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"In Transit": Expanded Definition Covers Loss from Theft at Vault

NELL M. HURLEY

When the principals of an armored car company steal cash that is being sorted at the company's vault facility, is the owner's loss covered under a bond providing coverage while the cash is "in transit?" A recent New York Appellate Court says so, reasoning that the theft occurred when the money was in the possession of the armored car service as part of the "contemplated delivery process" between the parties. *CashZone Check Cashing Corp. v. Vigilant Ins. Co.*, 116 A.D.3d 146 (1st Dep't 2014). The facts of the case were not in dispute, so the court was called upon to interpret the "in transit" provision of the bond to determine coverage. The court's ruling will frustrate fidelity professionals and insurers and appears to contradict case law in other jurisdictions.

The plaintiff was a national bank that also owned a check-cashing agency ("Bank"). The Bank had an agreement with Mount Vernon Car Company ("MVMC"), an armored car service, whereby MVMC retrieved currency on the

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Subcontractor Recovers Against Payment Bond; Court Says NY PPA Governs Interest Paid by Surety

NELL M. HURLEY

The trial of a payment bond claim resulted in an award of $4.7 million to a subcontractor in a recent decision from the Southern District of New York. *Innovative Design & Bldg. Serv. v. Arch Ins. Co.*, 2014 WL 4770098 (S.D.N.Y. 2014). The court rejected every defense raised by the surety. Further, the court held that the surety must pay interest at twelve percent in accordance with New York's Prompt Payment Statute, instead of the statutory nine percent. Not surprisingly, the surety has appealed.

The case stems from a multi-family housing construction project in Newburgh, New York, known as Orchard Hills ("Project"), which was financed with a HUD-insured mortgage. The dispute involved the subcontract for the manufacture and construction of modular housing for the Project by Innovative Design and Building Services, LLC ("IDBS") with the general contractor J.K. Scanlon ("JKS"). Arch Insurance Company ("Arch") provided payment and performance bonds for the Project on behalf of JKS, as principal.

The subcontract was initially envisioned by New Excel, IDBS's predecessor, and originally called for compensation of $16.6 million in cash, with a separate $3 million payment from the owner, and a five-percent ownership interest going to New Excel. A letter of intent ("LOI") was executed by New Excel and the Owner reflecting the compensation and ownership interest. HUD approval was obtained, however, based upon the parties' subsequent Memorandum of Understanding ("MOU") that stated the subcontract price of $16.6 million, but omitted any reference to the additional compensation or ownership interest. A few months later, IDBS completed an asset-purchase agreement for New Excel, in which IDBS expressly assumed the obligations of the LOI but not the MOU.

IDBS then chose to forego the equity interest under the LOI and opted for cash payment exclusively, negotiating seven subcontracts with JKS. The total of these subcontracts was $23.6 million, far in excess of the $16.6 million of the HUD-insured mortgage allocated to modular construction. Arch became involved after the owner made a performance bond claim against the Project when JKS experienced financial distress because of the funding gap. Arch denied the claims alleging that JKS had subsequently gained controlling interest in the Project. Arch's investigation did, however, disclosed the correct IDBS subcontract amount and the $6 million funding gap. JKS, of course, assured Arch that more money was on its way and that the gap was a "dead issue." Despite JKS's cancellation of portions of the subcontracted work, IDBS, too, assured Arch that everything was fine with the subcontract and the Project.

After JKS continued to struggle, IDBS made a claim on the payment bond for the unpaid balance then due, but continued performance after a partial payment by Arch

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Service Disabled Vet Company Withstands Bid Protest for VA Contract

THOMAS K. O'GARA

After a service-disabled Veteran-owned small business ("SDVOSB") had its low bid disqualified and its status as a SDVOSB removed, Ernstrom & Dreste ("E&D") secured a victory reinstating the bid and restoring the contractor's status as a SDVOSB. The process resulted in a U.S. Court of Federal Claims decision in favor of the SDVOSB contractor finding that the federal government violated the SDVOSB contractor's due-process rights and that the government's actions were otherwise arbitrary and capricious. The decision is one that Vetslikeme.org called "an important victory not just for AmBuild, but for all SDVOSBs."

AmBuild Company, LLC ("AmBuild") is a verified SDVOSB, eligible to bid on federal set-aside projects. AmBuild was the lowest bidder on a set-aside project at the Syracuse VA Hospital. A disappointed bidder protested the award. The protest alleged that AmBuild did not meet the requirements for a SDVOSB because it was allegedly affiliated with other companies. AmBuild submitted a response to the protest to the U.S. Small Business Administration ("SBA") and the Department of Veterans Affairs ("VA").

Both the VA and the SBA found every allegation in the protest to be without merit. That should have been the end of the inquiry. Instead, the VA unilaterally expanded the scope of the bid protest and ruled against AmBuild on other grounds, which were never previously disclosed to AmBuild. The VA's ruling was based on an outdated, inoperable Operating Agreement that was no longer in effect.

As a result, the VA also stripped AmBuild of its SDVOSB status, preventing it from bidding for other federal set-aside contracts. An administrative appeal followed, with the VA Executive Director upholding the initial VA determination, on yet another ground not specified in the bid protest.

E&D immediately brought suit in the U.S. Court of Federal Claims, challenging the VA's actions on the basis of denial of AmBuild's due-process rights. At the request of E&D, the court heard the matter on an expedited basis. AmBuild argued that the basic requirements of due process required that the VA give AmBuild notice of the new allegations and an opportunity to respond. AmBuild also argued that the VA misapplied AmBuild's Operating Agreement in a manner that was inconsistent with practical business arrangements and therefore, could not be upheld. AmBuild faced a heightened standard of establishing that the VA's actions were arbitrary or capricious.

The court agreed with AmBuild on every account. The court held that the VA could unilaterally expand the scope of a bid protest, but only if it first notified the company of the new allegations and provided an opportunity to respond, before a decision was made. A failure to provide notice and an opportunity to respond violates the minimal requirements of due process as mandated by federal law.

Turning to the substance of AmBuild's argument, the court held that AmBuild's Operating Agreement did not violate any provision of the VA's regulations. The VA argued that AmBuild's service-disabled Veteran owner did not unconditionally own AmBuild due to certain provisions in its Operating Agreement. The court held that VA's interpretation of the Operating Agreement was incorrect, impractical, and could not be sustained.

As a result, the court ruled that the VA should accept AmBuild's low bid and restore AmBuild to the list of verified SDVOSBs. This permitted AmBuild to begin bidding on federal set-aside contracts immediately. In addition, AmBuild's low bid on the Syracuse VA Hospital was restored.

The victory for AmBuild was important for all SDVOSBs. The court's decision will, hopefully, no longer permit the VA to disqualify bidders without first providing notice of all allegations and an opportunity to respond. E&D

CONTINUED "'IN TRANSIT': EXPANDED DEFINITION COVERS LOSS FROM THEFT AT VAULT"

Bank's behalf from the Federal Reserve Bank of New York, took it to the MVMC vault to be counted, sorted, bundled, and delivered to the Bank's financial centers. MVMC also replenished the Bank's ATM cassettes at the Bank's ATM locations.

MVMC agreed to maintain custody of the funds at all times from pick up at the Federal Reserve Bank to delivery at the Bank's facilities. The president and chief operating officer of MVMC misappropriated over $400,000 of the Bank's money, resulting in criminal convictions. After the theft, the Bank made a claim for the loss under the bond, which was purchased from Vigilant Insurance Company ("Vigilant").

Vigilant denied the Bank's claim because, at the time of the loss, the money was not "in transit" as set forth in the bond. Instead, the money was sitting in MVMC's vault. Vigilant argued that the "in transit" provision only encompassed situations when money was stolen while it was in the armored vehicle, while the vehicle was being loaded or unloaded, or during an incidental stop, such as gas or meals. None of these situations applied to this theft.

The Bank commenced a declaratory judgment action and each side moved for summary judgment. The motion court ruled for Vigilant, finding that the money's presence at the MVMC vault, which is where the theft occurred, was a substantive interruption of the transit process under the language of the bond. Therefore, the money was not "in transit."

The Appellate Court disagreed. According to the Appellate Court, the

CONTINUED "SUBCONTRACT ABLE TO RECOVER AGAINST PAYMENT BOND; COURT SAYS NY PPA GOVERNS INTEREST PAID BY SURETY"

of approximately $750,000. IDBS subsequently accelerated all balances due, as it was permitted to do under an amendment to the subcontract and updated its claim with Arch.

At a bench trial, Arch presented numerous equitable defenses to preclude recovery, including that IDBS assumed liability under the MOU limiting its entire contract price to $16.6 million. Arch further alleged that IDBS had a duty to disclose the difference in the compensation between the LOI and MOU and that the doctrine of promissory estoppel rendered the subcontracts void since IDBS was already obligated to provide the modular units under the LOI. Arch argued that IDBS was estopped from recovering under the last two contracts because it knew there were no funds and that IDBS misrepresented and acted in concert with JKS to deceive Arch as to the financial status of the Project, which precluded recovery for the last three buildings. Finally, Arch contended that IDBS waived its claims by executing releases for progress payments.

After a five-day nonjury trial, the court ruled in favor of IDBS, dismissing every defense raised by Arch. There was no express or implied assumption of liability by IDBS, based upon its predecessor's MOU, limiting the subcontract value to $16.6 million, said the court. IDBS had no "duty to speak" about the discrepancy under the circumstances, and Arch did not rely on IDBS's representations for its conclusion that the subcontract was only $16.6 million. The court found that the LOI did not contain an unambiguous promise as to the price of the subcontract and was not relied upon by JKS in formulating its bid for the Project. Therefore, there was no detrimental reliance.

In addition, the court found that even if IDBS knew that HUD-financed subcontract funds had been exhausted, it did not make a false representation or concealment of fact to Arch to support a defense of equitable or promissory estoppel. While there were facts to support the claim that IDBS acted in concert with JKS to persuade Arch that the Project was well financed at the time of the performance bond claim, Arch did not rely on IDBS's representation. Without such reliance, the court reasoned, there is no estoppel defense.

Arch further argued that IDBS partially released its claim by signing a Release and Acknowledgment of Partial Payment. The court disregarded this argument, finding that the prior conduct of JKS and IDBS demonstrates that the partial release was nothing more than a document of the current amounts due, and therefore, inconsistent with Arch's theory of a general release.

Rejecting other efforts by Arch to offset the amounts due to IDBS under the subcontract, the court found the total subcontract amount to be $23.9 million, not $16.6 million. After reduction for payments made, Arch was found liable for approximately $4.7 million.

Further, the court agreed with IDBS that it was entitled to interest from Arch at one percent per month (twelve percent per year) under New York's Prompt Payment Statute instead of the statutory rate of nine percent. The court stated that "New York courts have recognized that the obligations of contractors and sureties under [the statutory provision] were modified by the [Prompt Payment Statute]," though many surety attorneys in New York would dispute that conclusion. It is expected that this very issue will soon be presented to the Second Circuit Court of Appeals in this case, since there is authority that the statutory rate should be applied to sureties. We will be following this one, so stay tuned. E&D

term "in transit" in the context of transportation insurance coverage is a "settled point of law in New York." The test for whether goods are "in transit" requires a determination of whether they are still on their way, with the stoppage being merely incidental to the main purpose for delivery or periods of rest during the continuous undertaking.

Applying these principles, the Appellate Court found that the transit process for the funds was never completed, and the funds were "in transit" at the time of the theft. The court viewed the collection of money by MVMC and its transportation to the vault for sorting in preparation for delivery to the Bank's locations as one continuous shipment process. Rejecting Vigilant's argument that the MVMC vault stop was a substantive rather than an "incidental" interruption under the bond, the court found that it was, indeed, incidental to the process of taking the cash from the site of pick up to the Bank's business locations. The court stated:

> Because the contemplated delivery process necessarily included the sorting and processing of the money, we consider the entire process to be included in the "transit" of the cash.

This expansive view of the term "in transit" is concerning to fidelity insurers, especially in New York. This view appears to contradict case law in other jurisdictions. The New York court's broad interpretation expands insurers' potential liability to risks that may not be contemplated or intended. E&D

ERNSTROM & DRESTE LLP

NEW YORK
180 Canal View Boulevard
Suite 600
Rochester, New York 14623

Visit us online at:
WWW.ERNSTROMDRESTE.COM

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FIRM NEWS

E&D attorneys Named Super Lawyers

Ernstrom & Dreste, LLP is pleased to announce that John W. Dreste, Todd R. Braggins, Martha A. Connolly, and Kevin F. Peartree have been named 2014 New York Super Lawyers. Timothy D. Boldt and Thomas K. O'Gara have both been named 2014 New York Super Lawyers Rising Stars.

Hurley Attends Fidelity Seminar

Attorney Nell M. Hurley recently attended the fidelity seminar sponsored by the ABA titled "Commercial Crime Insurance Coverage" in Philadelphia, Pennsylvania in November 2014.