

RECENT DEVELOPMENTS IN FIDELITY AND  
SURETY LAW

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The following is a survey of selected fidelity and surety law decisions reported during the past year, together with a summary of selected legislation in the fidelity and surety area enacted during the past year. This survey is intended to highlight some of the more significant developments in fidelity and surety law and is by no means intended to be exhaustive.

#### I. FIDELITY LAW

##### A. *Employee Dishonesty*

In *Shoemaker v. Lumbermens Mutual Casualty Co.*,<sup>1</sup> the administratrix of a decedent's estate sued to obtain benefits under an employee dishonesty policy. The policy had been issued to the employer of the former executor of the estate who had been convicted of misappropriating estate funds. The district court concluded that the executor did not act with the necessary

1. 176 F. Supp. 2d 449 (W.D. Pa. 2001).

manifest intent to cause a loss to his employer and entered summary judgment in favor of the insurer.

The executor had used funds in the estate's account primarily to cover his employer's fees. Although the conduct was illegal, the court found no evidence that the executor intended to cause a loss to his employer. Applying a specific intent standard, the court concluded that the plaintiff did not show that the executor knew or expected that his theft of funds from the estate would inevitably result in a loss to his employer.

In *Scirex Corp. v. Fed. Ins. Co.*,<sup>2</sup> the plaintiff incurred losses in connection with the failure of four clinical trials testing the efficacy of experimental drugs for the relief of pain after oral surgery. It claimed that nurses had knowingly violated testing protocols, entitling it to recovery under a succession of crime insurance policies covering employee dishonesty. Following a bench trial, the court held that the nurses' conduct was not fraudulent or dishonest.

The court found that the nurses honestly believed that they were substantially complying with the testing requirements. In holding that the policy did not provide coverage, the court noted that the meaning of the terms "fraudulent" and "dishonest" depends upon the intent of the actor and contemplates "intentional conduct perceived by the actor as wrongful."<sup>3</sup> The court held that none of the nurses acted with such dishonest intent.

The court rejected the insurer's alternative argument that the plaintiff did not sustain a direct loss to covered property. The court concluded that the clinical studies constituted property within the meaning of the policy and that the damage to the studies was a direct loss. The measure of damages, the court determined, should be the replacement cost of the studies.<sup>4</sup>

In *Holloway Sportswear, Inc. v. Transportation Ins. Co.*,<sup>5</sup> the plaintiff claimed that its former employee sold a competitor confidential clothing designs, pricing information, and other trade secrets. Plaintiff sought recovery under a commercial insurance policy that included coverage for loss caused by employee dishonesty. The district court entered summary judgment in favor of the insurer.

As defined in the policy, "covered property" included money, securities, and "property other than money or securities." The term "property other than money or securities" was defined as "tangible property." Applying Ohio law, the court held that trade secrets and confidential information

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2. No. CIV.A. 00-1129, 2001 WL 1491133 (E.D. Pa. Nov. 15, 2001).

3. *Id.* at \*3.

4. *Id.* at \*4.

5. 177 F. Supp. 2d 764 (S.D. Ohio 2001).

constitute intangible property and, therefore, did not fall within the defined term "covered property."<sup>6</sup>

In *First Nat'l Bank of Fulda v. BancInsure, Inc.*,<sup>7</sup> a loan officer embezzled funds using customer lines of credit. One of the customers and his creditor sued the bank, claiming that the employee had promised that the bank would continue financing. The bank sought coverage under its financial institution bond for its settlement payment to the creditor and its ongoing litigation expenses. The district court denied the bank's motion for summary judgment.

The court held that the bank did not establish the employee acted with manifest intent to cause the loss relating to the third-party lawsuit. The court rejected the "purely objective" manifest intent standard urged by the bank. Rather, the court ruled, an intent to cause a loss must be obvious from the employee's conduct, such as when the loss is a natural consequence of the action. The court held that the employee's subjective state of mind is relevant to that determination, but concluded there was no evidence the lawsuit was a "direct" result of the employee's fraudulent embezzlement scheme.<sup>8</sup>

In *Pacific Enterprises v. Fed. Ins. Co.*,<sup>9</sup> an officer of the plaintiff's subsidiary submitted false invoices and altered documents to obtain letters of credit on the plaintiff's credit line, resulting in a \$39 million loss. Plaintiff sought recovery under a crime policy that included coverage for direct losses caused by theft or forgery by an employee of the insured. The district court granted the insurer summary judgment because the plaintiff failed to meet its burden of establishing a loss caused by the theft of the letter of credit proceeds. The Ninth Circuit reversed, finding that the plaintiff had raised genuine issues of material fact concerning the existence and scope of its loss and was not required to establish the exact amount of its loss to preclude summary judgment.

#### B. *Definition of Employee*

In *Mountain Lodge Ass'n. v. Crum & Forster Indem. Co.*,<sup>10</sup> the plaintiff proposed to act as general contractor, rather than rely on a commercial general contractor, for the renovation of its condominium complex. The condominium board hired Tyler as its construction manager. During his tenure as construction manager, Tyler misappropriated funds by overbilling for work and materials. The plaintiff sought recovery of the loss under a gen-

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6. *Id.* at 772.

7. No. Civ. 00-2002, 2001 WL 1663872 (D. Minn. Dec. 21, 2001).

8. *Id.* at \*2.

9. No. 99-56309, 2001 WL 1029238 (9th Cir. Sept. 7, 2001).

10. 558 S.E.2d 336 (W. Va. 2001).

eral liability policy that included employee theft coverage. Claiming that Tyler was not the plaintiff's employee, the insurer denied the claim and brought a declaratory judgment action.

The appellate court ruled that the trial court erred in granting the insurer summary judgment. The court stated that the controlling factor in determining whether a person is an employee or an independent contractor is whether the hiring party retains the right to control and direct the work. The court held that there was a genuine issue of material fact as to whether the plaintiff retained the right to exercise control over Tyler and supervise his work.

In *Mansion Hills Condo. Ass'n v. Am. Family Mut. Ins. Co.*,<sup>11</sup> the plaintiff sought coverage under an employee dishonesty endorsement of a business insurance policy for loss resulting from embezzlements by an on-site manager. The court of appeals reversed the entry of judgment for the insurer. Under the policy, an "employee" included any person "employed by an employment contractor" while the person is performing services under the insured's direction and control. The plaintiff retained KEM, the contractor that developed the property, to manage the facility and staff the office, and KEM hired and paid the officer manager. The office manager worked under the plaintiff's supervision. The insurer argued that KEM was not an "employment contractor" within the meaning of the policy because the undefined term "employment contractor" referred only to a temporary employment agency. The appellate court concluded that the term "employment contractor" does not have "any readily discernible ordinary meaning."<sup>12</sup> It held the term ambiguous and adopted the construction most favorable to the insured.

### C. Forgery

In *First Ins. Funding Corp. v. Fed. Ins. Co.*,<sup>13</sup> Federal provided financial institution bond coverage to an insurance premium finance company, which was in the business of financing the purchase of insurance policies. The insured engaged Colesons, a financing agent, to find prospective borrowers and to submit their financing applications to the insured for approval. Colesons embezzled \$4.3 million by inducing the insured to approve insurance premium financing for fictitious entities.

The bond covered losses resulting from fraudulent or dishonest conduct perpetrated against the insured but excluded coverage for losses caused by "any agent, broker, factor, commission merchant, independent contractor, intermediary, finder, or other representative of the same general character

11. 62 S.W.3d 633 (Mo. Ct. App. 2001).

12. *Id.* at 636.

13. 284 F.3d 799 (7th Cir. 2002).

of the Assured.” The insured maintained that the exclusion did not apply because Colesons was not actually acting as a finder or intermediary in the context of fraudulent transactions. The district court dismissed the insured’s claim, and the Seventh Circuit affirmed.

The Seventh Circuit held that the policy unambiguously excluded coverage for losses caused by an intermediary, finder, or other similar representative of the insured. The court found that Colesons’s activities—bringing businesses together to consummate a transaction—was precisely the type of conduct contemplated by that exclusion. The court rejected the insured’s contention that Colesons was not acting as a finder or intermediary in the context of fraudulent transactions because it was acting only to benefit itself, concluding that the insured, not Federal, bore the risk of having selected a faithless finder or intermediary.

In *Universal Bank v. Northland Ins. Co.*,<sup>14</sup> the Ninth Circuit affirmed the district court’s dismissal of a bank’s claim under a fiduciary bond. The bond included coverage for forged or defective signatures on real property mortgages. The court held that the forgery claim failed because the signatures upon which the claim was based did not purport to be those of a bank customer, as required for coverage. The court determined that the claim was also deficient because the purchase orders and escrow instructions bearing the signatures were not “instructions” or “advices,” as defined in the bond, and because the documents were not directed to the insured.<sup>15</sup> With respect to the claim for defective signatures in real property mortgages, the court concluded that the purchase agreements and escrow instructions at issue were not mortgages, deeds of trust, or similar instruments pertaining to realty, as required by the bond, because the documents did not represent a debtor-creditor relationship between a buyer and a third party or act as security.

#### D. Exclusions

In *Cincinnati Ins. Co. v. Tuscaloosa County Parking and Transit Auth.*,<sup>16</sup> members of the insured’s board of directors embezzled funds by issuing payroll checks in excess of their salaries. The trial court entered summary judgment for the insured, finding that the embezzled funds did not constitute salaries within the meaning of the exclusion in the insured’s fidelity policy. The Alabama Supreme Court affirmed. As a condition of coverage, the insured was required to prove that it incurred a loss due to employee dishonesty committed by the employee with the manifest intent to cause a loss to the insured and to obtain a benefit, other than salaries and other benefits earned in the normal course of employment. The court concluded

14. No. 99–56495, 2001 WL 435072 (9th Cir. Apr. 27, 2001).

15. *Id.* at \*1.

16. 827 So. 2d 765 (Ala. 2002).

that the monies taken in the form of payroll checks did not constitute salary because the amounts received exceeded the fixed compensation to which the individuals were entitled. The court also held that the funds were not “earned” in the normal course of employment because they had been stolen.<sup>17</sup>

In *Ernie Von Scheldorn, Ltd. v. United Fire & Cas. Co.*,<sup>18</sup> an automobile dealer, the insured under a commercial crime policy, sought coverage for loss caused by an employee who stole automobile parts by manipulating the insured’s electronic records. The trial court granted the insurer summary judgment based upon the inventory computation exclusion in the policy. The Wisconsin appellate court affirmed.

The proof of loss compared physical versus electronic inventory over several years and stated that “losses calculated above are further supported by inventory shortages.” The insured denied that it relied upon an inventory loss calculation to prove the fact or amount of the loss, and an employee’s affidavit stated that he “manually checked” invoices and confirmed the dishonest employee’s activity in a telephone interview.<sup>19</sup> The court noted that inventory computations that prove the amount of an insured’s loss are not excludable where independent evidence first shows the dishonest acts. The court held that the inventory exclusion applied because the only other information provided by the insured was an affidavit containing inadmissible hearsay.

In *Finkel v. St. Paul Fire and Marine Ins. Co.*,<sup>20</sup> the trustee for a bankrupt payroll administration company sued St. Paul to recover on behalf of the company’s former customers who had filed proofs of loss with the bankruptcy estate for their tax liabilities. The Employee Dishonesty Protection Rider of the policy limited coverage to loss resulting “directly” from employee dishonesty. The policy also excluded “loss that is an indirect result of any act or event covered by this agreement, including, but not limited to loss resulting from . . . payment of damages of any type for which you are legally liable.”<sup>21</sup>

The district court granted St. Paul’s motion for summary judgment. The court held that the policy unambiguously limited coverage to the insured’s direct loss from employee dishonesty and did not insure against the insured’s legal liability to third parties who were harmed by an employee’s dishonesty. The court stated that a separate policy provision covering property for which the insured is “legally liable” did not obviate the exclusion or afford third-party liability coverage.<sup>22</sup>

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17. *Id.* at \*3.

18. 635 N.W.2d 27 (Wis. Ct. App. 2001) (unpublished disposition).

19. *Id.*

20. No. 00 CV 1194 (AVN), 2002 WL 1359672 (D. Conn. June 6, 2002).

21. *Id.* at \*2.

22. *Id.*

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#### E. *Timeliness of Notice and Proof of Loss*

In *Acadia Ins. Co. v. Keiser Indus., Inc.*,<sup>23</sup> the insured sought employee dishonesty coverage under a commercial insurance policy for unauthorized credit card charges by the company president. The insurer denied coverage and filed a complaint for declaratory judgment. The Maine Supreme Court affirmed the entry of judgment in favor of the insurer. In March 1998, auditors apprised the insured of personal charges totaling \$40,000. The president promised to repay the charges within two weeks but failed to do so. A May 1999 audit revealed that the earlier charges had actually totaled \$71,000 and had thereafter increased to more than \$225,000. The insured submitted a proof of loss to the insurer in June 1999.

The policy required the insured, following discovery of loss, to notify the insurer "as soon as possible" and to submit a proof of loss within 120 days. The court held that the insured had discovered the loss in March 1998 and, therefore, the proof of loss was filed outside the time specified in the policy. The court concluded that the evidence supported the trial court's finding that the delay had prejudiced the insurer's ability to recoup the loss before the president's assets had been dissipated.<sup>24</sup>

#### F. *Termination of Coverage*

In the same case, *Acadia Ins. Co. v. Keiser Indus., Inc.*, the policy provided that coverage as to any employee was cancelled immediately upon discovery by any officer or director of the insured of any dishonest act committed by that employee. The court held that the insured had discovered the loss and coverage had terminated at the latest when the company president failed to keep his promise to repay the loss within two weeks after he was confronted by the board chairman in March 1998. The court rejected the insured's argument that the term "dishonest," as used in the cancellation clause, was ambiguous.<sup>25</sup>

In *Am. Cas. Co. of Reading, Pa. v. Etowah Bank*,<sup>26</sup> CNA issued a financial institution bond to Etowah for a two-year term commencing in December 1996. CNA denied coverage for an employee dishonesty loss discovered in October 1998 on the ground that coverage had terminated when Regions took over Etowah thirty days earlier. The Eleventh Circuit reversed the trial court's award of summary judgment to the insured and remanded with instructions to enter judgment for CNA.

Regions had purchased 100 percent of Etowah's outstanding stock in September 1998. Etowah became a wholly owned subsidiary of Regions but continued to operate as before, under the same bylaws and manage-

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23. 793 A.2d 495 (Me. 2002).

24. *Id.* at 498.

25. *Id.*

26. 288 F.3d 1282 (11th Cir. 2002).

ment, except that a new president was named. Regions argued that its acquisition was not a “taking over” because the transaction did not affect Etowah’s core functions.

Under its terms, the bond terminated immediately upon the taking over of the insured by another institution. The court held that the term “taking over,” as used in that provision, was not ambiguous and occurred when more than 50 percent of the insured’s stock was acquired, regardless of whether the purchaser exercised any control over the insured’s core functions. The court noted that the “core functions” test is only used to determine if bond coverage for a failing institution terminated upon the taking over of the insured’s core functions by regulators, where stock ownership did not change.<sup>27</sup>

#### G. *Third-Party Rights*

In *O/E Sys., Inc. v. Inacom Corp.*,<sup>28</sup> plaintiff leased computer equipment to Inacom. When Inacom filed for bankruptcy and closed its business, the equipment was lost. Plaintiff presumed that the equipment was taken by former Inacom employees and asserted a claim for the loss under Inacom’s crime policy. Dismissing the complaint, the district court held that plaintiff could not make a claim directly against the policy because it was not a named insured and the policy prohibited any third-party benefit.<sup>29</sup>

#### H. *Recoveries*

In *District No. 1–Pacific Coast Dist. v. Travelers Cas. and Sur. Co.*,<sup>30</sup> a fidelity insurer sued its insured to enforce a settlement agreement that apportioned recoveries. The insured refused to share recoveries that it obtained from its former officers. The District of Columbia Court of Appeals affirmed the entry of summary judgment for the insurer.

The insured, a labor union, claimed that its officers had rigged union elections and, following a merger with another union, had received fraudulent severance payments. The insurer agreed to pay the severance fraud loss but denied coverage for an aspect of the claim relating to wages received by the union officers. The settlement agreement stated that the insurer was entitled to receive certain of the recoveries obtained from the officers and their conspirators, “subject to the excess loss provision,” which the court concluded referred to the Recoveries section of the policy.<sup>31</sup>

Relying on the common law made-whole doctrine, the union argued it was entitled to keep all recoveries until it was fully reimbursed for its salary

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27. *Id.* at 1287.

28. 179 F. Supp. 2d 363 (D. Del. 2002).

29. *Id.* at 367.

30. 782 A.2d 269 (D.C. 2001).

31. *Id.* at 272.

loss. The court held that the made-whole doctrine had been modified by contract and, therefore, did not apply. Construing the agreement, the court held that the union did not incur a covered loss in excess of the coverage limits. It concluded that the insurer was entitled to receive 75 percent of the recoveries from two employees and 100 percent of the recoveries obtained from coconspirators, provided that the recoveries could be traced to the severance fraud.<sup>32</sup>

In *Fed. Ins. Co. v. Smith*,<sup>33</sup> the insurer paid a claim under an employee theft policy and then sought recovery of the loss from the wife of the responsible employee. After trial, the court held that the insurer had standing to sue the wife to recover for conversion and unjust enrichment. The employee, since deceased, had deposited embezzled funds into a joint checking account on which he and his wife were signatories. The stolen funds had been used to pay the couple's joint debts and the defendant's personal expenses. The court held that, regardless of whether the defendant had physically handled or deposited fraudulent checks, she converted the funds by accepting and exercising wrongful dominion over the stolen proceeds.

In *Kanawha Valley Radiologists, Inc. v. One Valley Bank*,<sup>34</sup> CNA intervened in a lawsuit filed by its insured to assert a subrogation claim against the defendant bank. The trial court ruled that the common law made-whole doctrine prevented CNA from exercising subrogation rights, and the appellate court affirmed. The insured's employee embezzled \$2.3 million over a ten-year period. About \$263,000 of the loss was sustained during the term of CNA's Business Package Policy, which provided \$50,000 of employee dishonesty coverage commencing in 1998. After CNA paid its policy limit, the insured initiated lawsuits to recover its loss from those responsible.

The court held that, under the made-whole doctrine, in the absence of statutory or contractual obligations to the contrary, an insured must be fully reimbursed for its loss before subrogation rights arise. In this case, the court noted, a subrogation clause in the policy stated ambiguously that "amounts paid in excess of the payments under this policy shall first be reimbursed up to the amount paid by those, including you, who made such payments." Interpreting the ambiguous clause in favor of the insured, the court concluded that, consistent with the made-whole doctrine, the clause allocated all recoveries first to the insured to the extent of its losses.

*Berner Foods, Inc. v. Fid. and Guar. Pallemyer Ins. Co.*<sup>35</sup> involved several

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32. *Id.*

33. 144 F. Supp. 2d 507 (E.D.Va. 2001).

34. 557 S.E.2d 277 (W. Va. App. 2001).

35. No. 00 C 5427, 2002 WL 461702 (N.D. Ill. Mar. 26, 2002).

insurance claims arising from a business dispute between Berner Foods and Dairy Source. The dispute resulted in multiple lawsuits between the companies. Berner maintained that Fidelity breached the general liability section of its business insurance policy by failing to defend Berner or settle the underlying claims by Dairy Source. Berner also sought indemnity under the employee dishonesty coverage section of the policy for loss attributed to the fraudulent acts of its former employee, a principal of Dairy Source.

Section 19 of the policy transferred Berner's recovery rights to Fidelity and required the insured to do nothing after loss to impair those rights. Fidelity moved for summary judgment, asserting that Berner's settlement with Dairy Source, without notice to Fidelity, had released the employee from liability and thereby prejudiced Fidelity's subrogation rights.

The court ruled that it is the insurer's burden to show that a settlement substantially prejudiced its interests. Denying summary judgment, the court held that factual uncertainties regarding the settlement negotiations prevented Fidelity from showing how the release of the employee substantially prejudiced Fidelity's interests. The court noted that Berner had paid Dairy Source more than \$1.3 million, but it was unclear if Berner received any setoff relating to the employee's conduct or if Berner could prove that it was damaged by employee dishonesty.

## II. SURETY LAW

### A. Statutory Bonds

#### 1. Generally

In *Am. Home Assurance Co. v. Plaza Materials Corp.*,<sup>36</sup> the Florida District Court of Appeal ruled that a payment bond that did not specifically reference the time and notice limitations, as required by the state's Little Miller Act, did not entitle the surety to the protection of those limitations, effectively converting a statutory bond into a common law bond for purposes of time and notice provisions. Specifically, section 255.05(6) of Florida's Little Miller Act requires that "[a]ll bonds executed pursuant to this section shall make reference to this section by number and shall contain reference to the notice and time limitation provisions of this section." Section 255.05(4), however, states that "[t]he payment provisions of all bonds furnished for public work contracts described in subsection (1) shall, regardless of form, be construed and deemed statutory bond provisions, subject to all requirements of subsection (2) [dealing with time and notice

36. 826 So. 2d 358 (Fla. Dist. Ct. App. 2002).

limitations].” The court seemed to focus on the words “*payment provisions*” in converting this statutory bond into a common law bond.<sup>37</sup>

In *Fed. Ins. Co. v. I. Kruger, Inc.*,<sup>38</sup> the court held that, when a payment bond shows on its face that it was executed in compliance with a state’s Little Miller Act, “a court is authorized to read into the bond the provisions of the statute and to give the bond the form and effect the statute contemplated, regardless of the contents of the bond.”<sup>39</sup> Also, the court held that a “pay-when-paid” clause between the contractor and subcontractor only sets the time of payment and is not a condition precedent to payment. A surety cannot avoid liability by claiming that a “pay-when-paid” clause in the contract is a condition precedent because (1) the subcontract is a different contract from the bond, and (2) to do so “would defeat the very purpose of a payment bond.”

In *United States ex rel. Walton Tech., Inc. v. Weststar Eng’g, Inc.*,<sup>40</sup> the court held that a subcontractor’s agreement to accept payment from the contractor “when and if paid” by the owner is not sufficient to constitute a “clear and explicit” waiver of its Miller Act rights.

## 2. Standing

In *Cleveland Wrecking Co. v. Nova Cas. Co.*,<sup>41</sup> the district court found that a “joint-venturer, sublet, or alter ego” of the principal could be a claimant under a public works surety bond under New York law.

In *United Pacific Ins. Co.*,<sup>42</sup> the Armed Services Board of Contract Appeals ruled that a surety that takes over performance of a project and completes it has no right to bring claims that arose prior to the surety’s takeover (i.e., claims of the original contractor), absent an explicit agreement by all parties.

## 3. Statute of Limitations/Timeliness of Notice

In *Arbor Vitae-Woodruff Joint Sch. Dist. v. Gulf Ins. Co.*,<sup>43</sup> the district court held that the one-year statute of limitations on actions against a surety under Wisconsin’s Little Miller Act that begins to run upon “completion of work under the contract” started when the obligee’s architect inspected the construction and approved the final payment. The appellate court reversed upon concluding that the “completion of work under the contract”

37. *Id.* at 360.

38. 829 So. 2d 732 (Ala. 2002).

39. *Id.* at 736.

40. 290 F.3d 1199 (9th Cir. 2002).

41. No. 00-CV-1003E(SC), 2001 WL 1823604 (W.D.N.Y. Nov. 21, 2001).

42. ASBCA No. 53051, 2001 WL 865380 (July 20, 2001).

43. 639 N.W.2d 788 (Wis. Ct. App. 2001).

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under the statute means “when the contractor has performed all the work it is responsible for under the terms of the contract.”<sup>44</sup>

In *J.D. Fields & Co., Inc. v. Gottfried Corp.*,<sup>45</sup> J.D. Fields leased pilings to a subcontractor and then sought payment under the surety’s Miller Act payment bond. The trial court held that notice was untimely because it was not given to the surety within ninety days of the equipment’s removal from the site. The Fifth Circuit reversed and held that the date for determining the timeliness of notice under the Miller Act was the date when the subcontractor notified the lessor that the equipment was ready for pickup pursuant to the lease agreement (or, in this case, the date that the subcontractor returned the equipment to the lessor) and not the date that the equipment was removed from the project.<sup>46</sup>

#### 4. Arbitration

In *United States ex rel. Humbarger v. The Law Co., Inc.*,<sup>47</sup> the district court ruled that the surety for the contractor would not be bound by the arbitration clause in the subcontract. Regardless, the court stayed the Miller Act action pending the outcome of the arbitration between the subcontractor and the contractor.<sup>48</sup>

#### 5. Penal Sums/Interest

In *United States ex rel. Maris Equip. Co., Inc. v. Morganti, Inc.*,<sup>49</sup> the district court entered judgment against the surety for the full penal sum of the payment bond. The surety acknowledged that the full penal sum was owed but disputed the prejudgment interest owed in excess of the amount of the penal sum. The court found that federal law normally determines whether interest is owed in excess of the penal sum. Because the Miller Act was silent on the issue, federal courts would look to state law. Here, the court turned to New York law, awarded interest in excess of the penal sum, and calculated that interest at the state statutory rate.<sup>50</sup>

#### 6. Damages

In *Murdock & Sons Constr., Inc. v. Gobeen Gen. Constr. Inc.*,<sup>51</sup> the district court held that the surety was not responsible for the subcontractor’s lost profits, consequential damages, loss of bonding capacity, and unjust enrichment claims against the principal under Indiana’s Little Miller Act.

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44. *Id.* at 792.

45. 272 F.3d 692 (5th Cir. 2001).

46. *Id.* at 697.

47. No. 97-09-01553, 2002 WL 436772 (D. Kan. Feb. 20, 2002).

48. *Id.* at \*4.

49. 175 F. Supp. 2d 458 (E.D.N.Y. 2001).

50. *Id.* at 460.

51. No. IP 99-1723-C-T/F, 2002 WL 243576 (S.D. Ind. Jan. 14, 2002).

## 7. Performance Bonds/Payroll Services

In *Gulf Ins. Co. v. GFA Group, Inc.*,<sup>52</sup> the Georgia Court of Appeals held that, under the state's Little Miller Act, an entity providing payroll services to the contractor has no claim under a performance bond. Traditionally, those who provide services to the contractor are covered, and those who are merely lenders to the contractor are not covered. The court noted that the payroll services company shared qualities of both businesses; it provided services by, among other things, taking care of payment arrangements, insurance, and income tax withholding, and also acted as a lender by advancing funds to pay the contractor's employees. The court focused on the more crucial aspect of payroll services, noting that the company did not locate, retain, or provide the labor used on the project. Because the company did not provide labor for the project, it was not entitled to make a claim under the Little Miller Act bond.<sup>53</sup>

In *Jean Simpson Pers. Servs. v. G & G Concrete*,<sup>54</sup> the Louisiana Court of Appeal ruled that a personnel services company could not be a claimant under the state's Public Works Act and entitled to relief from the surety on the public project. The personnel services company provided only advances for wages and bookkeeping, insurance, and withholding services. It provided no actual labor toward the project, and it had no supervisory capacity over the employees on the project. Accordingly, the personnel services company could not bring a claim against the bond "for doing work, performing labor, or furnishing materials or supplies for the construction, alteration, or repair of any public works."<sup>55</sup>

### B. Arbitration/Res Judicata

In *Azevedo & Boyle Contracting, Inc. v. J. Greaney Constr. Corp.*,<sup>56</sup> the court granted summary judgment in favor of a subcontractor seeking payment from the payment bond surety. The court held that the doctrine of collateral estoppel applied to issues between the contractor and the principal that had already been resolved in arbitration. Because the surety stands in the principal's shoes, the subcontractor is entitled to summary judgment against the surety based on the results of the arbitration.

In *Choctaw Generation v. Am. Home Assurance Co.*,<sup>57</sup> the principal and the obligee agreed in their contract to submit any disputes to arbitration. The surety was not a party to that contract but did supply the bond on the

52. 554 S.E.2d 746 (Ga. Ct. App. 2001).

53. *Id.* at 749.

54. 803 So. 2d 992 (La. Ct. App. 2001), *cert. denied*, 814 So. 2d 560 (La. 2002).

55. *Id.* at 995 (quoting the Louisiana Public Works Act, LA. REV. STAT. ANN. § 38:2242(A)(1)).

56. 728 N.Y.S.2d 743 (App. Div. 2001).

57. 271 F.3d 403 (2d Cir. 2001).

project. The surety sought to enforce the arbitration clause against the obligee under the theory that (1) because the bond incorporated the contract by reference, the obligee agreed to be bound by arbitration, or (2) the obligee was estopped from avoiding arbitration with the surety because the surety had a close relationship with the parties bound to arbitration, the dispute concerned that relationship, and the dispute was closely linked to a dispute that is subject to arbitration under the contract. The Second Circuit ruled in favor of the surety on the second theory, finding that the issues to be resolved in arbitration were so intertwined with the contract that the obligee was bound by the arbitration clause. Although the Second Circuit did not reach the first theory, the district court had concluded that the arbitration clause only covered the principal and the obligee even though the contract was integrated into the bond.

*C. Terms of the Bond/Integration of Contract or Subcontract*

In *Bank of Brewton, Inc. v. Int'l Fid. Ins. Co.*,<sup>58</sup> the Alabama Supreme Court affirmed summary judgment for the surety where the obligee failed to comply with the terms of the performance bond. The performance bond required notice, calling a meeting to attempt informal resolution, declaring a default, and agreeing to pay the contract balance. All of these steps were set out in the bond as conditions precedent to the surety's performance.

In *Capital Indem. Corp. v. Price Mun. Corp.*,<sup>59</sup> the court entered judgment, including costs and attorneys' fees, against the obligee and in favor of the surety, as well as an award of the surety's attorneys' fees incurred in defending the suit brought by the subcontractor. The construction contract integrated the surety's interest by requiring consent of the surety before release of the final payment to the contractor. The obligee did not obtain that consent before releasing the final payment. The subcontractor that performed the work for the contractor was never paid and sued the principal and the surety, obtaining a sizeable judgment (the principal later filed for bankruptcy). The surety sued the obligee for breach of contract arising from the obligee's failure to obtain the surety's consent before releasing payments.

In *Nat'l Technical Sys. v. Superior Court of Los Angeles County*,<sup>60</sup> the California Court of Appeal ruled that a surety on a stop notice release bond was liable for attorneys' fees incurred by the subcontractor in pursuing its claim against the principal because attorneys' fees were included in the contract between the subcontractor and the principal. The court also ruled that the surety would be liable for any statutory penalties incurred, rea-

58. 827 So. 2d 747 (Ala. 2002).

59. No. 2:99CV0141, 2002 WL 818064 (D. Utah Apr. 25, 2002).

60. 118 Cal. Rptr. 2d 465 (Ct. App. 2002).

soning that “if the surety makes the contract with the law before him, the law enters into and becomes part of the contract.”<sup>61</sup> The court noted, however, that the total award, including any attorneys’ fees and statutory penalties, cannot exceed the penal sum stated in the bond.

In *Island Ins. Co. v. Hawaiian Foliage & Landscape, Inc.*,<sup>62</sup> the Ninth Circuit, applying Hawaii law, held that the United States and Hawaii were third-party beneficiaries to the subcontractor’s common law payment and performance bond and the surety was required to pay the subcontractor’s unpaid state and federal employment taxes upon the subcontractor’s default. The court reasoned that the surety was liable for the taxes because the subcontractor’s payment of the taxes was one of the terms of the subcontract and discharge of the bond was conditioned upon the subcontractor’s performance of the contract. While the obligee was not liable for the payment of the principal’s taxes, the court focused on the terms of the subcontractor’s agreement.

In *Sch. Bd. of Broward County v. The Great Am. Ins. Co.*,<sup>63</sup> the bond at issue required the surety to “correct” any defaults within a reasonable time. The principal defaulted before performing any work. The obligee made demand on the surety to complete the project. In response, the surety offered to tender a new principal and bond to the obligee. The Florida District Court of Appeal reversed summary judgment in favor of the surety, finding that the surety “did not ‘correct’ [the principal’s] default by tendering only a new deal.”<sup>64</sup> In reaching that conclusion, the court ruled that the bond should not be construed against its drafter—the obligee—but instead noted that “Florida’s policy is to construe any ambiguity in a bond ‘in favor of granting the broadest possible coverage to those intended to be benefitted by protection of the bond.’”<sup>65</sup>

In *Walter Concrete Constr. Co. v. Lederle Labs.*,<sup>66</sup> the court held that, because the surety’s bond did not expressly require notice of default as a condition precedent to any legal action on the bond, it was not necessary that such notice be given with respect to the subcontractor’s default. The court also ruled that, by incorporating the subcontractor’s contract into the performance bond, the surety agreed to be bound by a provision therein to submit any disputes to binding arbitration. In May 2002, the New York Court of Appeals granted the surety’s motion for leave to appeal. It is anticipated that the appeal will be argued toward the end of 2002.

61. *Id.* at 473.

62. 288 F.3d 1161 (9th Cir. 2002).

63. 807 So. 2d 750 (Fla. Dist. Ct. App. 2002).

64. *Id.* at 752.

65. *Id.* (quoting *Nat’l Fire Ins. Co. of Hartford v. L.J. Clark Constr. Co.*, 579 So. 2d 743, 745 (Fla. Dist. Ct. App. 1991)).

66. 734 N.Y.S.2d 80 (App. Div. 2001), *appeal granted*, 98 N.Y.S.2d 603 (May 7, 2002).

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In *JPMorgan Chase Bank v. Liberty Mut. Ins. Co.*,<sup>67</sup> the court denied the obligee's motion for summary judgment seeking \$1.1 billion against several sureties under three advance payment supply bonds securing obligations to deliver gas and oil by subsidiaries of Enron Corporation. The court ruled that language in the bonds that the sureties' obligations were "absolute and unconditional" did not preclude the sureties' defense of fraudulent inducement and fraudulent concealment. The court noted that broad disclaimer language does preclude reliance on extrinsic representations of which the surety knows or has notice, but the disclaimer language does not bar defenses of fraudulent concealment or inducement if the surety did not have notice or knowledge of the unlawful activity. The court also found that the provision under New York Insurance Law obligating a surety to repay a loan even if the surety illegally guarantees the repayment does not apply to a surety that is fraudulently induced into issuing its bond.

#### D. *Bad Faith*

In *Norwood Co. v. RLI Ins. Co.*,<sup>68</sup> the court held that a party may not assert a bad-faith claim against a surety under the Pennsylvania bad-faith statute allowing actions "under an insurance policy."

In *Fed. Ins. Co. v. Maine Yankee Atomic Power Co.*,<sup>69</sup> the court held that the Maine Unfair Claims Settlement Practices Act does not apply to an obligee's performance bond claim. Treating the issue as a matter of statutory construction, the court reasoned that a surety is not the obligee's "own insurer" under the Act. Additionally, the court noted that the surety made no intentional misrepresentations as required by the Act.

In *Masterclean, Inc. v. Star Ins. Co.*,<sup>70</sup> the South Carolina Supreme Court held that a principal could not sue a surety for bad faith refusal to pay a performance bond claim. The court also ruled that no private right of action was created by the South Carolina fair claims statute. The principal claimed that the surety should have mitigated the damages by performing its bond obligations when it determined that the principal had defaulted instead of allowing the obligee to make its own arrangements for completion of the project. Much of the opinion differentiates surety-principal relationships and insurer-insured relationships. The court noted that sureties, like insurers, may have an incentive to delay performance because it will ultimately only be liable for the bond amount but stated that "this factor alone is insufficient to recognize a bad faith claim for sureties."<sup>71</sup> The court also noted that, "[w]hile a principal may not use bad faith as a

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67. 189 F. Supp. 2d 24 (S.D.N.Y. 2002).

68. No. CIV.A. 01-CV-6153, 2002 WL 485694 (E.D. Pa. Apr. 1, 2002).

69. 183 F. Supp. 2d 76 (D. Me. 2001).

70. 556 S.E.2d 371 (S.C. 2001).

71. *Id.* at 376.

sword to extract damages from a surety in tort, a principal is not precluded from using bad faith as a shield in contract against a surety seeking indemnification.”<sup>72</sup>

In *Schwerdt v. Int'l Fid. Ins. Co.*,<sup>73</sup> the court held that, under California law, tort damages for an alleged breach of the covenant of good faith and fair dealing arising from a surety's failure to pay on a surety bond were not allowed.

#### E. Penal Sum/Interest

In *United States v. Washington Int'l Ins. Co.*,<sup>74</sup> the Court of International Trade found that a surety could not be liable for interest in excess of the amount of the penal sum of its customs bond, except where the surety had been dilatory in failing to pay on the bond.

In *Bruce Supply Corp. v. D & M Plumbing & Heating Corp.*,<sup>75</sup> the court determined that a material supplier was entitled to prejudgment interest from the date that it first made demand on the surety for payment but found that the rate of interest should be the statutory 9 percent and not the 24 percent printed on the back of the supplier's invoices.

#### F. Subrogation

In *RLI Ins. Co. v. New York State Dep't of Labor*,<sup>76</sup> the New York Court of Appeals ruled that the New York State Department of Labor had improperly attempted to seize contract funds from a project completed by a surety due to the contractor's failure to pay prevailing wages on that project and another project not bonded by that surety. The court ruled that the funds in question constituted trust funds under Article 3-A of the Lien Law and that the completing surety's equitable subrogation rights were superior to the Department of Labor's rights to seize funds under the Labor Law.

#### G. Bid Bonds

In *Compton Unified Sch. Dist. v. Universal Constr. Maint. Integration Co.*,<sup>77</sup> the court found that the bid bond surety was not liable to the owner of the project where the owner refused to accept retraction or modification of the low bid, which contained a \$300,000 clerical error, because the school district never actually awarded the project to the contractor. The court observed that liability only attaches when the contractor is awarded the project and given the opportunity to perform. In this case, the contractor

72. *Id.* at 376-77.

73. No. 00-56385, 2002 WL 104928 (9th Cir. Jan. 25, 2002).

74. 177 F. Supp. 2d 1313 (Ct. Int'l Trade 2001).

75. 737 N.Y.S.2d 642 (App. Div. 2002).

76. 97 N.Y.2d 256 (2002).

77. No. B144260, 2002 WL 849970 (Cal. Ct. App. May 3, 2002).

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was simply removed from consideration; the undisputed evidence showed that the contractor was prepared to perform, and break even, if the project was awarded to it rather than take a substantial loss from its bid failure (\$262,000 difference between its bid and the next bid). Because there was no liability on the part of the principal, there was no liability on the part of the surety.

#### H. *Bankruptcy*

In *Wright v. Gulf Ins. Co.*,<sup>78</sup> the bankruptcy court ruled that the surety's claim as creditor under an indemnity agreement could not be discharged because the indemnity agreement required the principal to hold any funds paid on the project in trust for benefit of the surety. The court found that the diversion of those funds held in trust under the indemnity agreement constituted defalcation by the debtor in its fiduciary capacity as trustee and fell under the discharge exception therefor.

### III. LEGISLATION AND REGULATION

#### A. *Federal*

H.B. 10, Public Law No. 107-90, effective December 21, 2001, modernizes the financing of the railroad retirement system and provides enhanced benefits to employees and beneficiaries. Among other things, this law requires that every person who handles funds or other property of the National Railroad Retirement Investment Trust be bonded. The bond must protect the Trust against loss by reason of acts of fraud or dishonesty and must be in an amount not less than 10 percent of the funds handled. The bond must be at least \$1,000 but not more than \$500,000, except that the Railroad Retirement Board, after consideration of the record, may require an amount in excess of \$500,000, subject to the 10 percent limitation.

#### B. *States*

##### 1. Connecticut

S.B. 231, Public Act No. 02-111, Laws of 2002, effective October 1, 2002, requires that persons who work as a first mortgage broker or otherwise engage in the business of making first mortgage loans obtain a license and a surety bond, among other things.

##### 2. Florida

S.B. 332, Chapter 24, Laws of 2002, effective July 1, 2002, amends section 468.453 of the Florida statutes to eliminate the requirement that an indi-

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78. 266 B.R. 848 (Bankr. E.D. Ark. 2001).

vidual applying for a license as an athlete's agent first submit a \$15,000 surety bond.

### 3. Illinois

S.B. 1046, Public Act No. 92-518, Laws of 2002, effective June 1, 2002, amends the Condominium Property Act to replace provisions concerning insurance for condominium associations. In particular, a condominium association is required to obtain a fidelity bond covering persons, including the managing agent and its employees, who control or disburse funds of the association, for the maximum amount of coverage available to protect funds in the custody or control of the association, plus the association reserve fund.

R. 1636, effective March 8, 2002, establishes a framework for the Commerce Commission's regulation of the entry of alternative gas suppliers into the field of residential retail sales. Among other things, a license applicant must execute and maintain a license or permit bond equal to \$150,000, conditioned upon the full and faithful performance of all of the applicant's duties and obligations as an alternative gas supplier.

R. 1671, 71 Ill. Admin. Code 41, effective February 8, 2002, sets forth provisions to be included in all Capital Development Board<sup>79</sup> grant agreements. The CDB may require a grantee to obtain a fidelity bond in the amount of 125 percent of the grant amount. If the grantee does not have established procedures and contractual provisions requiring construction contractors to provide bonds, the CDB may mandate that the grantee require that its construction contractors obtain a bid bond in the amount of 10 percent of the bid, a performance bond in the full amount of the bid, and a separate labor and materials payment bond in the full amount of the bid, among other things.

### 4. Iowa

R. 1633, effective February 1, 2002, establishes provisions for the licensing and regulation of viatical settlement providers. As a condition of licensure, applicants for licensure as viatical settlement providers must provide a fidelity bond on each officer and director in the amount of \$100,000. The bond must be issued by an insurance carrier rated with one of the four highest categories by A.M. Best or a comparable rating by another rating agency.

### 5. Kansas

H.B. 2677, not yet chaptered, Laws of 2002, effective July 1, 2002, amends Kansas Statutes Annotated section 60-1111 (Supp. 2001) to prohibit directed suretyship on public works projects.

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<sup>79</sup> Hereinafter CDB.

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## 6. Louisiana

R. 1552, issued by the Commissioner of Insurance and effective on December 28, 2001, allows property and casualty insurers in Louisiana to use insurance policies and/or endorsements that exclude coverage for mold if the exclusion is directed at precluding coverage for (1) remedial costs, such as the costs of testing the insured premises for mold, or the cost of containment or fumigation of the insured premises, whether the mold is the result of a covered cause of loss or otherwise; or (2) mold that is not the result of a covered cause of loss.

R. 1704, effective February 15, 2002, requires collection agencies hired by the state to collect taxes, interest, penalties, and fees due to submit a performance bond, cash, or securities in an amount not to exceed \$100,000.

## 7. Maine

H.B. 1483, Public Law No. 689, Laws of 2002, effective July 25, 2002, authorizes the Department of Transportation to post advertisements for bids on construction contracts on the Internet, instead of requiring legal notices in newspapers.

## 8. Michigan

Public Act 362, signed May 23, 2002, requires that the secretary of state, the deputy secretary of state, and the private secretary and executive clerk of the governor provide surety bonds conditioned upon the faithful discharge of their duties.

H.B. 5434, Public Act No. 80, Laws of 2002, effective ninety days after adjournment (at the end of 2002), amends the Grain Dealers Act. Before a license issues to a grain dealer, other than a grain merchandiser or farm produce trucker, the dealer must provide the Department of Agriculture with a bond that secures only the dealer's warehouse receipts and open storage transactions. The amount of the bond is \$15,000 for the first 10,000 bushels of storage capacity of the dealer's facility used for open storage and storage under warehouse receipts, plus \$5,000 for each additional 10,000-bushel capacity, or fraction of that capacity, used for open storage and storage under warehouse receipts other than collateral warehouse receipts. Holders of collateral warehouse receipts or warehouse receipts issued in the name of the grain dealer are prohibited from recovering against a dealer's bond. A grain merchandiser or farm produce trucker must provide a bond to the department in the amount of \$100,000.

## 9. Minnesota

S.B. 2459, Chapter No. 287, Laws of 2002, effective April 9, 2002, amends provisions relating to supplemental nursing services agencies to require each agency to carry an employee dishonesty bond in the amount of

\$10,000 and maintain workers' compensation insurance coverage for all nurses, nursing assistants, nurse aides, and orderlies provided or procured by the agency, among other things.

S.B. 2890, Chapter 299, Laws of 2002, effective August 1, 2002, makes any clause in a public works contract that purports to limit the contractor's rights to recover damages for delay, disruption, or acceleration caused by acts or omissions within the control of the contracting public entity void as against public policy.

#### 10. Mississippi

H.B. 1562, Chapter 519, Laws of 2002, effective July 1, 2002, lowers the amount of retainage on public construction contracts from 10 percent to 5 percent and further reduces retainage upon 50 percent of project completion.

#### 11. New Hampshire

R. 02-013, effective June 1, 2002, requires that all insurance claim rejections and claim forms prominently display a toll-free telephone number that an insured may use to discuss his or her claim with a company representative.

#### 12. Ohio

H.B. 458, not yet chaptered, Laws of 2002, effective September 20, 2002, permits a state agency or political subdivision awarding a construction contract to request additional financial information for review from an apparent low bidder after it opens all submitted bids, even when the low bidder has provided a bid bond.

S.B. 109, effective May 15, 2002, enacts sections 9.315 and 9.316 of the Ohio Revised Code Annotated to prohibit any public authority from requiring any contractor to procure any bid, performance, or payment bond from a particular insurance or surety company, agent, or broker.

#### 13. South Carolina

H.B. 4823, Act 253, Laws of 2002, effective May 14, 2002, prohibits directed suretyship on competitively bid public projects.

#### 14. South Dakota

H.B. 1181, not yet chaptered, Laws of 2002, effective July 1, 2002, prohibits directed suretyship for any competitively bid public works project.

H.B. 1190, not yet chaptered, Laws of 2002, effective July 1, 2002, raises the minimum premium amount for which surety bonds are exempt from the countersignature requirements by resident agents from \$40 to \$100.

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15. Utah

S.B. 68, Chapter 80, Laws of 2002, effective May 6, 2002, prohibits directed suretyship on public works projects.

16. Virginia

H.B. 1215, Chapter 556, Laws of 2002, effective July 1, 2001, amends section 2.2-4337 of the Code of Virginia to exclude contractors of transportation-related projects that have received an award of any public construction contract exceeding \$100,000 from providing a performance bond in the sum of the contract amount conditioned upon the faithful performance of the contract in strict conformity with the plans, specifications, and conditions of the contract. The contractor for these projects would instead be required to furnish such bonds in a form and amount that is satisfactory to the public body.

S.B. 199, Chapter 147, Laws of 2002, effective July 1, 2002, allows the State Corporation Commission to require burial societies to provide certification of compliance with the requirement that they maintain a fidelity bond in an amount between \$10,000 to \$100,000, as determined by the commissioner.

17. Washington

S.B. 6577, Chapter 163, Laws of 2002, effective June 13, 2002, requires that each bidder on a prime public works construction contract that is expected to cost \$1 million or more submit the names of the subcontractors with whom the bidder, if awarded the contract, will subcontract for performance of certain work or to name itself for the work. The Act prohibits the substitution of a listed subcontractor in furtherance of bid shopping or bid peddling before or after the award of the prime contract. It permits substitution of a listed subcontractor by the prime contractor for several reasons, including the bankruptcy or insolvency of the listed subcontractor.

18. West Virginia

H.B. 4379, Chapter 39, Laws of 2002, effective June 7, 2002, amends certain sections regarding the regulation of mortgage brokers, lenders, servicers, and loan originators. Among other things, the bond amount required for mortgage brokers is increased from \$25,000 to \$50,000, and the bond amount required before a broker may participate in a table-funded residential mortgage loan is increased from \$50,000 to \$100,000.

19. Wyoming

H.B. 7, Chapter 4, Laws of 2002, effective July 1, 2002, increases the minimum surety bond amount for each applicant for a grain warehouseman's license from \$15,000 to \$20,000.

