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Newsletter

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2024 SURETY CLAIMS INSTITUTE MEETING AT CHEYENNE MOUNTAIN RESORT IN COLORADO SPRINGS, COLORADO PROGRAM PREVIEW

By: Amy E. Bentz, Esquire, Bentz Law Firm, P.C., Pittsburgh, PA

The Surety Claims Institute's 49th Annual Meeting will be held June 19, 2024, through June 21, 2024, at the beautiful Cheyenne Mountain Resort in Colorado Springs, Colorado. We are fortunate to have Brian Kantar of CSG Law and Rachel Walsh of Liberty Mutual Surety co-chairing the Educational Program and this promises to be a stellar program with important surety hot topics that affect each of us in our work. As always, the SCI Board of Directors endeavors to choose locations that offer a family-friendly atmosphere in an upscale setting. The Cheyenne Mountain Resort with its world-famous vistas is no exception.

Families will enjoy the first-class resort nestled in the Cheyenne mountains, which is "a step away from the great outdoors" and offers incredible activities for everyone of all ages. The resort boasts five heated pools including an Olympic sized pool, an extensive spa, a beach front lake for kayaking, sailing and other water sports, numerous dining venues with spectacular views and a world class golf course. (*Continued on page 5)*

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COMMENTS FROM THE EDITOR

While there is always a combination of nostalgia and sadness involved, one of the honors I have as editor-in-chief of this Newsletter is to recognize and honor friends who have passed. Elsewhere in this edition you will read an In Memoriam tribute to Bob Watt. I take this opportunity to add a few personal reminiscences of Bob, whom I knew for about 40 years.

Bob was a dynamo. He had enormous energy, and in the matters we had together, he would arrive to meetings as a whirlwind, usually backed up by another competent member of his team. Invariably, Bob would

bring enthusiasm and passion for the position of his client. He also had tremendous self-confidence which he used for his clients' benefit.

I recall one case in particular in which Bob represented a contractor on a project in New York City. I represented the surety. And an attorney, whom Bob and I both knew, represented the developer. My client was based in Seattle and the matter was large enough for the head of surety claims for the region to fly in from Seattle for a meeting. The purpose of the meeting was to understand the developer's performance bond claim better so that the surety could reach a decision as to whether to take over and complete the project, using the solvent principal, or to otherwise resolve the claim. Of course, another option was to stand behind the principal's defenses, deny the claim and litigate.

The meeting started with the developer's counsel objecting to Bob's presence. The developer's counsel took the position that the purpose of the meeting was to see what the surety was going to do about the claim and that the principal had no right to participate in that discussion. His position on behalf of the developer was that the principal had breached the contract, was not capable of finishing the job or otherwise worthy of doing so. I indicated that while that might be his client's view, the surety was still evaluating the claim, and wanted to hear the developer's point of view firsthand and to compare it with the principal's point of view on the issues in dispute. The most efficient way for the surety to understand and evaluate the claim and the developer/obligee's complaints and contentions was to have the principal and its counsel present to hear them and to provide the principal's side of the story for evaluation by the surety. I suggested that perhaps having the principal present and able to offer its point of view might be useful for purposes of evaluation by the developer as well, with the assistance of its counsel. Counsel for the developer disagreed, insisting that the principal and its counsel had no role to play and could not sit in on the meeting. I suggested as a compromise that they be permitted to sit in on the meeting, but would say nothing and, when I thought it appropriate, we could adjourn briefly for me to separately obtain the principal and its counsel's point of view.

But I suggested that, because the surety was not going to make any decisions without hearing from the principal, the most efficient way to proceed was for Bob and his client to be in the meeting, to hear firsthand what the developer had to say and to respond with its point of view for all to hear and evaluate. Otherwise, the meeting would be inefficient and would be subject to the vagaries of secondhand reporting of the positions of each of the developer and the principal. The developer's counsel stood firm and the choice then was to proceed with the meeting without Bob present or to conduct the meeting with frequent breaks for purposes of consulting with Bob and his client. The problem with not having the meeting at all was that my client had flown all the way out from Seattle. And Bob had flown in from Virginia. Since we were unable to convince the developer's counsel to proceed in one meeting, my client and I shuttled back-and-forth, with my client and I hearing very different perspectives on the facts, rights and responsibilities from each of the developer and the contractor. While Bob could have put on a show for his client similar to the show being put on by the developer's counsel, he did not do so (though having been quite capable of putting on a show had he considered it wise to do so). Rather, Bob conducted himself as a gentleman, albeit, during our breaks, as a rather exercised, passionate gentleman.

The meeting was not a success and litigation ensued. Bob only made a brief appearance at trial and had two of his partners try the case with me and one of my colleagues presenting the respective positions of the principal and surety. Bob's partners took the lead. Bob shuttled in and out of both the proceedings and meetings during the course of the trial, offering more cheerleading and encouragement than substantive input. That

is not because he did not provide substantive input. Rather, he had provided it prior to the commencement of the trial.

His partners were excellent trial attorneys with strong presentation skills. Given the aggression of the principal's counsel in our first meeting, it was quite satisfying that, at the end of the day, the developer's claim was denied and dismissed and an eight-figure award was returned in favor of the principal. Winning at trial is always fun. But winning when litigating against a very aggressive and arrogant adversary is always more fun.

In the end, Bob's substantive knowledge, energy, and commitment to his client were infused into his partners and was one of the keys to their success. His enthusiasm and passion were contagious and, at times, entertaining for all. He was unique and will be missed. He leaves behind the excellent law firm he founded, many friends and many good memories.

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2024 SURETY CLAIMS INSTITUTE MEETING AT CHEYENNE MOUNTAIN RESORT IN COLORADO SPRINGS, COLORADO PROGRAM PREVIEW

(*Continued from page 1)*

Families will enjoy the first-class resort nestled in the Cheyenne mountains, which is "a step away from the great outdoors" and offers incredible activities for everyone of all ages. The resort boasts five heated pools including an Olympic sized pool, an extensive spa, a beach front lake for kayaking, sailing and other water sports, numerous dining venues with spectacular views and a world class golf course. The Cheyenne Mountain Resort offers all the amenities you have come to expect from the SCI's annual meeting locations: rooms with breathtaking views, spacious meeting and reception venues, extensive activities, and attractions as well as other top shelf amenities.

In addition to the offerings of this fantastic venue and back by popular demand, SCI once again is offering the Surety School for our newer surety professionals. This one-day round-table-format program takes place on Wednesday from 10:00 am to 5:30pm before the Annual SCI Meeting. Surety School's program will cover a wide range of subjects from the business of surety, to indemnity, accounting and bankruptcy, and will include contract and commercial surety subjects. There is no cost to attend Surety School, but registration is limited to 20 students. Please contact Scott Williams (swilliams@manierherod.com) or Gina Lockwood (glockwood@merchantsbonding.com) to register.

This year's SCI Educational Program is designed for our more seasoned members and promises to provide critical information that should not be missed. This year's program covers subjects that are not generally addressed or thoroughly examined in other programs.

Thursday morning opens strong with Adam Friedman of CSG Law and Dan Pentecost of Westfield Insurance who will finally answer how to best explain suretyship to laypeople and to the courts. Jennifer Whritenour of Intact Insurance and Connor Cantrell of the Hustead Law Firm follow with "Bad Bond Forms; Part Deux" to offer insight into what we can do when dealing with onerous and problematic bonds (other than simply throwing up our hands and uttering expletives). Then, Douglass Wynne of Simon, Peragine and Jessica Derenbecker of Arch Insurance will review recent changes to the Davis Bacon Act and how they may affect us when handling bond claims.

After the break, Elliot Scharfenberg of Krebs Farley and Cassie Hewlings of Liberty Mutual Surety will explore the interplay of suretyship and insurance and the need to look to available insurance coverages as a potential source of salvage and loss mitigation. Thursday's program wraps up with the one-hour ethics discussion on mediation and negotiations presented by Christopher Brasco of Watt, Tieder, Hoffar, and Fitzgerald and Michael Cronin of Markel Surety.

Back by popular demand, Friday morning will begin with our Surety Law Update presented by Patricia Wager and Tiffany Schaak. Then, Scott Olson of Nicholson Consulting and Jay Cabello of Liberty Mutual Surety provide a timely and relevant update on the construction issues affecting surety claims. Immediately following in an aptly titled program "Demonstrating the Value of Surety Bonds Through Claims Handling", Scott Williams of

Manier and Herod, CharCretia DiBartolo of Liberty Mutual Surety, Julie Alleyne of the SFAA, and Jeff Broyles of Willis Towers Watson will discuss how we can all be good ambassadors for our industry and share how surety bonds can and have provided value in a number of situations. Friday's session concludes with a consummate program on the State of the Surety Industry. This must-see program will be presented by Gregory Horne of Liberty Mutual.

We hope you are as excited as we are about this year's annual meeting at the beautiful Cheyenne Mountain Resort in Colorado Springs, Colorado. We look forward to seeing everyone there!

IN MEMORIAM

ROBERT GIBBS WATT

By: John F. Finnegan III, Watt, Tieder, Hoffar & Fitzgerald, L.L.P., McLean, VA

On January 20, 2024, Robert (Bob) Gibbs Watt – founder of what is now Watt, Tieder, Hoffar & Fitzgerald, L.L.P. – peacefully passed away, having valiantly battled Parkinson's Disease with the trademark tenacity and indomitable will that imbued his pioneering legal career and life.

Born on July 1, 1945, in Mineral Wells, Texas, Bob spent his youth in Winchester, Illinois, where he excelled both in academics – including earning the salutatorian distinction of his graduating high school class – and athletics. Bob matriculated to Grinnell College in Iowa, where he starred as a three-sport athlete in football, basketball, and track, becoming only the fifth student in the college's history at the time to win nine varsity letters. Years later in 2002, Bob was inducted into the Grinnell College Athletics Hall of Fame.

Upon his collegiate graduation, Bob attended law school at the University of Illinois for one year, until he was called to serve in the D.C. National Guard. He transferred to The George Washington University Law School and completed his Juris Doctor degree, graduating with honors in 1971. Bob thereafter joined the law firm of Lewis, Mitchell, Bixler and Moore in Virginia, and practiced there for six years.

In what would come to represent his enduring legacy in the legal community, in early 1978 Bob, along with a handful of other attorneys, founded the firm of Watt, Tieder, Killian and Toole, which would later become Watt, Tieder, Hoffar & Fitzgerald, L.L.P. Throughout his Watt Tieder career, Bob advised clients on complex surety matters and high-profile public and private construction projects across the world, and handled disputes with a variety of governmental bodies, including the United States Corps of Engineers. Among numerous other honors, he was named to Best Lawyers in America, construction law category, from 2005–09, and Chambers Top Construction Lawyers in Virginia from 2004–09. Further, in 2008 and 2009, Bob was the only construction attorney in the U.S. to achieve the highest star rating.

For more than thirty years Bob served as Watt Tieder's managing partner, in which role he not only delivered successful results for clients

but also singularly contributed to the firm's culture. Under Bob's stewardship, Watt Tieder grew from its principal office in the Washington, D.C. area to a nationally recognized leader in surety, construction, and government contracts law, with additional offices in Irvine, California, Chicago, Illinois, Miami, Florida, and Boston, Massachusetts. Throughout such growth, Bob was considered the "heart and soul" of Watt Tieder, mentoring each generation of its attorneys with his infectious competitiveness, energy, insatiable intellectual curiosity, and excellence.

Bob is survived by his loving daughters, their spouses and children, and many other family members and dear friends.

Surety Claims Institute
49th Annual Meeting & Seminars

Tuesday, June 18 – Friday, June 21, 2024

CHEYENNE MOUNTAIN COLORADO SPRINGS

AGENDA

Tuesday, June 18		
3:00 – 5:00 p.m.	Registration Desk Open	Function Space Gallery

Wednesday, June 19		
9:00 – Noon	Board of Directors Meeting	Remingtons II
10:30 – 4 p.m.	Surety School*	TBD
2:00 p.m. – 5:00 p.m.	Registration	Function Space Gallery
1:00 – 5:00 p.m.	Speakers Rehearsal	TBD
6:00 – 9:00 p.m.	Get Acquainted Reception/ Buffet Dinner*	Grand Rivers Terrace & Ballroom

Thursday, June 20		
7:30 a.m.	Continental Breakfast for Registrants	Centennial Ballroom
8:00 a.m. – 11:30 a.m.	Seminar Program	Centennial Ballroom
1:00 – 5:00 p.m.	Golf Tournament*	Country Club of Colorado
6:30 – 9:30 p.m.	Children's Party*	Kid's Room
7:00 – 10:00 p.m.	Reception and Banquet Dinner *	Remingtons

Friday, June 21		
7:30 a.m.	Continental Breakfast for Registrants	Centennial Ballroom
8:00 a.m. – Noon	Seminar Program	Centennial Ballroom
Noon	Adjourn	

*Reservations Required

Locations/Times/speakers/and educational topics subject to change

49th SURETY CLAIMS MEETING - SEMINAR PROGRAM SCHEDULE

THURSDAY PROGRAM

8:00 – 8:15 **Opening Remarks: *Steve D. Nelson, Markel Surety***
Program Remarks/Introduction of Speakers: *Brian Kantar and Rachel Walsh*

8:15 – 8:45 **Explaining "Surety" to Laypeople and Courts**
Speakers: Adam Friedman and Dan Pentecost

8:45 – 9:15 **Bad Bond Forms: Part Deux – Where Do We Go from Here?**
Speakers: Connor Cantrell and Jennifer Whritenour

9:15 – 9:45 **Davis-Bacon Act: What's All the Fuss About?**
Speakers: Douglass Wynne and Jessica Derenbecker

9:45 – 10:00 BREAK

10:00 – 10:30 **Insurance: Possible Source of Salvage or Loss Mitigation?**
Speakers: Elliot Scharfenberg and Cassie Hewlings

10:30 – 11:30 **Ethics in Mediation and Negotiations**
Speakers: Christopher Brasco and Michael Cronin

FRIDAY PROGRAM

8:00 – 8:15 **Opening Remarks: *Steve D. Nelson, Markel Surety***
Program Remarks/Introduction of Speakers: *Brian Kantar and Rachel Walsh*

8:15 – 9:00 **Surety Law Update 2024 Update – Select Case Summaries**
Speakers: Patricia Wager and Tiffany Schaak

9:00 – 9:45 **Construction Update**
Speakers: Scott Olson and Jay Cabello

9:45 – 9:55 BREAK

9:55 – 10:30 **Demonstrating the Value of Surety Bonds Through Claims Handling**
Speakers: Scott Williams, CharCretia DiBartolo, Julie Alleyne, and Jeff Broyles

10:30 – 11:30 **State of the Surety Industry**
Speaker: Gregory Horne, Liberty Mutual Surety

Productivity Claims: The Cost of Disruption

By: Jeff Katz, PE, PSP, CCM, The Vertex Companies, New York, New York and Amanda Marutzky, Watt, Tieder, Hoffar & Fitzgerald, L.L.P., Irvine, California

Introduction

Construction is fraught with risk borne by contractors and subcontractors. When production cannot be achieved as planned, costs can quickly accrue. Despite being one of the most common impacts on a construction project, lost productivity is not easily discerned and even more difficult to calculate and substantiate. Parties may think they have a delay claim, when in reality their damages are more aligned with disruption or labor inefficiency resulting from any number of causes. Depending on factors such as availability and reliability of information and documentation, there are several methodologies available for prosecuting a productivity claim. Understanding what to track, how to assemble a claim, and how courts have ruled on these types of claims can be the difference between recovering the costs associated with productivity impacts or realizing a loss.

Delay vs. Disruption

Delay and disruption are two common causes of damages on a project. Delay damages relate to time-based costs associated with the extended performance resulting from delays. Delay damages can include extended general conditions/field office overhead, extended or unabsorbed home office overhead, extended equipment costs/standby costs, lost revenue, among other costs. Productivity damages are typically increased labor and equipment costs.

While delay relates to time, productivity relates to efficiency. Productivity losses can occur absent delays on a project. Productivity is the ratio of output (units produced) to input (typically, labor hours), as represented by the formula below:

$$Productivity = \frac{Output}{Input} = \frac{Production}{Time}$$

Oftentimes, the term productivity is used interchangeably with efficiency; lost productivity with inefficiency. Higher productivity levels typically allow contractors to increase profitability and improve competitiveness.[1]

The output for productivity is generally measured in physical units—say 1,000 linear feet of pipe or 5,000 square-feet of drywall. The input is time-based, typically labor hours. The example calculation in the figure below shows the

[1] *Construction Productivity: A Practical Guide for Building and Electrical Contractors*. (Eddy M. Rojas ed., J.Ross Publishing, 2008).

productivity calculation for a sitework contractor who needs to lay 1,000 linear feet of pipe, who estimates they can complete this work in 50 hours:

$$Productivity = \frac{Output}{Input}$$

$$Output = 1000\ LF$$

$$Input = 50\ hrs$$

$$Productivity = \frac{Output}{Input} = \frac{1000LF}{50hrs} = 20\ LF\ per\ hour$$

Figure 1. Sample Productivity Calculation

Output on a project is typically constant: in the absence of changes, there is a set amount of work to be performed. To achieve a desired output if productivity decreases, input must be increased, meaning more manpower or additional hours per person, and, thus, more input generally means greater cost. Rearranging the terms in the first figure above, we can represent the inverse relationship between input and productivity, as shown below:

$$\frac{Output}{Input} = Productivity$$

$$Production = Output = Productivity\ x\ Input$$

$$y = mx$$

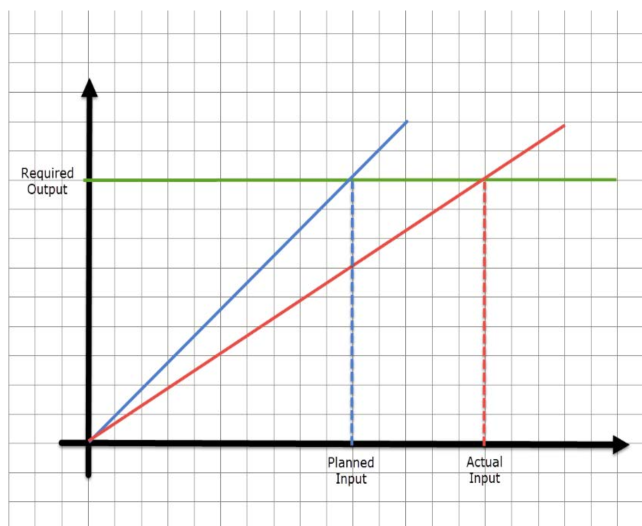

Figure 2. Inverse relationship between input and productivity

In the graphical relationship between input and productivity shown above, the steeper the slope of the line, the greater the productivity being achieved.

Factors Impacting Productivity

Numerous factors impact a contractor's productivity. Understanding factors that impact productivity allow for mitigative measures to be implemented. Some of these factors include schedule acceleration, out-of-sequence work, trade stacking, scope changes, overtime, adverse weather, site access, and others. Some of these impacts have been the subject of studies to correlate the impact to a loss of productivity. Other factors may require the use of project-specific information or other methodologies to calculate labor productivity loss.

Contractual Considerations and Entitlement

When advancing a claim—be it delay, differing site condition, productivity, or another—an understanding of contractual provisions, such as notice provisions, and necessary procedural requirements is essential. Unlike delay, as productivity impacts are often difficult to calculate contemporaneously, compliance with notice requirements when a contractor is experiencing productivity impacts may be more difficult than delays, which are often more discrete or are observed when a contractor issues a schedule update.

Contractors must carefully review their contract to find the applicable contract provision(s) that speak to a productivity claim. This may be a Changes clause or Differing Site Conditions clause. A productivity claim is different from a pure delay or extension of time claim. *Sauer, Inc. v. Danzig*, 224 F.3d 1340, 1348 (Fed. Cir. 2000) discusses the difference between the two types of damages: disruption damages may be present even if project completed on time, where greater costs were incurred because of disruptive events that forced claimant to accelerate, resequence, increase manpower, etc. There does not have to be a delay for the productivity claim to be actionable.[2]

[2] *See, e.g., Appeals of States Roofing Corp.*, ASBCA No. 54860, 10-1 B.C.A. (CCH) ¶ 34356 (Jan. 12, 2010) (distinguishing between delay and loss of productivity and rejecting argument that contractor could not recover damages for the lost productivity

Contracts may also include restrictive provisions or exculpatory clauses, such as a waiver of consequential damages or waiver of claims for lost profits, productivity, "soft costs," etc., as well as a no-damages for delay clause. The enforceability of these clauses varies by state, and by public or private work.[3] Even where there may be a no damages for delay clause in a contract, some courts have found that such a clause would not preclude a claimant from recovering for disruption.[4]

Proving Entitlement to Claim

To prove a claim for loss of productivity, a contractor generally bears the burden of proof for three elements: (1) liability; (2) causation; and (3) resultant injury for the impact of changes.[5] These elements generally must be proven by a preponderance of the evidence, meaning that the evidence must establish that it is more likely than not that each of these factors is present, and to recover for inefficiency a contractor must show "fundamental triad of proof."[6]

- Liability: Owner contractually responsible for impact, i.e., proof that the owner's actions or inactions changed the contractor's costs for which the owner is legally liable;
- Causation: Impact caused labor overruns;
- Injury/Resultant Cost Increase: Impact caused compensable loss.

1. Liability

To establish entitlement on a claim for lost productivity, the contractor must focus first on the nature of the impacts and then on the cause of the impacts, identifying the entity or entities that bear responsibility. The first question to answer regarding entitlement to a productivity claim is "Who is Responsible?"

If the Contractor is responsible for disruption, it must bear the loss, but if the cause of the disruption was due to the Owner, then the Owner will be liable.[7]

2. Causation

Causation is the toughest element of the three to prove. This is especially true for impacts that are not immediately felt or known when experienced. Thus, the contractor may miss a window of opportunity to develop a claim-oriented written record at a time when the recollection of its personal is still fresh. For example, in *Centex Bateson*, a contractor recognized the *individual* impact of changes to the work during negotiations with a project owner.[8] However, only with the benefit of hindsight did the contractor later appreciate the cumulative effect and disruption caused by the more than 1,500 separate "events" directed consisting of various contract changes, both unilateral and bilateral, requests for information, and alleged constructive changes. In support of its cumulative impact claim, the contractor presented limited contemporaneous support, and as a result, the claim was rejected. The administrative board responsible for hearing the dispute agreed with the project owner reasoning,

without demonstrating that the impacted activities affected the completion schedule); *City of Galveston v. Triple B Servs., LLP*, 498 S.W.3d 176 (Tex. App. 2016).

[3] Watt Tieder prepares a 50-state survey of key issues related to construction and engineering contracts, which includes enforceability of clauses such as no-damages-for-delay and waivers of consequential damage: https://50-state.watttieder.com/50stateanalysis#modal2

[4] *See, e.g., United States ex. rel. Wallace v. Flintco Inc.*, 143 F.3d 955 (5th Cir. 1998) (explaining that, under Texas law, a no damages for delay clause does not preclude recovery for productivity impacts when there is active interference with the contractor's performance).

[5] *See, e.g., George Sollitt Const. Co. v. United States*, 64 Fed. Cl. 229, 237 (2005).

[6] *Centex Bateson Constr. Co*., VABCA Nos. 4613, 5162-5165, 99-1 BCA P30, 153, 149, 258, *aff'd*, *Centex Bateson Constr. Co. v. West*, 250 F.3d 761 (Fed. Cir. 2000); *George Sollitt Const. Co. v. United States*, 64 Fed. Cl. 229, 237 (2005) (Preponderance of the Evidence Standard)

[7] *Stroh Corp v. Gen. Serv's Admin*., GSBCA No. 11, 029, 96-1 BCA ¶ 28, 265.

[8] *Centex Bateson Constr. Co*., VABCA Nos. 4613, 5162-5165, 99-1 BCA ¶ 30, 153, 149, 258, *aff'd*, *Centex Bateson Constr. Co. v. West*, 250 F.3d 761 (Fed. Cir. 2000).

in part, that there was a lack of contemporaneous project records to support the contractor's claim.[9]

In contrast, in *Lamb Engineering*, the contractor successfully argued for inefficiency costs resulting from differing site conditions by providing detailed documentation and even video evidence of the differing site conditions.[10] It is with good reason that contemporaneous project records are the best resource for demonstrating causation.

3. Resultant Injury

Finally, the contractor must prove incurred damages. The case law does not require proof to an exact certainty, but it does require proof to a reasonable degree of certainty concerning the fact and amount of damage incurred.[11] Courts are more likely to accept some degree of approximation when responsibility for damage is clear, but a reasonable basis for computation should be provided.

How Productivity Impacts are Calculated

The quantification of productivity impacts is a highly contentious topic within the construction claims arena. Damages pertaining to lost productivity are typically not tracked by contractors or are difficult to identify contemporaneously unlike direct costs stemming from a scope adjustment or other discrete change. Consequently, establishing both causation and entitlement with respect to lost productivity damages can be time-intensive and challenging. A further complicating factor is the absence of a consensus amongst construction professionals as to the ideal method of calculating damages resulting from lost productivity. There are several calculation methodologies available to quantify labor inefficiency costs. The appropriateness and validity of most methods are subject to challenge depending on the specific scenario. Such considerations make establishing a uniform agreement on the issue practically impossible.

AACE Recommended Practice 25R-03 provides an overview of the most common methods of calculating productivity loss damages and offers a hierarchy of methods to employ. This hierarchy divides the different methods into five general classifications. The classifications, in order of preference per AACE, are listed below:

1) Project-Specific Methodologies
2) Project Comparison Studies
3) Specialty Industry Studies
4) General Industry Studies
5) Cost Basis

1. Project Specific Methodologies

Courts, boards, and other legal forums have demonstrated a predilection for damage calculations that directly relate to the project that is the subject of the claim and rely on contemporaneously prepared documentation. The primary project-specific methodologies are the measured-mile and the earned value analysis.

While there is no consensus on the best method for calculating productivity losses, the measured mile approach is widely acknowledged as a highly favorable methodology.[12] A measured mile analysis compares identical (or similar) tasks in an impacted and non-impacted period to calculate the productivity loss caused by a known disruption.[13] The measured mile is viewed favorably because its calculations contemplate actual contract performance rather than relying on initial estimates. In other words, it compares actual performance with actual performance; not theoretical or planned performance.

The availability of reliable contemporaneous productivity data and the ability to identify a valid unimpacted period on the project (the "measured mile" period) are the two biggest barriers for use of this methodology. Sometimes a contractor's scope is impacted from the outset thereby making the establishment of a non-impacted period impossible. In such

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[9] *See also*, *Clark Construction Group, Inc*., VABCA No. 5674, 00-1 BCA ¶ 30,870 (denying claim due to lack of contemporaneous project records).

[10] *Lamb Engineering & Construction Co*. EBCA No. C-9304172, 97-2 BCA ¶ 29, 207.

[11] *See, e.g.*, *Luria Bros. & Co. v. United States*, 369 F.2d 701 (Ct. Cl. 1966) (weather related impact).

[12] Carter, John D., Coppi, Douglas F., Cushman, Robert F., & Gorman, Paul J., *Proving and Pricing Construction Claims*. United States: Wolters Kluwer Law & Business 87 (2000).

[13] McNamara, John J. & Schwartzkopf, William *Calculating Construction Damages* 64 (2000).

instances, use of the measured mile method is typically not appropriate. The measured mile requires contemporaneous, project-specific progress, resource, and performance data for both the impacted period and a comparable period of unimpacted progress. Most contractors do not have the project controls processes in place to adequately track productivity. The data collection and monitoring efforts involved in tracking productivity on active construction projects often exceed the perceived benefit in the eyes of most contractors. This view often changes after a contractor experiences a damaging productivity impact and it attempts to recover its damages. If sufficient contemporaneous productivity data is available, then the measured mile method remains available for use in calculating damages.

In circumstances where insufficient physical unit production data is available, an earned value analysis can be employed to demonstrate a loss of productivity. Earned value analysis evaluates how much time and budget should have been spent and compares it to the amount of work completed.[14] In other words, this method compares what was completed versus what was anticipated, i.e., the expected earnings per labor hour versus actual earnings per labor hours expended.

As with the measured mile, the earned value approach requires identification of periods for comparison. Such periods must allow for comparison of planned and actual performance during non-impacted and impacted periods. While this technique is not a total cost approach, as it contemplates progress and cost of work in progress, it does require demonstration that the bid or estimate data being relied upon is realistic. Additionally, the earned value analysis should compare similar quantities and similar activities and exclude change orders when evaluating labor hours and progress.

2. Project Comparison Methodologies

What if there was no unimpacted period to establish a measured mile? A contractor can look to other similar scope of work on the same project or similar projects as a yardstick for productivity. When there is insufficient contemporaneous project documentation or productivity data available, it is recommended that either a comparable work study or comparable project study be employed to support claims for lost productivity. These techniques still consider a contractor's actual productivity, rather than theoretical or study-based data, but rely on less directly comparable contemporaneous data than the measured mile or earned value methodologies.

In a comparable work study, the contractor estimates the productivity on the impacted portion of work and compares it to a non-impacted portion of work similar in nature to that of the impacted portion. This effectively substitutes the standard measured mile for one based on a similar but not identical scope of work on the same project.

In a comparable project study, the non-impacted baseline productivity rate used for comparison is based on that achieved for the same type of work on a similar project. When using comparable project data to demonstrate productivity loss it is important to review and establish that there was no unimpacted period on the subject project that would permit a measured mile. While such an approach provides the "next best" option for calculating productivity, it may be met with skepticism given the variables and factors that inevitably differ between the comparable project and the subject project. As such, comparable project studies should be viewed as secondary options to project-specific calculation methods. However, this method also can help further a measured mile by bolstering the analysis. Showing the non-impacted productivity during the measured mile period is comparable to unimpacted comparable project helps establish reliability of the non-impacted productivity rate.

3. Industry Studies

If neither the project-specific or project-comparison techniques are available, contractors may choose to rely on specialty or general industry studies to quantify loss of productivity damages.

Specialty industry studies are mostly commissioned by construction associations and organizations and are typically based on data compiled from actual construction projects. Some such studies measure the effects of acceleration, learning curve, overtime, and weather effects,

[14] Gibson, Roger, *A Practical Guide to Disruption and Productivity Loss on Construction and Engineering Projects* (2015).

among others. Most of these subject-specific productivity studies are either peer-reviewed scientific articles written on factors affecting labor productivity in construction projects or studies published by recognized labor associations and industry groups (Business Roundtable, Construction Industry Institute, etc.). Contractors encounter a variety of challenges when developing loss of productivity claims based on specialty industry studies. The main challenges are to demonstrate entitlement and causation, to establish that the subject project ran into situations like those demonstrated in the specialized studies, and to demonstrate the reasonableness of estimated increased time and/or costs.

General industry studies are typically used when specialized studies are not applicable and when sufficient contemporaneous and project specific project documentation (such as detailed and/or reliable labor and production tracking records) do not exist to demonstrate the productivity loss. Calculations relying on general industry studies are subject to additional scrutiny because they are not project or subject specific and may be less demonstrably applicable to the situation giving rise to the claim being prepared.

Some examples of general industry studies include the U.S. Army Corps of Engineers Modification Impact Evaluation Guide and the productivity loss factors established by Mechanical Contractors Association of America (MCAA).[15] Courts and review boards have accepted industry studies, although success has varied. The success of calculations based on industry studies, or lack thereof, can likely be attributed to inadequate establishment of causation. The use of productivity factors from industry studies are more likely to be successful when a contractor narrows its usage to fewer factors and more easily understood factors, focusing on establishing causation for the factors being pursued, and supporting this with backup. For example, with MCAA factors, courts have rarely considered the use of the "Severe" factor, typically allowing the "Minor" or "Average" adjustment. Pairing impact factors with relevant fact and expert testimony is a means of bolstering this methodology.[16]

4. Cost Basis

Cost basis evaluations are commonly used for calculating productivity damages. This includes the total cost and modified total cost methodologies.

The consensus "least-favorable" method of quantifying damages is the total cost method, which is simply the contractor's total costs on the project (plus allowable markups) less the value per the contractor's bid estimate. The overrun of the bid estimate is presented to represent the costs due to loss of efficiency. This method is appealing to contractors because it would result in full recovery of any losses on the project and the limited time required to calculate.

Because the method relies on the assumption that every dollar incurred above the bid estimate is due to an excusable impact for which the claimant is entitled to recovery, it is viewed with extreme skepticism by respondents and courts alike. To use the method, the claimant must demonstrate it can satisfy a four-part test.[17] If the claimant can satisfy the four-part test, the use of the method may be allowable. The four-part test requires demonstration of the following:

1. The nature of the costs and impacts were such that the claim could not be priced under any other method.
2. The contractor's bid or estimate was realistic.
3. The contractor's actual costs were reasonable.
4. The contractor was not responsible for the cost overrun.

The Modified Total Cost method is often employed as an improvement to the Total Cost method. The Modified Total Cost calculation takes the same approach as the Total Cost Method, but also factors in bid errors by the contractor, as well as other contractor or subcontractor-responsible issues. In making such considerations, the modified total cost method is a more reasonable approach since it does not assume the contractor executed the project

[15] Mechanical Contractors Association of America (MCAA), *Change Orders, Productivity, Overtime: A Primer for the Construction Industry* 135-136 (2020).

[16] *See Turner Constr. Co. v. Smithsonian Institution,* 17-1 B.C.A. (CCH) ¶ 36739 (Apr. 14, 2017).

[17] McNamara, John J. & Schwartzkopf, W., *supra* at 15.

flawlessly and deducts the value of such non-recoverable issues and inefficiencies from the claim value accordingly.

While the modified total cost calculation is more complex than the total cost method, it is a more equitable quantification of damages. The modified total cost method still requires the claimant to demonstrate satisfaction of the above-mentioned four-part test. And while it is viewed more favorably to the total cost method, the modified total cost method will still face scrutiny and consideration of the degree of subjectivity.

Contractor Considerations

1. What Method to Use?

The availability of reliable productivity data and contemporaneous project documentation will typically dictate what method should be employed on a productivity claim. While each claim scenario is unique, the hierarchy described above offers a general framework for choosing a methodology.

While we discussed the varying levels of preference between methodologies within the industry, fact finders have both accepted and rejected the various types of methodologies to varying degrees. The graph below summarizes a survey of productivity methodology acceptance rates in U.S. court and board decisions cases evaluated by Dale and D'Onforio: [18]

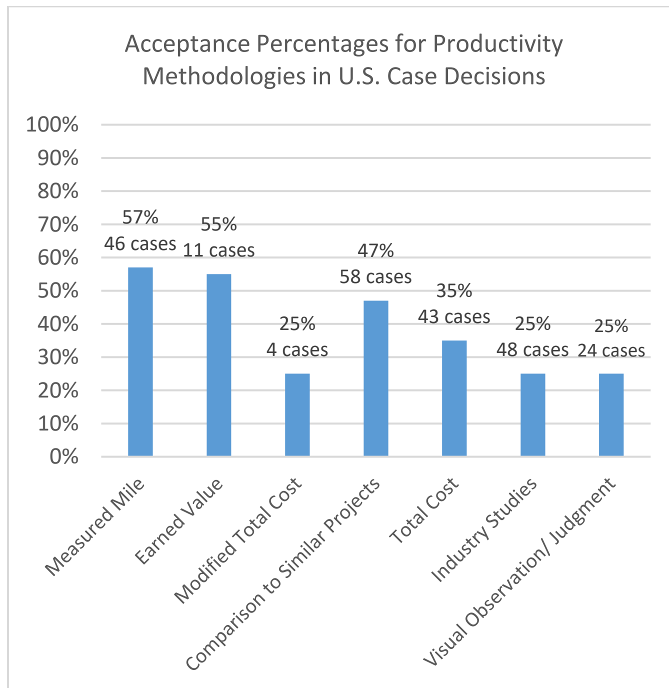

Figure 3. Acceptance percentages for productivity methodologies in U.S. cases

The case of *Turner v. Smithsonian* illustrates the impact of methodology on a damages award. Turner was the general contractor for a museum renovation project in Washington, D.C., and the matter involved contractor and subcontractor claims for delay and disruption costs of approximately seven million dollars.[19] Subcontractors asserted labor inefficiency claims which arose from "hazardous material abatement, MEP interferences, and continuing design changes," as well as "inefficiencies and delays attendant to limited site access and unforeseen security requirements." With several subcontractors pursuing claims, the weight of the methodologies used was evident in the Board decision. Despite many of the subcontractors being impacted by the same disruptions and witnesses for Turner and each of the subcontractors testifying to the impact of the disruptions which required a resequencing of work, the Board found that only *some* of the subcontractors proved their costs – two out of three using measured mile, one out of two using industry study factors, a

[18] Data from: Dale, W. Stephen, & D'Onofrio Robert M., *Construction Schedule Delays* (2022).

[19] *Turner Constr. Co.*, 17-1 B.C.A. (CCH) ¶ 36739 (Apr. 14, 2017).

partial award for a modified total cost, and a rejection of a total cost method. For the subcontractor whose claim was rejected that relied on factors from industry studies, the Board determined that while the subcontractor's witnesses "testified persuasively that crews become less efficient after working a series of sixty-hour weeks" they failed to provide any industry publication which supported its alleged 34% inefficiency rate or provide any expert testimony to support its application of the factor used.

The *Karton* Conundrum: Attorneys' Fee Awards in Excess of the Penal Sum

By: Nathan Diehl, Paskert Divers Thompson, Tampa, Florida

A few years ago, a California court rendered an opinion that has a potential far-reaching impact on our industry. Sureties carefully assess risk based on several factors, one of which being potential exposure. Most bond forms cap a surety's exposure at the penal sum. However, if not careful, as illustrated below, the surety could end up paying seven times the penal sum in attorneys' fees. In this article, we provide a summary of the *Karton* case and the cases that follow it. Additionally, we discuss tips to avoid the *Karton* conundrum.

Karton

In *Karton*, David and Cheryl Karton hired Ari Design & Constr., Inc. ("Ari") to perform construction on their home in exchange for $163,650.[1] Wesco Insurance Company (the "Surety") posted a contractor's bond with a penal sum of $12,500, which was the statutory amount required at the time.[2] The Kartons began to suspect an issue with Ari's insurance, eventually determining that Ari was not properly licensed or insured.[3] The Kartons instructed Ari to stop work.[4] By that time, they had paid Ari $92,651.[5] The Kartons claimed that they overpaid Ari and were entitled to a refund.[6] Ari agreed, but the Kartons and Ari could not agree on the amount.[7]

Eventually, the Kartons sued Ari and the Surety.[8] Mr. Karton was an attorney and

[1] *Karton v. Ari Design & Constr., Inc.*, 276 Cal. Rptr. 3d 46, 49 (Cal. Ct. App. 2021), *as modified on denial of reh'g* (Mar. 29, 2021).
[2] *Id.*
[3] *Id.*
[4] *Id.*
[5] *Id.*
[6] *Id.*
[7] *Id.*
[8] *Id.*

represented his wife and himself, but they also hired attorney Joe Abramson to represent their interests.[9] Rather than interplead the $12,500, the Surety tendered its defense to Ari.[10]

After a three-day bench trial where Ari failed to call any witnesses, the court awarded the Kartons damages for the full amount paid, $92,651, under the statute requiring an unlicensed contractor to return all compensation received.[11] The court also added an additional $10,000 statutory penalty and $2,850 in storage fees.[12] Finally, the court awarded the Kartons the full $12,500 penal sum against the Surety.[13]

The Kartons filed their bill of costs, after which the Surety sent the Kartons a check for $38,768.49, which included the full penal sum of the bond, certain litigation costs, and prejudgment interest.[14] The payment excluded attorneys' fees.[15] The Kartons acknowledged the payment, but reserved their right to claim entitlement to attorneys' fees from the Surety.[16]

After the entry of the judgment, the Kartons sought to recover $271,530 in attorneys' fees for Mr. Abramson's work on the case.[17] They sought these fees under Cal. Civ. Proc. Code § 1029.8, which gives the court discretion to award attorneys' fees to a prevailing party who is damaged by an unlicensed contractor.[18] The court found that the fees sought were excessive, but awarded $90,000 in attorneys' fees against Ari.[19] Additionally, the court found that the Kartons had no statutory or contractual basis for recovery of attorneys' fees against the Surety.[20]

The Kartons appealed both the amount of the attorneys' fee award and their entitlement to recover from the Surety.[21] The appellate court upheld the fee award, but reversed the trial court's ruling and found that the Kartons could recover the attorneys' fees from the Surety.[22] In its ruling, the court heavily relied on the *Pierce* case, which dealt with a motor vehicle dealer bond and an alleged violation of the Consumers Legal Remedies Act ("CLRA").[23] The CLRA provided for attorneys' fee awards to prevailing plaintiffs as a cost.[24] The *Karton* court found that the *Pierce* decision mandated a victory for the Kartons against the Surety.[25]

In making this determination, the court began with the concept that a surety's liability is commensurate with its principal.[26] The court held that, because Ari is liable for attorneys' fees under Cal. Civ. Proc. Code § 1029.8, so is the Surety.[27] In response to the Surety's argument that its liability cannot exceed the penal sum of the bond, the court found that the attorneys' fees were a statutory cost that was properly assessed against the Surety in excess of the penal sum.[28]

What was critical to the court's ruling was the fact that the Surety, by tendering defense to Ari, took the risk that the costs of the litigation would exceed the penal sum of the bond.[29] The court noted that to avoid these costs the Surety could have negotiated its own settlement or interpled the amount of the bond.[30] In the court's view, "[the Surety] elected to gamble" and lost.[31]

Chavez

[9] *Id.* at 51.
[10] *Id.* at 58.
[11] *Id.* at 49-50.
[12] *Id.* at 50.
[13] *Id.*
[14] *Id.* at 58.
[15] *Id.*
[16] *Id.*
[17] *Id.* at 51.
[18] *Id.* at 50.
[19] *Id.* at 52.
[20] *Id.* at 52-53.
[21] *Id.* at 53.
[22] *Id.* at 58.
[23] *Pierce v. W. Sur. Co.*, 207 Cal. Rptr. 3d 152, 155 (Cal. Ct. App. 2012).
[24] *Id.* at 157-58.
[25] *Karton*, 276 Cal. Rptr. 3d at 59.
[26] *Id.*
[27] *Id.*
[28] *Id.* at 60.
[29] *Id.*
[30] *Id.*
[31] *Id.*

Unfortunately, *Karton* is not alone. A lower California court came to the same conclusion last year.[32] In *Chavez*, a dispute arose between a contractor and obligee.[33] The contractor sued the obligee.[34] The obligee crossclaimed against Hudson Insurance Company (the "Surety"), the surety that issued a $15,000 contractor's license bond, alleging that the contractor was unlicensed.[35] After nearly a year of litigation, the Surety paid the owner the full $15,000 penal sum of the bond and asked to be dismissed from the crossclaim.[36] When the owner refused, the Surety filed its motion for summary judgment, arguing that its liability is limited to the penal sum of the bond, and its liability must be discharged by its payment of the penal sum.[37] In response, the obligee argued that the Surety could be liable for attorneys' fees based on the precedent in *Karton*.[38]

The court granted summary judgment in favor of the Surety on the issue of principal damages.[39] However, the court agreed with the owner on the issue of attorneys' fees, finding that the owner may be entitled to certain costs and attorneys' fees from the Surety in excess of the penal sum of the bond under Cal. Civ. Proc. Code § 1029.8.[40] In reaching this decision, the court found it critical that the Surety chose not to pursue procedures in interpleader and, rather, decided to litigate the matter for a year before making payment.[41]

Gonzalez

Unfortunately, we are not done yet. In an unpublished opinion from earlier this year, another California appellate court came to a similar conclusion.[42] In *Gonzalez*, Ms. Gonzalez, a purchaser of a used car, sued the dealership for violations of the Consumers Legal Remedies Act ("CLRA").[43] Ms. Gonzalez also sued Hudson Insurance Company (the "Surety"), who had issued a $50,000 motor vehicle dealer bond.[44] Ms. Gonzalez and the dealership arbitrated their disputes, and the arbitrator found for Ms. Gonzalez and awarded damages plus $120,581 in attorneys' fees against the Surety.[45]

Seven months later, a second plaintiff, Ms. McNeil, filed a lawsuit against the dealership and the Surety.[46] In response, the Surety filed an interpleader action and deposited $50,000 with the court.[47] The court discharged the Surety from liability and exonerated the bond.[48]

Ms. Gonzalez and the Surety filed competing motions for summary judgment on the bond claim in the initial lawsuit.[49] Ms. Gonzalez sought to hold the Surety liable for the attorneys' fee award.[50] The Surety argued that the interpleader action had completely exonerated it from any additional liability.[51] The court entered judgment in favor of Ms. Gonzalez and awarded her $264,440 in attorneys' fees against the Surety.[52]

The Surety appealed and the appellate court affirmed, finding that plaintiff was statutorily entitled to recover her attorneys' fees under the CLRA as an item of cost.[53] The court further found that the Surety was liable for those costs because its liability was commensurate with its principal.[54] Finally,

[32] *Chavez Gen. Constr. Inc. v. Moezinia*, 2023 Cal. Super. LEXIS 92932 (L.A. Cty. Sup. Ct., Nov. 28, 2023).
[33] *Id.* at *1-2.
[34] *Id.* at *2.
[35] *Id.* at *12.
[36] *Id.* at *12-13.
[37] *Id.* at *6.
[38] *Id.*
[39] *Id.* at *14.
[40] *Id.* at *13-14.
[41] *Id.* at *13.
[42] *Gonzalez v. the Surety Ins. Co.*, No. D080166, 2024 WL 566058 (Cal. Ct. App. Feb. 13, 2024).
[43] *Id.* at *1.
[44] *Id.*
[45] *Id.* at *2.
[46] *Id.*
[47] *Id.*
[48] *Id.*
[49] *Id.* at *3.
[50] *Id.*
[51] *Id.*
[52] *Id.*
[53] *Id.* at *7.
[54] *Id.*

the court found that the Surety's liability for costs was not limited to the penal sum of the bond.[55]

The court noted the competing policy arguments put forward by both sides. The Surety argued that holding sureties liable for costs in excess of the penal sum will result in higher bond premiums, which will be passed on to car buyers.[56] The Surety also argued that the ruling gives sureties an impossible task of deciding whether the settle early to avoid exposure or support its principal in the litigation.[57] Ms. Gonzalez argued that holding the surety liable for attorneys' fees in excess of the bond would protect car buyers by (1) incentivizing consumer attorneys' to take on cases and (2) promoting early resolution of cases.[58] Despite acknowledging the policy arguments, the court did not address the strengths and weaknesses of them.[59] Rather, the court stated that the legislature would be better suited to address those issues.[60]

I. Tips to Avoid the *Karton* Conundrum

A brief review of these cases might understandably cause an overreaction. If we are unable to limit our exposure to the penal sum of the bond, how are we possibly able to assess risk? While these decisions are undoubtably challenging ones for our industry, careful review of the opinions help provide guidance on how to avoid the *Karton* conundrum:

1. Consider the source of the attorneys' fee claim.

The above cases seem to suggest that a surety's liability for attorneys' fees is not limited to the penal sum of the bond. However, this is not necessarily the case. Each of the above California cases deal with statutory prevailing party attorneys' fee awards. In other words, the sureties are not called to pay fees in excess of the penal sum due to breach of the bond. Rather, they are called to pay attorneys' fees due to their status as a losing litigant, which fees are statutorily assessed and not limited to the penal sum of the bond. When it comes to construction bonds, even California courts have held that a surety's liability for attorneys' fees under its principal's contract with the obligee are limited to the penal sum of the bond.[61]

2. Be wary of litigating claims on bonds with small penal sums.

As we all know all too well, litigation is expensive. Costs of litigation, especially attorneys' fees, can quickly overwhelm a small penal sum, making claims difficult to resolve. Consider settling claims on small bonds quickly. If settlement is not possible, a surety might consider whether an interpleader action would ultimately limit its exposure.

3. Courts favor sureties who pay.

In finding that the surety was exposed to attorneys' fees in excess of the penal sum for improperly denying a claim, one court stated:

> The crucial fact is that sureties, like insurance companies, face minimal incentive to perform on their contracts if the maximum loss they may incur is the amount of the bond, especially since the transaction costs of litigation are likely to dissuade contractors who would

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[55] *Id.* at *8.
[56] *Id.*
[57] *Id.*
[58] *Id.*
[59] *Id.* at *9.
[60] *Id.*
[61] *T&R Painting Constr., Inc. v. St. Paul Fire & Marine Ins. Co.*, 23 Cal. App. 4th 738, 746 (Cal. Ct. App. 1994).

> otherwise assert their right to full payment in court. . . .
>
> The surety's position is like an insurance company-it calculates premiums based on the risk that it may have to make a payment. It is, like an insurance company, in a surety's financial interest to withhold payment. Ideally, a surety collects premiums and never pays claims. . . .
>
> When an event occurs that arguably triggers the surety or insurance company's duty to make payments, the parties may dispute whether payment is in fact owed. The disparity of power, at this point in the relationship, is compelling. Sureties may be tempted to withhold payment in every case, gambling that the transaction costs of litigation will dissuade even a percentage of their obligees from asserting their right to payment. If the maximum risk to the surety is the penal amount of its bond, a surety has nothing to lose. The obligee has no leverage over the surety to compel payment, except litigation. If the transaction costs of litigation are too high relative to the bond, obligees will simply cut their losses.
>
> This unfortunate reality hits the smallest construction companies hardest, as their projects are less expensive and thus so are their bonds. A construction company facing a surety refusing to pay several thousand dollars on a bond, after consulting an attorney, will likely decide that the transaction costs are too great to move forward with litigation. The surety, risking only the value of the bond, may be motivated to withhold payment. . . .[62]

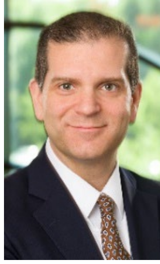
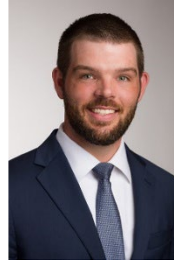
In both *Karton* and *Chavez*, the courts found it important that the sureties chose to litigate instead of resolving the claims or interpleading the funds at the outset. Courts do not favor the "wait and see" approach by sureties. Sureties should consider taking action at the outset of litigation to mitigate their damages.

1. Be careful tendering defense.

A surety's right to tender defense is an important one, and it may be tempting to do so in every case in an effort to mitigate damage. However, this is not always the best strategy. By tendering defense, we are giving up control of the case. Our principals oftentimes do not have the resources to adequately protect the surety from eventual loss. Tendered counsel doesn't always keep the surety informed and may not assert critical surety defenses. Additionally, principals may over-litigate the dispute without the ability to pay a huge fee award. As sureties, we must stay involved to protect our interests.

[62] *Colorado Structures, Inc. v. Ins. Co. of the W.*, 167 P.3d 1125, 1138-39 (Sup. Ct. Wa. 2007).

SURETY CASENOTES

By: Brian Kantar and Jase A. Brown, Chiesa Shahinian & Giantomasi PC, New York, NY and Roseland, NJ

Texas Court of Appeals Holds that Arbitration Provision in Subcontract Does Not Extend to Performance Bond Surety, Notwithstanding Bond's Incorporation by Reference of Subcontract

Trans-Vac Sys., LLC v. Hudson Ins. Co., 2023 WL 4146295 (Tex. App. June 23, 2023).

The surety issued a subcontract performance bond on behalf of MGB Group, Inc. ("MGB"), as principal, in favor of Trans-Vac Systems, LLC ("Trans-Vac"), as obligee, in connection with a project to build a new healthcare complex at the Fort Bliss Army Base in El Paso, Texas. The general contractor for the project hired Trans-Vac to install a pneumatic laundry service for the complex. In turn, Trans-Vac entered into a $600,000 subcontract with MGB to perform some of the work.

MGB ultimately defaulted under the subcontract. Trans-Vac sent MGB a twenty-four-hour notice to cure, advising that Trans-Vac would complete the work through a different subcontractor and charge the costs of completion to MGB if MGB did not take corrective action. MGB apparently did not remedy the default and Trans-Vac completed the work with another subcontractor.

Almost two years later, Trans-Vac sent a letter to the surety notifying the surety of MGB's default, advising that Trans-Vac had completed the work, and demanded payment from the surety in the amount of $458,966 (which represented the completion costs less the remaining contract balance). The surety denied the claim because it stated that Trans-Vac had elected its remedy under the subcontract and because Trans-Vac failed to timely notify the surety of the default and prejudiced the surety by preventing it from exercising its bargained-for-right to mitigate damages and arranging to complete the work under the subcontract.

In December 2021, Trans-Vac filed a demand for arbitration against the surety with the American Arbitration Association ("AAA") seeking damages for breach of the performance bond. The surety objected to the arbitration and refused to voluntarily participate.

In January 2022, the surety filed a petition in state court seeking a declaration that: (1) Trans-Vac's claim under the performance bond was time-barred pursuant to both the contractual limitations period, and (2) Trans-Vac's claim against the surety was not subject to the arbitration provision in the subcontract. Trans-Vac filed a counterclaim

against the surety for breach of the performance bond.

Trans-Vac thereafter filed a motion to compel arbitration, arguing that the surety was bound by the arbitration clause in the subcontract because the performance bond incorporated by reference the subcontract. Specifically, the bond stated that "[the] subcontract is by reference made a part hereof." The surety opposed the motion arguing that it was not a signatory to the subcontract and that the arbitration clause in the subcontract only applied to disputes between Trans-Vac and MGB arising from MGB's performance under the contract. The trial court denied the motion to compel arbitration and Trans-Vac filed an interlocutory appeal arguing that the trial court erred in denying the motion.

Citing to Texas caselaw, the appellate court stated that a party seeking to compel arbitration has the burden to prove that: (1) a valid and enforceable arbitration agreement exists, and (2) the claims raised fall within the agreement's scope. The court noted that although the law favors arbitration, arbitration is a matter of consent and not coercion and a party may not be compelled to arbitrate where it has not consented to do so. The court noted that its analysis was focused on the second prong of the test, whether the claims raised by Trans-Vac fell within the arbitration agreement's scope. Trans-Vac argued that the bond incorporated all terms of the subcontract and therefore the arbitration provision applied as to all disputes with the surety. The court disagreed.

The court analyzed the arbitration provision in the subcontract. Article 10.6 of the subcontract stated that: "Subcontractor hereby agrees that all claims, disputes and other matters arising out of or relating to the Subcontract or the Subcontract Documents . . . . shall be resolved through the following dispute resolution procedures." Article 10.6.1 then provided that if the "Contractor and Subcontractor cannot reach resolution on a matter relating to or arising out of the Subcontract or the Subcontractor's performance in connection with the Project," the "Parties" must first engage in good faith negotiations. And the subcontract defined "Parties" as the "Contractor" and the "Subcontractor." If negotiations were unsuccessful, Articles 10.6.2 and 10.6.3 next required the Parties to engage in AAA mediation. If mediation was unsuccessful, then Articles 10.6.4 and 10.6.5 provided for arbitration as the final resolution:

> 10.6.4: "For any claims subject to but not resolved by mediation pursuant to Articles 10.6.2 and 10.6.3, the method of binding dispute resolution shall be . . . Arbitration pursuant to Article 10.6.5 of the Subcontract."
>
> 10.6.5: "If the Parties have selected arbitration as the method of binding dispute resolution in Article 10.6.4, any claim subject to, but not resolved by, mediation shall be subject to arbitration which, unless the Parties mutually agree otherwise, shall be conducted in accordance with the Construction Industry Arbitration Rules of the American Arbitration Association in [effect] on the date of service of the demand for arbitration (the Arbitration rules)."

The appellate court held that this language clearly only applies to disputes between the contractor and subcontractor. It does not apply to a dispute between the contractor and surety as to whether there is coverage under

the performance bond. Additionally, the language of the performance bond stated that "Any *suit* under this bond must be instituted before the expiration of two years from the date on which final payment under the subcontract falls due." (emphasis added). The court held that the term "suit" is typically defined as a court action and affirmed the trial court's denial of the motion to compel arbitration.

Western District of New York Denies Surety's Motion to Abstain and/or Stay Federal Court Action Involving Substantially Similar Issues as Earlier-Filed State Court Action Under the *Colorado River* Abstention Doctrine

Norfolk S. Ry. Co. v. Philadelphia Indem. Ins. Co., 2024 WL 22698 (W.D.N.Y. Jan. 2, 2024).

The surety in this case issued a performance bond on behalf of Resetartis Construction Corporation ("RCC"), as principal, in favor of Norfolk Southern Railway Company ("Norfolk"), as obligee, in connection with a project for the construction of a rail car shop on Norfolk's property in Cheektowaga, New York. A dispute arose between Norfolk and RCC regarding RCC's work on the project. Norfolk ultimately terminated RCC and made a demand on the performance bond, which was denied by the surety.

On July 27, 2022, RCC filed an action against Norfolk in New York state court (the "State Court Action") alleging that Norfolk's attempt to terminate the construction contract was wrongful and that Norfolk did not afford RCC with reasonable notice and an opportunity to cure. The surety was not initially a party to the State Court Action.
Subsequently, on February 3, 2023, Norfolk filed suit against the surety in the Western District of New York (the "Federal Court Action") for breach of the performance bond. Norfolk asserted causes of action in the Federal Court Action for (1) declaratory judgment directing the surety to perform its obligations under the performance bond, and (2) damages for all costs incurred by Norfolk in completing the work under the construction contract.

After commencement of the Federal Court Action, the surety moved to intervene in the State Court Action which was granted by the state court. The surety thereafter filed a motion to dismiss and/or stay the Federal Court Action pursuant to the abstention doctrine set forth in *Colorado River Water Conservation Dist. v. United States*, 424 U.S. 800 (1976).

In ruling on the motion, the court stated that abstention from the exercise of federal jurisdiction is the exception, not the rule. In determining whether to abstain under *Colorado River*, the court noted that it must first determine whether the state and federal court actions are "parallel proceedings." Federal and state proceedings are "parallel" for purposes of abstention when the two proceedings are essentially the same—i.e., there is an identity of parties and the issues and relief sought are substantially the same. Complete identity of claims and parties is not required, however resolution of the state action must dispose of all claims at issue in the federal action.

The court found that the State Court Action and Federal Court Action were parallel because resolution of either one of the actions would conclusively resolve the claims in the other action as between Norfolk and the surety.

The court stated that a court must look to six factors to determine whether *Colorado Rivers* abstention is appropriate. The six factors are: (1) whether the dispute involves a particular res over which one of the courts has assumed jurisdiction; (2) whether one forum is more convenient than the other; (3)

whether a stay or dismissal of the federal action will avoid piecemeal litigation; (4) the order in which the actions were filed, and whether the litigation has advanced further in one forum; (5) whether federal law controls the rule of decision; and (6) whether the state forum can adequately protect the plaintiff's federal rights. To the extent any of the factors are facially neutral, the court stated that this was a basis for retaining jurisdiction, not yielding it.

With respect to the first factor, the court stated that the action did not involve judicial jurisdiction over property, and therefore this factor weighed in favor of retaining jurisdiction. For the second factor, the court noted that both courts sit in Western New York and therefore this factor also weighed in favor of retaining jurisdiction.

For the third factor, the court noted that this factor weighed in favor of abstention, but only to a modest degree. The court stated that "the mere potential for conflicting outcome between the two actions does not justify abstention under the piecemeal litigation factor." The court noted that is it difficult to imagine a scenario where one forum's resolution of the disputes between the plaintiff and defendant would not have a binding effect in the other forum under the principles of res judicata or collateral estoppel.

As to the fourth factor, the court stated that priority is not measured exclusively by which complaint was filed first, but rather by how much progress has been made in the two actions. In this case, the court noted that the State Court Action did not appear to have progressed much and that the surety just recently intervened in the State Court Action. Therefore, the court found that this factor was neutral and did not favor abstention.

For the fifth factor, the court stated that the substantive law was the same in both the State Court Action and the Federal Court Action and therefore, this factor weighed in favor of federal jurisdiction. Finally, for the sixth factor, the court noted that it is only significant if it militates in favor of federal litigation. The court said that, at most, this factor appeared to be neutral and provided no reason to abstain from exercising federal jurisdiction.

Based upon consideration of all of the *Colorado River* factors, the court denied the surety's motion for abstention and/or a stay of the Federal Court Action.

Middle District of Tennessee Denies Surety's Motion for Summary Judgment as Against Non-Signatory to Indemnity Agreement, Notwithstanding Language in Indemnity Agreement which Appeared to Extend to Non-Signatory

United States Fire Ins. Co. v. Norris Bros. Excavating, LLC, et al., 2:22-CV-00028, 2024 WL 23353 (M.D. Tenn. Jan. 2, 2024).

The defendants in this case were Norris Brothers Excavating, LLC ("NBE"), Norris Brothers Properties, LLC ("NBP"), Jacob Norris and Justin Norris. Each of the defendants, except for NBP, were signatories to an indemnity agreement with the surety. In reliance on the indemnity agreement, the surety issued performance and payment bonds on behalf of NBE related to two separate construction projects—the Ridgely Project and the Kingsport Project.

The surety received a payment bond claim on the Ridgely Project in the amount of $90,324.99, which it paid. NBE partially reimbursed the surety for that loss in the amount of $28,140.19. The surety also received a performance bond claim on the Kingsport Project, which the surety settled for $384,637.35. Additionally, the surety had attorneys' fees and costs in the amount of $61,654.16. Therefore, the surety had an

unreimbursed total loss in the amount of $508,476.31.

The surety brought an indemnity action against the defendants to recover for its loss, and subsequently filed a motion for summary judgment against all defendants, including non-signatory NBP. It was undisputed that NBE, Jacob Norris and Justin Norris each executed the indemnity agreement and that NBP did not execute the indemnity agreement. It was also undisputed that NBP was partially owned and controlled by Jacob Norris and Justin Norris. NBE, Jacob Norris and Justin Norris did not oppose the motion for summary judgment. NBP, however, did oppose the motion, arguing that because it did not sign the indemnity agreement, it owed no indemnity obligations to the surety.

In ruling on the motion for summary judgment, the court first noted that it would be applying Tennessee law. There was a choice-of-law provision in the indemnity agreement which stated that New York law governed the agreement, but the court found that the surety had waived the choice-of-law provision by asserting in its moving and reply papers that the agreement was executed in the State of Tennessee and therefore, Tennessee law governed its interpretation and enforcement.

The relevant provision in the indemnity agreement stated as follows:

> The term "indemnitor" shall mean the undersigned persons or entities, individually and collectively, and all of their existing or prospective heirs, personal representatives, executors, administrators, parent companies, purchasers, successors (through asset acquisition or otherwise), assigns, related entities, co-venturers, joint ventures, affiliates, subsidiaries, divisions, and marital communities along with any entity (whether partially or wholly owned and/or controlled) of whatever description and whenever formed or acquired in which any Indemnitor has ownership or beneficial interest. Indemnitor shall also include any Principal. The term "Indemnitor" shall also include all Indemnitors added to this Agreement by rider, and all of their heirs, executors, administrators, successors and assigns, and any entity that obtains Bonds from Company at the request of the aforementioned parties, or any combination of the above.

In applying Tennessee law, the court stated that under basic principles of contract law, a contract must result from a "meeting of the minds." Furthermore, to create an enforceable contract, there must be agreement between the parties on the material terms of the contract and the parties must have expressed an intent to be bound by those terms. The court noted that indemnity agreements are to be strictly construed.

The court said that it could not grant summary judgment as to NBP because there were issues of material fact. Specifically, the court said that it did not know NBE's relationship with NBP, and whether NBP was an "affiliate" or whether it was upstream or downstream from NBE. Nor did the court know what role(s) the Norris's had in relation to NBP. Of significant importance, the court said that it did not know why—if the intent of the parties was to bind NBP—Justin and Jacob Norris did not sign on its behalf, as they did with NBE.

The court rejected the surety's citation to two cases from the Southern District of New York—*U.S. Fid. & Guar. Co. v. Sequip Participacoes, S.A.*, , 2003 WL 22743430 (S.D.N.Y. Nov. 19, 2003) and *Star Ins. Co. v. Zanis Constr. Corp.*, 2000 WL 91941 (S.D.N.Y. Jan. 27, 2000)—each of which decided a similar issue in favor of the surety. The court stated that one case applied New York law, and the other applied Michigan law, but that neither was controlling. Moreover, the court found that the case applying New York law was decided on a much more fulsome record than what the court had here. And the court stated that the decision applying Michigan law and its discussion about the scope of an indemnity agreement was dicta.

Therefore, the court granted the surety's motion for summary judgment as against NBE, Justin Norris and Jacob Norris, but denied the motion as to non-signatory NBP.

Texas Court of Appeals Holds that Surety's Claims Against Government for Improper Release of Contract Funds and Violation of Prompt Payment Act are Barred by Governmental Immunity

San Antonio Water Sys. v. Guarantee Co. of N. Am. USA, 2024 WL 42357 (Tex. App. Jan. 3, 2024).

The surety issued performance bonds on behalf of Thyssen-Laughlin, Inc. ("Thyssen"), as principal, in favor of San Antonio Water Systems, an Agency of San Antonio ("SAWS"), as obligee, in connection with two different construction projects—the Mel Waiters Project and the Westpointe Project. A dispute between SAWS and Thyssen arose in connection with the Mel Waiters Project and SAWS sued: (1) Thyssen for breach of its obligations under the contract, and (2) the surety for breach of the performance bond.

The surety filed an answer and asserted three counterclaims against SAWS relating to the Westpointe Project: (1) SAWS breached the contract relating to the Westpointe Project by failing to pay the balance due of $119,990.33 to Thyssen, (2) SAWS improperly released contract funds to Thyssen in the amount of $346,037.45, without the surety's consent, nine days after the surety sent a letter to SAWS to not release any further funds without the surety's consent, and (3) SAWS violated the Prompt Payment Act.

SAWS filed a motion to dismiss the surety's second and third counterclaims, arguing that the government had not waived sovereign immunity as to such claims. The trial court denied the motion and SAWS filed an interlocutory appeal.

On appeal, it was undisputed that SAWS was a governmental entity generally immune from suit unless that immunity had been waived under the Texas Tort Claims Act (the "TTCA"). Absent waiver, governmental immunity would deprive the court of subject matter jurisdiction. It was also undisputed on appeal that the only possible waiver of governmental immunity was for breach of contract claims. Specifically, Local Government Code section 271.152 provides that: "[a] local governmental entity that is authorized by statute or the constitution to enter into a contract and that enters into a contract subject to this chapter waives sovereign immunity to suit for purposes of adjudicating a claim for breach of the contract, subject to the terms and conditions of this subchapter." Tex. Loc. Gov't Code Ann. § 271.152. "For there to be a waiver of immunity from suit under section 271.152, the following statutory criteria must be satisfied:"

(1) The entity must be "[a] local governmental entity that is authorized by statute or the

constitution to enter into a contract."

(2) The entity must enter into "a contract subject to this subchapter."

(3) The claim must be for breach of the contract and be asserted in a civil suit in "county or state court" or in an "authorized arbitration proceeding" in accordance with any "mandatory procedures established in the contract . . . for the arbitration proceedings."

Harris Cnty. Flood Control Dist. v. Great Am. Ins. Co., 359 S.W.3d 736, 742-43 (Tex. App. 2011); *see also* Tex. Loc. Gov't Code Ann. § 271.151(2)(A).

The court held that the first element was satisfied because SAWS was a local government entity. With respect to the second and third elements, however, the court noted that the only contract at issue was the contract between SAWS and Thyssen related to the Westpointe Project. The surety was not a signatory to the contract. The surety nevertheless argued that via equitable subrogation it was able to assert the claims of its principal, which proposition the court generally agreed with to an extent. The court, however, stated that, with respect to the second counterclaim for "improper release of contract funds," the principal had no claim to assert against SAWS because the principal was paid in accordance with the contract. Therefore, equitable subrogation did not permit the surety to assert this claim against the government. The court further rejected the surety's citation to caselaw which found that a public entity could be found liable for a surety's losses on a payment bond where the public entity made improper payments after notice of a principal's default. The court said that the surety's reliance on these cases was misplaced because in those cases, the construction contract expressly required the owner to retain funds and prohibited the release of those funds without the surety's consent. In contrast, in this case, SAWS did not breach a contract requiring it to retain funds or to obtain the surety's consent to release funds. Accordingly, the court found that the surety's counterclaim for "improper release of contract funds" did not fall within the scope of section 271.152's waiver of governmental immunity.

With respect to the "prompt payment" counterclaim, the court noted that the Prompt Payment Act's language was inapplicable to the government. Specifically, the Prompt Payment Act stated as follows:

> If an owner . . . receives a written payment request from a contractor for an amount that is allowed to the contractor under the contract for properly performed work or suitably stored or specially fabricated materials, the owner shall pay the amount to the contractor, less any amount withheld as authorized by statute, not later than the 35th day after the date the owner receives the request.

Tex. Prop. Code Ann. § 28.002(a). The Property Code defines "owner" as "a person or entity, *other than a governmental entity*, with an interest in real property that is improved, for whom an improvement is made, and who ordered the improvement to be made." *Id.* at 28.001(4) (emphasis added).

The court found that SAWS was a governmental entity and therefore the surety's prompt payment counterclaim did not fall within the scope of the Prompt

Payment Act. Thus, the court reversed the trial court's denial of the motion to dismiss the counterclaim for "improper release of contract funds" and the counterclaim for "violation of the Prompt Payment Act."

Eastern District of Washington Denies Surety's Motion for Summary Judgment for Indemnity, Finding an Issue of Material Fact as to Whether the Surety's Settlement of the Principal's Claims Against the Obligee Breached the Duty of Good Faith and Fair Dealing

Travelers Cas. & Sur. Co. of Am. v. Flawless Walls LLC, 2024 WL 71706 (E.D. Wash. Jan. 5, 2024).

The surety issued a performance and payment bond on behalf of Flawless Walls, LLC ("Flawless"), as principal, in favor of Jackson Contractor Group, Inc. ("Jackson"), as obligee, in connection with the Schweitzer Mountain Hotel and Resort project. Jackson was the general contractor and hired Flawless as subcontractor to perform certain of the work.

As consideration for the surety's issuance of the bonds, Flawless and several other entities/individuals executed an indemnity agreement in favor of the surety. The indemnity agreement stated, in relevant part:

> Company shall have the right, in its sole discretion, to determine for itself, and Indemnitor whether any claim, demand or suit brought against Company or any Indemnitor in connection with or relating to any Bond shall be paid, compromised, settled, tried, defended or appealed, and its determination shall be final, binding and conclusive upon the Indemnitors. Company shall be entitled to immediate reimbursement for any and all Loss incurred under the belief it was necessary or expedient to make such payments.

On May 11, 2021, Jackson issued a Notice of Supplementation of Work to Flawless due to what it characterized as Flawless' inability to meet the agreed-upon schedule. Flawless, for its part, blamed any inability to meet the schedule on Jackson's mismanagement and changing of the construction plans. On August 26, 2021, the contract between Flawless and Jackson ceased to exist. Jackson alleged that this was because Flawless gave notice that it was going out of business and ceased further work on the project. Flawless, on the other hand, said that the agreement was mutually dissolved on August 13, 2021, with the expectation that Flawless would complete certain remaining projects and the subcontract would be extinguished.

According to Flawless, the renegotiated contract was beneficial to both parties because the working relationship between Flawless and Jackson was irreparable. As consideration for the agreement, Flawless stated that it agreed not to receive payment for the work completed pursuant to its August 2021 payment application.

On March 25, 2022, Jackson made a claim on the performance bond, claiming losses in the amount of $753,154.40. The claim was denied by the surety and this lawsuit was commenced on July 26, 2022.

On February 1, 2023, the surety and Jackson notified the court that they had reached an agreement to settle the claims against the surety for $325,000, in exchange for a full release of the bonds. The settlement

agreement, dated May 2, 2023, also included a provision that released any claims Flawless may raise in connection with the action, including any claims related to the underlying subcontract with Jackson.

Shortly after the settlement was reached, the surety filed a third-party complaint against the indemnitors (including Flawless) for indemnification. The surety argued that it had the right under the indemnity agreement to settle the underlying action and that it properly exercised that right in settling the dispute with Jackson. The indemnitors, on the other hand, argued that the surety had breached its duty of good faith and fair dealing under the indemnity agreement. The indemnitors argued that the surety had previously taken the position that Jackson's claim was without merit—a position with which Flawless agreed. The indemnitors also argued that there was evidence in the record to support the fact that Jackson's claims had no merit. Therefore, the indemnitors argued that the surety's settlement of the lawsuit was not "necessary or expedient" and was a breach of its duty of good faith and fair dealing.

In ruling on the surety's motion for summary judgment for indemnification, the court noted that under Washington law, there is a duty of good faith and fair dealing read into every contract. And when a contract gives one party discretionary authority to exercise a right therein, that discretion must be exercised in good faith.
The indemnitors stated that they opposed the surety's settlement of the claim and that the surety's choice to settle after previously furthering an argument that Jackson's claim lacked merit was a demonstration of bad faith. At a minimum, the indemnitors argued that they should be entitled to discovery on the issue of whether settlement of Jackson's claim was necessary or expedient.

In denying the surety's motion for summary judgment for indemnification, the court stated that Flawless had produced evidence of a rocky and tenuous working relationship with Jackson, in which Flawless still managed to substantially perform, thereby raising an issue of material fact as to whether the settlement was necessary or expedient. Additionally, Flawless produced documents showing that Flawless had disputed Jackson's allegations of default and the surety had relied on those same documents to deny Jackson's claim and to further Flawless's position that it did not breach the subcontract.

The court stated that when viewed in a light most favorable to the third-party defendant indemnitors, it could not determine that the surety's decision to settle was necessary or expedient, given the surety's initial position regarding Flawless in dealing with Jackson. The surety had made several statements in the litigation and otherwise that suggested that the surety believed that Flawless was not in breach of the subcontract.

Thus, the court found that the third-party defendants had raised an issue of material fact defeating summary judgment on the indemnity claim.

FIDELITY CASENOTES

By: Matthew C. Kalin, Travelers, Braintree, MA

Ninth Circuit Finds Potential Coverage Under Computer Fraud Insuring Agreement Holding That "Fraudulent Entry" Qualifies Information Entered in a Computer System

Cachet Fin. Servs. v. Berkley Ins. Co. 2024 WL 1042985 (9th Cir. Mar. 11, 2024).

A discussion regarding the district court's opinion in this matter can be found in the May 2023 Newsletter. Please see that casenote for a full recitation of the facts. As set forth there in greater detail, the insured is a payroll processing entity that provides automated clearing house services for payroll servicing companies. It receives and transmits funds for employers using batch information uploaded by these intermediary payroll processing entities. As part of its functions, the insured reviews and verifies the information to ensure that the distributions balance with the funds provided by employers. Upon completing this process, the insured funds the batch transaction with the funds from the employer, and distributes the same to individual employees as directed by the batch information provided by the intermediary payroll processing entities. In this instance, the insured submitted a claim to its carrier alleging a loss of approximately $40,000,000.00 arising out of distributions made in accordance with allegedly fraudulent information provided by two intermediary payroll processing entities.

The insured submitted its loss to its primary and excess carriers seeking coverage under forgery or alteration, computer fraud and funds transfer fraud insuring agreements. The coverage dispute between the insured and carrier resulted in litigation commenced by the insured. The district court granted the carriers' motion to dismiss. Of particular note in the decision was the court's analysis of the computer fraud insuring agreement, which required a showing of a loss resulting directly from a "fraudulent … entry … or change" of electronic data or information within the insured's computer system. The district court also found in favor of the carriers with respect to coverage under the policy's forgery or alteration and funds transfer fraud insuring agreements. In siding with the carriers, the district court agreed that, although the bad actors entered fraudulent data into the insured's computer system, the coverage required that the entry or access to the computer system itself must be fraudulent, not necessarily the data input by the bad actor. Stated another way, the court agreed with the carriers' position that because all entries of data were done by the insured's clients in an authorized fashion, i.e., the clients used the process of uploading data to

the insured in an authorized manner, then there could be no fraudulent entry or change as required by the coverage. In essence, the court found that the word "fraudulent" modified the action, not qualified the information, requiring a showing of unauthorized access to the insured's computer system. The insured timely appealed the matter to the Ninth Circuit.

The Ninth Circuit affirmed in part, reversed in part and remanded the matter back to the district court for further proceedings. At the center of the court's decision to reverse and remand was the interpretation of the computer fraud language regarding whether "fraudulent" modified the method by which the bad actors entered the data or the data itself, i.e., if the data itself was fraudulent, which appears undisputed. The Ninth Circuit admittedly found the district court's interpretation "reasonable"; however, the court held that it believed there was more than one reasonable interpretation. Specifically, the court noted: "[a]lthough [the insured] authorized the remarketers to upload the electronic batch files onto its server, the authorized submission of fraudulent *electronic data* into [the insured's] computer system can arguably be described as a 'fraudulent entry.'" (Emphasis in original.) In so holding, the court appears to have held that the term or phrase is ambiguous, and rejected the carriers' argument that *contra proferentem* should not apply to such a sophisticated insured. While the court held in favor of the insured on the application of fraudulent in this context, the court remanded the matter back to the district court to consider, among other things, the carriers' arguments with respect to an exclusion precluding coverage where there was an entry to data by an authorized user of the insured's system.

Minnesota Federal Court Holds Exclusions and Verification Condition Precedent Bars Coverage Under Computer Fraud, Funds Transfer Fraud and Social Engineering Fraud Coverage Grants

Interstate Removal, LLC v. Nat'l Specialty Ins. Co., 2024 WL 1332006 (D. Minn. Mar. 28, 2024)

This matter concerns what presents as a social engineering fraud claim. Here, an employee of the insured received an email from a vendor that supplies vehicles requesting payment. According to the opinion, the insured's employees followed what appeared to be a routine procedure of routing the request to another employee tasked with issuing payments, who in turn emailed the vendor for the recipient bank information. It was at this point that a bad actor posing as the vendor requested that the insured issue the payment to an "updated bank account." All told, the insured transferred $178,936.93 to the bad actor. The insured discovered the fraud when it learned that just a week later the same or a different bad actor attempted to impersonate the insured to its bank and request a second transfer in the same amount, which the bank effectuated. The insured submitted the matter to its carrier. The carrier identified coverage for the second transfer but denied coverage on the initial transfer. Coverage for that initial transfer is the subject of this litigation which seeks coverage under two endorsements to the policy providing coverage for computer fraud, funds transfer fraud and social engineering fraud.

The carrier's motion to dismiss the insured's amended complaint was before the court. In sum, the court agreed with the carrier and dismissed the lawsuit. The court first addressed the policy's endorsement adding computer fraud and funds transfer fraud coverage. The carrier's position was that *SJ Computers, LLC v. Travelers Cas. & Ins. Co.*

of Am., 621 F. Supp. 3d 962 (D. Minn. 2022) applied, and supported the position that the insured's loss in this instance was not a direct loss, as required by the plain language of the policy. However, the court found that the policy at issue and the policy in *SJ Computers* were so different that the analysis did not apply in that the various coverages available under this insured's policy were not so evidently mutually exclusive as the coverages in the policy at issue in *SJ Computers*. Moreover, the court went on to agree with the insured that phrase "resulting directly from" connotes a proximate cause analysis. With little other analysis, the court held that the insured's "first transfer was proximately caused by a fraudulent entry of data into [the insured's] computer system," and as such, triggered the coverage. However, the court still found for the carrier, citing a policy exclusion that precludes coverage where an insured employee transfers funds when acting upon a fraudulent instruction. The insured's objection to this conclusion was that the exclusion rendered the coverage provisions ambiguous. Of particular note in the court's rejection of the insured's argument, the court stated: "[i]t may be true that [the exclusion] eliminates *most* of the coverage provided by [the insuring agreement] [(emphasis in original)]. That does not make the policy ambiguous, however, but just less useful to [the insured]."

The insured faced a similar fate under the policy's endorsement adding social engineering fraud coverage. Putting aside whether the matter triggered the coverage, the carrier argued that the coverage's verification condition precedent barred coverage. In addition, the carrier argued for the application of an exclusion that barred coverage for the loss of money as a result of a "Security Breach" or "Cyber Incident." The court agreed on both fronts. First, the court found that the amended complaint insufficiently plead facts to indicate compliance with the verification condition precedent, noting that the amended complaint did not indicate that the insured's employees followed an "established and documented" verification process, or that they actually verified the wire transfer instructions. Second, the court held that even if the insured complied with the verification condition precedent in the coverage, the exclusion precluding coverage for loss arising out of a "Security Breach" or "Cyber Event" applied. Here, whether true or not, the insured alleged that the bad actor "'hacked'" into the insured's computer system to perpetrate the fraudulent scheme. That the loss arises out of what the insured plead as unauthorized access to the insured's email system, whether or not this actually happened, implicated the very exclusion that bars coverage under the social engineering fraud coverage grant.

LEGISLATIVE UPDATE

By: Adam Brackemyre, Vice President of Government Relations, and Patrick Russell, Director of Government Relations, Surety and Fidelity Association of America, Washington, D.C.

The follow summaries are meant to provide an insight into surety-related legislative developments this year. In general, federal government activity and state government activity has been somewhat lighter than usual, but neither development is surprising as this is an election year.

FEDERAL UPDATE

2023 in Review

2023 was a big year for Congress, but not necessarily in a good way. Reapportionment and redistricting left fewer swing seats in the House of Representatives than Congress has ever seen before, and despite the anticipated backlash that political parties of the sitting President typically see during midterm elections, House Republicans started off with only a five-seat majority.

Negotiations over the nation's debt and the federal debt ceiling resulted in the Fiscal Responsibility Act of 2023 (FRA), which placed limits on spending in exchange for avoiding default. That ordeal took up valuable time and distracted focus from looming appropriations deadlines, creating a situation where multiple continuing resolutions were needed to keep the government funded. This led to House Republicans' frustrations boiling over, resulting in Speaker Kevin McCarthy's (R-CA) ouster in October - the first time in history that the House removed its leader.

One legislative package of note from 2023 is the Fiscal Year (FY) 2024 National Defense Authorization Act (NDAA) – HR 2670. It could have some impacts on the government contracting and construction space, which in turn could affect the surety industry.

The FY24 NDAA, signed into law on December 22, 2023, with a budget of $886B, makes numerous changes to acquisition policy and the treatment of small businesses involved in government contracting.

Within the NDAA, Section 824 extends the temporary authority provided in last year's budget to modify certain contracts and options to counteract the impacts of inflation until December 31, 2024. Prior to the passage of the FY2024 NDAA, the Department of Defense had limited ability to provide relief to its contractors. This provision can provide important assistance for contractors that have been negatively affected by high inflation while performing multiyear, fixed-price contracts. The law makes accessing this potential relief easier by increasing the monetary thresholds above which senior agency official approval is

required. However, Section 824 does not appropriate any funding for such relief.
Along those same lines, Section 826 now allows the amounts authorized under the NDAA to be used to modify the terms and conditions of a contract to provide for economic price adjustments ("EPAs") consistent with FAR sections 16.203-1 and 16.203-2. A fixed-price contract with an EPA provides for the upward or downward adjustment of a contract price based on certain contingencies. EPAs consist of three types: adjustments based on established prices; adjustments based on actual costs of labor or material; and adjustments based on cost indexes of labor or material. Agencies may use these types of contracts when there is doubt regarding the stability of the market or labor conditions over the contract period, and contingencies that would otherwise be included in the contract price can be covered separately elsewhere in the contract.

The NDAA also includes several provisions aimed at helping small business contractors. Section 862 reduces the time period after which a contractor must notify the contracting officer that it is past due on paying a subcontractor from 90 days to 30 days. Section 863 increases the government-wide goal for participation in federal contracts by Service-Disabled Veteran-Owned Small Businesses (SDVOSBs) from three percent to five percent. Finally, Section 865 mandates a new Defense Federal Acquisition Regulation Supplement (DFARS) clause requiring contracting officers to consider the past performance of affiliates when evaluating small businesses' offers.

Moving into 2024

Despite the 2024 fiscal year starting in October of 2023, Congressional leaders didn't agree on topline spending for the FY24 budget until January of 2024. A fourth continuing resolution, which furthered a "laddered" approach, allowed appropriators to negotiate and pass an initial "minibus" of six less controversial appropriations bills on March 6th – covering Agriculture, Commerce-Justice-Science, Energy-Water, Interior-Environment, Military Construction-VA, and Transportation-HUD, along with a subsequent additional "minibus" for the remaining six bills on March 22 to avoid a government shutdown.

The FRA, however, constrained FY24 spending to a total of $1.59 trillion, creating a situation where cuts in non-defense spending were necessary. Some agencies key to infrastructure development— and therefore the surety industry—like the Departments of Transportation and Energy, will see slight increases in FY24, the majority of agencies will see flat spending or, in the case of the Environmental Protection Agency (EPA), slight funding cuts.
Focusing on the specific accounts and programs vital to strengthening the nation's water and energy resources infrastructure:

- The U.S. Army Corps of Engineers Construction account received $1.8 billion, $300 million below FY 2023.
- The USACE's Water Infrastructure Finance Program (CWIFP) received $7.2 million, enabling the program to begin providing financing for non-federal dam safety projects, in accordance with IIJA.
- The Department of Energy's Electricity Account received $280 million, which is $70 million below last year's level, to support technologies that enhance grid resilience and efficiency, and strengthen the capability to incorporate new energy technologies.
- The Bureau of Reclamation received $1.92 billion, which

is $451 million above the Biden Administration's budget request, but $31 million below the funding level it received in 2023. Bureau of Reclamation funds support water conservation, restoration, and other water resources projects in western states affected by significant drought conditions. The EPA received $9.16 billion, $942 million less than FY23. EPA's State Revolving Fund programs were funded at FY23 levels, with the Clean Water State Revolving Fund (CWSRF) receiving $1.639 billion, and the Drinking Water State Revolving Fund (DWSRF) receiving $1.126 billion. Out of these funding levels, Community Project Funding (Congressionally Directed Spending, or earmarks) $787.65 million was set aside for CWSRF projects, and $631.66 million was set aside for DWSRF projects, further reducing the amount of program funds allocated directly to states to support financing for water infrastructure capital improvement projects.

- And finally, EPA's Water Infrastructure Finance and Innovation Act (WIFIA) program received $72.27 million, an increase of $3.4 million to support low-interest financing for water infrastructure projects.

Given that the budget is six months behind schedule and only lasts until September of 2024, attention will be turning toward FY25 negotiations immediately, as well as other "must-pass" legislation, including the FY25 NDAA, the Federal Aviation Administration reauthorization and the Farm Bill facing down hard deadlines and limited days in remaining in the legislative calendar.
The outlook for additional legislative action throughout the remainder of the 118th Congress might be bleak, but infighting and tight vote margins have no effect on agency rulemaking.

To avoid viable Congressional Review Act challenges, the Administration and its agencies have kicked off a season of final rules issuance—most notable to the surety industry would be the recently released Risk Management and Financial Assurances for OCS Lease and Grant Obligations rule from the Bureau of Ocean Energy Management (BOEM). The final rule amends existing regulations in an effort to strengthen financial assurance requirements for the offshore oil and gas industry operating on the U.S. Outer Continental Shelf (OCS).

BOEM, in partnership with the Bureau of Safety and Environmental Enforcement (BSEE), estimate that using new, streamlined evaluation criteria of lessees and grant holders will result in operators needing to provide an additional $6.9 billion in supplemental financial assurances to cover potential environmental remediation and decommissioning costs.

BOEM will be basing supplemental financial assurance requirement determinations on an operator's credit rating (specifically investment grade credit rating threshold of BBB- or Baa3, or a proxy credit rating equivalent), and/or the ratio of the value of reserves to decommissioning liabilities—with a minimum 3-to-1 ratio.

Prior to this new final rule, BOEM's practice was to set a lower supplemental financial assurance requirement for lessees with financially strong predecessor lessees.

BOEM will retain the authority to pursue predecessor lessees for the performance of decommissioning under the new rule. However, in an attempt to ensure current lessees have the financial capability to fulfill end-of-life decommissioning costs, it will not be allowed to rely upon the financial strength of predecessor lessees when determining whether, or how much, supplemental financial assurance should be provided by current OCS leaseholders.

BOEM will be implementing a phase-in approach for new supplemental financial assurance requirements over a 3-year period for existing leaseholders. Any company receiving a supplemental financial assurance demand will need to post one-third of the total amount each year for three years.

The Bureau of Land Management (BLM) issued a similar rule recently revising fiscal terms of the onshore federal oil and gas leasing program. The Fluid Mineral Leases and Leasing Process final rule, which is the BLM's first update to the onshore oil and gas leasing framework since 1988, updates minimum bonding levels previously set in 1960. The rule increases the minimum lease bond amount to $150,000 and the minimum statewide bond to $500,000, and it eliminates nationwide and unit bonds. The previous lease bond amount of $10,000 no longer provided an adequate incentive for companies to meet their reclamation obligations, nor does it cover the potential costs to reclaim a well should this obligation not be met, leaving taxpayers at risk for the cost of cleanup. Bond amounts will be adjusted for inflation every ten years.

Given that the budget is six months behind schedule and only lasts until September of 2024, attention will be turning toward FY25 negotiations immediately.

STATE UPDATE

Florida

Phased bonding

Legislation on the governor's desk would allow a phased bonding option for progressive design build projects authorized under Florida law.[1]

Minnesota

Bonding exemptions for BIPOC contractors

Failed legislation in Minnesota would have exempted Black, Indigenous, and other people of color (BIPOC) from the state's Little Miller Act bonding requirements. The bill did not receive a hearing in either chamber before a procedural deadline.[2]

New Jersey

Construction Default Delay Fines

Proposed legislation in New Jersey would fine a surety at least $10K a day if a replacement contractor is not under contract 60 days after a project is declared to be in default or construction has not restarted 60 days after the replacement contractor is under contract. The political motivation for the bill is the high-profile default of the Route 206 widening project near Hillsborough, NJ. From our understanding of the default, the project delays have been caused by factors outside of the surety's control and this information has been communicated to legislators. Amendments have been submitted to the legislation and surety and contractors are working with the sponsors.[3]

[1] H.B. 287; effective July 1, 2024 when signed

[2] H.F. 4324/ S.F. 3785

[3] A.B. 3943/ S.B. 1639

New York and Washington

Retainage

Both states passed laws limiting private project retainage to no more than five percent.[4][5]

Oregon

Retainage bond

Enacted legislation would require project owners to accept a new retainage bond in lieu of retainage. The legislation was modeled after Washington State's law.[6]

Vermont and California

Escrow bonds

Vermont's legislation is advancing to the governor's desk and California's legislation is recently introduced. Each bill would permit developers to use bonded escrow funds, under certain conditions, to fund residential construction with the bond guaranteeing the consumer that his/her funds will be used lawfully.[7] [8]

Wisconsin

Earned Wage Access Provider License Bond

Companies that offer earned wage access services to Wisconsin consumers are required to be licensed by the Wisconsin Department of Financial Institutions (DFI) as a condition of doing business in Wisconsin and maintain a $25,000 bond.[9]

RV Dealer License Bond

Requires a recreational vehicle dealer, as a condition of licensure by the DOT, to provide and maintain in force a bond or irrevocable letter of credit of not less than $50,000.[10]

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[4] NY Gen Bus L § 756-a and 756-c (S.B. 3539; effective November 17, 2023)
[5] Wash. Rev. Code Ann. § 60.30.x (S.B. 5528; effective July 23, 2023; not yet chaptered).
[6] Or. Rev. Stat. Ann 279C.560 (H.B. 4060; effective March 7, 2024)
[7] Vt. Stat. Ann. tit. 27A § 4-110 (H.666; effective April 29, 2024)
[8] CA S.B. 1462
[9] Wis. Stat. Ann. § 203.03(6) (A.B. 574; effective September 22, 2024)
[10] Wis. Stat. Ann. § 218.11(2) (A.B. 230; effective October 22, 2024)

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