AMERICAN BAR ASSOCIATION
Tort Trial and Insurance Practice Section

Summer 2021

COMMITTEE NEWS

Fidelity & Surety Law

Evaluating the Potential For Defensive Payment Bond Discharge As A Defense To A False Claims Act Complaint

Drew J. Gentsch
Whitfield & Eddy, P.L.C.

***Drew J. Gentsch** is a member attorney at Whitfield & Eddy, P.L.C. in the Firm's Des Moines office.*

Can the False Claims Act[1] be used as a payment bond defense for a surety? The issue comes to mind as a result of the United States Court of Appeals for the Eighth Circuit's recently published decision in the performance bond case of *Hanover Insurance Company v. Dunbar Mechanical Contractors, LLC.*[2] The Court's overturning of summary judgment for the surety on its defense to a performance bond claim on a potential violation of the False Claims Act creates the possibility for similar results in a payment bond context. However, the case law on point in the payment bond context appears to be slim. Perhaps the lack of cases demonstrates that sureties have been doing better than other industries to avoid such costly snares in the payment bond context. Or, perhaps the *Hanover* case presents a novel decision at the circuit court level. Given a void in the jurisprudence to provide

Read more on page 13

1 31 U.S.C.A. § 3729 (West 2009).

2 Hanover Ins. Co. v. Dunbar Mech. Contractors, LLC, 964 F.3d 763 (8th Cir. 2020).

In This Issue

Chair Message

Chad L. Schexnayder
Jennings Haug Cunningham

Chad Schexnayder*, a veteran partner at Jennings, Haug & Cunningham, has achieved national recognition as a successful commercial litigator, trial attorney, author, speaker and consultant. His areas of practice include Fidelity & Surety, construction law, bankruptcy, real estate, residential construction defects and personal injury defense.*

Dear FSLC Members,

This is my last "Chair's letter" for the FSLC newsletter. In August, my term as chair ends and Jeff Price's term begins. I am very excited by Jeff's energy and his ideas for the committee in 2021-2022. Hopefully, his tenure and programs will only be mildly impacted by COVID effects.

As you were aware from our committee calendar, we had planned to present a program in May of 2021 at the Omni Montelucia Resort in Phoenix/Scottsdale, Arizona on Surety Aspects of Bankruptcy Law and Practice. This in-person program was cancelled, and the decision was made not to substitute a virtual program, but to go in a different direction, which I will explain below. I am very pleased to inform you that as you read this, we will have available a brand new FSLC publication, *Surety Aspects of Bankruptcy Law and Practice.* Michael Collins and I are co-editors, and you will be hearing more from the hand-selected collection of exemplary authors/contributors to this important publication.

I want to thank Patrick Lee-O'Halloran, Christine Bartholdt and Jason Leiker for co-chairing our Midwinter Construction program. Many of you were in attendance on February 3rd and 4th when they hosted 2 hours each day of speakers and panels on their program, *The Disaster Artist: Avoiding Disasters On A Construction Project.* The program was well attended and well received. I particularly enjoyed the tight, quick pace of the presentations, laden with content.

Keep an eye out for links to video messages on the FSLC YouTube channel, attempting to keep you updated on committee activities and legal developments. With Jeff Price and Carol Smith, our Chair Elect Designee, we have been working on expanding FSLC video logs, or VLOGS, and developing a video log library of topics that will be permanently available to FLSC members and the surety and fidelity industries. In furtherance of that goal, the contributing authors to *Surety Aspects of Bankruptcy Law and Practice* will be preparing and posting short videos about numerous bankruptcy and surety law points in the next couple of months. These videos promise to be very interesting, and a quick guide to what you can find in the new book. Everyone else, please continue to contribute to our successful VLOG series with case updates and practice pointers. You can always contact me with your interest or ideas for VLOGs.

We held our spring FSLC Leadership and Vice Chair meeting virtually in early May. Every member of the section was welcome to attend and we loved seeing new faces.

Speaking of new faces, you will see a new feature in this newsletter. To encourage and increase exposure of our newer and younger members (i.e., the future of our committee), we will include a short profile of a couple of new and/or younger FSLC members, so all the rest of us will recognize them at our next in person meeting. I leaned on Ryan DeLaune and Alana Porrazzo to be our guinea pigs for this feature in the spring newsletter. Our membership committee subcommittees, such as Young Lawyers Division, Women's Involvement, Diversity and Inclusion will be our feeder source for other new and younger members to introduce to you in future newsletters. If your company or firm has someone who would benefit from an opportunity to be introduced to our membership, please reach out to the cochairs of these membership subcommittees or Jeff Price.

Friends, my "year" as FSLC chair has not been what I anticipated it would be. I am OK with that. With the help and patience of so many of you, and of TIPS staff, we have come through this and stayed engaged. The old adage about not appreciating something fully until one has lost it is certainly true as it describes our in-person programs, meeting and social events. Look, I knew I enjoyed our gatherings; but now I see clearly that without them, my entire career and journey would have been a smaller and paler version of what it became courtesy of my time with all of you. Thank you.

Connect with Fidelity & Surety Law website

Stay Connected with TIPS

We encourage you to stay up-to-date on important Section news, TIPS meetings and events and important topics in your area of practice by following TIPS on **Twitter** @ABATIPS, joining our groups on **LinkedIn**, following us on **Instagram**, and visiting our **YouTube** page! In addition, you can easily connect with TIPS substantive committees on these various social media outlets by clicking on any of the links.

Member Roster

Chair
Chad Schexnayder
Jennings Haug & Cunningham LLP
2800 N Central Ave, Ste 1800
Phoenix, AZ 85004-1049
(602) 234-7830
Fax: (602) 277-5595
CLS@JHC.Law

Chair-Elect
Jeffrey Price
Manier & Herod
1201 Demonbreun St, Ste 900
Nashville, TN 37203-3140
(615) 244-0030
Fax: (615) 242-4203
jprice@manierherod.com

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

Council Representative
Sam Poteet
Manier & Herod
1201 Demonbreun St, Ste 900
Nashville, TN 37203-3140
(615) 742-9321
Fax: (615) 242-4203
spoteet@manierherod.com

Diversity Vice-Chair
David Bresel
Zurich
1205 Pierce St
Omaha, NE 68108
(410) 559-8715
dbresel@gmail.com

Membership Vice-Chair
Carol Smith
Dysart Taylor Cotter McMonigle & Brumitt P.C.
4420 Madison Ave, te 200
Kansas City, MO 64111
(816) 931-2700
Fax: (913) 317-9100
csmith@dysarttaylor.com

Social Media Vice-Chair
James Breckenridge
Levy Craig Law Firm
4520 Main St, Ste 1600
Kansas City, MO 64111
(816) 460-1839
jbreckenridge@levycraig.com

Vice-Chairs
Richard Baudouin
Krebs Farley & Dry PLLC
400 Poydras St, Ste 2500
New Orleans, LA 70130-3224
(504) 299-3570
Fax: (504) 299-3582
rbaudouin@kfplaw.com

Ashley Belleau
Lugenbuhl Wheaton Peck et al
601 Poydras St, Ste 2775
New Orleans, LA 70130
(504) 568-1990
Fax: (504) 310-9195
abelleau@lawla.com

Amy Bentz
Bentz Law Firm PC
680 Washington Rd, Ste 200
Pittsburgh, PA 15228
(412) 563-4500
Fax: (412) 563-4480
aebentz@bentzlaw.com

Amy Bernadas
Zurich
1339 East Second St
Pass Christian, MS 39571
(410) 5598512
amy.bernadas@zurichna.com

JoAnne Bonacci
Dreifuss Bonacci & Parker PC
26 Columbia Tpke, Ste 101
Florham Park, NJ 07932
(973) 514-1414
Fax: (973) 514-5959
jbonacci@dbplawfirm.com

Virginia Boyle
1425 Kershaw Drive
Raleigh, NC 27609
(610) 8582433

Lee Brewer
Bryan & Brewer LLC
355 E Campus View Blvd, Ste 100
Columbus, OH 43235-5616
(614) 228-6131
Fax: (614) 890-5638
lbrewer@bryanandbrewer.com

Shannon Briglia
Smith Currie & Hancock LLP
1950 Old Gallows Rd, Ste 750
Tysons, VA 22182-4014
(703) 506-1990
Fax: (703) 506-1140
sjbriglia@smithcurrie.com

Bogda Clarke
Nationwide Insurance
250 Greenwich St, Fl 37
New York, NY 10007-2140
(732) 759-1011
Fax: (732) 805-2395
bogda.clarke@nationwide.com

Christina Craddock
Liberty Mutual Group
3011 Sutton Gate Dr, Ste 300
Suwanee, GA 30024
(678) 4173913
Fax: (855) 318-4099
Christina.Craddock@LibertyMutual.com

CharCretia Di Bartolo
Watt Tieder Hoffar & Fitzgerald LLP
175 Federal St, Ste 1225
Boston, MA 02110-2221
(857) 504-1140
Fax: (617) 213-7001
cdibartolo@watttieder.com

Brett Divers
Mills Paskert Divers
100 N Tampa St, Ste 3700
Tampa, FL 33602-5835
(813) 2293500
Fax: (813) 229-3502
bdivers@mpdlegal.com

Ryan Dry
Krebs Farley & Dry PLLC
909 18th St
Plano, TX 75074
(972) 737-2530
rdry@kfplaw.com

Bruce Echigoshima
Liberty Mutual Group
23281 NE 17th St,
Sammamish, WA 98074-4447
(206) 545-5000
Fax: (866) 548-6837
bruce.echigoshima@libertymutual.com

Rebecca Farina
1604 Ports O Call D
Plano, TX 75075-2143
(213) 952-6645
becky.farina@zurichna.com

Robert Flowers
Travelers
1 Tower Sq, Ste S202A
Hartford, CT 06183-0001
(860) 277-7150
Fax: (860) 277-5722
rflowers@travelers.com

Katherine Freeman
CNA
15 Havercroft Ln
Greenville, SC 29615-5556
(864) 901-6899
katherine.freeman@cnasurety.com

Stephanie Geer
Liberty Mutual Group
3011 Sutton Gate Dr, Ste 300
Suwanee, GA 30024
(678) 6729142
stephanie.geer@libertymutual.com

Jeffrey Goldberg
SWISSRE
1450 American Lane, Ste 1100
Schaumburg, IL 60173-2276
(847) 273-1268
Fax: (847) 273-1260
jeff_goldberg@swissre.com

David Harris
Bovis, Kyle, Burch & Medlin, LLC
200 Ashford Center North, Ste 500
Atlanta, GA 30338
(678) 3383931
dah@boviskyle.com

Leigh Henican
Gray Casualty & Surety Company
1225 West Causeway Approach
Mandeville, LA 70471
(504) 780-7440
lhenican@graysurety.com

Stacy Hipsak Goetz
Liberty Mutual Group
2815 Forbs Ave, Ste 102
Hoffman Estates, IL 60192-3702
(847) 396-7140
Fax: (866) 548-7309
stacy.hipsakgoetz@libertymutual.com

Hilary Hoffman
Chubb
202 Halls Mill Rd
Whitehouse Station, NJ 08889-3454
(908) 605-3117
hhoffman@chubb.com

Member Roster | continued

Michael Hurley
Berkley Surety
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

Brian Kantar
Chiesa Shahinian & Giantomasi PC
Eleven Times Square
New York, NY 10036
(973) 5302112
Fax: (973) 530-2312
bkantar@csglaw.com

Susan Karlan
ICW Group - OPRS
15025 Innovation Drive
San Diego, CA 92128
(858) 3507213
Fax: (858) 350-2640
skarlan@icwgroup.com

Todd Kazlow
Kazlow & Fields LLC
8100 Sandpiper Cir, Ste 204
Baltimore, MD 21236-4999
(410) 8259644
Fax: (410) 825-6466
todd@kazlowfields.com

James Knox
369 Panorama Circle
Pottsboro, TX 75076
(708) 4042170
Fax: (312) 627-1717
james.knox@zurichna.com

Christina Kocke
Zurich North America
215 Savanna Drive
Luling, LA 70070
(504) 258-8509
tina.kocke@zurichna.com

Melissa Lee
Manier & Herod
1201 Demonbreun St, Ste 900
Nashville, TN 37203-3140
(615) 742-9372
Fax: (615) 242-4203
mlee@manierherod.com

Patrick Lee-O'Halloran
Thompson Tarasek Lee-o'Halloran PLLC
7101 York Ave S, Ste 255
Edina, MN 55435-4533
(612) 564-6966
Fax: (952) 844-0114
patrick@ttlolaw.com

Eric Levine
Crum & Forster
305 Madison Avenue
Morristown, NJ 07960
(973) 4906732
Fax: (973) 244-0016
eric.levine@cfins.com

Rosa Martinez-Genzon
Anderson McPharlin & Conners LLP
707 Wilshire Blvd, Ste 4000
Los Angeles, CA 90017-3623
(213) 236-1653
Fax: (213) 622-7594
rmg@amclaw.com

Christopher McKibbin
FCL LLP
439 University Ave, Ste 2300
Toronto, ON M5G1Y8
(416) 596-8331
Fax: (416) 594-3598
cmckibbin@fcl-law.com

Kyle Murphy
IAT Insurance
5 Park Center Ct, Ste 300
Owings Mills, MD 21117-4203
(443) 660-7377
Fax: (732) 559-7171
kyle.murphy@iatinsurance.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

Mark Oertel
Lewis Brisbois Bisgaard & Smith LLP
633 W 5th Street, Ste 4000
Los Angeles, CA 90071
(213) 250-1800
Fax: (213) 250-7900
mark.oertel@lewisbrisbois.com

Scott Olson
Markel Surety
9737 Great Hills Trl, Ste 320
Austin, TX 78759-6418
(512) 732-0099
Fax: (512) 732-8398
scott.olson@markel.com

Mary Jean Pethick
Zurich North America
600 Red Brook Blvd, Suite 600
Owings Mills, MD 21117
(610) 209-9794
mary.jean.pethick@zurichna.com

Derek Popeil
Chubb
150 Allen Road, Ste 101
Basking Ridge, NJ 07920
(908) 605-3009
Fax: (908) 903-5537
dpopeil@chubb.com

Alana Porrazzo
Jennings Haug & Cunningham LLP
2800 N Central Ave, Ste 1800
Phoenix, AZ 85004
(602) 234-7800
alp@jhc.law

Denise Puente
Simon Peragine Smith & Redfearn LLP
1100 Poydras St, Ste 3000
New Orleans, LA 70163-3000
(504) 569-2983
Fax: (504) 569-2999
denisep@spsr-law.com

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

Cynthia Rodgers-Waire
Wright Constable & Skeen LLP
7 St Paul St, Fl 18
Baltimore, MD 21202
(410) 659-1310
Fax: (410) 659-1350
crodgers-waire@wcslaw.com

Beth Rotenberg
Crum & Forster
305 Madison Avenue
Morristown, NJ 07960
(973) 490-6574
beth.rotenberg@cfins.com

John Sebastian
Watt Tieder Hoffar & Fitzgerald LLP
10 S Wacker Dr, Ste 1100
Chicago, IL 60606-7485
(312) 219-6900
Fax: (312) 559-2758
jsebastian@watttieder.com

Scott Spearing
Hermes Netburn O'Connor & Spearing PC
265 Franklin St, Fl 7
Boston, MA 02110-3113
(617) 728-0050
Fax: (617) 728-0052
sspearing@hermesnetburn.com

Ryan Springer
Emc Insurance
717 Mulberry St, Fl 17
Des Moines, IA 50309
(515) 345-7506
ryan.j.springer@emcins.com

Ira Sussman
IFIC Surety
1560 Wall Street, Ste 207
Naperville, IL 60563
(312) 404-8102
ira.sussman@iatinsurance.com

Shashauna Szczechowicz
Zurich North America
PO Box 968038,
Schaumburg, IL 60196
(410) 5590181
Fax: (415) 982-4328
shauna.szczechowicz@gmail.com

Christopher Ward
Clark Hill Strasburger PLC
2600 Dallas Parkway, Ste 600
Frisco, TX 75034-1872
(214) 651-4722
Fax: (214) 659-4108
christopher.ward@clarkhillstrasburger.com

Michael Weber
Dinsmore & Shohl LLP
222 W Adams St, Ste 3400
Chicago, IL 60606
(312) 775-1742
Fax: (312) 372-6085
michael.weber@dinsmore.com

Member Roster | continued

Ryan Weeks
Mills Paskert Divers
100 North Tampa St, Ste 3700
Tampa, FL 33602
(813) 229-3500
Fax: (813) 229-3502
rweeks@mpdlegal.com

Gregory Weinstein
Weinstein Radcliff Pipkin LLP
8350 North Central Expy, te 1550
Dallas, TX 75206
(214) 865-6126
Fax: (214) 865-6140
gweinstein@weinrad.com

John Wilcox
Liberty Mutual Group
1001 Fourth Ave, Fl 38
Seattle, WA 98154
(206) 473-3264
Fax: (425) 376-6533
blake.wilcox@libertymutual.com

Douglas Wills
Chubb
436 Walnut St, WA10A
Philadelphia, PA 19106
(215) 6401835
Fax: (908) 903-5537
dwills@chubb.com

Grace Winkler Cranley
Dinsmore & Shohl LLP
222 W Adams St, Ste 3400
Chicago, IL 60606
(312) 775-1744
Fax: (312) 372-6085
grace.cranley@dinsmore.com

Kimberly Zanotta
Travelers Casualty & Surety Company of America
111 Schilling Rd
Hunt Valley, MD 21031
(443) 3532121
Fax: (410) 205-0605
kimz1@ymail.com

Frederick Zauderer
AXIS Capital
1211 Avenue of The Americas, 24th Fl
New York, NY 10036
(908) 508-4370
Fax: (908) 508-4389
fred.zauderer@axiscapital.com

Practical Advice To A Commercial Surety Taking Collateral

Elliot Scharfenberg
Krebs Farley & Dry, PLLC

***Elliot Scharfenberg**, a partner at Krebs Farley & Dry, PLLC, in the firm's New Orleans office.*

"Beware of suretyship for thy best friend; he that payeth another man's debt seeketh his own decay." – Barrister Joseph Jekyll

Anyone involved in the surety industry knows exactly what Barrister Jekyll meant by his remark. A commercial surety's business is to literally inject itself into a business relationship in which it otherwise would not be involved, to stand behind the principal, and to perform the bonded obligation when and if the principal defaults. One of the ways to mitigate the risk that the loss falls entirely upon the surety is to seek collateral from the principal and the indemnitors. To quote another bit of ancient wisdom, "a bird in the hand is worth two in the bush." Having some collateral security, even if not in the full amount of the obligation, is better than a mere open-ended promise to indemnify or reimburse the surety for its loss and expense.

What neither Barrister Jekyll nor the ancient amanuenses had to contend with was the United States Bankruptcy Code. Taking note of the ancient wisdom and the realities of modern bankruptcy law, this article provides a few practice pointers to help a commercial surety underwriter take collateral and protect that collateral when the principal files for bankruptcy.

In all candor, the scope of this article is not as broad as the title would seem to suggest, and any article of this size can only graze the surface of what is a complex legal regime where bankruptcy and surety law intersect. This article offers an overview of the issues a commercial surety underwriter should consider when taking collateral security from the principal and a brief synopsis of how bankruptcy law can affect the surety's rights to that collateral security, with the assumption that the principal is a debtor-in-possession under Chapter 11 of the Bankruptcy Code (although much of the considerations will still apply in a Chapter 7 context). One size does not fit all, and there will be many situations that are more complex from both a legal and business perspective. With those caveats, let's get to it.

I. What Language Should be in the Indemnity Agreement?

The cornerstone of the relationship between the surety and the principal is the general indemnity agreement. It almost goes without saying that it is imperative for the surety to require at least the principal to execute an indemnity agreement in favor of the surety. The basis of the surety's rights to collateral will be in an indemnity agreement – or possibly a separate collateral agreement – without which

Read more on page 22

Member Profiles – Meet The Youth And Future Of FSLC

Alana Porrazzo
Jennings, Haug & Cunningham, LLP

Alana Porrazzo is an associate at the law firm of Jennings, Haug & Cunningham, LLP in Phoenix, Arizona, where she practices in the areas of surety and construction law. She is admitted to practice in AZ, NM, and LA.

Alana graduated from Yale University (B.A. '09) and Tulane University Law School (J.D. '16). Thereafter, Alana had the good fortune of jumping straight into surety and construction litigation with the firm of Shields Mott, LLP, in New Orleans. A work opportunity for Alana's husband originally prompted her relocation from the "Big Easy" to Phoenix and her home at Jennings, Haug & Cunningham.

When not litigating surety matters, Alana loves hiking, backpacking, and all manner of outdoor-adventuring with her husband and eight-year-old stepdaughter. In times more conducive to travel, Alana enjoys visiting family in her hometown of Boulder, Colorado, and hopes to return to Croatia among other international vacation destinations. (Ask her about the three years she spent in Croatia before law school, but be forewarned that she will talk your ear off about the azure waters of the Adriatic.)

Alana co-chairs the Young Professionals Subcommittee of the FSLC along with Heather Jonczak and Michael Sugar. Until chances for poker and happy hours return, please reach out to Alana and the YPS if you would like to get involved in the FSLC---or simply want to avoid the need for a "cold email" to connect with FSLC members.

*   *   *   *   *

Ryan DeLaune
Clark Hill, PLC

Ryan DeLaune is a partner at the law firm of Clark Hill, PLC (formerly Strasburger & Price) in Dallas, Texas. Ryan's practice focuses on construction and surety law.

Ryan graduated from Lewis & Clark College (B.A. '07) in Portland, Oregon, and Tulane University Law School (J.D. '10) in New Orleans, Louisiana. Ryan began his career at the Texas law firm of Baker Botts, LLP. In 2012, Ryan joined Strasburger & Price to practice in the firm's Fidelity and Surety practice group.

When not at his desk working, Ryan enjoys running, spending time outdoors, and discovering new restaurants with his husband. Prior to Covid, Ryan enjoys traveling and visiting his family in Baton Rouge and New Orleans, Louisiana.

Ryan co-chairs the Diversity and Inclusion Subcommittee of the FSLC with David Bresel. Ryan previously co-chaired the Young Professionals Subcommittee for several years.

Mapping The Limits Of Notary Bond Coverage

Shane C. Mecham, Esq
Levy Craig Law Firm, P.C.

***Shane C. Mecham, Esq**. is the head of litigation at the Levy Craig Law Firm, P.C. in Kansas City, Missouri. He is a frequent speaker and author on surety topics.*

A tactic used by some litigators in any contract or real estate dispute involving notarized documents is to add the notary—and the notary's surety—as defendants. The theory is that if there is some defect or dispute about the notarized document, then the notary is somehow at fault for notarizing it. This tactic is commonly effectuated through vague allegations that the notary knew, or should have known, about the problems in the transaction alleged by the plaintiff. In those cases, plaintiff's counsel is often hoping that the relatively low penal sum of the notary bond will motivate the surety to immediately pay some nuisance value rather than investigate or litigate the claim. This article lays out some of the important limits and defenses to liability for a notary and the notary's surety.

1. Notary bonds have limited penal sums.

With some exceptions, statutes in most states require notaries to be bonded..[1] Those statutes requiring a bond establish the penal sum of notary bonds and those penal sums are always low. For example, Missouri requires a $10,000 notary bond.[2] California requires a $15,000 notary bond.[3] Texas requires a $10,000 notary bond.[4] The limited penal sums of notary bonds motivate practitioners to be especially efficient when evaluating these claims.

2. Start by reading the applicable state statute.

Note that a notary's liability is usually defined by statute. So, just as it is important to read the bond, it is important to start by reading the statute in the state that authorized the notary. Subject to that qualification, the classic case for notary liability is based on the notary's alleged deliberate misfeasance or nonfeasance during the notary's official notarial duties. Such deliberate misfeasance or nonfeasance subjects the notary—and the notary's surety—to liability for damages proximately caused by that default.[5]

3. Evaluate causation.

Someone defending a claim against a notary and/or the notary's surety should

Read more on page 28

1 By way of example, New York does <u>not</u> require notaries to carry bonds or insurance. *See* N.Y. Exec. Law § 137 (McKinney 1951).

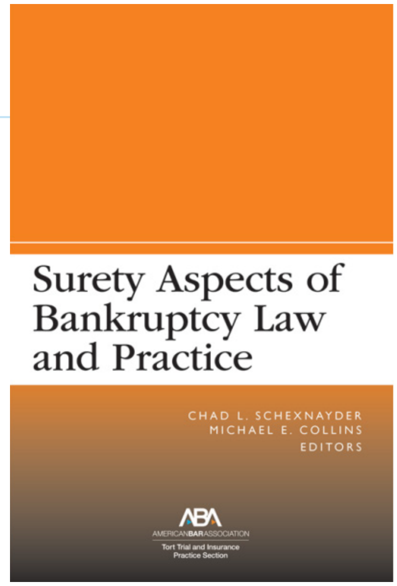
2 Mo. Rev. Stat. § 486.615 (2020).

3 Cal. Gov't Code § 8212 (West 1982).

4 Tex. Gov't Code Ann.§ 406.010 (West 2003).

5 *See* Summers Bros., Inc. v. Brewer, 420 So. 2d 197, 204 (La. App. 1982); Lewis v. Agric. Ins. Co., 2 Cal. App. 3d 285, 288-94 (Cal. Ct. App. 1969).

Make Sure To Check Out FSLC's Newest Publication!

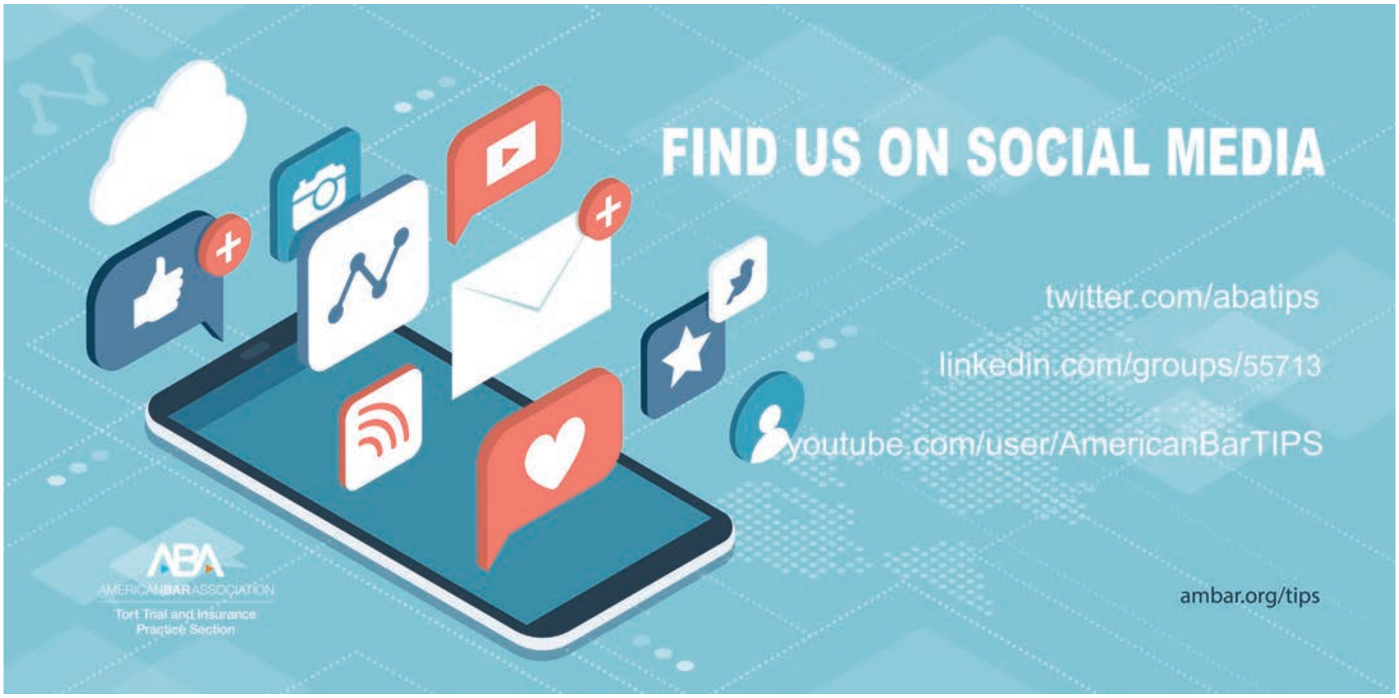


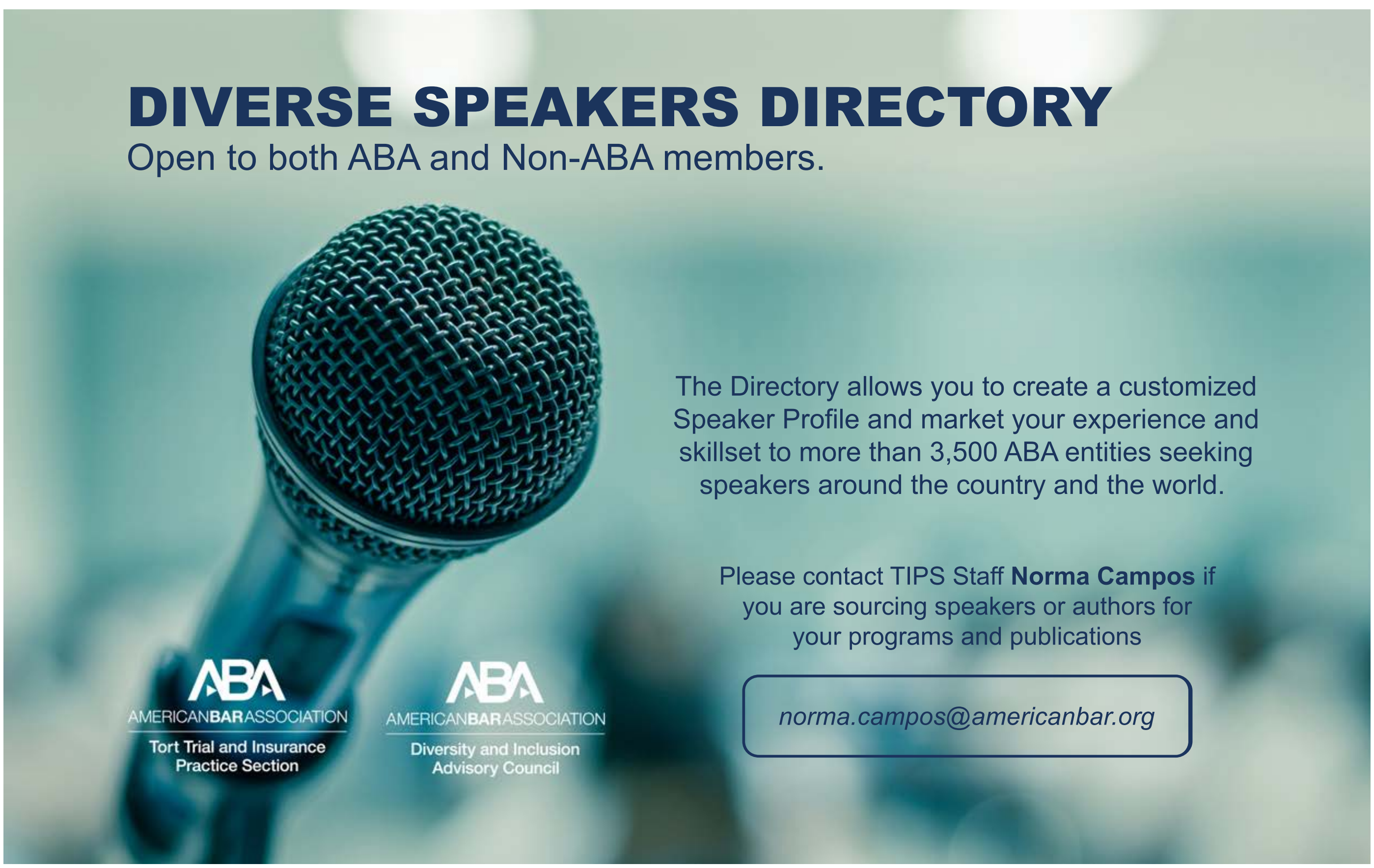
New from the ground up, **Surety Aspects of Bankruptcy Law and Practice**, is the comprehensive resource for surety practitioners, but is drafted as a treatise, rather than as a surety practice guide, to provide a surety law reference for judges, law clerks and bankruptcy practitioners. Edited by Michael Collins of Manier Herod and Chad Schexnayder of Jennings, Haug & Cunningham, the authors/contributors were hand selected for their bankruptcy experience, and their work product is exemplary. Special thanks to them: Lee E. Woodard, Elizabeth Lee Thompson, Michael A. Stover, Jan D. Sokol, Matthew H. Sloan, Alana L. Porrazzo, Mike F. Pipkin, Michael R. Morano, Robert W. Miller, Robert C. Graham, Jr., Drew J. Gentsch, Paul K. Friedrich, John F. Fatino, Matt J. Farley, Meredith E. Dishaw, Matthew G. Davis, Jadyn C. Cleveland, Peter J. Chalik, Gary D. Bressler, Duane J. Brescia, Matthew R. Berry, and Alberta "Ali" Adams.

The book covers a broad range of topics, as demonstrated by chapter headings, Tenets Of Surety Law, Overview Of Bankruptcy Code, Jurisdictional Issues, Commencement Of Case (including subtopics such as Chapter Options, Tolling Under § 108, First Day Motions), Case Administration, (including subtopics Assets Of The Estate, Automatic Stay, Sale Of Assets, Cash Collateral And The Surety, Post-Petition Credit, Executory Contracts, Remedies For Mismanagement Or Fraud), Surety Claims In Bankruptcy, Bankruptcy Estate (including subtopics Property Of The Estate, Avoidance Actions, Claims On Bonds by Bond Principal or Trustee/ Debtor-In-Possession, Turnover, Abandonment, Setoff & Recoupment), Chapter 7 Liquidation, Chapter 11 Reorganization, Chapter 15 Proceedings, and Bankruptcy Trustee Bonds.

Order your copy on line www.americanbar.org/products/inv/book/411453614

Don't have time today to read 494 pages of "can't put it down" bankruptcy discussion? You can hear from the book authors in their short bankruptcy topic vlogs, residing on the FSLC's YouTube channel! www.youtube.com/channel/UCArluIgH6xHaATHlVoScfuA





Evaluating... continued from page 1

guidance on this issue, research for this article revealed another line of somewhat analogous case law which may point the way for understanding how some courts might address such issues as they arise in the future.

This article first briefly provides background on the federal False Claims Act for context. A review of the *Hanover* case and its unique circumstances sets the stage for the potential defense that the Eighth Circuit rejected at the relatively early stage of the project. We will then provide background on the use of equitable estoppel as a defense and related case law to discern a possible future direction for analyzing federal False Claims Act issues arising in circumstances similar to the *Hanover* case, but in a payment bond context.

I. The False Claims Act

Generally, the federal False Claims Act[3] ("FCA") is grounded in the concept of fraudulently conducted transactions and imposes significant liability on a defendant who knowingly presents fraudulent claims or makes a false record to support fraudulent submissions for payment by the federal government.[4] Possible FCA violations may arise due to contractual relationships that are either entered into in a fraudulent manner or are conducted within the performance of the contract in a fraudulent manner. A founded violation of the FCA exposes the fraudster to potential liability for a civil penalty, treble damages sustained by the government, and the costs (including attorneys' fees) of recovering the penalty or damages.[5] It is conceivable that a surety could be charged with and found liable for an FCA violation in relation to its handling of a payment bond claim. As a result, sureties may attempt to use the FCA as a defense to discharge their obligation under a payment bond claim. The surety may assert, for example, that if it makes payment for stated claims, it risks triggering an FCA complaint against itself by participating in an illegal contract or scheme to improperly elicit payment from the federal government.[6]

II. *Hanover v. Dunbar*

While in the context of a performance bond claim, in *Hanover Insurance Company v. Dunbar Mechanical Contractors, LLC*, the Eighth Circuit announced its stance on sureties attempting to discharge bond obligations in relation to a default leading to an FCA violation.[7] Arguably, the case reflects that the *timing* of the surety's assertion

3 31 U.S.C.A. § 3729.

4 *See generally,* U.S. ex rel. Roop v. Hypoguard USA, Inc., 559 F.3d 818, 822 (8th Cir. 2009).

5 *See* Hanover Ins. Co. v. U.S., 134 Fed. Cl. 51, 65 (2017).

6 *See generally* U.S. ex rel. McGough v. Covington Tech. Co., 967 F.2d 1391, 1393 (9th Cir. 1992).

7 *Hanover.,* 964 F.3d at 766-67.

is critical. In *Hanover*, the Army Corps of Engineers awarded a contract to Dunbar Mechanical Contractors, LLC ("Dunbar") based on a Service Disabled Veteran Set-Aside Project ("SDVSAP"). Under the SDVSAP rules, Dunbar was required to qualify as a Service Disabled Veteran Owned Small Business ("SDVOSB").[8] Additionally, the rules required that Dunbar complete, or enlist other SDVSOB entities to complete, at least fifteen percent of the contract.

Dunbar subsequently entered into a subcontract with Harding Enterprises and separately its sole member (collectively "Harding") to perform work on the project, subject to changes in its scope of work at the discretion of Dunbar.[9] Hanover issued a performance bond related to Harding's work on the subcontract, naming Dunbar as the obligee. As the project proceeded in its early stages, Dunbar informed Hanover that Harding's subcontract was in default and that Dunbar planned to terminate Harding based upon the defaults. Dunbar demanded that Hanover perform its bonded obligations.[10]

Following Dunbar's notification of claim and demand, Hanover investigated and subsequently filed a declaratory judgment action in federal district court seeking a declaration that it had no obligation to Dunbar under the bond because Harding was not an SDVOSB and Dunbar had subcontracted in excess of eighty-five percent of the work under the prime contract to Harding. Hanover alleged that Dunbar was violating the requirement for an SDVOSB to perform at least fifteen percent of the work required by the prime contract, a likely FCA violation.[11] Hanover reasoned that if it completed the subcontracted scope of work as currently specified, it could be seen as contributing to the submission of claims to the federal government in violation of the FCA. In a motion for judgment on the pleadings that the district court converted into a motion for summary judgment, the district court agreed with Hanover that over ninety percent of the contract work had been subcontracted to non-qualifying subcontractors.[12] The district court entered summary judgment in favor of Hanover and discharged the surety's obligation under the bond.[13] Dunbar appealed and requested that the Eighth Circuit examine whether the subcontracts between Dunbar and Harding violated the SDVOSB rules, and whether Hanover, if it performs its bonded obligations, was subject to potential liability under the FCA.[14]

---

8 *Id.* at 764.
9 *Id.*
10 *Id.* at 765-66.
11 *Id.* at 766.
12 *Id.* at 766.
13 *Id.*
14 *Id.* at 766-68.

In addressing the federal regulation violation, the Eighth Circuit found that there was insufficient evidence to determine whether the fifteen percent requirement was satisfied because Dunbar had the power to alter the scope of Harding's work up to the point of completion.[15] The Eighth Circuit held that Hanover could not presently avoid its bonded obligations because there was insufficient evidence to support the contention that it would indeed be subject to liability under the FCA in the future.[16] Until there was more evidence – likely until the contract was fully performed and any actual breach of the minimum 15% subcontracting requirement occurred – Hanover would be incapable of proving a defense under the FCA based on the mere possibility that Dunbar could be fraudulently failing to perform its requirements under the SDVSAP.[17] As a result, the Eight Circuit reversed the judgment of the district court and remanded the case for further proceedings.[18] However, the court also provided some guidance for a surety caught on the horns of potential FCA liability under the circumstances presented: "[A surety] could either pay the obligee and, having satisfied its obligations, remove itself entirely from any further involvement, or perform under the bond while giving notice to the government of the potential for false claims if there is no further modification of contract performance."[19]

As a result of the findings in *Hanover*, it appears likely that the Eighth Circuit would similarly rule on a payment bond matter involving a factually related potential FCA violation. However, different timing, facts, or a different FCA violation could potentially lead to an allowable discharge of a payment bond obligation.

Not all circuit courts of appeals have specifically addressed a surety's attempt to discharge a payment bond obligation based upon an FCA violation. However, there is analogous case law under the doctrine of equitable estoppel which seems to provide some direction in how an FCA defense could work in favor of a surety. While these cases are not "on all fours" with *Hanover,* there are some similar fact patterns which allow for an intelligent comparison.

III. Equitable Estoppel

Generally, equitable estoppel prevents a party from "taking unconscionable advantage of [its] own wrong by asserting [its] strict legal rights."[20] The elements of equitable estoppel are:

---

15 *Id.* at 767.

16 *Id.* at 768.

17 *Id.*

18 *Id.*

19 *Id.*

20 Plymouth Foam Prods. v. City of Becker, 120 F.3d 153, 156 (8th Cir. 1997) (quoting Brown v. Minn. Dept. of Pub. Welfare, 368 N.W.2d 906, 910 (Minn. 1985)).

> (1) There must have been a false representation or a concealment of material facts; (2) the representation must have been made with knowledge of the facts; (3) the party to whom it was made must have been ignorant of the truth of the matter; (4) it must have been made with the intention that the other party should act upon it; (5) the other party must have been induced to act upon it.[21]

Of course, these elements vary by jurisdiction. Equitable estoppel is a possible defense available to sureties and may allow sureties to claim that improper or fraudulent actions by other parties could operate to discharge the surety of its payment bond obligations.[22]

A. Fifth Circuit.

The Fifth Circuit recognizes a defense of equitable estoppel in the context of a payment bond claim.[23] In *Graybar Electric Co v. John A. Volpe Construction Co*, Graybar was a material supplier to a subcontractor on a Miller Act project.[24] The general contractor was concerned about its subcontractor's finances early in the project and required several checks to be endorsed by the subcontractor to Graybar in an attempt to ensure proper payments under the contract.[25] Unfortunately, Graybar then endorsed the checks back to the subcontractor.[26] At the end of the project, Graybar made a payment claim for less than the value of the previously re-endorsed checks.[27] Despite the fact that Graybar had provided its notice of the claim to the general contractor (which still held retainage on behalf of the subcontractor), the general contractor nevertheless released the retainage to the subcontractor.[28] When the district court denied Graybar's claims, on appeal Graybar refocused solely on the retainage paid to the subcontractor after Graybar provided notice of its claim.[29] The Fifth Circuit affirmed that equitable estoppel may indeed be a defense to a Miller Act case.[30] The court went on to find that the highly remedial nature of the Miller Act is meant to protect the innocent, which Graybar was not considering its re-endorsement of checks back to the subcontractor.[31] In the circuit court's view, the general contractor had done "everything it reasonably could do to protect itself short

21 Coen v. Am. Sur. Co. of N.Y., 120 F.2d 393, 398 (8th Cir. 1941).

22 *See, e.g.,* U. S. ex rel. Westinghouse Elec. v. James Stewart Co., 336 F.2d 777 (9th Cir. 1964).

23 *See* Graybar Elec. Co. v. John A. Volpe Constr. Co., 387 F.2d 55 (5th Cir. 1967).

24 *Id.* at 56.

25 *Id.*

26 *Id.*

27 *Id.* at 57.

28 *Id.*

29 *Id.*

30 *Id.* at 59.

31 *Id.*

of completely taking over the operation of [its subcontractor]" and Graybar's claims were properly equitably estopped and dismissed.[32]

B. Ninth Circuit

In *United States ex rel. Westinghouse Electric v. James Stewart Co.*, the United States Court of Appeals for the Ninth Circuit reviewed a case wherein a surety successfully argued that a material supplier to a Miller Act project could be estopped from recovery under the payment bond.[33] Westinghouse was a material supplier to a subcontractor on the project.[34] The general contractor on the project became concerned that the subcontractor was not making payments to Westinghouse and made direct inquiry with Westinghouse.[35] While Westinghouse was not being fully paid for its deliveries to the project, Westinghouse denied the general contractor's offer to redirect payments as appropriate to meet Westinghouse's needs. The general contractor and Westinghouse then agreed that Westinghouse would inform the general contractor if satisfactory payments were not being made to Westinghouse and, if no notice was received from Westinghouse, payments under the contract would continue to be made directly to the subcontractor.[36] When no further word was received from Westinghouse related to payment issues, interim and final payments were made in due course to the subcontractor.[37]

As it turned out, Westinghouse received no further payments from the subcontractor through the remaining course of the project, and Westinghouse filed a payment bond claim related to its unpaid invoices after the subcontractor received its final payment.[38] Westinghouse filed its lawsuit against the general contractor, the subcontractor, and the payment bond surety, and the case proceeded to a jury trial.[39] The subcontractor became bankrupt.[40] The general contractor and its surety relied on the affirmative defense of estoppel, related to the general contractor's agreement with Westinghouse concerning ongoing payments under the subcontract.[41] When the jury accepted the estoppel defense, Westinghouse sought appellate review and asserted that estoppel does not lie in a Miller Act case.[42] Westinghouse further argued on appeal that because it had no direct contract with the general contractor,

---

32 *Id.* at 59-60.
33 *Westinghouse*, 336 F.2d 777.
34 *Id.* at 778.
35 *Id.*
36 *Id.*
37 *Id.* at 779.
38 *Id.*
39 *Id.*
40 *Id.*
41 *Id.*
42 *Id.*

the law and public policy behind the law would not support the discharge of the general contractor and surety.[43] The Ninth Circuit reviewed case law directly adverse to Westinghouse's position and affirmed the jury's verdict against Westinghouse.[44]

In another Ninth Circuit Case, Reliance Insurance Company ("Reliance") issued a payment bond on a Miller Act project wherein a material supplier provided timely notice and filed suit because of non-payment from the general contractor.[45] Reliance defended the payment claim on the basis of a pay when and if paid clause.[46] The district court agreed with Reliance and granted summary judgment against the material supplier.[47]

On appeal, the Ninth Circuit focused on the statutory terms of when a claimant is entitled to recover under the Miller Act and whether there was a conflict between the contract clause ("when and if paid") and the terms of the statute.[48] The court recognized that the statute expressly allows a right of recovery on a payment bond that accrues ninety days after completion of the subcontractor's work, "not when and if the prime contractor is paid by the government."[49] The court concluded that the pay when and if paid clause was not a valid waiver of Miller Act rights, as it lacked sufficient and express terms of a clear and explicit waiver.[50] As a result, the court appeared to equitably estop the surety's use of the pay when and if paid clause as an appropriate defense, and reversed the summary judgment in this regard.[51]

C. Second Circuit

The United States Court of Appeals for the Second Circuit allowed the application of the equitable estoppel defense to a payment bond claim.[52] In *United States ex rel. Hyland Electrical Supply Co. v. Franchi Bros. Construction Corp.*, a material supplier to a subcontractor accepted joint checks with the subcontractor on the project from the general contractor, endorsed the checks, then later booked payment, by agreement with the subcontractor, for part of the funds to the bonded project, and the other part to a previously incurred debt owed by the subcontractor.[53] When the subcontractor went bankrupt, the material supplier provided notice and filed a claim

---

43 *Id.* 779-80.
44 *Id.* (citing Moyer v. U.S., 206 F.2d 57 (4th Cir. 1953)).
45 U.S. ex rel. Walton Tech., Inc. v. Weststar Eng'g, Inc., 290 F.3d 1199, 1201-02 (9th Cir. 2002).
46 *Id.* at 1205.
47 *Id.* at 1203.
48 *Id.* at 1208.
49 *Id.*
50 *Id.* at 1208-09.
51 *Id.* at 1209.
52 *See* U. S. ex rel. Hyland Elec. Supply Co. v. Franchi Bros. Constr. Corp., 378 F.2d 134 (2d Cir. 1967).
53 *Id.* at 135-36.

for all unpaid supply invoices – not including credit for the full payments made under the joint check arrangement.[54] The material supplier sought to estop the general contractor from disputing the altered payment stream based upon its alleged notice to the general contractor in regard to how the payments were actually booked.[55] However, the appellate court found that the material supplier failed to prove its prejudicial reliance on the silence of the general contractor and, therefore, allowed the general contractor's equitable estoppel defense to payment.[56] While equitable estoppel was not utilized by the surety in the *Hyland* matter, the case additionally supports the use of the defense in the proper setting.

D. Eleventh Circuit

The United States Court of Appeals for the Eleventh Circuit also recognized the defense of equitable estoppel in relation to a payment bond claim.[57] In the case of *United States ex rel. Krupp Steel Products, Inc. v. Aetna Insurance Co.*, the court reviewed a procedurally complex matter.[58] This was the second time the case came before the Eleventh Circuit. In *Krupp*, a material supplier to a subcontractor raised issues of non-payment.[59] During the course of the project, the subcontractor presented two lien waivers that contained both an effective date and a distinct execution date.[60] The surety claimed that the confusing dating on the documents led the general contractor to reasonably rely on the documents in making payments, which later turned out to be to its detriment, creating a disputed difference in the alleged claim.[61] Based upon the jury instructions, the appellate court determined the case should be remanded for yet another proceeding to determine the factual issues related to the surety's equitable estoppel claim.[62]

E. Fourth Circuit

In the case of *United States ex rel. Damuth Services, Inc. v. Western Surety Co.*, Damuth supplied HVAC parts to a Miller Act project subcontractor.[63] As the subcontractor was experiencing financial difficulties and not paying Damuth on its bills, Damuth agreed to various payment plans with the subcontractor in order to avoid informing the general contractor and surety of the defaults.[64] Damuth continued to

---

54 *Id.* at 136.

55 *Id.* at 138-39.

56 *Id.* at 138.

57 *See* U.S. ex rel. Krupp Steel Prod., Inc. v. Aetna Ins. Co., 923 F.2d 1521, 1525–26 (11th Cir. 1991).

58 *Id.* at 1522.

59 *Id.* at 1522-23.

60 U.S. ex rel. Krupp Steel Prod., Inc. v. Aetna Ins. Co., 831 F.2d 978, 981 (11th Cir. 1987).

61 *Id.*

62 *Krupp,* 923 F.2d at 1527.

63 U.S. ex rel. Damuth Servs., Inc. v. W. Sur. Co., 368 F. App'x 383, 385 (4th Cir. 2010).

64 *Id.* at 385-86.

receive no payments from the subcontractor, despite the subcontractor's agreements and receipt of payments from the general contractor.[65] Damuth subsequently filed its notice and payment bond claim. The surety defended the claims based upon equitable estoppel and the district court entered summary judgment in favor of the surety on that basis.[66] On appeal to the United States Court of Appeals for the Fourth Circuit, Damuth sought to downplay its role as merely remaining silent in relation to the failure of payments from the subcontractor.[67] The appellate court found the agreement of Damuth and the subcontractor to be a violation of the appropriate payment protections and indemnity obligations, which attach to a properly and timely filed notice of claim.[68] The court likened the behavior as "analytically similar to the false receipts provided in [another case] and the misleading arrangement undertaken in [yet another case]," and, therefore, affirmed the surety's invocation of equitable estoppel to defeat the payment bond claim of Damuth.[69]

IV. Conclusion

From the various cases discussed above, a potential for violation of the FCA does appear to be a defense for a surety. Situations where a subcontractor or material supplier fails to properly and adequately protect its payment stream, or where there are mismatches in documentation or contract documents versus the controlling statutory/regulatory authority, raise issues that may present a potential false claim and provide the surety with an opportunity to raise an FCA defense to a payment claim. However, the timing of the violation in connection with the defense by the surety seems to be the critical factor in relation to the result reached by the Eighth Circuit in *Hanover*. Moreover, the practitioner may also utilize the defense of equitable estoppel to defeat certain claims where a defense under the FCA may not be factually or procedurally proper.[70]

---

65 *Id.* at 386.

66 *Id.*

67 *Id.* at 387.

68 *See id.* at 390.

69 *See id.*

70 The author wishes to acknowledge the substantial contributions of research and drafting assistance received from Clark Butler, a law clerk with the firm, as well as the co-chairs of the payment bond committee and editors for the Newsletter.

Practical... continued from page 8

the surety may be left with little or no collateral security rights. But are all indemnity agreements created equal? No, they are not. While I recognize that the business realities of underwriting a commercial surety account may dictate a less inclusive indemnity agreement, the following are a few provisions that should be considered when taking collateral security. Failure to include some of these provisions could affect the surety's rights to the collateral when the principal declares bankruptcy.

First, the surety should include a provision that gives the surety the right to be placed in funds at any time. Ideally, this provision would allow the surety to demand the form of the collateral, i.e., an irrevocable letter of credit, and will give the surety the right to set the amount of the collateral in the surety's sole discretion. The collateral should cover all surety bonds and should expressly allow the surety to use the collateral to pay loss and expense, hold as a reserve against future claims, pay premiums, and pay the costs of the surety's professionals.

Second, the indemnity agreement should expressly state that it is a security agreement and may be filed as a financing statement for purposes of the Uniform Commercial Code (the "UCC"). An indemnity agreement that meets these criteria may make the surety a secured creditor for certain types of collateral that may be listed in the indemnity agreement. When a surety perfects its security interest, this type of provision may also provide the surety with a secured position in the principal's bankruptcy proceeding.

In addition to the indemnity agreement, a surety may require the principal to execute a separate collateral agreement. Unlike the indemnity agreement, the collateral agreement will describe in detail the collateral that the principal provides to the surety. For example, the collateral agreement can define the surety's rights to the collateral and the periods of time during which the surety may retain the collateral and must release the collateral.

Finally, keep in mind that a good indemnity agreement or collateral agreement is the first step, but not the only step, to securing rights to collateral. The surety will want to timely perfect its security interest under the UCC, which may take some effort if the collateral being taken is not subject to perfection by possession. An attached but unperfected security interest is generally not worth much even before a bankruptcy filing, and it is especially flimsy after the principal files for bankruptcy.

II. What Form of Collateral Should the Surety Take?

The answer to the question of what type of collateral a surety should take is either incredibly straightforward or a bit more legally complex. The straightforward answer is that the surety should take whatever form of collateral the surety can get its hands on. As they say, beggars can't be choosers. But what if the surety has more leverage – for example, the surety is taking collateral as a condition to issuing bonds – and the principal has the financial means and inclination to give the surety its preferred form of collateral? Under those circumstances, the best option is typically an irrevocable letter of credit, with appropriate language, from a reputable financial institution. There are many types of collateral that could be taken, and each has costs and benefits, but the two most common forms of collateral in commercial surety underwriting are letters of credit and cash.

A. Letters of Credit

Sureties are intimately familiar with the bank-issued letter of credit, which is a type of commercial paper governed by the UCC where at the request of an applicant (here, the principal), an issuer (usually a bank), on its own account, guarantees to the beneficiary (here, the surety) the payment of a sum of money upon a documentary presentation by the beneficiary.[1] As opposed to other options for collateral, such as real or personal property, a letter of credit provides the surety with several advantages. The proceeds of a letter of credit are liquid, and no sale or transfer of property is required. Along those lines, there are no fees, expenses, or transaction costs required in order to obtain the proceeds. Also, like cash, they have a fixed and known amount of proceeds that do not fluctuate over time due to market conditions. As explained further on, in the bankruptcy context, letters of credit are incredibly helpful. Chief among those benefits are that the letters of credit, and their proceeds, are generally not considered to be property of the estate.

B. Cash

Sureties also regularly take cash as collateral. Cash is often the most straightforward collateral a commercial surety underwriter may obtain. It has much of the same benefits as a letter of credit, in that it is liquid, has little transaction costs, and its value does not fluctuate due to market conditions. However, once a bankruptcy petition is filed, the surety's rights to use the cash become prescribed. The surety cannot use the cash collateral without first requesting relief from the automatic stay under section 362(d) of the Bankruptcy Code.[2] Cash is generally considered property of the debtor's estate, regardless of where the cash is located or who has possession or control.

Instead, when a surety is holding cash collateral, the surety is a secured creditor with its secured interest equaling the amount of the cash collateral. A surety's only option with a principal in bankruptcy is to file a motion for stay relief and obtain leave from the bankruptcy court to use the cash collateral. This general rule is subject to

1 U.C.C. § 5-102(10).

2 11 U.S.C.A. § 362(d) (2020).

some exceptions, for example, when the cash collateral is earmarked funds or trust property, which may not be property of the debtor's estate. However, that discussion is beyond the scope of this article.

III. What Happens When Your Principal Files for Bankruptcy?

The moment the principal files for bankruptcy, a new legal regime is imposed on all parties, including the surety. The surety must carefully comply with certain provisions of the Bankruptcy Code prior to exercising its rights against the principal's collateral. Just because a surety had a pre-bankruptcy right to use the collateral does not mean that the surety has that same right after the bankruptcy is filed. What follows is a brief overview of select sections of the Bankruptcy Code, a general knowledge of which will be helpful when planning for the principal's bankruptcy.

A. Property of the Estate

The commencement of a case under the Bankruptcy Code creates an estate, which includes all legal or equitable interests in property as of the commencement of the bankruptcy case.[3] Section 541(a) of the Bankruptcy Code has a broad scope, covering all kinds of property, including tangible property, intangible property, and causes of action.[4] That being said, the filing of a bankruptcy proceeding does not expand a debtor's interests in an asset or its rights against others. While the Bankruptcy Code defines what property is included in the estate, state law generally governs whether a debtor has a legal or equitable interest in property under section 541 and the extent of such interest.[5] This distinction will be good to keep in mind when considering the benefits of letters of credit, as opposed to other forms of collateral, especially in relation to avoidance and preference actions.

B. Automatic Stay

Probably the best-known, but often misunderstood, effect of a bankruptcy filing is the imposition of the automatic stay under section 362.[6] The debtor's filing of the petition operates as an automatic stay of almost all actions to enforce a debt or foreclose on the debtor's property. Therefore, once a principal commences its bankruptcy case, a surety may not immediately enforce its rights against the principal's property without risking a violation of the automatic stay. The automatic stay remains effective until the principal's property is no longer the property of the principal's estate.[7] Violations of the

3 *Id.* § 541(a).

4 *See* U.S. v. Whiting Pools, Inc., 462 U.S. 198, 204-05 (1983); 11 U.S.C.A § 541(a).

5 *See* Butner v. U.S., 440 U.S. 48 (1979).

6 *See* 11 U.S.C.A. § 362.

7 *Id.* § 362(c).

automatic stay are taken very seriously and can result in sanctions, assessment of damages, attorney's fees, and even punitive damages.[8]

That being said, a surety is not without remedies, but it should ask for permission and not forgiveness. A surety may seek to enforce its rights against property of the estate by moving for relief from the automatic stay.[9] Although it is outside the scope of this article, relief may be "for cause, including the lack of adequate protection of an interest in property of such party in interest."[10] The surety has the burden of proof on the issue of cause and on the issue of the debtor's equity in the property that serves as the surety's collateral.[11] In short, it may be a complicated process and may take longer than the surety would like, but the surety can generally make use of the collateral after a series of filings in the bankruptcy case.[12]

C. Avoidance and Preferential Transfer

The avoidance powers granted under the Bankruptcy Code are case in point that a surety should not wait until the last minute to perfect its security interest. Under section 544, the debtor-in-possession may avoid any certain liens that were not perfected when the debtor filed for bankruptcy.[13] While sureties tend to hesitate to file a UCC-1 financing statement until a loss is imminent or has been incurred, this delay may give rise to a preference issue under the Bankruptcy Code that could be detrimental to a surety's position as a secured creditor.

Thus, if the surety attempts to perfect its security interest by filing a financing statement in the ninety days prior to a bankruptcy filing, the debtor-in-possession may move to avoid the lien as a preference under section 547 of the Bankruptcy Code.[14] Regardless of when the security agreement (typically contained in the indemnity agreement or collateral agreement) was executed, any action taken to perfect the surety's interest in the indemnitor's property within that ninety-day period will likely be viewed as a transfer that may be avoided because it enables the surety to receive more than the surety otherwise would in the bankruptcy if the interest had not been perfected as of the commencement of the bankruptcy case.

In addition to preference issues, there are other, special issues a surety could encounter when it takes collateral during the ninety days preceding the principal's

---

8 *Id.* § 362(k).

9 *Id.* § 362(d).

10 *Id.* § 362(d)(1).

11 *Id.* § 362(g)(1).

12 Under § 506 of the Bankruptcy Code, secured creditors retain their senior, secured status after the bankruptcy filing, and § 1129(b)(2)(A) provides that secured creditors are to be paid in full first and retain any liens on the debtor's property until such payment is made.

13 11 U.S.C.A. § 544.

14 11 U.S.C.A. § 547(b).

bankruptcy filing. When the form of collateral is cash or any other property that forms part of the debtor's estate, the surety is generally out of luck. On the other hand, letters of credit can give the surety ammunition if the debtor-in-possession tries to claw back the collateral as a preferential transfer. Section 547(b) of the Bankruptcy Code allows a debtor-in-possession to avoid certain transfers of property made within ninety days before the date of the filing of the bankruptcy petition.[15] This can create a problem for a surety that takes collateral shortly before the debtor files for bankruptcy.

Because most courts have held that letters of credit and their proceeds are not property of the debtor's estate, these same courts also hold that preference avoidance powers do not apply to letters of credit or their proceeds.[16] However, there are several courts that have held otherwise.[17] Of course, the surety may also have the typical defenses to section 547, such as the "new value" defense.[18] This defense prevents the bankruptcy trustee from avoiding a transfer to the extent that such transfer was intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor.[19] Careful consideration should be given when encountering these bankruptcy issues, and it would be wise to seek legal counsel to protect the surety's interest.

IV. Conclusion and Practical Tips

While business considerations often do and should drive a commercial underwriter's decision to take collateral, having an understanding of how the surety's contractual rights can be altered by bankruptcy law should assist an underwriter in making that ultimate decision. And, as explained above: (1) the surety should carefully document its collateral security rights in an indemnity agreement or collateral agreement; (2) letters of credit generally give the surety more rights in bankruptcy than other forms of collateral; (3) the longer the surety waits to exercise its collateral security rights, the more tenuous its position; and (4) once the principal files for bankruptcy, make sure to carefully vet every move the surety makes so as not to unintentionally violate bankruptcy law or lose rights to collateral. A fifth and final piece of advice is to consult with a lawyer to ensure the surety is protected to the full extent the law allows.

---

15 *Id.* To prevent a debtor that contemplates bankruptcy from preferring creditors just before it files a bankruptcy petition, the Bankruptcy Code allows the debtor to reach back in time to require creditors to disgorge certain payments received prior to the bankruptcy petition.

16 *E.g.*, Wooten v. U.S. In re Dept. of Interior, 56 B.R. 227, 232 (Bankr. W.D. La. 1985); *In re Illinois-California Exp., Inc.*, 50 B.R. 232 (Bankr. Colo. 1985).

17 *E.g.*, *In re Air Conditioning, Inc. of Stuart*, 845 F.2d 293 (11th Cir. 1988) (reasoning that although a letter of credit and its proceeds are not considered property of the debtor's estate, collateral which the debtor has pledged as security for a letter of credit is property of the estate).

18 *See* 11 U.S.C.A. § 547(c)(1).

19 *Id.*

TIPS WEBINAR SERIES

TIPS Webinar Series offers educational, informative and instructional CLE programming for your practice.

AMERICAN**BAR**ASSOCIATION

Tort Trial and Insurance Practice Section

ambar.org/tips

Mapping... continued from page 10

evaluate whether the notarization was the proximate cause of the plaintiff's alleged damages. In order to recover for the wrongful acts of a notary, it is necessary not only to show that the act was wrongful, but also that it was the proximate cause of the loss or damages claimed to have been suffered.[6] A surety is not liable under the bond just because the notary made a false and fraudulent acknowledgment. The plaintiff must also show that the fraudulent act proximately caused the damages, i.e., by someone having "parted with value in reliance upon the verity of the certificate."[7] The following examples illustrate when proximate cause is present:

In Alabama, a notary acknowledged several forged mortgages.[8] Plaintiff then issued credit based on the forged notarized mortgages. The surety argued that the errant notarization did not cause the loss because the mortgages would have been forged even if they had been properly notarized. The Supreme Court of Alabama concluded that, even though the notarization was not the sole cause of the loss, it was still a substantial and proximate cause.[9] The surety was liable under the bond, but the court remanded the case for a trial to determine if the damages caused by the notary were substantial or nominal.[10]

In a Florida case, a notary's employer prepared a fraudulent mortgage and placed the property owners' signatures on the document.[11] The notary then notarized the document, knowing that the actual property owners were not present before her. The notarization was the act that allowed the mortgage to be recorded. The property owners had to pay off the mortgage when they discovered its existence years later. They then sued the notary for conspiracy to slander title. The court held that the notary was liable even though she did not actively conspire against the plaintiffs.[12] The cause of action was for the harm caused by the conspiracy, and her overt act allowed the wrong to be accomplished.[13]

By contrast, the following examples illustrate when proximate cause is not present:

In a California case, the plaintiff purchased $8,000 worth of stock in exchange for $3,000 in cash and a $5,000 promissory note to the vendor, secured by a deed of trust on property.[14] Plaintiff signed the note and deed of trust and delivered them

---

6 *See* MacBride v. Schoen, 8 P.2d 888, 889-90 (Cal. Ct. App. 1932); Atlas Sec. Co. v. O'Donnell, 232 N.W. 121, 121-22 (Iowa 1930).

7 Ellis v. Hale, 194 P. 155, 156-57 (Mont. 1920).

8 *See* Fogleman v. Nat'l Sur. Co., 132 So. 317, 319 (Ala. 1931).

9 *Id.* at 320.

10 *Id.* at 320-21.

11 DeCamp v. Allen, 156 So. 2d 661, 662 (Fla. Dist. Ct. App. 1963).

12 *Id.*

13 *Id.*

14 Macbaid v. Schoen, 8 P.2d 888 (Cal. Ct. App. 1932).

to the seller, but they were not notarized. The seller gave them to the defendant notary, who affixed the certificate of acknowledgment, but not in the presence of the plaintiff. The seller then assigned the note and deed to a third party, who recorded them and clouded title to the plaintiff's property. The court found that the plaintiff had delivered the note and deed to the seller voluntarily and intended them to be valid, but without receiving the consideration.[15] Although the certificates were improperly added later, the fact remained that her signature was in fact genuine and the documents were used as intended, so there was no direct connection between the notary's act and the injury claimed.[16]

In Pennsylvania, a woman held a mortgage to a house.[17] Her husband, who was "a member of the bar who had held judicial office," forged her name on paperwork to get a loan from a bank to pay off that mortgage.[18] To record the mortgage release, the husband had a notary acknowledge a power of attorney. The notary attested that the mortgage holder was in her presence when, in fact, the notary was speaking to another woman over the phone who was only pretending to be the mortgage holder. The Supreme Court of Pennsylvania held that, while the notary "acted reprehensibly in certifying to the acknowledgment of the power of attorney as having been made personally before her," she did not cause the loss.[19] The bank had approved and paid the loan before the notary acknowledged the power of attorney.[20]

In Iowa, a car dealer sold a Pontiac to a customer in exchange for a note guaranteeing payments over time.[21] A notary acknowledged the signatures of the dealer and customer on the conditional sale contract. The dealer then sold the contract and note to a finance company. The only problem was that the dealer never owned the Pontiac and the customer was fake. The Supreme Court of Iowa wrote that "there is no dissent from the proposition that a notary who violates his official duty, as by certifying to a false acknowledgment, is liable for the proximate damage to one injured thereby."[22] It held, however, that the notary was <u>not</u> liable because the statute only required that the signature of the buyer <u>or</u> seller be notarized, and the notary had properly acknowledged the seller's signature. More importantly, the finance company's losses were caused by the note—not the contract—being fraudulent, and the notary did not acknowledge any signatures on the note. The court emphasized "that a notary's certificate can in no wise

15 *Id.* at 889.

16 *Id.* at 890.

17 *See* Shay v Schrink, 6 A.2d 522, 523 (Pa. 1939).

18 *Id.* at 524.

19 *Id.* at 525.

20 *Id.*

21 *See* Atlas Sec. Co. v. O'Donnell, 232 N.W. 121 (Iowa 1930).

22 *Id.* at 122.

be deemed to certify, guarantee, or insure the ownership or title to the property described in the instrument acknowledged."[23]

A tenant in Michigan failed to pay rent for two months.[24] The landlord filed an eviction action, which had to be notarized. In a telephone conversation, the notary authorized the landlord's lawyer to sign her name notarizing the pleadings. A trial court entered judgment against the tenant in the eviction case. The tenant then filed a separate action against the notary and her surety. The Michigan appellate court recognized that it "is settled in this State (and indeed generally throughout the jurisdictions) that breach of the office of notary does not give rise to an action unless such breach was the proximate cause of the injuries sustained."[25] It held that the notary and surety were not liable because the signatures were genuine and, if another had been present, she would have acknowledged them. The court stated: "[i]n our opinion an improper notarization should not be regarded as the proximate cause of injury where the one who purported to sign the document did in fact sign, and was prepared to properly swear before a notary. . . ."[26]

4. Calculate the statute of limitations.

The statute of limitations is another defense worth considering because it can completely bar an otherwise valid action against a notary and his surety.[27] The general rule is that a cause of action against a notary accrues at the time of the notarization. There is an exception to that general rule, though, that the statute of limitations may be tolled if the notary themself hides the misconduct from the claimant.[28] However, there is an exception to that exception. If the state has a special statute of limitations for actions against notary publics and that special statute of limitations does not contain tolling language, then the cause of action accrues at the time of the notarization. It will <u>not</u> be tolled even by the notary's own efforts to hide the misconduct.[29]

5. Analyze whether the underlying instrument is valid.

A defective notary does not necessarily invalidate a document. It is a defense for

---

23 *Id.* at 123.

24 *See* Hope v. Victor, 162 N.W.2d 918 (Mich. App. 1968).

25 *Id.* at 920 (internal citations omitted).

26 *Id.*

27 *See* Norton v. Title Guar. & Sur. Co., 168 P. 16, 17 (Cal. 1917).

28 *See, e.g.*, State ex rel. O'Malley v. Musick, 130 S.W. 398, 402-03 (Mo. Ct. App. 1910), *revd on other grounds* State ex rel. O'Malley v. Nixon, 138 S.W. 342 (Mo. 1911); State ex rel. Hardt v. Dunn, 129 S.W.2d 17, 19-20 (Mo. Ct. App. 1939); *Okla.* Farm Mortg. Co. v. Jordan, 168 P. 1029, 1029-30 (Okla. 1917).

29 *See, e.g.*, Kohout v. Adler, 327 S.W.2d 492, 495-96 (Mo. Ct. App. 1959); Gulf Coast Inv. Corp. v. Law. Sur. Corp., 416 S.W.2d 779 (Tex. 1967).

the notary, and the notary's surety, if the underlying instrument is still enforceable despite the notary's error or misconduct. The measure of damages for a notary falsely acknowledging a forged instrument is based on the rights that would have accrued to the injured party if the underlying instrument had been valid. Courts have held that the clear implication from this rule is that there can be no recovery against the notary, or the notary's surety, for the notary's official misconduct in executing a false acknowledgment where the underlying instrument is valid.[30] In other words, it is a defense against a notary bond claim if the surety can prove that the underlying instrument was still legally enforceable.

6. Determine if the principal was acting as a notary when she caused the damages.

It is important for sureties to remember that principals rarely act solely as a notary public. Being a notary is often ancillary to the principal's profession as a real-estate broker, business agent, attorney, banker, etc. A notary bond is often limited to damages proximately caused by the principal acting as a notary. The surety has a defense to liability under the bond if the claimant was injured because she relied on the principal's advice in some other capacity, even if the principal also notarized a document involved in the dispute.

At the same time, though, be wary of *Bank of America National Trust & Savings Association v. Dowdy*.[31] A notary signed his own name on a bank document falsely declaring himself as the owner of his employer's business. He used his notary seal on the document but forged a false name as the "notary's" signature. Defendant then used those documents to receive credit from the bank. The California court held that the notary's surety was liable under the bond because the acts of the notary making a false certificate of acknowledgment and misusing his official seal constituted "official misconduct," even though the defendant was acting in his own business interest and not as the notary for someone else.[32]

Conclusion

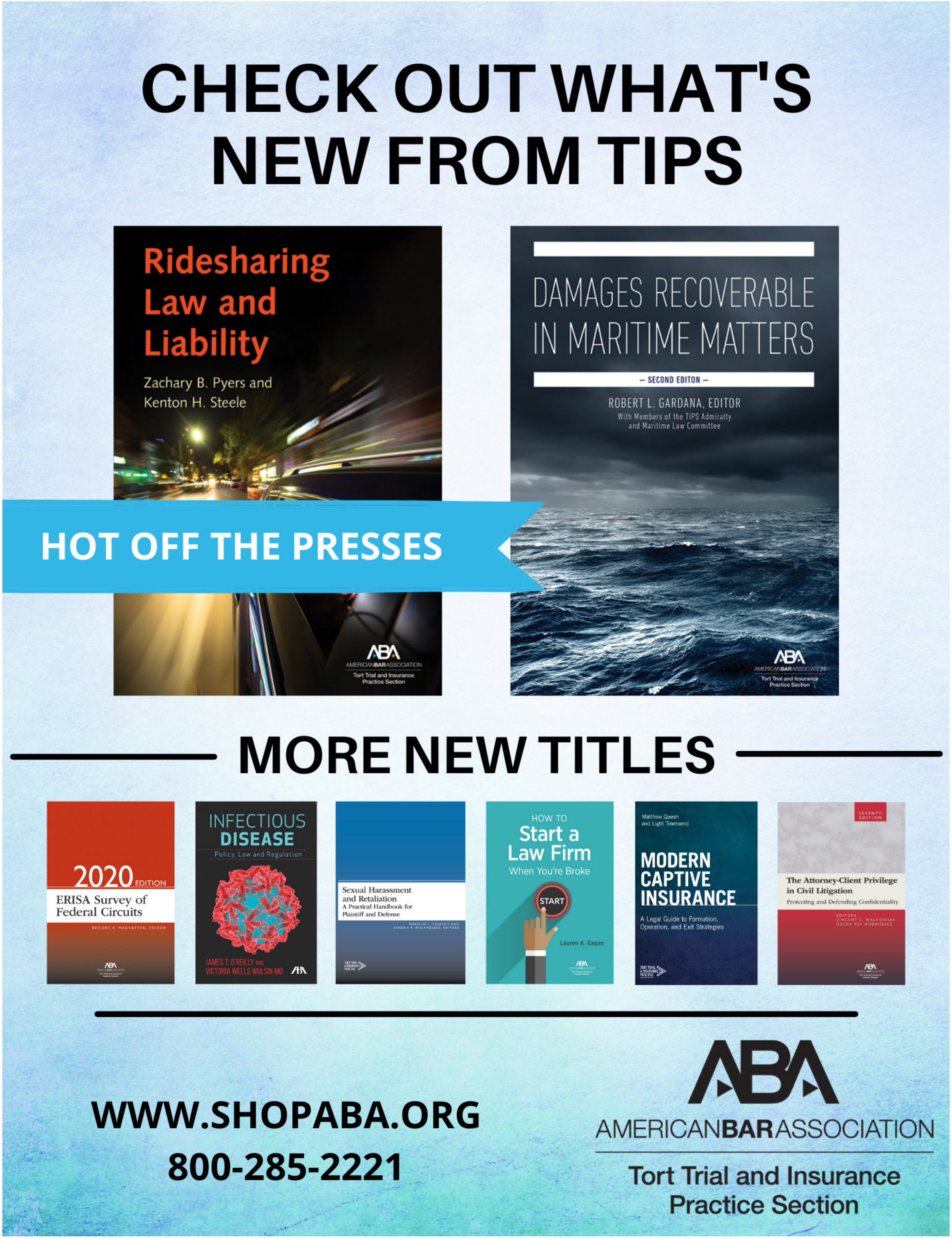
Just because a notary bond claim might have a small dollar value does not mean that it is not worth investigating and defending. "Nuisance value" might make economic sense in one case, but it becomes expensive when considering all the meritless notary bond claims that may follow. This article mapped out some of the key limits and defenses to notary bond claims. With it, a claims professional or defense attorney can more efficiently identify the key issues in their cases.

---

30 Kirsch v. Barnes, 153 F. Supp. 260, 263 (N.D. Cal. 1957).

31 9 Cal. Rptr. 779 (1960).

32 *Id.* at 781-82.


CHECK OUT WHAT'S NEW FROM TIPS
Ridesharing Law and Liability
Zachary B. Pyers and Kenton H. Steele
DAMAGES RECOVERABLE IN MARITIME MATTERS
– SECOND EDITON –
ROBERT L. GARDANA, EDITOR
With Members of the TIPS Admiralty and Maritime Law Committee
HOT OFF THE PRESSES
MORE NEW TITLES
2020 EDITION
ERISA Survey of Federal Circuits
INFECTIOUS DISEASE
Policy, Law and Regulation
JAMES T. O'REILLY AND VICTORIA WELLS WULSIN MD
Sexual Harassment and Retaliation
A Practical Handbook for Plaintiff and Defense
HOW TO Start a Law Firm When You're Broke
START
Lauren A. Eagan
Matthew Queen and Light Townsend
MODERN CAPTIVE INSURANCE
A Legal Guide to Formation, Operation, and Exit Strategies
SEVENTH EDITION
The Attorney-Client Privilege in Civil Litigation
Protecting and Defending Confidentiality
WWW.SHOPABA.ORG
800-285-2221
ABA
AMERICANBARASSOCIATION
Tort Trial and Insurance Practice Section

Calendar

September 18-22, 2021	**20th National Trial Academy** Contact: Danielle Daly – 312/988-5708	National Judicial College Reno, NV
October 13-16, 2021	**TIPS Annual Fall Meeting** Contact: Danielle Daly – 312/988-5708	Four Seasons Resort Dallas, TX
October 28-29, 2021	**Aviation Litigation Conference** Contact: Danielle Daly – 312/988-5708	Ritz Carlton Hotel Washington, DC
November 11-12, 2021	**FSLC & FLA Joint Fall Meeting** Contact: Danielle Daly – 312/988-5708	Westin Times Square New York, NY
January 19-21, 2022	**Fidelity & Surety Law Midwinter Conference** Contact: Danielle Daly – 312/988-5708	Grand Hyatt Nashville, TN
February 9-14, 2022	**ABA Midyear** Contact: Danielle Daly – 312/988-5708	Seattle, Washington
February 24-26, 2022	**Insurance Coverage Litigation Midyear Conference** Contact: Danielle Daly – 312/988-5708	Biltmore Scottsdale, AZ
March 3-5, 2022	**Workers Compensation Conference** Contact: Danielle Daly – 312/988-5708	The Westin New Orleans, LA
March 3-4, 2022	**Cybersecurity Conference** Contact: Theresa Beckom – 312/988-5672	TBD
April 6-8, 2022	**Motor Vehicle Products Liability Conference** Contact: Danielle Daly – 312/988-5708	Omni Montilucia Scottsdale, AZ
April 7-9, 2022	**Toxic Torts & Environmental Law Conference** Contact: Theresa Beckom – 312/988-5672	Omni Montilucia Scottsdale, AZ
April 27-30, 2022	**TIPS Annual Section Conference** Contact: Danielle Daly – 312/988-5708	Hyatt Regency Baltimore, MD
May 5-7, 2022	**Fidelity & Surety Law Spring Meeting** Contact: Danielle Daly – 312/988-5708	Marriott Hilton Head Hilton Head, SC