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Contractual Liability To Third Parties an Indirect Loss: No Coverage Under CCP

BY NELL M. HURLEY

A U.S. District Court in Texas recently refused to reconsider its determination that losses sustained as a result of contractual liability to third parties were indirect and therefore excluded by the terms of the applicable Commercial Crime Policy.

BJ Services S.R.L. et. al. v. Great American Insurance Co., 2012 WL 2529231(S.D.Tex), was a declaratory action for determination of coverage. The suit arose from a series of transactions in which agents of Plaintiff BJ Services fraudulently executed loan agreements (on behalf of BJ Services) with an Argentine bank and then converted nearly $5M of the loaned money to their own use. BJ Services was required to repay the funds to the Bank and then filed a claim under the policy. Great American denied coverage, asserting that the money was not "covered property" under the policy because it never became the property of BJ Services and because the loss did not result directly from employee dishonesty.

The District Court determined that the loss to BJ Services occurred when the company was required to satisfy its obligation to the financial institutions, as there had been no "actual depletion" of its funds before then. Since the loss was the

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Two Steps Forward and One (New) Step Back:

NEW YORK'S COURT OF APPEALS BLURS THE LINE BETWEEN SURETY SUBROGATION RIGHTS AND DISCHARGE DEFENSES

BY JOHN W. DRESTE

Incomplete facts coupled with confused legal principles will almost always result in unsound reasoning. After being presented with such a toxic mix, the New York State Court of Appeals issued a decision that, on its face, confuses the equitable subrogation rights of sureties with unrelated surety-specific defenses that may afford a complete discharge of suretyship exposure. Fortunately, the Court in this instance expressly held that the result applied only "under the facts of this case."

In *Mount Vernon City School Dist. v. Nova Cas. Co.*, 2012 WL 1080302, the Court was presented with a scenario in which a bonded contractor (DJH Mechanical Associates, Inc. or "DJH"), long before any default, directed that a school district owner ("District") release earned contract funds directly to the New York State Department of Labor ("DOL") to satisfy a cross-withholding for underpaid wages by DJH on a separate project. The District complied with the DJH request, releasing $214,000 directly to the DOL.

Although full details are not entirely clear, DJH subsequently fell increasingly behind on the bonded project and was ultimately terminated by the District the year following the release of funds to the DOL. Nova Casualty Company ("Nova") had issued performance and payment bonds naming DJH as Principal and the District as Obligee. After learning of the earlier release of the $214,000 directly to the DOL, Nova refused to perform, claiming that the payment to DOL was in violation of the trust provisions of New York's Lien Law. Nova further claimed that the released funds would have permitted the District to complete the bonded work at no loss and without calling upon Nova to perform. Nova urged that this payment, without notice to Nova, increased Nova's risk to a sufficient extent that it should be discharged under the bond. Nova further contended that, regardless of whether the payment amounted to a trust fund violation, it was in breach of a performance bond provision stating:

> [t]he Surety shall not be liable to the Owner or others for obligations of the Contractor that are unrelated to the Construction Contract, and the balance of the Contract Price shall not be reduced or set off on account of any such unrelated obligations.

Ultimately, the District completed the Project incurring a loss of $106,000, which sum was at the heart of the underlying lawsuit.

The Court did not reach the issue of whether or not the District's direct payment to the DOL constituted a trust fund violation, instead holding that Nova's failure to fully perform, by either funding or otherwise completing the work, deprived Nova of any subrogated rights of Lien Law trust fund beneficiaries and that Nova therefore lacked capacity to raise any alleged Lien Law violation. The Court used this rationale to distinguish this matter from its prior favorable holding in *Matter of RLI Insurance Co., Sur. Div. v. New York State Dept. of Labor*, 97 N.Y. 2d 256 (2002) and related cases in which the surety was deemed to have superior claims to Lien Law trust assets.

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Before You Takeover...A Cautionary Tale

BY THOMAS K. O'GARA

A recent case in Suffolk County Supreme Court underscores the potential dangers encountered when a surety enters into a takeover agreement for a defaulted principal. In *Comprehensive Care Mgmt. v. Utica Mut. Ins. Co.*, 33 Misc.3d 1236(A), 2011 WL 6338907 (Suffolk County Sup. Ct. 2011), the Surety entered into a takeover agreement after its Principal defaulted on the underlying contract with the Obligee. In the takeover agreement, the Surety assumed all of the Principal's obligations and was entitled to all of the Principal's rights based on the underlying contract with the Obligee. Even after the takeover agreement, the underlying contract and performance bond remained in full force and effect.

When the completion of work under the takeover agreement was delayed, lawsuits were filed between the Obligee, the Principal, and the Surety. The Obligee sued the Surety alleging that the Surety breached the takeover agreement by not meeting the date of substantial completion and failing to remove all liens against the property, including a lien filed by the Principal. The Obligee sought legal expenses, design professional costs, delay costs, and liquidated damages pursuant to the underlying contract and the performance bond.

The Surety moved to dismiss the Obligee's claims for attorneys' fees and liquidated damages because such costs were not provided for in the takeover agreement. The court dismissed the Surety's argument, finding that, despite the takeover agreement, the terms of the underlying contract and the performance bond remained in effect. In addition, the takeover agreement provided that the Surety would stand in the shoes of the Principal under the contract as if the Surety was the original contracting party.

The Surety next argued that the Obligee's claims for attorneys' fees and liquidated damages were barred by the two-year contractual limitations period in the performance bond. The Surety claimed that the Principal was in default when it failed to meet the substantial completion date of January 11, 2007, making the Obligee's lawsuit, commenced on June 29, 2007, untimely. The court also dismissed this argument, holding that the Principal's default was not triggered by its failure to meet the date of substantial completion. Instead, the claim accrued when the Obligee complied with the steps necessary to declare the Principal in default, as set forth in the performance bond.

The court then considered whether or not attorneys' fees were recoverable under the takeover agreement. Relying on the Second Circuit's opinion in *United States Fid. and Guar. Co. v. Braspetro Oil Servs. Co.*, 369 F.3d 34 (2d Cir. 2004) and the Supreme Court, Westchester County decision in *Mount Vernon City School Dist v. Nova Cas. Co.*, 30 Misc.3d 1233[A], 2009 WL 75242 (Westchester County Sup. Ct. 2009), the Court held that the "legal cost" language of the performance bond only included attorneys' fees if it was "unmistakably clear" that the parties intended for the Surety to become obligated to reimburse the Obligee for attorneys' fees.

Using this standard, the court determined that the Obligee was not entitled to recover attorneys' fees from the Surety in connection with the current litigation or any other litigation involving the Surety or the Principal. Instead, the Obligee's recovery was limited to attorneys' fees relating to its claim for additional cost incurred in completing the work of the underlying contract.

In addition, the court allowed the Obligee to recover liquidated damages only if it did not recover its actual damages. Because liquidated damages and actual damages are mutually exclusive remedies under New York law, the Obligee cannot recover both in the same lawsuit.

Finally, the Obligee looked to the Surety to satisfy the lien filed by the Principal. Since the takeover agreement only required the Surety to accept responsibility for those liens for which the Principal was liable, the Surety was not required to remove or satisfy the Principal's lien.

When a surety enters into a takeover agreement, there are many factors to be taken into consideration. This case underscores the significance of the terms of the underlying contract and performance bond, even after execution of the takeover agreement. Such language is critical to understanding the surety's obligations when completing for a defaulted principal. F&D

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result of contractual third-party liability, it was not directly caused by the agents' misconduct and thus was not covered under the policy. Because its ruling on this issue disposed of the case, the Court did not decide whether the misappropriated funds were "covered property."

Plaintiffs argued that the Court should vacate its decision because the issue of who owned or held the funds was central to the finding of whether the loss was direct. Some of Plaintiffs' arguments in support of this position were dismissed by the Court because they had not been presented in the initial motion. But the Plaintiffs also argued that they were entitled to reconsideration based upon the Court's "apparent misunderstanding" of a Seventh Circuit case relied upon in finding that the losses were indirect. The Plaintiffs claimed that the BJ Services Court created a bright-line rule from the opinion that was unwarranted.

Not so, says the *BJ Services* Court. The ruling on whether the loss was direct or indirect is dispositive and there were no disputed facts that were material to that decision, it holds. Plaintiffs' losses did not result directly from employee dishonesty but, instead, resulted from Plaintiffs' contractual liability to the third-party financial institutions. The Court revisited that Seventh Circuit case, *Universal Mortgage Corp. v. Wurttembergische*, 651 F3d 759 (7th Cir. 2011), finding its reasoning persuasive on the issue of whether Plaintiffs' claimed loss was indirect and, therefore, not covered by the policy.

In the *Universal Mortgage* case, the Seventh Circuit Court of Appeals affirmed a finding of no coverage, holding that:

> A financial loss resulting from contractual liability to third parties is not "directly" caused by employee misconduct, even if employee misconduct is the source of the contract liability.

In that case, involving a mortgage bankers

Perhaps more troubling, the Court suggested that, because the $214,000 payment when made was not in excess of what was then due and owing to DJH, it "neither materially altered the contract nor impaired Nova's surety obligation" in order to support discharge.[1] The Court reasoned that "even assuming that the payment ... was an improper diversion, it does not appear that the payment committed Nova to a dollar more than [the] amount for which it bonded DJH." From what can be gleaned from the portions of the Record presently available for review, it seems that the following simple question was asked: how is this scenario any different in effect than if the District had paid the funds to DJH, and DJH then directly paid the DOL instead?

Said differently, the Court was reluctant to hold the Obligee responsible for payments directed to a third-party at the Principal's direction well before any default by the Principal on the bonded contract. The Record is lacking any discussion concerning the contract rights of the Obligee to hold and apply contract funds, and there is little to suggest that the Principal's ultimate inability to complete the work was a result of the $214,000 payment that was diverted to the DOL.[2] The problem, however, is in the confused analysis of whether or not that application of contract funds materially modified the bonded risk, and whether the surety could only raise such a defense via subrogation to trust fund beneficiaries who were not paid. There was no showing that any subcontractors or suppliers went unpaid, but the greater confusion within the decision appears to suggest that a surety may only assert defenses affording a complete discharge after fully performing the obligation for which the discharge is sought. This cannot be the intent of the Court. Regardless of whether or not the payment constituted a trust fund diversion, the proper analysis (and ideally the focus of proof) should simply have been whether or not that dissipation of bonded contract proceeds sufficiently increased the bonded risk to afford a discharge, regardless of whether the payment itself constituted a trust fund violation.

There is support for the proposition that the payment to the DOL constituted a diversion of trust funds, made illegal under New York Law. A vigorous dissenting opinion thoroughly reviews New York's strong prohibition against diversions of construction trust funds, as well as the recognized rights of sureties to pursue and/or recoup diverted funds.[3] Support as well is found within the terms of the Lien Law, which expressly provide that such funds may not be levied upon or be subject to a restraining notice and, in fact, that any transaction, before payment or discharge of all trust claims, is a diversion of trust assets, whether or not there are trust claims in existence at the time of the transaction. *N.Y. Lien Law §72*. The problem confronted by the Court was that there was no showing of unpaid trust beneficiaries, and to the extent there was an arguable diversion, the result was a dissipation of funds available to the District/Obligee for the costs of completion.

New York, as with many states, is reluctant to permit a full discharge in many instances, but will recognize at least the *pro tanto* increase in risk once demonstrated. Thus, what if the surety had performed under a full reservation of rights, asserting instead a right to payment or recoupment at least on a *pro tanto* basis due to what amounted to an overpayment of contract funds?

The Principal, DJH, should clearly be answerable under its indemnification obligations, as well as under the trust fund provisions of the Lien Law. Additionally, the DOL itself could potentially be pursued as being a recipient of diverted trust proceeds. However, the Owner/Obligee itself could properly be held responsible for the shortfall in completion funds, whether analyzed under the trust fund provisions of the Lien Law or otherwise. This partial, *pro tanto* discharge, and resulting ability to recoup or be repaid some loss, is explained most clearly within §§ 37 and 44 of the Restatement of the Law Third, *Suretyship and Guaranty* (The American Law Institute, 1995).

The bottom line is that the surety here may have over-reached in an effort to obtain a complete discharge, but this was then compounded by confusion on the part of the many judges that heard the matter through various levels of trial and appellate courts. The end result is a decision at the highest level court in New York that will likely be asserted in the face of surety defenses to performance in the future. However, properly understanding that this case is limited to its facts (and lack thereof), and that the underlying Record confused the distinction between direct defenses and those obtained via subrogation, should help mitigate its impact. E&D

1 The Court does confirm reliance on the Restatement [Third] of Sureyship & Guaranty in general, citing §§37 and 49.

2 Thus, the Court could not conclude there had been any demonstration of sufficient prejudice to support a showing of "impairment of suretyship status" as contemplated under the Restatement.

3 The dissenting opinion also generally tracks the long-standing rule in New York that a material modification of a bonded risk may result in the surety's discharge.

blanket bond but containing direct-loss causation language, the employee engaged in a scheme so that Universal Mortgage funded mortgages that did not meet its required standards. Universal then sold the mortgages, not knowing they were substandard, but nonetheless warranting them. When the mortgage buyers later forced Universal Mortgage to repurchase the loans, Universal Mortgage sustained a significant loss and filed a claim on the bond.

In upholding the denial of coverage, the *Universal Mortgage* appeals court acknowledged the influence of years of court decisions upon the development of the various terms of the bonds as well as the existence of two interpretive "camps" regarding the construal of the term "direct loss." The "proximate cause" camp holds that the direct cause of the loss does not have to be the "sole cause" but need only be a proximate or substantial cause. (See *Scirex Corp v. Fed. Ins. Co.*, 313 F3d 841 (3d Cir. 2002)). The other camp concludes that "direct means direct" and does not support indemnity under the bond for the claims of third parties. (See *Vons Companies, Inc v. Federal Insurance Company*, 212 F3d 489 (9th Cir. 2000)).

The *Universal Mortgage* Court, and now the *BJ Services* Court, clearly supports the "direct means direct" camp where a loss resulting from an insured's liability to third parties is not a direct loss under a fidelity bond or Commercial Crime Policy, even if the liability resulted from a covered act. In each case, the court rejected efforts by the plaintiffs to expand the coverage to include loss incurred by the insured in paying the claims of third parties. While these holdings are good news for fidelity carriers providing policies in these jurisdictions, they also illustrate that insureds are continuing to litigate coverage, seeking to gain entry into the "proximate cause" camp. Fidelity claim managers are well-advised to be familiar with the applicable case law in the jurisdictions where their company writes its policies and bonds. E&D

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FIRM NEWS

Ernstrom & Dreste, LLP Announces New Managing Partner, Celebrates 20th Anniversary

Ernstrom & Dreste, LLP is pleased to announce Todd R. Braggins is Managing Partner effective May 11, 2012. Mr. Braggins has been with the firm since 1993. His practice is focused in the area of commercial litigation, with particular emphasis in the fields of surety and construction law. The firm also celebrates twenty years of service to its clients in the surety and construction industries in August 2012.

Thomas K. O'Gara is authoring a chapter on the ConsensusDOCS BIM Addendum for the 2013 Cumulative Supplement to the ConsensusDOCS Contract Documents Handbook, published by Wolters Kluwer.