ERNSTROM & DRESTE LLP

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Notice Failure Dooms Bond Claim, Bonded Subcontract Complete

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A recent decision out of New York County Supreme Court shows that surety performance bond liability continues to be limited by the language of the bond, including the enforcement of its notice provisions as conditions precedent, and by the scope and status of the underlying bonded contract. The court granted the surety's summary judgment motion dismissing $60 million in claims by the obligee-construction manager.[1]

The matter stems from a $40 million private construction subcontract between construction manager, JDS Development, Inc. ("JDS"), and subcontractor Parkside Construction Builders Co. ("Parkside"), to provide superstructure work to build the 85-story Steinway Building in New York City. Parkside's surety, Allied World Insurance Co. ("Allied"), was unable to bond the subcontract for the entire structure due to its $25 million per bond/transaction restriction under its reinsurance treaty. Instead, in March 2016, the parties "carved out" a separate $24.9 million subcontract and rider, specifically limited to Parkside's work from the cellar to the 36th floor ("Bonded Subcontract"). In April 2016, Allied issued industry standard form AIA A312 payment and performance bonds related to the Bonded Subcontract, with Parkside as principal and JDS as obligee.

Nearly immediately, JDS internally documented Parkside's various defaults, and assisted Parkside to correct alleged deficiencies with funds from the project owner. After more defaults, JDS considered terminating Parkside but did not, nor did it provide notice of any default to the surety under the performance bond. In 2017, Parkside admitted to JDS that it had failed in its subcontract obligations and needed more money, despite no remaining subcontract contract funds. JDS then agreed to a $20 million change order/price adjustment, increasing the overall subcontract amount to $60 million. By October 2017, Parkside had completed 100% of the Bonded Subcontract work (superstructure work through the 36th floor), a full one year late.

Apparently, problems with the project continued and, in May 2018, while working on the 60th floor, Parkside was indicted for wage theft and fraud and thereafter ceased to be a functional company. JDS notified Parkside and Allied that it was considering declaring a default, hired a new contractor to complete the remaining project work, notified Allied of Parkside's default, terminated Parkside, and then demanded that Allied perform its obligations under the bond. Unsurprisingly, the bond claim was denied. JDS sued Allied and Parkside for subcontract breaches, including delay damages, and on the performance bond. Parkside defaulted in the lawsuit, and Allied and JDS cross-moved for summary judgment.

Unfortunately for JDS, Allied's bond was limited by its terms to Parkside's work on the Bonded Subcontract (work to the 36th floor), said the court, which was completed (and paid) in 2017. Thus, with JDS notices for default not given until 8 months later (and perhaps related to unbonded work), the court held that JDS failed to timely comply with the bond's notice provisions, which were conditions precedent to any bond obligation by the surety. That failure of notice prevented Allied from any opportunity to take action,

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Equitable Subrogation: No Court Order, No Surety Indemnity Under Principal's CGL

MARINA S. DE ROSA

It is well established that a surety has contractual and common law rights to recover losses from its principal and indemnitors, as well as the right to equitable subrogation to recover against others with a relationship to the principal, such as the principal's liability carrier.[1] However, whether a surety may recover from the principal's commercial general liability ("CGL") carrier may be an issue of jurisdictional interpretation, and a recent California federal court decision shows how impactful that interpretation can be, and not in a good way.

The case is *Berkley Regional Insurance Co. v. Capitol Specialty Insurance Corp.*,[2] which involved a surety that issued subcontract performance and payment bonds on a California project related to construction for a school. The principal, JMS Air Conditioning & Appliance Service, Inc. ("JMS"), was a subcontractor required to install chiller pipes and related back filling. The obligee initiated a claim against both bonds, asserting that JMS performed the work "incorrectly, negligently, and below construction industry standards." Specifically, the obligee claimed that JMS installed "leaking hydronic piping that caused damage to the project."

After an investigation, the surety determined the claim was valid and it paid the contractors and material suppliers who were

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Scollick Court Rejects Expansion of Surety False Claims Act Liability

NELL M. HURLEY

A collective sigh of relief was heard in the surety industry this past July when the U.S. District Court for the District of Columbia issued its long-awaited decision in *United States ex. rel. Scollick, U.S v. Narula*.[1] The *Scollick* motion court dismissed all claims against the surety defendants, refusing to expand False Claims Act[2] ("FCA") liability to sureties related to certification of minority businesses for set-aside contracts.

As we detailed in a 2021 newsletter,[3] the matter involves a "whistleblower" plaintiff-relator that sought to extend FCA liability to two surety companies alleging that, by virtue of their underwriting processes, the sureties knew or should have known facts that show their bond principals falsely claimed Veterans Affairs ("VA") service-disabled veteran-owned small business ("SDVOSB") status, or otherwise were not qualified to procure certain set-aside government contracts. The significant and numerous concerns about such an expansion voiced by the surety defendants and the surety industry, including the SFAA[4] in its amicus brief, were persuasive to the court as it held that no reasonable jury could find for the plaintiff-relator on the claims.

First, the court found that the plaintiff-relator "produced no evidence…that [the sureties] had knowledge of the [principals'] fraud – that they were fraudulently claiming status as SDVOSBs." Despite allegations in the complaint asserting that the sureties knew, must have known, and even concealed facts about their principals' alleged fraud, the evidence on the motion showed surety knowledge of only the bid proposals and some details of ownership of the companies involved, which is insufficient to demonstrate actual knowledge of the SDVOSB requirements or any fraud, said the court.

Second, plaintiff-relator failed to show deliberate indifference or reckless disregard of the truth by the sureties, which could support an FCA claim in the absence of proof of actual knowledge. The court rejected the argument that the sureties were and should be required to "apply the ownership and control regulations applicable to SDVOSB set-aside contracts" to facts it has about its principals and the bids, opining:

> "[T]his is no "simple step" for the [sureties]… It is a significant leap in terms of liability. Without facts indicating that the [sureties] knew of the specific SDVOSB requirements, this Court will not impose an affirmative duty on [sureties] to double check the government's verification [of the principal's qualification for the program]."

While the court acknowledged that the contractor-participants themselves are obligated to familiarize themselves with set-side program regulations, like VA SDVOSB requirements, it was unpersuaded by efforts to impose that duty on the participants' sureties. The court concluded that the plaintiff-relator "has tried to construct a duty out of thin air: [claiming] that it *should* be incumbent on the sureties to know SDVOSB regulations" but it has failed to show any legal support for it.

Since knowledge of the fraud was an essential element of all of the FCA claims against the sureties, and plaintiff-relator showed neither actual knowledge of SDVOSB requirements by the sureties, nor any duty to familiarize themselves with them, the sureties were entitled to summary judgment in their favor.

It appears that this particular bullet was dodged by the sureties, at least for the time being. Nonetheless, sureties and their counsel would be wise to remain vigilant in the face of growing efforts to enforce the FCA and state false claims acts with novel bases for liability, especially for parties that are perceived as having a deep pocket. F&D

1 2022 WL 3020936 [D.C. Dist. July 29, 2022].

2 31 U.S.C. § 3729, et seq.

3 *"Federal Court Weighs Sureties' False Claims Act Liability for Principals' Alleged Fraud"* Ernstrom & Dreste, LLP Fidelity & Surety Reporter, Issue 36, Summer 2021. Available on our Publications page at www.ernstromdreste.com.

4 The Surety & Fidelity Association of America

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and is fatal to JDS's claim, the court concluded, including its claim against the surety for delay damages.[2] JDS's efforts to recover under a purported "liquidating agreement" for damages incurred by the owner was also rejected because the agreement lacked the requisite "pass-through" provision and failed to demonstrate the existence of a credit or off-set between the parties.

This decision is interesting because the performance bond clearly applied to only the first portion (36 floors) of the subcontractor's project work, apparently leaving the subsequent work to be performed by Parkside unbonded. While it is understandable that JDS's primary focus was on expediting the work of a difficult or deficient contractor, its failure to understand and/or follow the bond's terms left it quite exposed, even as it claimed to be mitigating its damages. While this is a reassuring result for the surety, the court aptly noted that perhaps what this contractor wanted, and could have obtained, was subcontractor default insurance rather than a surety bond. F&D

1 *JDS Dev. LLC v. Parkside Const. Builders Corp.*, 2022 WL 3010193 [Sup Ct, NY County 2022].

2 See *153 Hudson Dev., LLC v. DiNunno*, 8 AD3d 77 [1st Dept 2004].

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hired to remedy the project damage. It then sought reimbursement from two different CGL insurers of JMS under the doctrine of equitable subrogation. The two insurance policies had identical contract language. Like many general liability policies, the provisions in these contracts provided that the insurer pay "those sums that the insured becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage' to which this insurance applies."

The surety brought suit against the two insurers, arguing that after it paid the costs to repair the project work, it had the right to pursue full recovery from the insurers who were primarily responsible for the loss. The insurers claimed that even if the surety stepped into the principal-insured's shoes, the applicable policies were not triggered because neither JMS nor the surety was determined to be legally obligated to pay any damages. The court sided with the insurers, dismissing the surety's action.

It was the meaning of the policy language "damages" that was the sticking point. The court held that under California law, the principal never became legally obligated to pay damages because the term "damages" in the liability insurance indemnity provisions is interpreted under a "bright line rule" to mean *only money ordered by a court to be paid*. This interpretation was upheld by the California courts in numerous instances, noted the court, and the language is unambiguous. Thus, because litigation against JMS never ensued, and there was no court order for JMS (or the surety on JMS's behalf) to pay damages to the obligee related to the insured's loss, the surety suffered no damages required to be indemnified under the policies.

A surety's success under its principal's CGL policy typically represents only partial recovery and only for certain types of claims, all tied to the language of the insurance contract. But this decision appears to put the surety in quite a pickle, at least in California, to ever recover under a principal's CGL policy for indemnity based upon equitable subrogation. Bond obligations require a timely response from the surety to investigate the claim, pay and/or perform, or else the surety risks allegations of bad faith and violations of fair claims practices laws. There is no waiting for a court order. And thus, if indemnity to the surety under a principal's CGL requires a court order, the surety in this scenario will nearly always come up short. E&D

1 Matthew G. Davis & Daniel Pentecost, *Drive for Show, Recover From CGL Carriers for Dough*, National Bond Claim Association [2022].

2 2022 U.S. Dist. LEXIS 174456 [Cent. Dist. Cal., Sept. 26, 2022, No. CV 20-6622 FMO (Ex)].

Two Attorneys Join E&D

Ernstrom & Dreste, LLP is pleased to announce the addition of two associate attorneys to our team of surety and construction law professionals.

Cavan S. Boyle

Cavan S. Boyle brings a broad legal practice background that includes extensive litigation and courtroom experience. Admitted to practice in Massachusetts and New Hampshire, Cavan most recently worked for a well-respected firm in the Boston area, practicing general civil litigation and honing his skills as a zealous advocate for his clients. Prior to that, after earning his law degree in 2013 from Suffolk University Law School, Cavan worked with his father's New Hampshire private and varied law practice. Cavan is also a graduate of Bates College. Cavan awaits admission in New York on motion and will represent clients in surety, construction, and other complex commercial matters, including all aspects of claims, risk management, and litigation.

Marina S. De Rosa

Marina S. De Rosa recently graduated *cum laude* from Syracuse University College of Law, where she was an Associate Editor of the Journal of Science and Technology and a member of the Travis H.D. Lewin Advocacy Honor Society. Marina competed in the prestigious NBTA 2021 Tournament of Champions, and in the National Trial Competition, placing first in the Region with her partner in 2021. Marina was awarded the Lee S. Michaels Advocate of the Year Award, the International Academy of Trial Lawyers Student Advocate Award, and was inducted into the Order of the Barristers. Marina is also a *magna cum laude* graduate of Florida State University. Having passed the New York bar examination this summer, her admission to the bar is anticipated soon. Marina will practice in the areas of surety and construction law, including all phases of claims, litigation and alternative dispute resolution.

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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

Todd Braggins and Brian Streicher attended the Annual Meeting of the National Bond Claims Association October 12-14, 2022 at Streamsong Resort in Bowling Green, FL.

Brian Streicher attended the rescheduled 2022 Midwinter Conference of the ABA/TIPS Fidelity & Surety Law Committee held in Nashville August 17-19, 2022.

Todd Braggins and Brian Streicher plan to join the 2023 ABA/TIPS Fidelity & Surety Law Committee Midwinter Conference January 19-20 in Washington, D.C. Todd will speak on the topic "*Complementary Provisions of the Indemnity Agreement.*"

Todd Braggins attended the Philadelphia Surety Claims Association's June 6, 2022 annual golf outing at Philadelphia's Bala Golf Club.

Kevin Peartree delivered a discussion of "*The Integration of Delegated Design, Design Assist, and Design Build*," for the DBIA Liberty Region Upstate Chapter on December 1, 2022.

Brian Streicher recently joined the Board of Directors of the Junior Builders Exchange of Rochester (JBX).

Brian Streicher was a speaker at the 2022 Pearlman Association Annual Conference addressing the topic of "*Ethics: Joint Defense Agreements and the Common Interest Privilege.*"