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Getting it Right: Court Applies Language in Indemnity Agreement

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As demonstrated in *Berkley Regional Ins. Co. v. Weir Bros., Inc., et al.*, 2013 WL 6020785 (S.D.N.Y., November 6, 2013), in New York, under a properly worded indemnity agreement, a surety's right to resolve claims is broad, and proving bad faith or an unreasonable payment is a high hurdle for indemnitors to overcome. *Berkley* also demonstrates that in New York, forum-selection clauses are given great deference by the courts.

In *Berkley*, Defendant Weir Bros. Inc. ("WBI") was a contractor from Texas who obtained performance and payment bonds from Berkley Regional Insurance Company ("Surety"). In exchange for issuing bonds, WBI and individual Defendants executed a General Agreement of Indemnity (the "Indemnity Agreement") in favor of Surety. The parties met to discuss the bonds and the Indemnity Agreement in Texas, and Surety did not permit Defendants to change the Indemnity Agreement. Despite this, Defendants signed the Indemnity Agreement. Subsequently, claims were asserted against the bonds, and Surety incurred costs in paying and settling the claims, including attorneys' and consultant fees.

Surety then sued in the Southern District of New York under the Indemnity Agreement's forum-selection clause. Defendants claimed that Surety failed to mitigate its damages, failed to collect all payments, credits, and offset due to Defendants, and moved to dismiss for lack of personal jurisdiction or to change venue. Surety moved for summary judgment on its indemnity claims.

The first issue the court resolved was whether the forum-selection clause prevailed. Surety is a Delaware corporation, and all Defendants were corporations and individuals residing in Texas that did not engage in business in New York. Based on this, Defendants sought to dismiss the action for lack of personal jurisdiction by the New York court. The court rejected the claim and held "Defendants, by signing the Indemnity Agreement, consented to jurisdiction in the State of New York and waived objection to venue here, their motion to dismiss is denied."

Defendants next sought a change of venue to a Texas court based on convenience of the parties. All Defendants and projects at issue were located in Texas. The court, however, held that a forum-selection clause "figures centrally" in the court's analysis regarding venue, that the Second Circuit has a "strong policy" of enforcing forum-selection agreements. Defendants also waived any "claims of inconvenient or improper venue or forum" by signing the Indemnity Agreement. Defendants attempted to get around this by claiming the clause was unjust or unreasonable because Surety refused to negotiate the Indemnity Agreement's terms. The court held that the mere fact that Surety refused to negotiate over the terms of the Indemnity Agreement does not "constitute fraud, overreaching or unconscionability" necessary to void a forum-selection clause.

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Miller Act Bond Time Limit Not Jurisdictional; Federal Court Permitted to Rule on Motion to Stay Action

NELL M. HURLEY

When a Miller Act payment bond lawsuit is untimely, a surety might think that a federal court would be required to dismiss the action and be precluded from granting a stay of the action pending arbitration of the dispute. That surety would be wrong, at least according to a recent federal court decision from Ohio. *U.S. v. Cannon Management Group, LLC*, 2013 WL 4499739, (S.D. Ohio Aug. 21, 2013). In *Cannon*, the district court held that the Miller Act's time limitation on filing actions is not jurisdictional and proceeded to stay the action while the underlying matter was arbitrated.

The case arose out of a dispute involving work on a Veteran's Affairs facility in Chillicothe, Ohio. A subcontractor, N. R. Lee ("Lee"), brought an action in federal court against the contractor, Cannon Management Group, LLC ("Cannon") and its surety, American Contractors Indemnity Company ("Surety"). Lee assert-

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ed claims of breach of contract, violation of the payment bond provisions of the Miller Act, and reformation of contract.

Cannon and Surety ("Defendants") moved to dismiss the complaint for lack of subject matter jurisdiction, arguing that the court had no jurisdiction over this lawsuit because Lee failed to commence its action within the time proscribed by the Miller Act. Lee then filed a motion to stay the case pending the outcome of an imminent arbitration between the parties. Defendants responded that the court's lack of subject matter jurisdiction over the lawsuit prevented it from ruling on the motion to stay pending arbitration. Lee claimed that the time limit was not jurisdictional and, therefore, the court could rule on the motion to stay.

Acknowledging its role as a court of limited jurisdiction, the district court examined the differences between federal statutory requirements that are jurisdictional and others that are "merely essential ingredients of a federal claim." The court noted that judicial opinions often confuse the issue when they dismiss a claim in which some threshold fact has not been established "for lack of jurisdiction" instead of, more correctly described, for failure to state a claim for which relief can be granted.

The court reviewed the 2006 United States Supreme Court case of *Arbaugh v. Y & H Corp.*, 546 U.S. 500 (2006), which examined the significant consequences of classifying a provision as jurisdictional rather that as an element of a claim. The distinction impacts the court's underlying power to hear the case and the court's ability to exercise supplemental jurisdiction over related claims. The *Arbaugh* Court concluded that when Congress does not rank a statutory limitation on coverage as jurisdictional, then courts should treat it as non-jurisdictional.

The district court then examined the nature of the Miller Act's time limitation

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The next issue was Surety's motion for summary judgment. Surety claimed that, under the Indemnity Agreement, Defendants were liable for $4,615,934.70 plus interest and attorneys' fees incurred in commencing the indemnity lawsuit.

The Indemnity Agreement provided in broad terms that Defendants would indemnify Surety for its losses and costs in connection with the bonds. It also provided Surety with broad settlement authority and stated that itemized statements of payments sworn to by Surety's officer or copies of checks of its payment constituted prima facie evidence of Defendant indemnitors' liability.

The court noted that in New York, under an indemnity agreement, a surety is entitled to indemnification upon proof of payment, unless payment was made in bad faith or was unreasonable in amount. This rule applies regardless of whether the principal was actually in default or liable under its contract with the obligee.

Because Surety provided itemized statements of its performance and payment bond payments, copies of cancelled checks, and an affidavit from Surety's case manager, the burden shifted to the Defendants to show that the payments were made in bad faith or unreasonable amount.

Defendants alleged that they had a collateral agreement requiring Surety to submit certain claims to them for approval and such approval was a condition precedent to their liability under the Indemnity Agreement. The court dismissed this argument because the Indemnity Agreement precluded side agreements unless in writing, and nothing in the Indemnity Agreement established an approval process. Instead, the Indemnity Agreement gave Surety the exclusive right to pay and settle claims against the bonds, making no mention of that right being conditioned on Surety's submission of such claims to the Defendants. Any modification of that right had to be in writing.

Defendants also disputed their liability for several specific payments made by Surety. For instance, Defendants contended that Surety failed to investigate WBI's rights under a contract and needlessly settled an owner's claim. Defendants argued this rendered the payment unreasonable or in bad faith. However, Defendants failed to provide evidence supporting this argument. Regardless, the court found that even "if Defendants had introduced the necessary evidence, it would avail them of nothing. Under the Indemnity Agreement, Surety has the exclusive right to determine whether claims should be settled or defended."

Defendants also argued there was no proper investigation, analysis, or assessment of the circumstances surrounding the months of delays caused by an owner on a project. The court held that "proof that Surety failed to investigate the claim fully would not impugn the good faith of Surety in making the payment."

Defendants also argued WBI was owed $607,790.97 by another owner for work WBI did before it was taken off the project. WBI assigned all its unpaid contract proceeds to Surety, but Surety never collected this amount or provided a credit to the Defendants, thereby failing to mitigate its damage.

Again, the court rejected this argument because Surety had the exclusive right, under the Indemnity Agreement, to resolve claims against its bonds, including the right to pursue or abandon any off-sets. Given the latitude the law and Indemnity Agreement afford Surety to decide how to complete projects and resolve claims, this procedure is not obviously a bad faith or unreasonable way for Surety to resolve its obligations, and Defendants offered no evidence of fraud or collusion between Surety and the owner.

This case demonstrates that in New York, under a properly worded indemnity agreement, a surety's right to resolve claims is very broad. Proving bad faith or unreasonable amount of payment is a high hurdle for an indemnitor to overcome. E&D

on filing of actions to determine whether it was jurisdiction, i.e., whether the court had the power to hear the case. The court concluded that the Miller Act's limitation period is a "run of the mill statute of limitations," does not speak in jurisdictional terms, and is not located in a jurisdiction-granting part of the statute. Instead, for this limitations provision to be jurisdictional, there must be a clear indication that Congress intended for treatment as such. In fact, the Supreme Court has never held the provision to be jurisdictional and there is no uniformity among the circuit courts on the issue. Finally, the court cited the Miller Act's highly remedial purpose in concluding that it is unlikely that Congress intended that the Act's filing period be a jurisdictional requirement. Because the court had subject matter jurisdiction, it could rule on the merits of Lee's motion to stay pending arbitration.

The subcontract agreements between Lee and Cannon contained valid arbitration clauses, which compelled Surety to enter into arbitration. The court held that sureties on Miller Act subcontracts are bound by ensuing arbitration proceedings even if the sureties were not named parties in the arbitration as long as they had constructive notice of the proceeding.

It appears that Defendants limited their motion to dismiss to the issue of subject matter jurisdiction and did not move to dismiss for failure to state a claim. If the lawsuit was obviously untimely under the Act, Defendants may have won the motion if it was based upon failure to state a claim. However, in that case, even if the Miller Act action was dismissed, the court could still retain supplemental jurisdiction of the related, timely commenced claims. Sureties should thus be aware that federal courts can maintain jurisdiction over Miller Act bond actions, even untimely ones. If there is clear evidence that the claim is untimely, the surety should move to dismiss for a failure to state a claim upon which relief can be granted. E&D

Lower Courts Applying Higher Standard for Defalcation

THOMAS K. O'GARA

As previously discussed in this newsletter, the United States Supreme Court recently defined the term "defalcation" in the context of non-dischargeable debt in bankruptcy. In *Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754 (May 13, 2013), the Court determined that a culpable state of mind was required in order to come within the defalcation exception as set forth in § 523(a)(4) of the Bankruptcy Code. In a unanimous decision, the Court held that "where the conduct at issue does not involve bad faith, moral turpitude, or other immoral conduct, the term requires an intentional wrong." The Court added that defalcation could also occur with a conscious disregard for, or willful blindness to, "a substantial and unjustifiable risk" involving "a *gross deviation* from the standard of conduct that a law-abiding person would observe."

This standard makes it harder for a creditor to have its debt declared non-dischargeable and was recently applied to a surety in Virginia. In *Cincinnati Ins. Co. v. Chidester*, 2013 WL 4539103 (W.D.Va 2013), the Debtor was appointed as a guardian and conservator for an incapacitated person, which required the posting of a guardian bond. When the individual past away, the Debtor failed to file a final accounting with the court and failed to respond to an order to show cause. As a result, Cincinnati Insurance Company, the surety issuing the guardian bond, was forced to pay the deceased's estate the full value of the bond.

Cincinnati Insurance, in turn, commenced an indemnity lawsuit against the Debtor. The Debtor also defaulted in that matter, and Cincinnati Insurance was awarded judgment in the amount of its payment to the estate, plus interest, expenses, and attorneys' fees. When the Debtor filed for bankruptcy, Cincinnati Insurance commenced an adversary proceeding, seeking to have its judgment declared to be non-dischargeable. Cincinnati Insurance filed a motion for summary judgment arguing that the Debtor's failure to file a final accounting and respond to the court amounted to defalcation. As a result, the debt he owed to Cincinnati Insurance could not be discharged through bankruptcy. The basis for alleging defalcation was the Debtor's dishonesty in his fiduciary capacity as a guardian and conservator.

Previously, in the Fourth Circuit, a debt would be declared non-dischargeable in bankruptcy if (1) the debtor was acting in a fiduciary capacity when the debt arose; and (2) the debt arose from the debtor's defalcation. In *In re Uwimana,* 274 F.3d 806 (4th Cir. 2001), the Fourth Circuit did not require a finding of recklessness or ill-intent in order for a debt to be exempted under Section 523(a)(4), noting that defalcation is merely "the failure to meet an obligation or a non-fraudulent default." Under *In re Uwimana*, for a debt to be deemed non-dischargeable, the defalcation did not need to rise to the level of fraud, embezzlement, or misappropriation. In fact, even an innocent mistake, which results in misappropriation or failure to account" could have been defalcation.

The Supreme Court's decision in *Bullock* abrogated and elevated the Fourth Circuit's previous standard. Under *Bullock*, negligence or an innocent mistake could not constitute defalcation. Therefore, Cincinnati Insurance must make a showing of bad faith or gross recklessness, i.e., that the Debtor consciously disregarded a substantial and unjustifiable risk that his conduct violated a fiduciary duty. Absent meeting this high burden, Cincinnati Insurance's debt will be discharged in bankruptcy.

As seen in this decision, the Supreme Court's definition of defalcation is having a direct and immediate impact of the surety industry. This case is merely a representation of the difficulties sureties can expect when seeking to have their debt declared to be non-dischargeable in bankruptcy. E&D

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