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Amendment of Notice of Claim Pursuant to New York State Public Authorities Law §1744(2) Permitted Absent Showing of Prejudice

BY DOUGLAS A. BASS

The New York State Appellate Division's First Department, one of New York's intermediate appellate courts, was recently presented with the following issue of first impression: Absent prejudice, can a notice of claim filed pursuant to New York State Public Authorities Law §1744(2) be amended to conform to the evidence more than three months after the claim accrues? The Court also addressed the related question of whether, for purposes of N. Y. S. Pub. Auth. L. §1744(2), a new "claim" accrues when a party subsequently discovers that its quantum of damages is greater than the amount stated in its notice of claim, thereby requiring the filing of an additional notice of claim?

The First Department found that when a party's actual damages are subsequently discovered to be greater than those stated in its notice of claim, an entirely new claim does not arise and no new notice of claim need be filed. It further held that, absent a showing of prejudice, a notice of claim may be amended to correct

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Exceptions to Bankruptcy Discharge
Provisions of Indemnity Agreement as "Express Trust"

BY WILLIAM E. BRUECKNER

Sureties are generally familiar with the fact that many states impose on contractors "statutory trusts." Typically, those statutory trusts require that a contractor pay subcontractors, material suppliers, and laborers before retaining any monies for the contractor's own use, and impose a fiduciary duty on the contractor to retain the money for the benefit of the subcontractors, material suppliers and laborers. Coupled with the provisions of the Bankruptcy Code that exclude debts arising from a breach of fiduciary duty, those statutory trusts provide a powerful tool for sureties when a contractor files for bankruptcy relief.

Sureties should be aware, though, that "statutory trusts" are not the only means to achieve the exception to discharge. A well-written indemnity agreement almost always includes language, referred to in the law as an "express trust," that imposes a similar fiduciary obligation, and should serve as an equally strong basis for a request that a bankruptcy court deny the discharge with respect to the indemnity obligation.

In Re Fox, a recent case decided by the Bankruptcy Court for the Eastern District of Arkansas is illustrative. Arkansas does not appear to be one of the states that impose a statutory trust. However, a surety that issued bonds to an Arkansas contractor was able to take advantage of a provision in its indemnity agreement, which read as follows:

> [T]he Contractor and Indemnitors covenant and agree that all payments received for or on account of said contract shall be held as a trust fund in which the Surety has an interest, for the payment of obligations incurred in the performance of the contact and for labor, materials and services furnished in the prosecution of the contract or any authorized extension or modification thereof; and further, it is expressly understood and declared that all monies due under any contract or contracts covered by the Bonds are trust funds, whether in the possession of the Contractor or Indemnitors or otherwise, for the benefit of and for payment of all such obligation in connection with any such contract or contracts for which the Surety would be liable under any of said Bonds, which said trust also inures to the benefit of the Surety for any liability or loss it may have or sustain under any said Bonds ... .

Section 523 of the Bankruptcy Code sets forth certain categories of debt that will be excepted from the scope of a bankruptcy discharge. Among those categories of debt are all debts "for fraud or defalcation while acting in a fiduciary capacity ... ." *11 USC § 523(a)(4)*. Bankruptcy Courts have widely recognized "statutory trusts"

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the quantum of damages indicated so long as the amendment is not based on actual damages that accrued more than three months after the notice was filed. *American Safety Cas. Ins. Co. v. New York City School Constr. Auth.*, 33 A.D.3d 441 (1st Dept. 2006) *citing Rondout Elec. v. Dover Union Free School Dist.*, 304 A.D.2d 808 (2nd Dept. 2003).

In February 2000, American Safety Casualty Insurance Company ("ASCIC") and R & D General Construction, Inc. ("R&D") entered into a surety bonding relationship that included R&D's execution of a General Agreement of Indemnity ("GAI"). ASCIC thereafter extended surety credit to R&D in the form of surety bonding for various construction projects. The GAI included an assignment to ASCIC of R&D's rights to all monies due on bonded or unbonded contracts, as well as all accounts receivable. The GAI was effective as of the date of execution and its assignment clause was to be triggered by R&D's default under the terms of the GAI.

Subsequently, R&D defaulted on certain of the ASCIC bonded projects, resulting in substantial loss to ASCIC. By July 2001, ASCIC had incurred over $800,000 in losses and related expenses in completing two R&D projects. ASCIC ultimately obtained judgment exceeding $1.1 million against R&D in early 2004.

In 2000, R&D entered into two contracts with the New York City School Construction Authority ("SCA") for work on public schools in Brooklyn and Staten Island. Neither project was bonded by ASCIC. Upon learning of these contracts, on or about March 29, 2001, ASCIC asserted its rights as assignee of the R&D receivables and demanded that SCA cease direct payments to R&D on the SCA contracts absent written authorization from ASCIC. ASCIC provided SCA with a copy of the February 29, 2000 GAI executed by R&D, which included R&D's assignment to ASCIC of R&D's receivables, including its rights to nonbonded contract proceeds.

Thereafter, ASCIC sent numerous correspondences to the SCA continually asserting its assignment rights and advising them that ASCIC did not consent to the release of the SCA contract monies to R&D. Inexplicably, the SCA chose to disregard the assignment by ignoring ASCIC's rights, deciding instead to make direct payments to R&D under the contracts. Rather than advise ASCIC that it objected to ASCIC'S claim, the SCA simply ceased all communication with ASCIC in July 2001.

Recognizing that the SCA had decided to ignore ASCIC's assignment rights, on September 19, 2001, ASCIC filed a verified notice of claim with the SCA requesting payment of all sums remaining due or to become due under the SCA contracts. Because neither R&D nor the SCA would voluntarily share the relevant information to permit ASCIC to determine the specific amount remaining due under the SCA contracts, the notice of claim estimated that such sum, as "ascertained to date", "equals or exceeds" the sum of $55,000.00. This sum was based upon the limited information available to ASCIC at the time.

ASCIC commenced its action on November 15, 2001 seeking all sums due or to become due R&D as of the date the SCA was put on notice of the assignment. After receiving the SCA's responses to ASCIC's discovery demands, ASCIC moved for summary judgment. The trial court granted partial summary judgment on liability in favor of ASCIC, leaving the issue of damages for trial.

At the damages trial, the SCA argued, for the first time in the litigation, that ASCIC's damages should be limited to the approximate amount stated in its notice of claim. The trial court properly rejected this argument and permitted ASCIC to amend its notice of claim to conform to the proof *nunc pro tunc* (substituting the approximate amount of $55,000.00, initially inputted at a time when the SCA withheld information, with the specific amount of $128,834.54, learned only after the SCA was compelled to disclose this information). The trial court found that, given the absence of prejudice to the SCA, the amendment of the notice of claim to conform to the proof was proper, and a judgment was entered in favor of ASCIC and against the SCA in the amount of $128,834.54.

On appeal, the SCA argued that the Court of Appeals decision in *Varsity Trust, Inc. v. The Board of Education of the City of New York*, (5 N.Y.3d 532 [2005]), decided subsequent to the damages trial, should be interpreted as mandating that an amendment of a notice of claim after the three-month post-accrual time limit is not permitted. The First Department disagreed, holding:

> [The SCA's] reliance on *Varsity Tr. v. Board of Educ. of City of N.Y.* (5 N.Y.3d 532 [2005]) is misplaced. There, the Court of Appeals held that Education Law §3813(1) required the plaintiff to file a new notice of claim for damages that continued to accrue after the action started as a result of a continuing breach of contract. Here, plaintiff's damages remained constant throughout; plaintiff was simply unaware of the amount.

American Safety Cas. Ins. Co. v. New York City School Constr. Auth., 33 A.D.3d 441 (1st Dept. 2006).

Therefore, absent a showing of prejudice, a notice of claim filed pursuant to New York State Public Authorities Law §1744(2) may be amended to correct the quantum of damages indicated so long as the amendment is not based on actual damages that accrued more than three months after the notice was filed. *Id., citing Rondout Elec. v. Dover Union Free School Dist.*, 304 A.D.2d 808 (2nd Dept. 2003). E&D

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as a source of fiduciary obligation for contractors but "express trusts," such as the one imposed by the foregoing language, are alternate sources of fiduciary obligation that may be more comprehensively available. As summarized by the *Fox* Court, "It is the mere act of using the trust fund for any purpose other than the purpose for which the trust was created that constitutes misuse or misappropriation of the trust fund which is a defalcation committed by the fiduciary." *In Re Fox, 2006 WL 3579968 (Bankr. E.D. Ark., Dec. 8, 2006)*.

In Fox, the Court determined that the contractor had received funds from project owners on bonded projects, but had neglected to pay those funds to those who were defined by the indemnity agreement as trust beneficiaries. The Court accepted and gave credence to the Debtor's testimony that his company was not profitable, that the company had lost money on each of the bonded jobs, and that all of the funds were used for the company's legitimate business purposes (which were characterized as "burden," "job support costs," and "general or administrative expenses"). The court rejected each of these offered excuses:

> There is no allegation or finding that Fox committed a bad act; however, ... Section 523(a)(4) requires no such bad act, only misuse of trust property. The misuse occurred here because the (money received from project owners) was sufficient to pay the direct costs incurred on these jobs was not used accordingly. Material suppliers and equipment rentals were not paid, and one job was not completed. The Court finds that the amount of job receipts spent on non-direct costs ... are therefore nondischargeable in this bankruptcy case.

If you would like to learn more about the effectiveness of "express trusts" as a tool in defeating an indemnitor's effort to discharge obligations imposed by an indemnity agreement, or the possible effectiveness of a "statutory trust" for the same purpose, feel free to contact us. E&D

Federal Court Grants Judgment Declaring Penal Sum Of Bonds To Be Increased By Over 1,400% Due To Bond Language Contemplating Increases to Bonded Contract and Penal Sum

BY GAVIN M. LANKFORD

In *Centex Construction vs. ACSTAR Insurance Co.*, 448 F.Supp.2d 697 (E.D.Va. 2006), the United States District Court for the Eastern District of Virginia declared the penal sum of the surety's subcontract bonds to be $2,577,012.00 although the penal sum listed on the bonds was $170,200.00 and the bond principal never paid any increase in premiums for the additional scope of work added to the subcontract.

On June 24, 2003, Centex Construction, LLC ("Centex") entered into a written subcontract agreement (the "Subcontract") with Accutronics Datacom, Inc. ("Accutronics"). The original Subcontract amount was $170,200.00. The Subcontract provided for the addition of specified "options", which would add significantly to Accutronics' scope of work. The Subcontract specifically delineated seven options, including an option to install certain telecommunications and data cabling for the lump sum amount of $1,500,626.00.

In connection with the Subcontract, Accutronics procured performance and payment bonds from ACSTAR Insurance Company ("ACSTAR"). The bonds named Centex as the obligee and Accutronics as the principal. The penal sum listed on the bonds was $170,200.00. However, both bonds stated:

> [A]ny increase in the Subcontract amount shall automatically result in a corresponding increase in the penal amount of the bond without notice to or consent from the Surety, such notice and consent being waived. Decreases in the Subcontract amount shall not, however, reduce the penal amount of the Bond unless specifically provided in said Change Order.

Thereafter, Centex and Accutronics executed eight additive change orders to the Subcontract totaling $2,406,812.00. The terms of the Subcontract provided that Accutronics was to include the cost of any additional bond premiums due to an increase in the Subcontract amount in its change order proposal. Accordingly, Accutronics included charges allocated for bond premiums in several of the additive change orders proposals. However, Accutronics never actually paid ACSTAR any of the bond premiums included in the change orders.

During the course of the project, Centex notified Accutronics and ACSTAR that Accutronics was in default of its Subcontract obligations for failure to properly perform certain Subcontract work and failure to pay its material suppliers. Eventually, Centex commenced an action against both Accutronics and ACSTAR for breaches of the Subcontract, performance bond and payment bond. Additionally, Count I of Centex's complaint sought a judgment declaring the penal sum of the bonds to be $2,577,012.00.

Centex moved for partial summary judgment seeking, among other things, declaratory judgment that the penal sum of the bonds was $2,577,012.00. ACSTAR opposed Centex's motion by arguing that the exponential increase in the Subcontract amount constituted a material modification of the bonded risk.

The Court granted Centex's motion for partial summary judgment and declared the penal sum of the bonds to be the increased amount of $2,577,012.00. The Court found ACSTAR's argument of material modification of the bonded risk to be unavailing because the escalation provisions of the bonds unambiguously provided that the penal amounts of the bond would increase with each additive change order.

This case represents yet another example of the perils involved with using bond forms that deviate from standard industry forms. E&D

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ERNSTROM & DRESTE NEWS

John W. Dreste, Kevin F. Peartree and Gavin M. Lankford will be presenting a seminar in Rochester, New York on February 13th for Lorman Education Services entitled The Fundamentals of Construction Contracts. The seminar will address the complexities and liabilities of commercial construction, with particular emphasis on managing the risk of construction through the proper use and understanding of standard construction contracts.

Kevin F. Peartree will be conducting a training seminar for construction project managers on February 15th and 16th in Rochester, New York for the General Building Contractors of the State of New York. The seminar is part of the GBC's annual project managers training program.

Kevin F. Peartree is the author of the 2007 Supplement to the AGC Contract Documents Handbook which will be published this Spring. The Supplement analyzes and discusses AGC Document No. 299, Standard Form of Project Joint Venture Agreement Between Contractors.

In the Fall of 2006, Theodore M. Baum was added to the Board of Directors of the Western NY Chapter of the Construction Financial Management Association (CFMA).

Theodore M. Baum is the co-editor of the recently published American Bar Association Publication, the Performance Bond Manual.

Todd R. Braggins is the co-editor of the recently published American Bar Association Publication, the Payment Bond Manual, Third Edition.