BATTLING SURETY BOND FRAUD: WHY BOND VERIFICATION IS SO IMPORTANT

By: Martha L. Perkins

The below article is part one of a two part column appearing in the FSLC Fall and Winter editions.

I. Introduction

Certain events in recent years have reinforced the importance of verifying the authority of a company or an individual to issue surety bonds and verifying that the bond was authorized by the surety. During the recession and aftermath of the slow recovery, surety bond fraud and scams became a distinct feature of the construction landscape. It is an unfortunate, but verifiable, truth that there is a long and ugly history of surety bond fraud in the United States. Bond fraud can cause all kinds of unpleasant mischief on both public and private works projects: it can prevent the lowest bidder from being awarded the contract; it can leave subcontractors and suppliers without a payment remedy in the event of the principal’s default; it can leave an obligee without performance recourse in the event of the principal’s default; and it can undermine the public’s confidence in the efficacy and responsiveness of contract surety bonds. If you have been reading Engineering News-Record the past couple of years, then you are aware of the various fraudulent bond schemes that recently
LETTER FROM THE CHAIR

While the gavel was given to me by David Olson at the FSLC Spring CLE and Leadership Meeting in Louisville, Kentucky, back in May, the official “passing of the torch” occurred at the ABA Annual Meeting in Boston, Massachusetts, in early August. Before we turn the page, we must express not only our thanks and appreciation for Dave’s work and leadership during 2013-2014, but also our congratulations as he accepted, on behalf of the Committee, the TIPS Award for “overall excellence in the intensity and quality of its efforts to involve members in the activities of the Committee and the Section.”

Even with all of the planning and preparation that has been ongoing since Kevin Lybeck called during the winter of 2012, the visceral feelings associated with this tremendous opportunity to serve our Committee and the industries in which we practice, led to several nights of fitful sleep. On more than one occasion, dreams were invaded with questions: Are our five national CLE programs on schedule? Is a schedule of three major FSLC publications in six months too aggressive? Have we considered every possibility and detail, to make certain that the 2014-2015 FSLC year at least meets the standards of excellence for which our Committee is known throughout TIPS?

Fortunately, I rest easier as each day passes, as the answers to the above questions are “Yes,” “Not by a long shot,” and “We will, if we haven’t already done so.” And the reason that each day brings less trepidation and more anticipation and excitement is the support of the fantastic membership of this Committee, coupled with the expertise of the TIPS Staff that allows us to maintain that level of “overall excellence.”

So, for my first column as Chair of the FSLC, I want to focus on three things. First, we will look at what’s on tap for the FSLC in 2014-2015. Second, we will highlight some of the people who allow us to do what do best for the industries we serve. Finally, we will emphasize the multitude of possibilities available to our members to get involved in the scholarship, stewardship, and leadership of the FSLC, not only during 2014-2015, but for years to come.

First, let’s turn briefly to what we have scheduled for the upcoming year. By the time you receive this, the brochure for our first national CLE meeting, the Fall Fidelity CLE Meeting in Philadelphia, PA, will already be in your hands, so I won’t belabor what will be set out in great detail elsewhere. Be sure to join us at the Ritz Carlton on November 5 through 7, 2014, for 1 ½ days of fidelity programming focused on commercial crime insurance protection, and based upon the new Third Edition of Commercial Crime Policy, edited by our Program Co-Chairs, Randy Marmor of Gordon & Rees LLP, and Susan Sullivan of Sedgwick LLP. The FSLC Fall CLE Meeting follows the Annual Meeting of the Fidelity Law Association, also at the Ritz Carlton in Philadelphia.

Next, mark your calendars for Thursday, December 11, 2014, when Paula-Lee Chambers of Hinshaw & Culbertson LLP will moderate an FSLC Webinar Teleconference on the ethical issues facing fidelity and surety attorneys in connection with communications with unrepresented individuals. The one-hour ethics CLE will also discuss privilege issues arising out of joint defense agreements, as well as other topics.

The turn of the calendar leads us to our annual MidWinter CLE and Leadership Meetings, returning to The Waldorf-Astoria Hotel and Towers in New York City, January 21-23, 2015. Make plans to arrive in the Big Apple in time to attend the business meetings many of our committees and subcommittees (discussed in further detail below) on Wednesday, January 21. Meetings start as early as 9:00 a.m.; the schedule will be distributed in December 2014, so that you can make your travel reservations well in advance.

The FSLC MidWinter CLE Meetings begin on Thursday, January 22 and, as usual, the quality and content of FSLC CLE programming will make it difficult to choose where to attend. The MidWinter Fidelity CLE
Program, co-chaired by Jeffrey Price of Manier & Herod and Mike Hennigan of The Cincinnati Insurance Company, begins on Thursday morning and concludes at midday on Friday, January 23. The focus of the fidelity program will be on non-standard forms and manuscripted policies, including presentations and panel discussions on the law and policy governing the use and interpretation of manuscripted policy language. Presenters will include a panel discussion with a current federal magistrate and a retired judge addressing the judicial perspective on contract interpretation and interpretation of insurance policies, as well as a presentation from TIPS National Sponsor DecisionQuest with practical observations and advice on the litigation of coverage disputes to a jury.

Simultaneously on Thursday, James Diwik of Sedgwick LLP, Darrell Leonard of Zurich, and Caryn Maxfield of Walsh Group will co-chair the FSLC’s MidWinter Construction CLE Program, leading an interactive journey through the life of a large construction project. The morning will be filled with panel presentations and discussions on the bid process, and the program will conclude on Thursday afternoon with thoughts on issues arising during construction, including the impact of the newest technologies on project management.

The FSLC MidWinter CLE Meeting will conclude on Friday with the annual MidWinter Surety CLE Program, co-chaired by Bruce Corriveau of Travelers and Edward Etcheverry of Etcheverry Harrison LLP. The focus of the program will be on the analysis of the troubled contractor and the surety’s financing options. This program promises to be on the cutting edge of FSLC presentations, including the use of social media platforms to interact with the audience and advance the underlying fact scenario. To achieve this, the Program Co-Chairs have assembled an extraordinary faculty of distinguished surety professionals and attorneys, accountants and engineers, and seasoned business advisors. The sessions will include a detailed review of the methodologies utilized by accountants and engineers to investigate, implement, and track financing of the principal, a survey of the various financing options available to the surety, recovery strategies to reduce and reimburse the surety’s loss, and many other engaging topics.

The 2014-2015 FSLC program year will conclude in La Jolla, California, May 6-9, 2015, at the Estancia La Jolla Hotel & Spa, for the 2015 FSLC Spring CLE and Leadership Meetings. Program Chairs Carol Smith, Thomas Vollbrecht, and Blake Wilcox are planning a comprehensive program geared toward the next generation of surety claims attorneys, allowing for tremendous interaction between that generation and those of us whose hair may be “silvering”. The curriculum will arise from the next edition of the FSLC’s seminal publication, Bond Default Manual, and the week will conclude with a meeting of FSLC leadership on Saturday morning.

In addition to the highest quality of CLE and CE programming in the fidelity, surety, and construction industries, all of the FSLC’s meetings in 2014-2015 will continue our tradition of exceptional networking opportunities, in historic and beautiful locations. However, none of the FSLC’s programs happen without the priceless professional support that we enjoy from our TIPS staff. Whenever you have an opportunity, at whatever venue at which you encounter them, please be certain to thank and show your appreciation to the following individuals, without whom we would surely wilt: Mary Ann Peter (TIPS Director), Janet Hummons (CLE Director), Debra Dotson (Senior Meetings Manager), Donald Quarles (CLE Coordinator), and Felisha Stewart (Meetings Assistant). They are all vital cogs in everything we do as a Committee, and we would be in the weeds without them.

Most importantly, as we begin a new FSLC year, I want to highlight how all of the above germinate and grow, and how you can be a part of it. There is no question that the historical success of the FSLC is a function of the work of its Divisions and Subdivisions. And that’s where you can get involved. The
following is a summary of several of the FSLC’s Divisions and their respective chairs, who are waiting for your call and/or e-mail, so they can put you to work on behalf of the FSLC:

<table>
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<tr>
<th>Committee/Subcommittee</th>
<th>Chairs</th>
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<tr>
<td>Communications Division (includes contributions to the TIPS Journal, the FSLC Newsletter, The Brief (the TIPS magazine), Technology (including FSLC’s Homepage on the ABA website, the FSLC LinkedIn page, and its growing Twitter presence), CLE Teleconferences, and book marketing)</td>
<td>Brad Carver, Patricia Wager, and Wayne Walton</td>
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<tr>
<td>Law Division (where FSLC programming and publishing germinate to grow to fruition, including fidelity, construction, performance bonds, payment bonds, miscellaneous bonds, bankruptcy, indemnity, extra-contractual issues, ADR, underwriting &amp; risk management, and international)</td>
<td>Cindy Rodgers-Waire, Doug Wills, and John Sebastian</td>
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<td>Membership/Inclusion (including women involvement, young professionals, new members and mentoring, and the FSLC Directory)</td>
<td>Scott Olson, Chris Ward, and Bruce Corriveau</td>
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<td>Community Service</td>
<td>Marcha Durcan, Mike Spinelli, and Ty Thompson</td>
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I look forward to seeing you in Philadelphia, New York City, and La Jolla, and to hearing from you during the course of the year. Be on the lookout for more information about all of our upcoming programs and activities, as well as information on the FSLC’s community service focus for 2014-2015, New Friends New Life (www.newfriendsnewlife.org). Finally, join us at LinkedIn and follow us on Twitter (@ABATIPSFSLC).

Mike F. Pipkin  
Sedgwick LLP  
Chair, ABA TIPS Fidelity and Surety Law Committee

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Much has been written lately about the death of the jury trial and other dire predictions about the end of civil litigation as we all knew it. The reason is very simple: alternative dispute resolution, including arbitration and mediation, have overwhelmed and often replaced the litigation process.

This is especially true in the construction law arena, where cases tend to be so complex and technical that it simply is neither economical nor feasible, nor very smart, to try these cases before a jury. Thus, most of these complex cases are arbitrated in accordance with various rules, usually the American Arbitration Association’s Construction Industry Rules.

The standard construction documents, including the AIA 201 Standard General Conditions, provide not only for arbitration (if the parties check off the correct box), but also require mediation prior to arbitration. Courts will enforce that obligation before allowing any suit or arbitration to proceed.

When I mediate complex construction cases, I am amazed that attorneys would consider trying these cases before an uneducated jury or even a judge with no technical background. That is probably why 75% of the construction cases that go through a form of mediation settle prior to arbitration or trial. Since statistics show that almost 95% of all cases eventually settle, not only will your case probably settle in mediation, but whether you “win” or “lose” the mediation may depend on the rules that are set forth below.

I have done over 400 construction mediations, all over the country, and I think I may have figured out some of the reasons why some attorneys do consistently better than others in the mediation process. Thus, here are my ten ways to “lose” your construction mediation.

Rule 1. Pick the Wrong Mediator.

There is always a dispute among lawyers and mediators as to whether complex construction cases are better mediated by mediators who have more expertise in the mediation process, rather than those with more substantive expertise. I really don’t think there is a definitive answer to this because I have mediated before both, and have had success and failure with both.

In complex construction cases, as opposed to most other kinds of complex legal cases, expertise in construction law is necessary. I find that contractors especially are more likely to respect the opinions of the mediators if they feel they have a background in the construction/insurance issues that are being discussed.

There also is a dispute among construction lawyers as to whether an evaluative or facilitative mediator is more appropriate in these cases. Every case is different, and no mediator works for every case. However, an evaluative mediator – one who would be more likely to inject his/her own opinion at some stage in the proceeding – may be more useful when you are dealing with strong personalities among contractors, owners, sureties, and subcontractors.

Finally, does it matter who picks the mediator? Picking a mediator is not like picking an arbitrator – the mediator can decide nothing in the case, and if the other side wants a certain mediator and he or she is competent, I will normally agree because at some stage in the proceeding, the mediator may need to tell your opponent why they should accept a certain settlement offer, or make a certain offer, and your opponent will be much more likely to accept that from somebody they have picked, rather than somebody that you recommended.

Rule 2. Don’t Prepare Your Case Like You Would Prepare for Trial. Consider the Mediation Just Another Status Conference.

As a mediator I am always surprised that in every mediation, one or more parties will show up with very little knowledge of their case, no real settlement authority, or without having had any detailed discussions with their clients or adjusters, some of whom do not show up to the mediation either. This is a big mistake.

Attorneys ought to prepare for mediations the same way they prepare for litigation. Since most cases settle in mediation, the mediation session is as important as going to court. Also, this may be your first opportunity to try your case before the other attorney’s client, not just before the attorneys. From my own experience, clients

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CONSTRUCTION WITHOUT A LICENSE IS A DISASTER

By: Douglass F. Wynne, Jr.

I. Introduction

Hurricane season is here, and while it is important to be prepared, it is also important to remember some of the other issues that can result from natural disasters. Natural disasters cause widespread destruction of property and infrastructure that must be rebuilt as quickly as possible. After such a disaster, many contractors will rush to a devastated area in an all-out free-for-all. For example, after Hurricane Sandy, unlicensed contractors swarmed the affected areas and preyed on unsuspecting victims. Licensing law violations, however, are not always committed on purpose. In the scramble to obtain construction contracts, many contractors run afoul of state licensing laws and subject themselves to liability because, while licensed in their own states, they fail to obtain the required license in the devastated state. Further, there is a common misconception in these situations that licensing laws are suspended due to the disaster, but this is not always the case. Licensing requirements will remain in place even in an emergency, unless there is a directive suspending or loosening a state’s licensing laws.

Most states have established construction licensing laws for contractors, architects, and/or engineers. While rules vary from state to state, generally, a contractor is required to possess a valid contractor’s license in the state in which it is performing construction work. Performing work without a valid license can result in both civil and criminal penalties, and greatly diminishes a contractor’s ability to recover payment for work performed. Some states have gone so far as to enact laws that increase the penalties for contractors who perform work without a license during a state of emergency.

Many states deploy aggressive licensing boards, with inspectors who visit major construction projects – public or private – and require that the general contractor and owner provide them with a list of all subcontractors on that project. They will then check to see if the listed companies are properly licensed in the state, and whether they are licensed in the categories in which they are working. Once an unlicensed contractor is determined to be working on a project, licensing boards commonly will issue a cease and desist order, essentially shutting down the project. There is no easy way to remedy this situation, and a subsequently-obtained license often is invalid.

II. The License Requirement

While regulations vary from state-to-state, whether a license is required will generally rest on two main factors: (1) the type of work being performed, and (2) the value of the work being performed. Many states provide a broad definition of what constitutes a “contractor.” This definition can encompass general contractors, architects, and, in certain circumstances, even engineers.

Licenses generally are issued under different classifications. Examples of such classifications include building construction, heavy construction, municipal and public works construction, electrical, mechanical, hazardous materials, and plumbing. In addition, many states provide for more specialized sub-classifications for even more specialized areas of work. Failure to hold a license within a required classification or sub-classification is a violation of the contractor’s licensing law. As an additional precaution, many states have established waiting requirements, which restrict a contractor from obtaining a license until it has waited a certain number of days after the application for the license is submitted.

III. The Consequences of Performing Work without a Contractor’s License

Penalties for performing work without a license are generally enforced by a local state licensing board. The licensing board’s power to assess penalties will be governed by the relevant state’s laws, but such penalties generally consist of the issuance of stop work orders, fines, and, in some cases, criminal sanctions.

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PUBLIC-PRIVATE PARTNERSHIPS – MORE PLAYERS IN THE SURETY SANDBOX

By: Courtney T. Walker and Thomas T. Pennington

A public private partnership (“P3”) project comes in several flavors, all of which involve shifting some of the traditional public owner responsibilities to the private sector. The two that most commonly involve surety bonds are: (i) Design – Build – Finance (“DBF”); and (ii) Design – Build – Finance – Operate and Maintain (“DBFOM”).

DBF is a contract between the Sponsor (the ultimate project owner) and the project Proposer for the design, construction, and full or partial financing of a facility. The DBF Proposer may use a combination of debt and equity to fund the project costs in advance of receiving any project-related revenue or owner contribution. The DBFOM method is more complicated, in that the Sponsor transfers the design, build, and finance responsibilities, as well as the operation and maintenance of the project, to a single Proposer (also sometimes referenced as the “Concessionaire”). Generally, the successful Concessionaire will contract separately with a Design Build contractor and an Operation and Maintenance provider; either, both, or neither of which may be affiliates of the Concessionaire. The Concessionaire is primarily responsible for financing the project throughout the construction, maintenance, and operation phases. The ultimate source of payment from the project Sponsor for DBF and DBFOM projects is typically from either: (i) user fees such as tolls (“demand payments”); (ii) availability payments from the Sponsor based on the availability of the project for use (as opposed to actual use); or perhaps (iii) infrastructure financing loans arranged by the Proposer but retired by the Sponsor over a period of time (considerably longer than the period for project completion) to cover the “gap” between whatever public funds are available from a Sponsor for a specific project and the actual cost of timely completion. If it is the latter, then the financing burden for the Proposer is limited to the “gap” between the dedicated resources and the total cost of the project.

Assuming that the design and construction piece is bonded, the challenge for the surety in executing the payment and performance bonds is in identifying the proper obligee(s) and avoiding interference with the surety’s traditional rights and remedies. Remember that, in a P3 project, the ultimate owner (Sponsor) of the finished project is separate from the source of contract progress payments during construction given that it is the Proposer/Concessionaire, not the Owner, who has primary financing responsibility regardless of how project and financing costs are ultimately paid. Also, any periodic payments due by the Sponsor/owner under the Concession Agreement (or infrastructure financing loans) are typically extended over many years, which is cold comfort in the face of immediate completion costs incurred by a performing surety.

Given the above issues, the surety is smart to address its rights to completion payments in conjunction with any rights the lenders may have under related project agreements such as a Lender’s Direct Agreement or even an Intercreditor Agreement between the project finance entities and the surety. Negotiation of these agreements can be complicated, and requirements may vary by project. In these circumstances, three basic elements should be considered: (a) surety consent to the assignment of extended periodic payments to the lender(s) to service the debt in the ordinary course, in accordance with applicable credit documents; (b) confirmation by the lender(s) that the performing surety may draw against construction funds as work is prosecuted, i.e., the funding will continue notwithstanding potential defaults by the original Borrower/Proposer/Concessionaire;1 and (c) confirmation by the lender(s) of the surety’s rights of equitable subrogation to be prosecuted for the joint benefit of the surety and the lender(s) as their respective

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1 The continuation of funding does not necessarily constitute a waiver of default by the Lender as against its Borrower, and may result in the adjustment of the unfunded loan commitment under the credit documents. The surety remains obligated, however, to complete the project on behalf of its principal even though it has not guaranteed the performance of its principal as Borrower. Drafting documents in anticipation of such issues will serve to mitigate – if not eliminate – the out-of-pocket expense the surety otherwise may incur for project completion.
As a result of the housing bust, developers all over the country lost subdivisions to foreclosure, many of which were subsequently purchased by successor developers. Sureties have received, and continue to receive, claims on subdivision bonds made by the government at the behest of the subsequent developer. The successor developer is seeking to obtain subdivision improvements without expending any of its own funds. Frequently, the subdivision bond proceeds represent a substantial windfall to the subsequent developer. Many jurisdictions do not have any case law addressing the propriety (or impropriety) of a subdivision bond claim under such circumstances. There are a few decisions, however, that are unfavorable to the surety, which developers are quick to cite to courts confronting the issue for the first time. A very recent Arizona decision may be helpful to sureties both in supporting their position and in communicating with public obligees regarding their right not to invoke subdivision bonds solely for the economic benefit of private parties.

In *Ponderosa Fire Dist. v. Coconino County*, Empire Residential Construction subdivided and developed a three-unit residential subdivision in Coconino County, Arizona. Empire completed single-family residences in Units 1 and 2, and then the County Board of Supervisors approved the preliminary plat for Unit 3, contingent upon Empire obtaining a performance bond to ensure completion of certain subdivision improvements. Empire obtained four subdivision bonds totaling $4,396,241.32. Empire then completed an emergency evacuation route improvement for the subdivision before filing for bankruptcy and abandoning Unit 3 before any other improvements could be started. At the time Empire abandoned Unit 3, the subdivision did not have any functional internal roads or utilities, no construction of homes had begun, and no lots had been sold to consumers.

Bellemont 276 purchased Unit 3 at a trustee’s sale, with the intent of constructing residences on the subdivided lots and selling them to the public. Bellemont asked the County Board to call the bonds. The Board found that the improvements to Unit 3 were “essentially unconstructed,” that “there [were] no current residents suffering from lack of infrastructure,” that the infrastructure covered by the bonds was “not needed to serve a substantial public interest,” and that calling the bonds “would primarily benefit only the single current owner rather than substantially benefitting the general public or the neighborhood.” As a result, the Board rejected Bellemont’s request.

Bellemont filed suit to compel the Board to call the bonds. Joining Bellemont’s suit were the homeowner’s associations of Units 1 and 2, who argued that they were being denied the right to live in the “completed subdivision” represented in the public records when they purchased the property. The trial court ruled in favor of the plaintiffs and ordered the County Board to adopt a resolution calling the bonds.

The Arizona Court of Appeals reversed. The court noted that the primary purpose of the Arizona statute requiring that developers post subdivision bonds “is to protect the public from bearing the costs of necessary subdivision improvements by requiring the developer to install and pay for such improvements.” The statute itself was silent on whether (if ever) a county is required to call a bond to complete improvements. As a result, the court ruled that it was within the County’s discretion to determine whether to call the bond. Because the County’s decision not to call the bond and instead to require Bellemont to pay for the improvements was
consistent with the statute’s purpose and language, the court reversed the trial court’s ruling.

The holding and analysis in *Ponderosa Fire* may be useful to a surety in responding to a claim from a developer who wants to compel the government to call a subdivision bond. Additionally, it has potential application to cases where the government is attempting to call the bond so that the funds can be turned over to a subsequent developer to develop the subdivision improvements free of cost. In such circumstances, a surety can cite to the *Ponderosa Fire* court’s decision and reasoning emphasizing that the purpose of a subdivision bond is to protect the public and ensure that the party who profits from the sale of lots pays for the cost of related public improvements. This case illustrates just how bold parties buying projects out of foreclosure have become in viewing the subdivision bond as their personal “entitlement,” a concept that Coconino County, and the Arizona Court of Appeals, rejected.

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BATTLING SURETY BOND…  
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have been perpetuated on contractors, subcontractors, suppliers, obligees, and the public.1

The surety bond product already, at times, has a public relations issue, as there is so much misinformation and misunderstanding about what a surety bond is – and what it isn’t. The contract surety industry performs unique and valuable services for owners, taxpayers, and subcontractors and suppliers through its prequalification services, guarantees of contract completion, and payment of certain subcontractors and suppliers; but there is no shortage of articles in public space that misconstrue, either through ignorance or willfulness, the nature of bid, performance, and payment bonds.

Although most contract surety bonds written are legitimate bonds, history suggests that a prudent obligee, contractor, and subcontractor should take affirmative steps to assure that the bond proffered is not fraudulent and will, in fact, provide the promised protection. Such due diligence is necessary to avoid becoming a victim of bond fraud and to protect the good name and the positive public perception of the surety product.

This article addresses the law in the United States concerning the authority of corporate sureties and individual sureties to issue bonds and, in doing so, examines selected case law involving fraudulent sureties and bonds.2 In addition, this article focuses on selected advocacy efforts and educational initiatives to combat surety bond fraud, with the aim of guiding contractors, subcontractors, suppliers, and obligees on how to avoid becoming a victim of bond fraud. All construction industry stakeholders can and should combat surety fraud by taking certain delineated steps to verify the legitimacy of the surety and to ensure that the surety authorized the bond.

II. Corporate Sureties and Fraud Perpetrated in Their Names

In the United States, almost all surety bonds are written by companies regularly engaged in the business of acting as a surety. Surety companies typically are authorized and qualified to do business by the state insurance commissioner where they are domiciled and in the jurisdiction where the bond is issued. The state departments of insurance regulate surety companies, which must meet minimum capital requirements, file periodic financial reports in those jurisdictions where they are authorized to do business, and are subject to market conduct investigations, among other regulatory requirements and actions.

Obligees, principals, and payment bond beneficiaries should always check with the state insurance commissioner to determine if the surety company is admitted to write surety bonds in the relevant jurisdiction, paying particular care to ensure that the name of the surety company is an exact match for the name of the admitted surety company. Most states maintain lists of admitted insurance companies on the website of the state insurance commissioner or will respond to phone inquiries regarding the status of licensed surety insurers.

Surety companies that wish to write Miller Act bonds on federal construction projects must have a certificate of authority from the United States Department of the Treasury. The Treasury Department conducts a financial review of the company and sets a single bond “underwriting limitation” for the surety. The list of certified surety companies approved to write bonds on federal projects – known as Department Circular 570, the “Treasury List”, or the “T-List” – is posted on the Bureau of the Fiscal Service website.4 The website includes a listing of the phone numbers of state insurance departments, which can provide further

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2 The author wishes to gratefully acknowledge use of material from the fine article by Edward G. Gallagher and Mark H. McCallum, The Importance of Surety Bond Verification, 39:2 PUB. CONT. L.J. 269 (Winter 2010).
information about surety companies admitted in that jurisdiction.

Of course, the fact that a surety company is genuine and solvent is not enough if the bond was not authorized by that company. There have been a number of cases in which an unscrupulous party has been convicted of fraud in furnishing bonds that seemed to be, but were not, authorized by legitimate sureties. There are instances in which the supposed surety on a worthless bond had the same name as, or similar to, a well-known, reputable surety company.

For instance, in a 2014 case, Federal Insurance Co. v. Campbell, a federal district court adopted the Report and Recommendation of the magistrate judge and entered a default judgment and a permanent injunction against defendants Eric Campbell, Individual Surety Group, LLC, Steve Stokeling, and First Fidelity Asurety Company, LLC. The plaintiffs were insurance company subsidiaries of The Chubb Corporation. The complaint alleged that the defendants sold at least a dozen fraudulent surety bonds bearing the name of Chubb subsidiaries to various construction companies and collected millions of dollars in “premium”. The Findings of Fact adopted by the district court, in relevant part, as follows:

Defendants created fraudulent surety bonds bearing plaintiffs’ names –insurance companies affiliated through their “common corporate parent,” the Chubb Corporation. . . . Defendants also falsely held themselves out as authorized agents or representatives of these entities and offered these forged bonds as surety for various projects throughout the United States . . . . Some of these construction projects were funded by federal, state, and local governmental entities. . . . The defendants perpetrated such a scheme in an effort to defraud construction companies throughout the United States and obtain a profit. Defendants do not have the authority to execute or issue surety bonds or policies on behalf of the plaintiffs or any other affiliate or subsidiary of The Chubb Corporation.

The court permanently enjoined the defendants, among other things, from “[s]elling falsified surety bonds bearing the names of Plaintiffs, or otherwise indicating that there is any commercial relationship between them and Plaintiffs . . . .”

In another 2014 case, Allen Engineering Contractor, Inc. v. United States, the Court of Federal Claims upheld the Navy’s default termination of a general contractor that had submitted fraudulent Miller Act performance and payment bonds on a project at Camp Pendleton, California. In its complaint, the plaintiff contractor alleged that the government improperly terminated the contract between the parties. The court’s order provides a lucid discussion of the purpose of Miller Act bonds on federal projects, and the case provides an object lesson on why it is critical that contractors verify that their bonds are issued by authorized sureties and that the surety actually authorized the issuance of the bonds.

In Allen Engineering, after the contractor and the Navy executed the construction contract, the general contractor provided performance and payment bonds from Liberty Mutual Insurance Company. Thereafter, the contractor submitted a second set of bonds from the Individual Surety Group, which purportedly were issued by Pacific Indemnity Company (“PIC”). The Individual Surety Company represented itself as a broker for PIC, a subsidiary of The Chubb Group.

The Navy learned from a Chubb representative that the PIC bonds were not in fact issued by PIC and were, therefore, invalid. When the contractor was unable to obtain replacement bonds, the Navy issued a notice of termination for default. The contractor responded by filing suit in the Court of Federal Claims, which firmly rejected the contractor’s claim that the Navy violated its own regulations by accepting fraudulent bonds. The contractor’s arguments, in essence, centered on the general theory that the Navy had violated some affirmative duty to the contractor to ensure that the bonds, submitted by the contractor, were not fraudulent.

The contractor alleged that the Navy violated several Federal Acquisition Regulation (“FAR”) provisions and Navy regulations by not properly ensuring the validity of the bonds. The court made short work of these arguments, finding that these regulations dealing with authentication or approval of bonds were

6 Id. at *1.
7 Id.
8 Id. at *2.
9 Id. at *1.
11 Id. at 459-60.
12 Id. at 460.
13 Id.
14 Id. at 461.
designed for the benefit of government employees, not private contractors. Holding that the contractor had no claim as a matter of law, the court stated the following regarding the cited Navy regulations and the purpose of Miller Act bonds:

The essential function of performance and payment bonds is to protect the government’s interests and the interests of suppliers of labor and materials, respectively. See 40 U.S.C. § 3131(b)(1) (stating that a “performance bond . . . [is] for the protection of the Government”); (b)(2) (stating that a “payment bond . . . [is] for the protection of all persons supplying labor and material in carrying out the work provided for in the contract”). As such, ensuring that bonds are authentic logically serves the same interests. Because this [Navy] regulation is evidently meant as a measure of protection for the Navy and for suppliers engaged by plaintiff, but not to protect the plaintiff itself, plaintiff’s claim for relief . . . fails as a matter of law.15

The important lesson to be learned from Allen Engineering is that it is generally the responsibility of the contractor seeking surety bonds to protect itself from bond fraud. As the case illustrates, the fact that a specific surety company is genuine and solvent is not sufficient if the bond was not authorized, as in this case, by that company. It always is good practice for a contractor to contact the surety company directly and ask for confirmation that the bond was authorized. The result otherwise could be a default termination for failure to maintain valid bonds throughout the contract term.

III. Individual Sureties and Fraudulent Schemes Perpetrated

State insurance laws require natural persons, not just companies, who wish to act as a surety on contract bid, performance, and payment bonds to obtain a license or certificate of authority from the state insurance department.16 The two exceptions to this are found in Alaska and Maryland, and the Maryland exception sunsets on September 30, 2014. The Alaska Little Miller Act provides that public works performance and payment bonds must be from “a corporate surety qualified to do business in the state, or at least two individual sureties who shall each justify in a sum equal to the amount of the bond . . . .”17

In 2014, the Maryland General Assembly wisely determined that it would allow the statute permitting individual sureties to write bonds on public works contracts without a certificate of authority from the insurance department to sunset. In 2006, the General Assembly had enacted a bill to permit individual sureties to write surety bonds under certain circumstances for prime contractors on public construction projects without obtaining a certificate of authority as an authorized insurer from the Maryland Insurance Administration (“MIA”).18 The law was due to terminate on September 30, 2009; and that sunset provision was extended to September 30, 2014. In Chapters 299/300, Acts of 2012, the Maryland General Assembly, among other things, required the MIA to study and report on the practices of individual and corporate sureties.

On November 25, 2013, the MIA released its Final Report on the Analysis of the Practices of Corporate Sureties and Individual Sureties in Maryland (the “MIA Final Report”).19 The substance of the MIA Final Report, along with significant lobbying efforts by the National Association of Surety Bond Producers (“NASBP”)20 and others, helped to defeat Maryland 2014 SB 851, which would have extended the 2006 law until 2019, continuing to permit an unregulated individual surety market in Maryland. Among other conclusions, the MIA Final Report included the following conclusions concerning individual sureties:

[T]he sanctioned individual sureties have engaged in fraudulent or misleading conduct, such as: (1) creating the illusion of a corporate

15 Id. at 463.
16 Most states define “insurer” to include an individual, define “insurance” to include surety bonds, and require any insurer writing insurance in the state to have a license or certificate of authority from the state insurance department. See, e.g., Tex. Ins. Code Ann. § 524.02-.03, .401, .606(1)(a) (West 2009); Tex. Prop Code Ann. § 101.002,.051(b)(2), .102 (Vernon 2009); Va. Code Ann. § 38.2-100 -.121, -1024(A) (West 2009).
20 The NASBP is a national trade association located in Washington, DC, representing agencies employing licensed surety bond producers placing bid, performance, and payment bonds throughout the United States. The author is in-house general counsel at the NASBP, and is not a lobbyist.
form, which could mislead the public into believing that the same safeguards in place for corporate sureties exist as to the individual surety (e.g., regulatory financial oversight, rate approval, and, in some cases, the backing of the state’s guaranty fund); (2) inflating the valuation of property pledged; (3) pledging the same collateral for multiple projects so that the total amount of the surety bonds outstanding far exceeded the value of the collateral; or (4) misrepresenting other information as part of the surety bond submission.21

* * *

In recent years, at least 13 . . . states have issued Cease and Desist Orders against individuals acting as sureties without first obtaining a certificate of authority or license. The MIA has identified no basis for continuing to permit unregulated individuals to solicit or issue surety bonds or contracts of surety insurance. The MIA recommends that the laws authorizing the use of individual sureties in the State be permitted to sunset as scheduled on September 30, 2014.22

* * *

In order to better safeguard the public against the issuance of fraudulent surety bonds or contracts of surety insurance, all sureties doing business in the state should be required to obtain a certificate of authority issued by the Commissioner and should be subject to the same level of regulatory oversight required for corporate sureties under Maryland law.23

The MIA Final Report recommended that the individual surety law in Maryland should be allowed to expire so that all sureties doing business in Maryland would be subject to the same level of scrutiny and regulation that exists under Maryland law. And so the law sunsets on September 30, 2014, leaving Alaska as the sole state permitting unregulated individual sureties to write contract bonds for state projects.

The federal government does accept bonds from individual sureties – if they place cash or cash equivalents equal to the amount of the bonds in escrow with a federally insured financial institution, or provide the government with a deed of trust on real property with sufficient equity to secure the bonds. Acceptance of Miller Act performance and payment bonds with individual sureties is governed by Part 28 of the FAR.24 Under the current FAR, an individual surety can be accepted only if she or he provides a security interest in acceptable assets.25 FAR 28.203-1(b) requires that the value of the pledged assets must be equal to or greater than the aggregate penal sums of the bonds. If the asset is real property, a recorded lien in favor of the government and proof of the value of the property must be furnished with the bond.26 If the asset is anything other than real estate, it must be held in an “escrow account with a federally insured financial institution in the name of the contracting agency.”27

Unlike the evaluation of corporate sureties by the Treasury Department, there is no central entity to evaluate individual surety bonds. That evaluation falls to the contracting officer (“CO”) responsible for a particular procurement, which places a significant burden on the COs, many of whom do not have sufficient knowledge regarding surety bonds and the proper assets to back the bonds. Individual sureties are required to complete and execute an Affidavit of Individual Surety, known as Standard Form (“SF”) 28. The sworn affidavit must include a description of the assets pledged and identify other bonds for which the assets have been pledged and any encumbrances on the assets. While the information on SF 28 is intended to assist the CO in determining the acceptability of the individual surety and its assets, COs can be fooled by submissions that are not backed by real assets meeting the FAR requirements.

21 Id. at 2.
23 Id. at 26.
25 Id. §28.203-1.
27 Id. § 28.203-1(b)(1).
28 Id. § 53.228(e).
Encon International, Inc. v. Garrahan illustrates the scenario of an individual surety pledging illusory real estate as collateral for Miller Act bonds. When the Environmental Protection Agency ("EPA") awarded Encon International a nearly $5 million contract to remediate certain lots of contaminated soil in Kansas, Encon, inexperienced with bonding, contacted Karen Barbour of The Barbour Group ("TBG"), and relied on her to help obtain the required Miller Act bonds. Through TBG’s contacts, it was determined that Linda Garrahan would serve as the individual surety on the bonds. Garrahan executed an Affidavit of Individual Surety that identified her as the individual surety and TBG as the bond broker. The Affidavit stated that it was “made to induce the United States of America to accept [Linda Garrahan] as surety on the attached bond,” pledging certain identified property in Nevada as a lien in favor of the EPA. The red flag for the EPA CO should have been that Garrahan stated in a letter to the EPA that there were “unavoidable delays” in the lien filing process and that the proof of title to the United States would be forthcoming later. The dispute arose when the defendants demanded various funds be placed in a reserve account pursuant to the indemnity agreement signed by the parties. Readers will not be surprised to know that Garrahan did not own the Nevada property pledged as collateral to secure the bonds.

Martha L. Perkins is general counsel of the National Association of Surety Bond Producers. Part two of this article will appear in the FSLC Winter 2015 newsletter edition.

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30 Id. at 7-8.
31 Id. at 9.
32 Id. at 9-10.
33 Id. at 11-12.
34 Id. at 12.
HOW TO LOSE YOUR...

Continued from page 8

often make settlement decisions that day based on how they assess the opposing lawyer.

As a mediator, I always ask for position papers prior to the mediation. Some mediators do not. All I can say is that they must be a lot smarter than I am because I can’t imagine going into a complex construction mediation without having background information and contracts from the parties. It has been my experience that parties often overlook fairly basic contract issues when they get tied up in the complexities of construction defect cases, without necessarily considering the contractual limitations. For instance, I have been involved in mediations where parties have presented rather detailed delay and disruption claims, only to find out that there is limiting language in the contracts that essentially provide no damages for delay. The mediator can focus in on those areas and give the parties incentives to settle that they might not have considered before.

Rule 3. Don’t Get Settlement Authority in Advance.

Parties and attorneys often come to mediations without adequate settlement authority. I see this most often with regard to insurance company attorneys who are representing the insured, where the insured may not be present at the mediation, and the insurance adjuster is often in a distant city and cannot attend the mediation. As the mediation progresses, these attorneys get on the phone to their adjusters, who may have a minimal knowledge of the case. It is a very frustrating process for a mediator, and may also be frustrating for the insured, who was relying on his insurance company to protect his interests.

When I am mediating a case as a litigant, I always try to get a range of authority, especially from an insurance client. If I think the case would settle for $50,000, I try to get a range from $25,000 – $75,000, so I don’t have to keep coming back to the insurer for more authority. There is one thing insurance adjusters hate (other than attending mediations), and that is getting multiple calls from their attorneys requesting additional settlement authority!

Rule 4. Don’t Bring a Decision Maker to the Mediation.

This problem often manifests itself with regard to insurance company adjusters. Very often, the insured himself does not show up, and all you have is the attorney representing the insured on behalf of the insurer, with the insurer’s adjuster often in a distant city. This puts the attorney, and the insured, at a great disadvantage because the adjuster does not have the opportunity of participating in the process and getting a better understanding of the various aspects of the case. It is easy to say “no” from a thousand miles away, especially if you have not viewed all of the evidence and heard the attorneys put forth their theories of the case.

One of the most critical decisions an attorney can make for his or her client is who they should bring to the mediation. That decision very often can determine whether the mediation is successful. I always like to see the CEO of a contractor or subcontractor present, but in any event, the person who is the decision maker and who does not need to get on the phone to seek additional authority to settle the case is the one who should be there.

A number of contractors and subcontractors bring project managers and field people to the mediation, especially those with technical information. My advice to you is to limit the number of these individuals, especially those who may have a position to defend in the mediation. I have found that very often we spend an inordinate amount of time arguing with the project manager and the field people, defending decisions they made on the job, rather than trying to work towards settlement. I think the most effective mediations have involved cases where the CEO who shows up to represent the contractor or subcontractor was not involved in the actual technicalities of the dispute itself. They usually have a much more objective viewpoint and are much more willing to try to work towards a commercial resolution.

Rule 5. File a Lengthy Brief Rather Than a Position Paper, and Don’t Give the Mediator a Clue as to How You Think the Case Should Settle.

I ask for position papers before every mediation, and prefer that they be thorough and include the contracts that are at issue in the case. What I often get, however, is not a position paper, but a brief. This really doesn’t help me much as a mediator. The best position papers I have gotten are concise, to the point, and give me some idea of how the case can be settled. Therefore, while I need to know your theory and understand the facts, it is just as important for the parties to provide some creative ways to resolve the case.

Several years ago I mediated a case in Georgia involving eighteen parties on a complex construction...
project. Prior to the mediation, the major players in the mediation laid out their road maps for settlement of the case. This was extremely helpful to me in understanding the various dynamics among the parties. More importantly, they gave me some ideas of the personalities involved, the attitude of some of the insurers, and some general range as to where the matter could be resolved. The case would never have been successfully resolved without those discussions and ideas that I got from these lawyers prior to the mediation.

**Rule 6. Give a Long Opening With Slides and Videos and Really Lay into the Other Side.**

I am not against opening presentations with slides and videos. Often in a complex case, it is very helpful for the mediator to get a general idea of the nature of the project and the theories of the other parties. I do a number of mediations where the parties ask me in advance not to have any opening statements because of the antagonism among the parties, and I will usually honor that request. I have seen situations where long opening statements, or videos, can actually polarize the room, and make it more difficult to get the case back on track for resolution. My advice would be simply to make it short; keep it objective, not personal; and get to the settlement caucuses as soon as possible. This is especially true if the case has lingered for a number of years, and all of the parties are very familiar with the facts and circumstances of the case.

**Rule 7. Once You Get Authority, Dig In, Hang Tough, and Don’t Let Yourself Be Persuaded by the Mediator or the Other Lawyers.**

I have seen attorneys come to the mediation, tell me what their authority is, and hang in all day without moving much from the initial authority. This often occurs where an attorney is at a mediation without his or her insurer/adjuster, who is off somewhere in another office in another city, and who has not had an opportunity to be persuaded by the mediator or by the other attorneys. One of the reasons that the parties hire a knowledgeable construction mediator is that the mediator can take a second look at the case, and give the parties the first objective look from somebody who has no dog in the fight. If the adjuster does not have that opportunity, they may well hang tough in New York or Atlanta, and put the attorney at a great disadvantage because he cannot make use of the knowledge or impressions he gets at the mediation.

**Rule 8. Don’t Take Attorneys’ Fees and Costs into Account When Assessing Your Potential Liability and Settlement Posture.**

I don’t want to pick on insurers too much, since I represent a number of them. However, I hear more and more at these mediations from insurance representatives that attorneys don’t take their fees and costs into account when deciding what to offer in settlement. This is another variation, I think, on the “trick the mediator” philosophy, where they won’t let the mediator convince them to factor in costs, expenses and attorneys’ fees in evaluating the settlement range for a case. Otherwise, they push us to put up more money. I like to ask these folks if their attorneys work for free, but their position is that if they give in on this issue, it will just encourage attorneys to file frivolous suits against them and “extort” from them settlements for “defense costs”.

Where an insurer is looking at substantial attorneys’ fees in the future to try a lengthy jury trial or arbitration, and the insurer has some exposure, and can get out of a case for less than the potential future attorneys’ fees and costs, it simply does not make good business sense to do otherwise.

**Rule 9. Keep The Mediator In The Dark As Long As Possible. In Fact, Let’s Play The Game Called “Trick The Mediator”.**

I do not expect, nor do I think it is a good idea, for parties to inform the mediator early on what their ultimate authority is. Personally, I do not even want to know that number in the early stages of the mediation. However, since the mediation process is confidential, I really do expect the parties to level with me at some point, and at least let me know the potential downside to their case. The mediator is not there to trick anybody. As I noted before, the great thing about having a mediator who has experience in the construction field is that, for maybe the first time, the parties will get an independent, objective view of the evidence and the possible exposure of the various parties. As a litigant, I find it extremely helpful to listen to an experienced construction lawyer/mediator give me their evaluation of the case, and it is especially helpful for my client to hear.

**Rule 10. If You Get Insulted by an Offer, Be Prepared to Walk Out Early.**

Before we break into private caucuses, one of the things I tell all the parties is that they should not be insulted by offers they hear early on in the process. I
explain to them that there is a dynamic to mediations, which none of us fully understand, but they have set aside a day or two, and they owe it to themselves and their client to let the process work out.

In spite of this admonition, I am constantly told that an early offer (or non-offer) is an “insult”, and I even have some folks pull the “pack the bags” routine. I guess I have been insulted by early offers as a litigant, but it is important to understand that some parties, for whatever reason, feel the necessity to throw out an unreasonable offer just to get the process started. If you think the claim against this insurance company and its subcontractor client is worth $200,000, and you get a $5,000 offer, the initial reaction would be that this case will never settle and let’s go home. Most experienced construction mediators will tell you that this first offer really makes no difference, and often cases with this kind of wide variation in offers and counteroffers can eventually settle. It is important that the attorneys representing the contractors and their insurers explain this to their clients before the mediation.

These are the Rules that I have come up with, and I probably could come up with another ten if I worked at it. The important thing to remember is that the mediator is there to help you resolve the case; they are not there to trick you into settlement. You are paying for the resource; use it to the best extent possible. Lengthy litigation is especially expensive in complex construction cases. The parties that know the most about the construction project at issue are the parties that are sitting at the mediation, and they are usually the parties that can best come up with resolutions that are creative and fair to all parties.  

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CONSTRUCTION WITHOUT... Continued from page 9

In addition, performing work without a valid license can make it extremely difficult for a contractor to recover payment under the contract for the work it actually performed. For example, in many states, the contract of an unlicensed contractor is an absolute nullity and is unenforceable.5 As noted by one court, because contractor’s licensing laws are “enacted to protect an interest vital to the public order, whatever contracting agreement entered into...having been done in contravention of a prohibitory law, is void.”6

Having a construction contract declared null can have dire consequences. First, and most obviously, the contractor could lose the right to be paid. Secondly, it may lose contractual protections it had under the contract.7 Where its contract is void, the contractor no longer would be able to avail itself of forum selection clauses or dispute resolution agreements, losing any control it would have had over the forum or venue of the dispute. Further, the contractor could lose other protections in the contract, such as a waiver of consequential damages. Worse still, the contractor could lose its right to file a lien on the project, along with any other statutory protections that could have been available. In some cases, courts even have held that an unlicensed contractor loses the right to file suit altogether.8 Finally, without a valid contract, accessory obligations, such as bonds, may fail. Obviously, this would be of serious concern to the project owner.9

The loss of the contract does not always mean that the contractor will lose its right to recover any payment completely. In some instances, contractors who perform work without a license have been allowed to recover payment under the theory of unjust enrichment.10 However, some courts have found that an unlicensed contractor is not entitled to any compensation whatsoever.11 For example, in Dennis Talbot Construction Co. v. Private General Contractors, Inc.,12 the court held that an unlicensed subcontractor was not entitled to recover from a general contractor under the theory of unjust enrichment. The court denied recovery despite the general contractor’s knowledge that the subcontractor did not possess the required license when work began, because the subcontractor was aware of the law requiring a contractor’s license to perform jobs in excess of $50,000. Thus, this prohibition can be effective even if the person who hired the contractor knew that the contractor did not possess the required license.13

Some states have enacted statutes that prevent unlicensed contractors from recovering for work performed. For example, in Florida, contracts entered into by an unlicensed contractor are “unenforceable in law or in equity by the unlicensed contractor.”14 In California, all actions that seek compensation for illegal unlicensed work are barred.15 However, amounts already paid to an unlicensed contractor may not be recoverable. For example, in Sutton v. Ohrbach,16 an owner sought to recoup the amounts he had already paid


6 Hagberg, 435 So.2d at 584-85 (citations omitted).

7 See John Hancock-Gannon Joint Venture II v. McNulty, 800 So. 2d 294, 296 (Fla. Dist. Ct. App. 2001) (finding that a roofing contractor could not rely on contractual defenses to recover payment under the contract for the work it actually performed. For example, in Florida, contracts entered into by an unlicensed contractor are “unenforceable in law or in equity by the unlicensed contractor.”14 In California, all actions that seek compensation for illegal unlicensed work are barred.15 However, amounts already paid to an unlicensed contractor may not be recoverable. For example, in Sutton v. Ohrbach,16 an owner sought to recoup the amounts he had already paid
to his architect because the architect was not licensed. The Court concluded, however, that while the architect may not be able to enforce its contract or obtain quantum meruit, the owners could not use the licensing statutes as a “sword” to recoup the amounts already paid for unlicensed services.17

IV. Construction After a Disaster

As noted, contractors commonly run afoul of licensing laws after natural disasters. This issue was prevalent in Louisiana after Hurricane Katrina. There, the Louisiana State Licensing Board for Contractors is the state administrative body that ensures compliance with the license requirements for contractors.18

Following previous hurricanes, Louisiana governors issued executive orders declaring the suspension of licensing laws pertaining to debris removal.19 However, in the aftermath of Hurricane Katrina, the Governor issued no such order.20 Nevertheless, the Louisiana Licensing Board decided to “delay active and aggressive enforcement of licensure laws pertaining to debris removal and demolition for a period of 90 days, more particularly from September 1, 2005, through December 1, 2005.”21 The Board “did not take any aggressive action concerning enforcement of licensure laws during the 90 day suspension period. . . .”22 The suspension of enforcement was not absolute and, thus, the licensing laws at issue remained valid statutory requirements, the enforcement of which was only temporarily relaxed.23 Accordingly, the Licensing Board’s decision to loosen its enforcement of licensing requirements in the aftermath of the hurricanes did not suspend the requirement that contractors be licensed in the State.24

The consequence of providing emergency services without a license where the licensing requirements are not suspended is exemplified in Touro Infirmary v. Travelers Property & Casualty Company of America.25 In Touro Infirmary, the Eastern District of Louisiana held that a contract to repair a hospital following damage from Hurricane Katrina was completely void because the contractor was not properly licensed in Louisiana. Similarly, in Tradewinds Environmental Restoration, Inc. v. St. Tammany Park, LLC,26 an unlicensed contractor, Tradewinds, was hired to provide emergency mold remediation and restoration at an apartment complex following Hurricanes Katrina and Rita.27 Tradewinds completed the work contemplated by the contract, but the owner of the apartment complex, STP, refused to pay the remainder of the bill.28 Tradewinds filed a breach of contract action against STP to recover the balance due. The lower court held that the contract with STP was absolutely null and Tradewinds could recover only the costs of the materials, services, and labor provided.

On appeal, the Fifth Circuit upheld the lower court’s ruling, noting that “Louisiana courts have long recognized that statutory licensing requirements were enacted to protect an interest vital to the public order, and have relied on these Civil Code articles to invalidate contracting agreements entered into with unlicensed contractors.”29 Accordingly, the court held that the district court correctly concluded that Louisiana’s rule of absolute nullity for a contracting agreement entered into without the benefit of a contractor’s license would limit Tradewinds’ recovery to “the actual cost of materials, services and labor.”30

Issues also have arisen in California, where unlicensed contractors often attempt to perform work after wildfires. The issues became such a problem that a district attorney formed a “Wild Fire Task Force” to speak with residents in fire-ravaged areas about fraud prevention. The task force also provided warnings regarding unlicensed contractors that were operating

17 Id. at 144 (citing Charlebois v. Weller Assoc., 531 N.E.2d 1288 (N.Y. 1988)); Unger v. Travel Arrangements, Inc., 266 N.Y.S.2d 715 (App. Div. 1966); but see Matrise, 183 Cal. App. 4th 656 (holding that a homeowner could recover all amounts paid to a landscape contractor for a project started while the contractor was unlicensed, including amounts paid for work after the landscaping contractor obtained a license, where the statutory substantial compliance rules were not met); and Saul v. Rowan Heating & Air Conditioning, Inc., 623 A.2d 619 (D.C. 1993) (holding that a consumer may recover sums already paid to an unlicensed contractor).
20 Id.
21 Id. at *3.
22 Id.
23 Tradewinds Envtl. Restoration, Inc. v. St. Tammany Park, LLC, 578 F.3d 255, 261 (5th Cir. 2009).
24 Id.
26 578 F.3d 255 (5th Cir. 2009).
27 Id. at 257.
28 Id. at 258.
29 Id. at 259 (citations omitted).
30 Id. at 260 (citations omitted).
in the area, and warned unlicensed contractors that operating in a declared state of emergency is a felony in California.31 Similar efforts were made during the 2003 and 2007 wildfires.32

Based on the foregoing, a contractor wishing to perform work in another state, even in the wake of a natural disaster, should proceed with extreme caution and thoroughly research that state’s licensing rules to ensure that it complies with the licensure requirements. Not only will this help avoid imposition of penalties or criminal sanctions, it also will preserve a contractor’s ability to recover payment for work performed and the profit and overhead incorporated in its contract.

V. Solutions to Licensing Dilemmas

Presented above are many of the pitfalls associated with state contractor’s license laws that are prevalent after natural disasters. However, knowing all of the problems that can arise may do little good when it is discovered that the party contracted with is unlicensed. Once this is discovered, that subcontractor’s work on the project must be stopped immediately or the general contractor will subject itself to claims of knowingly allowing an unlicensed contractor to perform work on a project. If the unlicensed contractor’s scope is on the critical path of the project, the decision to stop work can be devastating, bringing the entire project to a screeching halt. Thus, all possible solutions for quickly solving these issues must be explored.

One possible solution is to put the employees of the unlicensed subcontractor on the licensed general contractor’s payroll. This may create other difficulties, but the new employees then would be able to act under the umbrella of a valid license. A caveat here is that the employees must be real employees, supervised by the licensed contractor, with rights and benefits commensurate with the licensed contractor’s other employees, and not independent contractors. This solution may not be available in all states, and if it proves to be impossible or unworkable, the only remaining option may be to terminate the unlicensed subcontractor and find a replacement.

Another possible solution is to eliminate the provision of labor from the unlicensed subcontractor’s subcontract. Thus, the subcontractor would be required only to supply materials, and would not perform unlicensed labor. Installation of the materials would be performed by another licensed subcontractor. This way, the unlicensed subcontractor would not be performing any actual “construction”, and may not be required to possess a contractor’s license. However, in some instances, efforts to divide a construction subcontract into several subcontracts will not be a valid solution because, depending on the circumstances, such efforts may be viewed as an attempt to circumvent the licensing requirements’ contract price threshold.

The best possible solution is for all contractors desiring to perform work following a natural disaster to obtain the required state licensure to perform labor and supply materials before they perform any work. Where the contractor neglects or purposefully fails to comply with licensure statutes, the consequences for both the unlicensed contractor and the other contracting party may be significant. 57

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32 S.D. Jewishworld Article.
interests may appear. Under such an agreement, the surety is never liable, directly or indirectly, for the project financing, and the lender(s) acquires a means of ensuring completion of the construction contract to protect its financial investment/exposure. In this way the surety’s rights of equitable subrogation support, rather than oppose, the interests of the project’s construction lenders.

The identity of the obligees also needs to be considered and addressed in the bond and any dual obligee rider. Typically, the P3 bonded contract is the agreement between the Concessionaire and the Design Build Contractor. Presumably, the bond principal is the Design Build Contractor and the Concessionaire is the primary obligee, with additional obligee status extended to the Sponsor and, likely, the lenders. While the Sponsor may be an appropriate co-obligee, the surety must be careful to avoid inadvertently bonding the entire Concession Agreement (which, among other things, encompasses project finance issues). Further, if there is an institutional relationship between the Design Build Contractor and the Concessionaire entity, a surety may require a “non-claimant”-type agreement. The authors note that underwriting requirements vary between companies, and having an indemnitor as an obligee may be addressed differently among surety companies. Last, the lender(s) likely will claim dual obligee status. The agreements discussed above in conjunction with a savings clause in the dual obligee rider generally will provide reassurance to the surety that contract funds will continue to flow to the surety for completion costs in the event of a default.

The increased use of the P3 project delivery method reallocates certain project risks to the parties best able to control and mitigate adverse results. In the P3 demand payment model, the Sponsor may retain the risk that user fees may not turn out as expected, and may find that its control over rate-setting is limited either by applicable regulation or economic imperatives. In the availability payments model, the Concessionaire is allocated both the responsibility for design and construction as well as the burden of financing to completion, but is amply incentivized by the prospect of revenue generation in the form of payments based upon the readiness of the project for use to deliver a defect-free project on a timely basis. A potential downside now apparent is that the size of the projects together with the financing requirements may limit the number of Concessionaires and/or design-build contractors capable of sustaining multiple projects simultaneously. Given the political environment and the effect of market forces at work, however, P3 projects may be a new vision of an old future; thereby necessitating that the surety industry acknowledge new parties to the bonded construction process.

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## 2014 - 2015 TIPS CALENDAR

### October 2014

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<td>5-7</td>
<td>FSLC &amp; FLA Fall Meeting</td>
<td>Ritz Carlton Hotel</td>
<td>Donald Quarles – 312/988-5708</td>
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### December 2014

<table>
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<tr>
<th>Date</th>
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<tbody>
<tr>
<td>8</td>
<td>Member’s Monday</td>
<td>Free Teleconference</td>
<td>Ninah F. Moore – 312/988-5498</td>
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### January 2015

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<th>Date</th>
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<tbody>
<tr>
<td>15-17</td>
<td>LHPR Midwinter Symposium</td>
<td>Loews Ventana Canyon</td>
<td>Ninah F. Moore – 312/988-5498</td>
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<td>Tucson, AZ</td>
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<td>21-23</td>
<td>Fidelity &amp; Surety Committee Midwinter Mtg</td>
<td>Waldorf Astoria Hotel</td>
<td>Felisha A. Stewart – 312/988-5672</td>
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### February 2015

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<tbody>
<tr>
<td>5-8</td>
<td>ABA Midyear Meeting</td>
<td>Hilton of the Americas</td>
<td>Felisha A. Stewart – 312/988-5672</td>
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<td>19-21</td>
<td>Insurance Coverage Litigation Midyear Mtg</td>
<td>Arizona Biltmore</td>
<td>Ninah F. Moore – 312/988-5498</td>
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### March 2015

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<tr>
<td>11-13</td>
<td>Transportation Megaconference</td>
<td>Sheraton Hotel</td>
<td>Donald Quarles – 312/988-5708</td>
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