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Newsletter

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2022 SURETY CLAIMS INSTITUTE MEETING AT OMNI GROVE PARK INN AND SPA, ASHEVILLE, NORTH CAROLINA -PROGRAM PREVIEW-

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

The Surety Claims Institute's 47th annual meeting will be held June 22, 2022 through June 24, 2022 at the Omni Grove Park Inn and Spa located in Asheville, North Carolina. This year, Chris Ward of Clark Hill Strasburger continues his two-year tenure as chair of the educational program with thoughtful and relevant topics. As always, the SCI Board of Directors chooses top drawer locations with family-friendly options and has done so for this year. The Omni Grove Park Inn and Spa is a favorite of our members, which is why the Institute's annual meeting is returning to Asheville this year.

The Omni Grove Park Inn and Spa is easily accessible from the Asheville airport and offers all of the amenities you have come to expect from the SCI's annual meeting locations: rooms with beautiful views, an on-site golf course, excellent meeting and reception venues as well as gorgeous rustic elegance. (*Continued on page 4)*

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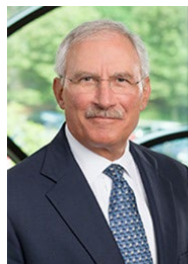
COMMENTS FROM THE EDITOR



I would like to take this opportunity to highlight the substantial and excellent contributions of our SCI Newsletter editors and regular contributors toward making this Newsletter happen. While I am Editor-in-Chief, I have mastered the art of delegation of the real work to others. And as I have been Editor-in-Chief of the SCI Newsletter for nearly 20 years now, I have been lucky enough to latch onto wonderful editors, most of whom now have been holding their posts for many years. I am not willing to allow them to escape!! While they are

listed on the Masthead, a few additional comments are in order.

The fidelity casenotes are drafted by Matt Kalin of Travelers Bond and are edited by Bob Flowers, also of Travelers Bond. Both are in Hartford, CT. The surety casenotes are drafted by Brian Kantar of Chiesa Shahinian & Giantomasi of West Orange, NJ and New York, NY, and are edited by Ken Rockenbach of Liberty Mutual in Seattle, WA. The legislative update is drafted (and effectively edited) by Matt Vece of the American Property Casualty Insurance Association in Washington, DC, and the Articles Editor is Chris Ward of Clark Hill in Dallas, TX. Brian Kantar also doubles as Managing Editor. Amy Bentz of the Bentz Law Firm in Pittsburgh, PA has taken over the lead article authorship role formerly held by the late great Jerry Sunderland. In that role, she provides information regarding our annual meeting both before and after it occurs. Jessica Mattheiss of our firm takes on primary duty for the Newsletter's layout. My sincere thanks go out to each of them, as their excellence in their respective roles and their continuity and experience in producing fine content has made my job as Editor-in-Chief relatively easy, for which I am grateful!!

I also wanted to note the untimely passing late last year of Frank Elmore of Greenville, SC. Frank was known and respected by many of us in the surety world and was active as both a construction and surety litigator. Frank was a Fellow of the American College of Construction Lawyers and a Member of its Board of Governors. He was also a Governing Committee Member of the ABA Forum on the Construction Industry among other bar and community leadership roles. Frank was an old friend who passed too young — and since he was a couple of years younger than me, I particularly feel that it was way too young. He will be missed.

Finally, thanks as always for reading!!

Armen Shahinian
Editor-In-Chief
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West Orange, NJ
New York, NY

2022 SURETY CLAIMS INSTITUTE MEETING AT OMNI GROVE PARK INN AND SPA, ASHEVILLE, NORTH CAROLINA
-PROGRAM PREVIEW-

(Continued from page 1) Asheville's breathtaking mountain views, thriving arts community, numerous activities and attractions as well as other amenities are a huge benefit to this choice location. The Omni and its surroundings offer miles of scenic hiking and mountain biking trails. The Vanderbilt Mansion known as the Biltmore Estate is a "must see" and the hotel is a short drive from the Botanical Gardens at Asheville. The 50,000 square foot sports complex with indoor and outdoor tennis courts, family pool, outdoor pool complete with a cabana bar and grill are just a few of the amenities the hotel has to offer.

In addition to the amenities and offerings of the meeting's picturesque location, we are also excited about the educational program that Chris Ward has put together, the focus of which is an array of topics that are of interest to the surety claims practitioner, but are not often discussed in other programs.

Thursday morning opens strong with "The Good, the Bad, the Ugly – Bond Contract Language" presented by Carol Smith, Robert Duke and Shannon Briglia. Alec Taylor, Michael Cronin and Jennifer Leuschner will follow to discuss the all-important topics of Subrogation and Salvage. Adam P. Friedman and Chris Alexander will present a riveting discussion on Indemnity and the important bankruptcy issues will be addressed by Duane Brescia and Darrell Leonard. Finally, Mark McCallum and Nick Newton will close out Thursday's program with Insights on the State of the Industry.

Friday morning will begin with our popular Surety Update– Contract/Commercial Surety Bonds presented by Patricia Wager and Tiffany Schaak. Curtis Cline and Sonny Shields will discuss the problems we all confront with project completion and our efforts to preserve the penal sum of the bond. On a related topic, Connor Cantrell and Patrick Laverty will address extra Contractual Liability. The final ethics presentation is captioned "Navigating the Ethical Minefield of Representing the Surety and the Principal and in Handling the Principal's

Claims." This must-see program will be presented by Ali Adams, Shauna Szczechowicz, Maribel Luzinaris, and Jessica Derenbecker.

Surety Claims Institute
47th Annual Meeting & Seminars

Tuesday, June 21 – Friday, June 24, 2022

The Omni Grove Park Inn, Asheville, North Carolina

AGENDA

Tuesday, June 21		
3:00 – 5:00 p.m.	Registration Desk Open	
6:30 p.m.-8:00 p.m.	Reception for All Early Arrivals	

Wednesday, June 22		
9:00 a.m. – Noon	Board of Directors Meeting	Eisenhower FG
2:00 – 5:00 p.m.	Registration Desk Open	
2:00 – 5:00 p.m.	Speakers' Rehearsal	Grand Ballroom C
6:00 – 9:00 p.m.	Get Acquainted Reception/ Buffet Dinner*	Mountain View Terrace

Thursday, June 23		
7:30 a.m.	Continental Breakfast for Registrants	Grand Ballroom B
8:00 a.m. – 11:30 a.m.	Seminar Program	Grand Ballroom C
1:00 – 5:00 p.m.	Golf Tournament*	Grove Park Inn
6:30 – 9:30 p.m.	Children's Party*	Sports Center
7:00 – 10:00 p.m.	Reception and Banquet Dinner *	Pavilion

Friday, June 24		
7:30 a.m.	Continental Breakfast for Registrants	Grand Ballroom B
8:00 a.m. – Noon	Seminar Program	Grand Ballroom C
Noon	Adjourn	

*Reservations Required

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

47th SURETY CLAIMS MEETING
SEMINAR PROGRAM SCHEDULE

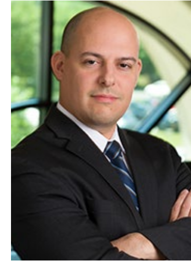
THURSDAY PROGRAM

8:00 – 8:15	Opening Remarks: *Steve D. Nelson, Markel Surety* Program Remarks/Introduction of Speakers: *Christopher R. Ward, Clark Hill*
8:15 – 8:45	The Good, the Bad, and the Ugly - Bond and Contract Language *Speakers: Carol Smith, Robert Duke, and Shannon Briglia*
8:45 – 9:15	The Good, the Bad, and the Ugly – Subrogation/Salvage *Speakers: Alec Taylor, Michael Cronin, and Jennifer Leuschner*
9:15 – 9:45	The Good, the Bad, and the Ugly - Indemnity *Speakers: Adam P. Friedman and Chris Alexander*
9:45 – 10:00	BREAK
10:00 – 10:30	The Good, the Bad, and the Ugly - Bankruptcy *Speakers: Duane Brescia and Darrell Leonard*
10:30 – 11:30	Insights on the State of the Industry *Speakers: Mark McCallum and Nick Newton*

FRIDAY PROGRAM

8:00 – 8:15	Opening Remarks: *Steve D. Nelson, Markel Surety* Program Remarks/Introduction of Speakers: *Christopher R. Ward, Clark Hill*
8:15 – 9:05	Surety Update – Contract/Commercial Surety Bonds *Speakers: Patricia Wager and Tiffany Schaak*
9:05 – 9:40	The Good, the Bad, and the Ugly - Completion/Penal Limit, etc. *Speakers: Curtis Cline and Sonny Shields*
9:40 – 10:15	The Good, the Bad, and the Ugly – Extra Contractual Liability *Speakers: Connor Cantrell and Patrick Laverty*
10:15 – 10:30	BREAK
10:30 – 11:30	Navigating the Ethical Minefield of Representing the Surety and the Principal and in Handling the Principal's Claims. *Speakers: Ali Adams, Shauna Szczechowicz, Maribel Luzinaris, and Jessica Derenbecker*

“SMALL BUSINESS” BANKRUPTCIES: WHAT YOU NEED TO KNOW ABOUT SUBCHAPTER V OF CHAPTER 11



By: Sam Della Fera Jr., Robert Hornby, and Michael Caruso, Chiesa Shahinian & Giantomasi PC, New York, NY and West Orange, NJ

The Small Business Reorganization Act of 2019 (the “SBRA”), which became effective in February 2020, created a new subchapter within Chapter 11 of the Bankruptcy Code—Subchapter V, bringing with it sweeping changes to the way Chapter 11 bankruptcies are conducted for qualifying small businesses.

The new law was particularly timely, as the COVID-19 crisis hit the American economy about a month after its effective date. As a result of the pandemic’s economic impact, Congress expanded the law’s reach in March 2020, nearly tripling the maximum debt threshold for businesses to qualify for Subchapter V treatment and thereby granting access to tens of thousands of additional potential debtors.

As the economic impact of the pandemic endures, Subchapter V will likely be used to a greater degree by small businesses in Chapter 11 bankruptcies, which—as many bankruptcy professionals and attorneys in the commercial lending, leasing, and equipment finance industries expect—will burgeon in 2022.

This article provides an overview of Subchapter V provisions of which creditors should be aware, including: (i) the meaning of “small business debtor” and the current increased debt threshold for filing under Subchapter V; (ii) key distinctions between a Subchapter V case and a traditional (non-Subchapter V) Chapter 11 case; and (iii) the creditors’ rights and protections that remain unaltered by Subchapter V.

Why Was Subchapter V Enacted?

The stated purpose of the SBRA is “to streamline the process by which small business debtors reorganize and rehabilitate their financial affairs.”[1] The underlying goal of this streamlined process is to give small businesses a better opportunity to reorganize, which historically has been difficult for them through Chapter 11 proceedings. Chapter 11 is more suited for larger, often publicly traded companies with substantial and complicated debt structures. Accordingly, the reorganization process in Chapter 11 is often long and expensive, with significant legal fees payable to counsel not only for the debtor company, but also for one or more official committees, as well as quarterly fees payable to the Office of the United States Trustee (the “UST”).

Subchapter V seeks to remedy the high administrative costs and lengthy time burdens that many small businesses encounter in traditional Chapter 11 cases, so that they are more likely to confirm a plan and avoid liquidation. For both debtors and creditors, this means that cases will move faster, and plan payments should begin sooner. Speed and cost savings, however, come at the expense of certain rights of creditors to challenge a debtor’s proposed reorganization.

Who Is Eligible to File Under Subchapter V?

As noted above, only a few weeks after the SBRA took effect in February 2020, Congress, as part of the Coronavirus Aid, Relief, and Economic Security Act (the “CARES Act”), which took effect on March 27, 2020, amended the new Subchapter V to expand the eligibility of companies seeking bankruptcy protection thereunder. Most notably, the maximum debt threshold for eligibility was increased almost

[1] H.R. Rep. No. 116-171, at 1 (2019).

threefold—from $2,725,625 to $7,500,000. It was estimated that, under the increased debt cap, well over 50% of all Chapter 11 cases would be eligible for Subchapter V treatment.

The increased Subchapter V debt threshold under the CARES Act was scheduled to sunset after one year, but in March 2021 it was extended for another 12 months until March 2022. As businesses continue to feel the adverse economic impact of the pandemic, it is expected that Congress and the President will agree to a further extension. If the increased threshold is not extended, or ultimately made permanent, its looming expiration will no doubt cause many small businesses to elect to file under Subchapter V while they still can.

Only "small business debtors" are eligible for Subchapter V. Bankruptcy Code section 101(51D) defines a small business debtor as person (including an individual or business): "engaged in commercial or business activities … in an amount not more than $7,500,000 [previously $2,725,625] (excluding debts owed to 1 or more affiliates or insiders) not less than 50 percent of which arose from the commercial or business activities of the debtor." Specifically excluded from this definition is any entity the primary purpose of which is the owning of a single-asset real estate.

Significantly, a qualifying debtor must expressly elect to proceed under Subchapter V; it does not apply automatically. A creditor may object to a debtor's Subchapter V designation within 30 days from the section 341(a) creditors' meeting, or within 30 days from the filing of an amended designation if later.[2] As to the conversion of cases pending in bankruptcy courts prior to the effective date of Subchapter V, courts have been liberally permitting such re-designation, even where a case had been pending for more than a year.[3]

How Does Subchapter V Differ from a Traditional Chapter 11?

(1) The Subchapter V Trustee

In a traditional Chapter 11 case, a trustee is appointed only for cause, such as fraud or gross mismanagement, and the trustee then seizes control of the debtor's operations. By contrast, in all Subchapter V cases, the UST, which serves as the government watchdog in bankruptcy cases, automatically appoints a Subchapter V Trustee. There are 10 Subchapter V Trustees eligible for appointment in the District of New Jersey, including one of the authors of this article.

The Subchapter V Trustee has a narrower set of duties and powers than a Chapter 11 (or Chapter 7 or 13) Trustee, and is primarily tasked with the responsibility to "facilitate the development of a consensual plan of reorganization" and "ensure that the debtor commences making timely payments required by a plan[.]"[4]

(2) Accelerated Case Administration and Plan Confirmation Process

With respect to plan filing and confirmation, and general case administration, Subchapter V cases generally move faster and less expensively than typical Chapter 11 cases. This is accomplished by altering the typical manner in which the case proceeds. Among these changes are that: (a) no committee of unsecured creditors, with the ability to hire professionals paid by the debtor's estate, will be formed unless cause exists;[5] (b) no quarterly fees are payable to the UST, a significant savings of potentially tens of thousands of dollars; and (c) no disclosure statement, separate from the reorganization plan and subject to approval before solicitation of creditor acceptance of the plan, is required. Instead, a Subchapter V plan must include certain of the information ordinarily included in the disclosure statement.[6]

[2] *See* Fed. R. Bankr. P. 1020(b).

[3] *See In re Ventura*, 615 B.R. 1 (Bankr. E.D.N.Y. 2020); *see, e.g.*, *In re Body Transit, Inc.*, 613 B.R. 400 (Bankr. E.D. Pa. 2020); *In re Moore Properties of Person Cnty., LLC*, No. 20-80081, 2020 WL 995544 (Bankr. M.D.N.C. Feb. 28, 2020); *In re Progressive Sols., Inc.*, 615 B.R. 894 (Bankr. C.D. Cal. 2020).

[4] *See* 11 U.S.C. §§ 1183-1184.

[5] *See* 11 U.S.C. § 1181(b).

[6] *See* 11 U.S.C. § 1190(1).

Other important changes include:

- The bankruptcy court holds a status conference within 60 days of the case filing "to further the expeditious and economical resolution" of the case.
- The debtor must file a report not later than 14 days before the status conference, detailing the debtor's efforts to achieve a consensual plan of reorganization.
- The debtor must file a plan of reorganization not later than 90 days after entering bankruptcy, unless the need for the extension is caused by circumstances "for which the debtor should not justly be held accountable."[7]. By contrast, there is no mandatory deadline for filing a plan in a traditional Chapter 11, and a debtor's "exclusive" period to do so is routinely extended.

Perhaps the most significant changes, however, relate to confirming a plan of reorganization. In a traditional Chapter 11 case, any party-in-interest may file a plan once the debtor's "exclusivity period" has expired. In a Subchapter V case, there are no competing plans permitted; the debtor maintains an exclusive right to confirm a plan throughout.[8] Furthermore, the debtor need not obtain the acceptance of an impaired consenting class of creditors to confirm a Subchapter V plan.[9] Unlike traditional Chapter 11 plans, a Subchapter V plan may be approved by the court even if no class of creditors accepts it.

(3) Equity Holders Can Continue Ownership Post-Confirmation

Under the absolute priority rule in non-Subchapter V cases, the debtor's existing owners cannot retain equity in the debtor over the objection of a class of unsecured creditors, unless the class is paid in full or the owners contribute new capital to the company. As a result, traditional Chapter 11 cases often result in the cancellation of equity interests.

By contrast, in a Subchapter V case, equity holders can continue to own and manage their business even where all creditors vote against the plan and object to confirmation; provided, however, that the plan cannot discriminate unfairly and is "fair and equitable" with respect to each class of claims. A Subchapter V debtor satisfies the fair and equitable requirement if the plan pays unsecured creditors all of the debtor's "disposable income" for a period of three to five years. Disposable income excludes income that is reasonably necessary to be expended "for the payment of expenditures necessary for the continuation, preservation, or operation of the business of the debtor."[10]

(4) Deferred Payment of Administrative Expense Claims

In a traditional Chapter 11 case, administrative expense claims (i.e., post-bankruptcy expenses and obligations) must be paid in the ordinary course of business or in full on a plan's effective date. In Subchapter V, a small business debtor may stretch payment of administrative expenses, including professional fees, over the term of the plan (i.e., up to three to five years).[11]

(5) Discharge

If the court confirms a consensual plan in Subchapter V, typically with the help of the Subchapter V Trustee, the debtor receives a discharge of its liabilities at confirmation. However, if the confirmed plan is a non-consensual/cramdown plan, the debtor does not receive a discharge until all plan payments are completed.[12]

Creditor Protections that Are Unaltered by Subchapter V

Despite the significant changes outlined above, certain creditor protections in Chapter 11 remain unaltered in Subchapter V cases, including, without limitation, the following:

[7] *See* 11 U.S.C. § 1189(b).
[8] *See* 11 U.S.C. § 1189(a).
[9] *See* 11 U.S.C. § 1191(b).
[10] 11 U.S.C. § 1191(d)(2).
[11] *See* 11 U.S.C. § 1191(e).
[12] *See* 11 U.S.C. § 1192.

- The "best interest test" is preserved, such that in order to be confirmed a plan must provide creditors at least as much value as they would receive if the small business debtor was liquidated and not reorganized.[13]
- Secured creditors retain their rights to have their collateral "adequately protected" against diminution in value, or be granted relief from the automatic bankruptcy stay to realize on their collateral.[14] Secured creditors also retain their right to be paid the present value of their collateral under any confirmed plan.
- To assume executory contracts, small business debtors still must first cure defaults and provide adequate assurance of future performance.[15]
- Claims for goods delivered to the debtor within 20 days before the bankruptcy are still treated as administrative expenses claims under 11 U.S.C. § 503(b)(9).

Conclusion

Subchapter V has greatly altered Chapter 11 bankruptcies involving qualifying small businesses, as to both the plan process and the rights of creditors. Creditors must be even more vigilant at the outset of a Subchapter V case, as the matter will proceed more quickly and the opportunities to object to and challenge the debtor's actions are curtailed.

Among other things, affected creditors should promptly review the bankruptcy petition to confirm whether the debtor qualifies for Subchapter V treatment, and to object if not. If the debtor does qualify, creditors should quickly file an appearance and contact the Subchapter V Trustee to discuss their interests and concerns. Creditors also should be prepared for the debtor's initial status report, the early case status conference, and the filing of a plan within 90 days, all as mandated by the SBRA.

Finally, creditors must pay close attention to the new statutory provisions for plan confirmation, as the procedures and substantive requirements are different in several material respects.

[13] *See* 11 U.S.C. § 1129(a)(7).
[14] *See* 11 U.S.C. § 362(d).
[15] *See* 11 U.S.C. § 365(b).

CARDINAL CHANGE DOCTRINE

By: Michael A. Stover, Wright, Constable & Skeen, LLP, Baltimore, Maryland

Introduction

This article explores the Cardinal Change doctrine. A cardinal change can provide a defense to a surety and its principal under certain circumstances. Virtually every construction contract has a clause that allows the owner or upstream contractor to make changes to the scope of work (the "Changes Clause"). In the federal construction context, such clauses are mandated by the provisions of the Federal Acquisition Regulation. These Changes Clauses give the owner/contractor broad unilateral power to order changes to the work and generally require the contractor to perform the work, even if the contractor disputes or objects to the change. As the Supreme Court has observed, "[a] changes clause allows the Government to make unilateral contract modifications without seeking consent from the subcontractor and without being in breach of the contract."[16] But what if the changes ordered are unreasonable and outside of the contemplation of the parties when the contract was entered into?

For example, what if the change(s) double or triple the original contract work and price or extend the work double or triple the original contract time? Is the contractor or surety still bound by the Changes Clause to perform? The Cardinal Change doctrine says no! This doctrine can apply to a surety in a number of ways. First, if a surety takes over a project, the surety may directly face an overly broad change that it may not wish to perform. Second, the doctrine can be raised by the principal, or by the surety through its right to assert its principal's defenses, as a defense to an obligee's change demand or claims for costs to perform overly broad change work. The principal's/surety's position would be that they are not responsible for such costs because they were outside the permissible scope of the contract. Third, the doctrine can form the basis for claims for extra compensation in *quantum meruit* beyond the contract terms if the principal was forced to perform the overly broad change work.

The Cardinal Change Doctrine Defined

So, what is a cardinal change? A cardinal change is one which, because it fundamentally alters the contractual undertaking of the contractor, is not comprehended by the normal Changes Clause.[17] The United States Claims Court in *Edward R. Marden Corp. v. United States* stated that the purpose of the Cardinal Change doctrine "is to provide a breach remedy for contractors who are directed by the Government to perform work which is not within the general scope of the contract."[18] The Court of Appeals for the Federal Circuit put it this way: "A cardinal change occurs when . . . an alteration in the work [is] so drastic that it effectively requires the contractor to perform duties materially different from those originally bargained for."[19]

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[16] *Crown Coat Front Co. v. United States*, 386 U.S. 503 (1967).

[17] *Am. Line Builders, Inc. v. United States*, 26 Cl. Ct. 1155, 1177–78 (1992).

[18] 194 Ct. Cl. 799, 808–09 (1971).

[19] *Rumsfeld v. Freedom NY, Inc.*, 329 F.3d 1320, 1332 (Fed. Cir.), *adhered to on denial of reh'g en banc*, 346

The Fourth Circuit Court of Appeals phrased it as requiring the contractor to perform duties that are "materially different from those originally bargained for."[20] In other words, a change is cardinal when it cannot be said to have been within the contemplation of the parties when they entered into the contract.[21] Thus, by definition, a cardinal change is a change so profound that it is not redressable under the Changes Clause of the contract and renders the party directing the change in breach.[22] Stated differently, a cardinal change is such an unreasonable, unanticipated change that it actually "constitutes a material breach of the contract."[23] Because a cardinal change is a material breach it has "the effect of freeing the contractor of its obligations under the contract, including its obligations under the disputes clause" to continue performance during the pendency of the dispute.[24] Indeed, there is case law holding that where a cardinal change was found, the contractor was excused from contract provisions such as no damage for delay clauses, waivers, and claim notification provisions. Thus, when a cardinal change occurs, the performing party is legally justified in refusing to perform the change.

However, one of the difficulties in the application of this defense is that "[t]here is no automatic or easy formula which can be used to determine whether a change (or changes) is beyond the scope of the contract."[25] Initially, in deciding whether a single change or series of changes is a "cardinal change," many courts observed that "one must examine the work done in compliance with the changes and ascertain whether it is essentially the same work that the parties bargained for when the contract was awarded."[26] This is essentially taking a literal approach to the doctrine. So, you will have some cases where the court will say—yes, there were a lot of changes, delays, and impacts, but you were contracted to build a tunnel and you built a tunnel. For example, in *United States ex rel. Sun Construction Co. v. Torix General Contractors, LLC*, the federal district court in Colorado denied summary judgment in light of unresolved issues of fact concerning whether a two-year delay and $1,000,000 in increased costs qualified as "significant changes" where the contractor "built the same tunnel they originally were hired to build, and in essentially the same manner and location."[27] But the more modern interpretation of the doctrine is that "[a] cardinal change can occur even when there is no change in the final product because it is the 'entire undertaking' of the contractor, rather than the product, to which [courts] look."[28] Unfortunately for contractors and sureties facing a possible cardinal change, there is no reliable method to make a contemporaneous determination of cardinality. One court noted this dilemma, stating "[t]he obvious risk faced by a contractor contemplating the suspension of performance because of an alleged breach by the owner is that the contractor who abandons the work is liable for breach if the abandonment is deemed wrongful. Undoubtedly, the cautious contractor might often proceed under

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F.3d 1359 (Fed. Cir. 2003); *see also Krygoski Constr. Co. v. United States*, 94 F.3d 1537, 1543 (Fed. Cir. 1996) (citations omitted); *AT&T Commc'ns, Inc. v. Wiltel, Inc.*, 1 F.3d 1201, 1205 (Fed. Cir. 1993); *Allied Materials & Equip. Co. v. United States*, 215 Ct. Cl. 406 (1978).

[20] *Hancock Elecs. Corp. v. Wash. Metro. Area Transit Auth.*, 81 F.3d 451 (4th Cir. 1996).

[21] *Universal Contracting & Brick Pointing Co. v. United States*, 19 Cl. Ct. 785, 792 (1990).

[22] *Appeals of Gassman Corp.*, ASBCA No. 44975, 00-1 B.C.A. (CCH) ¶ 30720 (quoting *AT&T Communications, Inc.*, *supra* note 4).

[23] *Alliant Techsystems, Inc. v. United States*, 178 F.3d 1260, 1276 (Fed. Cir. 1999); *Air–A–Plane Corp. v. United States*, 187 Ct. Cl. 269 (1969); *General Dynamics Corp. v. United States*, 218 Ct. Cl. 40 (1978); *Allied Materials & Equip. Co.*, *supra* note 4.

[24] *Alliant Techsystems, Inc.*, *supra* note 8; *JJK Grp., Inc. v. VW Int'l, Inc.*, No. TDC-13-3933, 2015 WL 1459841, at *10 (D. Md. Mar. 27, 2015) (quoting *Alliant Techsystems, Inc.*, *supra* note 8).

[25] *Appeals of Gassman Corp.*, *supra* note 7 (quoting *Edward R. Marden Corp.*, 442 F.2d at 369); *see also Wunderlich Contracting Co. v. United States*, 173 Ct. Cl. 180 (1965).

[26] *Appeals of Gassman Corp.*, *supra* note 7 (citing *Aragona Constr. Co. v. United States*, 165 Ct. Cl. 382, 390–91 (1964)).

[27] Case No. 07–cv–01355–LTB–MJW, 2009 WL 3348287, at *4 (D. Colo. Oct. 15, 2009).

[28] *Rumsfeld*, 329 F.3d at 1332 (quoting *Edward R. Marden Corp.*, 442 F.2d at 370).

the revised contract because of doubt whether he could invoke the cardinal change doctrine."[29]

In *Becho, Inc. v. United States*, the Court of Federal Claims gave the following guidance concerning the Cardinal Change doctrine:

> [W]hile there is no precise calculus for determining whether a cardinal change has occurred, the courts have considered, *inter alia*, the following factors: (i) whether there is a significant change in the magnitude of work to be performed; (ii) whether the change is designed to provide a totally different item or drastically alter the quality, character, nature or type of work contemplated by the original contract; and (iii) whether the cost of the work ordered greatly exceeds the original contract cost.[30]

The Court of Federal Claims in *Wunderlich Contracting Co. v. United States* similarly observed that,

> "[t]here is no exact formula for determining the point at which a single change or a series of changes must be considered to be beyond the scope of the contract and necessarily in breach of it. Each case must be analyzed on its own facts and in light of its own circumstances, giving just consideration to the magnitude and quality of the changes ordered and their cumulative effect on the project as a whole."[31]

While these more modern cases addressing Cardinal Change doctrine broaden its application, the lack of a clear standard or bright-line rule makes it very difficult to look at a given situation and definitively determine if the doctrine will be upheld by the ultimate trier of fact.

History

The Cardinal Change doctrine originated in federal contract law. The early cases when the doctrine was being formed involved suits brought by contractors against the United States Government in the Court of Federal Claims.[32] It has been recognized that the doctrine, in part, "was created as a check on the government's ability to circumvent the competitive-bidding process by ordering drastic changes beyond those contemplated in the contract[.]"[33] While Changes Clauses permit broad changes, they do not authorize a drastic modification beyond the scope of the contract which would be in violation of applicable procurement law and contract law.[34] Thus, the government cannot award a contract for the construction of one road under competitive bidding procurement law and then under the Changes Clause of that contract require the contractor to build a second road and avoid the competitive bidding process for that second road. Further, in creating this doctrine, the courts have recognized that because of the broad nature of the Changes Clause, the power of the owner, be it a federal agency or a private developer, to order changes is subject to abuse. Thus, the Cardinal Change doctrine was created as an equitable remedy to allow a contractor, where the owner has abused its power, to assert a material breach

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[29] *Allied Materials & Equip. Co.*, 569 F.2d at 564.

[30] 47 Fed. Cl. 395, 601 (2000).

[31] 351 F.2d at 966.

[32] *See, e.g.*, *Allied Materials & Equip. Co.*, *supra* note 4; *Air–A–Plane Corp.*, 187 Ct. Cl. at 273–84; *Wunderlich Contracting Co.*, 173 Ct. Cl. at 183–205.

[33] *J.A. Jones Constr. Co. v. Lehrer McGovern Bovis, Inc.*, 89 P.3d 1009, 1020 (Nev. 2004); *see also Cray Research, Inc. v. Dep't of Navy*, 556 F. Supp. 201, 203 (D.D.C 1982).

[34] *Air–A–Plane Corp.*, 187 Ct. Cl. at 275–76; *L.K. Comstock & Co. v. Becon Constr. Co.*, 932 F. Supp. 906, 936 (E.D. Ky. 1993).

of contract, alleging that the changes ordered exceed the reasonable expectations of the parties.

Where Does the Doctrine Apply?

While the doctrine began in the federal courts, it has since been adopted in many state courts around the country. Further, while the doctrine originated in government procurement matters, it has been recognized on private projects as well. In one case, for example, the opposing party argued the doctrine was limited to government contracts. However, the court stated such a position "ignores the essential similarity of public and private construction contracts with regard to the mechanism for unilateral ordering of changes by the party for whom the work is being performed, and concerns about misuse or overuse of that unilateral authority. These features of any contract for construction are the central focus of the cardinal change doctrine."[35] Thus, the court concluded, "this broad principle has been recognized by state courts as well as federal tribunals, and in private as well as public contract settings."[36]

In *L.K. Comstock & Co. v. Becon Construction Co.*, the Kentucky federal court undertook a survey of state courts applying the Cardinal Change doctrine either explicitly or implicitly. For example, the court pointed to cases in Pennsylvania (*Fuller Co. v. Brown Minneapolis Tank & Fabricating Co.*[37]); Maryland (*Westinghouse Electric Corp. v. Garrett Corp.*[38]); Arkansas (*Housing Authority of City of Texarkana v. E.W. Johnson Construction Co.*[39] and *Hensel Phelps Construction Co. v. King County*[40]); Indiana (*Rudd v. Anderson*[41]); and Oklahoma (*Watt Plumbing, Air Conditioning & Electric, Inc. v. Tulsa Rig, Reel & Manufacturing Co.*[42]).

Ultimately, the court concluded,

> In summary, a number of courts in decisions based upon state law have applied the doctrine of cardinal change. While it may not always bear the name "cardinal change," and may or may not be clearly borrowed from federal procurement law, the core theory that *when* an owner orders changes beyond the scope of the work agreed to be performed the contractor is entitled to damages (in some form) for breach, has been widely recognized. . . . the result is the same: the party performing the work is entitled to seek a remedy outside the contract for the reasonable value of work performed.[43]

While the Cardinal Change doctrine has received wide acceptance, it is not universally accepted. For example, the court in *Ebenisterie Beaubois Ltee v. Marous Bros. Construction, Inc.* sitting in diversity and interpreting Ohio law, held that the Ohio Supreme Court would not recognize the Cardinal Change doctrine.[44] The court reasoned that Ohio courts consistently refuse to allow recovery in quasi-contract where an express contract governs the subject matter of the dispute. In addition, the court cited to two other courts that rejected the Cardinal Change doctrine as well for similar reasons. Specifically, the court referred to *Mellon Stuart Construction, Inc. v. Metropolitan Water Reclamation District of*

[35] *L.K. Comstock & Co.*, *supra* note 19 at 938–39.
[36] *Id*.
[37] 678 F. Supp. 506 (E.D. Pa. 1987) ("[U]nder the contract doctrine of 'cardinal' change that where a party to a contract alters the terms of the other party's performance to such an extent that the alterations could not have been within the realm of the parties' contemplation as evidenced by the parties' written agreement, the other party may elect not to perform and hold the other party liable for breach.").
[38] 437 F. Supp. 1301 (D. Md. 1977) *aff'd* 601 F.2d 155 (4th Cir. 1979) (addressing subcontractor's defense of cardinal change under state law).
[39] 573 S.W.2d 316 (Ark. 1978).
[40] 787 P.2d 58 (Wash. Ct. App. 1990).
[41] 285 N.E.2d 836, 840 (Ind. Ct. App. 1972).
[42] 533 P.2d 980, 982 (Okla. 1975).
[43] 932 F. Supp. at 938–39 (emphasis added).
[44] No. 02 CV 985, 2002 WL 32818011, at *3–6 (N.D. Ohio Oct. 17, 2002).

Chicago, in which the court found the Illinois Supreme Court would decline to recognize a claim for "cardinal change" breach of contract.[45] The court based its decision, in large part, on the deference Illinois provides to parties in defining their obligations under a contract. Similarly, in *Litton Systems, Inc. v. Frigitemp Corp.*, the district court refused to recognize a claim based on cardinal change breach of contract because "Mississippi law clearly and unequivocally denies extra-contractual relief where the parties have expressly contracted upon a subject."[46] As with so many issues, it is necessary to check the applicable jurisdiction to determine if the Cardinal Change doctrine is recognized.

The question may be asked by a surety, does the Cardinal Change doctrine apply to sureties? The answer is yes. Several courts have acknowledged specifically a surety's prerogative to raise the Cardinal Change doctrine as a defense.[47]

Some Examples of Cardinal Changes

One of the best methods of understanding the doctrine is to examine some examples of the Cardinal Change doctrine being applied. The first case is more of the classic cardinal change scenario where the government attempts to order a change to construct a whole different additional facility. In *Hartford Casualty Insurance Co. v. City of Marathon*, the City of Marathon was undertaking significant construction to implement a new water treatment plan for the city and surrounding area.[48] The new plan required the construction of seven water treatment plants around the city. Marathon awarded a contract to the contractor to build a treatment plant designated as Plant No. 3. Subsequently, the City issued a change order to the contractor requiring that treatment Plant No. 7 also be constructed as part of the contract. Plant No. 7 was based on separate plans and specifications and was to be constructed 5.5 miles away on a completely different site. As the court observed, "this was not a change order that merely extended or altered the specifications, timeline, or cost of the original treatment plant—this was a change order that ordered the building of a *second* treatment plant."[49] Marathon argued that despite the difference in location, the Plant 7 Change Order was not authorizing a separate project under the contract because the plain language of the underlying construction contract contemplated changes and the Plant 3 Project and Plant 7 Project were interrelated because they were both part of Marathon's larger water treatment plan. The court rejected Marathon's argument and stated that taken to its logical extreme, the argument would permit Marathon to issue change orders to include the entirety of the seven treatment plants under the Plant 3 contract and, in turn, obligate Hartford to bond additional millions of dollars without conducting an assessment of risk.[50]

The court noted the original contract price was for $2,061,000.00 to construct Plant No. 3. The Plant No. 7 Change Order came at an additional cost of $2,984,487.00, an increase of over 144 percent of the original contract sum. After reviewing all of the factors, the court held the Plant No. 7 Change Order was a cardinal change to the underlying construction contract.[51] The court also held that the facts demonstrated a significant, and potentially unbounded, increase in risk so as to prejudice and injure Hartford as the surety.[52] As a result, the court concluded that pursuant to the Cardinal Change doctrine,

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[45] No. 94 C 1915, 1995 WL 124133 (N.D. Ill. Mar. 20, 1995).

[46] 613 F. Supp. 1377, 1382 (S.D. Miss. 1985); s*ee also Durr Mech. Constr., Inc. v. PSEG Fossil, LLC*, 516 F. Supp. 3d 407 (D.N.J. 2021) (holding that New Jersey would not recognize the Cardinal Change doctrine because quasi contract recoveries cannot apply with an express contract).

[47] S*ee, e.g.*, *United States ex rel. Sun Constr. Co.*, 2009 WL 3348287, at *3; *In re Tech. for Energy Corp.*, 140 B.R. 214, 217 (Bankr. E.D. Tenn. 1992); *United States v. Seaboard Sur. Co.*, 622 F. Supp. 882, 887 (E.D.N.Y. 1985); *Hartford Cas. Ins. Co. v. City of Marathon*, 825 F. Supp. 2d 1276, 1285–88 (S.D. Fla. 2011), *rev'd in part, vacated in part sub nom*., *Hartford Cas. Ins. Co. v. Intrastate Constr. Corp.*, 501 F. App'x 929 (11th Cir. 2012); *Phila. Indem. Ins. Co. v. Ohana Control Sys., Inc.*, 450 F. Supp. 3d 1043, 1056–57 (D. Haw. 2020).

[48] Hartford Cas. Ins. Co., *supra* note 32, at 1285–88

[49] *Id.* at 1287 (emphasis in original).

[50] *Id.*

[51] *Id.*

[52] *Id.*

Hartford was not obligated to bond the Plant No. 7 change order.[53]

This next case involves the application of the cardinal change in a private project where the same project was built, but the manner of performance was dramatically altered. In *J.A. Jones Construction Co. v. Lehrer McGovern Bovis, Inc.*, the overall physical characteristics of the work changed very little, so the central issue was whether the entirety of the changes and impacts on the contractor's work was so extensive as to force the contractor to perform work beyond the confines of the contract's Changes Clause.[54] J.A. Jones was awarded a contract to install structural concrete at the Sands Exposition Center expansion in Las Vegas, Nevada. J.A. Jones' original bid amount was $8.4 million. In order to reduce the bid amount, the owner agreed to perform various site preparation tasks and to streamline other tasks to shorten, by about half, the time needed for J.A. Jones to complete its concrete construction, thus reducing Jones's labor, materials, equipment, and overhead costs. Both parties made concessions and ultimately agreed that J.A. Jones would perform the structural concrete work for $7.4 million. Because of the agreed upon site preparation and streamlined activities, J.A. Jones agreed to shortened milestones. However, those milestones were eventually exceeded by eight months because of changes made by the owner to the work and obstructions, hindrances, and inefficiencies that rendered J.A. Jones' work more difficult, time consuming, and costly to perform. Once construction started, the owner essentially failed to provide any of the site conditions that it said it would provide and upon which J.A. Jones agreed to lower its bid. J.A. Jones asserted that out of its $7.4 million bid, it expected to capture $1.9 million in overhead and profit, leaving $5.5 million in anticipated costs. The actual costs, according to J.A. Jones, totaled over $8.8 million. Additionally, J.A. Jones's expert testified that about $4 million, or 62 percent of the Phase I work value, was incurred because of changes. J.A. Jones was paid $1,078,303 for some of the changed-work expenses incurred during the delay by the owner and at trial J.A. Jones was awarded another $1.1 million for its damages, but, its cardinal change claim was dismissed. J.A. Jones was seeking $5 million in damages.[55]

On appeal, the Nevada Supreme Court ruled that a cause of action based on the Cardinal Change doctrine was permissible under Nevada law and that J.A. Jones was entitled to assert its cardinal change claim.[56] The court reversed the dismissal, and the case was remanded for a new trial.

In this next case, a cardinal change resulted from a failure to provide adequate construction drawings. In *Westinghouse Electric Corp.*, the plaintiff subcontracted with Westinghouse to assemble *cooling* pods for military electronic countermeasure devices. Westinghouse delayed several months in supplying the plaintiff with source control drawings ("SCDs"), which are similar to the construction drawings.[57] SCDs would have specified dimensions and tolerances and, like issued-for-construction drawings, would facilitate the subcontractor's efficient performance. Due to the lack of SCDs, the plaintiff was required to make constant design revisions, and it incurred substantial additional costs trying to overcome these deficiencies and maintain the tight completion schedule. The court examined the effect of Westinghouse's delay in supplying SCDs and held that Westinghouse imposed a cardinal change upon the plaintiff. According to the court, failure to provide SCDs fundamentally altered the nature of the plaintiff's undertaking.[58] Having SCDs to work from was the basis of the plaintiff's bargain. The plaintiff was entitled to the ease of working from a single source of information and to the facilitation of incorporating otherwise disruptive changes that come from having such a source or "base line."[59] On a contract with a tight delivery schedule, the SCDs became critical and fundamental, going to the heart of the vendor's undertaking.[60]

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[53] *Id.* at 1287–88.
[54] *J.A. Jones Constr. Co.*, 89 P.3d at 1021.
[55] *Id.* at 1012.
[56] *Id.* at 1021.
[57] 437 F. Supp. at 1310–12.
[58] *Id.* at 1333.
[59] *Id.*
[60] *Id.*

In *Edward R. Marden Corp.*, the plaintiff was working on the construction of an aircraft maintenance hangar when the structure collapsed, causing substantial damage to equipment and work already completed.[61] Following the collapse, the plaintiff, under protest, cleaned up the debris and reconstructed the hangar as directed by the government. The plaintiff then brought a claim for breach of contract, asserting that the government's specifications had been defective, the structure collapsed due to the defect, and the plaintiff was ordered to reconstruct the hangar which resulted in increased costs of $3.7 million.[62] The court found that considering the sheer magnitude of reconstruction work caused by the alleged defective specifications, a cardinal change had occurred.[63] Therefore, because the reconstruction work had not been bargained for when the contract was awarded, the plaintiff's breach of contract claim was not redressable under the contract's Changes Clause.[64]

Potential Impediments to Cardinal Change

A. Entering Into Change Orders

1. Change Orders May Bar Defense

In some cases, courts have denied a cardinal change claim because the contractor entered into change orders and continued performing. In *Colonna's Shipyard, Inc. v. United States*, the court found that a cardinal change did not occur under a contract for ship repair work when new "growth" work was added to a specification package and the parties entered into forty-six contract modifications.[65] Although the court noted that the growth work exceeded the plaintiff's expectations, the court explained:

> Plaintiff has not satisfactorily established that the work performed was materially different from that specified in the Contract. Despite the difficulties encountered, a contract to repair a ship remained a contract to repair a ship, and the modifications indicate that these changes were clearly redressable under the Contract. Had the changes been so profound that they were not redressable, it is unlikely that the parties would have been able to negotiate forty-six (46) bilateral contract modifications.[66]

In *Watt Plumbing, Air Conditioning & Electric, Inc.*, the plaintiff was the electrical subcontractor in a project to construct a new hospital wing.[67] Although the parties adhered to the contractually required written change order process, at the completion of the project, the plaintiff-subcontractor sued for *quantum meruit* recovery based upon a theory of breach by excessive changes. Rejecting the plaintiff's claim, the Oklahoma Supreme Court held:

> It is axiomatic that by mutual assent parties to an existing contract may subsequently enter into a valid contract to modify the former contract provided there is consideration for the new agreement. An alteration of a contract cannot constitute a breach of contract because it becomes a part of the contract. The contract as

[61] 194 Ct. Cl. at 802.
[62] *Id.* at 809.
[63] *Id.*
[64] *Id.*
[65] No. 2:14-cv-331, 2015 WL 9008222 (E.D. Va. Dec. 14, 2015).
[66] *Id.* at *19 (*citing Amertex Enters., Ltd. v. United States*, No. 1997 WL 73789, 1997 WL 73789, at *1 (Fed. Cir. Feb. 24, 1997)).
[67] 533 P.2d at 981–82.

altered is the agreement between the parties.[68]

2. Change Orders May Not Bar Defense

On the other hand, a number of decisions have recognized that a cardinal change claim is not barred by the fact that some or all of the changed work at issue is covered by executed change orders. The fact that a party may have sought, released, or otherwise compromised a claim under a contract's equitable adjustment clause or other remedial clause will not necessarily, at least in some courts, operate as a bar to claims for relief outside the contract. In *Saddler v. United States,* a contractor recovered under a cardinal change theory even though the contractor executed a change order concerning the changed work.[69] Near the completion date of the project, the government imposed a change which more than doubled the amount of earth and other material the contractor was required to place in a levee. The contractor performed the changed work, but initially refused to execute the change order the government issued. Rather, it proceeded with the work under protest. After losing a claim of breach for additional compensation before the Corps of Engineers Claims and Appeals Board, the contractor executed the change order. He received compensation for the additional work and accepted final payment. However, on appeal, the court of appeals held that a cardinal change occurred because the work covered by the executed change order altered the fundamental nature of the work performed.[70] There are numerous cases where the Cardinal Change doctrine was applied even though change orders were entered into. The *J.A. Jones Construction. Co.* and *City of Marathon* cases discussed above are examples.

B. Releases and Waivers

The cardinal change claim may be waived in a release or settlement. In *In re Boston Shipyard Corp.*, the plaintiff contracted for the overhaul of a naval vessel for approximately $5 million. There were hundreds of change orders.[71] The plaintiff and the government eventually negotiated a settlement of claimed costs due to delay and disruption in the amount of $500,000, which was executed as a modification to the contract. The modification bore the language that it "definitizes a settlement of all contractor's claims on the above job order" as of a certain date.[72] The court found the modification barred the plaintiff's claim under the Cardinal Change doctrine.

On the other hand, in *Atlantic Dry Dock Corp. v. United States*, the court refused to bar a cardinal change claim as matter of law on grounds of accord and satisfaction despite the fact the contractor entered into 130 change orders, each of which provided the change was "in full and final settlement of all claims arising out of this modification including all claims for delays or disruptions resulting from, caused by, or incident to such modifications or change orders."[73]

Conclusion

The Cardinal Change doctrine can be a very important tool in the right circumstances and can be wielded in a variety of circumstances—as a defense, as the basis of a claim, or as justification for refusing to perform work. The surety will need to ensure the doctrine applies in the relevant jurisdiction and review the case law to determine if the doctrine will apply in a specific factual scenario.

[68] *Id*. at 983.
[69] 152 Ct. Cl. 557 (1961).
[70] *Id.* at 564.
[71] 886 F.2d 451 (1st Cir. 1989).
[72] *Id.* at 454.
[73] 773 F. Supp. 335 (M.D. Fla. 1991).

CONSIDERATIONS ON HIRING A COMPLETION CONTRACTOR

By: R. Brent McSwain, Vice President of The Sage Group

Warren Buffet's maxim—"Price is what you pay; value is what you get"—applies to hiring completion contractors as well as buying securities. The lowest price may not result in the lowest cost since lower costs typically mean lesser services, which may result in higher costs if problems arise. There are a number of factors to consider when hiring a completion contractor that affect the ultimate costs incurred besides the price you agree to pay.

The typical project that is reprocured after a default is often delayed and over budget. However, the surety does not typically contemplate that the completion contractor will encounter new sources of delay and cost overruns during completion. But, such delays sometimes occur because of actions for which the owner or another party is responsible. As such, avenues for recovery of those new losses resulting from delays should be proactively considered by the surety at the time of reprocurement. To recover the losses resulting from new impacts and problems, it is necessary to determine the causal reasons for the new losses. The ability to both determine the causes of the impacts and recover the cost of those impacts is affected by decisions made in the selection of the completion contractor.

Analyzing and presenting requests for time extensions is difficult and expensive without good schedules that are both updated and properly utilized during the project. Recovery of additional costs is difficult and expensive without good cost controls that allow analysis and identification of additional costs. Recovery of unexpected costs and delays starts with analysis of the cost records, project schedules, and documentation. Proper use of cost accounting systems to capture accurate cost data compared to the budget assists the contractor in managing the project and identifying impacts. Conversely, when the cost records, schedules, and documentation are insufficient, management of the project suffers and identification and recovery of impacts is more difficult and costly to determine.

Hire a Qualified Completion Contractor

Effective cost performance of the completion work starts with hiring a completion contractor who is experienced in the type of work being performed and is proficient in the use of cost, scheduling, and documentation tools for the management of successful projects. The surety should ensure that the completion contractor it is considering has a proper cost module for its accounting system. A proper cost module records the costs incurred against the budgets for the direct labor, material, subcontractor, and change order costs when these actual and committed costs are being incurred.

The completion contractor also needs to show it uses the appropriate scheduling system and produces schedules with sufficient activity ID coding to track periodic progress, including impacts and delays. The completion contractor should be proficient in using fragnets inserted into the schedule contemporaneously when the delays occur. The surety should ensure the contractor issues monthly schedule reports documenting the work progress as well as the schedule impacts upon the final project completion date, while assigning delay

responsibility to any offending party. To document the events causing impact and delay, the completion contractor should organize, identify, and save all pertinent documentation, including email correspondence located on individual computers, for claim development and potential litigation.

By ensuring the completion contractor has the tools and experience necessary to administer and document the work, the surety will be better positioned to recover losses for which others may be responsible. A surety relies on its completion contractor to have and implement this knowledge to administer the project. However, without the proper cost information, schedule, and documentation, the identification and analysis of increased costs and schedule delays becomes problematic and cost recovery becomes more difficult—and costly—to prove.

Demand Proper Job Cost Accounting

The heart of any damage analysis is the cost report. The surety should insist that the completion contractor have a sufficient job cost accounting system and proficiency in implementing good cost accounting policies and procedures. The cost report should be generated by a cost accounting system that tracks costs to detailed cost codes for both self-performed and subcontracted work. When losses occur, analysis can determine what cost codes overran their budgets. This will preserve key evidence to support the surety's right to recover losses for which others are responsible. Of course, no one expects to make a claim on a project, but that does not mean you cannot assure yourself of better results by having the proper tools in place when needed.

The contractor's accounting department typically manages the cost report system and enters the expenditures when they are paid. The contractor's staff, usually the project manager, is typically responsible for validating all budgets entered into the cost report, assuring that the proper cost codes are funded. When change orders are approved, the project manager is responsible for providing the budget adjustments to the accounting department by specific cost code. When invoices are received, the project manager should code the invoice with the appropriate cost code for the accounting department's use.

Though simplistic in execution, significant mismanagement of the cost report is not uncommon, which causes additional time, effort, and cost to later determine not only the category of loss, but the amount of the loss because the original budgets are wrong, the change order budgets are not entered, and the subcontractor cost code budgets do not reflect the agreed-upon subcontract amounts. Even if a contractor may have the proper job cost accounting system, that does not mean the contractor is proficient using that system. Often, the mistakes are in how the accounting system is used, not in the system itself.

As such, the surety should:

- confirm what type of cost accounting system is being used by the completion contractor prior to selecting that firm and
- confirm whether that contractor can show a track record of properly administering the job cost report and tracking overall project costs.

In some instances, contractors arbitrarily increase their budgets to eliminate the appearance of cost overruns, simply to make the losses vanish so they do not have to explain them. Doing so may be a lost opportunity because the loss on a cost code may be the result of a claimable cost due to the action or inaction of another party. When the loss is eliminated artificially, the ability to identify and assert the loss becomes problematic.

By properly administering the job cost accounting system, the contractor can rely upon the validity of the cost report. The accounting department can run not only summary cost reports, but a multitude of other reports for loss analysis purposes. In contrast, some contractors still use spreadsheets to record costs instead of using accounting systems. The use of spreadsheets becomes problematic when neither the original nor change order budgets are incorporated by cost code. If no budgets exist, the contractor cannot manage the work to a budget, but is simply recording expenditures for

the surety to pay. The contractor may not be aware it is incurring losses until it has actually overrun the total cost anticipated by the surety. As a result, it may fail to issue contractually required notices of those impacts. When loss analysis is required, it is difficult and costly to recreate the required budgets as adjusted for change orders. In those instances, the budgets almost always have to be prepared on a summary level basis, not allowing individual cost code loss analysis. As a result, the credibility of the loss analysis may come into question.

The surety can eliminate this credibility issue by insisting the contractor demonstrate to the surety that a sufficient job cost accounting system will be used, as well as provide a detailed discussion on its use policy and procedures for proper budget, change order, and expenditure management. Losses can be mitigated if managed.

Demand Proper Change Order and Schedule Delay Management

The root cause of many claims is excessive owner-issued change orders. In many cases, the unpaid direct cost change orders are either not timely resolved, resolved for less than anticipated, remain unpaid, or are rejected. The surety should require that its completion contractor explain its change order management policy and procedures and provide staffing resources necessary to properly manage the change order process.

The surety should examine a sampling of the contractor's change order log to understand whether or not the contractor is sufficiently prepared to manage the change order process. The surety should also insist that contractor explain how it tracks change order costs in its cost report. When change order costs are commingled with the base contract costs, it can create significant challenges when the costs need to be separated for either loss analysis or billing purposes. Because change order management is essential to both cost and schedule management, the surety should determine whether its contractor is appropriately experienced and staffed to administer the change order process.

The contractor may be experienced in pricing change orders timely but ignore the schedule impact of the change on the base contract work. If critical path delay has either occurred or is expected, the contractor is likely entitled to general conditions costs for the extended duration. The surety should validate whether the contractor has experience in providing schedule delay analysis of changes to the work. If the contractor cannot determine with reasonable certainty the critical path schedule impact resulting from a specific change, then the contractor is not proficient in schedule delay management. The surety should request the completion contractor's scheduling policy and procedures to ensure the surety's rights are protected when critical path schedule delays occur.

The ability to show entitlement to both delay costs and the increased general conditions costs due to extended duration is dependent upon:

- accurate schedule progress and delay analysis;
- the documentation produced by the contractor contemporaneously throughout performance; and
- proper job cost budget and cost reporting.

The surety's ability to recover these types of losses is therefore dependent upon the contractor's ability to properly administer both the cost and schedule for the work.

The surety needs to verify that the contractor has policies and procedures to properly document and provide notice of delay. When the owner ignores the delay and no time extensions are approved, increased contractor cost will result from both the increased general conditions costs resulting from the delay as well as the direct costs resulting from the contractor constructively accelerating the work to mitigate the delay. To recover the losses, the surety needs to ensure its contractor is experienced in:

- documenting and providing notice of delay;
- calculating the delays through schedule analysis;
- pricing the extended duration costs properly; and
- properly tracking acceleration costs.

Otherwise, loss recovery will again be difficult and expensive.

Demand Adherence to Proper Scheduling Protocols

The surety should ensure the completion contractor has expertise in properly developing and statusing the project schedule. Though other scheduling software exists, contractors often use Primavera P6, Microsoft Project Manager, and ASTA scheduling software as their preferred choice. However, just having the software in place is not enough – the contractor must be proficient in its use. The surety should ensure that the contractor's staff charged with using the scheduling software understands proper schedule development and protocols in its use.

Typical issues that affect the ability to develop a strong delay claim include, but are not limited to:

- poorly developed baseline schedules;
- improperly statusing or calculating the monthly schedules;
- overuse of constraints;
- incorrect or missing logic connections;
- improperly sequenced or stacked work;
- missing required work scope; and
- poor duration development.

Schedules often fail to include sufficient time for:

- submittal review and approval;
- shop drawing development and review;
- fabrication; and
- jurisdictional review.

A poorly developed or incomplete schedule may result in credibility problems if the schedule issues resulted in significant self-inflicted delay which may be commingled with the delay you are asserting. Unraveling schedule issues during a delay analysis can be very time consuming and costly. Much of the time and expense can be avoided if the contractor lives up to its responsibility to implement proper procedures and protocols.

Because extended duration general conditions costs are a significant cost component of claims, it is imperative that the contractor develop good baseline schedules and maintain those schedules monthly as accurately as possible throughout the performance period. The reliability of the schedule and the delays incorporated in the progress updates are relied upon to support recovery entitlement of both direct costs and general conditions. If not properly developed, the schedule will be attacked as insufficient and used against the claim for losses. The goal is to prevent that argument from arising in the first place. As such, the surety should ensure that the contractor is experienced in:

- schedule development;
- schedule management; and
- schedule delay analysis.

Good management by the contractor during performance greatly increases the surety's ability to mitigate its losses.

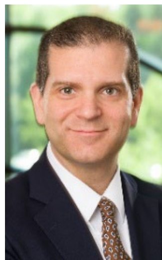
To supplement the monthly schedule progress updates, it is good practice to insist that the completion contractor issue monthly schedule narrative reports to the owner advising the owner of the schedule status and if the owner was the cause of any delay in that period. The schedule reports are used when claims are prepared to confirm the delays reported are identified by the expert when the delay analysis is being performed. The monthly schedule narratives can also be used to confirm that timely notice was provided to the owner of the delays which the surety is trying to recover.

What to do to Avoid or Mitigate Claims

The losses and delays may have resulted from the owner's late and incomplete designs, the owner's interference or maladministration, or because the completion contractor and its subcontractors simply failed to perform. Determination of the root causes of the new losses and delays is required to determine whether pursuing claims and litigation to recover the losses is warranted. One of the best ways for a surety to both avoid unexpected delays and added costs is to hire a completion contractor who

manages the work using accurate cost records and schedules. Contractors who manage the work in this manner tend to find and solve problems early when the problems arise.

SURETY CASENOTES



By: Brian Kantar, Chiesa Shahinian & Giantomasi PC, New York, NY and West Orange, NJ

Holding That Surety May Act in Its Own Interest in Resolving Claims, Federal Court Dismisses Indemnitors' Bad Faith Counterclaims Against Surety

Hartford Fire Ins. Co. v. E.R. Stuebner, Inc., 2022 WL 245237 (E.D. Pa. Jan 25, 2022)

E.R. Stuebner, Inc. ("Stuebner") was terminated from its construction contract with a school district. The school district made a claim under Stuebner's performance bond, which the surety honored. The surety commenced an indemnity action in federal court seeking recovery of its losses and expenses.

Stuebner believed the claim to be without merit and alleged that the surety knew the claim was meritless, but chose to honor it "purely because [the surety] wanted to avoid a legal dispute [and] believed that acquiescing in the…claim was less likely to result in financial losses to [the surety] than denying the claim." Stuebner further alleged that the surety failed to conduct a reasonable investigation into the school district's claim and instead "recklessly agreed" to honor it. After its termination, Stuebner sued the school district for wrongful termination and prevailed. The surety addressed the school district's performance bond claim during the pendency of Stuebner's wrongful termination claim. Stuebner (and the individual indemnitors) filed a counterclaim against the surety asserting that the surety acted in bad faith by honoring the school district's claim and breached the indemnity agreement and performance bond in doing so. The surety moved to dismiss the counterclaim for failure to state a claim. For the reasons that follow, the surety's motion was granted in its entirety.

The indemnitors plead that the surety breached two indemnity agreements by acting in bad faith. While the indemnity agreements did not contain a clause expressly requiring the parties to perform their duties in good faith, the indemnitors argued that such a duty is implicit in contracts. Although the court observed that Pennsylvania law is unsettled as to when the duty of good faith and fair dealing can be implied into a contract, for purposes of the motion, the court presumed such a duty may be implied. The indemnitors claimed the surety acted in bad faith in four ways: (i) failing to reasonably investigate the school district's claim before honoring it; (ii) honoring the claim despite allegedly knowing that Stuebner ultimately would not have been liable for the claim; (iii) incurring unnecessary expenses and failing to receive adequate compensation from the school district while completing the project, and; (iv) the surety's motivation to complete the project was solely the surety's self-interest. The court held that none of these allegations supported a plausible claim for breach of the implied duty of good faith because the express terms of the indemnity agreements suggested that the parties reasonably expected

that the surety could have taken the actions alleged.

The 2018 indemnity agreement, to which all but one of the indemnitors was a signatory, did not require that the surety undertake an investigation before taking over the project and provided the surety with the "absolute" right to take over the project upon request. Moreover, the agreement provided that the surety could honor claims for which the surety ultimately would not be liable: the agreement provided the surety with the right to "adjust, settle, dispute, litigate, appeal, finance, or compromise *any* claim, demand…or exposure." The words "any" and "absolute" made clear that the surety's right to honor claims was not limited to those claims for which the surety ultimately would be liable. The agreement permitted the surety to resolve the claim as it deemed best. As such, the surety could not have acted in bad faith in doing so.

The remaining indemnitor was a signatory to a 2001 indemnity agreement. That agreement likewise described the surety's discretion and takeover rights expansively. Among other things, the 2001 indemnity agreement: (i) permitted the surety to adjust, settle or compromise any claim or demand, (ii) assigned to the surety all of the indemnitors' rights related to any bonded contracts, and (iii) provided the indemnitors would be liable for any amount the surety deemed necessary to protect itself from all losses and expenses. While the 2001 agreement did not characterize the surety's rights as "absolute", the agreement's terms still clearly expressed an intent to privilege the surety's interests and maximized the surety's discretion to take over and complete the project. And generally, at the time the 2001 indemnity agreement was signed, it was already settled law that a surety did not act in bad faith by honor a claim purely out of self-interest or without thoroughly investigating a claim's merit.

Because the surety would not have acted in bad faith by honoring a claim without thoroughly investigating it, by honoring a claim that was meritless, by incurring unnecessary expenses and receiving inadequate compensation after taking over Stuebner's obligations, or by honoring a claim purely for the purpose of protecting the surety's own interests, the court dismissed the indemnitors' counterclaims.

Fifth Circuit Holds Surety's Failure to Comply with Contractual Dispute Resolution Procedures Incorporated into Takeover Agreement Precludes Award of Attorney's Fees Provided for in Incorporated Contract

Parkcrest Builders, LLC v. Liberty Mut. Ins. Co., 26 F.4th 691 (5th Cir. 2022).

In 2013, the Housing Authority of New Orleans ("HANO") entered into an $11 million contract with Parkcrest Builders, LLC ("Parkcrest") to build affordable housing units. HANO terminated Parkcrest in early 2015. Parkcrest immediately filed suit alleging breach of contract. Parkcrest's surety entered into a Takeover Agreement with HANO, which incorporated the original contract by reference. It appears that the incorporation included the original contract's dispute resolution procedures. The surety retained Parkcrest as its completion contractor. Ultimately, on June 29, 2016, HANO terminated the surety. The surety acknowledged the termination in a subsequent letter, but maintained the termination was wrongful.

Instead of following the contract's dispute-resolution procedures, which required that the parties try to resolve disagreements out of court, the surety intervened in the HANO-Parkcrest litigation. After a bench trial, the district court concluded that HANO breached the Takeover Agreement and the underlying contract by terminating the surety for convenience after the surety had substantially completed the project. The trial court awarded Liberty and Parkcrest damages and held they owed HANO nothing. The district court also held HANO liable to the surety for attorney's fees but did not quantify the award. In a separate opinion, the Fifth Circuit affirmed the district court's judgment against HANO, but refused to consider the award of attorney's fees because it lacked jurisdiction to do so. *Parkcrest Builders, LLC v. Liberty Mut. Ins. Co.*, 796 F. App'x 852 (5th Cir. 2020). The district court later quantified its fee award in favor of the surety in the amount of $526,192.25. HANO appealed. The court not only reviewed the amount of the award, but also the propriety of awarding fees. Because the surety did not comply with the contract's dispute resolution procedures, prior to filing suit, the

Fifth Circuit reversed and held that the surety "is entitled to nothing."

While the court observed that there was no dispute that HANO breached the Takeover Agreement by terminating the surety for convenience subsequent to the surety's substantial completion of the project, the underlying contract required that, prior to filing suit, the surety had to first file a dispute with HANO's Contracting Officer. The court held that surety's decision to file a complaint-in-intervention, prior to submitting the dispute to the Contracting Officer, was, itself, a breach of contract. The surety argued that HANO's initial, unjustified decision to terminate the surety excused the surety's subsequent non-compliance. The court rejected this argument because the dispute resolution provisions were meant to be binding even after a breach. Because the surety did not comply with the dispute resolution provisions of the contract, which were incorporated into the Takeover Agreement, the court held the surety was not entitled to attorney's fees, which the contract provided for in connection with a "properly presented claim."

<u>Obligee May Not Recover from Surety Under AIA A312 Performance Bond or Payment Bond for Work Performed by Contractor Hired by Obligee to Correct Principal's Work After Principal Completed Project, Was Paid in Full, and Was Not Terminated</u>

Prismatic Dev. Corp. v. Int'l Fid. Ins. Co., 2020 WL 596985 (N.Y. Sup. Ct. Feb 28, 2022).

Prismatic Development Corporation ("Prismatic") commenced this action demanding that the surety defend and indemnify Prismatic from claims asserted by a contractor retained by Prismatic, EIC Associates, Inc. ("EIC"), which allegedly had to work around or complete the bond principal's (Nacirema Environmental Services Company, Inc. ("Nacirema")) allegedly faulty work. Nacirema had previously finished its work, was paid without being terminated, and the construction project was long since complete. Prismatic asserted claims against both the performance and payment bonds, which were the industry-standard AIA Document A312 (1984 version).

With respect to the performance bond, Prismatic contended that Nacirema breached its contractual obligation to indemnify and defend Prismatic against the claims asserted by EIC arising out of Nacirema's work on the project. The surety argued for dismissal of Prismatic's performance bond claims on the grounds that Prismatic failed to comply with the conditions precedent set forth in paragraph 3 of the AIA A312 Performance Bond. Although Prismatic was aware of EIC's complaints while Nacirema was still performing its work, Prismatic did not: (i) provide the surety with notice that it was considering declaring a Contractor Default (as defined in the bond), (ii) declare a Contractor Default or formally terminate Nacirema's right to complete the contract, and/or (iii) offer to pay the balance of the Contract Price (as defined in the bond). Inasmuch as New York courts have repeatedly held that the conditions set forth in paragraph 3 are conditions precedent, the court found that the performance bond claim failed as a matter of law. In rendering its ruling, the court rejected Prismatic's argument that the conditions precedent were inapplicable to indemnification obligations, because paragraph 3 sets forth conditions precedent to *all* of the surety's obligations. The court was similarly unpersuaded by Prismatic's attempt to terminate Nacirema's contract nine years after Nacirema completed its work (and was paid by Prismatic) and six years after completion of the construction of the entire project.

The court also rejected Prismatic's claim under the payment bond. Prismatic argued that Paragraph 2.2 of the Payment Bond required the surety to defend, indemnify, and hold Prismatic "harmless from claims, demands, liens, or suits by any person or entity whose claim, demand, lien, or suit is for the payment for labor, materials, or equipment furnished for use in the performance of the Construction Contract". As such, Prismatic contended, the surety was obligated to compensate EIC for its additional costs incurred in performing work required under the Nacirema subcontract. The court rejected the claim because EIC's work was not in the performance of Nacirema's construction contract. The payment bond covers only work ordered or directed by Nacirema and there was no allegation that Nacirema asked EIC to perform any work. EIC's interrogatories stated that EIC

was direct by Prismatic to address Nacirema's prior defective performance. As such, citing to case law providing that an obligee may not recover damages from a surety under a payment bond, the court ruled that that the surety was not liable to Prismatic under the payment bond.

Supersedeas Bond Vacated Where Appellate Court Affirmed Judgment on Liability but Vacated Damages Award

Eshelman v. Puma Biotechnology, Inc., 2022 WL 989743 (E.D.N.C. Mar. 11, 2022).

A jury awarded plaintiff Eshelman $22.35 million in compensatory and punitive damages against Puma Biotechnology, Inc. ("Puma") for defamation. Puma appealed and provided a $29.5 million supersedeas bond to stay the judgment pending appeal. The United States Court of Appeals for the Fourth Circuit upheld the jury's liability verdict, vacated the jury's damages award, and remanded the case for a new trial on damages. Puma moved to release the bond, which Eshelman opposed. Puma also applied for allocation of costs associated with the supersedeas bond. Eshelman separately moved for disallowance of costs. In the interim, Eshelman filed a petition for a writ of certiorari to the United States Supreme Court, which was denied.

The supersedeas bond provided, in relevant part: "If [Puma] shall duly prosecute said appeal, and shall moreover pay the amount of said judgment rendered, then this obligation to be null and void, otherwise to remain in full force and effect…" The court interpreted the plain language of the bond as meaning that the bond is nullified when (a) Puma duly prosecutes its appeal and (2) Puma pays the amount of the judgment rendered on appeal. The parties dispute centered around whether the bond required Puma to prosecute its bond "to effect". The court held that it need not resolve whether the bond's language required Puma to prosecute its appeal "to effect" because under either reading the bond must be released. As a result of Puma's appeal, Puma had nothing left to pay of "the amount of said judgment rendered." Even if the bond required Puma to prosecute its appeal "to effect", Puma did so in securing the appellate court's judgment vacating the judgment. The Fourth Circuit's opinion targeted the sufficiency of the evidence supporting the jury's award of damages and did not merely remand the matter for a recalculation of damages. Because Eshelman must prove his damages on remand, there is no liability on the supersedeas bond.

Eshelman argued it would be inequitable to release the bond because Puma's allegedly weak financial position means Eshelman would be irreparably harmed if he obtains a second damages award and Puma is unable to pay it. The court rejected this argument because the supersedeas bond is meant to secure against the judgment-debtor's insolvency during the appellate process. As Puma's appeal was no longer pending and the damages award was vacated, there is no monetary award for the bond to insure – the bond served its purposes. The court denied the parties' respective motions on allocation of costs because neither party clearly prevailed on appeal.

Federal Court in Nevada Anomalously Holds Surety Liable Under Miller Act Where Same Court Found Claimant to Have Materially Breached Subcontract and That Principal Was Excused from Having to Pay Claimant!

United States ex rel. Source Helicopters, Division of Rogers Helicopters, Inc. v. Sayers Constr., LLC, 2022 WL 772935 (D. Nev. Mar. 14, 2022).

Source Helicopters, Division of Rogers Helicopters ("Rogers") entered into a subcontract with Sayers Construction, LLC ("Sayers") for Rogers to perform work for Sayers on a government electrical construction project (the "Project"). The subcontract contained a time is of the essence clause and a progress schedule that set forth mobilization and completion dates. Rogers failed to meet both deadlines. After completing its work, Rogers submitted five invoices to Sayers. Sayers refused to remit payment because Rogers completed its work after the agreed upon dates. Rogers commenced suit against Sayers for breach of contract and against Sayers and its surety under the Miller Act. Sayers answered the complaint and asserted counterclaims for fraudulent inducement, fraud, and breach of contract. The parties filed cross-motions for summary judgment.

With respect to the breach of contract claims, the court held that Rogers materially breached the contract by failing to complete the contract within the time set forth in the subcontract. Although there was a dispute as to the materiality of the breach, the court found that the time is of the essence clause rendered the delay to be a material breach. Rogers was unable to provide any evidence or documents (e.g., change orders) demonstrating that the deadlines set forth in the contract were extended. As such, the court entered summary judgment in favor of Sayers on the issue of breach and found that Sayers was excused from performance (i.e., the obligation to pay Rogers). The court denied Rogers' motion for summary judgment with respect to the damages Sayers incurred as a result of the loss. While the subcontract contained a consequential damages waiver, the court held that damages, such as lost profit and overhead, are direct and thus recoverable. The amount of damages to which Sayers would be entitled was an issue to be determined at trial.

The casual reader would expect that the court would have entered an order correspondingly dismissing Rogers' Miller Act claims against Sayers' surety because the surety's liability is co-extensive with that of its principal. That did not happen here. Instead, the court denied Sayers' motion for summary judgment and *granted* Rogers' motion for summary judgment on the Miller Act claim! Rogers argued that is satisfied all elements of the Miller Act because it: (i) supplied labor and materials in the prosecution of the work provided for in the subcontract, (ii) has not been paid for some of its labor and materials, (iii) had a good faith belief that the labor and materials were intended for the project, and (iv) met the jurisdictional requisites of timely notice and filing of the action. Sayers and its surety argued that a principal or surety is liable under the Miller Act only to the extent the principal is liable on the underlying subcontract. The court disagreed and held Rogers was entitled to its unpaid costs associated with the labor and materials provided for the project.

In rendering this anomalous ruling, the court cited to cases addressing the remedial nature of the Miller Act and urging a liberal construction to effectuate payment of those who provide labor and material for public projects. The court also, without analysis, cited to case law providing that where contract terms affect the timing of recovery under the Miller Act, enforcement of such terms to preclude Miller Act liability contradict the express terms of the Miller Act. Acknowledging that the Ninth Circuit had not expressly decided the issue of whether a subcontractor can recover for labor and materials under the Miller Act when it caused the delayed performance, the court held that "the express terms of the Miller Act do not preclude recovery of labor and material costs incurred by a subcontractor whose materials and labor are adequate in all aspects other than timeliness." In rendering this misguided ruling, the court appears to have misapprehended the nature of the time is of the essence provision. The provision did not seek to affect Rogers' rights under the Miller Act. The provision went to the benefit of the bargain. Sayers bought a subcontract that provided for work to be performed by a date certain. The court found that Rogers materially breached the contract and Sayers was not obligated to pay Rogers. Yet, at the same time, the Court held that the surety – a secondary obligor – should pay for labor and materials that the Court separately decided were not furnished in compliance with the express terms of the bonded subcontract. Subsequent to the entry of this decision, the surety filed a motion asking the court to reconsider its decision. No ruling has yet been issued in connection with the motion.

FIDELITY CASENOTES

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

New Jersey State Court Refuses to Apply War Exclusion to Ransomware Claim

Merck & Co., Inc., et al. v. Ace Am. Ins. Co., 2022 WL 1200682 (N.J. Super. Ct. Law Div. Dec. 6, 2021).

In this matter, it was undisputed that malware affected the insured's computers in its offices worldwide. Specifically, the insured alleged that the damage caused by the malware spread to 40,000 computers resulting in alleged losses of over $1,400,000,000.00. The insured and its captive (a co-plaintiff) had purchased $1,750,000,000.00 in property insurance to allegedly protect against this type of loss. The coverage, referred to as "all risk" by the court, protected the insured for damage resulting from, generally, the destruction or corruption of computer data and software. According to the court, none of these facts were in dispute. While the opinion does not provide an exact procedural history, it seems clear that the carrier denied the claim in whole or in part based on a war exclusion in the coverage. The insured commenced litigation, and the court faced dueling motions for partial summary judgment on this issue.

On summary judgment, the carrier argued that the malware was a tool of the Russian Federation used as part of its ongoing hostilities with Ukraine. Obviously, the insured disagreed that the malware derived from the Russian Federation and was used as part of its war efforts. The insured argued not that there were disputed material facts precluding summary judgment; rather, that there were undisputed facts showing that the ransomware was not a part of state action, and even if it was, that it was not instigated by Russia in its efforts with regard to Ukraine. After considering the arguments, the court sided with the insured.

The court's opinion largely contains citations to cases regarding the interpretation of insurance policies, how two different interpretations does not create an ambiguity, how the burden of proof with respect to exclusions falls to the carrier and generally how exclusions are interpreted by courts. The substantive focus of the court centered on the phrase "hostile and warlike action." The court agreed with the insured that warlike can only be interpreted as "like war," citing the Oxford English Dictionary. That dictionary defined hostile, in part, as "pertaining to, or characteristic of an enemy, pertaining to or engaged in actual hostilities." With that in mind, the insured argued the reasonable understanding of this exclusion involves the use of armed forces. As noted above, the court agreed, citing to several cases in New Jersey and around the country. Of note, a 1953 New Jersey state court case made the distinction that the term "war" "should not be construed on a public or political basis," but instead should be construed by its plain and ordinary meaning, i.e., actual hostilities between two opposed armed forces and only those of sovereign entities. The overarching theory of all of the cases was the covered peril was not excluded unless the warlike activities and hostilities between opposed armed forces "proximately" caused the loss.

With that backdrop, the court "unhesitatingly" held that the exclusion did not apply in this case. Here, the court noted the ubiquitous nature of cyber attacks at this point, both from private sources and even those funded by sovereign entities. It was the cyber nature of the loss that seemed to steer the court away from the application of the exclusion, noting that while

it seems common knowledge at this point that ransomware and cyber attacks occur with regularity, the carrier "did nothing to change the language of the exemption to put this insured on notice that it intended to exclude cyber attacks." Without a change in the traditional war exclusion language, the court found that it was reasonable for the insured to expect coverage and that the exclusion would only apply to "traditional forms of warfare." On this basis, the court awarded partial summary judgment to the insured and denied the carrier's efforts to apply the war exclusion.

Fifth Circuit Affirms Decision Concerning Ownership of Property Condition as to Client Funds

Realpage, Inc. v. Nat'l Union Fire Ins. Co. of Pitt., Pa., 21 F.4th 294 (5th Cir. 2021).

The district court's prior decisions (*Realpage Inc. v. Nat'l Union Fire Ins. Co. of Pitt., PA*, 2020 WL 1550798 (N.D. Tex. Apr. 1, 2020) and 2021 WL 718366 (N.D. Tex. Feb. 24, 2021)) are discussed in the September 2020 and May 2021 Newsletters. Please refer to those newsletters for a more fulsome recitation of all relevant facts and discussion of the lower court's holdings. In short, the case arises out of a phishing incident, where bad actors misappropriated login information to the insured's payment processor. The bad actors used these stolen credentials to divert over $10,000,000.00. After a large recovery, the insured was left with an alleged loss of approximately $6,000,000.00. The carrier denied coverage for the loss, in part, contending that the insured did not hold the funds, as required by the policy's ownership of property condition. With respect to client funds at the insured's payment processor, the district court agreed with the carrier that the funds did not fall within the policy's ownership of property provision, i.e., the insured did not own or hold the funds. On appeal, the Fifth Circuit affirmed.

On appeal of an award of summary judgment, the Fifth Circuit reviewed the matter *de novo*. The case boiled down to whether the client funds at issue were being held by the insured, as the insured did not contend that it owned or leased the funds (the carrier had covered funds held by the payment processor that were fees due to the insured, as it determined that those funds were owned by the insured). In interpreting the word "hold," the court turned to Black's Law Dictionary. In so doing, the court determined that "hold" can only be reasonably interpreted to mean "to keep in custody or under an obligation" or "to possess or occupy." As the court noted, neither of these definitions favored the insured.

Here, the insured did not contend that it ever had possession of the funds at issue. It appears the undisputed facts bear this out. Beyond providing the payment processor's information to its clients, the insured had no further involvement and never "touched" the funds. Under these facts, the court found, the insured could never have "held" the funds. It appears the insured's main argument focused on the notion of control as a way to circumvent the plain and ordinary meaning of "hold." The court did not agree, as it rejected the insured's efforts to use a collection of dictionary definitions to create the needed ambiguity to stretch the definition of "hold." In fact, the court went on to state that even if it adopted the control theory espoused by the insured, the funds remained uncovered. Given the nature of the transactions, it appears that the insured never controlled the funds at issue either, let alone held them. For example, in the agreement between the insured and the payment processor, all of the client funds, deposited into the payment processor's bank accounts, were controlled by the payment processor. The insured had no rights to those accounts and could not draw on those funds, as the payment processor reserved the right to impose these and other conditions on the funds by agreement. As a result, the Fifth Circuit affirmed the district court's decision, and upheld the carrier's denial of the claim on the bases of the ownership of property provision.

Ninth Circuit Reverses District Court and Finds Coverage for Social Engineering Fraud Loss Under Computer Fraud and Funds Transfer Fraud Coverages

Ernst and Haas Mgmt. Co., Inc. v. Hiscox, Inc., 23 F.4th 1195 (9th Cir. 2022).

The district court's decision (*Ernst & Haas Mgmt. Co., Inc. v. Hiscox, Inc.*, 2020 WL 6789095 (C.D. Cal. Nov. 18. 2020) is discussed in the May 2021 Newsletter. Please refer to that newsletter for a more fulsome recitation of all relevant facts and discussion of the lower court's holding. In short, in 2019, an employee of the insured received an email purporting to be from another employee directing a payment. The employee, unaware that a bad actor was impersonating the other employee, mistook the email as authentic and made multiple transfers totaling $200,000.00. The employee learned of the fraud when she attempted to verify a request to transfer another $470,000.00. By that time, the bad actor had absconded with the previously transferred $200,000.00. The insured submitted the claim to the carrier, which denied the claim, determining that neither the computer fraud nor funds transfer fraud coverage applied. The parties disputed whether the 2012 or the 2019 policy language applied; however, the district court decided the matter in favor of the carrier on the 2012 language. This appeal followed where the court made its determination solely on the language in the 2012 policy. On appeal, the court agreed with the insured, reversed and remanded the matter consistent with its decision.

As a threshold matter, the court held that the district court misconstrued the policy's computer fraud provision, noting that the district court misinterpreted and misapplied *Pestmaster Servs., Inc. v. Travelers Cas. & Sur. Co. of Am.*, 656 F. App'x 332 (9th Cir. 2016); *Pestmaster Servs., Inc. v. Travelers Cas. & Sur. Co. of Am.*, No. CV 13-5039-JFW, 2014 WL 3844627 (C.D. Cal. July 17, 2014). The court drew a factual distinction between *Pestmaster*, which involved theft by a payment processor, and the present matter where an employee of the insured received a series of fraudulent emails with fraudulent payment instructions. In this sense, the court held that the transfer of funds in each instance was not analogous, as the authorization in this matter was fraudulent and "initiating a wire transfer is not the same as authorizing a payment." The court focused on the fraudulent nature of the transfer request in this case to find that the transfer of funds was not authorized like it was in *Pestmaster*. In making this holding, the court labeled *Pestmaster* as "non-binding" and "distinguishable."

As to computer fraud coverage specifically, the court refused to interpret the coverage like the court in *Pestmaster*, finding it was not limited to instances of unauthorized use of the insured's computers or hacking. In doing so, the court heavily relied on *Am. Tooling Center, Inc., v. Travelers Cas. & Sur. Co. of Am.*, 895 F.3d 455 (6th Cir. 2018). The court appeared to adopt a broader interpretation of the word "direct" than previously adopted in the Ninth Circuit, notably in *Pestmaster*. For the court, it was important to note that the insured suffered its direct loss when it wired the funds as a result of the fraudulent email, finding no intervening event. In essence, the court found coverage under the computer fraud insuring agreement where an employee was defrauded and induced into following fraudulent wire instructions without any nefarious activity by the bad actor directly on or in the computer system.

With respect to coverage under the funds transfer fraud insuring agreement, the court also found coverage. The 2012 version of this insuring agreement provided coverage where there was a fraudulent instruction (defined in the policy) "directing a financial institution" to make a transfer. The policy defined fraudulent instruction to not only include when the bad actor impersonated the insured and directed a bank to transfer funds, but also where there was "an electronic instruction initially received by [the insured] which purports to have been transmitted by an Employee but which was in fact fraudulently transmitted by someone else without [the insured's] or the Employee's knowledge or consent." Relying heavily on *Principle Solutions Group, LLC v. Ironshore Indemnity*, 944 F.3d 886 (11th Cir. 2019) and on this "third definition" in the definition of fraudulent instruction, the court found coverage. The carrier argued that because the bad actor's emails went to the insured, and not the bank, there could not be coverage. On the other hand, the insured argued that, given the definition of fraudulent

instruction, loss flowing from the bad actor's emails to the insured were included in the coverage, and that the transfer was the "direct result of the insured having been duped" by the same. As noted above, the court agreed with the insured, finding that the sole purpose of the email was to direct the insured's bank to make the transfer, and such emails (where the bad actor directs the insured to direct the bank) were specifically included in the definition of fraudulent instruction. According to the court, any other interpretation of these facts as applied to the 2012 policy would render the "third definition" of fraudulent instruction, "which anticipates an instruction sent to the insured *before* the bank … superfluous." (Emphasis in original).

Virginia Federal Court Applies Exclusion Limiting Coverage to Employee Theft Insuring Agreement

Heartland Constr., Inc. v. Travelers Cas. & Sur. Co. of Am., 2022 WL 391308 (E.D. Va. Feb. 8, 2022).

This matter involves a dispute between a general contractor and one of its subcontractors, the insured. Here, the two entities entered into a firm fixed price subcontract under which the general contractor was to pay over $5,000,000.00 to the subcontractor. However, within a year of entering into the contract, the president of the subcontractor allegedly changed the contract to a "cost-type" contract, purportedly without any consent or knowledge from or of anyone else. Thereafter, the fidelity principal allegedly removed the original contract from the insured's computer system and destroyed it, replacing it with the one he had created. As a result of these actions, the insured claimed a loss of almost $900,000.00.

The insured submitted the matter to the carrier for coverage, eventually commencing the litigation after the carrier denied the claim. In the complaint, the insured sought coverage under four insuring agreements: (1) employee theft; (2) forgery or alteration; (3) on premises; and (4) computer fraud. The carrier moved to partially dismiss the complaint, arguing that the policy has an exclusion that limits any potential coverage for any claim involving the bad acts of an employee to, in this instance, just the employee theft insuring agreement. The court agreed with the carrier.

While the insured sought coverage under a swath of insuring agreements in the policy, the carrier argued for the applicability of an exclusion that precluded coverage for loss "resulting directly or indirectly from any fraudulent, dishonest or criminal committed by any employee … unless covered" under a series of enumerated inuring agreements, including the employee theft insuring agreement. In essence, the exclusion funnels any loss directly caused by the bad acts of employees. While the insured did not directly argue that the exclusion presented an ambiguity, it nonetheless asked the court to rule in its favor based on the use of the word "unless." The insured's argument was essentially that the use of the word "unless" meant that if there was coverage under one of the insuring agreements enumerated in the exclusion that it unlocked the rest of the insuring agreements in the policy to cover any such loss. Stated another way, the insured argued that if it could show that the loss was covered under one of the insuring agreements in the exclusion that it meant that all coverages applied, notwithstanding the plain and unambiguous language of the exclusion.

Again, while the court noted that the insured did not directly argue that the exclusion was ambiguous, it did argue that the exclusion meant something completely different from what the carrier stated. After reviewing the language, the court sided with the carrier, holding that the insured's interpretation was "unreasonable." The court noted that if the insured's interpretation was correct, the exclusion would not actually be an exclusion, but a provision providing a condition precedent to coverage under any of the insuring agreements in the policy. Here, on its face, the complaint alleged that an employee committed unlawful, dishonest and criminal actions. These allegations pulled the matter directly within the relevant exclusion. As a result, the court granted the carrier's partial motion to dismiss the claim for coverage under the forgery or alteration, on premises, and computer fraud insuring agreements, as they were not included in the enumerated list of the relevant exclusion.

Fifth Circuit Affirms District Court After Supreme Court of Texas Answers Certified Questions on Application of "Consequent Upon" in a Policy Exclusion and Concurrent Cause Law in Texas

Dillon Gage, Inc. of Dallas v. Certain Underwriters at Lloyds Subscribing to Policy No. EE1701590, 26 F.4th 323 (5th Cir. 2022).

The prior district court and Fifth Circuit's decisions (*Dillon Gage, Inc. of Dallas v. Certain Underwriters at Lloyds Subscribing to Policy No. EE1701590*, 440 F.Supp.3d 587 (N.D. Tex. 2020) and 992 F.3d 401 (5th Cir. 2021)) are discussed in the September 2021 Newsletter. Please refer to that newsletter for a more fulsome recitation of all relevant facts and discussion. In short, the insured suffered a multi-million dollar loss when it sent gold coins to a thief who forged checks and intercepted shipments as part of the scheme. The insured sought coverage for its loss, and the carrier issued a denial on the claim, arguing that an exclusion was applicable. The exclusion precluded coverage for loss incurred "consequent upon" turning the insured's property over to a third-party against payment by a fraudulent check. The actual procedural history of the matter involved competing motions for summary judgment at the district court, where the insured essentially sought a proximate cause holding (that the loss occurred as a result of the interception of the shipments, not the checks), while the carrier relied on the exclusion. The district court found for the carrier. On appeal, the Fifth Circuit determined that the insured had raised open questions under Texas law, and certified those to the Supreme Court of Texas. In response, the Supreme Court of Texas concluded that the exclusion applied, precluding coverage. As a result, the Fifth Circuit affirmed the district court.

The entire matter centered around the interpretation of the phrase "consequent upon" in the exclusion. The essential question was whether this phrase espoused a causation more proximate in nature or, rather, whether it was to be interpreted more narrowly. Per the Supreme Court of Texas, the phrase provides for "but-for causation." As a result, that court answered one of the Fifth Circuit's certified questions by finding that indeed the insured's losses were sustained consequent upon the insured's receipt of a check which led the insured to ship the goods. The second question certified to the Supreme Court of Texas again dealt with causation, asking whether the shipping carrier's alleged errors (being duped by the bad actor(s)) were "independent cause[s]" of the loss. The Supreme Court of Texas answered this second certified question in the negative, finding that the shipping carrier's negligence was a concurrent cause of the loss, again dependent on the insured accepting the fraudulent checks. As a result, the Fifth Circuit affirmed the district court, finding that the exclusion applied to preclude coverage. In addition, without a viable underlying claim, the court also affirmed the district court's decision to dismiss the extra-contractual claims.

Alaskan Federal Court Sides With Insured on Coverage for Social Engineering Loss Under a Computer Fraud Insuring Agreement

City of Unalaska v. Nat'l Union Fire Ins. Co., 2022 WL 826501 (D. Alaska Mar. 18, 2022).

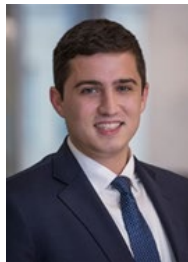
This matter stems from a common social engineering fraud fact pattern. In April 2019, an accounts payable employee at the insured received an email from what seemed like an existing vendor. The email requested a copy of the insured's form used to change payment instructions on invoices. After sending the form to the purported vendor, the bad actor returned the same which altered the normal process for sending/receiving payment from checks to electronic ACH transfers. In doing so, the bad actor sought to divert all future payments. After processing the requests internally, the insured sent almost $3,000,000.00 over the next two months pursuant to the fraudulent banking instructions. After discovering the fraud, the insured was able to recover most of its loss working with the FBI. Having reduced its loss to $637,861.67, the insured sought coverage from its carrier. The carrier accepted coverage, and paid $100,000.00 under the impersonation fraud coverage that, by endorsement, covers social engineering schemes involving impersonated vendors. The insured demanded that the carrier cover the balance of the loss under the policy's computer fraud coverage. The carrier denied coverage, arguing that the loss did not directly involve the use of a computer to fraudulently

cause the transfer, essentially tracking the insuring agreement's language. Thereafter, the insured filed suit.

The carried moved for a judgment on the pleadings, while the insured moved for summary judgment. Sitting in diversity, the court looked to Alaskan law. When interpreting an insurance policy, Alaskan law called for an examination of, among other things, whether the insured's expectations of coverage were "objectively reasonable." The carrier argued that a reasonable insured would not expect coverage under the computer fraud insuring agreement because a fair reading of the insuring agreement reveals that it intends to cover essentially hacking-type situations, and here, the emails with the fraudster were incidental to the loss, rather than its direct cause. On this latter point, the carrier noted the even if someone's use of a computer led to this loss, that use was far too proximate and not a direct cause of the loss evidenced by the myriad intervening events, particularly those at the insured concerning effectuating the actual transfers, as well as the passage of time. The insured countered these arguments by stating that its "reasonable expectation" of coverage comes from the alleged ordinary meaning of the phase "use of any computer" in the insuring agreement. The insured argued that the insuring agreement did not limit coverage to hacking-type scenarios, noting the carrier could have (and had in other situations) chosen to word the policy in a different manner if that was what actually was intended. The insured also argued that the phrase "resulting directly from" should be interpreted far more broadly than what the carrier contended, basically calling for a proximate cause holding.

Faced with a matter of first impression in Alaska, the court turned to the nationwide line of cases where insureds have sought coverage for social engineering losses under computer fraud insuring agreements. Having review the law from other jurisdictions, the court sided with the insured. With the legal landscape as its backdrop, the court determined that a "reasonable insured" would expect the computer fraud coverage to provide coverage. In what seems like an oversimplification, the court held the insured "experienced a loss of money resulting directly from the fraudster's use of a computer – sending an email impersonating the [insured's] vendor – to fraudulently cause a transfer of funds from the [insured] to the fraudster's bank account." In order to arrive at this holding the court applied what it thought was a reasonable expectations test, and rejected the notion that computer fraud coverage insured against losses directly stemming from hacking-type events. The court also had to adopt a broad proximate cause standard, as there were many intervening events between the fraudster's actions and the actual transfer of the funds at issue. Of note, the court even admitted the word "directly may connote immediacy when read in isolation;" however, a "reasonable insured would consider the phrase 'resulting directly from' to convey the concept of proximate cause." Given the foregoing, the court entered judgment in favor of the insured.

LEGISLATIVE UPDATE



By: Matthew Vece, Associate Counsel, American Property Casualty Insurance Association, Washington, D.C.

State legislative sessions are in full swing. 46 states and DC have now held legislative sessions in 2022, and regular legislative sessions will have already concluded for the year in 24

states by the end of April. Several states have recently enacted surety legislation. A sampling of those bills is provided below, followed by a federal regulatory update.

Florida

Consumer Finance License Bonds

Florida amended its Consumer Finance Act to allow a licensee or an applicant for a license to make and collect consumer finance loans to provide a surety bond of at least $25,000.[74] Previously, licensees or applicants were required to provide evidence of liquid assets of at least $25,000. This legislation allows the use of surety bonds in lieu of the liquid asset requirement.

New Jersey

Postconsumer Recycled Content Penalties

New Jersey enacted legislation to impose recycled content requirements for plastic containers, glass containers, paper carryout bags, reusable carryout bags made of plastic film, and plastic trash bags, and to prohibit the sale of polystyrene loose fill packaging. Violators are subject to a civil administrative penalty of up to $25,000, and the penalty "may be compromised by the department upon the posting of a performance bond by the violator, or upon terms and conditions the department may establish by rule or regulation."[75]

Virginia

Bid Bonds

Virginia amended its bid bond requirements by mandating that, except in cases of emergency, all bids and proposals for transportation-related contracts in excess of $350,000 and partially or wholly funded by the Commonwealth must be accompanied by a bid bond.[76] Prior law set the bid or proposal amount for such contracts at $250,000.

Performance and Payment Bonds

Virginia amended its little Miller act to require a performance bond and payment bond to be furnished by the contractor for all non-transportation-related public construction contracts that exceed $500,000 and all transportation-related projects that exceed $350,000 and are partially or wholly funded by the Commonwealth.[77] Prior law only required these bonds for certain types of contracts.

West Virginia

Mining Mutual Insurance Company

West Virginia authorized the creation of a Mining Mutual Insurance Company.[78] The purpose of the new mutual insurance company is to sell, and increase the availability of, reclamation bonds. The Mining Mutual Insurance Company will be seeded with $50 million in state funding.

DOT Regulatory Authority

West Virginia granted the state's Department of Transportation Division of Highways with the authority to set bond amounts on highway contracts up 110 percent of the contract price.[79]

Federal

The U.S. Treasury Department's Bureau of the Fiscal Service is proposing significant updates to its regulations governing the federal surety bond program for surety companies doing business with the United States.[80] The proposed amendments add two new categories of reinsurers that would be eligible for recognition by Treasury.

[74] Fla Stat. § 516.05 (S.B. 546; effective Oct. 1, 2022).
[75] N.J. Stat. Ann. § 13:1E-99.150 (S.B. 2515; effective Jan. 18, 2022).
[76] Va. Code Ann. § 2.2-4336 (S.B. 258; effective July 1, 2022).
[77] Va. Code Ann. § 2.2-4337 (S.B. 259; effective July 1, 2022).
[78] W. Va. Code §§ 33-61-1, et seq. (S.B. 1; effective Mar. 12, 2022).
[79] W. Va. Code § 17-4-20 (S.B. 611; effective June 10, 2022).
[80] 31 C.F.R. § 223.

The first category is complementary reinsurers. Complementary reinsurers must be based in a non-U.S. jurisdiction that is subject to an in-force covered agreement addressing the elimination of collateral requirements (currently the EU and UK are subject to covered agreements). Treasury-certified sureties ceding reinsurance to companies that are recognized as complementary reinsurers would receive credit for the ceded reinsurance without it being secured by collateral.

The second category is alien reinsurers, which must be based in a non-U.S. jurisdiction that the National Association of Insurance Commissioners (NAIC) recognizes as a "qualified jurisdiction" or a "reciprocal jurisdiction" that is not party to an in-force covered agreement. Certified sureties ceding reinsurance to companies that qualify as alien reinsurers would be eligible to receive credit for the ceded reinsurance to the extent allowed by the ceding company's state of domicile.

In addition to receiving credit for reinsurance ceded to complementary or alien reinsurers, certified sureties would be able to rely on complementary reinsurers or alien reinsurers to reinsure excess risks not running to the United States.

Treasury is accepting comments on the Notice of Proposed Rulemaking until May 2, 2022.

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