SURETY TODAY PRESENTATION
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<u>A 2019 Surety Case Law Review</u>

Our topic today is "A 2019 Surety Case Law Review." We have gone back over the last half of 2019 and gathered some cases that we think are worthy of review and comment. The pickings were slim; there just were not very many juicy cases the last half of 2019 that we have not already discussed in prior episodes. Today we will talk about surety trust fund provision in the GAI vs. the Bank and contract funds swept from the bank account; waiver and release provisions in payment applications and change orders; illegal subcontracts as a surety defense and other topics. I will get us started today by discussing an update to an issue we discussed last month.

<u>Bankruptcy Plan Release and Injunction Provisions Revisited</u> (Mike)

As you will recall, last month George and I discussed *The Surety and Chapter 11 Bankruptcy Plan Release and Injunction Provisions.* In the course of the presentation I discussed a topic I called *The Cautionary Tale!* In that topic I discussed the case of *In re Kimbell Hill, Inc.*, 565 B.R. 878 (Bankr. N.D. Ill. 2017). The point of the discussion was to convey that a surety needs to be vigilant about complying with bankruptcy plan releases and injunctions because the penalties can be huge. In *Kimbell Hill* the surety was found liable for breaching the confirmed Chapter 11 Plan's release and injunction provisions and was ordered to pay over $9.5 million in damages. There were multiple decisions regarding the matter, the issue of liability was bifurcated from damages and the facts were long and complicated. I will not rehash the facts and procedural history of those cases again here. Suffice it to say that the *Kimbell Hill* Bankruptcy Court found that the surety's actions in the case violated the release and injunction provisions and the court held the surety in contempt. One of the things that was unusual about the case, aside from the huge damage award, was the really remote nature of the alleged violation. The debtor, Kimball Hill, was a subdivision developer and at the time of its bankruptcy it owned several properties that were bonded which it was in the middle of developing. The plan of reorganization created a trust into which the subdivision property was transferred. The Trust later sold the bonded subdivisions to and entity named JNI, LLC. JNI, then sold the bonded properties to an entity known as TRG. Thus, the property was transferred three times and yet the Plan injunction and release provisions were still held to be applicable.

After our presentation in December we discovered that the Bankruptcy Court's decision and damage award had been vacated and remanded on appeal by the District Court in October 2019. The District Court opinion was not linked to the *Kimball Hill* case in the on-line database in Westlaw, so shepardizing *Kimball Hill* did not reference the District Court opinion. We only found it because George was looking at the SFAA blurbs in preparing for this episode. In any event we now need to look at why the court vacated and remanded the Bankruptcy Court opinion.

The District Court case is styled - *Fidelity & Deposit Company of Maryland v. TRG Venture Two, LLC*, 2019 WL 5208853 (N.D. Ill. Oct. 16, 2019). In the appeal, F&D raised a number of grounds for reversal of the Bankruptcy Court ruling. F&D contended that the Bankruptcy Court lacked subject matter jurisdiction to consider the underlying motion, that the Bankruptcy Court should have abstained from considering the motion out of concerns of comity with the underlying state court proceedings that were pending involving F&D and TRG and F&D also challenged whether the Plan and release covered TRG and F&D's claims in the underlying state court proceedings. The District Court rejected all of F&D substantive arguments on appeal.

So how did the case get vacated? The final ground for appeal raised by F&D was that the Bankruptcy Court applied the wrong legal standard in holding F&D in contempt. The Bankruptcy Court held that a party may be found in contempt if they willfully violated the injunction and that such standard is met if the party: (1) had knowledge of the injunction and (2) intended the action which violated the injunction. However, this past Summer, in June 2019, the Supreme Court issued a decision holding that a court may not find a creditor in civil contempt for violating a discharge order if the creditor had a "fair ground of doubt" as to whether its conduct might be lawful under the discharge order. The District Court could not determine if the Bankruptcy Court's finding of contempt against F&D would satisfy the Supreme Court's new standard and therefore vacated the Bankruptcy Court's ruling and remanded the case for further proceedings to consider the new standard.

In order to understand this new contempt standard we must consider the Supreme Court case of *Taggart v. Lorenzen*, 139 S.Ct. 1795 (2019), which set the new standard. The *Taggart* case did not involve a plan release and injunction, rather it involved a "discharge order" of a Chapter 7 debtor. The discharge order releases the debtor from all liabilities and bars creditors from attempting to collect debts covered by the order. Thus, the discharge order functions in the same manner as a plan release and injunction. In *Taggart*, the debtor was being sued by several parties when he filed a Chapter 7 bankruptcy. In the normal course, the bankruptcy court issued a discharge order of the debtor, which barred the parties in the prepetition litigation from continuing to pursue the debtor. However, the litigation continued and various actions were taken involving the debtor after the discharge order was entered. The parties in the litigation contended that the debtor had "rejoined the fray" after his discharge and that such action was an exception to the discharge order.

The bankruptcy court in *Taggart* applied the same contempt standard that the F&D Bankruptcy Court applied, which the Supreme Court characterized as the "strict liability" standard. The Ninth Circuit in *Taggart* applied a more lenient subjective "good faith belief standard." The Supreme Court rejected both standards and held that "a court may hold a creditor in civil contempt for violating a discharge order if there is no fair ground of doubt as to whether the order barred the creditor's conduct." The Court clarified "in other words, civil contempt may be appropriate if there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful." The Court observed that its standard reflects the fact that civil contempt is a "severe remedy" and basic concepts of fairness require that those enjoined receive explicit notice of what conduct is outlawed before being held in contempt. The Court concluded that in its view the "standard strikes a careful balance between the interests of creditors and debtors that the Bankruptcy Code often seeks to achieve."

The new standard, as worded, sounds rather nebulous to me and will be guided by objective reasonableness considerations, which will vary on a case by case basis. So, we will need to wait for the Supreme Court and lower courts to flesh out the boundaries of this new standard before we can affirmatively say what is and what is not contempt in bankruptcy. For now, however, F&D has a reprieve from the prior rulings while the Bankruptcy Court determines if the new standard changes its view of its contempt ruling.

<u>The Surety GIA Trust Fund Provision vs. The Bank</u> (George)

In *Guarantee Company of North America v. Associated Bank*,[1] out of the U.S. District Court in Minnesota, the surety claimed superior rights against a secured lender bank to earned and paid bonded contract funds that the principal deposited into the principal's account at the bank by asserting the surety's indemnity agreement trust fund provision rights. Factually, the progression went as follows:

1. In 2013, the principal executed an indemnity agreement with the surety.
2. The surety then issued numerous bonds for the principal in favor of various obligees.
3. In 2014, the bank loaned money to the principal and the principal opened an Account at the bank to receive contract funds paid to the principal.
4. The bank obtained a perfected security interest in the principal's assets, including contract receivables, and in the Account.
5. When the principal received payments from project owners, it deposited the payments into the Account.
6. From November 1 through December 14, 2016, the principal deposited over $2,300,000 of contract funds from contracts bonded by the surety (the "Bonded Contract Funds") into the Account, over $975,000 of which were swept by the bank to reduce the principal's obligations to the bank under the loans.
7. During 2017, the surety paid performance and payment bond claims with the net losses exceeding $2,300,000.
8. In September of 2017, the surety sued the bank for conversion of the Bonded Contract Funds swept from the Account.

The surety's theory was that it had superior rights as against the bank to the "converted" Bonded Contract Funds in the amount of $975,000 from the Account because the Bonded Contract Funds were trust funds under the indemnity agreement. The indemnity agreement provided that the Bonded Contract Funds were held in trust by the principal for the benefit of its subcontractors and suppliers and for the benefit of the surety to the extent that the surety paid those subcontractors and suppliers. The court reviewed the elements of common law conversion, which required the surety to have an "enforceable interest" in the Bonded Contract Funds in the principal's Account at the bank. The court then reviewed the elements for both the establishment of a statutory and a common law express trust under Minnesota law, and granted the bank's

[1] 2019 WL 489717 (D. Minn., August 8, 2019).

motion for summary judgment dismissing the surety's conversion claim based upon the following reasoning.

The establishment of a valid trust is dependent upon state law and whether the trust complies with the state's elements for creating a trust. In Minnesota, there are both statutory and common law requirements to establish an express trust. The court found that no trust was established by the indemnity agreement trust fund provision in the Bonded Contract Funds deposited into the Account for two reasons.

1. First, when the principal executed the indemnity agreement in 2013, the trust fund provision did not sufficiently identify as trust property the Bonded Contract Funds the principal expected to receive in the future from obligees, namely the Bonded Contract Funds deposited into the Account in 2016.

2. Second, the surety did not provide any further "manifestation of intent" or evidence to the bank of the principal's or the surety's intention to impose a trust on the Bonded Contract Funds deposited into the Account in 2016. The bank first received a copy of the indemnity agreement trust fund provision in 2017 <u>after</u> the principal's 2016 deposit to and the bank's sweep from the Account of the "allegedly converted" Bonded Contract Funds.

Furthermore, the court found that the principal's conduct after the execution of the indemnity agreement was inconsistent with the establishment of an express trust in the Bonded Contract Funds.

1. First, the principal merely endorsed each check for payment of the Bonded Contract Funds as if they were the principal's property and deposited them into the Account.

2. Second, the principal commingled the alleged Bonded Contract Funds with non-trust funds in the Account. There was no segregation of Bonded Contract Funds from other funds in the Account.

3. Third, none of the principal's financial records referred to the existence of the indemnity agreement creation of a trust fund in the Bonded Contract Funds.

Finally, the court stated that the surety's conduct was inconsistent with the establishment or existence of a trust because the surety never took action or required the principal to set up a separate trust bank account for the Bonded Contract Funds only as provided in the indemnity agreement trust fund provision.

Based upon the above, the court found that the surety could not establish the existence of a trust in the Bonded Contract Funds deposited into the principal's Account, and the bank prevailed.

It appears from the opinion that the surety made all of the possible arguments to support its position, but I am not surprised by the court's decision. I have written or edited two books – The Surety's Indemnity Agreement – Law & Practice, 2d Ed. and The Contract Bond Surety's Subrogation Rights – and have anticipated such a surety argument based upon the surety's indemnity agreement trust fund provision might be made, but this is the first case that I remember when a surety raised the argument so clearly and as its only argument.

The Indemnity Agreement book has a section on the indemnity agreement's trust fund provision, and cites to many cases in various jurisdictions about whether that provision creates a valid trust under state law. However, there are no citations to cases that are factually like the present case.

The Subrogation book does discuss the performance and payment bond surety's claims against a bank receiving bonded contract funds deposited by the principal, or directly by the obligee, into the principal's bank account. Furthermore, on March 13, 2017, Mike Stover and I gave a Surety Today presentation entitled "The Limitations on the Surety's Subrogation Rights." One of the limitations concerned the surety competing with a secured lender bank for earned and paid bonded contract funds that end up in the principal's bank account and then are swept by the bank. The surety's subrogation rights law is essentially:

1. When the earned and paid bonded contract funds are deposited into the principal's bank account prior to the principal's default, or if the bank receives payments from the principal without notice or knowledge that the principal has failed to pay its subcontractors and suppliers on the bonded project from the bonded contract funds, the surety has been unable to recover from the bank pursuant to its subrogation rights the payments received by the bank despite the fact that the surety may have subsequent losses under its bonds. In general, in the absence of knowledge or fraud on the part of the bank, the surety may not use its subrogation rights to obtain bonded contract funds that have already been paid to the bank or swept by the bank from the principal's bank account.

2. However, banks have been held to be on notice of the surety's subrogation rights as banks are charged with knowledge that many principals are required to provide bonds. When the principal is in default under the bonded contracts prior to the payment of the bonded contract funds, and the bank is aware of the principal's defaults, the surety may be entitled to obtain from the bank the bonded contract funds that were received by the bank.

This issue is fundamentally determined by the circumstances and facts of the case. The Subrogation Book addresses the issues and the factors, and especially what the bank knew about:

1. The principal's financial issues and possible financial distress;

2. The existence of the surety's subrogation rights to the bonded contract funds; and

3. The bank's actual or constructive knowledge or notice of the principal's bonded contract defaults.

Furthermore, the surety's subrogation rights do remain and are enforceable with respect to the surety's assertion of a state's trust fund statute rights that require a principal to pay its subcontractors and suppliers from any payments of bonded contract funds.

Finally, the following question arises: Why do the surety's indemnity agreement trust fund provision rights to have the bonded contract funds held in trust for the surety's benefit lose out to a secured lender bank as in the *Guarantee v. Associated* case, but prevail over the powers and lien rights of a trustee in bankruptcy? After all, the bankruptcy trustee has all of the rights of a "hypothetical lien creditor without knowledge" of the rights of any other creditor such as the indemnity agreement trust fund rights of a surety. The reason lies in the definitions of the powers of the trustee under the Bankruptcy Code.

The trustee's "hypothetical lien creditor without knowledge" rights are limited by Section 544 of the Bankruptcy Code. The trustee is provided with "judicial lien" rights as of the commencement of the bankruptcy case. A "lien" is defined as a charge against or an interest in property to secure payment of a debt or performance of an obligation. A "judicial lien" is defined as a lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding. The trustee is not provided with the rights of a secured creditor or a "security interest," which is a lien created by a security agreement such as a bank's security interest in the bonded contract funds and the principal's bank account.

What are the takeaways from the *Guarantee v. Associated* case?

1. The wording of the indemnity agreement trust fund provision is critical, and there may not be applicable language that will get around cases like the *Guarantee v. Associated* case.

2. If, as it should, the indemnity agreement trust fund provision does require, upon the surety's demand, that the principal establish a separate trust account for the bonded contract funds, and this is not done, the court will likely find that no trust has been established in the bonded contract funds deposited prior to such a demand.

3. Even if the surety makes such a demand, it may not assist the surety in recovering bonded contract funds that were previously swept by the bank from the principal's bank account.

4. BUT REMEMBER, if the surety does make a timely demand, and the principal actually opens a separate trust account, preferably at another bank, the principal's bank will stop lending (unless the secured lender bank agrees to such a separate account and continues to lend money to the principal). The bank's unwillingness to lend money to the principal once the bonded contract funds are deposited to another bank account not subject to the secured lender bank's rights will definitely affect the surety's claims handling of the principal's defaults, and especially any ongoing performance bond defaults.

Illegal Contract As A Defense To The Surety (Mike)

In *Hanover Ins. Co. v. Dunbar Mech. Contractors, LLC,*[2] United States District Court for the Eastern District of Arkansas, the United States Army Corps of Engineers awarded a Service Disabled Veteran Set-Aside contract to Dunbar Mechanical Contractors ("Dunbar") in the amount of $2 million. The contract was for the completion of construction on a project known as Ditch 27 & Tributaries in Arkansas. (I don't understand why ditches cost $2 million in Arkansas, but it's just our tax dollars at work.) As noted, the project was a Service Disabled

[2] No. 3:18CV00054 JM, 2019 WL 2353046 (E.D. Ark. June 3, 2019).

Veteran Owned Business (which I will refer to as "SDVOB") set aside project. Thus, in order to receive the award of the contract, the bidder must be a SDVOB. Further, under the SDVOB laws the contractor is prohibited from paying to non-SDVOB subcontractors more than 85% of the amount paid by the government under the set aside contract.[3] In other words, the SDVOB must perform 15% of the value of the work on the project.

Dunbar was an SDVOB and after receiving the award of the contract, in violation of the SDVOB laws, Dunbar entered into a subcontract with Harding Enterprises, LLC ("Harding") in the amount of almost $1.8 million for Harding to perform all of the work under Dunbar's contract with the USACE. This constituted subcontracting an amount that equaled 87.6% of Dunbar's contract price. In addition, Dunbar hired one of the owners of Harding to act as the project manager for an additional payment of $62,000.[4] The subcontract amount and employment agreement totaled just over 90% of the Dunbar/USACE contract.

Dunbar required Harding to provide payment and performance bonds to secure the subcontract. Hanover provided the bonds with Harding for the subcontract. Sometime later, Dunbar terminated the subcontract and employment agreement with Harding and made demand upon Hanover to perform under the performance bond. Hanover conducted its investigation and discovered the violations of the applicable laws and denied the claim. Hanover subsequently filed a declaratory judgment action seeking a declaration that Hanover had no obligations under the bonds because the subcontract was an unenforceable illegal contract.[5]

After filing suit, Hanover moved for summary judgment. In granting summary judgment in favor of Hanover, the Court found that the subcontract between Dunbar and Harding violated federal law. The Court stated:

> [a]ny act which is forbidden, either by the common or the statutory law, whether it is malum in se, or merely malum prohibitum, indictable or only subject to a penalty or forfeiture, or however otherwise prohibited by a statute or the common law, cannot be the foundation of a valid contract; nor can anything auxiliary to or promotive of such act.[6]

The Court further held that "[b]ecause the Subcontract is illegal, Hanover is not obligated to fulfill its obligations under the Bond which ensured performance of the Subcontract."[7] The Court further noted that if the surety were to perform under its bond, it may have had liability under the False Claims Act.[8] In many ways this case is the flip side of the *Scollick v. Narula* case, the False Claims Act case our office is involved with.[9] In *Scollick* the unfounded allegations are that the surety should be liable under the False Claims Act because the surety provided bonds to a principal it knew or should have known was not a valid SDVOB. Here the

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[3] 13 CFR §125.6(a)(3)

[4] 13 CFR §125.6(a)(3) requires that the SDVOB not pay more than 85% of the amount by the government to it to firms that are not SDVOBs.

[5] Hanover Ins. Co., 2019 WL 2353046, at *1.

[6] *Id.*, 2019 WL 2353046, at *3 (citing Eager v. Jonesboro, Lake City & E. Exp. Co., 147 S.W. 60, 64 (Ark. 1912)).

[7] *Id.*

[8] *Id.*

[9] *United States ex rel. Scollick v. Narula*, 2017 U.S. Dist. LEXIS 119530, 2017 WL 3268857 (D.D.C. July 31, 2017).

Hanover Court is saying in part that the surety is not required to perform under its bonds if in doing so it would be exposed to False Claims Act liability.

I have several cases pending right now in which we are taking the position that the surety has no obligation under the payment bonds issued to the claimants because the subcontracts between the principal and its alleged subcontractors are illegal. In my cases the principal improperly classified third parties as subcontractors and these alleged subcontractors then brought undocumented workers to the projects to perform the roofing work, improperly treated these laborers as independent contractors and paid them in cash. There is no paperwork, no certified payrolls, 1099's, W-2s, no taxes were paid or withheld, no worker's compensation insurance provided, etc. This same pattern of conduct was followed by the principal and several middlemen on multiple projects around Maryland. Our position is that the agreements to provide the labor are illegal and were performed illegally and if the surety pays such claims it could be exposed to liability to the IRS, DOL, various state agencies and potentially liable to claims under the state False Claims Act.

The takeaway from this case is that the surety must be vigilant in its investigation to determine if there is illegal conduct which might expose the surety to liability and if the surety discovers illegality it may be able to use that as a defense. I have a "practice pointer" article in the ABA/FSLC Newsletter – Winter Edition coming out soon that talks about these issues titled *Being Mindful of the False Claims Act*, so be sure to check that out if you are a member of the FSLC.

Waivers and Releases in Pay Applications and Change Orders (George)

In *Connelly v. Travelers*,[10] out of the U.S. Court of Appeals, 3rd Circuit, the general contractor principal and its surety defended against the claims of a subcontractor. The court found that: (a) the subcontractor had knowingly and voluntarily waived its claims by signing releases and change orders; and (a) the general contractor principal did not waive its right to rely on the releases and change orders in denying the subcontractor's claims.

Factually, the court found:

1. The subcontractor executed "monthly waiver and release forms" as required by the subcontract for payment.

2. Over the course of the project, the subcontractor executed five change orders, and all except the first contained language releasing the principal from any additional costs. While the subcontractor objected to the broad release language in the first change order and proposed new language to preserve a future claim, the subcontractor then signed the four subsequent change orders containing the same very broad release language to which it had once objected to. The subcontractor refused to sign one last change order out of concern that it would waive the potential subcontractor claims that it had.

[10] 2019 WL 5095754 (3rd Circuit, October 11, 2019).

With respect to the subcontractor, the appeals court stated that the trial court did not clearly err in finding that the subcontractor had knowingly and voluntarily waived its claims against the general contractor principal and its surety.

The subcontractor also contended that the general contractor principal waived its rights to enforce the releases by submitting the following "evidence:"

1. The principal's testimony that it did not always enforce its waivers.
2. The principal's testimony from its senior project manager on the project that "I will make you whole at the end of this job, you have to trust me."
3. Evidence that despite the waivers, the principal would sometimes pay the subcontractor for performing extra work.
4. Evidence that the principal would sometimes pay the subcontractor without the required releases.
5. Evidence of the principal's similar conduct with other subcontractors on the project.

Since the trial court held that these statements and actions did not amount to a waiver by the principal, and this was not clear error, the appeals court upheld the trial court's ruling that the general contractor principal "did not clearly and unambiguously relinquish its right to enforce the release language in the agreements."

<u>None of this is new to any of you</u>. This case is a reminder, however, that in defending against a subcontractor's payment bond claim, all of the documents, including the payment application releases and any change order releases, must be reviewed carefully to determine if the claimant subcontractor has released the claims it is making against the principal and the surety.

<u>But this case is also a reminder</u> that a surety can get burned by the same payment application and change order releases. Specifically, when a surety takes over the performance of a bonded project when its principal – whether it is a general contractor or subcontractor – is terminated by the obligee, the surety may be the one signing such documents. As a result, the takeover surety may waive and release claims that it has for extra work, changes, delays and other issues during the completion of the project. And, how many times have we cringed upon hearing from our completion contractor or even our consultant that there is an oral understanding with the obligee's project manager about something – delays, bartered exchanges, the completion contractor will do this and the owner/general contractor won't require that – that get lost in the shuffle at the end of the project. The following words are NOT sufficient for the takeover surety – "I will make you whole at the end of this job, you have to trust me."

As in *Connelly v. Travelers*, "trust me" won't preserve a claim or overcome a written release executed by a takeover surety or its completion contractor.

<u>Default Of The Principal And Effect On The Surety</u> (George)

In *Harris County Water Control v, Philadelphia Indemnity Insurance Company*,[11] the court addresses the sometimes horror story of a surety actively defending a claim in litigation on the merits, a default judgment is entered against the principal only, and the surety is bound by the default judgment. This has occurred many too many times.

In the *Drill South* case, the appeals court entered summary judgment against a surety that was actively defending a Miller Act payment bond claim by finding that a default judgment against the principal in the same action was conclusively binding on the surety.

In the *American Safety Casualty* case, the default judgment against the principal that became binding on the actively defending surety was based upon a discovery sanction against the principal, a defunct corporation, for failing to obey an order to name a corporate designee to give deposition testimony on the principal's behalf.

Other courts and jurisdictions may have different rulings, but this presentation is not an in-depth analysis of that issue.

In the present case, the court realized that the entry of a default judgment in favor of the plaintiff obligee against the surety's principal that did not file an answer or otherwise defend against the obligee's suit against the principal and the surety *might* result in a risk of inconsistent findings and prejudice to the surety actively defending against the obligee's claims. As a result, the court held off entering a default judgment against the principal to avoid prejudicing the surety's possible defenses to the obligee's claims.

The obvious takeaway from the Harris County case is to be careful when a default judgment is sought against your principal in litigation in which the surety is also a party, and that such a default judgment may have different effects on the surety and its defenses to the claims depending upon the jurisdiction in which the claim is being litigated.

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[11] 2019 WL 5191129 (S.D. Texas, October 15, 2019).