Committee News
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Fidelity & Surety Law Committee




FREEDOM OF CONTRACT COLLIDES WITH PUBLIC POLICY: A TREND UNDER THE MILLER ACT OF INVALIDATING DISPUTE CLAUSES IN CONTRACTOR/ SUBCONTRACTOR AGREEMENTS

By: Nina M. Durante, Charles W. Langfitt, John F. Fatino, and Zachary J. Hermsen

I. Introduction

Contractors, sureties, and their lawyers know that things can get complicated when the federal government undertakes a large construction project. The government needs to find the right general contractor, the general contractor needs to find the right subcontractors, and all parties must cooperate to finish the job on time and on budget. In addition to the difficulties in coordinating these moving pieces, the legal system imposes its own complexities into this process. This article will discuss

Continued on page 14

IN THIS ISSUE:

Uniting Plaintiff, Defense, Insurance, and Corporate Counsel to Advance the Civil Justice System

Chair

Gary Valeriano
Anderson McPharlin & Conners LLP
707 Wilshire Boulevard, Ste 4000
Los Angeles, CA 90017-3623
(213) 688-0080
Fax: (213) 622-7594
gjv@amclaw.com

Chair-Elect

Adam Friedman
Chiesa Shahinian & Giantomasi PC
One Boland Drive
West Orange, NJ 07052
(973) 530-2029
Fax: (973) 530-2229
afriedman@csglaw.com

Council Representative

Sam Poteet
Manier & Herod
150 4th Ave N, Ste 2200
Nashville, TN 37219
(615) 742-9321
Fax: (615) 242-4203
spoteet@manierherod.com

Immediate Past Chair

Mike Pipkin
Weinstein Radcliff Pipkin LLP
8350 N Central Expressway, Ste 1550
Dallas, TX 75206
(214) 865-7012
Fax: (214) 865-6140
mpipkin@weinrad.com

Newsletter Editor-in-Chiefs

Todd Braggins
Ernstrom & Dreste LLP
180 Canal View Blvd, Ste 600
Rochester, NY 14623-2849
(585) 473-3100
Fax: (585) 473-3113
tbraggins@ed-llp.com

Omar Harb
Alber Crafton PSC
2301 W Big Beaver Rd, Ste 300
Troy, MI 48084-3326
(248) 822-6190
Fax: (248) 822-6191
oharb@albercrafton.com

John Sebastian
Watt Tieder Hoffar & Fitzgerald LLP
10 S Wacker Dr, Ste 2935
Chicago, IL 60606-7411
(312) 219-6900
Fax: (312) 559-2758
jsebastian@watttieder.com

Scope Liaison

David Olson
Frost Brown Todd LLC
301 E 4th St, Ste 3300
Cincinnati, OH 45202-4257
(513) 651-6905
Fax: (513) 651-6981
dolson@fbtlaw.com

Vice-Chairs

Theodore Baum
McElroy, Deutsch, Mulvaney & Carpenter, LLP
920 Bausch & Lomb Place
Rochester, NY 14604
(585) 623-4286
Fax: (585) 295-8300
tbaum@mdmc-law.com

Ashley Belleau
Lugenbuhl, Wheaton, Peck, Rankin & Hubbard
601 Poydras St, Ste 2775
New Orleans, LA 70130
(504) 568-1990
Fax: (504) 200-8932
abelleau@lawla.com

Robert Berens
Salamirad Morrow Timpane & Dunn
2001 E Campbell Ave, Ste 203
Phoenix, AZ 85016-5574
(602) 258-6219
rberens@smtdlaw.com

Lisa Block
Axis Insurance
1211 Ave of The Americas, 24th Fl
New York, NY 10036
(212) 500-7689

Virginia Boyle
Liberty Mutual Group
450 Plymouth Rd, Ste 400
Plymouth Meeting, PA 19462-1644
(610) 832-8246
Fax: (610) 828-4684
virginia.boyle@libertymutual.com

Shannon Briglia
BrigliaMcLaughlin PLLC
1950 Old Gallows Rd, Ste 750
Vienna, VA 22182-4014
(703) 506-1990
Fax: (703) 506-1140
sbriglia@briglialaw.com

Elizabeth Carley
Cincinnati Insurance Company
PO Box 145496,
Cincinnati, OH 45250-5496
(513) 870-2173
Fax: (513) 371-7252
liz_carley@cinfin.com

Gerald Carozza
Selective Ins Co of Amer
40 Wantage Ave,
Attention Bond Claims
Branchville, NJ 07890
(973) 948-1823
Fax: (866) 324-3786
gerald.carozza@selective.com

Paula-Lee Chambers
Hinshaw & Culbertson LLP
28 State St, Fl 24
Boston, MA 02109-5709
(617) 213-7000
Fax: (617) 213-7001
pchambers@hinshawlaw.com

Andy Chambers
Jennings Strouss & Salmon PLC
1 E Washington St, Ste 1900
Phoenix, AZ 85004-2554
(602) 262-5846
Fax: (602) 495-2728
achambers@jsslaw.com

Bogda Clarke
The Hanover Insurance Group
400 Atrium Dr, Suite 500
Somerset, NJ 08873-4170
(732) 805-2378
Fax: (732) 805-2395
boclarke@hanover.com

Bruce Corriveau
Travelers
111 Schilling Rd
Hunt Valley, MD 21031-1110
(443) 353-2076
Fax: (410) 205-0608
bcorrive@travelers.com

James Diwik
Sedgwick LLP
333 Bush St, Fl 30
San Francisco, CA 94104-2834
(415) 781-7900
Fax: (415) 781-2635
james.diwik@sedgwicklaw.com

Marc Domres
Krebs Farley & Pelleteri PLLC
400 Poydras St, Ste 2500
New Orleans, LA 70130-3224
(504) 299-3570
Fax: (504) 299-3582
mdomres@kfplaw.com

Jennifer Fiore
Dunlap Fiore LLC
301 Main St, Ste 1100
Baton Rouge, LA 70801-1916
(225) 282-0652
Fax: (225) 282-0680
jfiore@dunlapfiore.com

Robert Flowers
Travelers
1 Tower Sq, Ste S104
Hartford, CT 06183-0001
(860) 277-7150
Fax: (860) 277-5722
rflowers@travelers.com

Jeffrey Frank
Alber Crafton PSC
2301 W Big Beaver Rd, Ste 300
Troy, MI 48084-3326
(248) 822-6190
Fax: (248) 822-6191
jfrank@albercrafton.com

Jeffrey Goldberg
SWISSRE
475 N Martingale Rd, Ste 850
Schaumburg, IL 60173-2276
(847) 273-1268
Fax: (847) 273-1260
jeff_goldberg@swissre.com

Ivette Gualdron
Zurich
236 Rue Landry Rd
Saint Rose, LA 70087-3666
(504) 471-2676
Fax: (504) 712-3507
ivette.gualdron@zurichna.com

Mike Hennigan
Cincinnati Insurance Company
6200 S Gilmore Rd
Fairfield, OH 45014-5100
(513) 870-2736
Fax: (513) 881-8913
mike_hennigan@cinfin.com

Hilary Hoffman
Chubb
15 Mountain View Rd
Warren, NJ 07059-6795
(908) 903-4706
hhoffman@chubb.com

Marchelle Houston
Travelers Bond & Specialty Insurance
1 Tower Sq, Ste 2S2
Hartford, CT 06183-0002
(860) 277-2408
Fax: (860) 277-5722
mhouston@travelers.com

Michael Hurley
Berkley Surety Group LLC
412 Mount Kemble Ave, Ste 310N
Morristown, NJ 07960-6669
(973) 775-5040
Fax: (973) 775-5204
mhurley@berkleysurety.com

Patrick Hustead
The Hustead Law Firm
4643 S Ulster St, Ste 1250
Denver, CO 80237-4307
(303) 721-5000
Fax: (303) 721-5001
pqh@thlf.com

Susan Karlan
ICW Group - OPRS
11455 El Camino Real
San Diego, CA 92130-2088
(858) 350-7213
Fax: (858) 350-2640
skarlan@icwgroup.com

Peter Karney
SWISSRE
475 N Martingale Rd, Ste 850
Schaumburg, IL 60173-2276
(847) 273-1259
Fax: (847) 273-1260
peter_karney@swissre.com

James Keating
Allied World Inse Company
30 South 17th Street, 16th Floor
Philadelphia, PA 19103
(267) 800-1819
james.keating@awac.com

Christina Kocke
Merchants Bonding Company
215 Savanna Drive
Luling, LA 70070
(504) 417-5164
tkocke@merchantsbonding.com

Mark Krone
Anderson McPharlin & Conners LLP
707 Wilshire Blvd, Ste 4000
Los Angeles, CA 90017-3623
(213) 688-0080
Fax: (213) 622-7594
mk@amclaw.com

Frank Lanak
HCC Surety Group
601 S Figueroa St, Ste 1600
Los Angeles, CA 90017-5721
(310) 242-4403
Fax: (310) 649-0891
flanak@hccsurety.com

Darrell Leonard
Zurich
11074 Inspiration Cir
Dublin, CA 94568-5530
(800) 654-5155
Fax: (800) 329-6105
darrell.leonard@zurichna.com

Lawrence Lerner
Levy Craig Law Firm
1301 Oak St, Ste 500
Kansas City, MO 64106-2865
(816) 460-1807
Fax: (816) 382-6606
llerner@levycraig.com

John McDevitt
Liberty Mutual Group
20 Riverside Rd
Weston, MA 02493-2206
(617) 243-7918
Fax: (866) 547-4882
john.mcdevitt@libertymutual.com

Mary McNamara
Travelers
111 Schilling Rd
Hunt Valley, MD 21031-1110
(443) 353-2130
Fax: (443) 353-1137
mmcnamar@travelers.com

Henry Minissale
ACE USA
436 Walnut St, WA10
Philadelphia, PA 19106
(215) 640-2641
Fax: (215) 640-5474
henry.minissale@acegroup.com

Vincent Miseo
Vincent C Miseo
211 Washington Corner Rd
Bernardsville, NJ 07924
(201) 267-7536
vcmiseolaw@gmail.com

Louis Modugno
McElroy Deutsch et al
1300 Mount Kemble Ave
Morristown, NJ 07960-8009
(973) 425-8660
Fax: (973) 425-0161
lmodugno@mdmc-law.com

Caryn Mohan-Maxfield
The Walsh Group
929 W Adams St
Chicago, IL 60607-3037
(312) 563-5936
cmaxfield@walshgroup.com

Thomas Moses
CNA
333 S Wabash Ave, Fl 41
Chicago, IL 60604
(312) 822-4528
mrholyamos@gmail.com

Robert Niesley
Watt Tieder Hoffar & Fitzgerald LLP
2040 Main St, Ste 300
Irvine, CA 92614-7291
(949) 852-6700
Fax: (949) 261-0771
rniesley@watttieder.com

Robert O'Brien
Liberty Mutual Group
9450 Seward Rd
Fairfield, OH 45014-5412
(513) 867-3718
Fax: (866) 442-4060
robert.obrien@libertymutual.com

Scott Olson
SureTec Insurance Co
9737 Great Hills Trl, Ste 320
Austin, TX 78759-6418
(512) 732-0099
Fax: (512) 732-8398
solson@suretec.com

Thomas Pennington
Frost Brown Todd LLC
150 3rd Ave S, Ste 1900
Nashville, TN 37201-2011
(615) 251-5550
Fax: (615) 251-5551
tpennington@fbtlaw.com

Martha Perkins
National Association of Surety Bond Producers
1140 19th St NW, Ste 800
Washington, DC 20036-6607
(202) 686-3700
Fax: (202) 686-3656
mperkins@nasbp.org

Derek Popeil
Chubb
15 Mountain View Road
Warren, NJ 07059
(908) 903-3182
Fax: (908) 903-5537
dpopeil@chubb.com

Stephen Rae
Liberty Mutual Group
450 Plymouth Rd, Ste 400
Plymouth Meeting
PA 19462-1644
(610) 832-8254
Fax: (610) 940-9112
stephen.rae@libertymutual.com

Toni Reed
Strasburger & Price LLP
901 Main St, Ste 4400
Dallas, TX 75202-3729
(214) 651-4345
Fax: (214) 659-4091
toni.reed@strasburger.com

Edward Reilly
20 Overhill Rd
Summit, NJ 07901-4127
(212) 441-2575
edward.reilly@aon.com

Frederick Rettig
State Farm Insurance
One State Farm Plaza A-3
Bloomington, IL 61710-0001
(309) 766-5051
fred.rettig.c8f1@statefarm.com

Edward Rubacha
Jennings Haug & Cunningham LLP
2800 N Central Ave, Ste 1800
Phoenix, AZ 85004-1049
(602) 234-7800
Fax: (602) 277-5595
er@jhc-law.com

Michelle Smith Cotto
225 Converse St
Longmeadow, MA 01106-1701
(413) 567-0409
Fax: (508) 635-0448

Jan Sokol
Stewart Sokol & Larkin LLC
2300 SW 1st Ave, Ste 200
Portland, OR 97201-5047
(503) 221-0699
Fax: (503) 227-5028
jdsokol@lawssl.com

W Speicher
Zurich
3787 Sells Mill Rd
Taneytown, MD 21787
(410) 840-9144
Fax: (800) 329-6106
w.glenn.speicher@zurichna.com

Michael Spinelli
801 Motor Pkwy, Ste 103
Hauppauge, NY 11788-5256
(631) 680-3100
Fax: (631) 737-9171
michael-spinelli@tourolaw.edu

Michael Stover
Wright Constable & Skeen LLP
100 N Charles St, Fl 16
Baltimore, MD 21201-3805
(410) 659-1321
Fax: (410) 659-1350
mstover@wcslaw.com

Dee Studler
SDC CPAs LLC
1444 N Farnsworth Ave, Ste 500
Aurora, IL 60505-1644
(630) 820-5770
Fax: (630) 820-5765
dstudler@sdccpa.com

Frank Tanzola
International Fidelity Insurance Company
1 Newark Ctr, Fl 20
Newark, NJ 07102-5219
(973) 624-7200
Fax: (973) 623-8006
ftanzola@ific.com

Ty Thompson
Mills Paskert Divers
100 N Tampa St, Ste 3700
Tampa, FL 33602-5835
(813) 229-3500
Fax: (813) 229-3502
tthompson@mpdlegal.com

Richard Towle
Chubb Group of Insurance Companies
15 Mountainview Rd
Warren, NJ 07059-6795
(908) 903-3423
Fax: (908) 903-3030
rtowle@chubb.com

Thomas Vollbrecht
Fabyanske Westra Hart & Thomson P.A.
333 S 7th St, Ste 2600
Minneapolis, MN 55402-2437
(612) 359-7659
tvollbrecht@fwhtlaw.com

Patricia Wager
Torre Lentz Gamell Gary & Rittmaster LLP
100 Jericho Quadrangle, Ste 309
Jericho, NY 11753-2702
(516) 240-8969
Fax: (516) 240-8950
pwager@tlggr.com

Courtney Walker
Berkshire Hathaway Specialty Insurance
4539 Laurelwood Dr
Memphis, TN 38117-3507
(617) 834-8652
courtney.walker@bhspecialty.com

Justin Wear
150 4th Avenue N, Ste 2200
Nashville, TN 37219
(615) 244-0030
Fax: (615) 242-4203
jwear@manierherod.com

Blake Wilcox
Liberty Mutual Group
1001 Fourth Avenue, Fl 47
Seattle, WA 98154
(206) 473-3264
Fax: (425) 376-6533
blake.wilcox@libertymutual.com

Douglas Wills
Chubb
15 Mountainview Rd
Warren, NJ 07059-6795
(908) 903-5339
Fax: (908) 903-5537
dwills@chubb.com

Editorial Policy: This Newsletter publishes information of interest to members of the Fidelity and Surety Law Committee of the Tort Trial & Insurance Practice Section of the American Bar Association — including reports, personal opinions, practice news, developing law and practice tips by the membership, as well as contributions of interest by nonmembers. Neither the ABA, the Section, the Committee, nor the Editors endorse the content or accuracy of any specific legal, personal, or other opinion, proposal or authority.

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MESSAGE FROM THE CHAIR

Wait a minute, it's already Spring? My year as Chair of the Fidelity and Surety Law Committee ("FSLC") is going way too fast. Needless to say, I have greatly enjoyed my time as Committee Chair and I want to acknowledge the kind assistance and support from the ABA staff members lead by Mary Ann Peter, Janet Hummons, Felisha Stewart, Ninah Moore, Debra Dotson and Donald Quarles, who have all been so helpful in making my time as Chair a happy one.

First of all, let me start by telling you about the wonderful Fall Program we had in Washington, D.C. on November 4-6, 2015. That program, which introduced the *Annotated Commercial Crime Insurance Policy, Third Edition* to the world, was chaired by Toni Scott Reed of Strasburger & Price LLP and Carleton Burch of Anderson, McPharlin & Conners LLP. Following the Annual Fidelity Law Association meeting, which was held on November 3, 2015, the FSLC program took a day and a half to present each and every topic of interest to fidelity practitioners and to update them on case law from the last 10 years. Everyone in attendance received a copy of the book, and if you have not already secured a copy, please do so by going to the ABA website to purchase the *Annotated Commercial Crime Insurance Policy, Third Edition*.

After the Fall Meeting, the Mid-Winter Meeting of the FSLC took place in New York City on January 20-22, 2016 at the Waldorf-Astoria Hotel. The weather was great for the program itself, but the following Saturday we did receive a record breaking 26 inches of snow which prevented many people from getting home at their planned time. We hope that this wasn't too inconvenient and I think it's a good way to help us appreciate next year's Mid-Winter Meeting, which will be taking place in New Orleans, Louisiana.

The Mid-Winter Meeting, as usual, was comprised of three separate programs — Construction, Fidelity and Surety. The Construction program was headed up by Shannon Briglia of BrigliaMcLaughlin PLLC and Larry Lerner of the Levy Craig Law Firm and was entitled, "Subcontractor Nuts and Bolts: The Essentials for the Surety and Construction Practitioner." The program was well-received and the presenters did an excellent job of going through the various phases of construction from the ground up.

The Fidelity meeting was co-chaired by Dominque Sena-DiDonato of the Chubb Group of Insurance Companies and Matt Horowitz of Wolf, Horowitz & Ettinger LLC. That program was entitled, "Mediating the Complex Fidelity Claim: How to Get it Right." The program dealt with different stages of a broker-related fidelity claim, but most importantly focused on the mediation of that claim. On the panels were several professional mediators who brought valuable and practical insight into the various strategies and practices necessary for a successful mediation.

The Surety program co-chairs were Jarrod Stone of Manier & Herod and Eric Mausolf of Travelers and was entitled, "The Law of Payment Bonds: The Updated Tips From the Pros." The program was an update to *The Law of Payment Bonds* which had been presented a few years before and which is the subject of another great America Bar Association publication, *The Law of Payment Bonds, Second Edition.* The program was excellent in all regards, and I am particularly proud of the fact that so many people were in attendance through the end on Friday afternoon, a very difficult task given the time and location. Hats off to Jarrod and Eric and all the presenters.

As you read this, we are coming up fast on the FSLC Spring Program entitled, "Surety Takeover From Default Through Dispute Resolution", which will be held on May 4 through 6, 2016 at the La Quinta Resort & Club in La Quinta, California. The program will be a day and a half commencing on Thursday, May 5th and ending at noon on Friday, May 6, 2016. Program Chairs for this presentation are Brett Divers of Mills Paskert Divers and Blake Wilcox of the Liberty Mutual Group. The program presenters will include experienced surety practitioners and surety company professionals, and the program's focus will be on covering all of the legal and practical issues concerning a surety takeover. Given the location and weather, which I guaranty will be fabulous, we have kept other scheduled events to a minimum. We have a cocktail reception planned for Wednesday, May 4, 2016, at the La Quinta Resort which is open to all registered attendees.

On Friday afternoon there will be a golf tournament benefitting *Homes For Our Troops* ("HFOT"). HFOT's mission is to build specifically adapted homes for severely injured veterans across the nation in order to enable them to rebuild their lives. These veterans have sustained injuries such as multiple limb amputations, partial or full paralysis, and/or severe dramatic brain damage. These homes restore some of the freedom and independence our veterans sacrificed while defending our country and enable them to focus on their families and rebuilding their lives. Empowered by the freedom a mortgage free and specially adapted home brings, these veterans can now focus on their recovery and returning to their life's work of serving others. Learn more about HFOT at http://www.hfotusa.org.

The golf tournament is at TPC Stadium Course at PGA West in La Quinta, which is a short drive from the La Quinta Resort & Club and is located in the foothills of the Santa Rosa Mountains. This course was designed for golf's biggest stage, the TPC Stadium Course — home of the CareerBuilder Challenge — and is where legends have made history. This par 72 Pete Dye-designed jewel is a "must play" for those seeking the ultimate golf challenge.

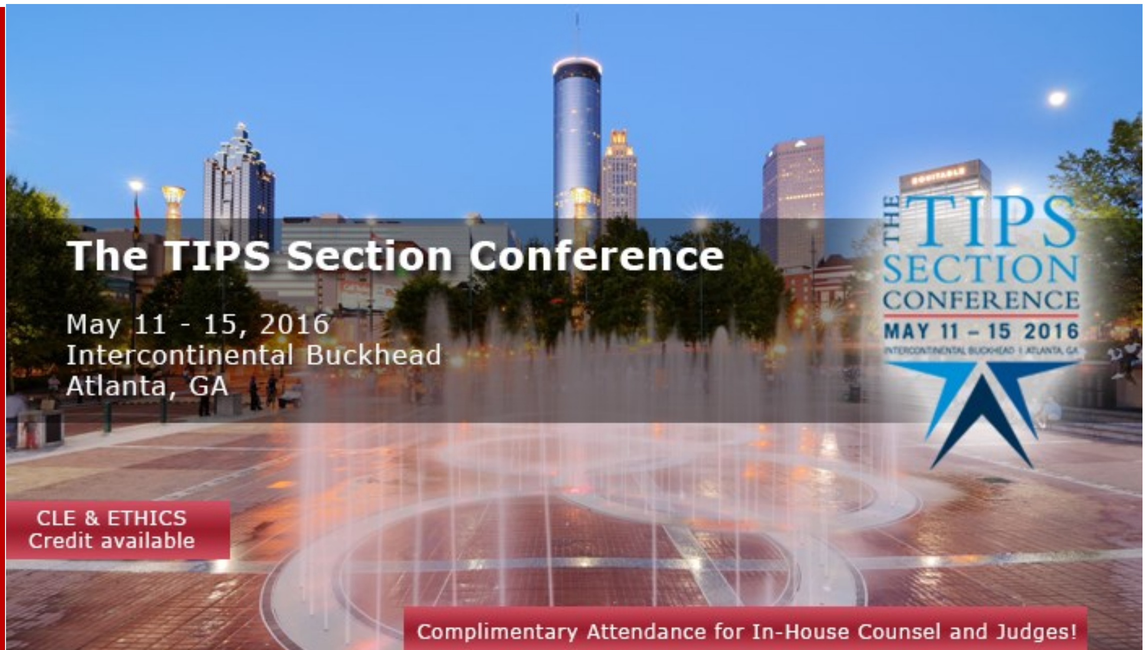
The tournament will be a four person scramble to ensure that players of all skill levels can enjoy the event. You are free to put together a team or we will place you in a foursome. Jeff Price of Manier & Herod has been gracious enough to organize the tournament and any questions can be directed to Jeff at jprice@manierherod.com.

On Friday evening, there will be a Vice Chairs dinner for all Vice Chairs and past Chairs. The dinner will be at the La Quinta Resort, hopefully outside and in good weather. On Saturday, there will be a Vice Chairs breakfast and meeting from 9:00 a.m. until noon at the resort as well.

As I wind down my year as Chair I would like to thank all of the people mentioned above, and all of the people I have reached out to over the course of my year for advice and guidance. While the Chairmanship does take time and effort, it is a vastly rewarding and wonderful experience. I thank all of my friends in the FSLC, all of the ABA staff and everyone who has attended our various meetings.

Finally, please register for the 2016 FSLC Spring Program and book your hotel rooms at the La Quinta Resort & Club, La Quinta, California for May 4-6, 2016. I look forward to seeing you all there. ⚖

Gary J. Valeriano
Anderson, McPharlin & Conners LLP
Chair, ABA TIPS Fidelity and Surety Law Committee



The 2016 TIPS Section Conference

The TIPS Section Conference is the premier CLE conference for a wide-range of attorneys, including both plaintiffs and defense counsel, insurance industry employees, and in-house corporate counsel. With over 25 CLE hours, nationally known speakers, and a variety of unique networking events, this conference provides exceptional CLE and valuable opportunities. TIPS is excited to host the second annual Section Conference at the InterContinental Buckhead in Atlanta, GA, May 11-15, 2016.

Program Highlights Include:

- U.S. Supreme Court Update
- Legal and Ethical Considerations for In-house Counsel
- Trial Tips: Effectively Examining Expert Witnesses
- Resolving Insurance Disputes Quickly
- Establishing a Successful Referral Relationship
- Handling and Litigating Claims of Bad Faith
- Cyber-Liability: Planning for the Risk
- Communicating with Millennial Jurors

A number of exciting social events will provide opportunities for attendees to meet with colleagues and expand their network: A young professionals event at SweetWater Brewery, the TIPS Leadership Luncheon, and multiple nightly networking receptions. The social highlight will be Friday's dinner at the Coca-Cola Museum.

Register Here Now!

CLE Credit: This program is expected to qualify for 13.5 CLE credit hours (including 6.0 ethics/professionalism hours) in 60-minute states, and 16.20 credit hours (including 7.20 ethics hours) in 50-minute states. CE Credit: ABA-TIPS has partnered with CEU Institute to provide CE Credit for licensed adjusters in all states with a CE requirement. Credit hours awarded are based on state review and approval.

PROMPT PAYMENT LAWS – TRAPS FOR THE UNWARY: COMMON ISSUES AFFECTING OWNERS, CONTRACTORS AND SUBCONTRACTORS

By: Patrick F. Welch

I. Introduction

For over thirty years, prompt pay has been a cornerstone of federal contracting statutes. The Federal Prompt Payment Act ("Federal PPA") requires the owner/government to pay the general contractor within fourteen days of the general contractor submitting a payment application to the owner. If the payment application is for final payment on the project, the owner/government must pay it within thirty days after final acceptance by the owner and submittal of the final invoice. In addition, the Federal PPA directs that the general contractor pay first tier subcontractors within seven days after the general contractor receives payment from the owner.[1] Following the federal government's lead, every state but New Hampshire has enacted a public prompt pay statute and two-thirds of the states have enacted a private prompt payment statute. The legislative impetus for passing prompt payment statutes shares a common thread (timely payment throughout the contracting chain).[2] Thus, the state statutory schemes tend to follow the same general pattern.

While prompt payment statutes are well-intended and have strengthened the construction payment process by adding clarity to each party's obligations, these statutes are traps for the unwary. For example, when parties get into a construction dispute, a paying party tends to withhold payment until the dispute has been resolved. While this may be an effective bargaining tactic in a pre-litigation setting, the result may be disastrous for the withholding party because it violates the applicable prompt payment statute. That party's violation of the prompt payment statute is tantamount to a breach of the contract, which may cause that party to lose all contract rights against the non-breaching contractor. Indeed, the paying party's material breach can have far-reaching consequences that may compromise its rights against applicable performance bonds.

This article provides an overview of common issues arising under federal and state prompt payment statutes that affect owners, contractors, and subcontractors. It also highlights common pitfalls these parties routinely encounter with prompt payment statutes, the consequences of not complying with the statutes, and best practices to ensure compliance.

II. Summary of Prompt Payment Statutes

With the exception of New Hampshire, state legislatures have unanimously followed the federal government's lead by using the Federal PPA as a template for their respective public prompt payment schemes. The growing trend over the last decade shows states are now also enacting private prompt payment legislation though some states have resisted this trend.[3] The number of states adopting private prompt pay statutes will likely grow in coming years based upon the efficiencies seen in those jurisdictions where prompt pay schemes are in effect.

Although states have used the Federal PPA as a general template, no uniform prompt payment act has emerged. The state legislatures have thus far crafted their own statutes with varying provisions, but the state statutory schemes share the following common themes:

1. The general contractor is entitled to payment within a certain number of days after it submits its payment application to the owner (for example, in the author's home state of Arizona, the owner has fourteen days to approve and then an additional seven days to make payment).[4]
2. If the owner disputes all or part of a payment application, the owner must object in writing, quantify the amount disputed and pay the undisputed amount to the general contractor.[5]

Continued on page 21

1 31 U.S.C. §§ 3901-3907 (1998); 48 C.F.R. § 52.232-27 (2014).

2 *See* Stonecreek Building Co. v. Shure, 162 P.3d 675, 678-79, ¶ 16 (Ariz. Ct. App. 2007) ("[T]he primary purpose of the [Prompt Pay] Act is to establish a framework for ensuring timely payments from the owner to the contractor and down the line to the subcontractors and suppliers whose work has been approved.")

3 Alaska, Arkansas, Colorado, Idaho, Indiana, Iowa, Michigan, Nebraska, New Hampshire, North Dakota, Oklahoma, Rhode Island, South Dakota, Virginia, Washington, West Virginia, Wisconsin and Wyoming do not have private prompt pay statutes.

4 *See* Ariz. Rev. Stat. Ann. § 32-1129.01 (2011).

5 *See* *id.*

PRACTICE POINTER

CLASS WARFARE: INITIAL DEFENSE OF POTENTIAL CLASS ACTION CLAIMS AGAINST MVD BONDS

By: Brandon J. Held and Matthew Davis

Although sureties do not routinely face class action claims, the potential exposure from such claims can be enormous when they occur. A recent trend involves efforts by savvy claimant's counsel to certify a class for an action against miscellaneous commercial bonds, in particular, motor vehicle dealership bonds ("MVD bonds"). Many surety practitioners may be initially unprepared to respond and might not be aware that preventing class certification may be the surety's best option.

By way of background, statutes and regulations often require MVD bonds before the governing body will issue a license to sell vehicles.[1] The conditions of MVD bonds vary from state to state but are typically conditioned upon a dealership's compliance with its contracts regarding the sale of vehicles, as well as conformity with the laws and regulations governing dealerships in the relevant jurisdiction. The penal sums of the bonds also vary but are usually relatively small. While Florida law requires a $25,000 penal sum bond, other states like South Carolina and Washington require $30,000 bonds.[2] Despite the generally low penal sums of these bonds, and with the correspondingly low premiums, potential exposure to a class action claim can be a serious matter for a surety.

For class actions in the MVD bond context, claimant's counsel will usually find what it believes to be a contractual or statutory violation in the principal's business transaction with one consumer. Since MVD bond principals typically use form contracts with respect to every purchase transaction, claimant's counsel will then try to extrapolate the alleged violation to all of the principal's business transactions with all consumers. After that, claimant's counsel will seek to certify a class that may involve hundreds or even thousands of claimants.

Since 1937, Rule 23 of the Federal Rules of Civil Procedure has governed federal class action claims and resolved questions of "common or general interest to many persons constituting a class so numerous as to make it impracticable to bring them all before the court."[3] Proponents of class actions describe them as a means to allow "numerous plaintiffs to pool their resources and collaborate in a single litigation[,]… provide a vehicle with which to effect broad social change[, and]… motivate the filing of some lawsuits by plaintiffs who otherwise would have thought their individual claims too petty to pursue."[4] In other words, "class actions alleviate costs that might otherwise prohibit individual plaintiffs from seeking relief."[5]

Several states adopted similar rules or statutes governing class action claims based upon Rule 23.[6] Thus, many states consider federal decisions and authorities interpreting class action requirements as persuasive authority.[7] Class certification must occur before a class action claim can proceed, and Rule 23 sets out the requirements for class certification.[8] To certify a class, the purported class must satisfy each of

Continued on page 24

1 *See, e.g.*, Fla. Stat. § 320.27(10) (2016), S.C. Code Ann. § 56-15-320 (2015), Wash. Rev. Code Ann. § 46.70.070 (West 2016).

2 *See supra* note 1.

3 *See* Fed. R. Civ. P. 23 advisory committee's note (1937) (explaining that Rule 23 represented an adoption of Equity Rule 38).

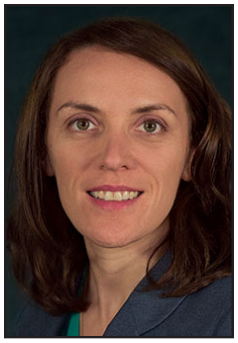
4 David Hill Koysza, *Preventing Defendants from Mooting Class Actions by Picking Off Named Plaintiffs*, 53 Duke L.J. 781, 793 (2003).

5 *Id.*

6 *See, e.g.*, Fla. R. Civ. P. 1.220 advisory committee's note (1980) ("The class action rule has been completely revised to bring it in line with modern practice. The rule is based on Federal Rule of Civil Procedure 23"); *see also* Sw. Ref. Co. v. Bernal, 22 S.W.3d 425, 433 (Tex. 2000) ("Rule 42 of the Texas Rules of Civil Procedure governs class certification [and] is patterned after Federal Rule of Civil Procedure 23").

7 Chase Manhattan Mortg. Corp. v. Porcher, 898 So. 2d 153, 156-57 (Fla. Dist. Ct. App. 2005) ("Florida courts may generally look to federal cases as persuasive authority in their interpretation of rule 1.220."); *Bernal*, 22 S.W.3d at 433.

8 Blake v. Arnett, 663 F.2d 906, 912 (9th Cir. 1981).



COMPUTER-RELATED FRAUD: IS IT COMPUTER CRIME, OR SOMETHING ELSE?

By: Anne E. Briard

In recent years, law firms and other businesses have begun storing more information electronically and "in the cloud." Businesses frequently use electronic billing and payment systems. It is increasingly common to rely on electronic means to communicate with clients and others, and many transactions seem to occur automatically. Cloud-based storage has notable advantages including convenient, 24-7 access to data. At the same time, electronic data storage and transactions present an increased opportunity for hackers to access that data and cause financial harm.

Recognizing the potential for losses from computer theft, some insurers offer limited coverage for computer crime. A typical insuring agreement for computer crime covers "direct loss of, or your direct loss from damage to, Money, Securities and Other Property directly caused by Computer Fraud."[1] The computer crime insuring agreement generally provides a definition for the term "computer fraud." For example, the policy in one recent case defined computer fraud as "[t]he use of any computer to fraudulently cause a transfer of Money, Securities or other Property from inside the Premises or Banking Premises … to a person (other than a Messenger) outside the Premises or Banking Premises; or … to a place outside the Premises or Banking Premises."[2] A policy at issue in a different case contained similar language, defining "computer fraud" as "any act of stealing property following and directly related to the use of any computer to fraudulently cause a transfer of that property from inside of your premises or from a banking institution or similar safe depository, to a person (other than a 'messenger') outside those premises or to a place outside those premises."[3]

Several recent decisions have focused on whether a loss was "directly" caused by the use of a computer. Some courts have found that the loss was too far removed from the computer use to be covered. Other courts hold that there is potential coverage if the use (or misuse) of the computer is a proximate cause of the loss. The courts' analyses tend to be very fact-intensive and focus on the details of the fraud scheme. As a result, court decisions on coverage for fraud under the computer crime insuring agreement seem to be all over the map.

For example, in *Pestmaster Services, Inc. v. Travelers Casualty & Surety Co. of America*,[4] the policyholder (Pestmaster) claimed that it sustained losses when its payroll company failed to pay Pestmaster's quarterly payroll taxes for over a year. Pestmaster had authorized the payroll company to transfer funds automatically from Pestmaster's account to pay employees' salaries and payroll taxes. The payroll company would typically complete payroll on a Friday and pay payroll taxes the following Wednesday. But the payroll company failed to pay the taxes.

The *Pestmaster* court found there was no coverage under the computer crime insuring agreement because Pestmaster failed to show that its losses were directly caused by the use of a computer. The court reasoned that because Pestmaster had authorized the electronic funds transfer to the payroll company, the loss did not occur at the point of the funds transfer via computer. Rather, the loss occurred later, when the payroll company transferred Pestmaster's funds into its own account. Thus, the court concluded that there was no computer fraud because the computer use was merely incidental to the alleged loss. The *Pestmaster* court also held that the insured's lost business profits, future earnings and opportunities, and out of pocket expenses were indirect costs that were too attenuated from the fraud and therefore were barred from coverage by an exclusion for "indirect or consequential loss."[5]

In another case involving an apparent fraud scheme, *Pinnacle Processing Group, Inc. v. Hartford Insurance. Co.*,[6] the insured, Pinnacle, was in the business of

1 *Pestmaster Servs., Inc. v. Travelers Cas. & Sur. Co. of Am.*, No. CV 13-5039-JFW (MRWx), 2014 U.S. Dist. LEXIS 108416, at *14-15, 2014 WL 3844627 (C.D. Cal. July 17, 2014).

2 *Id.*

3 *Pinnacle Processing Grp., Inc. v. Hartford Cas. Ins. Co.*, No. C10-1126-RSM, 2011 U.S. Dist. LEXIS 128203, at * 7, 2011 WL 5299557 (W.D. Wash. Nov. 4, 2011). Sometimes, there is a sublimit for computer crime coverage. *See id.* at *7-8 (policy covered "up to $5,000 in any one occurrence for physical loss of or physical damage to 'money,' 'securities,' and other property having intrinsic value resulting directly from computer fraud").

4 2014 U.S. Dist. LEXIS 108416, 2014 WL 3844627.

5 *Id.* at *25-26.

6 2011 U.S. Dist. LEXIS 128203, 2011 WL 5299557.

leasing credit card terminals to merchants. Each time a customer made a purchase at the merchants' businesses, the data passed through the Pinnacle credit card terminal to the bank that issued the customer's credit card. The issuing bank would then indicate whether the customer's card had sufficient funds or credit to make the purchase. Pinnacle contracted with a merchant bank, Merrick Bank, to deposit the purchase price into its merchants' accounts at the end of each day. When money was refunded to a customer whether due to a return, an error, or fraud, the funds would be returned to the customer's bank. Under Pinnacle's agreement with Merrick Bank, Pinnacle bore the risk of the chargeback loss. In 2008 and 2009, several merchants processed fraudulent credit card transactions through Pinnacle's system, causing Pinnacle to incur chargeback losses of $36,823.56.

On summary judgment, the insurer argued that Pinnacle's losses were not covered under the policy's computer fraud insuring agreement because they were not directly related to the use of a computer. The court agreed, holding that the loss was not directly linked to the use of a computer because Pinnacle did not suffer a loss until all of the following events had taken place: (1) Pinnacle's merchant bank, Merrick Bank, was unable to recover the chargeback funds; (2) Merrick Bank deducted funds from a $250,000 reserve Pinnacle was required to maintain; and (3) Pinnacle replaced the funds in the reserve. The court found that this was not a direct loss, but rather the loss resulted from an "attenuated chain of events," that began with a computer. In the court's view, the insured's interpretation would read the word "directly" out of the insuring agreement.[7]

The *Pinnacle* court also rejected the insured's argument that it had suffered a loss as soon as the fraudulent refund requests were issued by computer because it incurred a chargeback debt at that point. The court reasoned that the insuring agreement only covered the loss of securities or other property and not the incurring of a debt.[8]

In a case decided last year, *Taylor & Lieberman v. Federal Insurance Co.*,[9] a third party posing as a client of the insured accounting firm sent fraudulent payment instructions by email to the plaintiff requesting wire transfers to a bank in Malaysia. Upon discovery of the fraud, the accounting firm attempted unsuccessfully to recover the funds stolen from the client, and repaid its client with its own money. The accounting firm then made a claim to its computer fraud insurer, which was denied.

The *Taylor* court held that the insurer correctly denied coverage under its computer fraud policy that covered "direct loss sustained by an Insured resulting from Computer Fraud committed by a Third Party."[10] The court reasoned that the policy did not provide third-party coverage and that there was no direct loss *to the insured* from computer fraud. Rather, the fraud at issue caused the loss of a client's (third party's) money. The court also rejected the insured's argument that it sustained direct loss because it had power of attorney over the client's funds. The client's funds were held in a separate bank account and the power of attorney was granted in favor of just one of the plaintiff insured's employees. In light of these facts, the loss was simply too remote from the computer fraud. The court suggested that the loss might have been covered if the client's funds had been held in the insured's own account and that account had been depleted by a hacker who directly accessed the insured's computer system.[11]

In *Brightpoint, Inc. v. Zurich American Insurance Co.*,[12] the insured, Brightpoint, distributed prepaid phone cards through a dealer in the Philippines. The dealer would send copies of post-dated checks and bank guaranties of sufficient funds to Brightpoint with its purchase order. On receipt of the dealer's information, Brightpoint purchased phone cards and physically delivered them to the dealer in exchange for the original checks and guaranties. After one such delivery, the dealer refused to pay for a shipment of phone cards, claiming that it had not authorized its representative to pick up the phone cards or to issue guaranties. The court held that these facts did not satisfy the computer fraud insuring agreement's requirement for a direct loss.[13] Although the post-dated checks and the guaranties were transmitted by facsimile, the fax was not the proximate cause of the theft because the phone cards were not transferred to the purchaser electronically, but instead through an in-person meeting.

Other court decisions, however, have found that the computer crime insuring agreement potentially provides coverage for fraudulent transactions that involve the use of a computer in some but not all steps in the fraud. Like

7 *Id.* at *13.

8 *Id.* at *16-17.

9 No. CV 14-3608 RSWL (SHx), 2015 U.S. Dist. LEXIS 79358, 2015 WL 3824130 (C.D. Cal. June 18, 2015).

10 *Id.* at *6.

11 *Id.* at *10.

12 No. 1:04-CV-2085-SEB-JPG, 2006 U.S. Dist. LEXIS 26018, 2006 WL 693377 (S.D. Ind. Mar. 10, 2006).

13 *Id.* at *21-22.

the *Brightpoint* decision, these courts generally apply the standard of whether the use of a computer was the proximate cause of the loss. In one such case, *Retail Ventures, Inc. v. National Union Fire Insurance Co.*,[14] the United States Court of Appeals for the Sixth Circuit issued a decision that appears to be at odds with *Pestmaster*. In *Retail Ventures*, hackers used the wireless network at a DSW shoe store to download customers' credit card and checking account information through Retail Ventures' computer system. Subsequently, Retail Ventures was informed of fraudulent transactions using the stolen data, and incurred expenses to notify customers, for public relations services to alleviate the damage to its image, and to pay for customer claims, lawsuits and attorneys' fees.

The parties in *Retail Ventures* did not dispute that the access and copying of customer information constituted a computer fraud, but disagreed as to whether the alleged losses resulted directly from the theft of insured property by computer fraud. Finding that the state court in Ohio would interpret the phrase "resulting directly from" to impose a traditional proximate cause standard, the district court held that there was a sufficient link between the computer hacking and the third party customers' claimed financial losses from the improper use of the data obtained through the computer hack.[15]

On appeal, the insurer argued that the district court should have applied a more stringent causation standard and that the policy at issue provided first-party coverage only. The Sixth Circuit rejected the insurer's argument, finding that the language "resulting directly from" did not unambiguously limit coverage to loss resulting "solely" or "immediately" from the electronic theft of data.[16] The court also disagreed with the insurer that exclusions for defense costs, damages for which the insured is legally liable, and costs incurred by the insured in establishing the loss, limited the policy's coverage to first-party coverage.[17] Arguably, the *Retail Ventures* decision expands the fidelity bond coverage to a liability policy that provides third-party coverage.

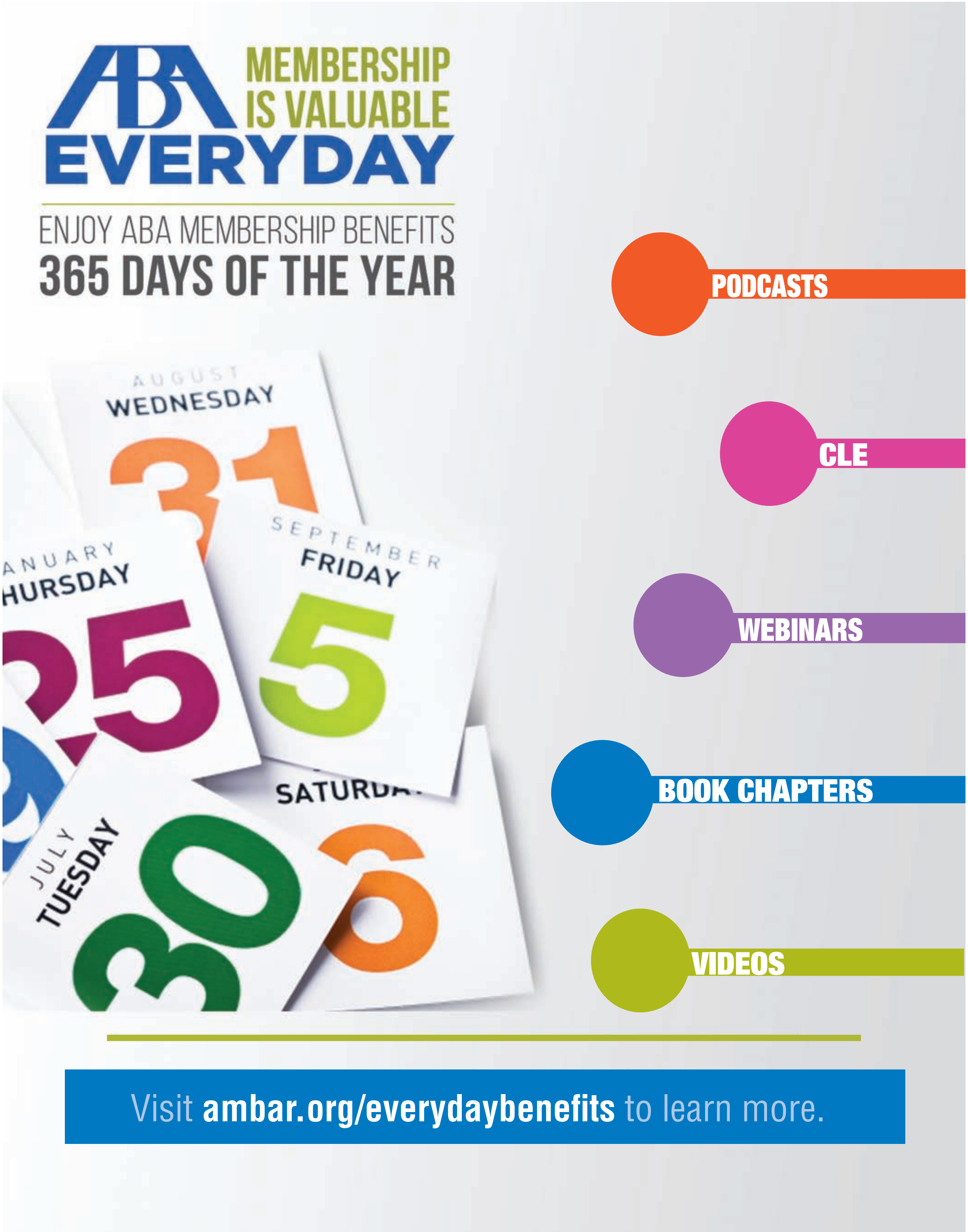
In *Owens, Schine & Nicola, P.C. v. Travelers Casualty & Surety Co. of America*,[18] the plaintiff law firm received an email requesting representation in a collection matter. The law firm entered a client representation agreement to collect a debt and emailed the agreement to the putative client. Later, the client advised it had negotiated an agreement with the debtor and mailed a check to the law firm, asking it to deposit the check into its trust account and wire transfer the funds to a bank in South Korea. Unfortunately, the debtor's check turned out to be fraudulent and the law firm's bank debited the law firm's account for the amount of the check.

The law firm made a claim to its computer crime insurer, which was denied. In the lawsuit, the law firm argued that the loss resulted from the use of a computer because its communications with the client were by email and because the client had used a computer to create the fraudulent check. In response, the insurer asserted that the loss could only be covered if a computer was used to actually transfer the money. The district court denied the insurer's motion for summary judgment. In the court's view, the policy was ambiguous as to the amount of computer use necessary. The court reasoned that a proximate cause analysis would determine whether the use of the computer was the direct cause, and found that emails from the client proximately caused the loss.[19]

These cases demonstrate the inconsistency among jurisdictions about whether the loss of data or funds is covered under a computer crime insuring agreement when a law firm or other business falls victim to fraud. But today many initial interactions with new clients are by email as in the *Taylor* and *Owens* decisions. Further, computers are used for all kinds of communications and to generate checks, guaranties, settlement agreements, wire transfers, draws on letters of credit, and similar financial transactions. The courts need to draw the line somewhere. An overly broad application of the computer crime insuring agreement as in Owens could expand the insuring agreement to cover losses *indirectly* caused by computer fraud, as the court warned in *Pinnacle*. A better view would be to require that the actual theft take place by computer, which appears to be the intent of the coverage. Instead of exposing insurers to enormous losses indirectly caused by computer, a more limited interpretation would restore the focus to actual theft, against which policyholders could protect themselves by implementing better security measures. This would help to ensure that insurance coverage remains available for losses directly caused by computer crime.

Anne E. Briard is an attorney with *Lugenbuhl, Wheaton, Peck, Rankin and Hubbard*, New Orleans, Louisiana.

14 691 F.3d 821 (6th Cir. 2012).
15 *Id.* at 828.
16 *Id.* at 831.
17 *Id.* at 828-29.
18 No. CV 095024601S, 2011 Conn. Super. LEXIS 1572, 2011 WL 3200296 (Conn. Super. Ct. June 24, 2011).
19 *Id.* at *26-27.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FREEDOM OF CONTRACT...

Continued from page 1

one of these complexities, the federal Miller Act[1] and, specifically, the extent to which courts interpret the Miller Act as limiting contrat agreements regarding future legal disputes.

The Miller Act's primary purpose is to protect subcontractors on federal construction jobs by helping them secure payment for their work.[2] Congress granted subcontractors special protection in these situations for two reasons. First, federal law does not have a mechanism for subcontractors to place liens against government property. Second, the subcontractor has no contractual privity with the government, meaning the subcontractor has no legal right to pursue direct claims against the government.[3] The Miller Act protects a subcontractor's payment rights by requiring the general contractor to post a payment bond that allows the subcontractor to sue in federal court ninety days after the subcontractor completes its work.[4]

In 1999, Congress enacted the Construction Industry Payment Protection Act,[5] which added 40 U.S.C. § 3133(c) setting forth stringent requirements for a subcontractor to be found to have waived its Miller Act rights.[6] Section 3133(c) requires that the subcontractor's waiver be in writing, signed, and executed *after* the subcontractor "has furnished labor or material" to the project. In addition to these statutory requirements, courts have long held that a subcontractor's waiver of its Miller Act rights must be "clear and explicit."[7]

These waiver requirements seem fairly simple at first glance. However, just as contractors often find themselves facing more complex construction problems than originally anticipated, courts applying these waiver requirements have faced construction problems of their own. At the heart of the dilemma is the well-established legal principle that the surety's liability under a Miller Act payment bond is defined by the underlying contract between the general contractor and subcontractor, with the surety's liability co-extensive with its general contractor's unless there is a conflict between that co-extensive liability and the Miller Act.[8] In applying section 3133(c), courts have grappled with two issues: (A) the definition of "waiver," and (B) the meaning and scope of the Miller Act's waiver requirements.

II. Case Examples

Several notable cases have wrestled with the legality of subcontractor pre-work "waivers." These alleged waivers involve contractual agreements between a subcontractor and a general contractor regarding the proper course of action in the event of a future dispute. Subsection A discusses four contractual provisions that courts struck down as violating the Miller Act: (1) a provision giving the project owner sole discretion over change orders; (2) an ambiguous time limitation for bringing a Miller Act claim; (3) a subcontractor's pre-work agreement to be conclusively bound by the results of alternative dispute procedures between the general contractor and the subcontractor; and (4) a "pay when paid" provision. Subsection B discusses two contractual provisions that courts found permissible under the Miller Act: (1) a "no damages for delay" clause, and (2) a subcontractor's agreement to stay Miller Act suits pending the completion of other alternative dispute procedures.

A. Contract Provisions Struck Down

1. Sole Discretion to Project Owner as to Change Orders

In *HPS Mechanical, Inc. v. JMR Construction Corp.*, the subcontract provision stated:

> Notwithstanding any other provision, if the Subcontract Work for which the Subcontractor claims additional compensation is determined by the [Owner] not to entitle the Contractor to a Change Order, additional compensation or a

1 40 U.S.C §§ 3131-3134 (2006).

2 *See* U.S. *ex rel.* T&C Dirtworks v. L&S-CKY JV & Ins. Co. of Pa., No. 10-985 SECTION: B(3), 2011 U.S. Dist. LEXIS 32210, at *7-8, 2011 WL 1192944 (E.D. La. Mar. 28, 2011).

3 United States v. Zurich Am. Ins. Co., 99 F. Supp. 3d 543, 546-47 (E.D. Pa. 2015).

4 40 U.S.C. § 3133(b) (2006).

5 Pub. L. No. 106-49, § 2(b)- (c), 113 Stat. 231 (1999).

6 *Id.*

7 *See* Youngstown Welding & Eng'g v. Travelers Indem. Co., 802 F.2d 1164, 1166 (10th Cir. 1986).

8 U.S. *ex rel.* Walton Tech., Inc. v. Westar Eng'g, Inc., 290 F.3d 1199, 1206 (9th Cir. 2002).

> time extension because such work is within the scope of the Subcontract Work as defined by Paragraph 3.1, then the Contractor shall not be liable to the Subcontractor for any additional compensation or time extension for such Subcontract Work, unless the Contractor agrees in writing to pay such additional compensation or to grant such extension.[9]

The court interpreted this provision as "precluding the subcontractor from bringing a [Miller Act] claim in the event the owner decides a change order or 'adjustment' is not warranted."[10] The court concluded that this constituted an "implied waiver" of the subcontractor's Miller Act rights but did not explain.[11] The issues appear to have been that (1) the parties included the provision in the subcontract in violation of the statutory requirement that Miller Act waivers be made *after* the subcontractor starts work,[12] and (2) it was not sufficiently clear and express, thereby constituting an *implied*, rather than express, waiver.[13]

2. *Subcontractor's Pre-Work Agreement to be Bound by Results of Alternative Dispute Procedures Between General Contractor and Project Owner*

In *Foundation Fence, Inc. v. Kiewit Pacific Co.*, the court addressed a subcontract with the following provision:

> Subcontractor shall submit any claims it may have… to Contractor… in writing in sufficient time and form to allow Contractor to process such claims within the time and in the manner provided for and in accordance with the applicable provisions of the Prime Contract. Subcontractor agrees that it will accept such adjustment, if any, received by Contractor from Owner as full satisfaction and discharge of such claim.[14]

The subcontractor sought additional payments and asked that the general contractor submit its claims to the project owner.[15] When the general contractor continued to delay prosecution of the claims, the subcontractor brought a Miller Act suit.[16] The general contractor argued that the subcontractor failed to follow the procedures in the subcontract provision.[17]

The court refused to enforce the provision, finding instead that it was an invalid implied waiver of the subcontractor's Miller Act rights.[18] The court interpreted the provision's language as an impermissible implied waiver of the subcontractor's right to bring a Miller Act claim, which included any claims brought after the subcontractor had exhausted the subcontract's alternative disputes procedures.[19] The court noted that the overwhelming majority of courts do not enforce such clauses unless they are accompanied by "a clear and explicit waiver of the subcontractor's Miller Act rights," apparently concluding that the language of the subcontract did not meet this standard.[20]

In *DVBE Trucking & Construction Co. v. McCarthy Building Cos.,* the general contractor and project owner agreed to be subject to Federal Acquisition Regulations ("FAR") dispute procedures, and the subcontract stated that the subcontractor "shall be bound by the result of any such dispute resolution procedure" between the general contractor and the project owner.[21] The

9 No. 11-cv-02600-JCS, 2014 U.S. Dist. LEXIS 105888, at *41-42, 2014 WL 3845176 (N.D. Cal. Aug. 1, 2014).

10 *Id.* at *45.w

11 *Id.*

12 40 U.S.C. § 3133(c) (2006).

13 *See id.*

14 No. 09cv2062DMS (JMA), 2010 U.S. Dist. LEXIS 108915, at *13-16, 2010 WL 4024877 (S.D. Cal. Oct. 13, 2010).

15 *Id.* at *2.

16 *Id.* at *3-4.

17 *Id.* at *5.

18 *Id.* at *14-15.

19 *Id.*

20 *Id. at *5-6*

21 No. 13-cv-03699, 2015 U.S. Dist. LEXIS 90052, at *4-6, 2015 WL 4198794 (N.D. Cal. July 10, 2015).

court held that this provision violated the Miller Act.[22] Rather than merely requiring the subcontractor to delay Miller Act proceedings while first allowing the FAR dispute procedures to proceed, the provision's language implied that the subcontractor's remedies were limited *exclusively* to the FAR procedures.[23] The court found that this was an impermissible waiver and explained: "It is contrary to the intent of the Miller Act to require [a subcontractor] to await, and be bound by, the result of a process that it may not participate in. In effect, this is a waiver of [the subcontractor's] Miller Act rights."[24] The waiver was invalid because (1) it was not sufficiently clear and explicit, and (2) it was included in the subcontract and therefore agreed upon *prior* to the subcontractor commencing work.[25]

3. Ambiguous Time Limitation for Bringing Miller Act Claim

In *United States ex rel. T&C Dirtworks v. L&S-CKY JV & Insurance Co. of Pennsylvania.*, the subcontract provided, "CLAIMS – SUBCONTRACTOR agrees that no claim against Prime Contractor regarding work performed under the terms of this agreement shall be considered valid if filed more than 30 days following completion of Subcontractor's Scope of Work."[26] The subcontractor sued the general contractor for payments allegedly due and the general contractor argued that the provision barred the subcontractor's Miller Act suit because the subcontractor failed to bring the claim within the provision's 30 day time period.[27]

The court disagreed and held, instead, that the provision violated the Miller Act because it was a waiver that was not "clear and express."[28] The court reasoned that the provision did "not specifically address the meaning" of the terms "claim" and "filed," resulting in an ambiguous provision.[29] For example, the claim could be "filed" either when the subcontractor gives the general contractor notice of the claim or when the subcontractor actually files a complaint.[30] Thus, the court concluded that"[t]he ambiguity of these terms in the Subcontract do not exhibit a clear and express provision by which Plaintiff's rights were waived."[31]

4. "Pay When Paid" Provisions

In *United States ex rel. U.S. Glass, Inc. v. Patterson*, a subcontractor sued a general contractor and its surety under the Miller Act for nonpayment.[32] The general contractor's surety argued that a "pay when paid" clause in the subcontract precluded the suit.[33] The clause required the general contractor "to pay the SUBCONTRACTOR upon the submission of periodic estimates, within fifteen (15) days of the date the CONTRACTOR is paid by the OWNER, or such period required by the CONTRACT DOCUMENTS…."[34] The surety argued that because the project owner had not paid the general contractor, the "pay when paid" clause meant that the general contractor's surety did not have to pay the subcontractor.[35]

The court rejected the argument and held that (1) the "pay when paid" clause constituted a waiver of the subcontractor's Miller Act rights; (2) the clause failed to comply with the Miller Act's waiver requirements; and, therefore, (3) the clause was unenforceable, meaning the subcontractor could proceed with its Miller Act claim despite the general contractor not having received the project owner's payments.[36] The court explained that enforcing "pay when paid" clauses in a manner that prohibits Miller Act claims "would delay many claims beyond [the Miller] Act's one-year statute of limitations, *see* 40 U.S.C. §3133(b)(4), and would thus render the clause an implicit waiver of the subcontractor's Miller Act rights."[37] Since the provision in this case was not

22 *Id.* at *6.
23 *Id.* at *5.
24 *Id.*
25 *Id.* at *6.
26 No. 10-985 SECTION: B(3), 2011 U.S. Dist. LEXIS 32210, at *7- 8, 2011 WL 1192944 (E.D. La. Mar. 28, 2011).
27 *Id.* at *3, *7.
28 *Id.* at *7-8
29 *Id.* at *7.
30 *Id.*
31 *Id.* at *8.
32 No. 12-2634, 2014 U.S. Dist. LEXIS 13827, at *6, 2014 WL 442853 (E.D. Pa. Feb. 4, 2014).
33 *Id.* at *2.
34 *Id.* at *5 cmt. 1.
35 *Id.* at *2.
36 *Id.* at *7-8.
37 *Id.*

accompanied by a "clear and explicit" Miller Act waiver, the clause constituted an implied waiver and was thus void under the Miller Act.[38]

B. Contract Provisions Upheld

1. "No Damages for Delay" Clauses

In *United States ex rel. Chasney & Co. v. Hartford Accident & Indemnity Co.*, the subcontractor sued its general contractor, asserting that the general contractor had recovered payments for delays from the owner but wrongfully failed to pass those payments on to the subcontractor.[39] In defense, the general contractor relied upon this subcontract provision:

> The Contractor shall not be liable to [the] Subcontractor for delays caused by the Owner or other subcontractors or suppliers. [The] subcontractor shall be entitled to reimbursement only for damages for delays recovered from the Owner, and the Subcontractor shall have the right, at its expense, to exercise against the Owner all provisions of the Prime Contract to recover said damages. The Contractor shall have the right, at any time and for any reason, to delay, suspend, or accelerate the whole or any part of the work without incurring liability therefor.[40]

The court agreed, in part, with the general contractor's argument, agreeing that the "no damages for delay" clause was enforceable, noting that the subcontract provisions which concerned the "measure rather than the timing of payment" are generally permissible under the Miller Act, because courts look to the subcontract to determine the measure of damages for the subcontractor.[41] Nonetheless, the general contractor's motion for summary judgment was denied because, under the specific facts of the case, the court read the subcontract in a manner that authorized the subcontractor's claim for damages.[42]

2. Agreements to Stay Miller Act Suits Pending Alternative Dispute Procedures Agreed to in the Subcontract

The most easily enforceable pre-work dispute provisions are agreements to stay Miller Act suits while alternative dispute procedures, such as arbitration, are pending. Courts generally uphold such agreements because the right to bring a Miller Act suit is merely temporarily stayed and does not constitute a true "waiver" and thus is not subject to the Miller Act's strict anti-waiver rules. For instance, in *United States v. Dick/Morganti*, the subcontractor brought a Miller Act claim, and the general contractor countered that the project owner was responsible for the cost overruns at issue.[43] The subcontract provision stated:

> If the Owner and the Contractor, pursuant to the General Contract or by agreement, submit any dispute, controversy, or claim between them to ARBITRATION or some other dispute resolution procedure specified in the General Contract and such a matter involves or relates to a dispute, controversy, or claim between the Contractor and the Subcontractor, Subcontractor agrees…to stay any action filed by the Subcontractor until the dispute resolution and appeals process between the Contractor and the Owner is exhausted.[44]

The general contractor claimed that this provision required the subcontractor to allow the general contractor to submit the dispute to arbitration prior to bringing a Miller Act claim.[45] The court agreed and ordered a stay of the Miller Act suit pending the general contractor's arbitration with the project owner.[46] The court reasoned that "stays which merely postpone a subcontractor's

38 *Id.*

39 No. WDQ-14-2148, 2015 U.S. Dist. LEXIS 80649, at *6, 2015 WL 3887792 (N.D. Md. June 22, 2015).

40 *Id.* at *2-3.

41 *Id.* at *6; *See also* U.S. *ex rel.* Kogok Corp. v. Travelers Cas. & Sur. Co., 55 F. Supp. 3d 852, 860 (N.D. W. Va. 2014) (holding that "no damage for delay" clauses do not violate the Miller Act because they affect the measure rather than the timing of recovery).

42 *Id.*

43 No. C 07-02564 CRB, 2007 U.S. Dist. LEXIS 84750, at *5, 2007 WL 3231717 (N.D. Cal. Oct. 30, 2007).

44 *Id.* at *6.

45 *Id.* at *5.

46 *Id.* at *12.

Miller Act right to sue" are not waivers at all.[47] The court in *Dick/Morganti* pointed out that:

> The legislative history forcefully demonstrates that…§3133(c) does not apply to stays which merely postpone a subcontractor's Miller Act right to sue. Congress explained that was not intended to '*void subcontract provisions requiring arbitration or other alternative methods of resolving disputes. Such provisions would remain enforceable with a claimant's Miller Act rights preserved by a timely suit that can be stayed pending the outcome of the subcontract dispute resolution procedure.'* The bill respects the freedom of the parties to the subcontract to specify means to resolve their disputes and the exclusive jurisdiction of the district court to decide issues arising under the Miller Act.[48]

The court in *United States ex rel. Humbarger v. Law Co.* went even further in upholding an arbitration provision.[49] The subcontract provision read:

> In the event a dispute arises between Contractor…and Subcontractor… in regard to this Subcontract… Subcontractor shall be conclusively bound by Contractor's decision unless Subcontractor initiates arbitration or commences a legal action, as provided below, within thirty (30) days following Subcontractor's receipt of notification of Contractor's decision….
>
> A Contractor-Subcontractor dispute shall be resolved through an arbitration proceeding as described below, unless the amount involved in the…dispute exceeds $200,000.[50]

This language appears to be much more restrictive than the contract language in *Dick/Morganti*. Specifically, requiring contractor-subcontractor disputes to "be resolved through an arbitration proceeding" looks very much like a Miller Act waiver. Even so, the court held that the provision merely required the subcontractor to stay Miller Act proceedings pending arbitration.[51] As the "plaintiff's remedy of a suit under the Miller Act is unchanged by the arbitration procedures mandated by the parties' agreement," the court found that the arbitration provision was not a waiver.[52] Regarding the risk that the subcontractor's statute of limitations could expire while arbitration was proceeding, the court explained that the subcontractor could avoid this by filing a protective suit.[53]

Thus, the courts in *Humbarger* and *Dick/Morganti* upheld agreements to stay Miller Act claims pending alternative dispute procedures. While this appears to represent the majority position on this issue,[54] at least one court has found that an agreement to stay Miller Act proceedings is invalid under the Miller Act despite clear Congressional intent that §3133(c) should not have that effect.[55]

There is another potential argument for upholding alternative dispute provisions. In *Gabriel Fuentes Jr. Construction Co. v. Carter Concrete Structures, Inc.*, the general contractor argued that the subcontract required the court to stay the suit pending alternative dispute resolution procedures.[56] The subcontract's stay provision read:

> For any dispute to which these Disputes provisions apply, [Subcontractor] agrees to forbear in filing, or to stay any claim or action that has been filed by [Subcontractor] pursuant to: (1) Article XVIII of the Agreement; and (2) any other right or remedy that Subcontractor may have, at law or in equity, including without limitation rights or remedies

47 *Id.* at *11.

48 *Id.* at *11-12.

49 No. 01-4156-SAC, 2002 U.S. Dist. LEXIS 4702, 2002 WL 436772 (D. Kan. Feb 20, 2002).

50 *Id.* at *2.

51 *Id.* at *8.

52 *Id.*

53 *Id.* at *6.

54 *See* *Humbarger*, 2002 U.S. Dist. LEXIS 4702, at *4, 2002 WL 436772 (stating that "every case located by this court which has examined" the issue of agreements to arbitrate prior to bringing a Miller Act claim "rejects the…proposition" that the Miller Act precludes arbitration.).

55 United States v. Zurich Am. Ins. Co., 99 F. Supp. 3d 543, 546 (E.D. Pa. 2015). In *Zurich*, the court refused to grant a stay pending CDA procedures as agreed in the subcontract. *Id.* at 550-51. The court distinguished other cases that allowed stays because the subcontracts contained explicit stay provisions. *Id.* at 551 n.3. However, despite the apparent importance of the specific language in the subcontract, the *Zurich* court failed to identify the subcontract language at issue.

56 No. 14-1473 (DRD), 2014 U.S. Dist. LEXIS 174235, at *1-2, 2014 WL 7046519 (D.P.R. Dec. 12, 2014).

> under the Miller Act (citation omitted) until dispute resolution and appeal processes set forth in these Dispute provisions are exhausted.[57]

The court sided with the general contractor and "reluctantly" granted a stay of the subcontractor's action based on the language of the subcontract provision.[58] The court found that the general contractor had, in fact, incorporated the subcontractor's claim into the claim against the government in a parallel proceeding.[59]

The result in *Gabriel Fuentes* may be explained by the fact that the general contractor demonstrated that the subcontractor's claim had been passed through to the government. Though the court did not specifically reference it, "[s]ubcontract clauses providing for direct 'pass through' of unsettled claims to the Government under federal contracts are authorized by the Federal Acquisition Regulations."[60] While beyond the scope of this article, generally speaking, "where a contractor has no liability to its subcontractor or supplier… it cannot recover damages on behalf of its subcontractor and supplier."[61]

One additional note is the inconsistency between *Humbarger* and *T&C Dirtworks. Humbarger* upheld a thirty day limitation period on a subcontractor's claims, while *T&C Dirtworks* struck down a thirty day limitation period on a subcontractor's claims as being an invalid waiver of the subcontractor's Miller Act rights. It is difficult to reconcile these cases. At best, they highlight the unpredictability of pre-work Miller Act waiver cases.

III. Untapped Argument to Protect Subcontractor and General Contractor Agreements

As these cases demonstrate, courts have been extremely tough on pre-work subcontract agreements regarding future disputes. A party seeking to enforce such agreements faces an uphill battle. One argument for enforcing such agreements, not yet apparently addressed by a court, is based on the Federal Acquisition Regulations. The FAR allow a subcontractor and general contractor to contractually agree at the outset of the work to have the general contractor pass the subcontractor's claims through to the government.[62] The FAR seem to represent a government policy favoring pre-work contractual agreements between subcontractors and contractors regarding future disputes. However, many courts interpreting the Miller Act have taken the opposite view, striking down dispute clauses in subcontracts. These approaches seem to conflict: on the one hand, the FAR encourage pre-work agreements; on the other hand, courts interpreting the Miller Act generally strike down such agreements. There are exceptions, including *Gabriel Fuentes*. It could certainly be argued that the FAR permit subcontractors and general contractors to reach pre-work agreements regarding future dispute resolution, as long as such contractual provisions are not considered to be a waiver of the subcontractor's Miller Act claims.

IV. Tips for Drafting Alternative Dispute Agreements in Government Construction Subcontracts

As the case law stands today, counsel should tread lightly when drafting or attempting to enforce dispute resolution subcontract provisions on a federal government construction project. The most readily enforceable provision is an agreement to submit a claim to an alternative dispute procedure. Courts will likely enforce these provisions as long as there is no language suggesting that the provision precludes Miller Act suits even after the alternative procedure is complete.

The situation is more difficult for the general contractor looking to use conduit clauses to limit its exposure to subcontractor claims based upon payment received from the government. One solution, albeit an imperfect one, is the use of a clause that affects only the measure of recovery and not the timing or existence of the subcontractor's Miller Act rights. For example, current case law suggests that "no damage for delay" clauses pass the "measure of recovery" litmus test.[63] Arguably other clauses restricting the amount of a subcontractor's recovery may be enforceable. A note

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57 *Id.* at *13-14.

58 *Id.* at *14.

59 *Id.*

60 Philip L. Bruner & Patrick J. O'Connor, 6 Bruner and O'Connor on Construction Law § 19: 25 n.11 (2015) (citing to F.A.R. § 44.203(c), 48 C.F.R. § 44.203(c)); Atl. States Constr., Inc. v. Hand, 892 F.2d 1530, 1536 (11th Cir. 1990) (upholding subcontract provision incorporating the prime contract's equitable adjustment clauses and limiting the general contractor's liability to the subcontractor to the amount the general contractor recovers from the Government on the subcontractor's claims).

61 *Id.* at § 19:25 (based upon the Severin Doctrine—Severin v. United States, 99 Ct. Cl. 435 (Fed. Cl. 1943)).

62 48 C.F.R. § 44.203(c) (2004); for a further discussion of FAR and pass through claims, *see* James F. Nagle & Jonathan A. DeMella, *A Primer on Prime Contract-Subcontractor Disputes Under Federal Contracts*, 46 (2) The Procurement Lawyer 12, 12-15 (Winter 2011).

63 U.S. *ex rel.* Chasney & Co. v. Hartford Accident & Indem.Co., 2015 U.S. Dist. LEXIS 80649, at *6, 2015 WL 3887792 (N.D. Md. June 22, 2015); U.S. *ex rel.* Kogok Corp. v. Travelers Cas. & Sur. Co., 55 F. Supp. 3d 852, 860 (N.D. W. Va. 2014).

of caution is necessary, however, since decisions such as *Foundation Fence*[64] void subcontract dispute resolution provisions in part because they attempt to limit the subcontractor's recovery to what the general contractor secures from the government.[65] In addition, any effort to obtain a subcontractor's complete waiver of its Miller Act rights in a subcontract executed *prior* to starting work is automatically unenforceable as a violation of section 3133(c)'s requirement that waivers be executed only after starting work. Yet another drafting hurdle is the "clear and express" requirement. As *T&C Dirtworks* demonstrates, some courts read this requirement strictly. As a result, drafters must ensure that applicable clauses leave absolutely no ambiguity. At a minimum, the language should specifically reference the subcontractor's "Miller Act" rights by name. To do otherwise risks a court finding that the waiver or limiting language is not sufficiently "clear and explicit" as seen in *DVBE Trucking* and *Foundation Fence*.

V. Conclusion

Just as large federal construction projects can be unpredictable, a wide range of seemingly simple subcontract terms are often struck down as violating the Miller Act's anti-waiver rules. Attorneys drafting these subcontract provisions will do well to remember the overarching policy against a subcontractor's waiver of its right to bring a Miller Act claim. Counsel should, therefore, draft carefully with these principles and cases in mind.

Nina M. Durante is a Senior Surety Claims Counsel for the Commercial Surety Claims Region at Liberty Mutual Insurance Company.

Charles W. Langfitt is a Second Vice President and Counsel at Travelers where he leads the Western Region's Bond Claim Department.

John F. Fatino is a Member of the Iowa law firm of Whitfield & Eddy, P.L.C.

Zachary J. Hermsen is an Associate with the Iowa law firm of Whitfield & Eddy, P.L.C.

64 Foundation Fence, Inc. v. Kiewit Pacific Co., No. 09cv2062DMS (JMA), 2010 U.S. Dist. LEXIS 108915, at *13- 16, 2010 WL 4024877 (S.D. Cal. Oct. 13, 2010).

65 Although distinguished by the *Foundation Fence* court, the decision of U.S. *ex rel.* R. Rudnick & Co. v. Daniel, Urbahn, Seelye, & Fuller, 357 F. Supp. 853 (N.D. Ill. 1973), may provide a drafting solution if the language is revised and included in a subcontract with the appropriate entity designated as the decision maker. The *Foundation Fence* court noted that the disputes clause in *Daniel, Urbahn,* did not amount to a waiver because the clause specifically provided for judicial review of decisions that were fraudulent, capricious, arbitrary, or so grossly erroneous as necessarily to imply bad faith or were not supported by substantial evidence. 2010 U.S. Dist. LEXIS 108915, at *13-16, 2010 WL 4024877.

PROMPT PAYMENT LAWS…

Continued from page 8

3. The general contractor must pay its first tier subcontractors within a certain number of days of receipt of payment from the owner. For example, in Arizona, the time period for the general contractor to pay subs is seven days.[6] Again, if the general contractor disputes a subcontractor's payment application, it must object in writing, quantify the amount disputed (which may be the result of withholding by the owner due to the subcontractor's defective work), and pay the undisputed amount to the subcontractor.[7]
4. If the owner or general contractor does not timely object to a payment application, the application is deemed admitted, and failure to timely pay is a breach of contract by the owner or general contractor.[8]
5. In some states, prompt payment statutes have been expanded to address change order requests. In Nevada, an owner's failure to timely respond to a contractor's properly submitted change order request causes the change order to be incorporated into the contract.[9]
6. Typically, the prompt payment statute incorporates its statutory terms into contracts entered into in that jurisdiction and, absent express statutory authority, the parties are prohibited from modifying the statutory terms by contract.[10]

Other than these general principles, there is no uniformity among state and federal prompt payment statutes. In some states, an owner is allowed only five working days after invoice to pay the general contractor.[11] Other states allow the owner up to sixty days to pay the general contractor.[12] Some states have different payment deadlines for public and private projects.[13] Payment deadlines often differ between general contractors and subcontractors, with the time for payment by the general contractor to subcontractors typically less than the time for payment by the owner to the general contractor. For instance, Montana's Prompt Payment Act requires an owner to pay a general contractor within thirty days after invoice or receipt of services, whichever is later. General contractors must pay subcontractors within seven days after the general contractor's receipt of payment from the owner.[14]

Prompt payment statutes can be confusing and some courts have misconstrued the language of the statutes or misinterpreted the legislature's intent. A glaring example of this occurred in *Stonecreek Building*.[15] There, the Arizona Court of Appeals misinterpreted the Arizona Prompt Payment Act, ruling that the statute precluded an owner from withholding payment for defective work performed by the general contractor in a prior pay period. Indeed, the owner's withholding for defective work was held to be a breach of contract. Legal commentators and construction organizations heavily criticized the opinion, which led the Arizona Legislature to pass a 2010 amendment to the Prompt Payment Act that essentially overruled the *Stonecreek Building* decision.[16]

Prompt pay is clearly here to stay, and those states that have not yet passed private prompt pay statutes are likely to do so in the future. To properly advise clients, construction law practitioners should research applicable prompt payment statutes to understand the varied payment deadlines and notice provisions and how they may impact their clients.

III. Traps for the Unwary – Common Scenarios

Determining applicable public and/or private prompt payment statutes is a critical first step. To fully

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6 Ariz. Rev. Stat. Ann. § 32-1129.02 (2011).

7 *See* id.

8 *See* Ariz. Rev. Stat. Ann. §§ 32-1129.01-02 (2011).

9 *See* Nev. Rev. Stat. Ann. § 624.610 (2005). Nevada's Prompt Payment Act was amended in 2005 to address change orders after several well-publicized incidents with major developers involving construction of casinos and other high profile projects in Las Vegas. The developers' failures to pay led the contractor lobby to push for additional protections under Nevada's contracting statutes, including in circumstances when an owner refuses to respond to a general contractor's change order request and refuses to pay the amount due under a change order. *See* Leon F. Mead, Nevada Construction Law § 3.20 (2010) for an overview of the Nevada Prompt Payment Act and its author's personal experience participating in the 2005 Nevada amendment.

10 For example, Arizona's Prompt Payment Act requires the statutory payment billing cycle or payment terms unless a legend is conspicuously typed on each page of the bid plans and construction plans which contains a "Notice of Alternate Billing Cycle" or "Notice of Extended Payment Provision." *See* Ariz. Rev. Stat. Ann. § 32-1129.01.

11 *See* Ark. Code Ann. §§ 19-4-1411-1416 (West 2003).

12 *See* Idaho Code Ann. § 67-2302 (West 1986).

13 *See* Ariz. Rev. Stat. Ann. §§ 32-1129, 34-221 (2011).

14 Mont. Code Ann. §§ 17-8-241-244 (West 1983).

15 162 P.3d 675.

16 Ariz. Rev. Stat. § 32-1129 (2010).

advise a client and avoid potentially costly mistakes, construction law practitioners should consider the most common scenarios for prompt payment pitfalls. These scenarios usually fall into one of the following four broad categories:

A. Scenario I: The Contract Does Not Comply With the Applicable Prompt Payment Statute

When a construction contract fails to comply with the requirements of the applicable prompt payment statute, the owner and the general contractor face serious risks. Generally, when processing payment applications, the owner follows the contract's terms, not the applicable prompt payment statute's requirements, and the court later finds that the owner breached the contract as a matter of law.

For instance, in a case involving a City of Phoenix wastewater treatment plant project, the City used the Engineers Joint Contract Document Committee's ("EJCDC") contract form. The EJCDC is an esteemed construction industry organization consisting of four prominent design professional and contractor organizations.[17] The EJCDC's contract forms are first rate and municipalities and other public bodies routinely use them. Unfortunately for the City, however, EJCDC's contract forms did not comply with Arizona's Prompt Payment Act. For months, the City processed payment applications under the EJCDC contract forms in violation of the Arizona Prompt Payment Act. Later, the City sued the contractor and its surety alleging breach of the construction contract and the performance bond, and sought damages exceeding $100 million. The contractor and surety moved for summary judgment based upon the City's prompt pay violations. The trial court held that the City was in breach of contract as a matter of law from the inception of the project. The case settled, so there is no reported decision, but the summary judgment ruling was critical to the favorable settlement negotiated by the contractor and the surety.

Sometimes clients do not seek legal advice in the solicitation/bidding and contract negotiation process, and unknowingly execute contracts that do not comply with the applicable prompt payment statute. To avoid this pitfall, construction law practitioners should actively engage their clients early, during the solicitation/bidding and contract negotiation processes. Timely consultation will ensure that the construction contract complies with the applicable prompt payment statute and help to avoid costly mistakes.

B. Scenario II: There is No Dispute with the Contractor, but the Owner Fails to Timely Pay the Contractor

In this scenario, the contract complies with the applicable prompt payment statute, but the owner chooses to "slow pay" the general contractor (or the analogous situation where the general contractor chooses to "slow pay" a subcontractor). The owner's failure to pay is generally considered a material breach which relieves the non-breaching party (contractor) of its contractual obligation.[18]

Courts define material breach as a failure to do something that is so fundamental to the contract that the failure to perform that obligation defeats an essential purpose of the contract.[19] Particularly with regard to progress payments on construction projects, courts are inclined to find a material breach for missed payments.[20] Notably, a material non-payment that discharges the contractor from its obligation under a bonded contract also discharges the surety from its bond obligation to the owner.[21]

Because courts strictly enforce payment deadlines under prompt payment statutes, construction law practitioners must educate themselves about these

17 The American Council of Engineering Companies, the American Society of Civil Engineers, the National Society of Professional Engineers and the Associated General Contractors of America.

18 *See* Brady Brick & Supply Co. v. Lotito, 356 N.E.2d 1126, 1130 (Ill. App. Ct. 1976) (failure to pay installment of contract price is a substantial breach of contract and gives the contractor the right to consider the contract at an end, to cease work, and to recover value of the work already performed).

19 *See* Ernst v. Ohio Dep't of Adm. Servs., 590 N.E.2d 812, 817 (Ohio Ct. App. 1990) (owner's failure to pay progress installments constitutes a material breach where the failures goes to the essence of the contract); Zulla Steel, Inc. v. A & M Gregos, Inc., 415 A.2d 1183, 1187 (N.J. Super. Ct. App. Div. 1980) (failure to make payment was material breach); Salo Landscape & Constr. Co., v. Liberty Elec. Co., 376 A.2d. 1379, 1382 (R.I. 1977) (party who fails to make installment payment is guilty of breach that goes to the very essence of the contract).

20 See U.S. *ex rel*. C.J.C., Inc. v. W. States Mech. Contractors, Inc., 834 F.2d 1533, 1551 (10th Cir. 1987) (failure to make progress payments when due is a substantial breach of the contract); Macri v. U.S. *ex rel.* John H. Maxwell & Co., 353 F.2d 804, 810 (9th Cir. 1965) ("[I]t is well settled that an owner's failure to make progress payments on a building contract may constitute a material breach").

21 *See* Wellington Power Corp. v. CNA Sur. Corp., 614 S.E.2d 680, 687 (W. Va. 2005) ("It is a fundamental precept of suretyship law that the liability of the surety is conditioned on accrual of some obligation on the part of the principal; the surety will not be liable on the surety contract if the principal has not incurred liability on the primary contract"); McClintock v. Serv-Us Bakers, 423 P.2d. 722, 727 (Ariz. Ct. App. 1967) (when the principal is discharged from its obligation, the surety guaranteeing that obligation is likewise discharged), *vacated on other grounds*, 436 P.2d 891 (Ariz. 1968).

payment deadlines. Counseling larger owners and general contractors to use construction payment software to track payment applications and payment deadlines, and ensuring that their personnel are trained on that software is recommended. For smaller owners and general contractors that might not have the financial resources to invest in such software, use of an electronic calendaring system can ensure the client complies with applicable payment deadlines. General contractors and subcontractors who are victimized by a "slow paying" party should be advised about available remedies under the applicable prompt payment statute (such as termination of the contract) and ensure that they comply with any notice provisions prior to using such remedies.

C. Scenario III: There is a Dispute with the Contractor, and the Owner Fails to Pay the Contractor, but Fails to Timely Object to the Contractor's Payment Application

This is, by far, the most common scenario. The general contractor (or, by analogy, the subcontractor) has performed work and the owner is dissatisfied with the quality or timeliness. When the contractor submits a progress payment application, the owner chooses to "sit on" the application, neither objecting to it in writing nor paying it. Most prompt payment statutes require the owner to timely object in writing to a disputed payment application, to quantify the value of the disputed work and to pay the undisputed amount. The problem is that tempers flare in construction disputes, and many owners refuse to pay anything to contractors with whom they are fighting, even if they know withholding payment is illegal under the prompt payment statute. In most jurisdictions, if an owner fails to timely object to a payment application, the owner is estopped from denying the payment application. Furthermore, the owner's refusal to pay also gives the surety a full defense to the owner's performance bond claim.

Occasionally, an owner will timely object in writing to a payment application, but fail to pay the undisputed amount to the contractor. This is a prompt pay violation, and is treated no differently than if the owner had failed to timely object and failed to pay. The failure to pay gives rise to the prompt pay violation regardless of the existence of a dispute. Due to lack of proper written objection, the owner has breached the prompt payment statute as well as its contract with the general contractor.

The construction payment software program or other calendaring system employed to track payment deadlines should also be used to track deadlines for objecting to payment applications. Construction law practitioners should encourage their clients to be proactive and immediately object to a payment application if there is a valid reason and to include specific grounds for the objection. Not only does this ensure compliance with the applicable prompt payment statute, it creates a detailed record in writing.

D. Section IV: Owner Fails to Respond to Change Order Requests

A few jurisdictions require the owner to timely process a contractor's properly submitted request for a change order and to object to it in writing, if it is disputed. Sometimes an owner will choose not to process change order requests, either in response to perceived provocation by the contractor or (from the owner's perspective) to compensate it for the contractor's allegedly defective or untimely performed work. In those jurisdictions, the result is very unfavorable to the owner – the change order request is deemed accepted, and the revised change order amount and/or time for performance are incorporated into the contract for the project. If the change order work has been performed, the contractor must be paid in the next payment application for this work.[22]

In these jurisdictions, compliance with time limits for intake and processing of change order requests must also be tracked by the software program or calendaring system of the owner or general contractor.

IV. Conclusion

Where states have enacted prompt payment statutes, the payment process within the construction industry have improved significantly, leading to more successful projects and ensuring general contractors and subcontractors are timely paid. Even so, prompt payment schemes are not without their own hazards. In order to address these risks, construction law practitioners that advise owners, general contractors and subcontractors must have a strong command of the applicable prompt payment statute and should encourage their clients to take a proactive approach to the payment process.

Patrick F. Welch is a Member at *Jennings, Strouss & Salmon, PLC*, Phoenix, Arizona

22 *See* Nev. Rev. Stat. Ann. § 624.610 (2005); Leon F. Mead, Nevada Construction Law § 3:20 (2010).

PRACTICE POINTER…

Continued from page 9

the four requirements of Rule 23(a), generally referred to as "numerosity," "commonality," "typicality," and "adequacy of representation."[9] In addition, the purported class must meet at least one of the requirements of Rule 23(b), which provides various reasons for a class action to exist.[10] A court must assess the putative class and determine whether it meets the criteria of Rules 23(a) and (b) "at an early practicable time after a person sues or is sued as a class representative."[11]

Analysis of each requirement for class certification, and the defenses the surety can assert to each, far exceeds the scope of this article. But the recent trend by MVD bond claimants to turn their individual claims into a class claim requires the surety, and its counsel, to focus on issues that customarily arise in class actions and the strategic mechanisms that it can employ to combat class certification, along with other potential considerations.

As a general rule, preventing class certification can be a primary and critical step to limiting the surety's potential exposure to a large number of claimants and a substantial claim. By successfully opposing class certification, the surety can avoid the additional consequences and liabilities that arise in connection with a class action, including increased interest awards and granting of attorneys' fees If the class is not certified, the burden remains on the plaintiffs to assert and prove each of their claims individually, which understandably tends to reduce the number of claims pursued.

Each of the requirements under Rules 23(a) and (b) provides an opportunity to defeat class certification and possibly decrease the surety's exposure. As an initial exercise, the surety practitioner should explore all bases for defending against class certification pursuant to Rules 23(a) and (b), and may need to obtain pre-certification discovery in order to do so.

The surety must also consider at the outset whether resolving the nominal claimant's claim to avoid class certification is the best strategic defense to overall liability even when the surety believes it has legitimate defenses to the claimant's claim. In certain jurisdictions, a surety can prevent class certification by fully resolving the plaintiff's claim before the class claim is certified.[12] Finally, if multiple bond periods are involved, the surety practitioner must also consider the potential impact of any available statute of limitations defense.

When a surety client is faced with a potential class action, such as in recent MVD bond class certification efforts, the surety practitioner must analyze the laws regarding class action claims in the applicable jurisdiction and determine the extent to which the putative class representative has met its burden for class certification. Development of a successful strategy for opposing class certification may be the surety practitioner's best bet.

Brandon J. Held is a shareholder, and Matthew Davis is an associate, with the law firm of Mills, Paskert, Divers in Tampa, FL.

9 Fed. R. Civ. P. 23(a) provides, in relevant part, as follows:

> **(a) Prerequisites.** One or more members of a class may sue or be sued as representative parties on behalf of all members only if:
>
> **(1)** the class is so numerous that joinder of all members is impracticable;
>
> **(2)** there are questions of law or fact common to the class;
>
> **(3)** the claims or defenses of the representative parties are typical of the claims or defenses of the class; and
>
> **(4)** the representative parties will fairly and adequately protect the interests of the class.

10 Fed. R. Civ. P. 23(b) provides, in relevant part, as follows:

> **(b) Types of Class Actions.** A class action may be maintained if Rule 23(a) is satisfied and if:
>
> **(1)** prosecuting separate actions by or against individual class members would create a risk of:
>
> **(A)** inconsistent or varying adjudications with respect to individual class members . . .; or
>
> **(B)** adjudications with respect to individual class members that, as a practical matter, would be dispositive of the interests of the other members not parties to the individual adjudications…;
>
> **(2)** the party opposing the class has acted or refused to act on grounds that apply generally to the class, so that final injunctive relief or corresponding declaratory relief is appropriate . . .; or
>
> **(3)** the court finds that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy. . . .

11 Fed. R. Civ. P. 23(c)(1)(A).

12 Ahern v. Mayo Clinic, 180 So. 3d 165, 170 (Fla. Dist. Ct. App. 2015) (citing Sosa v. Safeway Premium Fin. Co., 73 So. 3d 91, 116 (Fla. 2011) and holding that Florida has a bright line rule that a class representative must have standing at all times before certification. Consequently, if the plaintiff has been made whole, then there is no standing to pursue anything further, including class certification.); *but see* Campbell-Ewald Co. v. Gomez, 136 S. Ct. 663 (2016). In *Gomez*, the United States Supreme Court held that an unaccepted offer of judgment did not render a plaintiff's class action claims moot. However, the Court noted that it was not deciding whether the result would be different, and the attempt to certify the class nullified if, instead of making an offer, the defendant deposited the full amount of the plaintiff's claim in an account for the plaintiff. In fact, Justice Roberts' dissent addressed depositing the full amount of the plaintiff's claim into district court.

2016 TIPS CALENDAR

May 2016

5-6	**FSLC Spring Workshop** Contact: Donald Quarles – 312/988-5708	**La Quinta Hotel & Spa** **La Quinta, CA**
11-15	**TIPS Section Conference** Contact: Felisha A. Stewart – 312/988-5672 Speaker Contact: Donald Quarles – 312/988-5708	**Intercontinental Buckhead** **Atlanta, GA**

August 2016

4-7	**ABA Annual Meeting** Contact: Felisha A. Stewart – 312/988-5672 Speaker Contact: Donald Quarles – 312/988-5708	**Westin St. Francis Hotel** **San Francisco, CA**

October 2016

19-23	**TIPS Fall Leadership Meeting** Contact: Felisha Stewart – 312/988-5672	**Hotel Del Coronado** **Coronado, CA**

November 2016

3-4	**Aviation Litigation Committee Mtgg** Contact: Donald Quarles – 312/988-5708	**Ritz-Carlton, Washington DC** **Washington, DC**
9-11	**FSLC & FLA Fall Meeting** Contact: Donald Quarles – 312/988-5708	**Fairmont Chicago** **Chicago, IL**

January, 2017

19-21	**Fidelity & Surety Committee Midwinter Mtg** Contact: Felisha Stewart – 312/988-5672	**Roosevelt Hotel** **New Orleans, LA**

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