ERNSTROM & DRESTE LLP

FIDELITY & SURETY REPORTER

WINTER 2020 ISSUE 33

## Extended Stay: Indemnitor's Bankruptcy Stays Claims Against Surety

BRIAN M. STREICHER

There is no co-debtor stay triggered by a Chapter 11 bankruptcy. The bankruptcy filing of one defendant in a lawsuit does not automatically stay the lawsuit against the non-bankrupt co-defendants.[1] That is the general rule, anyway. But like so many points of law, the rub lies in the exception. What happens, for example, when there is such a unity of identity between the bankrupt debtor and its non-bankrupt co-defendant that continuing the lawsuit against the non-bankrupt co-defendant would undermine the purpose of the bankruptcy proceeding? The Bankruptcy Court for the Southern District of New York recently addressed this issue in the context of surety bonds and indemnity agreements in the matter of *Durr Mechanical Construction, Inc. v. I.K. Construction, Inc.*[2]

Durr Mechanical was hired as the construction manager for the Essex Baghouse Project in New Jersey. Durr subcontracted with I.K. Construction to perform structural steel work. During construction, Durr terminated I.K. for alleged delays and other contractual defaults. I.K. contended that it was fully performing under the

CONTINUED ON PAGE 2

## No Consent Needed in Surety Takeover: Defaulted Contractor Can Complete Over Obligee's Objections

MATTHEW D. HOLMES

The Third District Court of Appeal in Florida issued a recent decision[1] holding that a surety has the right to use the defaulted bond principal to complete the contract work under a surety takeover agreement involving the standard AIA A312 performance bond form.

In the case, a condominium association hired a contractor in 2014 for a $5.4 million construction project to renovate three condominium buildings in Marathon, Florida. Under the applicable performance bonds, the association was the named obligee and the contractor was the principal. In 2017, the association discovered defects in the renovations, declared the contractor in default, and terminated the construction contract. The association then requested the surety to "promptly make an election under Paragraph 4" of the performance bonds.

Paragraph 4 of the performance bonds provided the surety a series of options to choose from, only two of them relevant here:

> 4.1 Arrange for the CONTRACTOR, with consent of the OWNER, to perform and complete the Contract; or
>
> 4.2 Undertake to perform and complete the Contract itself, through its agents or through independent contractors.

The surety elected the option under Paragraph 4.2 and prepared a takeover agreement in which the same contractor that the association had terminated would complete the work. Unsurprisingly, the association rejected the takeover agreement, contending that it materially modified the original project terms, and that the performance bonds prohibited the surety from retaining the defaulted contractor to complete the work. Discussions ensued, but the surety insisted that Paragraph 4.2 imposed no restrictions on the selection of completion contractors. The association refused to sign the agreement and filed an action seeking a declaration that the surety was prohibited from hiring the defaulted contractor to complete the contract work. It also argued that under a takeover agreement with the surety, the surety assumes the role of general contractor and, since it did not have a contractor's license, the surety was prohibited from electing the option under Paragraph 4.2. The surety countered that the association's refusal to sign the takeover agreement was a breach of contract and thus the surety was relieved of all obligations under the bonds.

The trial court held that the surety was well within its rights under Paragraph 4.2 of the bonds to complete the contract with the defaulted contractor, despite the association's objections. The clear and unambiguous language of Paragraph 4.2 places no restrictions on the surety in using the defaulted contractor, the court said. The association's argument that the surety was required to possess a contractor's license was rejected by the trial court, but it found no breach of the bonds by the association in refusing the agreement and seeking declaratory relief. Both parties appealed.

The appellate court likewise found in the surety's favor regarding its selection of the defaulted contractor, noting:

CONTINUED ON PAGE 2

### IN THIS ISSUE

CONTINUED "NO CONSENT NEEDED IN SURETY TAKEOVER: DEFAULTED CONTRACTOR CAN COMPLETE OVER OBLIGEE'S OBJECTIONS"

> "[I]t is common practice for a surety undertaking to complete the project itself to hire the original contractor, as [surety] elected to do here…By completing the project itself, the surety obtains greater control than it would have had if it elected to require the obligee to complete, because the surety can select the completing contractor or consultants to finish the project as well as control the costs of completion."

In its ruling, the court noted that the option under Paragraph 4.1 requires owner consent, but stated that the association could not take that "owner consent" language and "graft it" onto Paragraph 4.2.

The appellate court also dismissed the argument that the surety needed to be a licensed contractor to select the option under Paragraph 4.2 since the surety was not actually completing the construction itself. Finally, the court rejected the surety's position regarding the association's alleged breach of the bonds, finding that the parties genuinely disagreed as to the meaning of the bonds' language and the association sought prompt judicial intervention.

In a default situation, the surety faces a complex set of circumstances and options, where often no course of action is appealing. But with this decision, the surety can know that, if its bond forms contain the language of the commonly used AIA A312, it does not need the obligee's consent to proceed using the defaulted principal under a surety takeover agreement. The bad blood between the principal and the obligee will likely remain, but this case makes clear that it is the surety's choice, not the obligee's, to use that contractor. Be aware however, that this decision may prompt owners to seek modification of bond forms, inserting an owner consent requirement under the surety takeover option. E&D

1 *Seawatch at Marathon Condo. Ass'n, Inc. v. Guar. Co.*, 2019 Fla. App. LEXIS (Fla. 3d DCA Oct. 2, 2019).

CONTINUED "EXTENDED STAY: INDEMNITOR'S BANKRUPTCY STAYS CLAIMS AGAINST SURETY"

subcontract and later made a claim on the subcontract payment bond issued by Fidelity & Deposit Company of Maryland ("F&D") on behalf of Durr. To secure its obligations under the payment bond, Durr had executed an indemnity agreement fully indemnifying F&D for all losses and/or expenses sustained by F&D by virtue of paying any claims on the bond.

I.K. brought suit in New Jersey state court against Durr, F&D, and others, to be paid on the subcontract and payment bond. After two years of litigation in New Jersey, Durr filed Chapter 11 bankruptcy in the Southern District of New York. I.K. filed a proof of claim in the Chapter 11 proceeding.

Since F&D was a non-bankrupt co-defendant in the New Jersey lawsuit, I.K. attempted to proceed to trial against F&D during the pendency of Durr's Chapter 11 in accordance with the general rule above. In response, Durr moved to extend the automatic stay to F&D. Durr argued that the litigation against F&D would have an immediate adverse economic impact on the bankruptcy estate since (a) Durr had an absolute obligation to indemnify F&D for its litigation expenses, including its attorneys' fees; and (b) a protracted New Jersey litigation would drain valuable time and resources from Durr during a critical juncture of its attempt to reorganize.

The Bankruptcy Court granted Durr's motion, extending the automatic stay to all litigation against F&D. The Court cited an exception to the general rule set down by the Second Circuit in *Queenie v. Nygard International* that applies where a claim against the non-debtor will have an immediate, adverse economic impact on the bankruptcy estate, such as where "there is such identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant."[3] Applying this exception, the Court reasoned that, since F&D's liability to I.K. under the payment bond was "wholly derivative of Durr's liability…and Durr has an absolute obligation to indemnify [F&D] for its losses[,] should it lose[,] and its legal expenses and attorneys' fees, win or lose," the New Jersey litigation would have an immediate, adverse economic impact on the bankruptcy estate and its unsecured creditors.[4] Since Durr's indemnity obligations to F&D were secured by collateral owned by the estate, any judgment against F&D and resultant liability to Durr would deplete the collateral from the estate and reduce the assets available for Durr's reorganization or payment to creditors, said the Court. The decision further noted that I.K.'s filing of a proof of claim demonstrated its consent to the Bankruptcy Court's jurisdiction over the entire dispute, rather than bifurcation of the proceedings in state court and bankruptcy court.

While *Durr* does not carve out a new, watershed exception to the co-debtor stay rule, it is a noteworthy extension of the exception to sureties in the context of bonds and indemnity agreements. An indemnitor going bankrupt is not uncommon, and it may benefit sureties that resolution of cases against claimants are consolidated into one proceeding. Of note, however, is the fact that F&D only survived I.K.'s constitutional *Stern v. Marshall*[5] challenge because I.K. acquiesced to the Bankruptcy Court's equitable jurisdiction via its proof of claim. In cases where the claimant does not file a proof of claim against the bankruptcy estate, sureties may face a constitutional challenge to consolidation of the litigation into a bankruptcy adversary proceeding. E&D

1 *See Nippon Fire & Marine Ins. Co. v. Skyway Freight Sys., Inc.*, 235 F.3d 53, 58 (2d Cir. 2000) ("It is well-established that stays pursuant to § 362(a) are limited to debtors and do not encompass non-bankrupt co-defendants.").

2 604 B.R. 131 (Bankr. S.D.N.Y. Aug. 12, 2019).

3 321 F.3d 282, 288 (2d Cir. 2003).

4 *Durr*, 604 B.R. at 137.

5 564 U.S. 462 (2011) (holding that Article III of the Constitution precludes claims that are not "core" to the bankruptcy from forcible adjudication in the bankruptcy court).

# Bank Got the Contract Funds? No Conversion Claim Based Solely on Indemnity Agreement

NELL M. HURLEY

In the age-old battle between the surety and the bank over contract funds, a Minnesota federal district court recently rejected a surety's claim that the bank converted funds it took from the principal-indemnitor-debtor's bank account. Finding that the agreement between the surety and the indemnitor – the general agreement of indemnity – failed to create an express trust in the contract funds for the surety's benefit, the court granted the bank's summary judgment motion dismissing the conversion action. The case represents the ongoing struggle for sureties to lay claim to contract funds paid to the principal by owner-obligees, a situation often encountered in bankruptcy settings.

The Guarantee Co. ("The Guarantee" or surety), paid out over $3.5 million in performance and payment bond claims on behalf of its principal, H & S Contracting, Inc. ("H&S") for public contract work done in 2015-2016 on numerous projects in Minnesota. H&S had an ongoing relationship with Associated Bank, N.A. ("Associated" or bank), with a 2014 credit agreement that created a security interest in H&S's assets, including its checking account at Associated. In a one month period in 2016, H&S deposited over $2 million in contract funds into the account. Because of H&S defaults on the credit agreement, Associated took nearly half of that amount in monies later traceable to those deposits. The Guarantee filed an action against Associated for conversion of the funds. Associated moved for summary judgment, arguing that there could be no conversion because The Guarantee lacked an enforceable property interest in the contract funds.

The Guarantee countered that it had an enforceable interest in the funds because of the surety relationship between The Guarantee and H&S and, specifically, that the language of the 2013 General Agreement of Indemnity ("GAI") established an express trust in the contract funds. The GAI contained industry-typical language that all payments on bonded contracts received by H&S "are trust funds for the benefit and payment of [bonded contract obligations] for which [The Guarantee] would be liable…If [The Guarantee] discharges [the obligation], it shall be entitled to assert the claim of such person to the trust funds." This created a trust by declaration, the surety contended, and a valid property interest in the contract funds the bank acquired from the H&S account.

The bank maintained that the language of the GAI was insufficient to create an express trust because H&S did not own the proceeds from the bonded contracts at the time it executed the GAI and failed to take any subsequent action to place specific, identifiable proceeds into trust. Without an existing, definite trust res in which the trustee (H&S) has legal title, there can be no trust, Associated argued.

The court agreed with Associated, finding the GAI language insufficient to identify a specific trust res in which H&S held legal title, but instead showed only an expectation or hope by H&S of receiving potential trust property in the future. Some further manifestation of trust creation by H&S was necessary, concurrent with the acquisition of the trust res, to alert third parties such as the bank, the court stated. Further, the court noted that H&S:

- Deposited checks without any trust account notation;
- Commingled the proceeds of bonded contracts with non-trust monies which were used for non-trust purposes, and;
- Represented bonded contract balances as H&S assets on its financials without any indication of a trust.

Similarly, the surety failed to require H&S to establish separate trust accounts for bonded contracts, though it was permitted to do so under the GAI, the court said. The court opined that the GAI, by itself, provided an option for the parties to create a trust at a later date, but that the parties failed to take further action to exercise this option. Without that, there was no definite and unequivocal declaration of trust after acquiring the alleged trust res, and thus no express trust, the court concluded, and it granted the bank's motion dismissing the conversion claim. That the surety may be "equitably subrogated to the claims of H&S's subcontractors and suppliers" did not change its conclusion, the court stated.

Courts have reached differing results as to whether an agreement between a surety and principal creates an express trust, so results may vary by jurisdiction. Even so, surety professionals would do well to be mindful of this court's conclusion that action on the part of the principal, and even the surety, regarding the treatment and characterization of bonded contract proceeds will likely impact a surety's assertion that bonded contract monies are trust assets in later disputes. F&D

1 Guar. Co. v. Associated Bank, N.A., 2019 U.S. Dist. LEXIS 176124* (D. Minn. Aug. 27, 2019).


Matt Holmes, left, and Brian Streicher, right, took to the links at a Construction Financial Management Association of Greater Rochester charity golf event in August, 2019 in Victor, New York.

ERNSTROM & DRESTE LLP

925 Clinton Square
Rochester, New York 14604

Visit us online at:
ERNSTROMDRESTE.COM

**Ernstrom & Dreste, LLP also publishes the ContrACT Construction Risk Management Reporter. If you would like to receive that publication as well, please contact Clara Onderdonk at conderdonk@ed-llp.com. Copies of ContrACT Construction Risk Management Reporter and The Fidelity and Surety Reporter can also be obtained at Ernstrom & Dreste, LLP's website (ernstromdreste.com).**



## FIRM NEWS

Brian Streicher was a speaker at the 2019 Surety Day event held by the Surety Association of Syracuse on November 6, 2019 in Syracuse, New York. The topic he presented was *MWBE Laws in New York: What You Need to Know About Where We Are and Where We Are Going*.

Matthew Holmes attended The Fidelity Law Association/ ABA Fidelity & Surety Law Committee Conference held in Boston, Massachusetts on November 6-8, 2019.

Tim Boldt attended the Associated General Contractors of America's Joint Contractors Conference held in Tucson, Arizona on November 6-8, 2019. Tim is board member of the Specialty Contractors Committee.

Todd Braggins co-chaired the 2019 Pearlman Association Annual Conference in Woodinville, Washington in September 2019. Matt Holmes was a speaker at the presentation of *Being a Good Wingman: Tendering "Mr. or Mrs. Right" to the Bond Obligee to Complete the Project*.

Kevin Peartree will present his annual Construction Law Update for the Builders Exchange of Rochester on January 21, 2020.

Todd Braggins, Brian Streicher and Matt Holmes will attend the ABA Fidelity & Surety Law Committee Mid-Winter Conference in New York City, January 29-31, 2020.