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E&D Offices

180 Canal View Boulevard
Suite 600
Rochester, New York 14623
Telephone: 585-473-3100
Facsimile: 585-473-3113

1050 Connecticut Avenue, NW
Suite 1054
Washington, DC 20036
Telephone: 202-772-1127
Facsimile: 202-772-3308

317 Madison Avenue
Suite 703
New York, New York 10017
Telephone: 212-687-0303
Facsimile: 212-687-1597

345 Route 17 South
Suite 19
Upper Saddle River, NJ 07458
Telephone: 201-934-4243
Facsimile: 201-934-4146

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This newsletter is intended purely as a resource guide for its readers. It is not intended to provide specific legal advice. Laws vary substantially from State to State. You should always retain and consult knowledgeable counsel with respect to any specific legal inquiries or concerns. No information provided in this newsletter shall create an attorney-client relationship.

Sureties Beware: Despite Principal's Voluntary Letter of Default, Illinois Federal Court Cuts Off Surety's Subrogation Rights To Contract Funds In The Absence Of Owner's Declaration of Default

By Derek A. Popeil, Esq.

Liberty Mutual Insurance Company v. Construction Management Services, 2004 WL 2271811 (N.D. Ill.) represents a case in which the surety, by trying to act proactively in conjunction with its financially strapped principal, may have moved too quickly and without adequate protection to guarantee reimbursement from the owner's contract funds for funds advanced to its troubled principal for project completion.

Construction Management Services, Inc. ("CMS") entered into a contract with Wheaton Warrenville Community Unit School District # 200 ("Wheaton" or "School District") for the construction of a high school and middle school in Wheaton, Illinois. Liberty Mutual Insurance Company ("Liberty Mutual") issued a performance bond on behalf of CMS, naming Wheaton as obligee. Shortly after Liberty executed the performance bond, CMS sent a letter of voluntary default to Wheaton, voluntarily abandoning and terminating its construction contract. On the same day, CMS also sent a letter of direction to Wheaton instructing it to make all future disbursements of the contract funds directly to Liberty Mutual. In exchange for the assignment of the contract funds, Liberty Mutual provided financing to CMS in order to enable CMS to complete the project. There is no indication that a takeover agreement was ever executed or that there was any acknowledgement by Wheaton that Liberty Mutual was financing CMS to complete the project. Despite the letter of direction, the School District made payments to CMS instead of Liberty Mutual.

Liberty Mutual notified the School District of CMS's letter of direction and demanded all future payments be made directly to Liberty Mutual. However, Bovis, the construction manager (apparently misidentified by the Court as the general contractor), then sent a letter to CMS requesting that it return to the Project and complete its work under the terms of the original contract, which it did. Bovis subsequently notified Liberty Mutual that CMS had returned to the Project and that it would not be seeking other subcontractors to complete CMS's work.

Liberty Mutual filed suit against Wheaton on a number of grounds, including conversion, breach of stakeholder's duty, assignment and equitable subrogation. The Court, in its first decision, denied Liberty Mutual's claim for conversion as not being sufficiently plead and found that Liberty Mutual's claim of a breach of stakeholder duty was improper because the letter of direction from CMS did not transform the money owed under a construction project into a "stake." Therefore, Wheaton was not a stakeholder, but instead remained the owner of the funds. The Court preliminarily allowed the equitable subrogation and assignment claims to survive the first challenge.

In this second decision, the Court found against Liberty Mutual on its equitable subrogation claim. The Court agreed with Wheaton, noting that a condition precedent to Liberty Mutual's obligations under the bond required a declaration of default by the School District, not CMS or Liberty Mutual. The bond's operative language reads as follows: "NOW THEREFORE, THE CONDITION OF THIS OBLIGATION IS... Whenever the Contractor [CMS] shall be, and declared by Owner [School District] to be in default under the Contract...." Therefore, Liberty Mutual was not legally compelled to perform under the bond or to finance CMS. In essence, the Court determined that in the absence of a declaration of default or request to perform *by the School District*, and despite issuance of CMS's voluntary letter of default, Liberty Mutual was under no

obligation to act pursuant to the terms of the bond. Thus, Liberty Mutual acted as a volunteer in providing the financing to CMS. Accordingly, Liberty Mutual's equitable subrogation rights never arose because it never had an obligation to perform.

However, the Court agreed with Liberty Mutual that a declaration of default by Wheaton was not required to trigger the assignment clause contained in the General Agreement of Indemnity executed by CMS. The Court determined that a factual dispute existed as to whether Wheaton had knowledge of the assignment before it released additional payments to CMS.

It is common for a surety to have its principal execute a voluntary letter of default prior to providing financing. However, this decision suggests that the surety should also confirm the owner's acceptance of the voluntary letter of default and obtain written confirmation that the Owner will remit all future payments to the surety. Absent a takeover agreement or some other acknowledgement by the Owner that the surety is completing the project, the surety could put at risk both its ability to obtain the remaining contract balance as well as its argument that it is entitled to a credit against the penal sum of the performance bond for any funds expended toward completion of the project.

One-Year Limitations Period Under Payment Bond is Not Tolled While Surety Investigates Claim on the Bond, and Repair Work Performed After Lapse of One-Year Limitations Period Does Not Resurrect Lapsed Limitations Period

By Kevin K. McKain, Esq.

Whether it is a statutory payment bond or a common-law payment bond, bond claimants consistently seek ways to lengthen or altogether avoid the bond's limitations period. In the recent case of *J. Caiazzo Plumbing and Heating Corp. v. United States Fidelity and Guaranty Company*, 2004 WL 2848548 (S.D.N.Y.), the claimant on a common-law bond sought both a toll of the bond's one-year limitations period for commencing a suit on the bond and to resurrect the limitations period after it had already lapsed.

In *Caiazzo Plumbing*, the Plaintiff/Claimant provided plumbing and related services as a subcontractor on the project. The Court determined the last day that Plaintiff or anyone on the project performed work or supplied materials was August 1, 2001. However, it is undisputed that in February 2002, Plaintiff returned to the project to repair some admitted deficiencies in its work, including a repair of a bathroom faucet and an adjustment to the building's water pressure. Plaintiff did not invoice any party for the repair work.

Sometime after August 1, 2001, Plaintiff submitted a claim on the applicable payment bond for unpaid work. The surety, United States Fidelity and Guaranty ("USF&G") acknowledged receipt of Plaintiff's claim and advised Plaintiff that it would investigate the claim. Significantly, USF&G reserved its rights under the bond.

On December 23, 2002, Plaintiff commenced suit against USF&G under the payment bond, which bond provided that any such suit must be commenced within one (1) year from the date "on which the last labor or service was performed by anyone under the Construction Contract," Stating that all work on the project was complete as of August 1, 2001, USF&G sought dismissal of Plaintiff's claim, on the basis that the payment bond's one-year limitations period had lapsed.

Plaintiff contended that the one-year limitations period under the payment bond did not foreclose its suit for two separate reasons. First, Plaintiff contended that USF&G's acknowledgment of Plaintiff's claim, promise to investigate the claim and failure to deny the claim prior to the expiration of the limitations period estopped USF&G from asserting the limitations period as a defense. Second, Plaintiff contended that the one-year limitations period had not lapsed at all, because it should not have accrued any earlier than February 2002, the date Plaintiff returned to perform the repair work.

The Court rejected both of Plaintiff's arguments. On the estoppel issue, the Court held that unless Plaintiff could prove that USF&G intentionally "lulled" Plaintiff into inactivity by its actions, estoppel could not be invoked. Critically, the Court emphasized that New York courts have consistently rejected estoppel claims against a surety when the surety acknowledged receipt of the claim, reserved its rights on numerous occasions, the amount of the claim was disputed, and no settlement was ever offered by the surety. The Court's decision further illustrates why it is crucial that sureties always include language within their correspondence to payment bond claimants expressly reserving their rights and defenses.

With respect to Plaintiff's argument that the bond's one-year limitations period had not lapsed, the Court held that the bond's limitations period did not accrue on the date of the subsequent repair work because that work was not performed "under the Construction Contract", as required under the bond. Instead, the work was performed under the subcontract. While the court's analysis is questionable, it nevertheless went on to hold that even had the subcontract incorporated the general contract, so that the repair work was considered "under the Construction Contract", the bond's limitations period still would have lapsed. The Court stated that the applicable legal test is whether the work was performed "as part of the original contract", which is covered by the bond, or "for the purpose of correcting defects or making repairs following inspection." Here, the work performed by Plaintiff was clearly performed to repair a defect in its original work and therefore did not toll the statute of limitations. Finally, the Court noted that the public policy behind enforcement of the limitations period is to encourage the speedy resolution of disputes, to permit distribution of assets, and to provide the debtor and surety with finality. If repeated, minor adjustments to completed projects could extend the surety's liability on the bond, this would be impossible.

New York State Trial Court Holds That Surety's Obligations Are Discharged When New Principal Was Unknowingly Substituted To Perform Work On Bonded Contract

By: Gavin M. Lankford, Esq.

The New York Supreme Court, Kings County, recently examined the issues of bonded risk and corporate identity. In *95 Lorimer, LLC v. The Insurance Company of the State of Pennsylvania*, 2004 WL 2656670 (N.Y. Sup. Ct. Kings Cty 2004), the Court held that a surety was released from its guaranty obligations under a performance bond when a new contractor was allowed to take over the work of the surety's original bonded principal without the surety's knowledge.

On July 10, 1998, Lorimer, LLC ("Lorimer") and Iroquois Demolition Corporation a/k/a Iroquois Wrecking Corp. ("Iroquois"), entered into a contract wherein Iroquois agreed to perform certain demolition and removal work at a site owned by Lorimer. On July 13, 1998, The Insurance Company of the State of Pennsylvania ("ICP") issued payment and performance bonds on the contract on behalf of Iroquois, as principal, to Lorimer, as owner and obligee. It was undisputed that Iroquois performed work under the contract and received payment from Lorimer until June 18, 1999. According to Lorimer, sometime between June 18, 1999 and August 4, 1999, Philip Schwab, known to be an owner and principal of Iroquois, informed Lorimer that Iroquois had changed its name to Irondequoit Corporation ("Irondequoit") and all payments due under the contract were to be issued to Irondequoit.

Starting on August 4, 1999, Lorimer began making contract payments to Irondequoit and not Iroquois. However, it was not until November 19, 1999 that Irondequoit filed incorporation papers with the New York State Secretary of State. At that time, Iroquois was still a separate and distinct corporate entity in the State of New York. In fact, Iroquois remained an active New York corporation until June 26, 2002, when it was involuntarily dissolved by proclamation of the New York Secretary of State for non-payment of taxes.

ICP was not informed of the name change, nor was it notified that the contract payments were assigned and issued to Irondequoit, as opposed to Iroquois. Most importantly, ICP's permission was not sought to change the identity of the principal on the bonds from Iroquois to Irondequoit. In fact, Lorimer did not notify ICP of the change in the corporate entity that was performing work under the contract and receiving payments until December 2001 – after Lorimer had a dispute with Irondequoit concerning certain excavation work and more than two years after Lorimer made its last contract payment to Iroquois. These findings were critical because the bond contained a statute of limitations provision requiring commencement of suit within two (2) years after the contractor/principal ceases to perform work under the contract.

Eventually, Lorimer declared Irondequoit to be in default and ICP took the position that its obligations under the bond had been discharged. Thereafter, Lorimer filed suit seeking recovery under the bond. ICP moved to dismiss Lorimer's complaint arguing that Iroquois, its principal, was a separate and distinct corporate entity from Irondequoit. As such, Lorimer's suit, which was commenced in May 2002, was time-barred because Iroquois last performed work and received payments under the contract in June 1999 – nearly three years before Lorimer commenced its action. Lorimer opposed ICP's motion on the grounds that Iroquois and Irondequoit were the same entity. Lorimer argued that the change was only in name and location, and the bonded entity remained the same, because Irondequoit had the same principals and employees, and Irondequoit performed the same work functions as Iroquois had.

The Court granted ICP's motion to dismiss the complaint, finding Iroquois and Irondequoit to be separate and distinct corporate entities. The Court noted:

> Mere formalistic changes in the identity of a principal obligor, such as its name or location, do not discharge the surety (see *State of New York v. International Fidelity Insurance Co.*, 152 A.D.2d 77, 80, 547 N.Y.S.2d 87 (3rd Dept. 1983)). However, "a guaranty does not extend to a subsequent entity if there has been a true change in the composition or structure of the enterprise" (see *Anti-Hydro Co., Inc. v. Castiglia*, 92 A.D.2d 741, 461 N.Y.S.2d 87 (4th Dept. 1983)).

One factor that the Court stressed in determining that Iroquois and Irondequoit were separate and distinct corporate entities was the fact that both entities co-existed at the same time. This was not a case where Irondequoit was formed and Iroquois was simultaneously dissolved. The two corporate entities actually co-existed for approximately two and half years until Iroquois was dissolved by the New York Secretary of State. This was apparently because Iroquois shareholders simply stopped paying franchise taxes.

The Court also relied upon the general principle of surety law that a guaranty must be strictly construed according to the terms of the agreement and that the agreement cannot be altered, extended or enlarged without the guarantor's consent. The Court acknowledged the prejudice to sureties when a new principal is unknowingly substituted to perform work on a bonded contract:

> ...the change in corporate legal entities was significant and prejudicial and increased defendant's [ICP's] risk of liability under the bond in that it was done outside of defendant s [ICP's] knowledge and permission; defendant [ICP] was not granted any opportunity to conduct a credit or other check on the newly formed corporate legal entity known as Irondequoit or to obtain a personal guaranty from any of its principals

This case, although fact intensive, serves as helpful guidance for the surety industry. It illustrates the difference between mere formalistic changes in the identity of a principal, which may not discharge a surety from its bond obligations, and the unknowing substitution of a separate and distinct entity to perform the bonded work, which will result in a discharge.

MAIL TO:

180 Canal View Boulevard
Suite 600
Rochester, New York 14623

1050 Connecticut Avenue , NW
Suite 1054
Washington, DC 20036

317 Madison Avenue
Suite 703
New York, New York 10017

345 Route 17 South
Suite 19
Upper Saddle River, NJ 07458

www.ernstromdreste.com

Firm News

The Col. Patrick O'Rorke Bridge, a 918 foot lift bridge over the Genesee River in Rochester, New York, was recently given the first-place Excellence in Partnering award by the New York State Department of Transportation and the Associated General Contractors of America. The new bridge and related roadwork cost $104 million and was completed in October, 2004. **Todd R. Braggins** served as Partnering Facilitator on the Project.

In November of 2004, The New York State Thruway Authority, Oakgrove Construction, Inc. and Urban Engineers received an award from the Associated General Contractors of America for their formal partnering efforts on the MP 418 Mill & Resurface Project in Erie County. The Project involved night paving of the mainline New York State Thruway through the Buffalo, New York commuter corridor. **Todd R. Braggins** served as Partnering Facilitator for the Project Team.

On December 15, 2004, **Kevin F. Peartree** presented a seminar on the "Risks of Design-Build" for the Design-Build Institute of America in Rochester, New York.

On January 28, 2005, **Theodore M. Baum** will moderate a panel discussion of surety defenses at the ABA's Fidelity and Surety Law Committee Mid-Winter Meeting at the Waldorf=Astoria Hotel in New York, New York.

On February 15 and 16, 2005, **Kevin F. Peartree** will be giving a presentation on Contract Document issues for Session 2 of the GBC's Construction Project Manager Training Program in Rochester, New York.

On February 17, 2005, **Martha A. Connolly** and **Kevin K. McKain** will be conducting a seminar in Rochester, New York for the National Business Institute entitled, "Mechanic s Lien Law and Strategies in New York".

At the Surety Claims Institute Meeting in Galloway, New Jersey, on June 23 and 24, 2005, **Martha L. Perkins** will give a presentation on a paper entitled, "The Rights and Obligations of the Surety Under a Co-Obligee Bond".

The 2005 Supplement to the AGC Contract Documents Handbook will be published this spring. The Handbook is co-edited by **J. William Ernstrom** and **Kevin F. Peartree**.