Tort Trial & Insurance Practice Law Journal, Winter 2018 (53:2)

RECENT DEVELOPMENTS IN FIDELITY AND SURETY LAW

James A. Knox, Jr., Lee M. Brewer, Jonathan M. Bryan, Eric D. Coleman, Adam D. Cornett, Carla Crapster, Adam M. Friedman, Evan B. Gatewood, David A. Harris, Mark J. Krone, Mario Nicholas, Christopher A. Scifres, and Jessica Wynn

This information or any portion thereof may not be copied or disseminated in any form or by any means or downloaded or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

RECENT DEVELOPMENTS IN FIDELITY AND SURETY LAW

James A. Knox, Jr., Lee M. Brewer, Jonathan M. Bryan, Eric D. Coleman, Adam D. Cornett, Carla Crapster, Adam M. Friedman, Evan B. Gatewood, David A. Harris, Mark J. Krone, Mario Nicholas, Christopher A. Scifres, and Jessica Wynn

I. Surety Law 394
A. Performance Bonds 394
1. Conditions Precedent 394
2. Arbitration 396
3. Attorney Fees 398
4. Limitations 398
B. Payment Bonds 399
1. Jurisdiction 399
2. Venue 400

James A. Knox, Jr. (jim.knox@strasburger.com) is of counsel with the Dallas office of Strasburger & Price, LLP. Lee M. Brewer (lbrewer@bryanandbrewer.com) and Jonathan M. Bryan (jbryan@bryanandbrewer.com) are partners with Bryan & Brewer, LLC in Columbus, Ohio. Eric D. Coleman (ecoleman@carltonfields.com) is an associate with Carlton Fields in Miami. Adam D. Cornett (acornett@abais.com) is a senior attorney with ABA Insurance Services in Mayfield Heights, Ohio. Carla Crapster (carla.crapster@strasburger.com) is an associate with Strasburger & Price, LLP in Dallas. Adam M. Friedman (afriedman@csglaw.com) is a partner with Chiesa, Shahinian & Giantomasi PC in West Orange, New Jersey. Evan B. Gatewood (egatewood@hmglawyers.com) is a partner with Hayes, Magrini & Gatewood in Oklahoma City. David A. Harris (dah@boviskyle.com) is an associate with Bovis, Kyle, Burch & Melin LLC in Atlanta. Mark J. Krone (mk@amclaw.com) is an attorney with Anderson, McPharlin & Conners LLP, in Los Angeles. Mario Nicholas (mnicholas@lawssl.com) is an associate with Stewart Sokol & Larkin in Portland, Oregon. Christopher A. Scifres (cscifres@weinrad.com) is an associate with Weinstein Radcliff Pipkin, LLC in Dallas. Jessica L. Wynn (jwynn@alberfrank.com) is an associate with Alber Frank, PSC in Troy, Michigan.

3. Notice ... 401
4. Limitations ... 401
5. Proper Claimant ... 402
6. Labor and Material ... 403
7. Principal's Defenses ... 404
8. Damages ... 405
C. Other Bonds ... 406
1. Public Official Bond ... 406
2. Probate Bond ... 407
3. Subdivision Bond ... 407
4. Release of Lien Bond ... 408
5. Mortgage Lender Bond ... 409
6. Motor Vehicle Dealer Bond ... 410
D. Rights of Surety ... 411
1. Indemnity ... 411
2. Collateral Deposit ... 414
3. Subrogation ... 415
II. Fidelity Law ... 417
A. Employee Theft/Employee Dishonesty ... 417
1. Who Is an Employee? ... 417
2. Improper Financial Benefit ... 418
B. Insuring Agreements D and E ... 419
C. Computer Fraud ... 421
1. Hacking Requirement ... 421
2. Use of Computer ... 424
D. Discovery of Loss ... 425
E. Termination Upon Change of Control ... 426
F. Inventory Exclusion ... 426
G. Limitations ... 427
H. Claim Handling/Bad Faith ... 427

I. SURETY LAW

A. *Performance Bonds*

1. Conditions Precedent

In *Bovis Lend Lease (LMB) Inc. v. Lower Manhattan Development Corp.*,[1] a prime contractor sued a subcontractor's performance bond surety. The surety contended that it was discharged by the prime contractor's refusal to let the surety use the subcontractor to complete the work.[2] The prime

1. 40 N.Y.S.3d 371 (N.Y. App. Div. 2016).
2. *Id.* at 598.

contractor had terminated the subcontract after a criminal conviction of the subcontractor for removing a standpipe that could have brought water to the building to put out a fire. The court held that the surety could not contest that the subcontractor had breached its duties as found in the criminal case and that it was not discharged by the prime contractor's refusal to let it use that subcontractor. The subcontract incorporated the prime contract that required the owner and the prime contractor to approve any replacement contractor. The court held that their refusal to let the convicted subcontractor come back on the job was not unreasonable.[3]

In *RKI Construction, LLC v. WDF Inc.*,[4] a subsubcontractor's surety contended the obligee subcontractor could not recover because it failed to agree to pay the balance of the contract price to the surety as required by the AIA A312 performance bond at issue.[5] The subsubcontractor argued it was discharged by defects in the subcontractor's notices of default and termination, but the court found that strict compliance with the default and termination provisions in the underlying contract was not a condition precedent to the subcontractor's right of recovery.[6] In contrast, the court held that the requirement in the performance bond that the subcontractor agree to pay the balance of the contract price was enforceable as a condition precedent and that the subcontractor failed to comply with this.[7] The court did not agree that the subcontractor had no chance to comply before the surety denied the claim.[8]

In *Arch Insurance Co. v. John Moriarty & Associates of Florida*,[9] a subcontractor's AIA A312 performance bond surety argued that the obligee contractor could not recover its completion costs because it failed to satisfy conditions precedent.[10] The owner had used the bonded subcontractor to complete the work. Although the obligee provided notice to the surety that it was considering declaring a contractor default, the contractor never declared a default, terminated the contract, or agreed to pay the contract balance to the surety as the bond also required. Instead, the obligee simply proceeded with the project work, never terminating the contractor. The surety objected several times in writing.[11] The court rejected the obligee's argument that it was solely the obligee's decision whether to default its own subcontractor.[12] The court concluded that once the obligee notified

3. *Id.* at 599.
4. No. 14-cv-1803, 2017 U.S. Dist. LEXIS 50397 (E.D.N.Y. Apr. 13, 2007).
5. *Id.*
6. *Id.* at *17–19.
7. *Id.* at *28.
8. *Id.* at *26.
9. 223 F. Supp. 3d 1275, 1276 (S.D. Fla. 2016).
10. *Id.* at 1277.
11. *Id* at 1278.
12. *Id.*

the surety that it was considering declaring the subcontractor in default, the obligee could proceed to use the subcontractor to complete "only with [the surety]'s consent."[13]

International Fidelity Insurance Co. v. Amercaribe-Moriarty JV[14] involved a subcontract performance bond. The prime contractor as bond obligee gave notice of the subcontractor's default to the surety.[15] The surety responded that it would need to investigate and the contractor should not take steps to complete the subcontract on its own.[16] Immediately and without notice, the contractor engaged a completing subcontractor anyway, terminated the bonded subcontractor, and made demand on the surety.[17] The court discharged the surety. It had no chance to exercise its completion options as spelled out in the bond.[18] It did not matter that the contractor did not formally contract with the new subcontractor until after the bond's election period had run.[19] The surety also was discharged even if the bond incorporated the subcontract's provision for a three-day notice of any undertaking by the contractor to complete the subcontract.[20] Neither agreement allowed the contractor to hire a replacement contractor without notice. It did not matter that the contractor did not formally sign up the subcontractor until after the bond's election period. "It would defeat the purpose of the notice and election if the contractor could just work around the requirements by waiting to sign a contract."[21]

2. Arbitration

In *Developers Surety & Indemnity Co. v. Carothers Construction, Inc.*,[22] a prime contractor demanded arbitration against a subcontractor and its performance bond surety on four projects in four states. The contractor asserted that the subcontracts had a mandatory arbitration clause extending to all disputes arising out of the subcontracts, and the bonds incorporated the subcontracts.[23] The arbitration clause specified Jackson, Mississippi, as the arbitration forum. The surety sought a declaratory judgment in the U.S. District Court for the District of South Carolina that it was not bound by the arbitration clause.[24] The prime contractor filed a motion to either dismiss or transfer the action to the Southern District of

13. *Id.*
14. 681 F. App'x 771 (11th Cir. 2017).
15. *Id.* at 773.
16. *Id.*
17. *Id.* at 774.
18. *Id.* at 776–77.
19. *Id.*
20. *Id.* at 775.
21. *Id.* at 775–76.
22. No. 9:17-1419, 2017 U.S. Dist. LEXIS 111021 (D.S.C. July 18, 2017).
23. *Id.* at *6.
24. *Id.* at *2.

Mississippi so that an order compelling arbitration could be issued.[25] The court declined to dismiss the surety's suit; the surety had sufficiently stated a claim for a determination of whether the claims against it were subject to arbitration. In opposition to the motion to transfer, the surety argued that the arbitration clause expressly extended only to claims arising from the subcontract and the contractor's claim against the surety did not arise from the subcontract. The court, however, observed that a surety's liability is coextensive with its principal's liability. Therefore, the bond and the subcontract, including its arbitration clause, had to be construed together as a whole.[26] When this was done, it was clear that the claims against the surety did arise from the subcontract. If the subcontractor were found liable for an arbitral award, the surety would be liable as well. The surety was bound by the arbitration clause, including the forum it selected. The court thus granted the motion to transfer.[27]

In *Schneider Electric Buildings Critical Systems, Inc. v. Western Surety Co.*,[28] the court considered whether a subcontractor's performance bond surety was subject to an arbitration provision in a subcontract with an electrical contractor.[29] The bond incorporated by reference a particular subcontract, and that subcontract incorporated a master subcontract agreement (MSA) between the subcontractor and the contractor. The MSA had a mandatory arbitration clause.[30] The contractor issued a demand for arbitration to the subcontractor and its surety. The surety filed a declaratory judgment action and moved for a stay of the arbitration. The court saw the issue of whether the arbitration clause could be applied against the surety as one of contract formation against a non-signatory—a state law issue, not subject to federal law, which presumes in favor of arbitration.[31] The court concluded that even if the surety was jointly and severally bound with its principal, the subcontractor, the surety was not subject to the arbitration provision of the incorporated MSA and therefore could not be compelled to participate in the pending arbitration.[32] A bond's mere incorporation by reference of a contract containing an arbitration clause does not obligate the surety to arbitrate.[33] The surety's liability extended only to completion of the project pursuant to the subcontract. The surety was not bound by every term of the subcontract, notwithstanding the incorporation by reference clause.

25. *Id.*
26. *Id.* at *10.
27. *Id.* at *10–11.
28. 149 A.3d 778 (Md. Ct. Spec. App. 2016).
29. *Id.* at 780–81.
30. *Id.* at 780.
31. *Id.*
32. *Id.*
33. *Id.* at 792.

In addition, there were references in the bond to litigation being necessary to establish liability against the surety.

3. Attorney Fees

In *King County v. Vinci Construction Grands Projects/Parsons RCI/Frontier-Kemper, JV*,[34] the Washington Supreme Court affirmed a jury's $15 million award of attorney fees to the project owner against the principal and its performance bond sureties.[35] That award went along with a damages award of $130 million.[36] The court applied its holding in *Olympic Steamship v. Centennial Insurance Co.*[37] that attorney fees must be awarded against an insurer that compels an insured to assume the burden of legal action to obtain the full benefit of its insurance contract. Attorney fees should be awarded when the insurer compels the insured to litigate coverage and then loses.[38] While the sureties argued that *Olympic Steamship* did not apply because they were not insurers litigating a coverage dispute with the owner, but sureties adopting the principal's defenses, the court held that by adopting the principal's defenses, the sureties made the owner's claims against the principal indistinguishable from the owner's claims against the sureties. Thus the dispute was one of coverage, with no way to segregate attorney fees between the claims against the two.[39] A statute providing an attorney fee remedy for disputes involving public works contracts was not the exclusive remedy.[40]

4. Limitations

In *Hensel Phelps Construction Co. v. Thompson Masonry Contracting, Inc.*, Virginia Polytechnic Institute and State University (Virginia Tech) discovered and repaired defective workmanship in a student health center fourteen years after substantial completion. Virginia Tech then sought to recover the cost of the repairs from the prime contractor. Its claim was not untimely because, as an arm of the state, the statute of limitation did not run against it. The contractor settled with Virginia Tech and made warranty and indemnity claims against several subcontractors and their sureties.[41] The trial court held that a five-year statute of limitations barred the warranty claims. The contractor appealed. The contractor pointed to a flow down provision in the subcontracts that was also incor-

---

34. 398 P.3d 1093 (Wash. 2017).
35. *Id.* at 1101.
36. *Id.*
37. *Id.* at 1097 (citing Olympic S.S. Co. v. Centennial Ins. Co., 811 P.2d 673 (Wash. 1991)).
38. *Id.*
39. *Id.* at 1100–01.
40. *Id.* at 1101.
41. 791 S.E.2d 734, 737 (Va. 2016).

porated in the bonds. The provision expressly required the subcontractors to assume any warranty obligations the contractor owed to the owner. The contractor argued that this amounted to a waiver by the subcontractors of the statute of limitations.[42] The court was not persuaded. "[A] general incorporation provision is insufficient to expressly waive a limitations period [because it] "does not expressly acknowledge the right to a limitations period or intent to waive that right."[43] The subcontractors did not have continuing workmanship obligations under the warranty provision.[44] The contractor had five years to identify any defective work and require that it be repaired by any subcontractors at fault.[45] The statute had run, as it was more than five years since the subcontractors allegedly breached the warranty by performing defective work.[46] The statute applied because the subcontractors' alleged warranty duties were contract performance duties, not duties to indemnify. The contractor also invoked a separate indemnity provision in the subcontractors, but the court found that provision to be against public policy and unenforceable as it required the subcontractors to indemnify the contractor for its own negligence.

B. *Payment Bond*

1. Jurisdiction

In *United States ex rel. J. A. Manning Construction Co. v. Bronze Oak*,[47] the U.S. District Court for the Northern District of Oklahoma considered a jurisdictional issue.[48] Federal funds were provided to the Cherokee Nation to construct a road and bridge.[49] The project was bonded and a subcontractor filed a Miller Act suit against the surety under the payment bond.[50] The surety filed a motion to dismiss the suit based on lack of subject matter jurisdiction.[51] In granting the surety's motion, the court held that the federal government's relationship to the project, which consisted of providing funds to the autonomous Cherokee Nation and being named as the obligee on the bond, was not strong enough to support jurisdiction under the Miller Act.[52] No public work of the federal government was at issue as the statute required. Nor was there federal jurisdiction under 28 U.S.C. § 1352 on the basis that the bond had been required under a

---

42. *Id.* at 738.
43. *Id.* at 737.
44. *Id.* at 740.
45. *Id.*
46. *Id.*
47. No. 16-CV-0588, 2017 U.S. Dist. Lexis 6054 (N.D. Okla. Jan. 17, 2017).
48. *Id.* at *16.
49. *Id.* at *2.
50. *Id.* at *5.
51. *Id.*
52. *Id.* at *12–13.

law of the United States, even though the bond had been issued pursuant to Bureau of Indian Affairs regulations.

2. Venue

In *United Corrosion Control, LLC v. G-W Management Services, LLC*,[53] the federal project at issue was in Virginia but a Miller Act claimant brought suit in Maryland, the venue provided for in the contractual forum selection clause.[54] The contractor sought to have the case dismissed for improper venue under the Miller Act, which specifies the district in which the contract is to be performed as the proper venue. The court denied the motion and held that Miller Act venue is not jurisdictional and does not invalidate an otherwise valid and enforceable contractual forum selection clause.

Chaney Trucking & Development, Inc. v. Asset Group, Inc.[55] involved a motion to transfer a Miller Act suit from Louisiana to Oklahoma pursuant to 28 U.S.C. § 1404(a). The claimant argued that the project was located in Louisiana and under Louisiana law, a contractual forum-selection clause calling for venue in a state other than Louisiana with respect to a project in Louisiana was against public policy.[56] The court held that this was not controlling but instead would be considered in determining whether there were sufficient public interests to overcome the private interests expressed in the contract.[57] The court also noted that under federal law, forum-selection clauses are valid and enforceable. Ultimately, the court transferred venue; the public concerns did not overcome the parties' bargained for agreement.[58]

In *United States ex rel. Nasatka Barrier, Inc. v. International Fidelity Insurance Co.*,[59] the defendants to a Miller Act lawsuit sought to transfer venue pursuant to a contractual forum-selection clause that provided for suit to be filed "in the appropriate court in Orange County, California."[60] The court held that the clause was valid because it preserved federal jurisdiction by allowing the claim to be filed in federal court.[61] The court considered public and private factors and ordered that the case be transferred under 28 U.S.C. § 1404(a).[62]

53. No. CV JKB-16-1856, 2016 WL 6610993 (D. Md. Nov. 9, 2016).
54. *Id.* at *1.
55. No. 2:16-CV-782, 2016 WL 6608390 (W.D. La. Nov. 8, 2016).
56. *Id.* at *2.
57. *Id.* at *3.
58. *Id.*
59. No. C16-5142, 2016 WL 5920091 (W.D. Wash. Oct. 11, 2016).
60. *Id.* at *1.
61. *Id.* at *2.
62. *Id.* at *3–4.

3. Notice

In *84 Lumber v. F.H. Paschen, S.N. Nielsen & Associates, LLC*,[63] a sub-subcontractor sued the prime contractor and its payment bond surety after filing sworn statements that it had not been paid on two projects. The sub-subcontractor also had sent two emails to the contractor before it filed suit. Those emails included copies of letters it had sent to the project owners to advise them it had not been paid.[64] The prime contractor and surety contended that the sub-subcontractor's presuit communications did not meet the Louisiana Public Work Act's requirement that written notice of a claim be given by registered or certified mail to the prime contractor within forty-five days of the sworn statement's recordation.[65] The claimant argued that the contractor had actual notice of the claim on receipt of the complaint and the emails to its counsel.[66] The court held that the complaint could not count as notice because the statute made notice a condition to suit. Nor did the emails suffice to meet the statute. Among other things, the claimant had no proof they were received. The claimant also could not recover for unjust enrichment. The LPWA's remedy was exclusive.[67]

4. Limitations

In *United States ex. rel. American Civil Construction, LLC v. Hirani Engineering & Land Surveying, P.C.*,[68] the Corps of Engineers terminated the prime contractor for default on April 26, 2013. The prime contractor instructed the subcontractor to keep working while the prime contractor contested the termination.[69] There was evidence the subcontractor was working on the site as late as May 1, 2013.[70] The subcontractor sought payment under the prime contractor's payment bond.[71] The surety contended that the Miller Act's one-year statute of limitation barred the claim. That statute runs from the date that the claimant last provided labor or material to the project pursuant to its subcontract.[72] The surety argued that this date could not fall beyond the termination of the prime contract on April 26, 2013, which was more than a year before the subcontractor filed suit on April 29, 2014.[73] The court determined that the subcontract was independent of the prime

63. No. 12-1748, 2017 WL 2119949 (E.D. La. May 16, 2017).
64. *Id.* at *5.
65. La. Rev. Stat. § 38.2247.
66. *84 Lumber*, 2017 WL 2119949, at *5.
67. *Id.* at *7–8.
68. No. 14-cv-00745 (APM), 2017 WL 2787590 (D.D.C. June 27, 2017).
69. *Id.* at *6.
70. *Id.*
71. *Id.* at *7.
72. *Id.* at *8.
73. *Id.* at *10.

contract.[74] A fact issue remained as to whether the subcontractor did work on May 1, 2013. If so, the subcontractor's suit was timely.[75]

In *Strickland v. Arch Insurance Co.*,[76] a surety asserted a limitations defense in response to a payment bond suit by a supplier to the surety's contractor on a road project. The Georgia Department of Transportation (GDOT) informally accepted the project on September 14, 2011, and the road was open and in use by then.[77] GDOT did not issue a formal written acceptance until September 22, 2015.[78] The surety contended that the supplier did not file suit within a year of the completion and (informal) acceptance of the contract, so the suit was time-barred under Ga. Code Ann. § 13-10-65.[79] The court sided with the surety. It was actual completion and acceptance that mattered, not the finalization of paperwork resulting in the issuance of a formal acceptance a week later. That the road had been opened to traffic showed it had been completed and accepted more than a year before the supplier filed suit. The supplier's suit thus was time barred.[80]

5. Proper Claimant

Sitetech, Inc. v. Cross Environmental Services, Inc.[81] concerned a contract to demolish a power plant. The prime contractor entered into two subcontracts, one with Sitetech to generally perform the work and one with Cross Environmental Services to remove asbestos. Cross made a claim under Sitetech's payment bond. The surety argued Cross was not a subcontractor to Sitetech and provided no labor or material to Sitetech. However, the court found coverage because Sitetech had a duty under its contract with the prime contractor to remove all materials, including asbestos.[82] The surety also did not "directly dispute that plaintiff is a Claimant."[83]

In *Equipment Rental Source, LLC v. Western Surety Co.*,[84] the court looked to Miller Act cases for guidance and held that the payment bond claim of a supplier to a second tier subcontractor was barred under Nebraska's Little Miller Act.[85] The supplier did not have a direct contractual relationship with the prime contractor or the prime's subcontractor. It

74. *Id.* at *11.
75. *Id.* at *12.
76. No. 5:14-CV-70, 2017 WL 104320 (S.D. Ga. Jan. 10, 2017).
77. *Id.* at *2.
78. *Id.* at *1.
79. *Id.* at *2.
80. *Id.* at *2–3.
81. No. 16-cv-10943, 2016 U.S. Dist. LEXIS 145858 (E.D. Mich. Oct. 21, 2016).
82. *Id.* at *4.
83. *Id.* at *3.
84. No. 4:15 CV 3061, 2016 U.S. Dist. LEXIS 141298 (D. Neb. Oct. 12, 2016).
85. *Id.* at *8–9 (citing NEB. REV. STAT. § 52-118).

was too remote to pursue a bond claim.[86] A direct contractual relationship with the prime contractor or subcontractor is necessary.

Isufi v. Prometal Construction, Inc.[87] involved prevailing wage and overtime claims brought by employees of a subcontractor on a New York City Housing Authority (NYCHA) project as a class action against the subcontractor, the prime contractor, and the prime contractor's payment bond surety. The workers claimed they were third-party beneficiaries of a NYCHA contract clause requiring that prevailing wages be paid pursuant to the Davis-Bacon Act.[88] Prior to the suit, at the workers' request, NYCHA opened an investigation of the alleged violations.[89] The defendants sought dismissal. They argued that collateral estoppel required the workers to exhaust their administrative remedies. The court could not find any remedies to exhaust. The NYCHA's mere investigation did not foreclose judicial remedies. The court declined to dismiss the suit. It found that the workers' common law rights were independent of the NYCHA's non-compulsory investigation.[90]

6. Labor and Material

In *Aztec Engineering Group, Inc. v Liberty Mutual Insurance Co.*,[91] a design consultant entered into a subcontract on a public private project. The design consultant sued on the contractor's payment bond to recover its fees. The contractor's sureties contended the bond did not cover design services.[92] The court held that the bond did provide coverage because: (1) the bond incorporated the design build contract between the prime contractor and the developer;[93] (2) the bond incorporated the public private agreement's performance and payment security provisions, which related to both design and construction;[94] (3) the amount of the bond was based on total project cost, including design work;[95] (4) the bond was not a mere statutory bond restricted to the coverage available under Indiana Code § 8-15.5 because the parties had permissibly contracted for coverage beyond the statute;[96] and (5) the term "labor" as used in the bond included design services.[97] The pos-

86. *Id.* at *20–21.
87. No. 653265/2012, 2017 N.Y. Misc. LEXIS 1193 (N.Y. Sup. Ct. Apr. 3, 2017).
88. *Id.* at *2.
89. *Id.* at *5–6.
90. *Id.* at *7.
91. No. 1:16-cv-01657, 2017 U.S. Dist. LEXIS 58584 (S.D. Ind. Apr. 18, 2017).
92. *Id.* at *1.
93. *Id.* at *9–10.
94. *Id.* at *8.
95. *Id.*
96. *Id.* at *6–7.
97. *Id.*

sibility that the prime contractor might have some offsetting claim against the surety did not matter when the prime had not actually made a claim.[98]

In *Widmer Engineering, Inc. v. Five-R Excavating, Inc.*,[99] a subcontractor was not paid for engineering services it provided to a design build project. The subcontractor made a claim under the prime contractor's statutory payment bond.[100] The surety denied the claim on the basis that the subcontractor was not a proper claimant under the bond. The court upheld the surety's position.[101] The subcontractor's engineering services were not "labor" under the statute or the bond form. The term "labor" means physical labor rather than technical or professional judgment. For example, the mere provision of plans by an architect is not labor but the architect's supervision of the execution of those plans would be. Here, the subcontractor did not provide labor.[102] The court expressed concern about the fact that the bond was for the full contract price, which included engineering services, but that concern did not overcome the well-established rule that professional series are not labor under well-established payment bond and mechanics lien law.[103]

7. Principal's Defenses

In *United States ex rel. VT Milcom, Inc. v. PAT USA, Inc.*,[104] a contractor on a federal project in Qatar paid for 20 percent of the materials furnished by a supplier pursuant to a schedule of values requiring that amount to be paid on the milestone of "material purchase." The contractor was terminated for default by the government but did not advise the subcontractor. Rather, the contractor asked the supplier to deliver the remaining materials while refusing to pay the remaining balance due on the basis of the "Termination by Owner" clause, which provided that "the contractor's liability to the subcontractor shall be limited to the extent of the Contractor's recovery on the Subcontractor's behalf."[105] The court held that the prime contractor's default did not affect these terms and enforced them literally. The supplier was not entitled to recover under the subcontract. The court found the prime contractor and its surety liable under the Miller Act payment bond, however, because the schedule of values was a timing provision, not a measure of recovery provision. The timing provision was unenforceable because it contradicted the express terms of the

98. *Id.* at *11–12.
99. No. 257 C.D. 2016, 2017 WL 959485 (Pa. Commw. Ct. Mar. 13, 2017).
100. *Id.* at *2.
101. *Id.* at *10.
102. *Id.* at *4–7.
103. *Id.* at *9.
104. No. 5:16-CV-00007, 2017 WL 3022367 (W.D. Va. July 14, 2017).
105. *Id.* at *5.

Miller Act, which require payment for sums justly due.[106] The reference to 20 percent in the schedule of values ignored pricing terms elsewhere in the supplier's subcontract.

8. Damages

In *Tri-State Electric, Inc. v. Western Surety Co.*,[107] a dispute arose concerning delay claims of the principal, its subcontractor, and a sub-subcontractor on a project for the Department of Veterans Affairs (V.A.).[108] The project was initially scheduled to be performed in 240 days, but took more than 950 days to complete.[109] The principal settled its claims and those of its subcontractors.[110] The V.A. attributed part of the settlement to subcontractor costs.[111] The subcontractors sued the principal and its surety under the Miller Act. One of the subcontractors claimed consulting fees incurred in developing a delay damages claim under the Federal Acquisition Regulations (FAR) and the subcontract.[112] This raised an issue of fact. Consulting fees would be recoverable if incurred to facilitate pre-claim negotiations, but not for the prosecution of a claim against the government.[113] The subcontractor also had not properly documented the consulting fees.[114] The court also held that the subcontractor's damages could not be capped by the V.A.'s estimate of subcontractor costs.[115] A subcontract provision did allow the contractor to resolve any dispute involving the V.A. with the subcontractor to be bound by such resolution.[116] However, the subcontract was executed before the subcontractor performed any work on the project. The court therefore found that the provision was an invalid waiver of Miller Act rights and was unenforceable.[117] The court also held that a second-tier subcontractor was not precluded from recovering delay damages due to a no-damages-for-delay provision.[118] A fact issue existed as to whether this provision too was an unenforceable waiver of Miller Act rights[119] and as to the foreseeability of the 690-day delay.[120]

106. *Id.* at *8.
107. 1:14-CV-00245, 2017 WL 123426 (D. Idaho Jan. 11, 2017).
108. *Id.* at *1.
109. *Id.* at *21.
110. *Id.* at *3.
111. *Id.*
112. *Id.*
113. *Id.* at *14.
114. *Id.* at *16.
115. *Id.* at *17.
116. *Id.*
117. *Id.*
118. *Id.* at *18.
119. *Id.* at *19.
120. *Id.* at *20.

In *United States ex rel. Tsi Tri-State Painting, LLC v. Federal Insurance Co.*,[121] the court considered a surety's motion to dismiss or stay a payment bond suit by a painting subcontractor under the Miller Act.[122] The subcontractor alleged it found additional lead paint to remove and that this was beyond the scope of its contract. A new contract was awarded under which the subcontractor procured new equipment and air containment systems to enable it to remove the lead paint safely. Problems arose with the systems, however. The subcontractor sought extra costs of $14 million and an extension of time. The surety pointed to the subcontract's no-damages-for-delay clause but that clause was subject to a condition precedent—the prime contractor was obligated to grant an extension of time if it caused delay.[123] In denying the surety's motion, the court concluded it was plausible that the prime contractor (the surety's principal) knew about the excess lead paint that caused the delay before it entered into the subcontract and did not notify the subcontractor.[124] If so, the prime contractor caused the delay and its failure to grant an extension precluded recourse to the no damages for delay provision.[125]

C. *Other Bonds*

1. Public Official Bond

In *Bueker v. Madison County*,[126] the Illinois Supreme Court addressed whether private citizens were proper claimants on a statutory public official bond.[127] The former Madison County treasurer and tax collector allegedly conspired with taxpayer debt purchasers to inflate the interest rate delinquent property taxpayers paid to the purchasers when discharging liens on the property and redeeming the property. The treasurer and tax collector inflated the interest rate on the debt in exchange for financial support from purchasers of the debt.[128] The plaintiffs, as individual citizens, in their own interest and on behalf of a purported class of similarly situated persons, brought an action against the surety to recover damages resulting from the alleged scheme.[129]

The court observed that under the Illinois Counties Code and Property Tax Code, the obligee on the statutory public official bond at issue was "the People of the State of Illinois."[130] This referred to the body pol-

121. No. CV 216-113, 2016 U.S. Dist. LEXIS 175845 (S.D. Ga. Dec. 20, 2016).
122. *Id.* at *1.
123. *Id.* at *5, *7–8.
124. *Id.* at *10.
125. *Id.* at *9.
126. 72 N.E.3d 269 (Ill. 2016).
127. *Id.* at 270–71.
128. *Id.* at 271.
129. *Id.*
130. *Id.* at 273.

itic, not individual citizens or a class of citizens.[131] A body politic is a group of people in a political sense that is organized under a single governmental authority. The legislature had used different language to allow private citizens to file suits in other statutes but did not do that here. The court held that the plaintiffs, being private citizens, could not sue for damages on the bond at issue.[132] The court thus affirmed the dismissal of all claims against the surety.[133]

2. Probate Bond

In *In re Gladstone*,[134] the probate court appointed a husband as conservator for his wife, who suffered from dementia.[135] The court later removed the husband for breaching his fiduciary duties as conservator by looting the conservatorship account. The court entered judgment against him and his surety for both actual and punitive damages.[136] On appeal, the surety argued its bond did not cover punitive damages.[137] The court disagreed. "Although OCGA § 29-5-41(c) requires that a conservator's bond 'be in an amount equal to the estimated value of the estate,' . . . it does not necessarily follow . . . that recovery is limited to actual loss."[138] The court found it sufficient that punitive damages are insurable. It did not apply the established rule that a surety can be charged with punitive damages only for its own misconduct. The surety also argued that the probate court violated the surety's due process rights by failing to provide pre-judgment notice that punitive damages were possible.[139] The court was not persuaded. The surety had been given notice to show cause why Gladstone did not breach his fiduciary duty and why damages should not be assessed.[140] "Because the surety was afforded notice and a hearing, its due process argument is without merit."[141]

3. Subdivision Bonds

In *In re Kimball Hill, Inc.*,[142] a surety issued subdivision bonds in favor of municipalities on behalf of a developer, Kimball Hill. The surety incurred losses when Kimball Hill filed chapter 11 bankruptcy and the municipalities sued on the bonds. Meanwhile, a claim injunction was entered in the

131. *Id.* at 274.
132. *Id.*
133. *Id.* at 276.
134. 798 S.E.2d 660 (Ga. Ct. App. 2017), *cert. granted* (Sept. 13, 2017).
135. *Id.*
136. *Id.* at 662.
137. *Id.* at 665.
138. *Id.* at 666.
139. *Id.*
140. *Id.*
141. *Id.* at 667.
142. 565 B.R. 878 (Bankr. N.D. Ill. 2017).

Kimball Hill's bankruptcy when it bankruptcy plan was confirmed. The injunction barred the surety's indemnity claims against Kimball Hill.[143] In the pending state court actions, however, the surety brought third-party claims against another developer, TRG. TRG had purchased properties, which the surety had bonded, from Kimball Hill's bankruptcy estate. The state trial court dismissed the surety's claims against TRG, but the appellate court reversed the dismissals in two of the suits.[144] TRG filed a motion in Kimball Hill's bankruptcy for an order finding that the surety's state court claims against TRG violated Kimball Hill's bankruptcy plan injunction.[145] The bankruptcy court granted TRG's motion. It declined to abstain in favor of the state court or find estoppel, waiver, laches, or claim preclusion. The court concluded that TRG was raising a bankruptcy issue, not a state law issue. TRG was entitled to the protection of Kimball Hill's bankruptcy plan as a purchaser from the Kimball Hill estate.[146]

In *Furlong Development Co., LLC v. Georgetown-Scott County Planning & Zoning Commission*,[147] the Supreme Court of Kentucky found a surety and a principal developer liable to a county commission on a subdivision bond for infrastructure improvements in a development despite the fact the development was never started.[148] After the developer defaulted on its loan during the Great Recession, the bank accepted a deed to the property in lieu of foreclosure. The bank then asked the commission to call the developer's bonds and place the proceeds in escrow to reimburse the bank for completion of the improvements per the developer's approved plat.[149] The court rejected the developer's argument that the "bonds were not callable because no homes had been built on the development property prior to Developer's default."[150] "[I]t is clear that the property had been irreparably converted from rural farm land and had undergone significant stages of sub-division development," thereby reducing the property's value and the flexibility for future development.[151] The bank did not need to sue for damages and was not unjustly enriched as a contract existed.

4. Release of Lien Bond

Wagner Interior Supply of Wichita, Inc. v. Dynamic Drywall, Inc.[152] involved a statutory release of lien bond posted by a prime contractor and its surety

143. *Id.* at 884–85.
144. *Id.* at 886.
145. *Id.*
146. *Id.* at 887.
147. 504 S.W.3d 34 (Ky. 2016).
148. *Id.* at 36.
149. *Id.* at 37.
150. *Id.*
151. *Id.* at 39.
152. 389 P.3d 205 (Kan. 2017).

on a hotel project. The bond released the mechanics lien of a supplier to a subcontractor. The contractor and surety contended the lien had been improperly perfected so they could assert the imperfection as a defense just as the prime contractor and owner could have done had the lien not been released.[153] The supplier argued that once the bond was posted, the validity of the lien could no longer be contested.[154] The Kansas Supreme Court agreed, finding that it was undisputed that the supplier had not been paid for materials used on the project and therefore the surety was liable as a matter of law. "With the filing of an approved bond, the lien is discharged and the focus shifts from the satisfaction of each statutory element required for the lien, to the ability of the claimant to prove the basis for its claim against the bond."[155]

5. Mortgage Lenders Bond

In *Federer v. Zurich American Insurance Co.*,[156] a borrower sued several banks in federal court for improper lending practices, but omitted American Mortgage Express Corporation (AMEC) from that suit although it had made a loan to the borrower as well. The court dismissed the suit and entered judgment against the borrower. The borrower then sued the banks in state court, including AMEC. The other banks obtained dismissal on the basis of res judicata but a default judgment was entered against AMEC.[157] The borrower died, but her estate filed a federal suit against the surety on AMEC's mortgage lender bond to recover the default judgment. The court held that the suit was barred by res judicata and dismissed it in favor of the surety.[158] The bond covered AMEC's performance only as a mortgage lender, and nothing in the bond suggested it was meant to respond to liability based only on a judgment. The bond was intended to meet a Georgia state licensing requirement and thus it was a performance bond.[159] A surety on such a bond is not necessarily bound by any judgment against its principal. Rather, the judgment is only prima facie evidence of principal's liability to the creditor and the surety may introduce rebuttal evidence. The surety is liable only on proof that the principal failed to perform as promised by agreement or obligation. In contrast, under a judgment bond, the surety agrees to be liable for a judgment even if it had no notice. The judgment is conclusive against it absent fraud.[160]

153. *Id.* at 209.
154. *Id.*
155. *Id.* at 211.
156. No. 16-16592, 2017 WL 16-16592 (11th Cir. July 11, 2017).
157. *Id.* at *1.
158. *Id.*
159. *Id.* at *3.
160. *Id.* at *2.

6. Motor Vehicle Dealer Bonds

In *Bell v. Western Surety Co.*,[161] a car buyer sued a Missouri dealer for refusal to refund the down payment when the car broke down. The buyer obtained a default judgment against the dealer that included damages not only for the down payment but also for lost use of the car and emotional distress.[162] The buyer sent a copy of the judgment to a state revenue agency, which in turn notified the dealer's statutory motor vehicle bond surety. When the surety refused to pay, the buyer filed suit. The trial court found the surety "strictly liable" for all of the damages but dismissed the buyer's vexatious refusal to pay claim.[163] On appeal, the surety argued it did not issue a judgment bond and should have had the right to contest the lost use and emotional distress damages, which its bond did not cover.[164] The court found that the bond, as governed by Mo. Rev. Stat. § 301.560 and by the bond's own terms, covered "any loss" arising from acts sufficient to justify suspending or revoking the dealer's license. The buyers' damages fell within this coverage as a "natural, necessary and logical consequence" of the dealer's conduct, not as a strict liability. The surety could not relitigate the damages; it was bound by the buyer's default judgment against the dealer.[165]

In *Sanchez v. AN Luxury Imports of Pembroke Pines, Inc.*, a purchaser asserted claims under the Florida Deceptive and Unfair Trade Practices Act (FDUTPA) against a car dealer and its surety in connection with the sale of a certified pre-owned vehicle that was later discovered to have been involved in an accident.[166] The trial court entered a judgment against the surety that included attorney fees in excess of the bond amount. On appeal, the court found the surety was not jointly and severally liable with its principal for attorney fees under FDUTPA as that Act expressly provides that sureties are not subject to such assessments.[167] Instead, the trial court should have awarded the attorney fees under Fla. Stat. Ann. § 627.428, which allows for a fee multiplier.[168] The appellate court also found that the surety's liability for attorney fees was limited to the $25,000 face amount of the bond, however. The trial court was instructed to enter a judgment that included attorney fees under Section 627.428 but was capped at $25,000.[169]

161. 524 S.W.3d 109 (Mo. Ct. App. 2017).
162. *Id.* at 112.
163. *Id.*
164. *Id.* at 112–13.
165. *Id.* at 114–16.
166. 216 So. 3d 723 (Fla. Dist. Ct. App. 2017).
167. *Id.* at 728–29.
168. *Id.* at 730.
169. *Id.* at 733–34.

In *Per Jonas Ingvar Gustafsson v. Aid Auto Brokers, Inc.*,[170] a buyer entered into a mediated settlement agreement (MSA) with a car dealer and its surety. The parties agreed that the buyer "is entitled to reasonable attorneys' fees pursuant to § 501, Fla. Stat. only."[171] The trial court determined that the buyer's reasonable attorney fees and costs were $70,150 and entered a final judgment against the dealer in that amount.[172] After the dealer went out of business, the trial court entered an amended order finding the surety liable for the buyer's attorney fees, but limiting the fees to the $25,000 face amount of the bond. On appeal, the court determined that the surety was not obligated to pay the buyer any attorney fees because the MSA limited the buyer's entitlement to Chapter 501, "which does not apply to entities—such as sureties—that are regulated by the Department of Financial Services."[173]

D. *Rights of Surety*

1. Indemnity

In *International Fidelity Insurance Co. v. La Porte Construction, Inc.*,[174] a contract surety required the principal and others, including limited liability companies (LLCs), in which the principal held a minimal interest, to execute a general indemnity agreement.[175] The LLCs contended that the individual who signed on their behalf as "managing member" was not actually authorized to do so.[176] The court agreed and entered summary judgment for the LLCs. The individual had no authority to sign for the LLCs under any operating agreements or resolutions.[177] The surety waived any argument about apparent authority.[178]

In *Western Surety Co. v. La Cumbre Office Partners, LLC*,[179] the court held that an indemnity agreement was enforceable against an LLC despite its managing member's lack of actual authority to execute the indemnity agreement on behalf of the LLC. The surety did not know of the lack of authority and a California statute[180] provided that a contract signed by the managing member "is not invalidated as to the [LLC] by any lack of authority of the signing managers or manager in the absence of actual knowledge on the part of the other person that the signing managers or

170. 212 So. 3d 405, 406 (Fla. Dist. Ct. App. 2017).
171. *Id.* at 407.
172. *Id.*
173. *Id.* at 408.
174. No. 2:16-cv-00032, 2017 WL 876261 (D. Utah Mar. 3, 2017).
175. *Id.* at *12.
176. *Id.* at *24.
177. *Id.* at *32.
178. *Id.*
179. 213 Cal. Rptr. 3d 460 (Cal. Ct. App. 2017).
180. Cal. Corp. Code § 11703.01(d).

manager had no authority to execute the same." The statute thus furnishes "a conclusive evidentiary presumption of the managing member's authority, relieving the party relying on the signature of the burden of establishing justifiable reliance upon the authority of the executing officers."[181] In the case before the court, the signer's inaccurate designation of his position did not invalidate the indemnity agreement as there was no requirement that the signer's position be set forth in the agreement.[182]

In *Dipizio Construction Co., Inc. v. Erie Canal Harbor Development Corp.*,[183] a surety issued performance and payment bonds on behalf of a contractor. The project fell behind schedule and the contractor blamed the owner.[184] The owner issued notice of intent to terminate the contractor and also filed suit against the contractor. The surety entered into a takeover agreement with the owner, joined the suit against the contractor, and claimed its excess completion costs as damages.[185] An issue arose about the extent to which the contractor's claims had been assigned to the surety under the contractor's general agreement of indemnity in favor of the surety. The surety asserted that its assignment rights were triggered when the owner declared the contractor in default and the contractor defaulted under the indemnity agreement by failing to indemnify the surety for bond losses. The surety did not need a judicial determination to treat this as a default sufficient to trigger assignment, including any tort claims arising out of the bonded contract.[186] The court rejected the argument that the surety had acted in bad faith by failing to investigate the default so as to forfeit its assignment rights. The surety was a real party in interest and the assignee could pursue the claims asserted by its principal against the owner.[187]

In *Allegheny Casualty Co. v. Vedadi*,[188] a surety sought indemnity under a general indemnity agreement from its principal and co-indemnitors of losses it incurred under bonds issued on a construction project after the principal's default. The indemnitors asserted counterclaims against the surety for breach of the covenant of good faith and fair dealing. The surety moved for judgment on the pleadings. The surety argued that it could not be liable in tort for bad faith, or on any other basis, to an indemnitor under an agreement of indemnity. Applying Arizona law, the court agreed.[189] Liability for

181. *Western Surety Co.*, 213 Cal. Rptr 3d at 465 (citing Snukal v. Flightways Mfg., Inc., 3 P.3d 286 (Cal. 2000)).

182. *Id.* at 455–56.

183. 48 N.Y.S.3d 909 (N.Y. App. Div. 2017), *affirming* Dipizio Constr. Co., Inc. v. Erie Canal Harbor Dev. Corp., 55 Misc. 3d 1215(A) (N.Y. Sup. Ct. 2015).

184. *Dipizio*, 55 Misc. 3d at *1.

185. *Id.* at *2.

186. *Id.* at *5–6.

187. *Id.* at *7–8.

188. No. CV-16-02270, 2017 WL 1550481, at *3 (D. Ariz. May 1, 2017).

189. *Id.* at *4.

bad faith arises only when there is a special relationship between the contracting parties—"something more than commercial advantage."[190] No such relationship exists between a surety and its indemnitors.[191] "[I]t is the surety who looks to the indemnitor for indemnification, not the other way."[192]

In *American Safety Casualty Insurance Co. v. Happy Acres Enterprises Co.*,[193] a contractor was found liable under its indemnity agreement to a performance bond surety. The contractor then filed an arbitration demand against the project owner, along with a suit on its mechanic's lien. The owner impleaded the surety in the lien suit. The surety intervened in the arbitration and prevailed together with the contractor against the owner.[194] The surety then sought indemnity from the contractor and its co-indemnitors of the attorney fees and costs the surety had incurred in the lien suit and the arbitration.[195] The court entered judgment against the indemnitors for the full amount sought. The court remarked that an express indemnity agreement between a surety and its indemnitors is "strictly enforced."[196] The surety also was entitled to the funds that the owner had deposited in state court following the arbitration award against the owner.[197]

In *City of Galveston v. Consolidated Concepts, Inc.*,[198] the City of Galveston awarded the bond principal a contract to repair homes and structures damaged by Hurricane Ike. The principal failed to pay subcontractors and suppliers. The city learned of this and issued checks made jointly payable to the principal and its subcontractors. The principal failed to negotiate the checks. The city interpleaded the funds after various parties made claims—the principal's surety, subcontractors and suppliers, the IRS with a tax lien, and a bank with a judgment lien.[199] The surety sought recovery of losses it had paid on other projects by enforcing its general indemnity agreement with the principal as a security agreement. The surety had no losses on the project at issue, however. One subcontractor had sued the surety but the surety had not paid that claim. The lender did not have a properly perfected security interest. The subcontractors and suppliers could not recover because the funds were not statutory trust

190. *Id.* at *7.
191. *Id.*
192. *Id.* at *7–8.
193. No. C16-0044, 2017 WL 385969 (W.D. Wash. Jan. 26, 2017).
194. *Id.* at *2–3.
195. *Id.* at *3.
196. *Id.* at *6.
197. *Id.* at *6–7.
198. 3:14-CV-00253, 2017 WL 1196213 (S.D. Tex. Mar. 31, 2017).
199. *Id.* at *4–6.

funds.[200] The court awarded the interpleaded funds to the IRS after finding that its claim was superior to all the others.[201]

2. Collateral Deposit

In *Guarantee Co. of North America USA v. Ikhana, LLC*,[202] a surety issued Miller Act performance and payment bonds on behalf of a prime contractor. Following substantial delays, the Corps of Engineers terminated the bonded contract.[203] The surety engaged a completion contractor, paid a supplier and a subcontractor, and demanded the contractor post collateral under its general indemnity agreement.[204] Meanwhile, the contractor filed an appeal with the Armed Services Board of Contract Appeals (ASBCA) alleging wrongful termination.[205] The surety settled with the Corps and sued the contractor for indemnity and a declaration that it had authority under its indemnity agreement to settle with Corps, including an agreed dismissal of the contractor's ASBCA appeal. The contractor moved to stay the surety's suit against it until the ASBCA appeal was resolved.[206] The court granted the motion to stay; it saw the issue of whether the contractor's termination was wrongful (i.e., that it was not in default) as needing to be resolved before the surety could proceed, in spite of arguments for the surety on the basis of contrary provisions in the general indemnity agreement.[207]

In *Allied World Specialty Insurance Co. v. Abat Lerew Construction, LLC*,[208] a surety moved for a preliminary injunction and order requiring the bond principal and co-indemnitors to deposit $400,000 as security against claims in excess of $300,000. The court noted the surety was not seeking specific performance or claiming an inadequate remedy at law. It ruled that the surety had not shown irreparable harm as necessary to support the injunctive relief it was seeking. Specifically, the surety had not shown that the indemnitors were insolvent, that they were disposing of assets, or that they were hiding assets. Moreover, the surety conceded "that it has not paid out any claims and [] [was] in the process of investigating the claims."[209] The balance of harms thus favored indemnitors. They had presented "unrefuted evidence that [their] financial condition, ability to meet [their] ongoing financial obligations, and ability to perform the two presently uncompleted public construction projects would be put in jeopardy if an injunction

200. *Id* at *13.
201. *Id.*
202. No. 1:16-cv-1484, 2017 WL 1821106 (E.D. Va. May 4, 2017).
203. *Id.* at *1.
204. *Id.*
205. *Id.* at *2.
206. *Id.*
207. *Id.* at *3–5.
208. No. 8:16CV545, 2017 WL 1476131 (D. Neb. Apr. 24, 2017).
209. *Id.* at *13–14.

were granted[.]"[210] The public interest would be furthered by denial of "the extraordinary relief of a preliminary injunction before discovery and without adequate development of an indemnitor's arguable defenses."[211]

In *Great American Insurance Co. v. Nelson*,[212] a contractor was terminated on a federal project and appealed to the Armed Services Board of Contract Appeals (ASBCA). While the appeal was pending, the surety filed suit against the contractor and its co-indemnitors under a general indemnity agreement. The surety sought to recover payments it had made under its payment bond. The surety and indemnitors settled this suit. The settlement agreement required the personal indemnitors to make payments to the surety and help it obtain remaining contract funds. ASBCA then found that the contractor had been wrongfully terminated. The government paid a settlement to the contractor. The surety now filed a second suit against the contractor, alleging breach of the indemnity agreement and breach of its settlement agreement with the indemnitors, even though the contractor had not been a party to that agreement. The personal indemnitors filed bankruptcy. The court held that the claim against the contractor was not time barred. The statute of limitations did not begin to run until the surety paid under its bond, not when it received the claim.[213] Moreover, the contractor's indemnity obligations did not merge into the later settlement agreement.[214] The court granted the surety summary judgment on its indemnity claims, but denied judgment on the surety's claims under the settlement agreement. An issue of fact existed as to whether the contractor, which was not a party to the agreement, nevertheless sought affirmative relief thereunder such that it could be liable for breach of the agreement.[215] The court also granted specific performance of the collateral security provision of the indemnity agreement as to the settlement funds the contractor received from the government in satisfaction of its wrongful termination claim. The contractor was required to deposit those funds into an account controlled by the surety.[216]

3. Subrogation

In *Jutte Electric, Ltd. v. Ohio Facilities Construction Commission*,[217] a surety financed its principal contractor's completion of electrical work on a state school for the deaf and blind after the contractor filed bankruptcy. The

210. *Id.* at *15.
211. *Id.* at *16–17.
212. No. 2016-cv-02283, 2017 WL 1417378 (W.D. Tenn. Apr. 20, 2017).
213. *Id.* at *4.
214. *Id.* at *6.
215. *Id.*
216. *Id.* at *8.
217. 2016 WL 8731738 (Ohio Ct. Cl. Dec. 13, 2016).

surety then sought to recover cost overruns from the owner on the basis of the owner's mismanagement.[218] The court recognized that by way of equitable subrogation a surety may "step into the shoes" of its principal and sue for damages owed to the principal.[219] However, "[e]quitable subrogation exists to allocate proceeds of already-established rights, not to create new ones."[220] Neither the contractor nor the surety had timely asserted a claim against the owner. The surety could not assert a right the contractor no longer possessed. Nor could the surety recover under any assignment of the contractor's rights. The contract allowed an assignment with the owner's consent but no such assignment could be found.[221] The court remarked that the surety should have paid the penal sum of the bond rather than provide financing that ended up exceeding the penal sum. A memorandum of understanding did not replace the underlying contract or the relationship between the parties. Nor did it operate as an assignment of the contractor's rights to the surety even thought the underlying contract allowed an assignment with the owner's consent.

In *American Safety Insurance Co. v. DLM, LLC*,[222] a bonded contractor filed Chapter 11 bankruptcy in 2009. Under the contractor's bankruptcy plan, it agreed to assume continued liability under its construction contracts and surety bonds but not its indemnity agreements. In 2014, the surety received notice that the contractor had breached its bonded contracts. The surety resolved the resulting bond claims and sought indemnity from the contractor's co-indemnitors. When they refused to pay, the surety sued them under the indemnity agreements and, as the owner's subrogee, also sued the contractor for breach of the bonded contracts. The court denied the defendants' motion to dismiss. The bankruptcy court's discharge of the surety's indemnity rights against the contractor did not discharge the surety's subrogation claim against the contractor.[223] The subrogation claim was not barred by Maryland's three-year statute of limitations,[224] and a demand letter attached to the complaint failed to cap the damages at the amount stated therein. The complaint itself sought additional damages and the demand letter had reserved all rights and remedies.[225]

218. *Id* at *27.
219. *Id* at *47.
220. *Id* at *49.
221. *Id* at *56.
222. No. GLR-16-3628, 2017 U.S. Dist. LEXIS 105716 (D. Md. July 10, 2017).
223. *Id.* at *14–15.
224. *Id.* at *17–18.
225. *Id.* at *20.

II. FIDELITY LAW

A. *Employee Theft/Employee Dishonesty*

1. Who Is an Employee?

In *Commercial Ventures, Inc. v. Scottsdale Insurance Co.*,[226] an insured alleged that one of its owners, Richard Guido, committed "employee theft" within the meaning of the crime coverage part of the policy. In addition to being an owner, Guido functioned as the insured's president. The insured's operating agreement provided that, as long as Guido served as president, he would receive $27,500 per month. If Guido was to fit within the policy's definition of "employee," these payments had to qualify as "wages, salary, or commissions." In reviewing the dictionary definitions of "wages," "salary," and "commissions," the court found that each term referred to compensation for a person's services. The court then focused on the operating agreement between Guido and the insured. It characterized the monthly payment as a "distribution" and defined "distribution" as "the transfer of money or property by [the insured] to one or more Members without separate consideration."[227] Given this, it followed that Guido did not receive any "distribution" as compensation or consideration for his services as president. The distributions instead were payments of his share as an owner of the insured.[228] Because Guido did not receive "wages, salary, or commissions," he was not an "employee" and his receipt of the payments was not "employee theft" within the policy's coverage.[229]

In *Colony Tire Corp. v. Federal Insurance Co.*,[230] the court examined whether a payroll service was an "employee" for purposes of a claim under the employee theft insuring agreement. The insured hired a payroll servicer, ESN, and authorized it to withdraw funds from a designated bank account to pay the insured's payroll and taxes. ESN was owned and controlled by two brothers, James and William Staz. After working with ESN for years, the insured received a notice of deficiency from the IRS, alerting it that ESN had not been paying the insured's payroll taxes, but had been pocketing the money for itself.

The insured sought to recover the loss under its employee theft coverage, but the insurer denied the claim on the basis that the Staz brothers were not "employees" within the meaning of the policy. The policy defined "employee" to include "any contractual independent contractor," i.e., "any natural person . . . while in the regular service of an organization . . . pur-

226. No. CV15-08359, 2017 WL 1196462 (C.D. Cal. Mar. 23, 2017).
227. *Id.* at *7 (emphasis added).
228. *Id.* at *8.
229. *Id.* at *9.
230. 217 F. Supp. 3d 860 (E.D.N.C. 2016).

suant to a written contract between such organization, and either (A) such natural person independent contractor, or (B) any other entity acting on behalf of such natural person . . . for services."[231] The court had to decide whether the Staz brothers qualified as independent contractors within the employee definition. While the insured's contract was with ESN and not with the brothers, ESN acted "on behalf" of the brothers and they were "natural persons." ESN was not a legitimate business; it existed solely "to facilitate the Stazes' embezzlement[232] and therefore acted "on behalf of" the Stazes when it contracted with the plaintiff for the purpose of facilitating the Stazes' embezzlement."[233]

The court further held that neither state law nor the policy wording precluded a finding that a corporation may act on behalf of another entity or individual. ESN as a payroll servicer acted "on behalf of" the Staz brothers when it contracted with the insured for the purpose of facilitating the Staz brothers' embezzlement. The court concluded that every element of the employee definition had been met. The Staz brothers were "contractual independent contractors" and thus "employees" under the policy.[234]

2. Improper Financial Benefit

In *Renasant Bank v. St. Paul Mercury Insurance Co.*,[235] a veteran loan officer of the insured, a state bank, became involved with a notorious fraudster and allegedly colluded with him to make improper loans for development projects.[236] When the borrower defaulted on the loans, the insured sought to recover its loss under its financial institution bond. The bond included a clause stating that, if the insured's loss resulted in any way from a loan, coverage was available only if the dishonest employee colluded with one or more parties to the transaction and received an improper financial benefit in connection with the transaction.[237] The insured's sole evidence of the employee's receipt of an improper financial benefit was that the employee received a commission upon the closing of the loan.[238] The bond, however, excluded commissions earned in the normal course of employment from its definition of "financial benefit." The court agreed with the insurer that the commission did not constitute an improper "financial benefit."[239] The insured attempted to circumvent this by contending the requirement of an im-

231. *Id.* at 865.
232. *Id.* at 867.
233. *Id.*
234. *Id.* at 866–67.
235. 235 F. Supp. 3d 805 (N.D. Miss. 2017).
236. *Id.* at 807–08.
237. *Id.* at 808.
238. *Id.* at 819–21.
239. *Id.*

proper financial benefit be read out of the bond because the bond was required by a state statute that did not include this requirement. The court agreed that the bond was statutory; it had been furnished to comply with the state's requirement that a bank obtain fidelity coverage.[240] The court also held, however, that this did not mean the bond's heightened requirements for loan losses had to be read out of the bond. Those requirements were not inconsistent with the underlying purpose of the statute, which was to ensure that banks had coverage for employee dishonesty. The bond's requirements of an "improper financial benefit" and "collusion" were "logical requirements in keeping with the statutory language."[241]

Maldonado Investments LLC v. State Farm Fire & Casualty Co.[242] involved a fire insurance policy. The body of the policy excluded coverage for dishonest or criminal acts by any of the insured's employees.[243] However, an endorsement provided that the insurer would pay "for direct physical loss to business personal property . . . resulting from dishonest acts committed by any of your 'employees'" with the manifest intent to cause the insured to sustain a loss and obtain a financial benefit.[244] The insured sought coverage after a fire on the insured's premises. The insurer determined that the fire was deliberately set by one of the insured's employees (who later pleaded guilty to arson). The insurer denied coverage on the ground that the loss was excluded because it resulted from a criminal act by one of its own employees. The insured argued for coverage under the endorsement as an exception to the exclusion. The court disagreed. The endorsement did not apply because the insured did not prove that the employee himself received a "financial benefit" or that he intended anyone else to receive a financial benefit, as required by the employee dishonesty endorsement.[245]

B. *Insuring Agreements "D" and "E"*

In *Harvard Savings Bank v. Security National Insurance Co.*[246] the court denied the insurer's motion for summary judgment under Insuring Agreements "D" and "E." This case involved a fraudulent loan scheme, in which the perpetrators submitted falsified documents to the U.S. Department of Agriculture (USDA) to become certified as a non-traditional lender of USDA-guaranteed loans and then issued loans to fictitious borrowers, creating loan packets with fake documents and forged signatures.[247] The in-

240. *Id.* at 814–16.
241. *Id.* at 816.
242. No. 14-2597, 2016 WL 8135411 (W.D. La. Nov. 4, 2016).
243. *Id.* at *3.
244. *Id.* at *4.
245. *Id.* at *5.
246. Civil Action No. 15 CV 11674, 2017 WL 2560900 (N.D. Ill. June 12, 2017).
247. *Id.* at *1–2.

surer argued that Insuring Agreement "D" did not apply because there was no "negotiable instrument," but the court held that the various loan documents, considered together (i.e., bundled), satisfied the definition of "negotiable instrument."[248] With regard to Insuring Agreement "E," the insurer argued that fake loans cannot be "counterfeit" because no authentic, original loan documents existed.[249] The court disagreed, stating that "common usage would indicate that counterfeit is something that purports to be something that it is not."[250] The court held that the "dispute whether the fake loans were counterfeit ends when the Court determines that the fake loans looked all right even as to details, but they were not what they seemed to be."[251]

In *Citizens Bank Holding Inc. v. Atlantic Specialty Insurance Co.*,[252] a case that involved the same scheme as *Harvard Savings*, the court reached the opposite conclusion. The bank purchased $15 million in fictitious loans from a supposed lender in Florida. Included in the loan documents were USDA guarantees, which were later discovered to have forged signatures. The bank sought coverage under its financial institution bond, alleging specifically that the loss was covered under Insuring Agreements "D" and "E." As a matter of contract interpretation, the court observed that under Wisconsin law insurance policies are interpreted consistent with the understanding of a "reasonable insured." Considering that the drafting of the bond form involved both the banking and insurance industries, however, the policy language was not construed against the insurer.[253]

As regards coverage under Insuring Agreement "E," which covers only "corporate, partnership or personal" guarantees, the court found that there was no coverage. The USDA guarantees were given by an arm of the government and therefore were neither corporate, partnership, nor personal. The court rejected the bank's attempt to manipulate the USDA guarantees into the definition of "corporate" guarantees. Had the parties, including the "reasonable insured," intended to cover governmental guarantees, the bond would have said so. The court also rejected the insured's argument that the USDA guarantees were "certificated securities;" they clearly were "guarantees," which are expressly addressed by Insuring Agreement "E." Turning to Insuring Agreement "D," the court rejected the insured's argument that the guarantees fell within the definition of "letters of credit." A reasonable insured would not expect that the documents—clearly

248. *Id.* at *5.
249. *Id.* at *8.
250. *Id.*
251. *Id.* (internal quotation marks omitted).
252. No. 15-V-782, 2016 WL 8505590 (E.D. Wis. Nov. 16, 2016).
253. *Id.* at *3.

labeled as "guarantees" and falling squarely within the bond's definition of "guarantee"—would be considered to be "letters of credit" under the bond.[254]

C. *Computer Fraud*

1. Hacking Requirement

In *Apache Corp. v. Great American Insurance Co.*,[255] a fraudster posing as a vendor phoned and asked the insured's employee to change the vendor's bank account for future payments. The employee advised that the change could not be made without a formal request on the vendor's letterhead. As instructed, the fraudster e-mailed what appeared to be a formal request that purported to be on the vendor's letterhead. The e-mail domain address resembled, but was not, the vendor's genuine address. After calling the number on the putative letterhead for verification, the insured accepted that the request was authentic, changed the account information, and wired funds to the account in payment of genuine invoices.[256] After learning of the fraud, the insured sought coverage for loss "resulting directly from the use of any computer to fraudulently cause a transfer" of funds under the insurer's crime protection policy.[257] Reversing the district court's award of summary judgment to the insured, the Fifth Circuit held that the loss was not covered under the crime protection policy and, instead, awarded the insurer summary judgment. With the exception of one vacated trial court ruling from another state,[258] the court found "cross-jurisdictional uniformity in declining to extend coverage when the fraudulent transfer was the result of other events and not directly by the computer use."[259] The insured's loss was not caused by computer use; at best, the e-mail with the deceptively similar address was incidental to the occurrence of the loss. The court noted that the phone calls between the insured and the fraudsters, both before and after the e-mail, were instrumental in the insured's decision to wire funds. The loss thus was caused by the insured's telephone conduct and its failure to investigate the account change request properly.[260] "To interpret the computer-fraud provision as reaching any fraudulent scheme in which an e-mail communication was part of the process would . . . convert the computer-fraud pro-

254. *Id.* at *7.
255. 662 F. App'x 252 (5th Cir. 2016).
256. *Id.* at 253.
257. *Id.* at 254.
258. Owens, Schine & Nicola, P.C. v. Travelers Cas. & Sur. Co. of Am., 2010 WL 4226958 (Conn. Super. Ct. Sept. 20, 2010), *vacated*, 2012 WL 12246940 (Conn. Super. Ct. Apr. 18, 2012).
259. *Apache*, 662 F. App'x at 258.
260. *Id.*

vision to one for general fraud."[261] The Fifth Circuit also held that the transfers were made not because of fraudulent e-mail information, but because the insured elected to pay legitimate invoices: "Restated, the invoices, not the e-mail, were the reason for the funds transfers."[262]

In *Taylor & Lieberman v. Federal Insurance Co.*,[263] the court similarly held that a fraudulent e-mail is not a fraudulent "instruction" of the type that computer fraud insuring agreements in fidelity insurance are designed to cover. The insured was an accounting firm that received fraudulent e-mails asking it to make certain wire transfers.[264] The e-mails appeared to be from the insured's client (but of course were not). The insured made these wire transfers, sustained a loss, and sought to recover its loss under insuring agreements for forgery, computer fraud, and funds transfer fraud. The Ninth Circuit affirmed the award of summary judgment to the insurer, holding that "forgery" coverage was unavailable, because only forgeries of "financial instruments" were covered. The e-mails did not fit the definition of a "financial instrument."[265] As to the "computer fraud" claim, the court held that e-mails were "not the type of instructions that the policy was designed to cover, like the introduction of a 'malicious code.'"[266] As to the "funds transfer fraud" coverage, the court found it unavailable because the insured had authorized the wire transfers.[267]

American Tooling Center, Inc. v. Travelers Casualty & Surety Co. of America[268] presented another all-too-familiar fact pattern of fraudulent e-mail representations. The insured sent an e-mail to its vendor asking for copies of invoices. The insured received an e-mail in response, purportedly from the vendor, asking that payment be wired to a new bank account. The sender's e-mail address was slightly different from the vendor's actual address, but the insured did not notice the difference. Without conducting any verification of the request to change banking information, the insured wired $800,000 to the new bank account before the fraud was detected. The insurer rejected the insured's claim under the computer fraud insuring agreement, which covered loss resulting the insured's "direct loss" of money "directly caused by Computer Fraud."[269] "Computer Fraud" was defined as "the use of any computer to fraudulently cause a transfer of

261. *Id.*
262. *Id.* at 259.
263. 681 F. App'x 627 (9th Cir. 2017).
264. *Id.* at 628–29.
265. *Id.*
266. *Id.* at 629.
267. *Id.*
268. No. 16-12108, 2017 WL 3263356 (E.D. Mich. Aug. 1, 2017).
269. *Id.* at *1.

Money. . . ."[270] The court sided with the insurer, for two reasons. First, the loss did not result directly—that is immediately and without anything intervening—from the fraudulent e-mail. The e-mails themselves did not cause the transfer. Rather a series of intervening events caused the insured to complete the transfer, including its failure to verify the account change. Second, although the e-mails duped the insured into transferring funds, they did not qualify as the "use of any computer to fraudulently cause a transfer."[271] No infiltration or hacking of the insured's computer system occurred. The transfer itself was not fraudulent; it was authorized by the insured.[272]

One case, however, is an outlier. *Medidata Solutions, Inc. v. Federal Insurance Co.*[273] is inconsistent with the overwhelming majority of recent case law on computer fraud claims. The fraud involved an unsolicited e-mail to one of the insured's employees that purported to be from the insured's president, advising that an attorney would be calling about an acquisition. The "attorney" called the employee and requested that the insured perform a wire transfer in connection with the supposed transaction. The employee informed the fraudster that she needed an e-mail from the insured's president. She and other employees then received an e-mail through a Google email system that purported to be from the president, instructing the employees to proceed with the wire transfer. The fraudster was able to cause the e-mail to appear to come from employees of the insured. The coding of the e-mail was doctored so that it came with the photo that accompanied Google system e-mails from employees of the insured. The employee proceeded to arrange the wire transfer, and two account managers reviewed and approved the wire transfer without speaking to the insured's president to confirm his authorization. Ultimately, $4.7 million was transferred to the fraudster's bank account. The following month, the "lawyer" contacted the account employee again to arrange another wire transfer. The account employee followed the same procedure, but this time the transfer was prevented when one of the account managers noticed the "reply to" address in the e-mail was suspicious. The fraud was uncovered after further investigation.[274]

The insured made a claim under its computer fraud coverage, which protected against "direct loss of Money" resulting from "Computer Fraud." "Computer Fraud" was defined as "the unlawful taking or the fraudulently induced transfer of Money . . . resulting from a Computer Violation." A "Computer Violation" was defined as "the fraudulent: (a) entry of Data

270. *Id.*
271. *Id.* at *3.
272. *Id.*
273. No. 15-CV-907 (ALC), 2017 WL 3268529 (S.D.N.Y. July 21, 2017).
274. *Id.* at *1–2.

into . . . a Computer System; [and] (b) change to Data elements or program logic of a Computer System, which is kept in machine readable format. . . ."[275] "Data" included any "representation or information."[276] "Computer System" meant "a computer and all input, output, processing, storage, off-line media library and communication facilities which are connected to such computer" used by the insured.[277] The court held that the fraudster's mere e-mail spoofing was the type of "deceitful and dishonest access" to a computer system that computer fraud insurance was intended to cover.[278] The court rejected the insurer's argument that the fraudster did not enter any computer system of the insured because the e-mail system was run by Google, and it ignored precedent requiring that the loss to the insured result directly or immediately from the use of a computer.[279] The court also rejected the Fifth Circuit's rationale in *Apache*, which recognized that the insured's inadequate investigation of the request for the wire transfers was one of the facts that severed any "direct" chain of causation.[280]

2. Use of Computer

In *Incomm Holdings, Inc. v. Great American Insurance Co.*,[281] the court held that the policy's computer fraud provision was not triggered because the use of a telephone to access an Interactive Voice Response (IVR) system does not qualify as the "use of a computer."[282] The underlying claim involved debit cards that allowed cardholders to increase prepaid credit balances by purchasing "chits" from a retailer and loading the value onto their cards using an IVR telephone service.[283] An error in the IVR system allowed cardholders to load the same chit multiple times, which improperly increased the prepaid credit balances.[284] The court looked to the dictionary for the definition of "computer" and agreed with the insurer that the use of a telephone system did not constitute the use of a "computer," despite the interaction of the IVR telephone system with a computer.[285] The court also held that the loss was not the "direct" result of cardholders redeeming the same chit multiple times because the loss was contingent upon a series of other events occurring.[286]

275. *Id.* at *2.
276. *Id.*
277. *Id.*
278. *Id.* at *5.
279. *Id.* at *5–6.
280. *Id.* at *6.
281. No. 1:15-cv-2671-WSD, 2017 WL 1021749 (N.D. Ga. Mar. 16, 2017).
282. *Id.* at *2–3.
283. *Id.* at *3–4.
284. *Id.* at *6.
285. *Id.* at *23.
286. *Id.* at *32.

D. *Discovery of Loss*

NCUA v. CUMIS Insurance Society, Inc.[287] involved the chief operating officer of the insured credit union, who made bad loans in return for bribes. The bribes began in 2000; by 2010, the credit union had lost $72.5 million due to these bad loans.[288] As a result, the NCUA took over the credit union and sought coverage under a fidelity bond purchased earlier that year. The insurer denied coverage on the grounds that directors of the credit union knew that the chief operating officer (COO) was misrepresenting loan delinquencies as early as 2005 and, as such, coverage never incepted as to the COO. On appeal, the NCUA argued that, under the bond, coverage terminated only as to acts "occurring after the effective date" of the termination, and thus losses sustained prior to 2005 were covered under the recently purchased bond.[289] The Sixth Circuit concluded that the NCUA waived its argument that the termination provision did not bar recovery in its entirety.[290] In reaching this conclusion, the court considered whether finding a waiver would present "exceptional circumstances" or a "miscarriage of justice," which required the court to delve into the merits.[291] The court reasoned that to hold that the bond covered losses resulting from acts that occurred before the credit union discovered the COO's dishonesty in 2005 would invite a prospective insured to apply for a bond, not disclose the dishonesty in the application, and then seek coverage for losses that arose from acts that occurred before the dishonesty was discovered.[292] Essentially, the Sixth Circuit held that to allow this type of recovery would amount to insurance fraud.[293]

Dillon v. Continental Casualty Co.[294] held that, under California law, the "adverse domination" of the insured tolled a crime policy's discovery period. In *Dillon*, the owners of a 1031 exchange stole funds that they held in trust for clients.[295] The insured's receiver argued that the policy's discovery period should have been equitably tolled because the owners of the insured so dominated the insured's operations that "discovery" under the policy was impossible, and the court agreed. It held that a "discovery" provision is akin to a limitations period, which California law allows to be equitably tolled under an "adverse domination" theory. The court concluded that the same result is appropriate for a fidelity bond's period

287. 689 F. App'x 428 (6th Cir. 2017).
288. *Id.* at 429.
289. *Id.* at 432–33.
290. *Id.* at 436.
291. *Id.* at 433.
292. *Id.*
293. *Id.* at 436–37.
294. No. 5:10-cv-05238-EJD, 2017 WL 4355070 (N.D. Cal. Sept. 29. 2017).
295. *Id.* at *1.

for discovery of a loss, even if discovery of the loss by other employees had been possible.[296]

E. *Termination Upon Change of Control*

In *FDIC v. Kansas Bankers Surety Co.*,[297] an insured bank provided its financial institution bond insurer with notice of an unlawful scheme to circumvent the bank's lending limits in which the insured's employee and customer were involved. The court held, however, that the FDIC, as the insured's successor, could not recover under the bond because the insured did not submit a proof of loss prior to inception of the FDIC's receivership.[298] By its terms, the bond terminated when a receiver took over the insured. The bond further provided that no receiver shall exercise any right to make a claim against the insurer "unless a Proof of Loss, duly sworn to, with full particulars and complete documentation has been received by [the insurer] prior to termination."[299] Finding that Colorado law expressly permitted such language, the court rejected the FDIC's argument that the provision should have been construed against the insurer and in favor of coverage because it was ambiguous and contained nonstandard language.[300] The FDIC never acquired the right to enforce the bond because it stood in the shoes of the bank, and the bank never acquired the right to enforce the bond because it failed to submit a proof of loss prior to the FDIC's takeover.[301]

F. *Inventory Exclusion*

In *Khazai Rug Gallery, LLC v. State Auto Property & Casualty Insurance Co.*,[302] an insured was a rug gallery. One of its employees stole five rugs, but later admitted the theft and returned them.[303] The insured then performed an inventory analysis and discovered far more rugs were missing—seventy-nine rugs, to be precise. No one confessed to the apparent thefts, and the insured did not have any other proof that a theft had occurred.[304] The insured also claimed that $16,000 was missing from a cash drawer but, similarly, there was no evidence of a theft other than the memory of one of the insured's employees that the drawer once held $16,000 more than it did at the time.[305] The trial court granted summary judgment to the insurer on the

296. *Id.* at *6–7.
297. 840 F.3d 1167 (10th Cir. 2016).
298. *Id.* at 1174.
299. *Id.*
300. *Id.*
301. *Id.*
302. No. 2016-CA-000129-MR, 2017 WL 945116 (Ky. Ct. App. Mar. 10, 2017).
303. *Id.* at *1.
304. *Id.*
305. *Id.*

basis of the inventory exclusion as to the rugs and also held there was no coverage of the allegedly missing cash, given the flimsiness of the evidence that it had been lost. The appellate court affirmed. It noted that, while courts vary as to whether inventory computations are acceptable proof of a loss when there is other modest independent proof of employee theft, at the very least there has to be independent prima facie evidence of employee theft before the insured can attempt to rely upon an inventory computation.[306] Because the insured lacked independent evidence that the seventy-nine rugs or $16,000 were stolen (let alone stolen by an employee), it was properly barred from relying upon an inventory calculation to establish its (alleged) loss.[307]

G. *Limitations*

In *Hantz Financial Services, Inc. v. American International Specialty Lines Insurance Co.*,[308] the Sixth Circuit agreed that an insured's suit against the insurer was time barred, as it had failed to bring that suit within twenty-four months of "final judgment" as required by the bond's limitations provision.[309] The insured argued that "final judgment" was ambiguous, but the court held the term has a specific legal meaning: a judgment issued by a court, even if appealable.[310] The insured also argued that the insurer should be equitably estopped from enforcing the bond's limitations provision because it induced the insured to believe that the limitations period would not be enforced, implicitly waiving the provision.[311] The court held that, despite the fact that the insurer investigated the claim for nearly three years, it never expressed or implied that it would waive the limitations period, nor did it suggest that it otherwise would cover the loss.[312]

H. *Claim Handling/Bad Faith*

In *Ameritas Life Insurance Corp. v. Federal Insurance Co.*,[313] an insurer moved to bifurcate the insured's contract claims from its remaining claims, including bad faith. The insured was itself an insurance company and had hired an employee to sell policies and securities. During a two-year span, several of the insured's customers alleged that an employee of the insured stole money from them. They demanded that the insured pay them compensation and rescind the policies that the dishonest employee had sold. The insured paid $2,547,221 to resolve these claims

306. *Id.* at *5.
307. *Id.* at *6.
308. 664 F. App'x 452 (6th Cir. 2016).
309. *Id.* at 460.
310. *Id.* at 459.
311. *Id.* at 460.
312. *Id.* at 461.
313. No. 4:16CV3006, 2017 WL 432693 (D. Neb. Jan. 31, 2017).

and sought indemnification from the insurer. The insurer paid only a portion of the total claim, disclaiming liability for the remainder, and litigation ensued. The court granted the insurer's motion to bifurcate under Rule 42 of the Federal Rules of Civil Procedure, noting that "evidence relevant on the breach of contract and bad faith actions will not significantly overlap, and evidence presented for the bad faith claim will potentially prejudice a fair determination of the breach of contract claim."[314] Thus, "absent a threshold showing that the contract was breached," discovery of the insured's claim processing information could potentially require the disclosure of privileged information, create jury confusion, and inject prejudice into the proceedings.[315]

314. *Id.* at *3.
315. *Id.*