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Kathleen O. Barnes

Hot-Tubs And Other ADR Remedies For Disputes That Ail You (Part 3)

by Kathleen O. Barnes and Christopher J. Brasco, Senior Partners, and George "Trip" Stewart, Associate


Christopher J. Brasco


George "Trip" Stewart

Adapting The Hot Tub's Benefits To Other ADR Remedies

An essential aim of the hot-tub approach to expert presentation is to empower experts to participate more directly in determining the resolution of a dispute. The experts play a central role in defining the debate, identifying areas of compromise and narrowing the divergence between the parties' opposing viewpoints. Several ADR methods provide the flexibility to adopt the goals of the hot-tub in structuring a dispute process which allows experts to more directly influence the outcome. Successful adaptation depends on identifying disputes where expert analysis will be pivotal in the resolution and incorporating procedures which mitigate the potential downside of having a subject matter specialist thrust to the fore of an, oftentimes, unfamiliar role in the disputes process.

- <u>Mini-Trials Focused On Expert Presentation</u>

Parties who seek to resolve complex, technical disputes short of a costly and time-consuming trial or hearing in arbitration, but wish to avoid ceding control of the presentation of crucial expert testimony to the fact-finder, or even predominately to the expert witnesses, may choose to engage in a mini-trial. The mini-trial may be structured to best suit the needs of the parties and the dispute, but its intent is to permit the parties to engage in a confidential exchange of information, which will result in a dialogue on the merits of the dispute, or its settlement. It is the inherent flexibility of the mini-trial that allows for an approach which focuses on the exchange of expert testimony but also accounts for the concern that lawyers more familiar with the nuances of the courtroom will cede too much control of the case presentation.

Some background concerning the availability and use of the mini-trial ADR option should help in tailoring expert presentations so that the strength and weaknesses of the hot tub approach are balanced. Mini-trials have been favored in construction disputes involving federal government contracts as the government has been reluctant to enter into arbitration agreements, even though the use of arbitration to resolve disputes under federal government contracts has been determined to be constitutional. For example, the CBCA Rules describe the mini-trial, but also provide that the Board will consider the use of any procedure agreed to by the parties, which is deemed to be fair, reasonable, in the best interest of the parties and the Board, and likely to assist in the resolution of the dispute. The CBCA Rules provide in part:

> **Minitrial.** In a minitrial proceeding, the ADR Neutral and the designated principal representative of each party sit as a minitrial panel. The Panel hears and evaluates abbreviated presentations by the parties. The party representatives then may meet with the ADR Neutral to discuss settlement of the dispute. In some cases, the ADR Neutral may provide the party representatives with a non-binding advisory opinion or even a binding decision resolving the dispute.

Similarly, the ASBCA Rules identify the mini-trial as one of several ADR methods available to parties, but also states that the Board will consider other informal methods agreed to by parties to the extent the methods are structured and tailored to suit the requirements of the individual appeal:

Minitrial. The minitrial is an expedited proceeding that may be tailored to meet the needs of the individual appeal. In a minitrial proceeding, the neutral and the designated principal representative of each party will sit as a panel to hear and evaluate abbreviated presentations by the parties. Following the presentations, the party representatives may meet to discuss settlement of the dispute. In a minitrial, any opinions offered by the neutral will be non-binding on the parties.

The International Institute for Conflict Prevention and Resolution ("CPR") also has published model procedures for minitrials administered by the CPR. The key procedures in the CPR model include:

1. **Minitrial Panel.** The minitrial panel may consist of one member of management from each party, the members from the parties should not have had direct involvement in the dispute and shall have authority to negotiate a settlement on behalf of the party represented. The panel also will include a Neutral Adviser, who is to be objective and independent of both parties.

2. **Discovery.** Where the parties agree that there is a substantial need to conduct at least limited discovery prior to the minitrial presentations, the parties may agree to voluntary exchange of "strictly necessary, expeditious discovery."

3. **Briefs and Exhibits.** Before the information exchange, the parties shall exchange, and submit to the Neutral Adviser, briefs, as well as all documents or other exhibits on which the parties intend to rely during the presentations.

4. **Mini-trial presentations.** The presentations and rebuttals of each party may be made in any form, and by any individuals selected by a party, including fact and expert witnesses. Generally, members of the panel and counsel for each party may ask questions of opposing counsel and witnesses during open question and answer exchanges following the presentations and during rebuttal.

5. **Role of Experts.** In addition to participation as witnesses in the presentations of the parties, experts also may assist the management representatives and counsel as advisers in attendance during the presentations. The Neutral Advisor also may appoint an independent expert as an advisor on complex, technical matters.

6. **Negotiations.** Following the presentations of the parties, the minitrial panel will engage in negotiations in an effort to resolve all disputes.

7. **Confidentiality.** The entire process is a settlement negotiation. Therefore, all offers, promises, conduct and statements, whether oral or written, made in the course of the proceeding by any of the parties, their representatives, employees, experts and attorneys, and by the Neutral Adviser are confidential.

These rules highlight the adaptability of the min-trial process and how experts can be used in an integral way to shape the outcome of the proceeding. An illustration, however, may provide a glimpse as to how this process might highlight the expert's role in effectively resolving a highly complex construction dispute before the parties spent considerable time and money to litigate the matter. An expert-driven mini-trial was used to successfully resolve a dispute involving the construction of the twin highway tunnels through the Cumberland Gap National Historical Park.

In an effort to reduce uncertainties in the construction of the 4,100 foot long parallel highway tunnels through the Historical Park in Kentucky and Tennessee, the Federal Highway Administration ("FHWA") assembled a team of design consultants, geotechnical engineers, construction managers, and inspectors to perform a detailed geotechnical investigation of the project site, which culminated in the construction of a pilot tunnel at a crown drift along the alignment of the southbound tunnel. Despite these well-intended plans for avoiding uncertainty and costly disputes, the contractor submitted a differing site condition claim. The parties were unable to resolve the dispute short of submission of the claim for resolution in the Court of Federal Claims.

Prior to proceeding with significant discovery, the parties agreed to participate in a mini-trial. The presiding judge sat as a settlement judge and heard abbreviated presentations by the parties. The contractor presented fact evidence from its estimator and both parties presented the testimony of its geotechnical experts, with direct testimony and "non-aggressive" cross-examination. Following the presentations, party representatives met to discuss settlement of the dispute.

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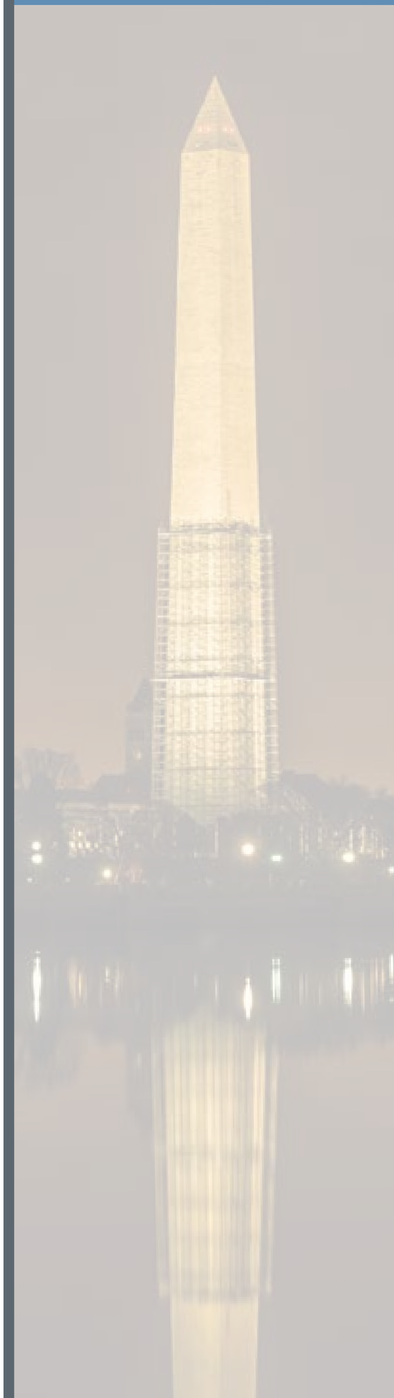

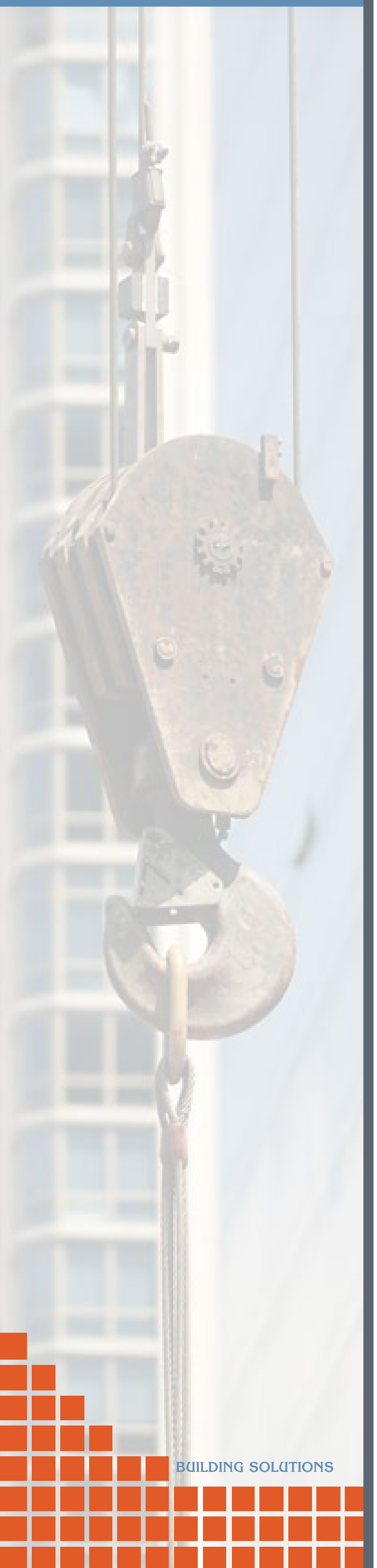

This minitrial procedure helped spur settlement talks by using experts to explain and discuss the technical matters involved in the dispute. Through the use of this mini-trial process, the parties were better able to understand the points at issue and expedite settlement discussions. While this procedure may not be applicable in all circumstances, when it is effectively applied to matters involving complex technical issues, it can help the parties quickly resolve the matter before proceeding with a costly trial.

- <u>Mediations With Mediator And Neutral Expert</u>

Mediation is yet another oft-used ADR technique for resolving complex construction disputes. The success of any particular mediation can depend on many factors, including, the mediator's skill set, the parties' investment in the process, and the exchange of information necessary to inform the parties' risk assessment. Underscoring the import of a sufficiently matured and well-framed controversy, the lack of adequate information to perform a principled risk assessment oftentimes results in a negotiation impasse. When resolving technical issues is integral to a principled risk assessment, a neutral expert can be utilized by the mediator to assist in weighing the relative merits of divergent expert positions. This referral of technical matters to a neutral expert is comparable to a court-appointed expert witness or special master. Unless specifically provided for by the parties' mediation agreement, however, the referral to a neutral expert as part of the mediation process can only be suggested by the mediator and must be agreed to by the parties. Given the added expense, using a neutral expert in the mediation process will only likely make sense when the matter in controversy is sizeable.

In large, technically-complex disputes, a neutral expert or technical mediator can work with the opposing experts to define both commonalities and areas of divergence in opposing opinions – akin to the hot-tub process. When considering the successful application of this expert-driven ADR technique, we had the opportunity to speak with Project Controls & Forensics, LLC's Mr. Kenji Hoshino regarding his familiarity with this approach. Reflecting on past experiences, Mr. Hoshino was able to provide important insight on how to best utilize the assistance of a technical mediator as part of the mediation effort. As an overarching consideration, it is important to select a neutral expert who has recognized expertise in the professional community and, preferably, familiarity with the opposing experts selected by the parties. Selecting a neutral expert who has credibility with the parties' experts will create the atmosphere of intellectual candor and professionalism conducive to developing consensus where practical and in pinpointing true areas of disagreement. Proficiency is also demanded of the neutral expert when having to digest the varying opinions presented and chart a course toward building consensus short of disregarding the reports presented and starting anew.

As for the process of interfacing with the party experts, Mr. Hoshino recommends face-to-face sessions among the experts outside of the formal mediation process. Depending upon the complexity of the issues being confronted, this exercise may evolve over several follow-up sessions and requests for supplemental analysis. These "behind the scenes" peer-reviews establish the professional environmental and candor necessary for meaningful concessions – while avoiding the stilted opposition often imposed by the adversary process. Bearing this in mind, an attempt to hot-tub the party experts in a general session as part of the mediation itself is not recommended.

To preserve the integrity of the process, ex parte dialogue with the party experts is to be avoided. In final preparation for the mediation, the technical mediator should prepare a report highlighting areas of agreement, framing remaining points of divergence and proposing means of reaching further agreement or compromise. To avoid unnecessary conflict at the mediation, this report should be circulated to the party experts for an opportunity to note any additional challenges to the neutral expert's findings or distillation of the remaining points of disagreement.

- <u>Expert Determination</u>

Another expert-driven ADR model that can be successfully employed in the proper circumstance is an ad hoc expert recommendation or binding determination. When considering the optimal use of an expert in this capacity, we again spoke with Mr. Hoshino for additional perspective. As a threshold matter, a referral for expert determination should not be made on disputes that involve significant legal determinations, as this will undermine the legitimacy and effectiveness of the process. Embroiling a subject matter expert in the wrestling among counsel concerning legal controversies will place the expert in an unfamiliar circumstance and can threaten the finality of any resolution reached. Likewise, it is equally important to clearly define the technical matters which are being submitted for expert consideration. Careful consideration when drafting the parties' arbitration submission documents will avoid a host of mischief during the proceedings and when enforcing any binding determination. Clear agreement must be reached as to the matters being submitted to arbitration, the information that is going to be provided by the parties for informing the inquiry and the procedure for reaching the termination. The more explicitly the procedures are detailed, the better positioned the technical expert will be to resolve the technical issues and avoid procedural challenges along the way.

This expert-centered process can be readily utilized in instances where technical judgment is paramount, such as the completion of punch-list items and the satisfaction of performance standards. Expert determination is also successfully used when the parties' settlement efforts require the resolution of discrete technical issues causing an impasse.

Conclusion

The use of experts is often vital when resolving complex construction disputes. As such, all participants in the disputes process should be mindful of developments in the effective presentation of expert testimony. The practice of offering concurrent expert testimony or hot tubbing experts is gaining significant traction in international dispute resolution. The lessons learned from this expert-centered approach to dispute resolution are not only important when considering the presentation of expert testimony, but can also be adapted when considering the role of the expert in alternative ADR proceedings.

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CREDITORS' RIGHTS

When A Contractor Files For Bankruptcy: Will A Bankruptcy Court Apply The Law Of Equitable Subrogation Or Honor An Assignment Clause In A General Agreement Of Indemnity And Order That Remaining Contract Balances Belong To The Surety?

by Jennifer L. Kneeland, Partner

On April 10, 2018, I joined my colleagues Hanna L. Blake and Marguerite L. DeVoll in a presentation to bankruptcy attorneys at a meeting of the Northern Virginia Bankruptcy Bar Association. We were asked to address the following topic — *From a Surety's Perspective: When a Contractor Hits the Zone of Insolvency or Files for Bankruptcy.* Our objective was to educate bankruptcy attorneys about how sureties view the law of equitable subrogation and how most sureties have enhanced their rights with assignment clauses in their general agreements of indemnity. We were surprised to learn that over half of our audience was unfamiliar with the principle of equitable subrogation and harbored the initial belief that unpaid contract balances should be paid to the bankruptcy estate, rather than directly from the obligee to the surety.

It may come as no surprise that, at times, bankruptcy courts appear to be just as unfamiliar with the doctrine of equitable subrogation and are loath to enforce provisions in a general agreement of indemnity that potentially ruin a debtor-contractor's chances of making a good-faith attempt to reorganize in the bankruptcy court. Consequently, bankruptcy decisions that address equitable subrogation do not come out consistently in favor of the surety. If

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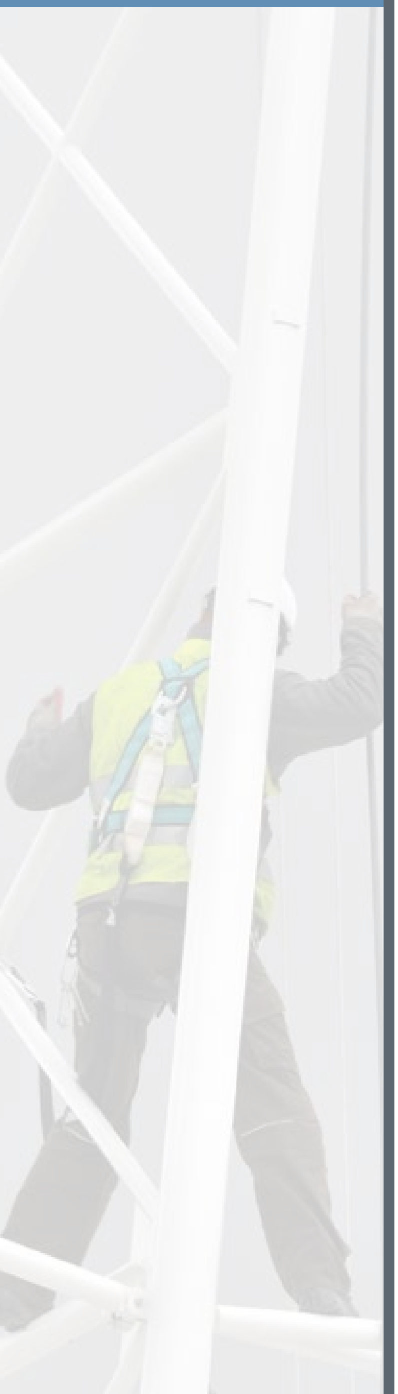
a bankruptcy court applies the law of equitable subrogation, then the remaining contract balance held by the obligee should be paid directly to the surety. In this case, the surety takes the remaining contract balance held by the obligee and the debtor-contractor's bankruptcy case is dead on arrival in the bankruptcy court without any cash to fund the reorganization or to pay creditors. The consequence of following the law of equitable subrogation or upholding an assignment clause in a general agreement of indemnity can be devastating to a bankruptcy case.



Guidance From The U.S. Supreme Court

The principle of equitable subrogation was first recognized by the U.S. Supreme Court in *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132 (1962). Decided under the Bankruptcy Act of 1978, the U.S. Supreme Court recognized the principle of equitable subrogation and its relationship to suretyship and bankruptcy law. The Supreme Court stated that "[t]he Bankruptcy Act simply does not authorize a trustee to distribute other people's property among a bankrupt's creditors." Applying the doctrine of equitable subrogation, the Supreme Court decided that when a surety has performed under a surety bond, money held by the U.S. Government on a terminated contract with its principal was not property of the principal's bankruptcy estate. Since the Supreme Court's holding in *Pearlman*, bankruptcy courts have applied its reasoning to varying results.

Whether A Bankruptcy Court Will Follow *Pearlman* May Depend On Where The Case Is Filed

It is well-established that when a contractor defaults under the terms of a public contract, the remaining funds that could be paid under the contract are ordinarily no longer owing to the contractor. Indeed, several courts have found that "[t]he law is clear that a surety under these circumstances has a right to the payments due the contractor to the extent of full reimbursement." *Kentucky Cent. Ins. Co. v. Brown (In re Larbar Corp.)*, 177 F.3d 439, 443 (6th Cir. 1999); *First Indem. of Am. Ins. Co. v. Modular Structures, Inc. (In re Modular Structures, Inc.)*, 27 F.3d 72, 77 (3d Cir. 1994); *In re Pac. Marine Dredging and Const.*, 79 B.R. 924, 929 (Bankr. D. Or. 1987). As a result, under the doctrine of equitable subrogation, the surety normally succeeds to the rights of the debtor-contractor to receive payment of any remaining funds held by the owner/obligee. *See Pearlman*, 371 U.S. at 138; *In re Jones Constr. & Renovation, Inc.*, 337 B.R. 579, 584 (Bankr. E.D. Va. 2006).

Some bankruptcy courts have followed these principles and determined that contract balances held by obligees after breach by a debtor-contractor are not property of the bankruptcy estate. For example, in *In re Pacific Marine Dredging*, an Oregon bankruptcy court found that a debtor-contractor failed to pay labor and material obligations. Consequently, the bankruptcy court ruled in favor of the surety and held that when the contractor/debtor breached the contract with the project owner, it lost any "legal or equitable interest" in the remaining sums due under the contract held by the project owner.

The Third Circuit reached a similar conclusion in *In re Modular Structures, Inc.*, 27 F.3d 72, 77-78 (3d Cir. 1993). The Third Circuit found that because the principal failed to fulfill its contractual obligations, either the funds held by the project owner should be paid to the surety (which is secondarily liable to subcontractors and suppliers under its payment bond) or made as "direct payments to the subcontractors" that remained unpaid by the principal contractor/debtor. Consequently, due to the contractor's breaches, the Third Circuit found that the principal contractor/debtor did not hold a property interest in the remaining funds and the funds "did not become a part of the estate in bankruptcy."

In addition to applying the doctrine of equitable subrogation, some bankruptcy courts have also enforced the surety's assignment clause in a general agreement of indemnity. These courts recognize that a pre-petition assignment clause in a general agreement of indemnity enhances a surety's rights to unpaid contract funds in the hands of the obligee. For example, in *In re Jones Constr. & Renovation, Inc.*, the bankruptcy court for the Eastern District of Virginia found that "although [the surety] enjoys the rights of equitable subrogation, it is also entitled to enhance and supplement those rights through the assignment provisions of the indemnity agreement." The bankruptcy court reasoned that the mere fact that the debtor filed for bankruptcy does not alter the parties' bargained for rights under state law. Rather, as the court noted, if pre-petition assignment clauses are valid under state law, then the proceeds of any assignment that vests rights in the assignee, *e.g.*, the surety, pre-petition are not property of the estate. As a result, the bankruptcy court held that the surety had an ownership interest in remaining contract funds under the pre-petition assignment clause, in addition to its equitable subrogation rights, which permitted the surety to recover contract balances on one project in excess of the losses for that specific project.

Unquestionably the Virginia bankruptcy court's decision in *Jones Construction* is music to a surety's ears. However, there are other bankruptcy court decisions that do not resonate quite as well. Recently, in 2016, the bankruptcy court for the Northern District of Illinois decided in *In re Glenbrook Group, Inc.*, 552 B.R. 735 (Bankr. N.D. Ill. 2016) that *Pearlman* had been superseded by the passage of the Bankruptcy Abuse and Prevention Act of 2005 ("BAPCPA") and that the principle of equitable subrogation no longer applies in bankruptcy cases. The court examined section 541 of the Bankruptcy Code, which defines what is property of a debtor's bankruptcy estate, and noted that the plain language of section 541(a)(1) and (d) instructs that any property in which the debtor has **the slightest interest** comes into the estate. The *Glenbrook Group* court concluded that BAPCA had expanded the definition of property of the estate. Consequently, the court reasoned that "the very things the [Supreme] Court states are not property of the estate in *Pearlman*, property subject to equitable interests, mortgages, liens, etc., are now included as property of the estate under § 541(d), albeit subject to any equitable interest." *Id.* Therefore, *Pearlman* was no longer binding precedent on the court. The bankruptcy court found that the debtor-contractor retained an equitable interest in the remaining contract funds held by the owner/oblige. As a result, the bankruptcy concluded that the remaining contract funds became property of the estate.

In reading the *Glenbrook Group* decision it occurs to me that the bankruptcy court simply did not appreciate that upon a contractor's default, well-established law clearly holds that the contractor loses all rights to unpaid contract balances because those rights vest fully with the surety. Therefore, the contractor simply has no rights (equitable or otherwise) to the remaining contract balance held by the owner/obligee. As a consequence, an examination of whether or not remaining contract funds are property of the debtor's estate is not the analysis that the court should have made.

Hanna Blake, Marguerite DeVoll and I were honored and delighted to provide the surety's perspective on this important area of bankruptcy law to the Northern Virginia Bankruptcy Bar Association. Given the troubling ruling by the *Glenbrook Group* court, we believe that it is important to continue to educate bankruptcy practitioners and judges regarding the intersection between surety law and bankruptcy law. We plan to take our show on the road in the upcoming months and are actively looking for places to make our presentation. If you would like us to present our discussion to your group, please let us know. We would be delighted to accept your request.

Do I Really Have To Give The Money Back? Preference Claims In Construction Bankruptcy Cases

by Marguerite Lee DeVoll, Associate

You just heard that the owner, general contractor, or higher-tiered subcontractor for whom you have been working has filed for bankruptcy. You breathe a sigh of relief thinking, "at least I was paid for all of my work before they filed," and move on to the next project. You later discover that you have been sued because some (or all) of those payments were "preferential" and must be returned. Surely, you do not have to give back the money, right? It depends.

The purpose of bankruptcy is to give debtors a breathing-spell while also leveling the playing field among all similarly-situated creditors, *e.g.*, unsecured creditors. Generally, when a debtor files for bankruptcy protection, it is in response to pressure from creditors and being unable to pay debts when they come due. However, prior to filing, a debtor may try to avoid the inevitable by keeping some of its creditors happy so that the debtor can continue to do business and avoid bankruptcy all together. As a result, the debtor may pay some of its creditors extra money or more often, enter into some other arrangement that treats one creditor more favorably than another similarly-situated creditor. Preference claims in bankruptcy are intended to address this "preferential" treatment of some creditors over others.

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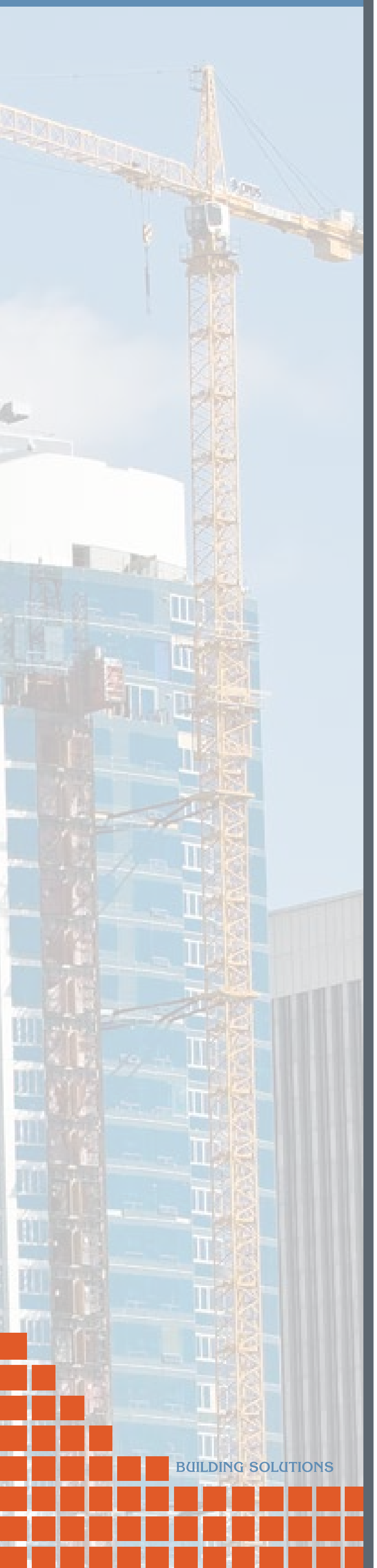

What Is A Preference Claim?

Section 547(b) of the Bankruptcy Code permits the debtor (in a chapter 11 case) or the trustee (in a chapter 7 case) to avoid or recover payments made to creditors (*e.g.*, the subcontractor) prior to the debtor's bankruptcy filing in certain situations. *See* 11 U.S.C. § 547(b). Specifically, if the debtor paid a creditor for amounts that the debtor owed within 90 days prior to the bankruptcy filing, there is a presumption that the payment was "preferential," and the creditor must return the money it received. The creditor, however, may still assert defenses to contest the alleged preferential payment.

As a side note, a debtor/trustee can also recover preferential payments made between 90 days and a year prior to the bankruptcy filing if the payments were made to insiders of the debtor, *i.e.*, the president, CEO, or managing member. While there is some overlap, this article focuses on the defenses for non-insider payments specifically in the context of construction projects.

Some Common Defenses To A Preference Claim

- <u>The Trust Fund Defense</u>

Under section 547 of the Bankruptcy Code, a debtor/trustee can only recover money that is "property of the estate," *e.g.*, money that belong(s/ed) to the debtor and not someone else. Money held in trust by the debtor for the benefit of another is not considered "property of the estate." Consequently, subcontractors defending against a section 547 preference claim commonly argue that the money paid by the debtor was not the debtor's property at all. In other words, the debtor paid the subcontractor from funds held in trust by the debtor for the subcontractor's sole benefit.

State law determines what constitutes a trust. In most states, the necessary requirements to establish a trust are: (1) a trustee; (2) a beneficiary; and (3) an identifiable trust property (the "*res*"). In construction cases, subcontractors have relied upon two sources to establish the existence of a trust: the state's construction fund statute and/or the language in the prime contract and subcontract.

Many state legislatures drafted construction fund statutes with the express intention of creating a trust to protect higher-tiered subcontractors (and sometimes, lower-tiered subcontractors and suppliers) from non-payment for work performed or materials supplied on a project. Generally, these statutes provide that a contractor must hold in trust all money paid by the owner for the benefit of the subcontractors that performed work or supplied labor. This same rule obligates higher-tiered subcontractors to hold in trust all money for their lower-tiered subcontractors and suppliers.

In many states, the language in these trust fund statutes would satisfy the common law requirements for establishing a trust. There is a trustee, *e.g.*, the contractor or higher-tiered subcontractor. There is identifiable trust property: the money paid by the owner (or contractor). And, there is a beneficiary: the subcontractors (or lower-tiered subcontractors and suppliers) who performed work or supplied materials for the project.

Sometimes prime contracts (and subcontracts) contain language similar to state construction fund statutes. Depending on the language in the contracts, the language may meet the requirements under state law for establishing a trust, and thus, provide an additional ground for asserting that the money paid to the subcontractor was money from a trust.

Establishing a trust, however, is only one part of the analysis. Oftentimes, debtor contractors receive payments from owners and deposit all funds into a single, general operating account, co-mingling the "trust funds" with the debtor contractor's other non-trust monies. As a result, bankruptcy courts have required the defendant subcontractor claiming that the money is "trust funds" to engage in a tracing analysis: the defendant subcontractor must show that the money it received from the contractor can be traced back to the identifiable money the contractor received from the project owner for the purposes of paying the subcontractor. If the money cannot be traced back to the project owner's payment, then courts have held that the defendant subcontractor cannot establish that the money is not "property of the estate" for purposes of establishing a defense to a section 547 claim.

- <u>The Debtor Received "New Value"</u>

Another common defense available to all defendants to a preference claim is the "new value" defense. The "new value" defense is a statutory defense available under section 547(c)(1). Under this defense, a defendant subcontractor can avoid having to return its payments if it can show that it gave "new value" in exchange for the payment. For example, if the subcontractor only continued to perform under the subcontract upon payment, and did indeed perform, a court may find that the subcontractor provided “new value” to the debtor contractor.

Subcontractors have also successfully claimed that they provided “new value” by executing a lien release in exchange for the payment. For example, a lien release given at or around the payment may constitute new value to the debtor depending on the circumstances surrounding the payment. The facts of each lien release and subsequent payment will determine the availability of this defense. Bankruptcy courts, however, have found that a lien release given in advance of the payment does not constitute new value to the debtor. Under this scenario, bankruptcy courts have found that, if a project owner has made final payment to the debtor contractor when the subcontractor was paid and released its lien, then there was no new value to the debtor. The value – the lien release – provided by the subcontractor did not flow to the debtor contractor, but flowed to the owner.

If, however, the project owner retained project funds, the subcontractor’s lien release may constitute new value. To illustrate, when a project owner retains funds and a subcontractor still has a lien claim, then the project owner could pay the subcontractor to obtain the lien release and offset that payment against what the owner owes to the debtor contractor. If, instead, the debtor contractor pays the subcontractor directly and obtains the lien release, then the project owner would pay what it owes the debtor contractor in full for that subcontractor. As a result, the subcontractor may have given new value to the debtor contractor indirectly by virtue of its lien release because the lien release entitled the debtor contractor to be paid in full by the project owner.

- <u>The Payments Were Made In The “Ordinary Course”</u>

Section 547(c)(2) of the Bankruptcy Code provides another potential statutory defense for defendants to a preference claim – the ordinary course defense. *See* 11 U.S.C. § 547(c)(2). As its name suggests, the ordinary course defense examines the debtor’s relationship with the defendant subcontractor. If the defendant subcontractor can establish that the payments were made in the ordinary course under one of two tests, then the bankruptcy court may find that the defendant subcontractor can keep its money.

Under the first test, the so-called “subjective prong,” bankruptcy courts examine whether the payments at issue are consistent with the ordinary course of affairs between the defendant subcontractor and the debtor contractor. Several factors are considered in this analysis: the length of the relationship; the frequency of the payments; the amount of past payments (where they full or partial payments); the method of payment (wire, cash, check); whether there was any unusual collection activity, such as demands for payment; and whether the defendant subcontractor took advantage of the debtor contractor’s weak financial condition. The circumstances of the prior payments are then compared to the payments at issue. If the payments at issue are similar to the other payments, then the defendant subcontractor may be able to claim that the payments at issue were in the ordinary course of its affairs with the debtor contractor.

Under the second test, the “objective prong,” bankruptcy courts examine whether the payments at issue were made according to ordinary business terms. If the payments are consistent with industry terms, then a defendant subcontractor may have a defense to the section 547 preference claim.

Conclusion

Oftentimes a debtor or the trustee, faced with pressure from creditors or a looming statute of limitations, will bring a section 547 preference action or make a demand for payment without examining the merit of the claim. The law provides for several different defenses to the defendant subcontractor: the trust fund defense, the new value defense, and the ordinary course defense. These defenses are non-exhaustive and other defenses may exist depending on the individual facts of the case. Depending on the facts of your case, you may not have to give your money back.

Frank J. Marsico

Bonded Contractor's Lender – Not A Holder In Due Course As To Bonded Construction Trust Funds

by Frank J. Marsico and John E. Sebastian, Senior Partners

John E. Sebastian

Introduction

Throughout the United States, federal and state courts have consistently held that a lending bank's security interest under Article 9 of the Uniform Commercial Code ("UCC") does not and cannot attach to trust funds held in its contractor borrower's account at the bank. Courts have reached that conclusion even when construction project trust funds are comingled with non-trust funds in the same account. On that basis, courts have held that a surety's equitable subrogation rights to project trust funds on bonded construction projects are superior to a lending bank's UCC security interests.

In a recent case in the United States District Court for the Northern District of Illinois, *Travelers Casualty and Surety Co. of America v. John P. Paderta and Fifth Third Bank*, No. 10 C 406, 2018 WL 1535117 (N.D. Ill. Mar. 29, 2018), the court addressed two related issues. First, the court addressed whether the "holder in due course" rule under Article 3 of the UCC applies to a lending institution acting as a collecting bank on a bonded construction project. Specifically, the court addressed whether defendant Fifth Third Bank ("Fifth Third") was a "holder in due course" with regard to checks deposited into its borrower's account (i.e., the bonded contractor's account), *after* the lending bank collected the proceeds of the checks from the project owners' banks and credited the proceeds to its borrower's account. Second, the court addressed whether the collecting bank, assuming it was a "holder in due course," could take the checks "without notice" of any superior claims by its borrower's surety, plaintiff Travelers Casualty and Surety Company of America ("Travelers").

As discussed in detail below, the court ruled in favor of Travelers (represented by Watt Tieder) as to both issues and granted Travelers' Motion for Summary Judgment against Fifth Third.

Factual Background

Krahl Associates, Inc. d/b/a Krahl Construction ("Krahl") entered into contracts with various public and private construction project owners located primarily in Illinois and Colorado, whereby such contracts required Krahl to obtain surety performance and payment bonds (which were ultimately issued by Travelers in exchange for Krahl entering into an Indemnity Agreement with Travelers). The Indemnity Agreement, consistent with universal surety industry custom and practice, required that Krahl treat all bonded construction project funds that it received from the project owners as trust funds for the benefit of Krahl's subcontractors.

On January 5, 2010, the FBI executed a search warrant upon Krahl's Chicago headquarters in connection with allegations of fraud on a data center project. Shortly after Fifth Third (which had previously loaned approximately $6 million to Krahl) learned of the FBI's raid upon Krahl's headquarters, it requested and conducted several meetings with Krahl's representatives to discuss how Krahl planned to continue to generate positive cash flow and operate, notwithstanding the future impact of the government's fraud allegations. After these meetings, Fifth Third did not believe that Krahl sufficiently addressed the concerns. Therefore, on January 8, 2010, Fifth Third set off the entire $3,086,931.05 balance contained in Krahl's business demand deposit account in order to satisfy Krahl's obligations to Fifth Third.

Shortly after the bank's set off, Travelers received a number of payments and performance bond claims on Krahl's bonded projects. Travelers notified Fifth Third that a substantial portion of the $3,086,931.05 in Krahl's account as of January 8, 2010 was comprised of bonded project trust funds (by virtue of the Krahl-Travelers Indemnity Agreement, as well as Section 21.02 of the Illinois Mechanics Lien Act and Section 38-26-109 of the Colorado Bond Act) and demanded that Fifth Third turn over all such trust funds to Travelers, as equitable subrogee to Krahl (as trustee for said funds), and Krahl's subcontractors (the beneficial owners of such trust funds, by virtue

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of supplying labor, materials and supplies to the bonded construction projects).

Fifth Third refused to turn over any portion of the trust funds to Travelers, based in part upon the following: 1) the bonded project funds in question were deposited into Krahl's account by means of checks written by bonded project owners and payable to Krahl; 2) as a result of Krahl's deposit of the checks into its account at Fifth Third, Fifth Third "took" and became a "holder" of the checks "for value" (i.e., given that Fifth Third previously loaned approximately $6MM to Krahl); and 3) Fifth Third had no "actual knowledge" of the trust fund nature of the checks from the bonded project owners, given that: a) the account in question was not specifically designated as a trust account; b) Fifth Third claimed that it lacked *actual knowledge* that the proceeds of such checks consisted of express/statutory trust funds; and c) the proceeds of such checks (trust funds), when deposited into the account in question, were comingled with non-trust funds.

Applicability Of "Holder In Due Course" Rule

The court first recognized the general rule that a "holder in due course" of an instrument (check) has a superior right against other competing claimants to that same instrument. The court also noted that neither of the parties challenged Fifth Third's right to have received and taken title to the proceeds of the checks (from the project owners' banks) *in the first place*.

The court noted, however, the following undisputed chain of events: 1) after Krahl deposited the checks into its account, Fifth Third, as collecting bank, presented and returned the checks to the bonded project owners' banks for payment (through the normal check clearinghouse process); 2) the project owners' banks then made payment for the checks to Fifth Third (as collecting bank for said checks); 3) upon Fifth Third's receipt of payment from the project owners' banks, Fifth Third then fully credited Krahl's account in amounts corresponding to the face value of the checks; and 4) upon the completion of the foregoing events *prior to January 8, 2010*, Fifth Third could no longer be considered a "holder" of any such *returned and paid* checks, which in turn precluded "holder in due course" status *as a matter of law*. The court explained:

> This is not an argument over the right to the account funds as proceeds of the checks (to which the holder in due course doctrine would be relevant), but the right to the account funds as between Krahl and Fifth Third each as creditor and debtor (Krahl as creditor of its account and debtor on its loan, and Fifth Third as debtor on the account and creditor on the loan). The holder in due course doctrine is not relevant to this issue.

What Constitutes "Notice" Under UCC Article 3?

The court then explained how even if the holder in due course doctrine was somehow relevant, Fifth Third still could not avail itself of "holder in due course" status given that it had "notice" of Travelers' claims to the checks from the bonded project owners. The court rejected Fifth Third's argument that only "actual knowledge" of the trust fund nature of the deposited funds could defeat its claimed holder in due course status. Instead, UCC Sections 3-302(a)(2)(v) and 1-202(a) (as enacted in Illinois) provide that a person has "notice" of a fact if the person: 1) has actual knowledge of it; 2) has received a notice or notification of it; *or* 3) from all the facts and circumstances known to the person at the time in question, has reason to know that it exists. The court explained:

> And the Court holds that no reasonable jury could find that Fifth Third did not have constructive knowledge that there were equitable trust claims to the funds in Krahl's account. There is no dispute that Fifth Third knew that much of Krahl's business required surety bonds....It is possible that when Fifth Third took the funds in Krahl's account it did not know specifically how much of those funds were bonded. But Krahl knew that some of the funds were bonded because it received monthly reports with this information, and it used this information to adjust Krahl's credit... Fifth Third could have identified the trust funds with reasonable diligence. The evidence is sufficient to grant summary judgment in Travelers' favor.

Based in part upon the foregoing analysis, the court held that Travelers sufficiently established its claims for conversion of the trust funds (Count I of Travelers' Second Amended Complaint) and constructive trust (Count II).

In conclusion, banks considering a claimed right of setoff against their bonded contractor borrowers' accounts (even if not specifically designated as trust accounts) should take notice of the surety's broad rights of equitable subrogation, regardless of whether the bank's anticipated defenses to the surety's claims are based upon Article 9 or Article 3 of the Uniform Commercial Code.

Security Clearances: An Easier Process Than You Thought

by Scott P. Fitzsimmons, Senior Partner

Government contractors often require access to classified information to perform their job. Therefore, they must seek security clearances for their company and their employees. Applying for a clearance may appear daunting, but the process is not as difficult as it seems. This article briefly addresses the security clearance process for companies and individuals, provides recent updates on the procedures, and discusses new case law in the security clearance process.

Levels Of Clearance

The Department of Defense (DoD) issues over 80% of national security clearances and recognizes three levels: "Confidential" is information that could cause *damage* to the national security; "Secret" is information that could cause *serious damage* to the national security; and, "Top Secret" is information that could cause *exceptionally grave damage* to national security. Individuals and companies may be issued clearances at each of these levels depending on their work requirements.

Facility v. Personnel Clearances

A difference exists between a clearance for a company and a clearance for specific individuals. A company may obtain a security clearance by being sponsored by a federal agency or another cleared contractor. For example, a company working with DoD or a prime contractor may require a clearance for their work. A company's clearance is a "Facility Security Clearance" or FCL. A facility clearance is an administrative determination that a facility is eligible for access to classified information at a certain classification level. A "facility" is defined as a plant, laboratory, office, college, university, or commercial structure with associated warehouses, storage areas, utilities, and components, that, when related by function and location, form an operating entity. Companies requesting a FCL submit their applications electronically in the e-FCL program managed by the Defense Security Service (DSS).

DSS is implementing a new program, the National Industrial Security System (NISS), to replace e-FCL. DSS planned to fully implement NISS in 2017; however, delays have caused e-FCL to remain the system of record for FCL applications.

Process For Facility Clearance

Obtaining a FCL begins with a request from an agency or cleared contractor and is managed by DSS, which will visit to review your business's organizational documents. The company must identify a Facility Security Officer responsible for managing the company's clearance. Key Management Personnel (KMP) of the business must also obtain Personnel Security Clearances (PCL). KMP often include company executives who will work on the project, and some personnel may be excluded from KMP. The final step in the process is the execution of several documents, including a DoD Security Agreement (DD Form 441), in which a company agrees to abide by all security laws and regulations.

Process For Personnel Clearances For Government Contractor Employees

The application process for an individual security clearance begins with a SF86 Security Clearance Questionnaire or an Electronic Questionnaire for Investigations Processing (EQIP), which requests extensive personal history including education, places of residence, employment history, criminal record, drug use, etc. The agency then requests a personal background investigation, which may include interviews with your co-workers, neighbors and references. Finally, you may be interviewed by a federal investigator.

If no negative information is found, the applicant is often given an interim clearance. Adjudicators at the DoD Central Adjudication Facility (DoD CAF), along with the requesting agency, will determine eligibility. If a clearance is granted, an electronic entry is made in the Joint Personnel Adjudication System (JPAS). If DoD CAF determines that issuing a clearance is not in the interest of national security, they will refer the clearance request to the Defense Office of Hearing and Appeals (DOHA).

Revised Adjudication Standards

Security Executive Agent Directive 4 (SEAD 4), effective June 8, 2017, revised the adjudication guidelines used to make security clearance eligibility determinations. These revised standards include: A) Allegiance to the United States; B) Foreign Influence; C) Foreign Preference; D) Sexual Behavior; E) Personal Conduct; F) Financial Considerations; G) Alcohol Consumption; H) Drug Involvement and Substance Misuse; I) Psychological Conditions; J) Criminal Conduct; K) Handling Protected Information; L) Outside Activities; and M) Use of Information Technology. These guidelines are used across the federal government to evaluate all security clearance applicants.

The Appeal Process

If a clearance is denied, the individual receives a "Statement of Reasons" (SOR) explaining why it is not in the national security interest to grant the clearance. An applicant has 20 days to respond to the SOR and to request a hearing before an Administrative Judge (AJ). An applicant should always request a hearing – cases decided without hearings are significantly more likely to be denied. After the hearing, the AJ issues a final decision, which may be appealed to the DOHA Appeal Board. The denial of a security clearance is an administrative matter and generally cannot be appealed to a federal court absent proof that the decision was arbitrary, capricious, an abuse of discretion or otherwise contrary to the law.

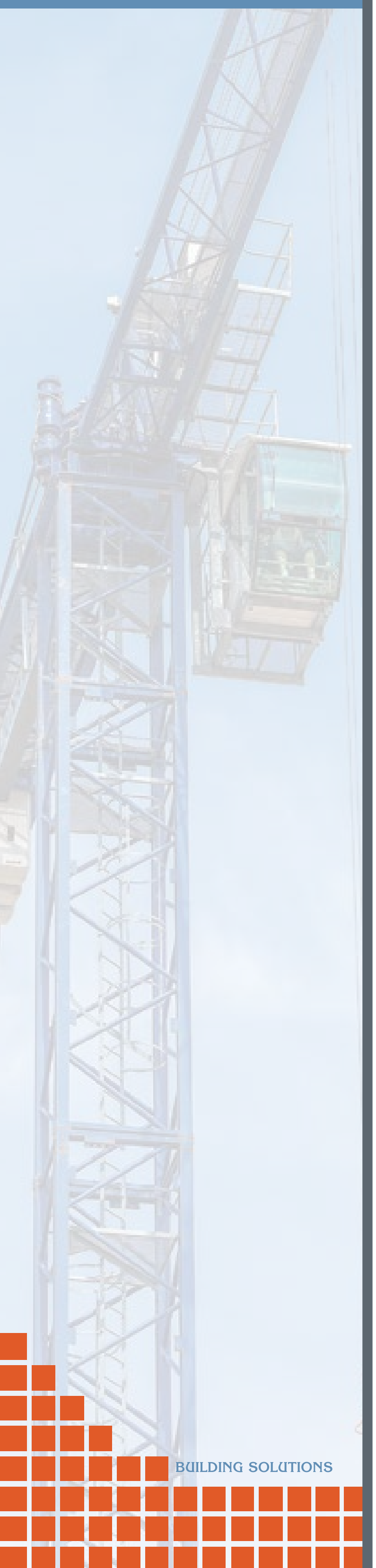
Recent DOHA decisions shed light on DOHA's approach to evaluating clearances. DOHA evaluates an applicant's eligibility for a security clearance using the "whole-person" concept by considering the totality of an applicant's conduct and all relevant circumstances. Accordingly, an individual will not automatically be denied a clearance if the initial reason for the denial has mitigating factors. Recently, DOHA has granted security clearances to three individuals who: (1) incurred delinquent medical debts and defaulted on a home equity loan (ISCR Case: 16-00539, Oct. 13, 2017); (2) improperly entered work hours and used marijuana (ISCR Case: 16-02352, Oct. 19, 2017); and, (3) had three delinquent student-loan accounts and two medical collections, and one delinquent consumer debt (ISCR Case: 15-08837, Oct. 20, 2017). In each case, the individual proved mitigating factors which allowed a clearance to be granted.

After Receiving A Clearance

After an applicant obtains a security clearance, she will be monitored for compliance. Re-investigations are required every five years for top secret clearances, every ten years for secret clearances, and every fifteen years for confidential clearances. Persons holding clearances, however, may be randomly investigated at any time. Additionally, all persons with security clearances have a duty to inform their FSO whenever adverse information affecting their clearance arises.

Conclusion

This article provides only a brief description of the security clearance procedures. However, armed with an understanding of the process, government contractors can successfully obtain personnel and facility clearances. Throughout the application process, remember the goal of security clearances: to ensure that applicants are able and willing to safeguard classified national security information. With that goal in mind, applicants should be honest, up-front about adverse information, eager to prove their loyalty, character, trustworthiness, and reliability, and ready to cooperate with the government at every step.



FIRM NEWS

Honors

Chambers USA Guide To America's Leading Lawyers For Business

Watt, Tieder, Hoffar & Fitzgerald, L.L.P. is recognized in the 2018 edition of **Chambers USA Guide to America's Leading Lawyers For Business** as a Band Two Construction Law Firm in the United States. Chambers and Partners has consistently named **Watt Tieder** and its attorneys among the top construction firms and attorneys both nationally and regionally since 2004.

Chambers also recognized the McLean, Virginia office as a Band One firm and the Irvine, California office as a Band Four construction law practice. The following **Watt Tieder** attorneys are recognized as leaders in their field for Construction Law: **Lewis J. Baker, Robert M. Fitzgerald** and **Robert C. Niesley.**

Super Lawyers

Watt Tieder is pleased to announce that its attorneys have once again been recognized by **Super Lawyers 2018**. **Super Lawyers** is an annual listing of lawyers who have achieved a high level of peer recognition and professional merit. Over seventy practice areas are evaluated during the selection process. Super Lawyers Magazine, published by Law and Politics, a division of Key Professional Media, Inc., is distributed nationwide.

The following **Watt Tieder** attorneys were named as 2018 Super Lawyers:

- McLean, Virginia – **Lewis J. Baker**, **Robert M. Fitzgerald**, **Vivian Katsantonis** and **Jennifer L. Kneeland**
- Irvine, California – **Robert C. Niesley**
- Chicago, Illinois – **John Sebastian**
- Miami, Florida – **Mariela Malfeld**

Recent and Upcoming Events

Northern Virginia Bankruptcy Bar Association, April 10, 2018; Fairfax, VA; **Hanna L. Blake**, **Jennifer L. Kneeland**, and **Marguerite L. DeVoll** presented on the topic "From a Surety's Perspective: When a Contractor Hits the Zone of Insolvency or Files for Bankruptcy."

Western States Surety Conference, April 20, 2018; Seattle, WA; **Christopher M. Bunge** spoke on developments in California surety law.

Bankruptcy Bar Association for the District of Maryland's 22nd Annual Spring Break Weekend, May 4, 2018; Annapolis, MD; **Jennifer L. Kneeland** served as moderator for the "Judges' Round Table on Business Bankruptcy Topics."

Bankruptcy Bar Association for the District of Maryland's 22nd Annual Spring Break Weekend, May 5, 2018; Annapolis, MD; **Marguerite L. DeVoll** served as a panelist discussing "Recent Case and Rule Developments in Business Bankruptcy Cases."

American Road & Transportation Builders Association ("ARTBA") 10th Annual Transportation Construction Law & Regulatory Forum, June 5-6, 2018; Washington, D.C.; **Christopher J. Brasco** and **Kathleen O. Barnes** will present on "10 Risk Management Hacks that Will Change Your Approach to Projects."

2018 Midwest Surety & Construction Claims Conference, July 18-19, 2018; Chicago, IL; **Watt Tieder** is co-sponsoring the event. July 18th includes a half-day seminar with a presentation on "Construction Documentation: Successfully Managing Risk and Preserving Claims." July 19th includes an all-day seminar entitled "Comprehensive Review of the Surety's Defenses on Performance Bond Claims."

ABA Fidelity and Surety Law Fall Conference, November 7-9, 2018; Philadelphia, PA; **Frank J. Marsico** will present on new/recent case law developments.

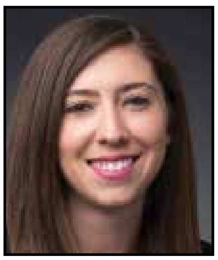
Announcement

Marguerite L. DeVoll was elected Co-Membership Chair for the board for the Greater Maryland Network for the International Women's Insolvency and Restructuring Confederation.

Publications

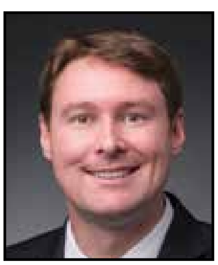
"Current Challenges Facing Contractors under Recent Changes to Domestic Preference Programs," Procurement Lawyer, Volume 53, Number 2; **George Stewart and Dominick Weinkam, co-authors.**

Watt Tieder Welcomes Two New Associates



Sarah K. Bloom joins the McLean, Virginia office. She focuses her practice on government contracts and construction litigation. Prior to joining the firm, Sarah served as agency counsel for the U.S. Department of Justice, Federal Bureau of Prisons. She has represented the Government in bid protests and contract disputes before the Government Accountability Office, the Civilian Board of Contract Appeals, and the U.S. Court of Federal Claims.

Sarah graduated with honors from The George Washington University Law School. While she was a student, she served on the Public Contract Law Journal and interned at the D.C. Superior Court.



John F. Finnegan, III also joins the McLean, Virginia office. John focuses his practice on construction and commercial litigation, government contracts, and suretyship law, representing owners, contractors, subcontractors, and sureties in federal and state courts as well as before administrative boards.

Prior to joining Watt Tieder, John practiced at a New Jersey-based law firm for over four years, where he represented private companies and public entities in commercial and employment matters. John obtained successful outcomes for his clients, which included higher education institutions and insurance companies, in federal and state courts, and negotiated favorable settlements in a cost-effective manner. In addition to his litigation background, John has significant experience drafting complex agreements and conducting internal investigations.

Upon graduation from Seton Hall University School of Law, John served two consecutive one-year clerkships for the Honorable Dorothea O'C. Wefing, Acting Associate Justice of the Supreme Court of New Jersey, and thereafter for the Honorable Michael A. Hammer, U.S. Magistrate Judge, District of New Jersey.

During law school, John was, among other distinctions, an editor and member of the Seton Hall Law Review, completed an externship at the U.S. Attorney's Office, D.N.J., and clerked in the in-house legal department at Valley National Bank.

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WATT TIEDER

WATT, TIEDER, HOFFAR & FITZGERALD, L.L.P.

Attorneys at Law

PRSRT STD
US POSTAGE
PAID
PERMIT #6418
DULLES, VA

WATT TIEDER

WATT, TIEDER, HOFFAR & FITZGERALD, L.L.P.

1765 Greensboro Station Place, Suite 1000
McLean, Virginia 22102

1765 Greensboro Station Place
Suite 1000
McLean, Virginia 22102
(703) 749-1000

2040 Main Street
Suite 300
Irvine, California 92614
(949) 852-6700

1200 Brickell Avenue
Suite 1800
Miami, Florida 33131
(305) 777-3572

10 South Wacker Drive
Suite 2935
Chicago, Illinois 60606
(312) 219-6900

1215 Fourth Avenue
Suite 2210
Seattle, Washington 98161
(206) 204-5800

HFK Rechtsanwälte*
Maximilianstrasse 29
D-80539 Munich, Germany
Phone 011 49 89 291 93 00

Independent Law Firm

Global Construction & Infrastructure
Legal Alliance
91, rue du Faubourg Saint-Honoré
75008 Paris, France
Phone 33 (0)1 44 71 35 97

The Watt, Tieder, Hoffar & Fitzgerald newsletter is published quarterly and is designed to provide information on general legal issues that are of interest to our friends and clients. For specific questions and concerns, the advice of legal counsel should be obtained. Any opinions expressed herein are solely those of the individual author.

Special Thanks to Editors, **Robert G. Barbour**, **William Groscup**, **Christopher M. Harris** and **Robyn N. Burrows**.

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