justice ("DoJ").[9]

The regulation now provides:

> The Contractor shall timely disclose, in writing, to the agency Office of the Inspector General (OIG), with a copy to the Contracting Officer, whenever, in connection with the award, performance, or closeout of this contract or any subcontract thereunder, the Contractor has credible evidence that a principal, employee, agent, or subcontractor of the Contractor has committed
>
> (A) A violation of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations found in Title 18 of the United States Code; or
>
> (B) A violation of the civil False Claims Act (31 U.S.C. 3729–3733).[10]

Additionally, a "knowing failure" by a "principal" of the contractor to timely disclose "credible evidence" of such criminal conduct or violations of the civil False Claims Act is grounds for disbarment or suspension. A knowing failure to timely disclose credible evidence of "significant overpayments" also will potentially expose the contractor to debarment or suspension.[11] The obligation to make such disclosures extends for three years after final payment.

The debarment and suspension regulations seem only to impose such penalties where a "principal" knowingly fails to disclose the improper conduct. The definition of "principal" as set forth in the regulation is "an officer, director, owner, partner, or a person having primary management or supervisory responsibilities,"[12] but the comments suggest that this definition should be interpreted broadly and could "include compliance officers or directors of internal audit."[13] It is difficult to imagine a situation in which a contractor would succeed with the defense that a principal did not have knowledge if the contractor, in fact, maintained a compliant ICS, with the attendant obligation of "assignment of responsibility at a sufficiently high level . . . to ensure effectiveness of the . . . internal control system."[14]

The heightened "credible evidence" standard was chosen over "reasonable grounds to believe" so as to provide the contractor "the opportunity to take some time for preliminary examination of the evidence to determine its credibility before deciding to disclose to the Government."[15] Additionally, the extension of the obligation to disclose for three years after final payment was considered to be consistent with record retention requirements of other sections of the FAR.[16]

48 C.F.R. § 52.203-13(c)(2)(ii)(g) requires full cooperation with government agencies responsible for audits, investigations, or corrective actions. Full

7 The comments expressly note that the rule "establishes a framework for institutional ethics management and disclosure and does not prescribe specific ethical requirements." 73 Fed. Reg. 67064-02 at B-4.

8 *See* DCAA Audit of Control Environment and Overall Accounting Systems, Version 5.0, July 2009, available at http://www.dcaa.mil/sap/ACTG-Internal_Control_Matrix.pdf.

9 73 Fed. Reg. 67064-02 at B-6.

10 48 C.F.R. § 52.203-13(b)(3)(i). A nearly identical responsibility is placed on the contractor with respect to its ICS by 48 C.F.R. § 52.203-13(c)(2)(ii)(F).

11 48 C.F.R. § 9.406-2(b)(1)(vi) (debarment); 48 C.F.R. § 9.407-2(a)(8) (suspension).

12 48 C.F.R. § 52.203-13 (a).

13 73 Fed. Reg. 67064-02 at B-16.

14 48 C.F.R. § 52.203-13(c)(2)(ii)(A).

15 73 Fed. Reg. 67064-02 at B-10.

16 *Id.* at B-11 (citing 48 C.F.R. §§ 52.214-26, 52-215-2).

cooperation means disclosure sufficient for law enforcement to identify the nature and extent of the offense, the responsible individuals, and timely responding to requests for documents and access to employees. The regulation expressly provides that the obligation of full cooperation does not require a waiver of the attorney-client privilege, the attorney work-product doctrine, or Fifth Amendment rights, and does not restrict a contractor from conducting an internal investigation or defending itself in claims disputes.[17]

A recent Federal Circuit case upheld the "no waiver" policy set forth in the rule. The decision, *In re Kellogg Brown & Root, Inc.*,[18] overturned an order of the District Court requiring a defense contractor to produce documents regarding an internal investigation performed by in-house counsel under its Code of Business Conduct. The *KBR* court rejected the District Court's reasoning that, because the investigation at issue was conducted pursuant to a compliance program (under 48 C.F.R. § 52.203-13), the enduring Supreme Court law that affords attorney-client privilege protections to corporations conducting internal investigations did not apply.[19] The Federal Circuit held that the District Court's approach created uncertainty as to whether the privilege would apply to internal investigations, with the unacceptable result of destabilization in an important area of law that would disable most public companies from undertaking internal investigations.[20]

A significant issue for contractors with respect to the mandatory disclosures relates to the types of conduct that must be disclosed. Under 48 C.F.R. § 52.203-13(b)(3)(i)(A), contractors are required to disclose fraud, conflict of interest, bribery, or gratuity crimes found in Title 18 of the United States Code, that are committed in the award, performance, or closeout of a government contract. The obligation to report "violations of Federal criminal law involving fraud" is an amorphous concept that could encompass multiple criminal provisions.[21] The application of FAR 52.203-13(b)(3)(i)(A), however, is relatively straightforward, requiring disclosures for obvious improper conduct such as bribery and clear conflicts of interest.[22]

Contractors also must disclose violations of the civil False Claims Act.[23] This act was enacted to "discourage contract fraud against the federal government"[24] and imposes civil penalties for, among other things, knowingly (a) presenting a false or fraudulent claim for payment or approval; (b) making, using or causing to be made or used, a false record or statement material to a fraudulent claim; and (c) conspiring to commit either of these offenses.[25] Under the False Claims Act, a contractor is deemed to have known that a claim submitted was false if it had actual knowledge of its falsity or if the contractor acted in deliberate ignorance or reckless disregard of the truth or falsity of the claim.[26] To be actionable under the False Claims Act, a conspiracy may require an overt act in furtherance of the conspiracy, in addition to the conspiracy itself.[27]

Under the False Claims Act, clearly the knowing submission of an invoice seeking an overpayment subjects a contractor to liability. The more difficult question concerns situations where a contractor's incorrect interpretation of its contract leads to an overpayment. A claim based upon a plausible, but erroneous, contract interpretation likely will not render the contractor in violation of the Act. However, the contractor will not be protected from implausible contractual interpretations where the contract is unambiguous.[28]

17 48 C.F.R. § 52.203-13(a).

18 756 F.3d 754 (Fed. Cir. 2014).

19 *Id.* at 762-63 (citing Upjohn Co. v. United States, 449 U.S. 383 (1981)).

20 *Id.*

21 *See e.g.*, 18 U.S.C. § 1031 (2015) (imposing criminal fines of up to $1,000,000 and imprisonment of up to ten years, for "major fraud against the United States," including knowing execution, or attempt to execute, any scheme or artifice to defraud the United States in contract or subcontract, if the value of the contract or subcontract is $1,000,000 or more); 18 U.S.C. § 1001 (2015) (imposing prison sentences of up to eight years for the knowing falsification or concealment of a material fact, materially fraudulent statements, or the use of a false writing, in "any manner within the jurisdiction of the executive, legislative, or judicial branch of the Government"); 18 U.S.C. § 1020 (2015) (imposing criminal fines and up to five years imprisonment for fraud committed with respect to federal highway projects, including false representation with respect to the character, quantity or quality or cost of any work performed).

22 *See e.g.*, 18 U.S.C. § 201 (2015) (imposing up to three times the amount of the bribe and not more than fifteen years imprisonment for giving, offering or promising anything of value to a public official otherwise than as provided by law for the proper discharge of official duty); 18 U.S.C. § 208 (2015) (making it a crime for an officer or employee of the executive branch to participate in a contract with an entity that he or she or certain related individuals and family members have a financial interest).

23 48 C.F.R. § 52.203-13(b)(3)(i)(B)

24 United States v. Jurik, 943 F. Supp. 2d 602, 609 (E.D.N.C. 2013) (citing Glynn v. EDO Corp., 710 F.3d 209, 213 (4th Cir. 2013)).

25 31 U.S.C. § 3729 (2015).

26 Commercial Contractors, Inc. v. United States, 154 F.3d 1357, 1362 (Fed. Cir. 1998); *see also* 31 U.S.C. § 3279(b)(1) (defining knowing and knowingly under the False Claims Act).

27 United States *ex rel.* Sanders v. Allison Eng'g Co., 364 F. Supp. 2d 713, 714 (S.D. Ohio 2003) (citing United States v. Murphy, 937 F.2d 1032 (6th Cir. 1991)).

28 *Commercial Contractors*, 154 F.3d at 1366.

For example, in *Commercial Contractors, Inc. v. United States*,[29] the contractor was held liable under the False Claims Act for receiving overpayments because, among other things, it was repeatedly warned by its surveyor-subcontractor that the interpretation it adopted as to payment for excavation and fill quantities was in conflict with the contract's plain terms and well-established industry practice.[30] If the facts of the case occurred today, under the Contractor Code there is an apparent obligation to make disclosure to the Engineer Inspector General of the Army Corps of Engineers, with a copy provided to the contracting officer. The *Commercial Contractor*s court touched on this concept: "when the contractor's purported interpretation of the contract borders on the frivolous, the contractor must either raise the interpretation issue with the government contracting officials or risk liability under the FCA."[31] Indeed, under current regulations, in addition to being liable under the False Claims Act, conduct similar to that in *Commercial Contractors* may subject the contractor to debarment or suspension by virtue of the failure to disclose as required by the Contractor Code.

By comparison, if the contractor presents the contract interpretation upon which it intends to rely prior to or with its payment application, the contractor may escape False Claims Act penalties if it later turns out that its contract interpretation is incorrect. In *United States ex rel. Durcholz v. FKW Inc.*,[32] the Seventh Circuit held: "[i]f the government knows and approves of the particulars of a claim for payment before that claim is presented, the presenter cannot be said to have knowingly presented a fraudulent or false claim. In such a case, the government's knowledge effectively negates the fraud or falsity required by the FCA." [33] In *Durcholz,* the government had previously requested and approved the contractor's characterization of its dredging work as excavation on its payment applications because there were no line-items for dredging in the Unit Price Book and the work needed to be carried out expeditiously.[34]

Reading *Durcholz* and *Commercial Contractors* together suggests that, when the interpretation of a federal contractor's payment terms are in doubt, a contractor's best practice is to notify the contracting officer of the interpretation upon which the contractor intends to rely. This interpretation should be communicated prior to submitting payment applications so as to avoid the risk of False Claims Act exposure and to comply with the disclosure requirements of the Contractor Code.

Lastly, a knowing failure to disclose credible evidence of "significant overpayments" in a timely manner can expose the contractor to debarment or suspension. This obligation extends for three years after final payment such that, if a contractor discovers within that period that it innocently received a significant overpayment, it must disclose it or risk suspension or debarment.[35] Overpayments, while not specifically addressed in the Contractor Code, are discussed in the comments to the enactment of the 2008 version. The comments noted that contractors already were required to report and return overpayments.[36] They indicate, however, that (a) suspension and debarment are reserved only for "significant overpayments" and not routine contract payment issues; (b) the issue of whether an overpayment is significant is entrusted to the discretion of the suspension or debarment official; and (c) the significant overpayment standard "implies more than just dollar value" and depends on the circumstances of the overpayment, as well as the amount.[37] The debarment and suspension provisions exempt significant overpayments with respect to contract financing payments. Progress payments on fixed-price construction contracts, however, are expressly excluded from the definition of contract financing payments.[38] Therefore, a contractor performing a typical fixed-price construction contract is required to disclose significant overpayments or potentially be subject to debarment or suspension.

29 154 F.3d 1357 (Fed. Cir. 1998).

30 *Id.*

31 *Id.*

32 189 F.3d 542 (7th Cir. 1999).

33 *Id.* at 545.

34 *Id.*

35 48 C.F.R. § 9.406-2(b)(1)(vi) (debarment); § 9-407-2(a)(8) (suspension).

36 73 Fed. Reg. 67064-02 at B-17 (citing 48 C.F.R. §§ 52.232-25, 52.232-26, 52.232-27, and 52.212-4(i)(5)); *see also* 48 C.F.R. § 52.232-5 (under a fixed-price construction contract, requiring notification if the contractor, after requesting a progress payment, later discovers that a portion or all of such request constitutes payment for performance by the contractor that fails to conform to the specifications).

37 73 Fed. Reg. 67064-02 at B-17.

38 *See* 48 C.F.R. § 9.406-2 (b)(1)(vi)(c) (providing for debarment for the knowing failure to disclose "significant overpayments on the contract, other than overpayments resulting from contract financing payments as defined in 32.001"); § 32.001 (excluding from the definition of "contract financing payments" progress payments made under § 52.232-5, regarding fixed price construction contracts).

Conclusion

Under the Contractor Code, federal contractors are required to establish a code of business ethics and conduct, as well as an ICS that is compliant with the minimum standards laid out in [48 C.F.R. § 52.203-13(c)(2)](). Contractors must cooperate fully with government audits, but in doing so are not required to waive the attorney-client privilege, work-product protection, or the rights afforded by the Fifth Amendment. Finally, contractors are required to disclose federal crimes relating to fraud, conflict of interest, bribery or gratuity, committed in connection with the award, performance or closeout of the contract or any related subcontract, as well as violations of the False Claims Act and significant overpayments.

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PRINCIPAL FILE...

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are subject to the prior rights of a debtor's lender with a floating lien on all inventory, including the goods subject to reclamation.[4] Second, reclamation rights are limited to the goods in the debtor's possession at the time of the reclamation demand (or, sometimes, on the bankruptcy filing date), which is often difficult to prove. Lastly, the only statutory remedy for a successful reclamation claimant – return of goods – can make recovery on a reclamation claim costly and time-intensive.

Alternatively, separate and apart from the reclamation remedy, the supplier or surety can file an administrative priority claim (paid first in the bankruptcy priority waterfall) under § 503(b)(9) for any goods furnished to the debtor within the 20-day window before the bankruptcy petition filing. This type of claim is generally referred to as a "503(b)(9) claim", and it often has a greater likelihood for success compared to a reclamation demand.[5] So, instead of the supplier or surety recovering a nominal percentage of its unsecured claim, it can expect (at least in theory) to recover 100 cents on the dollar. This provision is for goods only and does not apply to any type of service provided to the debtor or to goods received outside the 20 days immediately prior to the debtor filing for bankruptcy relief. Thus, the window for goods furnished to the debtor covered by a 503(b)(9) claim is even tighter than that provided for reclamation demands.

As a general matter, where a principal is in bankruptcy, whenever a surety pays claims under its bonds, it should be mindful of those payments that may be considered actual and necessary costs for preserving the estate.[6] Claims that accrue after the commencement of a bankruptcy and that are determined to be necessary to preserve a debtor's estate are permitted administrative priority. These claims are entitled to be paid in full, and the surety should file an administrative claim for all such costs.

Due to the narrow time limitations for suppliers' reclamation demand and administrative priority claims, the wise surety will be proactive in its investigation regarding materials supplied to its principal/debtor. Reaching out to suppliers who have filed bond claims may motivate them to protect their rights in bankruptcy. Even if the surety pays the supplier's claim, the surety may be able to improve its position in the bankruptcy and maximize its recovery by asserting the supplier's rights.

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4 *Id.*

5 Note that pursuant to 11 U.S.C. § 546(c)(2), the supplier or the surety need not make written demand to the debtor for the return of the goods in order to assert its administrative claim under § 503(b)(9).

6 11 U.S.C. § 503(b)(1).

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