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## ERNSTROM & DRESTE NEWS

On September 12th and 13th of this year, Kevin Peartree presented a seminar on insurance considerations in Design-Build Contracts and Risk Management for the Design-Build Institute of America in Rochester, New York.

J. William Ernstrom presented a paper entitled *The Changing World of Contract Risk Management—Understand or Die!* at the 9th Annual Construction Financial Management Conference sponsored by AGC and CFMA in Las Vegas, Nevada on October 27, 2005. This was an interactive session dealing with the risk transfer methods currently being used by owners and a practical solution to the problems.

At the 25th IRMI Construction Risk Conference in Las Vegas, Nevada being held November 7-10, 2005, J. William Ernstrom will be a co-presenter for Construction Contract Negotiation. This session examines key risk allocation and insurance provisions, including indemnity provisions, insurance requirements and waivers of damages, with emphasis on the negotiation process.

The 2006 Supplement to the AGC Contract Documents Handbook will be co-authored by Kevin Peartree and Gavin Lankford and will be published this spring.

Theodore Baum is the co-editor of an upcoming American Bar Association publication, the Performance Bond Manual. Mr. Baum will also be one of the leaders of a panel discussion of that publication at the joint meeting of the ABA's Forum on the Construction Industry and the Fidelity and Surety Law Committee meeting to be held at the Waldorf-Astoria Hotel, New York, New York in January, 2006.

J. William Ernstrom and William Brueckner will be co-authoring a paper entitled Pre-Existing Adverse Conditions at the Project Site to be presented by Mr. Ernstrom at the 2006 ABA Forum Mid-Winter meeting to be held at the Waldorf-Astoria Hotel, New York, New York in January.

Todd Braggins is the co-editor of an upcoming American Bar Association publication, the Payment Bond Manual, Third Edition. Mr. Braggins will also be a co-chairperson of the FSLC Spring meeting to be held in Scottsdale, Arizona in April of 2006.

### Second Circuit Holds Completion Agreement Invalid Due To an Unsatisfied Condition Precedent Owner's Written Consent to Assignment of Defaulted Contract to Completion Contractor

In *Aetna Casualty and Surety Co. v. Aniero Concrete Co., Inc.*, 404 F.3d 566 (2nd Cir. 2005) (construing New York law), the Second Circuit affirmed the district court's holding that a completion agreement was invalid due to an unsatisfied condition precedent—the owner's written consent to the assignment of the defaulted contract to the completion contractor.

The completion contractor recovered from the surety in quantum meruit, predicated on the invalidity of the completion agreement. See *Aniero Concrete Co., Inc. v. New York City Construction Authority*, 2003 WL 23018789 (S.D.N.Y. Dec. 23, 2003). The Second Circuit's affirmation of the holding that there was no valid completion agreement effectively affirmed the quantum meruit recovery. The Second Circuit did, however, make note that the surety challenged only the validity of the

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### Federal Court Upholds Surety's Rights to Release Bond Principal's Claims and Claim for Indemnification under the Indemnity Agreement

In *HRH Construction, LLC v. Fidelity and Guaranty Insurance Co.*, C.A. No. 04-Civ.-1606 (PKC) (S.D.N.Y. July 8, 2005) (unpublished decision), the United States District Court for the Southern District of New York analyzes the surety's "sweeping rights" provided by several standard indemnity agreement provisions in support of a surety's right to release the claims of its bond principal. In addition, the court grants the surety's motion for summary judgment on its indemnification claim.

The action arose when the project's general contractor, HRH Construction, Inc. ("HRH"), commenced a lawsuit against its subcontractor's surety, Fidelity and Guaranty Insurance Company ("FGIC") under a performance bond. FGIC issued the performance bond on behalf of its principal and subcontractor to HRH, Tres, Inc. ("Tres"). In a general indemnity agreement in favor of FGIC, Tres and individual indemnitors agreed to hold FGIC harmless for sums paid as a result of having issued the bonds.

In response, FGIC brought a third-party action against Tres under the indemnity agreement; and Tres asserted claims against HRH and HRH's own surety, including a claim for wrongful termination of its subcontract.

While the above claims were pending, HRH and FGIC entered into a settlement agreement, whereby FGIC agreed to satisfy HRH's performance bond claim and release

HRH from all claims asserted by Tres in connection with the project, including Tres' pending claims. As a result of the settlement agreement, HRH moved for summary judgment dismissing Tres' claims. Tres opposed the motion, asserting that FGIC lacked authority to release Tres' claims against HRH.

In granting HRH's motion, the Court discusses four provisions in the indemnity agreement that provide FGIC the contractual authority to release Tres' claims against HRH. The first provision, the "right-to-settle clause," expressly provided that FGIC could settle or compromise any claim on any bond issued or procured by it and that any such settlement would be binding upon the indemnitors. Furthermore, vouchers or other evidence of payments made by the surety are prima facie evidence of the fact and amount of liability of the indemnitors to FGIC.

The second provision, the "collateral assignment clause," granted FGIC an absolute assignment of all "collateral," which is defined as, among other things, all causes of action belonging to the indemnitors. The court emphasized that the indemnification agreement provided that the assignment is an absolute assignment of collateral and that "no further notice or other action by [FGIC] is required."

The third provision, the "attorney-in-fact clause," designated FGIC as the indemn-

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completion agreement and not the quantum meruit recovery on appeal:

"Because Aetna does not challenge the quantum meruit judgment except to ask that it be vacated if we conclude that there was a valid contract, and because we reach no such conclusion, we intimate no view as to the merits of the Court's determination of Aetna's liability to Aniero in quantum meruit."

Our story begins on July 1, 1992, when the New York City School Construction Authority ("SCA") contracted with P.J. Carlin Construction Company ("Carlin") for the modernization of Morris High School ("the Carlin Contract"). Carlin was ultimately terminated from the project, and its surety, Aetna and Casualty and Surety Company ("Aetna"), was called upon to complete the work. Aetna entered into a Completion Agreement with Aniero Concrete Company ("Aniero") based upon a bid of \$18,800,000. The Completion Agreement purported to assign Aetna's interest under the Carlin Contract to Aniero. The assignment clause in the Completion Agreement provided that Aetna would transfer to Aniero not only all of its duties under the Carlin contract but also all of its rights as well. The Completion Agreement contained a clause that the agreement would become effective only when the SCA consented, in writing, to the assignment of Carlin's contract.

Aniero began the project but later discovered that additional work was required which, in its opinion, was beyond what it had intended to complete, based upon an inaccurate and misleading description of the work completed by Carlin, the amount of work remaining to be performed, and the extent of remediation performed by Carlin. Aniero ceased work on the project and commenced the lawsuit. Aniero brought claims against Aetna's consultant Hudson and Aetna for, among other things, fraudulent concealment, fraudulent inducement, and negligent misrepresentation.

The Second Circuit issued a pithy opinion, which appears, deceptively, quite lengthy, as the court attaches three appendices,

"District Court's Memorandum Opinions and Orders" in the matter, dated January 2, 1997; February 27, 1997, and March 30, 1998. These three district court opinions set forth the background facts and the litigation's convoluted motion practice that dealt with various pleading deficiencies as well as whether Aniero had waived its right to claim that the bidding documents were defective.

The district court stated that the Waiver Clause in the bid documents and the Completion Agreement would bar Aniero from claiming reliance on information provided by Aetna unless it could demonstrate that its claims were based on facts peculiarly within the knowledge of Aetna ("special facts doctrine"). The court thus determined there were issues of fact and denied Aetna's motion for summary judgment on the waiver issue.

Of particular interest to sureties is the district court opinion set forth in Appendix C that analyzes the "Effectiveness of Completion Agreement." Aniero and its surety argued that, if Aetna failed to obtain the written consent of the SCA to the assignment of Carlin's contract to Aniero, then the Completion Agreement and the bond provided by Aniero would be void. Although Aetna did obtain a letter from the SCA stating it had no objection to the use of Aniero, the letter failed to acknowledge an assignment. Accordingly, the court found that, in the absence of the written consent, the Completion Agreement was invalid because a condition precedent was absent, based upon the terms of the Completion Agreement. The court thus held that Aniero's bond was likewise invalid because the bond attaches to the underlying contract that never came into existence. **E&D**

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itors' attorney-in-fact with full power to enter into any agreements necessary to provide FGIC with the "full protection intended" under the indemnity agreement.

Finally, the "settlement clause" of the indemnity agreement provided FGIC with the right to assert or prosecute any claim assigned or otherwise conveyed in the name of Tres and to settle such claims.

Having cited these "sweeping rights" provisions, the court reviewed a litany of cases construing New York law on a surety's entitlement under certain clauses of an indemnity agreement to release its principal's claims. In particular the court discussed Hutton Construction Co. v. County of Rockland, 52 F.3d 1191 (2d 1995), in which the Second Circuit made it clear that assignment and attorney-in-fact clauses similar to those in the instant matter give the surety authority to settle all claims on behalf of its principal, including not only claims against the bonds, but also the principal's affirmation claims arising out of the bonded contracts.

The court stated that, as a result of the relevant provisions in the indemnity agreement, FGIC was entitled to settle and release Tres' claims against HRH. The court, accordingly, granted summary judgment, dismissing the claims of Tres and the individual indemnitors against HRH and its surety.

The court further granted FGIC's motion for summary judgment against Tres and the individual indemnitors on its claim for indemnification to recover the costs, expenses, and attorneys' fees incurred. The indemnity agreement provided, in typical language, that the indemnitors shall indemnify FGIC for, among other things, "all claims, damages, expenses, losses, costs, professional and consulting fees, disbursements, interests and expenses of every nature" incurred by FGIC as a result of having issued the bonds.

The court noted the evidence of the amount paid by FGIC in executing its duties as surety, evidence of its investigation of HRH's claims, its extensive correspondence with HRH and others in connection with its the investigation; evidence of pretrial discovery conducted

prior to settlement, and other documentation. Through this documentation, FGIC had, the court observed, met its initial burden on the motion to demonstrate that "it acted in good faith both in performing its obligations as surety and in settling HRH's claims" and that the amounts incurred in doing so were reasonable.

The court found that Tres and the individual indemnitors could not survive FGIC's motion for summary judgment because they could offer no evidence of "fraud, collusion or other malfeasance that would call into question any of FGIC's actions and rights under the Indemnity Agreement." The court specifically stated that a question as to whether HRH or Tres was in default is insufficient to create a genuine issue of material fact to withstand summary judgment.

The moral of this story, as in so many similar ones, is each surety should ensure that its indemnity agreement contains clauses that give it "sweeping rights in the event a claim is made against it on the performance bond." In addition, each surety must submit the proper documentation, pursuant to the specific language of its indemnity agreement, to support its claim for indemnification. **E&D**

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 in New York Must Plead "Specifically and with Particularity" a Claimant's Failure to Perform a Condition Precedent

Sureties in the State of New York take note: affirmative defenses that a condition precedent has not been fulfilled must be pled "specifically and with particularity" pursuant to Civil Practice Law and Rules ("CPLR") 3015(a). CPLR 3015(a) provides as follows:

Conditions precedent. The performance or occurrence of a condition precedent in a contract need not be pleaded. A denial of performance or occurrence shall be made specifically and with particularity. In case of such denial, the party relying upon the performance or occurrence shall be required to prove on the trial only such performance or occurrence as shall have been so specified.

In a recent New York case, some of the surety's affirmative defenses were dismissed for failure to comply with this strict pleading provision. In 1199 Housing Corp. v. International Fidelity Insurance Co., 14 A.D.3d 383, 788 N.Y.S.2d 88 (1st Dept. 2005), the court reversed an order granting in part the surety's motion to dismiss and denying the claimant's motion to strike the surety's affirmative defenses based on the claimant's "own improper actions" and failure to comply with provisions concerning "notice, default and/or termination."

In this action, the surety on a performance bond sought to dismiss the complaint of the obligee that included delay claims and damages. The opinion does not give any information on the nature of the problems or the damages. The surety asserted a number of affirmative defenses, which included the failure of the obligee to allege compliance with unspecified conditions of the bond. In response, the obligee sought to dismiss those defenses based on the surety's failure to state with specificity in its affirmative defenses the conditions precedent that the obligee failed to satisfy. The lower court held that the failure of the obligee to comply with the notice provision in the bond constituted a bar to recovery under the bond. Nonetheless, the court allowed the obligee to pursue the delay claim, which, in its opinion, was not governed by the notice provisions.

The Appellate Division reversed the lower court and dismissed the surety's affirmative defenses pertaining to the obligee's failure to comply with conditions precedent. The court held that, while the "plaintiff is afforded the benefit of a liberal construction of the pleadings," the defendant is subject to "a strict pleading provision." Pursuant to CPLR 3015(a), in an action on a contract, "the obligation to raise the issue of compliance with conditions precedent rests on the party disputing their performance or occurrence." The court stated that, if the obligee had specifically pled in its complaint that it had complied with a condition precedent in the contract, a general denial in the answer would have been sufficient. However, because the complaint had not asserted compliance with a condition precedent, the surety was required to set forth with specificity the condition precedent with which the obligee failed to comply. Accordingly, the court dismissed the surety's affirmative defenses as deficient.

Therefore, sureties in New York that assert that an affirmative defense that a claimant failed to comply with a condition precedent to maintaining a claim on a surety bond must particularize those conditions precedent in the answer to a complaint or run the risk that the court will dismiss those defenses. **E&D**