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Federal Court Reaffirms Surety's Equitable Subrogation Rights As Against the City of New York

BY TODD R. BRAGGINS

In *Nobel Insurance Company v. City of New York*, 2008 WL 4185738, No. 07-01991 (S.D.N.Y. Sept. 3, 2008), the United States District Court for the Southern District of New York denied the Defendant City of New York's (the "City" or "Defendant") request to amend its answer to assert the defense of privity, finding that the City's motion was futile because the defense of privity does not apply to a claim based upon principles of equitable subrogation.

The action involved payment and performance bonds issued by Nobel on behalf of its principal, Zollo Construction Corp. (Zollo), which named the City's Department of Transportation ("DOT") as obligee. The project involved improvements to bulkhead facilities appurtenant to Shore Boulevard in Brooklyn, New York. Zollo was directed to commence work on September 16, 1996. Subsequent to the award of the contract, the New York City Department of Design and Construction ("DDC") took over responsibility for administering the contract from DOT. On or about June 23, 1997, DDC terminated the contract for convenience.

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Federal Court Upholds Surety's Good Faith Settlement with Obligee and Consequent Right to Idemnification

BY MONIQUE F. MAZZA

In *Travelers Indemnity Co. v. Harrison Construction Group Corp.*, 2008 WL 4725970, No. CV 06-4011 (E.D.N.Y. October 22, 2008), the United States District Court for the Eastern District of New York analyzed a surety's good faith obligation to make payment and the effect on the indemnitors' obligations due to the obligee's alleged failure to satisfy conditions precedent contained within the performance bond. The court granted the surety summary judgment for the amount of its losses and expenses pursuant to the terms of its indemnity agreement.

The action arose when the surety, Travelers Indemnity Company ("Travelers") settled with the obligee, Wynona Lipman Arms Urban Renewal Associates ("Wynona") on Wynona's performance bond claim and thereafter sued the principal, Harrison Construction Group Corp. ("Harrison") and the individual indemnitors (collectively the "defendants"), to recover the settlement amount and related loss adjustment expenses.

Pursuant to the idemnity agreement between Travelers and defendants, the settlement of claims was within the sole discretion of the surety. In pertinent part, the indemnity agreement gave Travelers the following right:

> ... the exclusive right to determine for itself and [defendants] whether any claim or suit brought...upon any such bond shall be settled or defended and its decision shall be binding and conclusive upon [defendants,]...and that in the event of payment by [Travelers], [defendants] agree to accept the voucher or other evidence of such payment as prima facie evidence of the propriety thereof, and of [defendants'] liability therefore...(citations omitted).

Regardless, the defendants argued that Travelers' performance bond obligations were conditioned upon a declaration of default by the obligee, citing the following language: "... *[w]henever [Harrison] shall be, and declared by [Wynona] to be in default under the Contract,* ... [Travelers] may promptly remedy the default, or shall either ... [c]omplete the Contract ... or ... make available ... sufficient funds to pay the cost of completion." (emphasis added). Thus, because Wynona had not formally terminated Harrision, defendants argued that Travelers's obligation to pay was never triggered and therefore Travelers had no right to recovery under the indemnity agreement.

The court rejected the defendants' argument, restating well-settled New York law:

> [W]here a surety and its principal have executed an overarching indemnity agreement giving the surety complete discretion whether to settle or defend claims pursuant to underlying bonds, 'such [complete discretion] provisions mean that the surety is entitled to indemnification upon proof of payment, unless payment was made in bad

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Consequently, work on the project stopped and a termination payment became due to Zollo.

On February 24, 1998, Nobel sent notice to DOT as original bond obligee advising that claims for payment had been made by Zollo's subcontractors and suppliers and that Nobel was otherwise being exposed to potential losses arising from its issuance of bonds for the project. Nobel further demanded that no funds be released to Zollo without the written consent and direction of Nobel.

Regardless, on or about March 3, 1998, DDC paid Zollo a termination payment of $492,229.77. As a result, Nobel contended that it lost the opportunity to seek reimbursement from the contract balance for the losses it sustained in discharge of its payment bond obligations. On March 9, 1998, counsel for DOT faxed a copy of Nobel's February 24, 1998 letter to counsel for DDC.

On February 1, 1999, Nobel timely filed a Notice of Claim with the Comptroller of the City of New York seeking an amount not less than $492,229.77, representing the funds released by the City to Zollo after notification by Nobel of claims against its payment bond. On February 18, 2000, Nobel commenced the present action against the City based upon principles of equitable subrogation. Following discovery, the City filed a motion for summary judgment, arguing that Nobel's claim was barred by the statute of limitations provision contained within the City's contract with Zollo. In *Nobel Insurance Company v. City of New York*, 2006 WL 2848121, No. 00-CV-1328 (S.D.N.Y. Sept. 9, 2006) ("Nobel I"), United States District Judge Karas rejected the City's argument and found that the contractual limitations provision applied only to claims by Zollo against the City and not to an action by the surety against the City pursuant to a theory of equitable subrogation. The *Nobel* I court further observed that through principles of subrogation, Nobel stood in the shoes of the subcontractors and suppliers it paid pursuant to its payment bond obligations.

Based upon that observation, the City moved in the instant action to amend its Answer to assert a privity defense. The City first argued that based upon the *Nobel I* decision, Nobel is subrogated only to the rights of the subcontractors and suppliers. Therefore, the City next argued that because the subcontractors and suppliers are not in privity with the City, Nobel is also not in privity with the City and its claims must be dismissed. Both arguments were rejected.

The Court noted that in *Nobel I*, Judge Karas recognized that New York courts have consistently recognized a surety's right of equitable subrogation in the context of public projects. The Court then concluded that the *Nobel I* court's statements concerning Nobel's rights as derivative of unpaid subcontractors and suppliers were mere dicta and could not be read to trump Judge Karas' broader holding that Nobel's equitable subrogation claim against the City was legally viable.

Further, the Court observed that even if Nobel were subrogated only to the rights of the subcontractors and suppliers, and thus not in privity with the City, amendment of the City's Answer would nevertheless be futile. Rejecting the

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> faith or was unreasonable in amount, and this rule applies regardless of whether the principal was actually in default or liable under its contract with the obligee.'

The *Harrison* court discussed a recent New York intermediate appellate court case, *Frontier Insurance Co. v. Renewal Arts Contracting Corp.*, which similarly held that an obligee's failure to satisfy conditions precedent within a performance bond was irrelevant to determining liability under an indemnity agreement unless the principal proved that the surety acted in bad faith. The court also discussed a contrary decision from the Southern District of New York which held that a surety that pays a claim it is not obligated to pay is considered a volunteer and is thus barred from recovering against the principal. *Gen. Ins. Co. of America v. K. Capolino Constr. Corp.*, 903 F. Supp. 623, 626 (S.D.N.Y. 1995). However, the *Harrison* court sided with the *Frontier* decision, finding that *Capolino* "misapplied" New York law because the "voluntary payment rule" is only applicable to cases without an indemnification agreement controlling the principal's obligation to the surety. Thus, the *Harrison* court concluded that the express terms of the indemnity agreement governed, and absent a showing of bad faith or unreasonableness of the amount paid by Travelers, any conditions precedent to liability under the performance bond were irrelevant to whether Harrison was in default of its indemnity obligations.

Next, the court examined whether defendants presented any evidence of bad faith or unreasonableness of the amount paid by Travelers. The defendants did not even challenge whether the payments made to Wynona by Travelers were unreasonable in amount and the court "generously construed" a statement in the defendants' pleading as an allegation of bad faith. In finding that the defendants did not present any evidence of bad faith, the court discussed in detail the concept of "bad faith." The court noted that although the Court of Appeals has not provided a definitive definition of bad faith in the surety indemnification context, New York courts have generally equated "bad faith" with "fraud or collusion." Here, the court found there were no allegations of facts that would suggest even a hint of bad faith, noting that the presence of a clause in the indemnity agreement waiving notice of claims by Harrison suggested that Travelers did not act with bad faith. Therefore, the court granted Travelers' summary judgment for the full amount of its losses and expenses.

In addition to reiterating New York's strong support of surety indemnification rights, the court also reaffirmed that claims of "bad faith" are not easily proven. Absent a showing of "fraud or collusion," such claims will likely not survive motion practice. FSD

City's argument that the dispute involved breach of contract, the Court recognized that an equitable subrogation claim is founded on principles of equity rather than substantive contract law. "Subrogation is an equitable remedy, the purpose of which is to compel the ultimate discharge of a debt or obligation by one who in good conscience ought to pay it." 2008 WL 4185738 at *4 (citation omitted). Therefore, the court found that since the doctrine of equitable subrogation is founded in equity and not in contract, privity was not required. Consequently, even if Nobel stood in the shoes of the subcontractors and suppliers, it was not precluded from recovery based on a theory of equitable subrogation.

This decision reflects New York's strong support for the equitable subrogation rights of sureties. Further, its discussion of *Nobel I* reminds us that the short statute of limitations periods frequently contained within New York City construction contracts are often not applicable to sureties, particularly when the surety's claim for contract funds is based upon principles of equitable subrogation. While not addressed by this Court, in addition to the subrogation rights that derive from payments to subcontractors and suppliers, sureties may also be entitled to assert equitable subrogation rights on behalf of the City as obligee. In either event, the short statute of limitations period contained within typical New York City contracts will likely not apply. E&D

Federal Case from Mississippi Draws Unfortunate Result on A312 Performance Bond

BY MONIQUE F. MAZZA

In *C & I Entertainment, LLC v. Fidelity and Deposit Co. of Maryland*, 2008 WL 4755413, No. 1:08CV16 (Oct. 27, 2008 N.D. Miss.), the United States District Court for the Northern District of Mississippi addressed whether the statute of limitations had run on a breach of contract claim by the obligee against the surety under an A312 Performance Bond and more specifically, when the three-year statute of limitations began to run on the obligee's claim. As discussed more fully below, the court held that the statute of limitations had not run on the claim and therefore denied the surety's motion for summary judgment.

The relevant time line of the case is as follows. In 2001, McKnight & Son Construction, Inc. ("McKnight"), as principal, obtained performance and payment bonds from Fidelity and Deposit Company of Maryland ("F&D") for a movie theater and skating rink project in Kosciuko, Mississippi. In December 2002, the obligee, C & I Entertainment, LLC ("C&I"), first became aware of alleged defects with McKnight's work. As a consequence, C&I withheld final payment from McKnight. On August 29, 2003, McKnight sued C&I for payment, and C&I in turn counterclaimed against McKnight.

C&I first wrote the surety on December 9, 2003, advising F&D that it was negotiating a resolution with McKnight, but that if full settlement was not achieved, C&I would look to F&D for satisfaction. On May 24, 2004, C&I made a formal demand on F&D pursuant to the bond. F&D denied the claim on March 3, 2005. Subsequently, on December 28, 2007, C&I filed suit against F&D for breach of contract and bad faith denial of its claim. F&D thereafter moved for summary judgment based on Mississippi's three-year statute of limitations for breach of contract.

The parties agreed that Mississippi's three-year statute of limitations applied, and that accrual occurs on the date the facts allow a plaintiff to bring a cause of action, but disagreed when the action accrued. F&D argued that the statute began to run on December 11, 2002, when C&I first noticed the construction defects. C&I contended that the statute began to run on March 3, 2005, when F&D denied its claim under the bond.

The court first determined that the obligee had satisfactorily satisfied the required conditions precedent prior to filing their claim on May 24, 2004. However, the court concluded that C&I's cause of action did not accrue on that date. Instead, the court concluded that the obligee could only seek a remedy, thereby effecting accrual of a cause of action, if the surety either denies liability or fails to act within fifteen days after receipt of notice from the obligee demanding performance pursuant to the bond. Since C&I never gave the notice to F&D, the court reasoned that C&I could not have sued on the bond until F&D denied liability, which was March 3, 2005. Therefore, the court found the action to be timely.

This case is particularly troublesome because it allows an obligee to benefit by its own inaction, that is, relying on the non-occurrence of a condition precedent, the non-occurrence of which was that party's own doing. The court's logic is questionable, as it theoretically allows a bond claimant to indefinitely extend the time to sue a surety by its own failure to discharge the bond conditions. The more reasoned conclusion is that a party should not be allowed to gain by its own inaction. For example, in New York, courts have held that a party cannot rely on the non-occurrence of a condition precedent when the non-occurrence is that party's own fault. *See A.H.A. Gen. Constr., Inc. v. New York City Hous. Auth.*, 92 N.Y.2d 20, 699 N.E.2d 368, 677 N.Y.S.2d 9 (1998) (stating that it is a "well-settled and salutary rule that a party cannot insist upon a condition precedent, when its non-performance has been caused by himself."). Nevertheless, sureties are once again reminded that courts are often inclined to construe bond provisions in favor of claimants. E&D

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John Dreste, Kevin Peartree and Douglas Bass presented a seminar on January 9, 2009 on the topic of AIA Contracts for Lorman Education Services.

Ernstrom & Dreste, LLP, along with Leo & Weber, PC and Shields Mott Lund, LLP, will be hosting its annual cocktail reception at the ABA Midwinter meeting in New York City on January 22, 2009.

Kevin Peartree's article on ConsensusDOCS 300, the Standard Form of Agreement for Collaborative Project Delivery will appear in the Winter 2009 edition of The Construction Lawyer, published by the American Bar Association's Forum on the Construction Industry.