

No Notice? Big Problem

BY THOMAS K. O'GARA

In *Hunt Construction Group, Inc. v. National Wrecking Corp.*, 587 F.3d 1119 (D.C. Cir. 2009), the Court of Appeals for the District of Columbia Circuit held that the general contractor's failure to comply with the notice provision of its subcontractor's performance bond precluded recovery against the subcontractor's sureties.

Hunt Construction Group, Inc. ("Hunt") was the general contractor for the construction of an Embassy Suites Hotel. Hunt subcontracted its excavation work on the Project to the National Wrecking Corporation ("National"). When National delayed the project, Hunt was forced to incur additional expenses to expedite the work of its other subcontractors. Hunt was aware of National's delays by February, 2004 and National finally completed its work in April, 2004.

Although aware of the delay in February 2004, Hunt waited until July 2004 (five months later and three months after National completed its work) to declare National in default and notify National's sureties. Instead, and without notifying the sureties, Hunt used other subcontractors

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IRS Immunity Statute Will Not Shield NYS From a Surety's Claim to Contract Balance

BY THEODORE M. BAUM

In the face of a surety's claim for contract balance, the State of New York cannot invoke the immunity provided by an Internal Revenue Code statute, a mid-level appellate court has ruled. The State will not appeal the ruling in *Kemper Insurance Co. v. State of New York*, 70 A.D.3d 192, 893 N.Y.S.2d 596 (3rd Dep't 2009). E&D represented Kemper, the successful surety. Kemper recently received a check for its claim plus interest.

In *Kemper*, the bond principal, Haseley Construction, had a contract with the New York Department of Transportation for a road construction job called the Military Road Project. When Haseley defaulted on the Project, the DOT made a performance bond claim with Kemper, Haseley's surety. The result was a takeover agreement. Under the terms of the takeover agreement, Kemper successfully completed the Project. Promptly following the default, Kemper had twice written to the State, demanding that the State not release any of the Project contract funds. In addition, in the takeover agreement, the State agreed to pay to Kemper all sums due and payable to Haseley under the Project. At the time of the default, the State was holding \$579,000 due or to become due to Haseley.

Meanwhile, the IRS sought to collect back taxes owed by Haseley. The IRS issued a notice of levy to the State. In response, the State paid the \$579,000 to the IRS. It was undisputed that before turning over the contract funds, the State made no inquiry or otherwise attempted to make any determination about whether Haseley's tax obligation arose out of the Military Road Project or out of unrelated projects. In fact, it was later determined that Haseley owed less than \$44,000 in taxes arising from the Military Road Project. The State also did not alert Kemper to the notice of levy or to the fact that it was making payment, despite Kemper's two written demands that the State not release any funds, and despite the State's stipulation in the takeover agreement to pay the funds over to Kemper.

Once Kemper discovered the release of funds, it immediately took two actions. First, it filed a wrongful levy action in federal court pursuant to the Internal Revenue Code. Second, it filed a claim against the State in the New York Court of Claims for the wrongful release of the funds. Kemper and the State then agreed that the action against the State would be stayed while Kemper pursued its wrongful levy action. In each case, Kemper asserted that as the surety which completed the project and paid payment bond claims, Kemper's right to the funds were superior to that of the IRS, at least to the extent that the tax obligations arose from projects other than the Military Road Project.

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In federal court, Kemper was successful in obtaining summary judgment against the IRS for \$535,000, which was the \$579,000 paid by the State minus the \$44,000 in taxes which actually arose from the Military Road Project. The IRS appealed, arguing that Kemper's wrongful levy action was commenced outside the nine-month statute of limitations provided by the Internal Revenue Code. Rather than risk losing all on the appeal, Kemper agreed to accept \$300,000 to settle its wrongful levy action.

Kemper then set its sights on the State of New York. After limited discovery, Kemper and the State agreed to submit the issues to the Court of Claims on cross-motions for summary judgment on largely stipulated facts. Among the facts to which the State stipulated were the following:

1. The State released the \$579,000 in contract funds to the IRS after receipt of two letters from Kemper demanding that no funds be released;
2. The State admitted it *had no knowledge* whether the tax obligations claimed by Haseley to the IRS arose from the Military Road Project or other projects;
3. The State admitted it *made no inquiry* whether the tax obligations claimed by Haseley to the IRS arose from the Military Road Project or other projects; and
4. The surety had completed the Military Road Project and paid payment bond claimants on the Military Road Project, incurring a loss greater than the contract funds paid to the surety.

The State claimed that because it turned over the funds to the IRS, it was entitled to the immunity afforded by 26 U.S.C. §6332(e) of the Internal Revenue Code. The intent of this statute is to protect those who turn over tax funds in response to a levy. The failure to honor a levy can subject one to damages and a penalty. 26 U.S.C. §6332(d). Relying on 26 C.F.R. §301.6332-1(c)(3), the State also argued that Kemper's exclusive remedy was the wrongful levy action.

The Code at 26 C.F.R. §301.6332-1(c)(3) provides:

Remedy. In situations described in paragraphs (c)(1) and (c)(2) of this section, taxpayers and third parties who have an interest in property surrendered in response to a levy may secure *from the Internal Revenue Service* the administrative relief provided for in section 6343(b) or may bring suit to recover the property under section 7426. (Emphasis added).

Kemper made two arguments in response. First, Kemper cited the Code of Federal Regulations at 26 C.F.R. §301.6332-1(c)(2), which provides:

(c) Effect of honoring levy—
(2) Exception for certain incorrectly surrendered property. Any person who surrenders to the Internal Revenue Service property or rights to property not properly subject to levy in which the delinquent taxpayer has **no apparent interest *is not relieved of liability to a third party who has an interest in the property.*** However, if the delinquent taxpayer **has an apparent interest** in property or rights to property, a person who makes a **good faith determination that such property or rights to property in his or her possession has been levied upon** by the Internal Revenue Service and who surrenders the property to the United States in response to the levy is relieved of liability to a third party who has an interest in the property or rights to property, even if it is subsequently determined that the property was not properly subject to levy. (Emphasis added).

In the face of these statutes, the trial court level Court of Claims ruled that Kemper's exclusive remedy was an action in federal court for wrongful levy. The Court of Claims denied Kemper's motion for summary judgment and granted the State's motion to dismiss the claim. Kemper appealed.

The Appellate Division, Third Department

ruled that this was error. The Appellate Division held:

A determination that the existence of these remedies against the United States also forecloses all remedies against other parties would render meaning the plain language of 26 C.F.R. §301.6332-1(c)(2) that a person who surrenders property in which the taxpayer has no apparent interest "is not relieved of liability to a third party who has an interest in the property." Such an interpretation "cannot be countenanced." (Citations omitted).

Thus, the Appellate Division rejected the Court of Claims' determination that a wrongful levy action in federal court was Kemper's exclusive remedy. The Appellate Division also noted that Kemper's simple breach of contract claim was properly established, and that the State came forward with no opposition to Kemper's entitlement to judgment. The Appellate Division reversed both determinations, and awarded Kemper judgment on its motion.

This decision underscores the importance of a surety's vigilance and persistence in notifying the New York State Comptroller in particular, and public entities in general, about a claim for contract funds. The court here seemed persuaded by the fact that the State made no inquiry about the funds when it had reason to believe that Kemper claimed a priority interest. In this case, if the State was genuinely confused about the rights of the IRS and the surety, an interpleader action could have protected the rights of all the parties concerned. **F&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.

45 Day Rule: Factual Defenses To Claimed Amount Permitted Despite Surety's Initial Denial of Entire Claim

BY NELL M. HURLEY

The surety's payment bond defenses survived a new, but related, attack by a subcontractor under the so-called "45 Day Rule" contained within Paragraph 6.1 of its AIA A312 (1984) payment bond in a recent decision from a Pennsylvania federal district court, *Sloan Co. v. Liberty Mutual Co.*, No. 07-5325, 2009 WL 4591906 (E.D. Pa. Dec. 3, 2009).

As many will recall, starting in 2005, the industry was surprised and alarmed by cases interpreting the long-standing A312 provision requiring a surety to

...answer a claimant within 45 days of receipt of the claim, stating the amounts that are disputed and the basis for challenging any amounts that are disputed.

Maryland's highest court held that a surety's non-response to a claimant's notice under the provision was a com-

plete waiver of all procedural and substantive defenses by the surety.¹ This was followed by a federal decision in Virginia that ruled that all fact-based defenses not identified within the 45-day period were waived.² Finally, there was the decision of a federal court in Florida that found the 45-day period began to run upon receipt of notice from the claimant and *not* from the date when the surety receives substantiating documentation of the claim.³

In *Sloan v. Liberty Mutual*, the claimant subcontractor contended that the surety was precluded from asserting the factual defenses of its principal as to the *amount* of the claim because the surety denied the claim in its entirety (during the 45 day period) based upon a conditional payment clause in the subcontract. Not so, said the Court.

Before reaching the main issue of the case regarding whether the payment clause was a pay-if-paid clause or a pay-when-paid clause, the Court rejected the claimant's argument that the surety's response had "contested only entitlement to payment at that time, not the *amount* of the claim" as an unintended and undesirable forfeiture of the surety's rights. Such a reading of the bond provisions would cause confusion, the Court reasoned, since the surety would then be obligated to state an undisputed amount, which it would then be required to pay, despite its general defense as to liability for all amounts.

Ultimately, the Court found the subcontract provision to be a pay-when-paid clause, partial summary judgment was entered against the surety for the undisputed amounts, and the surety was

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to recover time lost due to National's delayed performance.

The sureties moved for summary judgment based upon Hunt's failure to comply with the conditions precedent to recovery under terms of the performance bond. The sureties contended that Hunt's failure to provide timely notice of National's default prevented the sureties from exercising their rights under the bond to cure National's defective performance.

In pertinent part, the bond provided that the "Obligee *after reasonable notice to Surety*...may arrange for the performance of Principal's obligation under the subcontract...." To circumvent the late notice, Hunt relied upon the reasoning in *Colorado Structures, Inc. v. Insurance Co. of the West*, 167 P.3d 1125 (Wash. 2007), which held that the language in AIA A311 performance bond does not require notice as a condition precedent to recovery.¹

The Court rejected Hunt's rationale, and the holding in *Colorado Structures*, find-

ing that such a view would render meaningless the bond's notice requirement. Instead, the Court held that the sureties' duties "depend on the obligee's declaring the principal to be in default and giving notice of the declaration to the principal and the surety." The Court went on to hold that the bond's notice and declaration of default requirements are "...true conditions precedent, in the absence of which the surety has no liability on the bond."

Hunt further argued, citing New York case law, that since the bond could have used clearer language to impose a condition precedent, the bond should be construed *not* to include such a condition. The Court rejected this argument, noting that the issue is not whether the contract employs the most precise language, but rather, how to best read the contract as actually written, seeking to give effect to all of its provisions.

The Court further observed, after quoting excerpts from the *L&A Contracting*² and *Elm Haven Construction*³ decisions, that even if Hunt timely declared National in

default, Hunt was allowed to proceed to remedy the default only "...*after reasonable notice to Surety*." No such notice was given in this case.

This decision reaffirms that which seems obvious to the surety professional: a surety must be given notice of default and an opportunity to exercise its rights to cure its principal's defective performance before liability can be imposed. Unfortunately, case law to the contrary exists⁴ and will likely continue to be raised by obligees that fail to provide the required notices to the surety. **END**

1 The Hunt Court incorrectly identified the bond at issue as an A311 performance bond. Although employing terms similar to an A311 bond, the "after reasonable notice to the surety" language included in this bond sets it apart from the A311 bond.

2 *L&A Contracting Co. v. S. Concrete Servs., Inc.*, 17 F.3d 106 (5th Cir. 1994).

3 *Elm Haven Construction Ltd. Partnership v. Neri Construction LLC*, 376 F.3d 96 (2d Cir. 2004).

4 *Colorado Structures*, 167 P.3d 1125; *Walter Concrete Construction Corp. v. Lederle Laboratories*, 99 N.Y.2d 603 (N.Y. 2003).



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ERNSTROM & DRESTE NEWS

Nell M. Hurley, of counsel, joined E&D in February, bringing with her significant construction and surety law experience. Admitted to practice in New York since 1985, Ms. Hurley represents contractors, owners/developers and sureties. Her practice includes all aspects of contract drafting, review and negotiation, claims analysis and all phases of state and federal court litigation and arbitration.

Matthew D. Brown, has joined E&D as an associate after nearly seven years as a municipal attorney for the City of Rochester. In his previous employment Mr. Brown handled employment matters including disability discrimination, racial discrimination, sexual harassment, and wage and hour claims, as well as civil rights issues, contract disputes, commercial claims, design professional claims, property tax assessment, complex multi-party asbestos, and personal injury litigation in both federal and state courts. A 1996 graduate of Georgetown University Law Center, Mr. Brown served three years as an attorney in the U.S. Army JAG Corps.

Thomas K. O’Gara has joined the firm as an associate. A 2009 *cum laude* graduate of Albany Law School, Mr. O’Gara was the winner of the Karen C. McGovern Senior Prize Trials and the recipient of the Judge Merle Nahum Fogg, Jr. ‘45 Moot Court Prize.

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permitted to assert the factual defenses of its principal as to the remaining amount, if any, due claimant. The Court did not reference any of the other “45 Day Rule” cases in its decision.

Fortunately, the “45 Day Rule” and the recent court decisions impacting the rights of sureties thereunder will be a thing of the past with the AIA A312(2010) payment bond. In the new version, the period of time within which the surety must answer a claimant’s claim has been increased from 45 to 60 days and, more importantly, language has been added stating that a failure of the surety to answer or make payment within the time period specified is *not* a waiver of the surety’s and principal’s defenses to the claim, but may entitle the claimant to attorneys’ fees. **E&D**

- 1 *National Union Fire Insurance Co. of Pittsburgh v. David A. Bramble*, 879 A.2d 101 (Md. 2005).
- 2 *Casey Industrial, Inc. v. Seaboard Surety Co.*, No. 1:06 CV 249, 2006 WL 2850652 (E.D. Va. 2006).
- 3 *J.C. Gibson Plastering Co., Inc. v. XL Specialty Insurance Co.*, 521 F.Supp.2d 1326 (M.D. Fla. 2007).