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Surety Enforces Subcontract's Forum Selection Clause Despite Its Non-Signatory Status

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Sureties may have a choice of venue as they are permitted to rely on the forum-selection clause in the underlying bonded contract, a federal court in Manhattan recently held. In *Citi Structure Construction v. Zurich American Insurance Co.*,[1] the surety was able to dismiss the claimant's bond claim because the underlying subcontract agreement contained an exclusive forum-selection clause requiring suit in state court. Although not a signatory to the subcontract, the court found the clause valid and enforceable by the surety.

The case stemmed from two projects for the Metropolitan Transportation Authority in New York City. The surety, Zurich American Insurance Co. ("Zurich"), issued labor and material payment bonds on both projects for its principal, the contractor, Yonkers Contracting Company, Inc. ("Yonkers"). The claimant, Citi Structure Construction ("Citi") entered into a subcontract with Yonkers for each project. Citi claimed that Yonkers failed to pay as required

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Breaking *Bramble*

THOMAS K. O'GARA

The surety industry was dealt a devastating blow in 2005 when a Maryland Court ruled that a surety's failure to respond to a payment bond claim within sixty days constitutes a waiver of defenses.[1] In response to this rule, the surety industry reacted and amended the AIA A312 bond to specifically state that a failure to respond did not constitute a waiver. Now, thanks to a Connecticut Supreme Court decision, there is competing case law that can be used against the logic in *Bramble*.

In *Electrical Contractors, Inc. v. Insurance Co. of State*,[2] the Connecticut court held that surety's failure to make payment or serve notice denying liability on a claim pursuant to the statute was tantamount to a denial of the claim and did not constitute a waiver of the surety's right to defend the claim on the merits. While the *Electrical Contractor's* decision interpreted a Connecticut statute and not an AIA bond form, the reasoning is the same: a failure to respond does not equal a waiver of defenses.

Here, Plaintiff was a subcontractor on a public-works project for the renovation and expansion of the Newton High School. On June 3, 2011, Plaintiff made a claim against the performance bond issued by Defendant, seeking an equitable adjustment of its contract price in the amount of $746,300.25. In response to the Defendant's inquiry, Plaintiff later supplemented its claim with supporting documentation. Upon hearing no response from Defendant, Plaintiff commenced a lawsuit on September 15, 2011.

Under Connecticut's Little Miller Act, ninety days after service of a notice of claim "the surety shall make payment under the bond and satisfy the claim, or any portion of the claim which is not subject to a good faith dispute, and shall serve a notice on the claimant denying liability for any unpaid portion of the claim."

Upon a certified question from United States District Court for the District of Connecticut, The Supreme Court of Connecticut was asked to determine whether a surety on a public construction project, which fails either to pay or to deny a notice of claim within ninety days waives any substantive defenses and becomes automatically liable for the full amount of the claim. After careful review of the statutory language and realities of the surety industry, the court determined that a failure to respond within ninety days did not preclude the assertion of substantive defenses.

First, the court noted that Connecticut's Little Miller Act contains no default provision and nowhere provides that a surety waives its right to raise substantive defenses or is subject to automatic forfeiture. As the Defendant argued, and the court agreed, it would be inappropriate for the courts to read into the act a penalty provision that the legislature declined to impose expressly. Because the legislature did not elect to impose any express penalty on a surety that fails to comply within the ninety day response

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Obligee's Claims Untimely: Motion to Dismiss Surety's DJ Action Did Not Toll Limitations Period

NELL M. HURLEY

The Second Circuit Court of Appeals recently upheld summary judgment in favor of a surety and against an obligee, finding that the obligee's breach of contract claim was untimely under the bond's limitations period in *Peekskill City School District v. Colonial Surety Co.*[1] While a great result for the surety, the case provides a cautionary tale to all parties (and their counsel) who engage in pre-answer motion practice: Be certain that all rights are preserved.

In defense of the obligee, Peekskill City School District ("Peekskill"), this was not a typical breach of contract claim. The surety, Colonial Surety Co. ("Colonial"), began the litigation by commencing a declaratory judgment ("DJ") action. But Colonial voluntarily dismissed its DJ action prior to Peekskill asserting an answer, counterclaims, or filing its own suit. After the voluntarily withdrawal, Peekskill sought to file its own complaint, which was dismissed as untimely.

In 2006, Colonial's principal, All Phase Electrical Contracting ("All Phase"), contracted with Peekskill for the electrical work on a middle school construction project. In June 2008, All Phase filed for bankruptcy and stopped work on the project. The performance bond contained a limitations provision requiring that any proceeding under the bond be commenced within two years of when All Phase ceased work. After the bankruptcy stay was lifted, Peekskill demanded that Colonial perform under the bond. The parties were unable to reach agreement as to Colonial's bond obligations and, in October 2008, Colonial filed the DJ action in the Southern District of New York. In December 2008, Peekskill moved to dismiss Colonial's DJ complaint.

While the cause for the delay is unclear, in October 2010, the motion court scheduled a hearing on Peekskill's motion to dismiss for January 2011. On the return date, prior to any argument, Colonial voluntarily dismissed its DJ action. Peekskill immediately commenced a breach of contract action against Colonial. After discovery, Colonial moved for summary judgment because Peekskill commenced its lawsuit more than two years after All Phase ceased work. The District Court granted Colonial's motion and Peekskill appealed.

Unpersuaded by Peekskill's argument that the DJ action operated to toll the applicable limitations period, the Second Circuit affirmed. The court found "no basis for holding Colonial's declaratory judgment action tolled the statute." The court further refused to apply equitable tolling, stating that this was not a "rare and exceptional circumstance" in which equitable tolling is permitted. Peekskill had several opportunities to preserve its claims when faced with a DJ action and a relatively short limitations period. Peekskill could have answered, preserving its defenses and claims, and then moved to dismiss under F.R.C.P. 12(c), or it could have commenced its own action.

The District Court's decision, affirmed by the Second Circuit, explains that Peekskill was correct in its contention that it was not required to serve an answer until the motion court had ruled on its motion to dismiss. But, it does not follow that the limitations period on Peekskill's claims was also tolled while the motion was pending. Sadly for Peekskill, the District Court noted that Peekskill's claims could have been asserted in the DJ action even *after* the two-year period expired because they would have related back to the time of Colonial's DJ complaint. Peekskill's problem, however, was that its claims were never asserted before the DJ action was dismissed.

In hindsight, the lesson seems obvious. Oftentimes, however, in the context of pre-answer motion practice, a fundamental examination of claim preservation can be easily over-shadowed. The *Peekskill* case is an apt reminder to always respect the shortest limitations period by properly preserving all claims, just in case the unexpected happens. E&D

1 Case No. 14-1160-cv (2nd Cir. March 2, 2015), affirming the District Court's decision reported at 6 F. Supp. 3d 372 (S.D.N.Y. 2014).

CONTINUED "SURETY ENFORCES SUBCONTRACTS' FORUM SELECTION CLAUSE DESPITE ITS NON-SIGNATORY STATUS"

by the subcontracts for labor and materials Citi provided to the projects. Citi brought a payment bond claim against Zurich in federal court, based on diversity jurisdiction, but did not sue Yonkers. Zurich moved to dismiss the federal court action citing the forum-selection clauses in the subcontracts requiring state court.

Those subcontract clauses stated that:

> (1) the venue of any action or proceeding shall be exclusively in the Supreme Court of the State of New York, County of Westchester, before a Justice of said Court; and
>
> (2) Notwithstanding any contrary terms or conditions contained in any surety bond, the parties agree that the venue of any action or proceeding against any surety bonds made in connection with the project shall be exclusively in the Supreme Court of the State of New York, County of Westchester, before a Justice of said Court.

Citi argued that Zurich was not a signatory to the subcontract agreement containing the forum-selection clauses and it could not enforce them.

Employing the four-part test applicable in the Second Circuit, the district court held that the forum-selection clauses were valid and enforceable by Zurich. Citi conceded the first two parts of the test as it acknowledged that the clauses were "reasonably communi-

CONTINUED "BREAKING BRAMBLE"

requirement, it would be a draconian penalty for the court to read into the statute. In interpreting the text of the statute, the court found that the surety's duty to pay or to deny a claim is framed solely in affirmative terms, with no language expressly prohibiting a surety from denying a claim after ninety days have passed. The text and structure of the statute, then, strongly suggest that the legislature intended the response requirement to be directory, as opposed to mandatory.

The court also demonstrated a strong understanding of the realities of a surety in a dispute between principal and claimant. Based on the position in which a surety is often placed, it would be unjust to impose such a harsh penalty upon a surety. For example, when a surety first receives notice of a claim, it often has little, if any, familiarity with the specifics of the project. Often, the surety will be ignorant as to the details and history of the dispute between its principal and the claimant

The court found it unfair to penalize a surety that was given just ninety days to educate itself as to the particulars of the project, investigate the claim, collect all relevant documentation, and then determine which portions of the claim to pay and which to deny. To accomplish these tasks, the surety is heavily dependent on the expeditious cooperation of its principal and the claimant, who will typically possess most, if not all, of the relevant information and documentation.

As such, prompt compliance may not be within the complete control of the surety because the surety is caught in the middle between the claimant and the principal. The surety cannot compel either party to provide the information and documentation it needs to determine the relevant facts, resolve the dispute, and evaluate the validity of the claim. Moreover, the surety may need to solicit additional information from third parties such as the project owner, the architect, or other contractors and vendors associated with a project. Their cooperation also may not be timely.

Furthermore, a surety is placed in a difficult position because, if it does not fully and adequately investigate the claim, it could be exposed to additional damages, such as attorneys' fees. Under these circumstances, it would be unreasonable to hold that a surety that engages in a good-faith investigation, but is unable to reach an educated conclusion before ninety days have elapsed, waives any substantive defenses to the claim and becomes obligated to pay it in full, regardless of how exaggerated, baseless, or even fraudulent it may be.

Finally, the court found that the claimant would not be prejudiced. If the surety has not agreed to pay the claim within that time period – whether the surety expressly denies the claim or, as in the present case, simply does not respond substantively to the claim – only this window of opportunity has closed. The position of the claimant is exactly the same in either case: it is free to proceed with litigation in order to enforce its rights. Indeed, the ninety day timeframe is merely a window during which the parties have an opportunity and are encouraged to try to resolve the claim without the need for litigation.

Due to the realities of the surety industry, even the most diligent surety may not be able to determine fully the merits of a claim, in good faith, within ninety days. If a surety fails to respond, its silence becomes a rejection of the claim.

While the *Bramble* decision is still out there, the *Electric Contracting* case is another argument a surety can use to argue against the position that a failure to respond to a claim acts as a waiver of its substantive defenses. The conclusions reached by the Connecticut Supreme Court are logical, detailed, and reflect the realities of the surety industry. Courts facing similar legal issue would be wise to use the *Electric Contracting* case as guidance. E&D

1 *National Union Fire Ins. Co. of Pittsburgh v. David A. Bramble, Inc.*, 388 Md. 195 (Md. 2005).

2 314 Conn. 749 (Conn, 2015)

cated" and were mandatory. The third prong, whether the claims and parties involved in the suit are subject to the clauses, was the main focus of the court's inquiry.

The court found that the clauses applied to Citi's claims against Zurich since they arose directly from Citi's subcontract with Yonkers. Further, Zurich is subject to the forum-selection clauses because it is "closely related" to another signatory. Zurich's enforcement of the forum-selection clauses was not only foreseeable to Citi but was expressly contemplated by the language of the clauses.

This decision may prompt sureties to consider working with their principals to require such forum-selection clauses in their subcontracts. The advantage to the surety of having control over the legal forum is obvious: cost and convenience. To do so, ensure that the principal uses broad language that expressly references actions on the bonds. Be mindful, as well, that suit on performance bonds or other project-related actions involving the principal and the owner will likely be determined by the project's contract documents, which usually tie venue to the project location. E&D

1 14-CV-5371, NYLJ 1202735483911, at*1 (SDNY, Decided August 18, 2015).

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FIRM NEWS

In October, Kevin F. Peartree gave a presentation to the DBIA Tri-State Chapter, Liberty Northeast Region, on "Which Design-Build Contract is Right for You and Your Project?"

Also in October, John W. Dreste was a featured presenter for an AGC of NYS webinar titled "MWBE and DBE Laws, Regulations and Best Practices for Utilization and Compliance".

In November and December, Thomas K. O'Gara gave presentations to the Junior Builders Exchange of Rochester on the "ABCs of M/WBEs" and "Getting Paid: Trust Funds, Liens & Bond Claims".

E&D recently readied for publication the 2016 Annual Supplement to the ConsensusDocs Contract Documents Handbook, by Aspen Publishers. The supplement will look at ConsensusDocs 907, the Equipment Lease.