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Ernstrom & Dreste also publishes the **ContrACT Construction Risk Management Reporter**. If you would like to receive that publication as well, please contact Clara Onderdonk at [conderdonk@ed-llp.com](mailto:conderdonk@ed-llp.com). Copies of **ContrACT Construction Risk Management Reporter** and **The Fidelity and Surety Reporter** can also be obtained at Ernstrom & Dreste's website ([ernstromdreste.com](http://ernstromdreste.com)).

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.

## FIRM NEWS

Timothy Boldt, Esq. spoke at a national conference in Philadelphia, hosted by American Conference Institute on the topic of "Litigating Contract Surety Bond & Fidelity Insurance Claims." Mr. Boldt's presentation focused on ways for sureties to minimize risk on large, multi-surety projects, and also addressed exoneration of payment bonds, including a discussion of 2012 case-law developments which impact sureties' contractual and common law rights to be made whole for losses suffered under a bond.



Thomas K. O'Gara authored a chapter on the ConsensusDOCS BIM Addendum for the 2013 Cumulative Supplement to the ConsensusDOCS Contract Documents Handbook, published by Wolters Kluwer.



# FIDELITY & SURETY REPORTER

## No Recovery under Discharge Bond Until Valid Lien Judicially Established

BY THOMAS K. O'GARA

A recent decision out of the Supreme Court, New York County, reaffirmed that a lien discharge bond is not disgorged from the original lien. In the *Matter of the Ancillary Receivership of the Amwest Surety Insurance Company*, this office successfully dismissed a claim made by a subcontractor against a lien discharge bond. The claim was dismissed because the subcontractor did not establish the validity of its lien prior to making a claim against the lien discharge bond.

In the case, Subcontractor filed a lien after it had not been fully paid for the improvements made to a Pathmark Super Store in Harlem, New York. Thereafter, Contractor requested that Surety issue a lien discharge bond. Surety's obligation to pay under the lien discharge bond was for "any judgment that may be rendered against said property in any proceeding to enforce the aforesaid lien." Subcontractor later filed suit against only Contractor and Surety seeking full payment. But Subcontractor only moved for judgment against the lien discharge bond and did not seek to

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## Transamerica Extended? Surety's Right of Equitable Subrogation Supports Entitlement to Settlement Funds Paid to Contractor on Separate Government Contract

BY NELL M. HURLEY

A surety's right to settlement funds paid to the principal by the federal government on one contract can be asserted under the doctrine of equitable subrogation to set off surety losses incurred on another contract. So said the U.S. Federal Court of Claims in *Hartford Fire Ins. Co. v. United States*, 2012 WL 5194055, which applied the holding of *Transamerica Ins. Co. v. United States*, 989 F. 2d 1188 (Fed. Cir. 1993) to the facts in *Hartford*.

*Transamerica*, you will recall, held that a performance bond surety was entitled to equitable subrogation when, after completing one government contract, it sought funds payable by the obligee to the principal in the form of an equitable adjustment to a separate government contract involving the same principal and obligee. This allowed the surety to offset its loss on one contract with an amount due to the principal on a second contract with the same obligee, creating the so-called "two contract" rule. The *Transamerica* court determined that although the surety's equitable right to subrogation should be counterbalanced by other interests, when there are no obligee claims to be counterbalanced, it would be against fairness and good conscience to allow the defaulting principal to benefit, through the obligee's error, at the expense of the fully performing surety.

The *Hartford* case similarly involved two government contracts. Under the first contract ("Project 1"), the contractor proceeded through the government's claims process, resulting in a settlement agreement pursuant to which the contractor was due \$700,000. Subsequently, Hartford completed the defaulting contractor's work on the second contract ("Project 2"), incurring losses. Hartford alleged that once the government was notified of the contractor's imminent default on Project 2, the government became a "stakeholder" that owed a duty to Hartford regarding the administration of the funds that were designated under the Project 1 settlement agreement. At that point, Hartford argued, it stood in the shoes of the government and was entitled to avail itself of the government's well-established set-off right to those Project 1 funds, just as the government could have done if it had completed Project 2 itself, instead of Hartford.

The government, of course, saw it differently. It made a motion to dismiss Hartford's claim, arguing that under an earlier line of cases (*see Dependable Ins. Co., Inc v. United States*, 846 F.2d 65 (Fed. Cir. 1988)), Hartford was limited to the remaining funds on Project 2, the project generating the claim on which Hartford incurred completion expenses, and

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## Late Notice to a Municipality? Subrogation Argument May Help

BY MATTHEW D. BROWN

Many municipalities in the State of New York have notice requirements for a notice of claim beyond the General Municipal Law §50-e's requirement for tort claims. It is therefore important to check each municipality's notice requirements to determine if a notice of claim is required for contract claims, otherwise such claims may be barred. As an example, the City of Newburgh City Charter §C6.47 requires that a written notice of claim for all causes of action be served upon the City in the same manner as a Summons, within three (3) months of accrual of the claim. Courts have routinely found compliance with such notice of claim requirements a condition precedent that bars a lawsuit if not complied with. *Clayton Indus., Inc. v. City of Newburgh*, 17 AD3d 308 (2d Dep't 2005).

A claim for breach of contract based on a contractor's non-payment accrues either when the work is substantially complete or when the final application for payment is submitted. *Suburban Restoration Co., Inc. v. Wappingers Cent. Sch. Dist.*, 256 AD2d 572 (2d Dep't 1998). This presents a significant problem for a surety receiving payment bond claims on a public project after the principal completes its work and submits its final payment application. In such instances, the surety may have already missed the deadline to comply with the municipality's notice of claim requirement.

The Hanover Insurance Company found itself in this exact situation in the unreported case *The Hanover Ins. Co. v. City of Newburgh*, Index No. 3489/2011 (Orange County Sup. Ct. March 16, 2012). In this case, Hanover received payment bond claims on a City of Newburgh project three months after the principal submitted its final payment application. The City had not released final payment to the principal and still held contract funds. Hanover paid legitimate payment bond claims and, therefore, requested that the City release the contract balance to Hanover. The City, in turn, made a claim for defective work and refused to release the contract balance. The parties were unable to reach a resolution; Hanover sued for the contract balance, and the City moved to dismiss the lawsuit on the basis that Hanover failed to comply with the notice requirements found in the City Charter. Hanover cross-moved to amend its complaint to add a claim as subrogee of the City to the City's interest in the contract balance. The court dismissed all claims as untimely but allowed Hanover to amend its complaint to add a cause of action for the contract balance as subrogee of the City. The court held that:

"Plaintiff succeeded – under principles of subrogation – to all rights which defendant [City] might have against the contractor, including withholding money due the contractor and of applying it to the payment of unsatisfied claims for labor and materials furnished." *United States Fidelity and Guaranty Co. v. Triborough Bridge Authority*, 297 NY 31, 35 [1947] . . . Plaintiff acknowledges that the City may have a claim of setoff for any work it completed under the contract, but, beyond that, the City becomes a "mere stakeholder and [has] no rights of its own to assert." *Id.* At 36. Because Plaintiff's amended complaint seeks to recover based upon the rights of the City, and the City is a stakeholder with respect to the balance of the retained funds, the notice of claim requirement is inapplicable . . . Where, as here, there is no exposure to liability on the part of the City and no "claim" against the City, Plaintiff need not file a Notice of Claim.

While the better practice, where possible, is to ensure that all notice of claim requirements are satisfied, if for some reason the surety/contractor is unable to meet the notice requirements, the surety can argue that it is subrogated to the rights of the municipality and, therefore, the notice of claim requirements do not apply to it in such circumstances. **E&D**

CONTINUED "NO RECOVERY UNDER DISCHARGE BOND UNTIL VALID LIEN JUDICIALLY ESTABLISHED"

foreclose on the lien. At the time, Lien Law §44 required the owner to be named in any lien foreclosure action. Since Subcontractor's lawsuit, Lien Law §44 has been amended to no longer require an owner to be named as a necessary party when establishing the validity of a lien. Accordingly, Subcontractor's lien expired by virtue of its failure to file a lien extension, obtain a court order, or commence a lien foreclosure action.

In reaching its decision, the court looked at the purpose of a mechanic's lien discharge bond. Mechanic's liens are creatures of statute and do not exist in common law. Therefore, lienor must establish a statutory basis for its claim, and no action against a bond can be maintained after the lien has expired.

The court stated that a lien discharge bond "no longer seeks a judgment of foreclosure against real property, but rather seeks a judgment on the undertaking, in lieu of the real property." But that does not obviate the claimant's need to judicially establish the validity of the lien under the Lien Law before a surety is required to make payment on a lien discharge bond. In this case, because Subcontractor's lien expired, it was unable to judicially establish the validity of its lien. Without a valid lien, the Subcontractor was not entitled to recover against the Surety's lien discharge bond.

The Subcontractor argued that the Lien Law does not require enforcement of a lien against a lien discharge bond, instead, it is merely required to show that the originally lien was valid. The Subcontractor further argued that this matter should be construed under Lien Law §37, which allows an owner or contractor to file a bond to discharge all liens before any lien has been filed, to protect the owner's title.

The court rejected both arguments. First, the court held that to assert a claim against a lien discharge bond, the claimant must first judicially establish the validity of its lien. In this situation, Subcontractor's lien expired, making it impossible to judicially establish the validity of the lien. The court also rejected Subcontractor's assertion that its claim was asserted under Lien Law §37, which would have permitted Subcontractor to assert a claim directly against the bond. First, there was no indication that Lien Law §37 was ever invoked. In addition, Subcontractor did not comply with the specific procedures and timing requirements. Therefore, even with the liberal construction of the Lien Law, there is no statutory basis for the Subcontractor's claim. Subcontractor has filed a notice of appeal.

Sureties issuing lien discharge bonds must be mindful that a claimant is only entitled to payment once the validity of the lien has been judicially established. A claimant may not move directly against a lien discharge bond, but rather must establish the validity of its lien before it is entitled to recover under a lien discharge bond. **E&D**

CONTINUED "TRANSAMERICA EXTENDED?"

sought to distinguish the case from *Transamerica* on its facts.

The government cited *Transamerica's* stated limitation to cases in which the government did not have a "competing claim" and argued that since the settlement agreement for Project 1 settled competing claims (between the government and the contractor), *Transamerica's* "two-contract" theory of recovery was not available to the surety as the government's equitable subrogee. It also argued that because the funds sought by Hartford were in a Judgment Fund, instead of unexpended contract funds, the case further was distinguishable from *Transamerica*. The government claimed an extension of *Transamerica* to settlement funds would allow a surety to impede the government's settlement efforts.

The government also argued that Hartford's notice was insufficient to impose a stakeholder duty, because it only notified the contracting officer for Project 2, not the contracting officer for Project 1 or the Department of Justice, which maintained the Judgment Fund. Further, it claimed that Hartford could not succeed to the government's set-off right because, on the date it paid on the settlement, the government had no set-off right because it had not yet terminated the contractor on Project 2. Finally, it argued that Hartford actually benefitted from the settlement on Project 1 because that settlement limited Hartford's potential future liability for that Project.

The *Hartford* court rejected each the government's arguments, finding that the case adhered more closely to the *Transamerica* facts than the earlier cases cited by the government, which limited the surety's relief to the single contract at issue. *Transamerica*, the court noted, emphasized the importance of relief for the surety, which would never undertake the job of completion if doing so would leave it worse off than the government, had the government completed the job, and found that the same incentives applied in this case.

Specifically addressing the government's arguments, the court found the "competing claim" argument unpersuasive, noting in both cases the presence of the interests of the government in

securing contract performance and value for the public fisc. Whether as an equitable adjustment or an equitable adjustment "settlement," the parties arrived at a sum owed, the government was a stakeholder, and the contractor was the sum's only claimant. Citing *Transamerica*, the court said:

Where the only claimant to monies held by a government agency are the surety and a defaulting contractor, the surety...is subrogated to all of the rights and remedies which the government might have had against the principal had the government been forced to complete the project itself.

The difference in the source of settlement funds failed to provide a basis to deprive Hartford of relief either, said the court. The fact that the settlement funds were not contract funds would not prevent them from being collected by the contractor, and should not prevent Hartford from seeking them, the court reasoned. This policy helps prevent situations where the performance bond surety would be worse off for having undertaken performance.

Regarding the government's contention that Hartford's equitable subrogation claim was worthless because the government had no set-off right on the date of the settlement payment on Project 1, the court acknowledged that this "timing" argument could have merit as the right of equitable subrogation exists to allocate proceeds of already-established rights, not to create new ones. The court, however, found that Hartford alleged facts sufficient to counter the government's timing argument in order to withstand the motion to dismiss.

Likewise, the *Hartford* court ruled that for the purposes of defeating the motion to dismiss, Hartford's e-mail to the contracting officer on Project 2, and the ensuing events *may have been* adequate notice to the government of its stakeholder duty as to the Project 1 settlement funds. The issue is best left to be decided on the merits, stated the court.

Moreover, the court opined, even if adequate notice is given to invoke the stakeholder duty, the government retains reasonable discretion in disbursing funds, in light of the circumstances. For

instance, where the contract has been completed, the court noted, the government's interest in retaining funds to ensure contract completion disappears and the contractor's and surety's interests in the retained funds become paramount. The reasonableness of the government's actions in distributing the settlement funds for Project 1 to the contractor or in failing to promptly terminate the contractor on Project 2 and exercise its set-off right for the surety's benefit are questions of fact, not to be resolved on a motion to dismiss, the court said.

The takeaway from *Hartford* for surety professionals and counsel is that the right of equitable subrogation under *Transamerica*, and now *Hartford*, remains a viable tool for indemnity where the owner owes the defaulting contractor money. In cases where there is more than one contract with the same obligee, recovery will still depend on a balancing of the equities. These cases make clear however, that a completing surety in such cases should end up no worse off than the government would have been, had it completed, and that the defaulting contractor will not be permitted to benefit at the surety's expense. The specific source of the funds or their designation (contract balance, retainage, equitable adjustment, or settlement) will not be the determining factor. The surety is well advised, however, to carefully address how and to whom notice is given, in order to properly invoke the owner's stakeholder obligation. **E&D**

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