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**OPENING THE DOOR TO DISCOVERY OF A SURETY'S FILES  
IN SURETY AND FIDELITY LITIGATION:  
RELEVANCY CONSIDERATIONS IN DISPUTES INVOLVING  
SURETY-SPECIFIC CLAIMS AND DEFENSES**

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Sureties routinely maintain several distinct files, including underwriting and claim files, with respect to each bonded principal and/or project. Because some of these files contain confidential and proprietary information, sureties often have an interest in protecting them from unnecessarily-intrusive discovery requests made by an adversary in litigation. A surety may be successful in avoiding such unwanted discovery by objecting based upon the lack of relevancy of the requested documents, an objection that is often asserted in conjunction with claims of attorney-client privilege or work product.

A surety's obligation to disclose its internal records could depend, in part, upon decisions made by the surety in investigating and responding to a bond claim prior to litigation or in framing its claims or defenses in its initial pleadings. In formulating its strategy, sureties should account for the potential discovery consequences that could arise from these initial strategy decisions. They should understand the arguments that can be made to protect sensitive internal files from discovery and the types of claims and defenses that could ultimately open the door to the discovery of these documents.

Part I of this paper introduces the concept of relevancy by defining the term under the Federal Rules of Civil Procedure and related case law. Part II of this paper examines the types of internal files commonly maintained by sureties, and analyzes potential arguments that may justify withholding these documents from discovery based upon a lack of relevancy. Part II specifically addresses underwriting files, claim files (which would encompass information on reserves, salvage, the investigation, and procedures), reinsurance information, and indemnity agreements. Part III analyzes the extent to which special circumstances, such as an obligee's bad faith claim or a surety's assertion of impairment of suretyship may give rise to relevancy arguments pertaining to a surety's most sensitive internal records, thereby result in the disclosure of such information. Part IV addresses specific discovery issues that a surety may encounter in fidelity bond litigation.

## **I. Defining Relevancy for Discovery Purposes.**

The Federal Rules of Civil Procedure (and most state rules) establish a broad, yet not unlimited, framework for discovery in litigation. In crafting their discovery requests and conducting depositions, parties may seek discovery of "any matter, not privileged, that is relevant to the claim or defense of any party." Fed. R. Civ. P. 26(b)(1). Information that is relevant for discovery purposes need not be admissible at trial as long as it is "reasonably calculated to lead to the discovery of admissible evidence." *Id.* Courts have construed this standard liberally to permit parties broad access to all information that may bear on any issue that is, or may be, in dispute in a case. See Oppenheimer Fund, Inc. v. Sanders, 437 U.S. 340, 351 (1978); Bacon v. Smith Barney Shearson, Inc., 938 F. Supp. 98, 104 (D.N.H. 1996); Marker v. Union Fid. Life Ins. Co., 125 F.R.D. 121, 124 (M.D.N.C. 1989). As indicated in Rule 26(b)(1), relevance in discovery is not limited by considerations of evidentiary admissibility. Quaker Chair Corp. v. Litton Bus. Sys., Inc., 71 F.R.D. 527, 531 (S.D.N.Y. 1976); see also Democratic Nat'l Comm. v. McCord, 356 F. Supp. 1394, 1396 (D.D.C. 1973); United States v. Meyer, 398 F.2d 66, 76 (9th Cir. 1968).

Despite the expansive scope of discovery allowable under Rule 26(b)(1), courts and parties are constricted by certain considerations in the Rules that may preclude the discovery of otherwise relevant information. On motion or in its own discretion, a court may limit an item of discovery if it is found to be unreasonably cumulative or duplicative; if the information is

obtainable from a more convenient, less burdensome, and less expensive source; if the party seeking discovery has had ample opportunity to obtain the information earlier in the litigation; or if “the burden or expense of the proposed discovery outweighs its likely benefit, taking into account the needs of the case, the amount in controversy, the parties’ resources, the importance of the issues at stake in the litigation, and the importance of the proposed discovery in resolving the issues.” Fed. R. Civ. P. 26(b)(2)(C). In addition, claims of attorney-client or work product privilege can successfully shield otherwise probative information from discovery.

In the surety context, several courts have emphasized the Federal Rules’ broad standard of relevance in granting discovery of surety files. See Fid. & Deposit Co. of Md. v. County of Lake, 1998 U.S. Dist. LEXIS 19247, at \*5 (N.D.Ill. Dec. 2, 1998) (finding that a surety’s underwriting files were relevant given the “liberal federal discovery rules”); Green Constr. Co. v. Kan. Power & Light Co., 732 F. Supp. 1550, 1554 (D. Kan. 1990) (noting the “broad nature of relevancy for discovery purposes” in ordering the production of a surety’s bond forms). While courts have liberally applied the federal discovery standard in surety cases, they have entertained good-faith arguments by sureties based on the undue burden and expense of producing certain files, see Green, 732 F. Supp. 1550, or based upon claims of privilege or work product. See Aetna Cas. & Sur. Co. v. Manshul Constr. Corp., 2001 WL 484438 (S.D.N.Y. May 7, 2001); City of Elmira v. Larry Walter, Inc., 89 A.D.2d 645 (N.Y. App. Div. 1982).

Several decisions, including cases discussed in the next section, seem to suggest that there is a correlation—at least implicitly—between documents that have only tenuous relevancy to a dispute and the likelihood that a court will sustain an objection based upon other grounds, such as undue burden, privilege, or work product. Thus, while the standard for relevancy is broad, a well-reasoned relevancy objection may lend further credibility to one of the other myriad discovery objections. See, e.g., Rhone-Poulenc Rorer Inc. v. Home Indem. Co., 139 F.R.D. 609, 613-14 (E.D. Pa. 1991) (finding that information related to reserves is of “very tenuous relevance, if any relevance at all” and constitutes work product). The next section further explores what grounds may exist to assert a lack of relevancy objection to the discovery of internal surety files.

## **II. Files Commonly Maintained and Important Discoverability Considerations.**

### **A. Underwriting Files**

Underwriters typically review and analyze company-specific information to determine whether to issue bonds on behalf of a contractor. Thus, a surety creates an underwriting file that generally pertains to the financial strength of a bond principal. In evaluating a new account, an underwriter will assess several factors, which often include the financial history and performance of the company, the types of projects and work the contractor has performed, the nature of the specific project for which the bond is requested, the contractor’s management systems, its references, banking and insurance relationships, and related factors. Underwriting files also typically contain information related to the contractor’s financial condition based on year-end corporate financial statements, income statement, work-in progress schedules, accounts receivable/payable, and personal financial statements.

The types of documents reviewed and often maintained in an underwriting file may include: (i) full identification information on the principals, including addresses and telephone numbers; (ii) a questionnaire signed by the indemnitors (this can include financial information and projections, job profit analysis and detailed description of the principal's business); (iii) company financial statements prepared by a CPA; (iv) personal financial statements of individual indemnitors and information on collateral; (v) insurance policies; (vi) work in progress reports/updates on work in hand; (vii) credit/loan agreements; (viii) references; (ix) additional information on assets; and (x) information about bond obligees for specific projects.

Sureties often have an interest in protecting the contents of underwriting files from discovery—often due to pressure exerted by their principals—based upon the confidential and sensitive nature of these documents. Moreover, the surety's underwriting file might contain proprietary information related the financial risk assessment that undergirds its unique bonding program, including the proprietary calculus that the surety employs to underwrite its own risk.

There is no bright-line rule respecting the discoverability of the underwriting file, but the outcome is likely to depend on the types of claims and defenses asserted by the parties in litigation. In the insurance context, courts have suggested that relevancy is not a mere formality by declining to order discovery of underwriting files where the claimant was unable to make a cogent argument for relevancy. See, e.g., McCullough v. Fidelity & Deposit Co., 2 F.3d 110, 113 (5th Cir. 1993); see also Arkwright Mut. Ins. Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh, 1994 WL 510043, at \*18 (S.D.N.Y. 1994) (limiting discovery of underwriting files to those specifically pertaining to the claim at issue). Sureties often argue that the contents of their underwriting files have no relevance in a standard breach of bond claim, while obligees typically argue that the financial information contained in a surety's underwriting files is relevant to explain why a principal may have defaulted on its obligations.

Certain claims or defenses, however, could cause these files to become relevant to a particular dispute. A surety's defense of material alteration of its bonded risk or its principal's claim for loss of bonding capacity damages may open the door to an inquiry into the surety's original assessment of the risk posed by the bond principal. An obligee's claim of bad faith or fraud against the surety may also prompt a court to expand the concept of relevancy to encompass the surety's motives and the propriety of its internal decision-making process. The prospect of potentially expansive discovery, therefore, may provide additional justification to seek the dismissal of tenuous bad faith or fraud claims at the onset of litigation.

## **B. Claim Files**

In addition to its underwriting files, sureties also maintain claim files, which, unlike underwriting files, are generally project-specific. A claims file generally contains, among other things, information related to reserves and salvage and documents related to the surety's investigation. Claim files also commonly contain procedures or manuals that set forth the policies and steps followed when evaluating a claim. This kind of information is arguably confidential and proprietary as it outlines the claims evaluation processes unique to each surety company. Notwithstanding, these files are frequently requested as part of standard document production requests.

### **1. Reserves**

Upon receipt of a claim, a surety will typically establish a reserve. The reserve reflects the surety's general valuation of the monetary amount of the claim and factors in potential liabilities and expected recoveries from other sources. The amount of a particular reserve may be adjusted over time. The approach for calculating and adjusting reserves differs throughout the industry. For example, some sureties may establish claim adjustment expense reserves for each bond when it is determined that a project will not likely be completed in accordance with its terms, on a project-by-project basis. Other companies, in contrast, will establish claim adjustment expense reserves when it is determined that a contractor is unlikely to complete its bonded obligation, on a contractor-by-contractor basis.

While there is a dearth of case law directly addressing the discoverability of a surety's files related to its reserves established for a bond claim, at least one court has found that information related to reserves are not relevant to a performance bond claim. Green Construction Co. v. Kansas Power and Light Co., 732 F. Supp. 1550 (D. Kan. 1990). The body of law from the insurance context further seems to indicate that information on reserves is generally not relevant. See, e.g., Rhone-Poulenc Rorer Inc. v. Home Indem. Co., 139 F.R.D. 609, 613-14 (E.D. Pa. 1991) (finding that information related to reserves is of "very tenuous relevance, if any relevance at all" and constitutes work product). The limited circumstance in which courts have typically ordered discovery of information on reserves involves bad faith claims made by insureds against their insurers. See United States Fire Ins. Co. v. Bunge No. Am., Inc., -- F.R.D. --, 2007 WL 2103353 at \*6 (D. Kan. 2007) (finding that information related to reserves was relevant to insured's bad faith claim, albeit the information may not be admissible at trial); but see Oak Lane Printing & Letter Svc., Inc. v. Atlantic Mutual Ins. Co., 2007 WL 1725201 at \*4 (E.D. Pa. 2007) (mere allegations of bad faith insufficient to obtain discovery of reserves).

From a discovery perspective, a surety's reserve valuation reveals the intersection between relevancy and work product objections. The surety can certainly argue that its unique method of calculating and adjusting reserves is of questionable relevance because it not factual information but rather is an assessment of claim value based upon a preliminary view of the law and available facts. Rhone, 139 F.R.D. at 613. This information has also been found to be protected as work product because it represents mental impressions and evaluations (often provided by an attorney) made in anticipation of litigation. Id. at 614.

## **2. Salvage**

When a surety pays a bond claim, it generally takes an ownership interest in certain property previously owned by its principal, which is known as salvage. The surety's right to salvage is usually outlined by the terms of its indemnity agreement with its bond principal. Salvage may be used to assist the surety in completing its performance obligations and/or to offset the surety's losses. While a surety may maintain a separate file related to its valuation and recovery of salvage, the relevance of such materials in a standard breach of contract or bond claim is dubious, again, particularly where the surety's financial viability is not in question.

## **3. Surety Investigation Files**

The surety's file reflecting its investigation of a default termination is frequently requested during discovery and is often the subject of heated discovery disputes. While the investigation file is arguably irrelevant to a straightforward breach of contract or bond claim, the

surety's investigation often becomes relevant where there are allegations of fraud or bad faith. Additionally, a surety may open the door to discoverability of the investigation file by claiming that the obligee did not fully and adequately cooperate with the surety's investigation.

The surety may seek to shield certain documents in its investigation file from discovery, including communications with attorneys, experts, or consultants retained by either surety or its counsel. Even if the investigation file is deemed relevant, many of the included documents warrant protection under various privileges, including attorney-client and common-interest privileges and the work-product doctrine.

Notwithstanding these privileges, sureties should take care in preparing documents for inclusion in their investigation files because privilege and work product inquiries are fact-intensive, with the burden of proof on the party asserting the privilege. One common instance in which a surety may be compelled to produce documents exchanged with its attorneys or consultants occur when the lawyer or experts are tasked with gathering factual information as part of the investigation. Another circumstance in which documents shared with attorneys or non-testifying experts may become discoverable occurs when a document serves dual purposes. For example, a document may address practical business considerations or factual information related to a claim while also addressing legal strategy or including a request for legal advice. In such instances, unless the document can feasibly be redacted, courts are left to determine whether the primary purpose of the document is to seek legal advice (such that it is privileged) or to evaluate the merits of a claim or defense in anticipation of litigation (such that it is work product).

Sureties can take certain steps to ensure that documents properly prepared in anticipation of litigation receive adequate protection from discovery. For example, such documents should describe the purpose for which they were created, in addition to standard designations that the documents are confidential and constitute privileged work product. Mere recitations of factual information or documents reflecting practical business considerations should be maintained separately from any documents that contain information that is arguably privileged or work product. The surety should also maintain clear documentation as to when the surety first learns a claim may be made, when it received the claim, when it is clear the claim may be denied—e.g., for failure to satisfy conditions precedent to recovery under the bond—and when the surety first retains or seeks advice from counsel and/or consultants in preparation for litigation.

#### **4. Claims Procedures and Manuals**

Bond claimants will often request discovery of a surety's written claims procedures or manuals. Broadly-worded discovery requests can encompass anything from an informal procedure memorialized in an e-mail to a more formal commentary or set of instructions. Because these procedures or manuals may contain proprietary information regarding the surety's claims management strategy, a surety will generally want to protect these materials from disclosure.

Once again, the discoverability of claims manuals is not directly addressed in surety case law, and these files would seem to have questionable relevance in the absence of any claim of bad faith or any argument by the surety that it was precluded from performing a proper investigation. In such instances, a bond claimant may have grounds to argue that this

information is relevant to show whether or not a claim was processed in accordance with the surety's own procedures. See, e.g., Bunge, -- F.R.D. --, 2007 WL 2103353 at \*6 (claims manuals relevant to insurer's defense of lack of notice in bad faith claim). Otherwise, the surety's internal claims manuals and procedures may be subject to the same relevance objections that have proved successful in protecting underwriting and claim files.

### C. Reinsurance

Reinsurance is defined as the acceptance by one insurer of all or part of the risk or loss underwritten by another insurer. Reinsurance arrangements are typically reflected in a surety's reserve analysis. Discoverability of insurance-related agreements is usually governed by state law and is usually tempered by considerations of confidentiality and relevance. In disputing the relevance of reinsurance, sureties have often argued that reinsurance deals more remotely with potential overall losses arising under one or more indemnity agreements between the surety and one or more of its principals. Reinsurance treaties have little direct relationship to any one bond or project and, therefore, will have little relevance to a specific claim on a bond or project, particularly if there is no genuine question respecting the surety's solvency or ability to pay a potential judgment.

In the surety context, at least one court has found that reinsurance is not relevant to an obligee's performance bond claim. Green Construction Co. v. Kansas Power and Light Co., 732 F. Supp. 1550 (D. Kan. 1990); see also Independent Petrochemical Corp. v. Aetna Cas. & Surety Co., 117 F.R.D. 283 (D.D.C. 1986) (same holding in insurance context); but see Lumbermens Mutual Casualty Co. v. Able Telecommunications & Power, 2006 WL 229212 (N.D. Ga. 2006) (surety's reinsurance information relevant to indemnity action against principal) (discussed infra § III.D). Parties seeking the disclosure of reinsurance in federal court have argued that federal mandatory disclosure requirements, and those of many states, generally require disclosure of any insurance agreement that would render any insurer liable to pay, or indemnify or reimburse a party for payments made to satisfy a judgment in a given case. See, e.g., Federal Rule of Civil Procedure 26(a)(1)(D). Reinsurance does not appear to be encompassed by this mandatory disclosure rule because reinsurance treaties are not merely insurance policies to satisfy judgments. It is often the case that a judgment entered against a surety would be insufficient to trigger the reinsurer's obligations.

Several courts in the insurance context, however, have merely labeled reinsurance as a type of insurance and found that reinsurance treaties are per se discoverable, regardless of their tenuous relevance, because they fall within the mandatory disclosure requirements of FRCP 26(a)(1)(D). See Ohio Mgmt., LLC v. James River Ins. Co., 2006 WL 1985962 at \*2, n. 8 (E.D. La. 2006) (citing cases supporting the mandatory disclosure of reinsurance treaties); but see Rhone-Poulenc Rorer Inc. v. Home Indem. Co., 139 F.R.D. 609, 612-13 (E.D. Pa. 1991) (citing In re Texas Eastern Transmission Corp., slip. Op. at 15-16 (E.D. Pa. 1989)).

It should be noted that this rule has not been interpreted in the insurance context to require the mandatory disclosure of all reinsurance-related communications. The relevancy of these files is examined on a case-by-case basis, depending on the particular claims or defenses of the parties. See, e.g., Medmarc Cas. Ins. Co. v. Arrow Int'l, Inc., 2002 WL 1870452 at \*3-4 (E.D. Pa. 2002) ("courts appear reluctant to permit discovery of communications between cedents and their reinsurers for the purpose of establishing the proper interpretation of an unambiguous insurance policy, but are more willing to permit

discovery for other purposes, such as defending against an insurer's effort to rescind a policy; to deny claims for late notice; to reconstruct a lost policy; or as extrinsic evidence of an ambiguous policy provision.”); accord United States Fire Ins. Co. v. Bunge No. Am., Inc., -- F.R.D. --, 2007 WL 2103353 at \*3-4 (D. Kan. 2007) (applying Medmarc factors and ordering discovery of reinsurance information); Country Life Ins. Co. v. St. Paul Surplus Lines Ins. Co., 2005 WL 3690565 at \*10 (C.D. Ill. 2005) (applying Medmarc factors and holding reinsurance information not discoverable).

#### **D. Indemnity Agreements**

Under a standard indemnity agreement, the principal, along with various individual indemnitors, agree to reimburse the surety for any loss the surety may incur by virtue of issuing a bond. These agreements may require the principal and other indemnitors to post collateral upon default of a bonded contract, and they usually give the surety rights to job receivables and equipment in the event of default. Indemnity agreements also typically provide the surety with a number of rights and means with which it may attempt make itself whole after an outlay of funds on the principal's behalf.

A surety and principal will often enter a General Indemnity Agreement (“GIA”), which will enable the surety to subsequently issue a number of bonds on behalf of that principal. The GIA will most likely restate the surety's rights of contribution, exoneration, and subrogation. The fundamental purpose of the GIA is to provide the manner and means by which the surety may enforce these rights against the indemnitors in the event of the indemnitors default on any given bonded contract. For example, an indemnity agreement may include provisions addressing the surety's rights to: (i) indemnity against liability; (ii) collateral security; (iii) discharge; (iv) review the books and records of the principal; (v) financial information of others; (vi) refuse execution of bonds; and (vii) indemnity including reimbursement of legal fees. Additionally, the GIA may include rights of assignment of the subcontracts and/or materials and equipment. The GIA may also address the surety's right to takeover or complete performance of the bonded contract or its right to finance the principal. Finally, the GIA may outline the principal's duty to cooperate with the surety in defense of claims and the surety's right to settle or compromise those claims.

Unless the dispute is an indemnity action (discussed infra in § III.D), a surety or principal seeking to protect an indemnity agreement and related files from discovery will typically argue that the principal's ability to reimburse the surety for a judgment is not relevant to the question of the validity of a bond claim. In other contexts, several courts have held that indemnity agreements are not relevant to the issues in dispute. E.g., In re Lloyd's American Trust Fund Litigation, 1998 WL 50211 (S.D.N.Y. 1998) (indemnity agreement not relevant to show bias in breach of fiduciary action); Levito v. Hussman Food Svc. Co., 1990 WL 204378, at \*4 (E.D. Pa. 1990) (indemnity agreement not relevant to wrongful termination suit where the defendant's ability to pay a judgment was not at issue). The party seeking discovery will often argue that because the indemnity agreement defines the surety's rights upon the default of its principal on a given project, the agreement is relevant to prove the bias or motive of personal indemnitors. As with the other types of information maintained by sureties, the discovery of indemnity agreements will turn on the specific facts at issue in the litigation.

### **III. Specific Claims or Defenses that May Impact the Discoverability of a Surety's Internal Underwriting and Claim Files and Reinsurance or Indemnity Agreements.**

In litigation involving sureties, its underwriting and claim files and other internal records will always be a target for discovery. While relevancy is broadly-defined in the discovery context, sureties have had success in protecting certain of these files from disclosure where the claims and defenses are fairly straight-forward and do not involve surety-specific issues. Sureties have also had success in maintaining privilege and work production protection over documents created by their outside lawyers and consultants in circumstances where those retained to assist the surety are not merely acting as an "arm" of the surety in gathering factual information.

The available case law, however, seems to indicate that sureties are more likely to be required to disclose their underwriting, claim, and other files in several special circumstances. For example, a surety may be required to make a broad production of these documents where bad faith. A surety may also open the door to broad discovery where it asserts surety-specific claims or defenses are asserted, such as material alteration of the bonded risk, overpayment, etc. While it would not be prudent to allow the prospect of additional discovery to dictate a decision to forego the assertion of a potentially winning surety defense, sureties should be mindful of the potential discovery consequences of surety-specific defenses. A surety should also be mindful that broader discovery may be ordered in the event that it asserts an indemnity claim against its principal (or individual indemnitors). Finally, a surety's internal files may be subjected to discovery where a principal asserts a loss of bonding capacity claim.

#### **A. General Principles of Discoverability: Breach of Performance Bond**

##### **1. Relevancy**

The case of Green Construction Co. v. Kansas Power and Light Co., 732 F. Supp. 1550 (D. Kan. 1990), demonstrates that sureties are often successful in protecting their internal files from discovery in typical breach of performance bond cases that do not involve allegations of bad faith or surety-specific defenses. In Green, the contractor sought recovery from the owner for extra costs incurred in completing the parties' contract due to excess moisture on the project. Joined in the case as a counterclaim defendant, the contractor's performance bond surety sought an order protecting it from further discovery and limiting the scope of discovery by the owner.

Although one of the surety's defenses involved lack of notice, the surety prevailed in arguing that certain requests for internal files lacked relevance to the dispute. For instance, the court held that the surety's reinsurance file was not relevant to the litigation. Moreover, the court held that the surety's policies and procedures on setting reserves for performance bonds were not relevant. The court also denied the owner's request that the surety respond to matters regarding the histories of other claims on performance bonds issued by the surety for a 7-year period where lack of notice was raised as a defense. The court determined that the burden of complying with this request far outweighed any relevancy of the requested information, as over 62,000 bond claims had been filed in the 7-year period in question and compliance would require physical retrieval of all claim files. The only discovery ordered by the court involved disclosure of the surety's bond forms used over a 7-year period. The court

reasoned that, because the surety argued lack of notice as a defense, the forms were relevant to the issue of what notice was required. Id. at 1554.

## **2. Attorney-Client Privilege and Work Product**

While the subjects of attorney-client privilege and work product are the subject of other papers, several cases reveal the intersection of relevancy and privilege/work product objections in the surety context. For instance, in City of Elmira v. Larry Walter, Inc., 89 A.D.2d 645 (N.Y. App. Div. 1982), the obligee was seeking indemnification from the surety for its losses arising from the principal's termination. The court denied the city's motion to compel the production of memoranda and correspondence between the surety's senior account analyst who monitored the completion work and an attorney at the surety's corporate headquarters. The court found that the documents were not only privileged but also work product because all of the written material in question originated after the contractor had stopped work on the project and litigation was imminent. Id. But see United States Fidelity & Guaranty Co. v. Braspetro Oil Services Co., 2000 WL 744369 (S.D.N.Y. June 8, 2000) (holding that documents prepared as part of investigation were part of a surety's ordinary course of business) (discussed infra). Acknowledging the relevancy of this information, however, the court ordered the surety to produce its analyst for a deposition, as he was responsible for making the surety's business decision not to complete the work and for monitoring the obligee's completion efforts.

With respect to the common practice of utilizing lawyers and consultants to perform an investigation, the discoverability question often turns on the purpose for engaging counsel or consultants. For instance, in a breach of performance bond action, a surety successfully withheld from discovery handwritten comments prepared by one of its consultants on the grounds that the consultant was a non-testifying expert whose comments were intended to assist the surety in preparing for mediation. Aetna Casualty & Surety Co. v. Manshul Construction Corp., 2001 WL 484438 (S.D.N.Y. May 7, 2001).

In a case where the surety employed both consultants and lawyers to perform its investigation, however, the court ruled that the documents created by the investigative team were neither privileged nor work product. Levingston v. Allis-Chambers Corp., 109 F.R.D. 546 (S.D. Miss. 1985). Although the documents at issue were either authored or received by the surety's attorneys, representatives, and consultants, the court determined the individuals were hired to determine the status and completion costs of the bonded projects and not in anticipation of litigation. Thus, in addressing work product, the court distinguished between documents prepared in anticipation of litigation and those generated during a surety's routine process of determining completion costs on a project. The only documents that the court determined to be protected from discovery as work product were those which were proven to contain the mental impressions and opinions of the surety's attorneys in connection with the litigation. With respect to privilege, the court scrutinized the documents in camera to determine whether they were furnishing legal advice or sharing legal advice with attorneys for co-parties in furtherance of a common interest.

### **B. Specific Discovery Considerations: Impairment of Suretyship**

Two recent federal cases illustrate the difficulties of protecting surety files on relevance and privilege grounds when the surety asserts that the obligee's actions constitute an

impairment of suretyship. In Fidelity & Deposit Co. of Maryland v. County of Lake, 1998 U.S. Dist. LEXIS 19247 (N.D. Ill. Dec. 2, 1998), a performance and payment bond surety on a public project sued the owner and alleged that it was discharged from any bond liability by the owner's premature payments to the principal made without the proper mechanics' lien waiver. The owner requested in discovery underwriting files and other documents related to the surety's financial investigation of the contractor. The owner claimed that the surety had knowledge of the contractor's financial instability prior to the owner's last two payments to the contractor, and that evidence of how far back the surety became aware of the problem was relevant to show that the surety should not have issued a bond to the contractor in the first instance. The surety sought to limit discovery by arguing that its own investigation was not relevant to the issue of whether the owner's actions were improper.

In ordering the discovery of the surety's underwriting file, the court cited both the broad definition of relevance under Federal Rule of Civil Procedure 26 and the Restatement of Security, the court reasoned that "when a surety attempts to discharge or defend against its obligation in such circumstances, the knowledge of the surety regarding the obligee would be relevant." *Id.* at \*4. The court also observed that the status of the surety's knowledge could be relevant to the issue of whether the owner's conduct prejudiced the surety such that it was unable to mitigate damages.

Another federal court denied a surety's attempts to invoke the work product privilege in connection with materials sought by the owner to defend against the surety's claims of overpayment and material alteration of the bonded risk. In United States Fidelity & Guaranty Co. v. Braspetro Oil Services Co., 2000 WL 744369 (S.D.N.Y. June 8, 2000), the plaintiff sureties had issued performance bonds for the construction of two oil production facilities by a construction consortium. The sureties argued that the owners knew the consortium was experiencing financial difficulties, and that instead of terminating the contracts, they instituted drastic changes without change orders and increased the costs of contract performance. The sureties also alleged that the owners misdirected and commingled funds, and made premature payments to contractors. They concluded that all of these actions by the owners increased the risk of contractor default and materially increased the sureties' risks under the bonds. The sureties also argued that the consortium's eventual default termination was improper.

In response to these claims, the defendant owners sought broad discovery of the surety's claim investigation files. On this project, the surety had engaged legal counsel and consultants even prior to the owner's declaration of default. Thus, the owners requested materials prepared by the sureties' counsel, his associates, and the engineering consultant retained by the sureties to assist in their investigation during the period prior to the sureties' declination of liability, including witness statements, notes from witness interviews, documents identifying witnesses, translations, and investigative reports prepared by attorneys, investigators, and consultants.

The sureties argued that counsel was retained in contemplation of litigation and, therefore, all the documents they created or that were created on their behalf, including those of the engineering consultant, were protected as work product. In rejecting the surety's arguments, the court analogized to claims investigations in the insurance context, and noted as a threshold matter that "pre-litigation investigation is the routine business of insurance companies." *Id.* at \*9. The court reasoned that "there is no hard and fast rule" as to when the shift occurs from an investigation in the ordinary course of business to an investigation in

anticipation of litigation, and “a fact-specific inquiry is required to determine when this shift occurs.” *Id.* at \*9.

Although the sureties’ counsel contended that he was retained solely to represent the co-sureties as trial counsel in the expected litigation, the court found that “[t]his is simply not the only reasonable inference to be drawn from the retention of counsel. . . . [T]he deteriorating situation between the owners and the contractors, the complex inter-relationship of the parties to the sureties, and the various contractual options available, all presented complex issues, independent of litigation.” *Id.* at \*9 n.8. The court noted that while the retention of an attorney is “one indicia of the anticipation of litigation,” “it is not dispositive.” *Id.*

In concluding its inquiry, the court found that the sureties failed to offer any evidence that they retained counsel *solely* because of anticipated litigation. In fact, the court noted, the parties were “jointly exploring ways to resolve their differences.” *Id.* at \*10. The court even quoted from letters written by the sureties’ counsel urging that “cooperative efforts should be pursued,” that it was “premature to draw any conclusions about future action,” and that the parties should “continu[e] [their] good-faith efforts to reach a global solution” and avoid delay and disruption to the projects. *Id.* Other evidence showed that counsel repeatedly told the owners that until a default declaration and subsequent investigation, the sureties could not determine what course of action to take under the bonds—they had to independently determine whether to assume or deny liability under the bonds. While the sureties’ position was justified, it also opened the door to discovery of the files maintained by the lawyers and consultants as part of their fact-gathering process.

The court ordered the disclosure of this information up through the date of the surety’s declination of liability. This is because the court found that the actions of the sureties’ were consistent with routine surety business practice, regardless of the possibility of litigation. Merely because its counsel performed the necessary tasks of interviewing witnesses, reviewing documents, and retaining experts did not justify an assertion of privilege or work product. Rather, this information was gathered to assist the sureties’ in making the business decision as to whether and how to complete the work. The court made an important observation: “Simply because an attorney participated in and supervised this process does not transform investigative documents into work product.” *Id.* at \*12. There were complex issues to be addressed, irrespective of litigation, by an attorney schooled in suretyship law, and the sureties failed to make any assertions about how this investigation was different from their routine practice when confronted with a complex claim.

Finally, the court acknowledged the possibility that there were some notes generated by counsel and others in supervising the investigation that were specifically geared to litigation strategy or possible litigation defenses—these would be subject to work product protection because they would not have been produced in the same form irrespective of the threat of litigation. *Id.* However, the sureties erred in asserting that the documents generally reflected attorney thought processes, and not that specific documents on their face demonstrated litigation planning or strategy. If the latter argument had been made, the court suggested that the documents could have appropriately been reviewed *in camera*. *Id.* at \*12 n.13.

County of Lake and Braspetro demonstrate that a surety’s assertion of material alteration or overpayment can open the door to extensive discovery. The surety in County of Lake was required to produce its underwriting files as a result of its argument that the owner

had overpaid a principal that was in poor financial condition. The court in Braspetro similarly ordered broad discovery of the sureties' claim investigation files as a result of their discharge arguments. Because the sureties performed this investigation through the use of attorneys and consultants, it was obligated to produce the documents prepared by these outside parties. It was not the mere involvement of legal counsel and consultants that justified such broad discovery, but rather it was the use of counsel and consultants in a fact-finding role. Counsel's efforts to engage in dialogue and explore cooperative solutions, while perhaps prudent from a business perspective, further undermined the sureties' claim of work product.

### **C. Specific Discovery Considerations: Bad Faith Claims**

Courts are likely to be more receptive to requests for the production of surety files when a party has alleged bad faith by the surety. For example, in Reliance Insurance Co. v. River/Road Recycling, Inc., 2003 WL 22174238 (E.D. La. Sept. 8, 2003), the defendant indemnitor sought underwriting files from a performance bond surety, including a series of policy manuals, documents related to due diligence prior to the issuance of bonds, and documents related to persons from whom guarantees were obtained. Dismissing the surety's argument that the information was irrelevant, the court ruled that the underwriting files were discoverable given that the defendant raised a defense based on the duty of good faith and fair dealing. The court reasoned that, if the surety departed from the procedures in its manuals concerning the transactions at issue, this departure would be probative evidence of bad faith. While this case involved a claim of bad faith by an indemnitor, the same principle would seem to apply in the context of an owner alleging bad faith by a surety—policy manuals are an important source of evidence as to the surety's routine underwriting protocol, and would seem difficult to shield from discovery where bad faith is alleged and the documents are requested.

### **D. Specific Discovery Considerations: Indemnity Claims**

In indemnity cases, courts have granted fairly broad discovery to indemnitors seeking to defend against a surety's claim for reimbursement. For example, a court ordered the production of backup documentation from the surety's claim files related to claims paid by the surety for which it sought reimbursement under an indemnity agreement. Reliance Insurance Co. v. River/Road Recycling, Inc., 2003 WL 22174238 (E.D. La. Sept. 8, 2003). Another court ordered the discovery of the surety's reinsurance agreements in a case where the sought indemnity for certain costs and expenses incurred in connection with payments it was required to make under performance and payment bonds after the principal contractor defaulted. Lumbermens Mutual Casualty Co. v. Able Telecommunications & Power, 2006 WL 229212 (N.D. Ga. Jan. 31, 2006). The court found that the agreements were relevant to show whether or not the surety had already been reimbursed for its losses.

### **E. Specific Discovery Considerations: A Principal's Loss of Bonding Capacity Claim**

There is not a case directly addressing the discoverability of surety files in disputes where the principal asserts a claim against the obligee for loss of bonding capacity. It would seem, however, that such a claim would likely lead to discovery of the surety's underwriting files for that principal. The obligee would likely be entitled to discovery of documentation in the surety's files that may reflect the basis for and amount of the principal's original bonding capacity as well as any documentation that may indicate the reasons for reducing the

principal's bonding capacity. In an addition to underwriting files, an obligee would likely seek the surety's claim files on all of the principal's projects based upon the need for discovery on causation of damages.

#### **IV. Specific Claims or Defenses that May Impact the Discoverability of a Surety's Files in Fidelity Bond Litigation**

##### **A. General Principles of Discovery in Fidelity Bond Litigation**

In litigation involving fidelity bonds or fidelity insurance policies, the surety or insurer (hereinafter "the surety") will generally encounter the same discovery issues and principles as a surety on a contract or commercial bond. The surety will typically, in the context of discovery, expect to have to produce the fidelity bonds or policies which are the subject matter of the litigation. The surety should also expect that any documents supporting the payment or denial of the claim be produced. This likely would include instruments, checks, accounting reports, statements, audits and other documents which were submitted in support of the claim. This would include correspondence between the claimant and the surety as well as correspondence with third parties.

Notwithstanding the general principle requiring the production of documents and materials relevant to the litigation at hand, the surety in the context of fidelity litigation would typically not produce its entire claim file as much of that claim file might be relevant to the litigation or be subject to the attorney-client privilege and/or the work product doctrine. The surety would also not usually produce its underwriting file, its claims handling manuals or information regarding the handling of other claims by the surety, such as the handling of similar claims, other litigation involving the surety or bad faith claims and litigation.

##### **B. The Work-Product Doctrine and the Surety's Investigation**

One issue that provides particularly fertile grounds for dispute is the extent of the work-product doctrine and how much of the surety's investigation prior to litigation is subject to the work-product doctrine and how much is discoverable. Since the surety may have conducted an extensive investigation, consisting of procuring records from criminal proceedings, bank records, accounting records, witness statements, expert reports and then performed an analysis of this investigation, it is understandable that the insured would want to obtain this information.

An example of such a dispute is APL Corp. v. Aetna Casualty & Surety Co., 91 F.R.D. 10 (D. Md. 1980). In that case, APL sued Aetna under a fidelity policy after Aetna denied APL's claim on the basis that the claim was excluded under the "inventory computation" exclusion provision of the policy. In discovery, APL sought documents relating to Aetna's investigation and rejection of the claim, including documents relating to Aetna's interview of APL employees and third persons. APL also sought manuals setting forth Aetna's investigative procedures with respect to fidelity bond claims. When Aetna refused to turn these materials over to APL, APL filed a motion to compel discovery of these. Aetna opposed this motion, arguing that it was justified in refusing to turn over its investigation-related documents on the basis of the work product doctrine and its claims manual on the basis that this was a confidential, proprietary document. The court rejected Aetna's position and ordered

Aetna to turn over all of the requested documentation. In support of its order, the court reasoned that the investigative documents were not “prepared in anticipation of litigation” but merely part of its ordinary investigation. Moreover, the court reasoned, even if the documents were prepared in anticipation of litigation, the documents were still discoverable since APL met its burden of showing that it had “substantial need” for the documents and it would incur “undue hardship” in securing by other means substantially equivalent materials. The court further reasoned that since APL had a “bad faith” count in its lawsuit, “the documents in question may constitute quite important evidence as to whether Aetna conducted a diligent investigation of plaintiffs’ claim and whether Aetna acted in good faith in denying the claim.” Finally, in support of its order requiring Aetna to turn over certain sections of its claims investigation manual concerning Aetna’s interpretation of the inventory exclusion clause, the court reasoned that these were “relevant to the subject matter in the pending action” and that any concerns regarding preservation of the confidentiality of the manual could be addressed by an appropriate protective order. Id. at 15.

In contrast to APL, is Maryland American General Ins. Co. v. Blackmon, 639 S.W.2d 455 (Tex. S. Ct. 1982), where the Texas Supreme Court granted a writ of mandamus and, in effect, reversed the order of a trial judge that had required the turnover of the surety’s documents relating to its investigation. In Maryland American, the surety, Maryland American, had been sued by First State Bank on its bankers blanket bond as well as for bad faith. The Bank sought all of the documents relating to Maryland American’s investigation of the claim. In challenging this and the trial court’s order requiring the turnover of these documents, Maryland American argued that the documents were subject to the work-product doctrine and attorney-client privilege. The Bank argued that neither of these applied given its bad faith claim. In issuing its writ of mandamus against the trial judge and mandating that Maryland American need not produce its investigative documents, the Texas Supreme Court held that both the work-product doctrine and attorney-client privilege applied.

### **C. Bad Faith Claims**

Notwithstanding the fact that general principles of relevance, as well as the work-product and attorney-client privilege protect the surety from having to produce many of its files in fidelity bond litigation, there are instances where the assertion of a particular claim or defense may result in the claimant seeking to obtain information from the surety which the surety would ordinarily never produce. As in other surety cases, the most common tactic to attempt to open the scope of what must be produced by the surety in discovery is for a claimant to make a “bad faith” claim against the surety. In making such a claim, the claimant attempts to put the surety in a position where it is not only facing “extra-contractual” or punitive damages, but also in a position where it may have to face substantially-increased costs of complying with discovery, not to mention having to produce confidential and/or proprietary information to outsiders.

The APL and Maryland American cases, discussed supra., both involved bad faith allegations against a surety and the struggle between sureties and claimants over discovery of information that would likely not have been even arguably discoverable absent the bad faith claims. Both of those cases involved efforts to obtain investigative material that would otherwise be protected by the work product doctrine and attorney-client privilege. In addition to such material, claimants have used the bad faith claim to attempt to obtain access to other

materials, such as documentation in regard to the surety's reserves, reinsurance, claims and procedure manuals, as well as information regarding other bad faith claims or litigation involving the surety. Whether the claimant will be successful in obtaining up discovery by asserting a bad faith claim is dependent upon the particular facts and circumstances of the case, as well as the law in a particular jurisdiction. Nevertheless, the assertion of a bad faith claim will likely result in at least the attempt by the claimant to broaden its discovery requests.

Thus, in APL, supra., the claimant was able to obtain portions of the surety's claims manual. Likewise, in First National Bank of Louisville v. Lustig, 1991 WL 236839 (E.D. La. 1991), the court ordered one of the sureties in that case, Aetna, to produce documents containing information about its reserves. The court reasoned that the claimant's bad faith claim put at issue the sureties' states of mind in not paying on a fidelity bond and that the sureties' reserves were relevant to this issue. As authority for this, the court cited a number of other (non-fidelity) cases wherein courts allowed discovery of reserve information in cases involving bad faith claims. See, Loyal Order of Moose, Lodge 1392 v. Int'l Fidelity Ins. Co., 797 P.2d 622 (Ala. 1990); Tackett v. State Farm Fire and Casualty, 558 A.2d 1098 (Del. 1988); Bergeson v. National Surety Corp., 112 F.R.D. 692 (D. Mont. 1986); Samson v. Transamerican Ins. Co., 636 P.2d 32 (Cal. 1981); Town of Nassau v. Phoenix Assurance Co. of New York, 394 N.Y.S.2d 319 (N.Y.App.Div. 1977); Groben v. Travelers Indemn. Co., 266 N.Y.S.2d 616 (N.Y. Sup. Ct. 1965), aff'd, 282 N.Y.S.2d 214 (1967). However, the mere assertion of a bad faith claim will not automatically allow discovery of reserve information. See, e.g., Fidelity & Deposit Co. v. McCulloch, 168 F.R.D. 516 (E.D. Pa. 1996).

Although there are other claims or defenses that might open up discovery to otherwise non-discoverable information, the bad faith claim is the most frequent mechanism whereby the claimant attempts to effect this.

## **V. Conclusion.**

Many sureties justifiably resist the notion that the discovery process opens the door to all of its files related to a principal, including those which may contain confidential and proprietary information. This may include underwriting files, claim files, reinsurance files, and indemnity agreements. Although the body of published case law regarding surety discovery disputes is not well-developed, the available precedent does provide some guidance for sureties related to the potential discovery consequences that could arise from the types of claims or defenses asserted in a dispute. While potential discovery considerations should not solely dictate litigation strategy, sureties should account for these factors in making strategy decisions for the purposes of handling claims or preparing for litigation. The following is a checklist of some of the most important discovery considerations:

- While relevancy is a broad concept, it does not necessarily follow that a surety is required to disclose every document that relates to a principal or claim.
  - For example, sureties have successfully asserted relevancy as a basis to protect their files related to underwriting, reserves, and reinsurance in performance bond disputes where no surety-specific defenses have been asserted.

- While documents prepared by retained attorneys or consultants may be relevant, sureties have successfully asserted privilege and work product as a basis for non-disclosure.
  - The primary exception appears to involve disputes where the attorney or consultant is performing the investigation and is engaged as a “fact-finder” rather than to provide legal advice or to assist in evaluating the merits of claims in preparation for litigation.
- The assertion of specific surety defenses, such as impairment of suretyship, is more likely to result in broader discovery of the surety’s files.
  - For example, where a surety alleges that the obligee overpaid a struggling contractor or took any action that altered its risk, the surety may be required to disclose the bulk of its underwriting and claim files based upon the rationale that the surety’s own knowledge is relevant to its allegations.
  - When a surety attempts to cooperate with an obligee prior before ultimately asserting its surety defenses, the surety may have difficulty in asserting work product protection over any analyses that were performed on its behalf prior to declining liability.
    - The surety will likely be in the best position to preserve any work product or privilege protection over documents created by its counsel or consultants where the surety remains the primary fact finder during an investigation and is merely assisted by attorneys and experts who have a well-defined scope of work that involves providing legal advice or claims analysis in preparation for anticipated litigation.
  - In other special circumstances—bad faith claims by obligees, indemnity actions against the principal, or loss of bonding capacity claims by a principal—it is more likely that a surety’s files pertaining to underwriting, claims, reinsurance, or indemnity may be deemed relevant to the issues in dispute.

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