

## Pursuit of Settled Pass-Through Claim Means Surety Could Be on the Hook for Fraud

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A recent decision by the United States Court of Federal Claims should give sureties and their counsel pause in the common situation in which the surety settles a payment bond claim with its principal's subcontractor, while also asserting its equitable subrogation claim for it against the Government after fulfillment of its performance bond obligations.<sup>1</sup> In just such a scenario, the court granted the Government's motion to amend its answers to assert fraud-based affirmative defenses and counterclaims against both the principal and its surety after, among other things, disclosure of the surety's settlement agreement with a subcontractor for significantly less than the sub's original claim. The principal was presenting the entirety of the sub's claim as a pass-through in its claim against the Government. The court permitted the Government's assertion of fraud-based claims directly

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## Surety is Real Party in Interest, Again: Principal's Default Under GAI Triggers Assignment of All Claims Arising Under Bonded Contract

MATTHEW D. HOLMES

Once the principal defaults under a typical General Agreement of Indemnity ("GAI"), the scope of the resulting assignment of its claims to the surety can be broad indeed, extending to all claims that "grow out of" the bonded contract. A New York intermediate appellate court in *DiPizio Constr. Co., Inc. v Erie Canal Harbor Dev. Corp.*<sup>1</sup> recently found that the surety, not the principal, was the real party in interest in an action seeking a declaratory judgment that the termination of the bonded contract by the owner was a nullity because it was not authorized by its Board of Directors.

The matter stems from a 2012 public contract for the construction of improvements on the Erie Canal near Buffalo, New York. DiPizio was the contractor and obtained performance and payment bonds from Travelers Casualty & Surety Company of America ("Travelers"). In 2013, issues arose with the progress of the work and, after bringing in Travelers, the owner/obligee declared DiPizio to be in default under the contract. DiPizio brought several lawsuits against the owner including this action, which is based upon DiPizio's contention that the owner's president lacked authority to terminate the contract without express authority or formal action by its Board. The court held that the claim concerns a right or interest of DiPizio that "gr[ew] . . . out of the contract" between DiPizio and the owner under the terms of the GAI. Thus, the court found the assignment provisions of the GAI applicable such that Travelers is the real party in interest, not DiPizio, and Travelers was substituted in as plaintiff.

This is not the first time the appellate court had to consider the "real party in interest" issue for the parties. DiPizio had asserted numerous other causes of action against the owner in multiple lawsuits, including breach of contract, unjust enrichment, injunctive relief, various tort claims (fraudulent inducement, coercion/duress, tortious interference of business relations and prima facie tort), a declaratory judgment action (performance bond not triggered because of owner's prior material breach) and even a defamation action.

Prior appeals in those actions upheld the lower court's finding that DiPizio was in default under the GAI, triggering the assignment provisions of all claims that "grow out of" the contract. The court here observed that all of those other actions by DiPizio were properly found to have grown out of the bonded contract. This claim by DiPizio was no different, concluded the court.

<sup>1</sup> 151 A.D.3d 1750 (4th Dept., 2017).

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against the surety for allegedly allowing a false claim to be presented by the principal and failing to alert the court to the existence of the settlement agreement with the sub.

The matters arise out of a 2010 contract between the U.S. Army Corps of Engineers and Lodge Construction, Inc. ("Lodge") for work on the Everglades Upgrade project in south Florida. The Hanover Insurance Company ("Hanover") issued the payment and performance bonds. The contract was terminated for default in July, 2012 and by December, 2012 Hanover had tendered a new contractor and paid the Corps over \$23 million. In 2013, both Lodge and Hanover challenged the default termination and sought money damages, and Hanover asserted an equitable lien on any amounts recovered by Lodge pursuant to its indemnity agreement with Lodge. Lodge's claim included a \$1.1 million pass-through claim of its subcontractor, Civil Construction Technologies, Inc. ("CCT") for claims related to design and dewatering. In each of the four separate actions, the Government initially answered without asserting affirmative defenses or counterclaims. Over the next three years, the actions were consolidated and various motions and significant discovery ensued.

In April, 2017, the Government sought leave to amend its answers in each of the actions to include fraud-based defenses and counterclaims. In particular, the Government asserted that Lodge and Hanover had violated:

1. The Special Plea in Fraud defense, also known as the "Forfeiture Statute" or the "Forfeiture of Fraudulent Claims Act," which can result in claim forfeiture;
2. The Anti-Fraud Provisions of the Contract Disputes Act ("CDA"), which grant the Government damages and costs of review of the fraudulent portion of the claim; and
3. The Federal False Claims Act, which imposes civil penalties, triple damages and costs of recovery.

These claims stemmed, in part, from the fact that Lodge, and Hanover (through its equitable subrogation claim), pursued the full amount of CCT's \$1.1 million claim to the Corps and/or in the actions, despite a settlement agreement between Hanover and CCT that provided payment to CCT of only \$370,000. This fact was not discovered by the Government until August, 2016, when it deposed CCT's lead employee, and when a copy of the settlement agreement was provided in October, 2016. The Government contended that many aspects of the CCT pass-through claim were false, includ-

ing claims for delay that had already been compensated, double billed costs, false depreciation claims, and delay for days that occurred after the work had been completed. The Government also asserted that Lodge was not entitled to any further reimbursement for CCT's work due to the settlement agreement between Hanover and CCT.

Since these fraud-based claims were presented in the context of the Government's motion to amend its answers, the parties' arguments necessarily centered on whether the effort to assert the new claims was timely, would cause Lodge and Hanover undue prejudice, involved an improper motive by the Government or would be futile and destined to fail. The court found in favor of the Government in each instance. The test of whether the Government's assertion of the fraud-based claims would be futile was deemed by the court to be the same as that for a 12 (b)(6) motion to dismiss. Thus, the focus is not on the merits of the Government's claims, said the court, but whether the Government is entitled to offer evidence to support them.

Lodge and Hanover argued that there was no factual basis for the intent or requisite scienter required for the fraud-based claims and that the inaccuracies were, at worst, unintentional, honest, understandable errors made during the difficult task of quantifying a delay and inefficiency claim. The court observed that under each of the Government's three alleged bases for fraud, liability can be found where there is less than actual intent to commit fraud. False statements made with reckless disregard for their truth or falsity, that lack plausibility or a colorable basis, or that ignore obvious deficiencies, can be deemed fraudulent under the referenced statutes, noted the court. Thus, the court concluded that the Government was entitled to assert the claims and present evidence. The court further found that to the extent Lodge is found to have violated the anti-fraud provisions, Hanover cannot recover. Though Hanover could possibly be liable for actual damages caused by Lodge's assertion of the CCT claim, the court held that Hanover has no liability for any extra-contractual penalties or punitive assessments.

This case is a blunt reminder that any pass-through claim should be thoroughly vetted and updated, not just by the principal but by its surety, to prevent such fraud-based claims by owners/obligees, particularly in the federal contracting context. **F&D**

<sup>1</sup> The Sept. 15, 2017 decision, *Hanover Ins. Co. v. United States*, was effective for four consolidated cases: Nos. 13-500C, 13-499C, 13-800C and 16-1187C.

## NY Lien Rights are Derivative: Sub-Sub Can Only Enforce Lien to the Extent of Amount Due to Subcontractor

MATTHEW D. HOLMES

In *Specrite Design, LLC v Elli N.Y. Design Corp.*,<sup>1</sup> the United States District Court for the Southern District of New York granted a stay of a sub-subcontractor's lien foreclosure actions against the prime contractor and the lien discharge bond surety, pending the result of a state court breach of contract action between the prime and its subcontractor. The court reasoned that because New York Lien Law is derivative, it can only be enforced to the extent of the amount due to the subcontractor, which must be determined in that action first.

Specrite, the sub-subcontractor, alleged that the subcontractor had failed to pay it for labor and materials furnished on a public improvement project for the Dormitory Authority for the State of New York in the Bronx, New York. Specrite filed a lien, claiming that the subcontractor owed it over \$109,000 for work performed under its agreement with the subcontractor. Liberty Mutual, the prime contractor's surety for the project, issued a lien discharge bond.

Shortly thereafter, the subcontractor filed a breach of contract claim against the prime contractor and Liberty Mutual in the Bronx County Supreme Court, seeking to recover monies due under the subcontract. Liberty Mutual and the prime contractor asserted that the subcontractor had defaulted and that subcontract funds were expended to remedy that default. Specrite then filed the action in federal court to recover the money due under its agreement with the subcontractor. Included also were causes of action to foreclose the lien and recover under the lien discharge bond.

In moving to stay the lien actions, Liberty Mutual and the prime contrac-

tor argued that the amount due from the prime contractor to the subcontractor under the subcontract determined what Specrite can recover in the lien actions. Significantly, they also claimed that because the subcontract allowed the prime contractor to use earned and unearned funds to remedy a subcontractor default, there may be no lien funds from which Specrite can recover. The state court action would directly address the question of what, if any, amounts are due from the prime contractor to the subcontractor, they said, and thus the lien foreclosure actions must be stayed until such time as the amount of the lien fund is determined. Specrite contended that New York's Lien Law looks to the amount due to the subcontractor on the date that the lien was filed, rather than the amount later found due under the subcontract.

The court agreed with the arguments made by Liberty Mutual and the prime contractor. Under New York Lien Law, said the court, a lien can only be enforced to the extent of the amount actually due to the subcontractor since Specrite's lien right is derivative of the subcontractor's rights under its subcontract. The Court also observed that even though the lien had been discharged by bond, the same test for the validity of the lien and the amount available for Specrite's recovery applied, noting that the filing of the bond does not extinguish the lien but merely shifts it from the public fund to the bonds. Thus, the court granted the motions to stay the lien foreclosure actions, while the state court action determined the lien fund available, if any, for Specrite's lien.

Sureties and their counsel should be aware of this case in situations in which a subcontractor defaults and its

suppliers or sub-subs file liens. Review of subcontract language and knowledge of the state's specific lien laws may provide some good ammunition for defense. **E&D**

<sup>1</sup> No. 16 Civ. 6154 (ER), 2017 WL 3105859 (S.D.N.Y. July 20, 2017).

### Brian J. Geary joins firm

We are pleased to announce that Brian J. Geary is now of counsel to E&D. Brian has over 35 years of experience in construction, engineering, business and law. As a licensed professional engineer and successful construction supplier and businessman, Brian brings valuable technical and financial experience to the representation of E&D's clients. **E&D**



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## FIRM NEWS

In March, Matthew Holmes will be traveling to Chicago to present at the Chicago Surety Claims Institute.

Matthew Holmes is also writing a newsletter article for the Surety Claims Institute Newsletter which will be available in Spring 2018.

Todd Braggins traveled to Greensboro, GA in October, 2017 and presented at the 2017 National Bond Claims Association on "When Owners Attempt to Limit the Surety's Performance Options".