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COMMITTEE NEWS

Fidelity & Surety Law

And Then There Was One: The Emerging Split over Insurance Coverage for Social Engineering Fraud Claims

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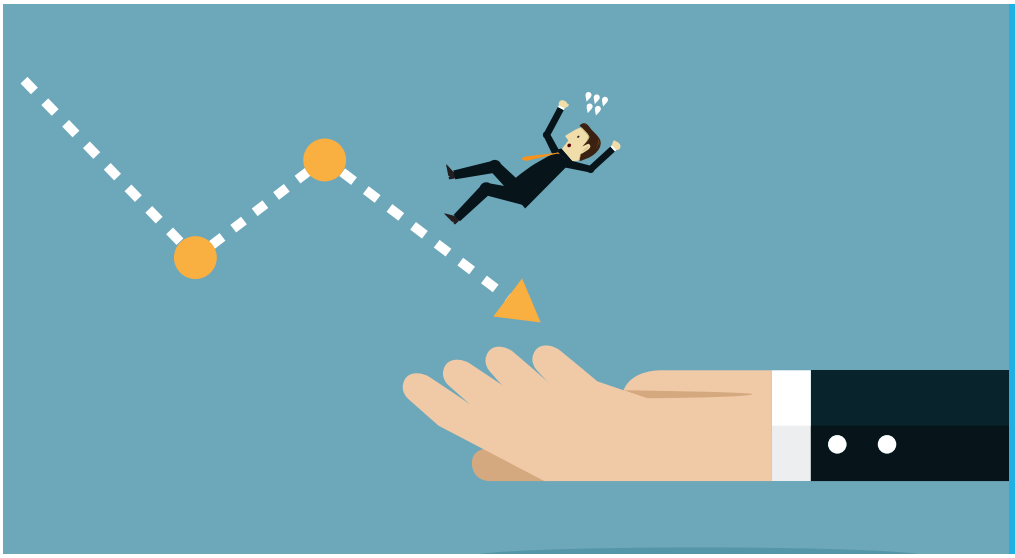
Entering 2018, five coverage cases involving claims of social engineering fraud were progressing through the Federal Circuit Courts of Appeal. Briefly, social engineering fraud consists of a fraudster using email to deceive an employee of a business into transferring funds to a source appearing legitimate, e.g., a trusted vendor, with the intention of the fraudster absconding with the funds. Importantly, social engineering fraud has exploded, with losses having increased 2370% in a recent two-year period, according to the FBI. See https://www.fbi.gov/contact-us/field-offices/chicago/news/stories/fbi-chicago-warns-area-business-owners-of-business-e-mail-compromise-scam.

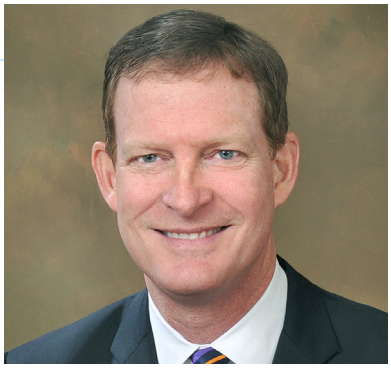
Decisions in four of the five cases have since been handed down, which is significant in light of the relative paucity of existing precedent. Below, we will analyze

Read more on page 14



In This Issue

Chair Message



Brett D. Divers
Mills Paskert Divers

Chair, ABA TIPS Fidelity and Surety Law Committee

Welcome to another action-packed FSLC year. I am honored to serve as your Chair for the year. Before turning to the 2108-19 programming year, congratulations are in order for our Immediate Past Chair, Toni Scott Reed. At the ABA's August Annual Meeting in Chicago, TIPS awarded the FSLC for its "overall excellence in the intensity and quality of its efforts to involve its members in the activities of the FSLC and TIPS." I had a front row seat to watch Toni guide every program, book chapter, article, and activity. Her graceful leadership directly led to the prestigious award the FSLC received.

Looking forward to this year, we will be going to some new places, but the educational programs will be just as informative as members have come to expect. First up, on November 7 and 8, we will be in Philadelphia for the Fall Fidelity Program. The title of the program is "An Analysis of Fidelity Claims for the Modern World." As in the past, our program will immediately follow the Fidelity Law Association's Fall Meeting. I encourage you to register for that program as well as ours. You will be updated on the latest developments and cases impacting fidelity practitioners. Please register early to make sure you take advantage of the special pricing we have arranged.

In the coming months, you will hear more about the other programs planned for the year. For now, please mark your calendars for the Mid-Winter Meeting that will take place from January 14 to 16, 2019 at the Hilton Bayfront San Diego. It will not feel like winter in Southern California in January and there will be time built in to allow you to enjoy being outside. We will be in Austin, Texas at the JW Marriott on May 8 to 10 for the Spring Surety Program. Dozens of authors and speakers have already been working for several months to prepare these programs for you. I hope you will make plans to attend as many of our conferences as you can.

One of our goals for this year is to provide greater networking opportunities for all of our members. Outsiders often remark about the collegiality of the FSLC's members. The best way to maintain that connectivity is to meet new people and include all of our members in social events. So, in addition to the substantive CLE/CE programs, we will have some events at the Fall and Spring meetings that will not only allow old friends to re-connect but that will also lead to new friendships. I hope you will attend the group social events we hold this year and that you make it a personal goal to meet at least one new person at each conference you attend.

In other news, we have a new website. The website should become the one-stop shop for all information you need about the FSLC. The content will become more robust in the coming months, but you will be able to get information about upcoming conferences, read the most recent newsletters, find a directory of members, and

obtain other useful information. Plans are in place to allow for interactive discussions (like a message board) where members can interact on a host of topics. Bookmark the page and visit it often because it will be your best resource for information.

The best way to make the most of your membership is to get involved. There are many ways you can do that – by writing an article, speaking at a conference, or participating on a committee. Please don't feel like you have to wait for someone to ask you. If you want to get involved, please let me know directly (bdivers@mpdlegal.com) and I will connect you with the right person.

We have a busy year ahead and will have some fun along the way. I look forward to serving you this year and hope to see you at our conferences.

Connect with Fidelity & Surety Law

website

Stay Connected with TIPS

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

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Case Update: Recent Appellate Court Ruling Potentially Increases Sureties' Performance Bond Exposure In Illinois For Payment Claims

Albert L. Chollet III, Partner

Introduction

In June 2018, the Third District Appellate Court of Illinois issued an opinion which provides cause for uncertainty and a substantial increased risk for sureties doing business in Illinois. The appellate court found that an unpaid wage and welfare fund for union laborers had the right to assert a claim for non-payment against a performance bond.

In Valley View School District 365-U for the use of IBEW Local 176 Health, Welfare, Pension, Vacation and Training Trust Fund Trustees v. Hartford Fire Insurance Company, a union benefit funds brought claims for non-payment of wage and welfare contributions against the surety's AIA A312 performance bond notwithstanding the existence of a companion AIA A312 payment bond. The claims were made after the expiration of the one-year limitation provision in the payment bond, but before the expiration of the two-year limitation period in the performance bond. The surety denied the union benefit funds' claims as time-barred under the payment bond. When the trial court ruled in favor of the union benefit funds finding that the union benefit funds had properly and timely asserted a claim against the performance bond, the surety appealed. The appellate court affirmed the trial court's ruling.

As discussed below, three noteworthy factors weighed upon the appellate court's ruling in Valley View: the exacting language of the Illinois Bond Act and the Illinois Supreme Court's 2014 opinion in Lake County Grading Co., LLC v. Village of Antioch, and the Illinois Prevailing Wage Act.

The Illinois Bond Act and the Lake County Grading Decision

The Illinois Bond Act requires a surety bond to secure both performance of a contract and payment for the material and labor performed in furtherance of a contract for public projects in excess of $50,000 for state-owned projects and $5,000 for political subdivision-owned projects. The Bond Act provides, in part, as follows:

> Except as otherwise provided by this Act, all officials, boards, commissions, or agents of this State in making contracts for public work of any kind costing over

Read more on page 19

How to Measure the Reasonableness of Completion Costs Post Termination-For-Cause

Jeffrey Katz, PE
The Vertex Companies, Inc.

VERTEX provides expert services and litigation support for attorneys, sureties, contractors and Owners who require cost estimating, damages allocation and analysis of terminations and completion costs. We have prepared affirmative claims, counterclaims, and defenses on hundreds of matters across the United States and internationally. For additional information, please visit us online or contact Ryan Phillips, PE at rphillips@vertexeng.com.

If an owner terminates its contractor for cause, or if a general contractor or construction manager terminates one of its subcontractors for cause, it owes the terminated party as well as its surety, if applicable, a duty to incur only the reasonable and necessary costs to complete the work.[1] In other words, the non-default party has a duty to mitigate the costs of completion.

1. How to Determine if Completion Costs are "reasonable."

Finishing the Work

Per Article 14.2 of the AIA A201 General Conditions, which is incorporated in most AIA contracts, the terminating party may "finish the Work by whatever reasonable method the Owner may deem expedient, including making demand on the surety to perform the Work." When this occurs, the Owner will not furnish further payments to the Contractor until the work is finished. Once the work is complete, the Owner will reconcile its completion costs with the remaining contract balance to determine any payments required to the principal or potential damages to be recovered.

Similarly, the Standard Form of Agreement and General Conditions between Owner and Contractor published by the Associated General Contractors of America ("AGC") and the Standard Form of Agreement between Contractor and Subcontractor (AGC Document No. 200 and 655 respectively) both provide similar requirements. Section 11.3 of Document No. 200 indicates that following a termination for cause:

> All costs incurred by the Owner in performing the Work, including attorney's fees, shall be deducted from any moneys due or to become due the Contractor under this Agreement. The Contractor shall be liable for the payment of any amount by which such expense may exceed the unpaid balance of the Contract Price. If the unpaid balance of the Contract Price for Work performed in accordance with this Agreement exceeds the expense of finishing the Work, Contractor shall be paid for Work performed in accordance with the Contract Documents up to the amount that the unpaid contract balance exceeds the expense of finishing the Work.

This paragraph further states that "[u]pon request of the Contractor the Owner shall furnish to the Contractor a detailed accounting of the costs incurred by the Owner

1 Cushman, Richard F, et al., editors. Termination for Default from Owner's Viewpoint. In Proving and Pricing Construction Claims, Third Edition (pp. 214). New York, NY: Wolters Kluwer Law & Business, 2001.

in finishing the Work." AGC Document No. 655, Section 10.1.2 presents nearly identical language.[2]

When an Owner terminates the Contractor and incurs costs to complete the Work (which often do exceed the contract balance), it is typically with an expectation that these costs will be recovered from the defaulting party.

2. When Are Costs Deemed Reasonable?

Reasonableness can be a subjective determination. In cases of construction contracts under federal contracting guidelines, the Federal Acquisition Regulation (FAR) contemplates that "a cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business."[3]

The non-default party will often be looked upon favorably, and likely have its costs deemed reasonable if:

a. A Thoughtful Re-Solicitation is Performed

If the completion of work is being re-let, solicitation of multiple bidders can promote competitiveness and allow for additional savings through cost negotiations. Original bidders on the project should be considered for the completion as they likely already have familiarity with the plans and specifications. Contractors familiar with completion work should also be considered. A proper bid analysis should be conducted prior to award.

While reviewing multiple bids can provide a better understanding of the completion costs dictated by the market, depending on the type or condition of the project, soliciting lump sum bids may not be practical, and can result in high bid amounts due to bidder's pricing contingencies and uncertainties associated with a project default in their bids. Efforts such as site walkthroughs and access to sufficient project documentation may help mitigate overestimates. Prudent consideration of the best means of completing the work by the Owner and putting oneself in the best position to decide can support cost reasonableness when electing to use a completion contractor.

b. Existing Subcontractors Are Utilized

Completion costs can typically be mitigated by entering into ratification

If an owner terminates its contractor for cause, or if a general contractor or construction manager terminates one of its subcontractors for cause, it owes the terminated party as well as its surety, if applicable, a duty to incur only the reasonable and necessary costs to complete the work.

2 All costs incurred by the Contractor in performing the Subcontract Work, including reasonable overhead, profit and attorneys' fees, costs and expenses, shall be deducted from any moneys due or to become due the Subcontractor. The Subcontractor shall be liable for the payment of any amount by which such expense may exceed the unpaid balance of the Subcontract Amount. At the Subcontractor's request, the Contractor shall provide a detailed accounting of the costs to finish the Subcontract Work

3 FAR § 31.201–3

agreements with the defaulted principal's subcontractors and vendors to complete the subcontracted work, due to the monetary benefit of using these subcontractors, time constraints and the ability to constrain overall completion costs. The principal's subcontractors may have already mobilized, are familiar with the project, and potentially have material available or on order, therefore allowing them to complete the remaining work at a lower price and in less time.[4] When utilizing a completion contractor, assignment of existing subcontractors can be a check against overstated costs, and can show reasonableness of costs as the principal would have presumably incurred the balance of its own subcontractor's costs if they had completed the work.

However, just because existing subcontractors are utilized may not mean that the costs are necessarily reasonable. In one matter, the completion contractor was utilizing assigned subcontractors, but was also charging a significant markup on the subcontractor costs in addition to a separate Contractor's Fee. The markup on subcontractor costs which the Owner paid the completion contractor on top of the Contractor's Fee was argued to be unreasonable.

c. Detailed Cost Tracking Is Performed

If it is worth doing, it is worth documenting. Project records are key to identifying and substantiating completion costs, and must be furnished to the defaulted party upon request per standard contracting clauses, allowing for a swift resolution of disputes. Change order, or ticket work, should be coded separately from base contract work, to allow for segregation of these costs. Necessary rework of the principal's issues should be documented sufficiently, with photographs and descriptive narrative in the daily field reports. Any self-induced deficiencies or inefficiencies should also be properly noted and removed from the recoverable costs: proper documentation and fair assignment of costs provide credibility to the recovery of completion costs. Typically, when a contractor is terminated, detailed daily reports will be kept by the completing contractor to substantiate all work performed, as these logs are the primary means of recordkeeping for activities occurring onsite and are especially important in disputes.[5] When the work is not properly documented, it may create issues substantiating the cost reasonableness and necessity of the costs.

When an Owner terminates the Contractor, and incurs costs to complete the Work (which often do exceed the contract balance), it is typically with an expectation that these costs will be recovered from the defaulting party.

4 Clore, Duncan L, et al., editors. Takeover and Completion. In Bond Default Manual, Third Edition (pp. 223 – 241). New York, NY: American Bar Association, 2005.

5 Clough, Richard H., et al. Construction Contracting: A Practical Guide to Company Management (Eight Ed.) (pp. 323 – 324). United States of America: John Wiley & Sons, 2015.

3. What Costs are not Reasonable for Recovery?

Costs may have been incurred in the completion of the work that are unreasonable or would otherwise be unnecessary had the non-default party acted prudently. Even when acting prudently, some costs may not be considered reasonable and therefore would not be recoverable.

Some examples of unreasonable costs are:

a. Betterments and changes to the scope of the original contract

Change orders issued after the termination, betterments to the project, and work performed that is not- in-scope should not be considered recoverable in a termination.

b. Rework of completing party's deficiencies

Costs incurred by the completing contractor correcting its own deficiencies are not reasonable costs to be assigned to the default party. However, costs for remedial work for defects of the original contractor would be reasonable if performed prudently.

c. Additional costs resulting from the non-default party not promptly completing the Work

Work, which remains dormant due the Owner inaction can be subject to escalation costs, repairs / rework, standby costs, warranty issues, liquidated or actual damages, winter conditions and more. If practical to progress the work meaningfully, these efforts must be considered, as costs resulting from abandonment or significant delay to the completion effort by the Owner may not be reasonable.

In one example, after re-commencing work, raw steel installed by the terminated principal was left exposed to oxidation. As priming of the steel was not promptly undertaken by the completing party, additional costs for blasting and wire brushing became necessary to allow for the painting work to proceed – these costs were not recoverable based on the work not being promptly resumed.

In another example, UV-sensitive materials that were staged for installation prior to termination were left exposed to sunlight and weather. While the duty to protect materials is often a contractual obligation of the principal, based on the timing of the termination and barring of the contractor from returning to the site, the material ended up remaining unprotected for longer than the manufacturer's exposure limit, and new material needed to be re-ordered and the existing material needed to be disposed of. Protecting the material with tarpaulins would

When disputes over completion costs arise, the adverse parties may look to retain damages and allocation experts to review the disputed costs. These experts will review the manner in which the work was completed, pore over the financial data and construction documents, and prepare their own estimates to affirm or contest the reasonableness of the costs.

have been a reasonable action and compensable cost of the non- default party. By not acting promptly, the cost incurred in replacing the materials was not reasonable.

d. Costs resulting from inexperience or unfamiliarity with type of construction

Completion work should be performed by a capable party who can perform the work efficiently and per industry standards. If the work is performed by an inexperienced party, costs associated with inefficiencies from the inexperienced contractor may not be considered reasonable.

In one case, a completion contractor was retained to construct an elevated parking deck with a pre- engineered, factory-built, reusable concrete forming system. At the time of the termination, the elevated deck work had not begun. When the completion contractor started this work, they proceeded in an inefficient, circular sequence of deck placements that required concrete to cure and post-tension cables to be stressed before cables could be laid on the subsequent deck area to be poured. Had a more common checkerboard sequence been utilized, which was possible with the forming equipment that was onsite, concrete curing and cable stressing would not have been critical predecessors to the subsequent deck placement, and the overall completion time of the project could have been reduced. The additional delay damages, labor, and rental costs resulting from the inexperience of the completing party were not reasonable as an experienced contractor, acting prudently, would have mitigated these costs by performing the work in accordance with generally accepted practices.

e. Unnecessary costs of expediting

If completion of work is not constrained by a deadline, and costs are spent on overtime labor or winter heating, these costs may not be practical and efficient, and would be disputed as unnecessary and unreasonable.

Other costs incurred in completing the work following a termination may be deemed unreasonable. When disputes over completion costs arise, the adverse parties may look to retain damages and allocation experts to review the disputed costs. These experts will review the manner in which the work was completed, pore over the financial data and construction documents, and prepare their own estimates to affirm or contest the reasonableness of the costs.

And Then.. continued from page 1

the decisions in chronological order, highlight the remaining undecided case, and discuss the overall impact of these rulings.

Aqua Star (USA) Corp. v. Travelers Cas. & Sur. Co of Am., 719 Fed. Appx. 701 (9th Cir. Apr. 17, 2018)

In the first and shortest decision of the four, the Ninth Circuit determined an exclusion in a computer fraud coverage part of a commercial crime policy barred coverage. Specifically, as developed before a Washington federal district court, the issue concerned whether the losses suffered by Aqua Star (USA) Corp. ("Aqua Star") due to a fraudulent email scheme were covered. The fraud was perpetrated when one of Aqua Star's Chinese vendors was hacked, which allowed the fraudster to monitor and intercept emails between an Aqua Star employee and a counterpart at the vendor. The fraudster then spoofed the email domains of the vendor's employees and, in turn, directed an Aqua Star employee to wire funds to a bank account controlled by the fraudster.

On appeal, the Ninth Circuit affirmed the lower court's decision, relying on Exclusion G applicable to the computer fraud coverage part, which stated the policy "will not apply to loss or damages resulting directly or indirectly from the input of Electronic Data by a natural person having the authority to enter the Insured's Computer System . . . ." The Ninth Circuit reasoned that since Aqua Star's losses resulted from its own employees (who were authorized to enter its computer system) having changed wiring information so the funds would be sent to the fraudster, the circumstances fell squarely within the exclusion.

Interactive Commcn's Int'l, Inc. v. Great Am. Ins. Co., 731 Fed.Appx. 929 (11th Cir. May 10, 2018)

A finding of no coverage was again reached by the Eleventh Circuit when it upheld a Georgia federal district court's summary judgment in favor of the insurer. A close analysis of the factual circumstances was especially relevant in this matter. The insured, Interactive Communications International, Inc. and an affiliate (collectively "InComm") operated a business that sold "chits" to consumers containing a money value which could then be loaded onto a debit card. To redeem the value of the chits, consumers called InComm's 1-800 number. They were then connected to InComm's interactive voice response ("IVR") computer system. The IVR system used eight computers that assisted consumers in redeeming chits. After redemption, the funds would become immediately available to the consumer. Notably, after making the funds available for use, InComm was contractually required to transfer the value of the funds to the card-issuing bank within 15 days.

"[T]he majority approach is wary to transform a computer fraud/crime policy into a general fraud policy.

… This rationale is perceptive since stand-alone social engineering fraud coverage can be purchased in the marketplace."

A problem arose when fraudsters began to exploit a vulnerability in the IVR system by attempting multiple redemptions of the same card concurrently. As a result, InComm lost $11.4 million, including $10.7 million in connection with debit cards issued by Bancorp. InComm turned to its commercial crime policy, and specifically, its computer fraud coverage. That coverage applied to losses "resulting directly from the use of any computer to fraudulently cause a transfer . . . ." Great American disputed coverage for the loss, and coverage litigation ensued.

The district court granted Great American's motion for summary judgment, finding, in pertinent part, that InComm's loss did not "result[ ] directly from the use of a[ ] computer." The Eleventh Circuit affirmed, holding specifically that InComm's losses did not result directly from the fraudsters' use of the IVR system. In doing so, the Court concluded the phrase "resulting directly" meant straightaway, immediately, and without any intervention or interruption. As a result, since several intervening acts occurred between the fraudulent redemption of chits and the ultimate loss of funds, InComm's loss did not result directly from fraud. Indeed, the Court found significant that four steps existed between the fraudster's actions and the "point of no return" leading to the loss. Also significant, days, weeks, or even years could pass between the fraud and the ultimate loss. As a result, the lack of immediacy doomed InComm's bid for coverage.

Medidata Solutions, Inc. v. Fed. Ins. Co., 729 Fed.Appx. 117 (2d Cir. July 6, 2018)

The Second Circuit's decision in Medidata upheld a New York federal district court's finding of coverage. The coverage dispute arose when the insured, Medidata Solutions, Inc. ("Medidata"), was victimized by an email spoofing attack wherein the fraudsters gained entry into Medidata's email system and, by inserting a computer code, were able to mask the fraudsters' true email address. The thieves were successful in defrauding Medidata by posing as Medidata's president until one of the executives grew suspicious of the "Reply To" email field.

The commercial crime policy issued to Medidata contained computer fraud coverage applicable to "direct loss" of money "resulting from" fraud committed by a third-party. Also significant, the policy defined a "Computer Fraud" as the "[u]nlawful taking or the fraudulent induced transfer of Money … resulting from a Computer Violation." In turn, a Computer Violation was defined as "the fraudulent: (a) entry of Data into a . . . Computer System; and (b) change to Data elements or program logic of a Computer System . . . ." In light of this unorthodox language, the district court determined there was "Computer Fraud" because the fraud was achieved by entering into Medidata's email system and inserting a computer code to mask the fraudsters' identity, which proximately caused the loss.

The Second Circuit affirmed using a summary order. It focused specifically on the nature of the attack, i.e., the introduction of the computer code enabling the fraudsters to impersonate Medidata's president. Moreover, the Second Circuit rejected the insurer's contention that the policy covered only brute force hacking scenarios in which hackers gain access to or control the insured's computers or network.

Am. Tooling Ctr, Inc. v. Travelers Cas. & Sur. Co. of Am., (6th Cir. July 13, 2018)

The most recent social engineering fraud decision by the Sixth Circuit concerned a classic scenario of a third party impersonating a vendor and stealing over $800,000 from the insured, American Tooling Center, Inc. ("ATC"). The Michigan district court granted summary judgment in favor of the insurer, but the Sixth Circuit reversed.

On appeal, the Sixth Circuit analyzed three requirements for Computer Fraud coverage. First, ATC argued it suffered a "direct loss" the moment it paid the impersonator. The Sixth Circuit agreed because it opined there were no intervening event between the fraudulent emails and ATC's transfer of funds to the impersonator.

Second, the Sixth Circuit considered whether the impersonator's conduct constituted "Computer Fraud." Relying on the fact that the impersonator sent ATC fraudulent emails using a computer, which allegedly caused the payments to the impersonator, the Sixth Circuit rejected the insurer's argument that "Computer Fraud" should be limited to hacking and other brute force attacks. Plus, looking at other policies in the marketplace, the Court chastised the insurer for not defining "Computer Fraud" as narrowly as others have in terms of confining the meaning to criminal hacking.

Third, the Sixth Circuit concluded ATC's loss was directly caused by Computer Fraud. Here, the Sixth Circuit specifically distinguished InComm by concluding the spoofed emails received by ATC served as the immediate cause of the loss.

Also significant, none of the exclusions precluded coverage, according to the Sixth Circuit, including the similarly worded Exclusion G, which the Ninth Circuit found compelling in Aqua Star. In short, the Court concluded the particular definition of "Electronic Data" did not include bank-routing instructions.

The One – Principle Solutions Grp. v. Ironshore Indem., Inc., No. 17-11703-FF (11th Cir.)

The case that remains pending on appeal is Principle Solutions before the Eleventh Circuit. The dispute there concerns a fraudster who spoofed the email of one of the managing directors of Principle Solutions Group ("Principle") and instructed Principle's controller to work with an "attorney" to make wire payments to the tune of $1.717 million.

The main coverage issue was whether the loss resulted directly from a "fraudulent instruction." The insurer argued the loss was not direct because additional information for the wire transfer was conveyed to Principle by the "attorney," and Principle's employees set up and approved the wire transfer. Since the Georgia federal district court deemed the pertinent policy language ambiguous, there was coverage because it was reasonable for Principle to interpret the language as allowing coverage even where there were intervening events between the fraud and the loss.

The issues concerning what constitutes "fraudulent instruction," as well as "directly from," are the focus on appeal. Unsurprisingly, the parties have been submitting the above-referenced decisions as supplemental authority contemporaneous with their release. A decision in Principle Solutions is unlikely to be seen until 2019, as oral argument likely will not be heard until November 2018. To be sure, the recent federal circuit court opinions, especially Incomm, will play a prominent part at the hearing and should be guideposts for the decision ultimately rendered by the Eleventh Circuit.

Where Do We Go from Here?

These four appellate decisions to date follow one of two paths. The decisions in Aqua Star and InComm take the approach of the majority of courts prior to 2018, i.e., a reluctance to find coverage for social engineering fraud. A maxim undergirding this approach is that since the use of computers is ubiquitous, virtually all fraudulent conduct merely involving the use of email could potentially be covered. In other words, the majority approach is wary to transform a computer fraud/crime policy into a general fraud policy. See Pestmaster Servs. v. Travelers Cas. & Surety Co. of Am., 656 F. Appx. 332 (9th Cir. 2016); Apache Corp. v. Great Am. Ins. Co., 662 Fed, Appx. 252 (5th Cir. 2016). This rationale is perceptive since stand-alone social engineering fraud coverage can be purchased in the marketplace. Those following the majority approach also hone in on the intervening acts between the initial fraudulent conduct and the resultant loss. Since most computer fraud provisions require the loss to "result directly from" computer fraud, it would stand to reason that where there are several steps taken by policyholders to process the funds transfer, and at any point during the process someone could have put a stop to the loss by using an independent method to verify the legitimacy of the request, there is no direct or immediate nexus between the spoofed email and the funds transfer. InComm best embodies the reasoning espoused by the majority.

Medidata and American Tooling suggest a potentially more attractive minority approach than previously anticipated. Notably, the fact that American Tooling is a

published opinion gives it additional weight. However, Medidata could be viewed as an outlier decision given the atypical policy language at issue and the unusual factual circumstances, including the fraudster's ability to insert computer code into the insured's email system.

At bottom, the majority of precedent remains skeptical of coverage for social engineering fraud under traditional commercial crime policies. However, if courts begin to take a different approach, a la American Tooling, insurers would be well-served to use the Sixth Circuit's reasoning as a blueprint to craft policy language for commercial crime policies that more precisely limits coverage to brute force hacking scenarios and further clarifies an intent to exclude coverage for social engineering fraud losses, thereby pushing this coverage to the stand-alone social engineering fraud products that are presently available for purchase.

Case Update... continued from page 8

> $50,000 to be performed for the State, and all officials, boards, commissions, or agents of any political subdivision of this State in making contracts for public work of any kind costing over $5,000 to be performed for the political subdivision, shall require every contractor for the work to furnish, supply and deliver a bond to the State, or to the political subdivision thereof entering into the contract, as the case may be, with good and sufficient sureties. The amount of the bond shall be fixed by the officials, boards, commissions, commissioners or agents, and the bond, among other conditions, shall be conditioned for completion of the contract, for the payment of material used in the work and for all labor performed in the work, whether by subcontractor or otherwise.

* * *

Each such bond is deemed to contain the following provisions whether such provisions are inserted in such bond or not: 'The principal and sureties on this bond agree that all the undertakings, covenants, terms, conditions and agreements of the contract or contracts entered into between the principal and the State or any political subdivision thereof will be performed and fulfilled and to pay all persons, firms and corporations having contracts with the principal or with subcontractors, all just claims due them under the provisions of such contracts for labor performed or materials furnished in the performance of the contract on account of which this bond is given, when such claims are not are not satisfied out of the contract price of the contract on account of which this bond is given, after final settlement between the officer, board, commission or agent of the State or of any political subdivision thereof and the principal has been made.

30 ILCS 550/1 (emphasis added).

In Lake County Grading Co., LLC v. Village of Antioch, the Illinois Supreme Court considered the import of above-quoted language in determining whether an unpaid vendor had standing to assert a claim against a performance bond when the surety did not also issue a payment bond. The Supreme Court concluded that "[e]ach such bond is 'deemed' to contain" both the completion and payment provisions of the Bond Act, even if such provisions are not expressly inserted in the bond. In short, the Supreme Court held that the statutory payment provision would be implied in a performance bond even though the bond was silent as to any payment guaranty.

In reaching this conclusion, the Supreme Court emphasized the policy behind the payment and completion provisions of the Bond Act. It noted that the Bond

Act "guards the tax money allotted for public works by assuring that the terms, conditions and agreements of the contract will be fulfilled and paid by the surety if the contractor does not complete the project." As such, it found that its interpretation of the Bond Act to be consistent with the overarching policy behind the enactment of the Bond Act.

The Valley View Arguments and Decision

Notwithstanding the precedent set by the Illinois Supreme Court in Lake County Grading, the surety in Valley View attempted to distinguish the two cases. The surety emphasized that it, unlike the surety in Lake County Grading, issued a statutorily compliant bond, providing for both performance and payment guarantees as required by the Bond Act. Specifically, the AIA A312 performance and payment bonds in Valley View contained both performance and payment guarantees that collectively complied with the requirements of the Bond Act. The surety noted that the performance and payment bonds were contained within one instrument, on sequentially numbered pages, and, thus, should be read in conjunction with one another. The surety argued that to permit payment claims against the performance bond even though the claims were untimely under the payment bond, would render the payment bond a superfluous nullity, contravening all canons of contractual interpretation.

The surety further argued that the policy implications were different in Valley View than in Lake County Grading. The union benefit funds trustees in Valley View had admitted that the claim was a claim for payment and not performance because the benefits were a component of labor performed on the bonded projects that was to be paid. As such, the surety maintained that it would potentially increase the exposure of all public project sureties within Illinois for claims sounding in non-payment. The surety contended that such an outcome would have the opposite effect desired by the Supreme Court in Lake County Grading, namely that by permitting the payment claims to be applied against the performance bond, the penal sum of the performance bonds would be reduced upon payment of such claims, which in turn would reduce the penal sum of the performance bond and associated funds available to public owners for completion of the bonded project.

The surety also attacked the standing of the union benefit funds trustees to maintain an against the performance bond because the trustees were not named obliges under the performance bond. The fund trustees argued in response that wage and welfare contributions were a component of labor to be paid under the Illinois' Prevailing Wage Act. The Prevailing Wage Act mandates that all public entities "require in all contractor's and subcontractor's bonds that the contractor or subcontractor include such provision as will guarantee the faithful performance of

such prevailing wage clause as provided by contract or other written instrument." 820 ILCS 130/4(c). As such, the trustees asserted that they had standing to bring a claim for non-payment on behalf of the union laborers as part of its obligation to enforce compliance of the Prevailing Wage Act.

In addition, the surety argued that the different time limitations in the performance bond (two years) and payment bond (one year) were appropriate under Illinois law because the time periods were reasonable. The appellate court acknowledged that this was a correct statement of law insofar as parties may reasonably limit the time for assertion of a claim under a contract, and the surety's position likely would have been successful had the appellate court not concluded that the union benefit funds trustees' claims could not be asserted against the performance bond.

Ultimately, the appellate court ruled that the union benefit funds trustees' claim against the performance bond was proper because the payment of wage and welfare contributions was a requirement under the Prevailing Wage Act and a component of completion of the principal's bonded contract. Because payment of these funds was a component of the principal's performance obligations owed to the owner, the appellate court concluded that the union benefit funds could assert its claim against the performance bond. In interpreting the Bond Act in under the facts of the case, the appellate court seized upon the Bond Act's use of "the bond" and "[e]ach such bond is deemed" to rule that the performance bond was deemed to impliedly include a payment protection for claimants, finding persuasive the reasoning in Lake County Grading.

Conclusion

The question of how the Valley View opinion will be interpreted and applied in lower courts remains unclear. It would be dangerous to apply Valley View broadly to all payment bond claims, permitting all payment bond claims to be asserted against either the performance or payment bond or to conflate notions of non-payment with non-performance.

It would be similarly imprudent to overlook the key and distinctive facts of the Valley View case when presented with similar claims. The Valley View fact pattern has many distinctions from the run-of-the-mill subcontractor payment bond claim. Valley View involved the payment of wage and welfare contributions required under the Illinois Prevailing Wage Act. In addition, the specific terms of the principal's contract with the owner led the appellate court to the conclusion that payment of those contributions was a component of "performance." Consequently, non-payment provided standing under the performance bond under those facts, but it

does not necessarily mean that all claims for non-payment can be claims for non-performance when convenient to serve the needs of a claimant.

Ultimately, the appellate court's expansive reading of the Illinois Bond Act in Valley View and disregard of the existence of a statutorily-compliant payment bond presents a precarious and potentially perilous situation for sureties that could greatly expand the extent of their bonded risk for payment claims beyond the penal sum of the payment bonds. The quandary in the wake of Valley View for both underwriters and claims professionals lies in the uncertainty of how it will be applied. What is certain is that Valley View results in potentially negative business and public policy outcomes, and it clearly reveals the need for clarification of the Illinois Bond Act. From both a business perspective and a legal perspective, it is an illogical absurdity to apply the Illinois Bond Act in such a manner as to render a perfectly valid payment bond a superfluous nullity. Unfortunately, until such time as the legislature provides clarification, sureties operating in Illinois will be navigating murky waters in terms of both underwriting projects and analyzing claims.

Calendar

October 10-14, 2018	**TIPS Fall Leadership Meeting** Contact: Janet Hummons – 312-988-5656	Ritz Carlton Amelia Island Amelia Island, FL
October 18-19, 2018	**Aviation Litigation Conference** Contact: Janet Hummons – 312-988-5656	Ritz Carlton Washington DC Washington, DC
November 7-9, 2018	**Fidelity & Surety Law Fall Conference** Contact: Janet Hummons – 312-988-5656	Ritz Carlton Philadelphia Philadelphia, PA
January 16-18, 2019	**Fidelity & Surety Law Midwinter Conference** Contact: Janet Hummons – 312-988-5656	Hilton San Diego Bayfront San Diego, CA
January 17-19, 2019	**Midwinter Symposium on Insurance and Employee Benefits** Contact: Janet Hummons – 312-988-5656	Hyatt Regency Coral Gables, FL
January 23-27, 2019	**ABA Midyear Meeting** Contact: Janet Hummons – 312-988-5656	Las Vegas, NV
February 21-23, 2019	**Insurance Coverage Litigation Midyear Conference** Contact: Janet Hummons – 312-988-5656	Arizona Biltmore Resort & Spa Phoenix, AZ
March 20-22, 2019	**Transportation MegaConference XIV** Contact: Janet Hummons – 312-988-5656	Sheraton New Orleans New Orleans, LA
March 22-23, 2019	**Admiralty and Maritime Law National Program** Contact: Janet Hummons – 312-988-5656	Sheraton New Orleans New Orleans, LA
April 4-5, 2019	**Motor Vehicle Products Liability Conference** Contact: Janet Hummons – 312-988-5656	Hotel Del Coronado Coronado, CA
April 5-6, 2019	**Toxic Torts & Environmental Law Conference** Contact: Janet Hummons – 312-988-5656	Hotel Del Coronado Coronado, CA