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WHAT'S YOUR JUDGMENT WORTH?

Important Changes and New Loopholes That Benefit Debtors

BY TIMOTHY D. BOLDT

The true value of a judgment largely depends on whether the judgment can be enforced. A million dollar judgment against an indemnitor may not be worth the paper it was printed on if a debtor's only asset is an old car and the clothes on their back. Prior to 2009, one of the common and effective enforcement tools was a bank sweep, whereby a restraining notice and information subpoena was served on every bank and financial institution in a geographical area. This was often a quick way of gaining leverage over a debtor even if the sum of money restrained was insignificant compared to the judgment. At a minimum, the restraint pushed debtors to actually communicate with creditors, a milestone that is often difficult to achieve.

Effective January 1, 2009, bank sweeps have been banned in New York by a statute known as the Exempt Income Protection Act ("EIPA"). Under EIPA:

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MIND THE GAP:

Court of Claims Declares the Only Remedy for an Unpaid Surety on a Takeover Contract With the State After Completing a Project Subject to a Cross-Withholding Lien Against the Defaulting Principal Is To Sit and Wait

BY DOUGLAS A. BASS

The Court of Claims' decision denying summary judgment in the recent case, *ORISKA Insurance Company v. New York, #2008-032-127, Claim No. 112919, Motion Nos. M-75096, M-75097*, exposed a gaping hole in the procedure established for a surety to challenge an erroneous determination of the Department of Labor ("DOL"). DOL decisions may only be challenged by bringing an Article 78 proceeding. This creates two important limitations that converged in this case causing the surety's claim to fall through the cracks, denying it any immediate remedy. First, an Article 78 may not be commenced until the challenged administrative decision is "final". Second, the statute of limitations on such an Article 78 action is a mere four months.

It is not unusual for a surety that completes a State project pursuant to its performance bond obligations to be unaware that the defaulting principal was subject to a Notice of Cross-Withholding. The surety in such a situation often does not learn of the Notice until after it fulfills all of its obligations and is denied payment, only then being informed of the lien against the principal's project funds. In that case, it would take a fair amount of blind luck for all of the necessary events causing a surety to be denied completion funds – the principal defaults, the surety executes a takeover contract with the State, the surety fully completes the project, the State authorizes full final payment, the State diverts the project funds to the DOL, and the State informs the surety that it is being denied its earned contract sums – to occur all within four short months from the date the Notice of Withholding was first served upon the principal.

If the surety is fortunate enough to be made aware of the Notice within the necessary four months and it already executed its takeover agreement making it responsible for the project's completion, it may file an Article 78 challenging the Notice. However, if the surety is not aware and the administrative proceedings to assess the validity of the allegations underlying the Notice are not yet complete when the surety learns of its predicament, it is left in a Catch-22. It may not file an Article 78 challenging the service of the Notice because it will be time-barred by the statute of limitations. It may not file an Article 78 challenging the DOL's determination which led to the State withholding its earned contract sums since the Court would not yet have a "final determination" to review, thus making the action premature.

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Without a "final determination" to challenge, the surety is left in limbo, waiting for a final outcome in the pending administrative proceedings, which may take months or years to complete. All the while, the surety is being denied earned income and, potentially, its ability to pay its subcontractors, materialmen, and employees who worked on the project in question.

Matters are made all the more frustrating if the basis of the lien is the defaulting principal's actions on a different project than the one the surety completed. Under these circumstances, the surety's right to the project funds are superior to the State's **as a matter of law**.[1] This means that the ultimate outcome is inevitable: the State ***must*** turn over all project funds to the surety, **regardless of the DOL's final determination, whatever that may be**. But without a vehicle to bring this action to a legal conclusion, the surety's only option is to wait for the DOL to conclude its meaningless administrative procedure and hope it complies with the established law. Meanwhile, each stage of the process – challenging the determination in the administrative proceeding, following the administrative appeals process if the decision denies the surety its project funds, and ultimately challenging the DOL's "final determination" if it concludes the surety is to be denied its project funds – force the surety to incur costly legal expenses, all to simply get paid sums the State has no legal right to withhold.

This is the unfortunate situation that the surety in the ORISKA matter found itself.

In ORISKA, the performance bond principal was subject to a cross-withholding lien on a Department of Transportation ("DOT") project's proceeds. The Notice of Withholding establishing that lien was issued by the DOL a year and half before the bond principal defaulted on its contract obligations with the State. This default triggered the surety's obligation to complete the work. The surety hired a replacement contractor approved by DOT and the replacement contractor successfully completed the project. DOT approved final payment to the surety for the replacement contractor's work, but made this payment into the Comptroller's Account instead of to the surety.

The DOL explained to the surety and both the original and replacement contractors that the final payment was diverted away from the surety because the DOL concluded that the replacement contractor was an alter ego, successor, or substantially-owned affiliate of the original contractor that was subject to the lien. As a result, DOL found that the replacement contractor was properly subject to the same sanctions as would apply to the original contract for its completion work on the project.

DOL gave both contractors the opportunity to challenge this finding in the ongoing administrative proceeding related to the Notice of Withholding that established the cross-withholding lien against the original contractor. DOL also involved the surety in the administrative proceeding.

Without waiting for a resolution to the contractors' challenge to the DOL determination, the surety filed the instant lawsuit in the Court of Claims for the contract proceeds. The surety's position was that, regardless of DOL's suspicions about the possible interrelated nature of the two contractors involved in this project, the surety's right to the contract funds was superior to the lien imposed by the DOL cross-withholding notice as a matter of New York State law. Therefore, since the State had no right as a matter of law to deny the payments, it should be compelled to compensate the surety immediately. It certainly makes no sense to wait for the DOL to issue a final determination that, regardless of its conclusion, can have no impact on altering the ultimate outcome.

Unfortunately, the Court of Claims believed its hands were tied by the Article 78 procedural paradox. It held that it had no authority to hear such a case because, by its very nature, the surety was asking the Court to find that the DOL's decision to serve its Notice of Cross-Withholding was in error. Thus, the only action that could be filed to challenge this determination was an Article 78 proceeding. The Court of Claims does not have the authority to hear an Article 78 proceeding so it could not convert this action into one to solve the problem.

In any event, the Court recognized that the surety found itself in the procedural "dead zone" created by the short Article 78 statute of limitations. It had been more than four months since the Notice was filed so the surety was time-barred from challenging it. The DOL's administrative proceedings were still pending so there was no "final determination" for any court to assess.

Therefore, the Court of Claims dismissed the surety's case, reasoning that it did not have jurisdiction to rule on it. In so doing, the Court of Claims concluded that the surety had no choice but to sit and wait for the administrative process to run its course. If the DOL followed the law, the funds would automatically be ordered turned over to the surety. If not, the surety would have its "final determination" and may challenge the determination in the Appellate Division in an Article 78 proceeding.[2]

This case illustrates a serious risk of which sureties may not be aware. To combat this procedural problem, sureties would be wise to address this issue in their performance bonds or general indemnity agreements. One suggestion is to require principals and the State, upon penalty of invalidating the bond, to disclose any notice that may lead the State to withhold any funds from the surety in the event it is forced to complete a project pursuant to its performance bond obligations.

This protective provision could include a requirement that if the principal disagrees with the notice, it must disclose to the surety its position with supporting proof. If the principal contests the grounds set forth in the notice, a companion provision may be in order to require the principal to bring the Article 78 challenge immediately.[3] If the principal does not contest the allegations in the Notice, at a minimum, the required disclosure would allow the surety to be aware of this risk before entering into the takeover contract.

The *ORISKA* case also carries with it an important warning. If a surety finds itself with the *ORISKA* problem of having missed its opportunity to challenge a Notice of Cross-Withholding, it must pursue its rights in the principal's administrative proceeding or potentially risk losing its right to its earned contract proceeds altogether. The window of

- Information subpoenas must now include a certification by the judgment creditor that it has a reasonable belief that the recipient bank has useful information. Sanctions may be imposed on judgment creditors who falsely certify.

  Previously, the only disincentive to performing a bank sweep was the associated expense combined with the risk that nothing would be discovered.

- The first $1,716.00 on deposit with a bank is automatically exempt and otherwise cannot be restrained regardless of whether it originated from an exempt source. If the funds came to the bank by direct deposit, the automatic exemption is $2,500.00. The base exemption of $1,716.00 is directly tied to statutory minimum wage and as such will increase in the near future to $1,740.00. The direct deposit exemption is tied to inflation and will change every three years beginning in 2012.

  Previously, there was no exemption based on the amount of money on deposit.

- If a debtor does not have more than the automatic exemption amount on deposit, the bank is not required to notify the judgment creditor or to otherwise respond.

  Previously, banks were obligated to honor all restraints regardless of how much money was on deposit and were also obligated to respond to information subpoenas in furtherance of judgment enforcement.

Additionally, there is a loophole that may allow debtors to keep non-exempt funds from creditors. If a creditor locates and properly restrains funds held by a financial institution, debtors now have the right, without obtaining legal counsel, to trigger a procedure that significantly disfavors creditors and arguably makes it easy for a debtor to repossess the restrained funds. The loophole lies in the following: when a creditor properly restrains an account, the financial institution must notify the debtor and provide them with instructions and a form to object to the restraint. The debtor has twenty days to submit an objection. The creditor then has eight days to evaluate the objection, determine its credibility, and make a motion for a court order continuing the restraint. The motion must be heard by a court within seven days from the date the notice of motion is served. The creditor must then obtain a decision and order from the court within five days of the motion date and must then serve the signed order on the bank and debtor within two days of receiving it. There are a total of twenty-two days allowed for this procedural mechanism.

The first and most notable problem is that the new rule requires banks to lift a restraint and allow the debtor complete access to the funds unless it has a court order validating the restraint within twenty-one days from the date it received the debtor's exemption objection. Furthermore, as many judgment creditors know all too well, it can be difficult and sometimes impossible to schedule a motion on seven days notice. Depending on the court clerk and the assigned judge's schedule, it often takes several weeks to be heard on a motion even when steps are taken to expedite the hearing. It can be even more difficult to obtain a court decision within five days from the return date of a motion. In New York, it is not uncommon to wait months for a court order, even on basic issues. Unless the courts accommodate creditors on restraint motions, banks will likely be forced to release lawfully restrained funds before the creditor can secure its rights. Furthermore, the rule includes a special instruction that judgment creditors must make these motions in good faith or else be subject to sanctions. This presents another problem for creditors because the procedure does not ensure that creditors will have any objective information to evaluate the exemption claim. Therefore, the decision to make a motion will need to be made based solely upon information supplied by the debtor. There is no corresponding rule imposing sanctions on debtors who submit exemption claims in bad faith.

In the face of EIPA, creditors in New York need to re-evaluate how they approach judgment enforcement, including ways to investigate and gain information about assets before judgment is obtained and determine whether it makes sense to take early and aggressive steps to obtain information directly from the judgment debtor. Although the table has been shifted in favor of debtors, creditors still have several enforcement tools available, including the right to post-judgment document discovery and a deposition to investigate other potential avenues of recovery. E&D

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opportunity to bring an Article 78 proceeding to challenge an administrative determination is as limited as the time open to challenge the initial Notice. A surety subject to the *ORISKA* paradox who tries to bypass the administrative process could find that, by the time it redirects its attention to the correct forum, the statute of limitations to bring the Article 78 proceeding challenging the administrative "final determination" may have run. If that occurs, the surety will have lost its chance to contest service of the Notice on the front end and an improper final determination on the back end. If this unfortunate confluence of events occurs, the negative administrative decision will be final. This could translate into a very expensive loss imposed upon a surety who will have been denied its day in court simply due to a procedural black hole. E&D

1 In Re RLI Ins. Co., Surety Div. v N.Y.S. D.O.L., 97 N.Y.2d 256 (2002).

2 N.Y. Labor Law §§ 220(8), 220-b(e).

3 Another solution may be to do so only under certain circumstances, such as if the amount of the lien exceeds a certain dollar amount or percentage of the total bonded contract.

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ERNSTROM & DRESTE NEWS

Kevin Peartree recently lectured on contract risk management for a class of Future Construction Leaders for the AGC of NYS.

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