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THE SURETY'S PRIORITY BATTLE WITH STATE LABOR DEPARTMENTS OVER UNPAID CONTRACT FUNDS – WHATEVER HAPPENED TO SUBROGATION?

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Introduction

Consider the following familiar scenario: The principal is in default of its contract with the obligee. The obligee terminates the principal and demands that the surety complete the project pursuant to the performance bond. The obligee has a contract balance of $200,000, which is far less than it will cost the surety to complete the project. In addition, the surety has made $100,000 in payments to claimants under its payment bond. Furthermore, mechanics' liens have been filed by subcontractors and suppliers who have furnished labor and materials to the project for which they have not been paid. The IRS has issued a tax levy to the obligee for the principal's failure to pay taxes. Various other creditors and assignees of the principal also make claim to the contract funds. Finally, the state Department of Labor or similar state labor agency has issued to the obligee a notice to withhold payment from the principal because of the principal's alleged failure to pay prevailing wages to its laborers. The surety demands the entire $200,000 pursuant to its subrogation rights, while all the other parties claim some right or entitlement to these funds. The obligee throws up its hands in the face of these competing claims, refusing to release the contract balance to anyone. Who wins?

The Surety's Equitable Rights of Subrogation

The surety's subrogation rights are extremely powerful and far-reaching. Indeed, upon completing a project and/or satisfying claims of subcontractors and material suppliers, the surety is subrogated to the rights of the claimants it has paid, the principal which is in default, as well as the obligee for whom the bond was issued. See, e.g., Pearlman v. Reliance Insurance Company, 371 U.S. 132 (1962). When it issues performance and payment bonds in connection with a construction project, the surety assumes that it will receive all unexpended contract funds if it becomes obligated to complete the work or to pay laborers or materialmen. Thus, in Prairie State National Bank v. United States, 164 U.S. 227, 41 L.Ed. 412 (1896), the Supreme Court determined that a surety's right to a contract balance is superior to that of an assignee bank. In Pearlman, supra, the same court ruled that the surety's right was superior to the principal's trustee in bankruptcy. In both cases, the Supreme Court's holding was based upon the proposition that contract funds must be available to complete the contract work and to pay claims of suppliers and subcontractors which are related to the principal's performance of that work. The high court rejected arguments which would have permitted the diversion of contract balances to satisfy debts of the principal which are unrelated to the bonded contract. Numerous reference materials exist which explore the surety's subrogation rights in detail, and no effort will be made here to duplicate those works.[1] Rather, this paper will focus exclusively on the surety's rights vis-a-vis one of the claimants in the above scenario: namely, a state

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[1] See, e.g., THE SUBROGATION DATABASE: CASES CONCERNING THE SUBROGATION RIGHTS OF THE CONTRACT BOND SURETY (George J. Bachrach ed., 1995); George J. Bachrach and John V. Burch, The Surety's Subrogation Rights, in THE LAW OF SURETYSHIP (Edward G. Gallagher ed., 1993); The Surety's Right to Obtain Salvage – Exoneration, Reimbursement, Subrogation and Contribution, in SALVAGE BY THE SURETY (George J. Bachrach ed., 1998).

labor agency which has ordered an owner to withhold contract funds from the principal based upon the principal's failure to pay prevailing wages or other statutorily required benefits. Such an order, sometimes referred to as a "notice to withhold" or "stop payment order," frequently includes an assessment of statutory fines and/or penalties.

Claims of state labor departments are no different conceptually from those of unpaid subcontractors, suppliers, or even the very laborers on whose behalf the labor department asserts its claim. Thus, except in very limited circumstances, they should be subordinate to the subrogated surety's claim. Unfortunately, some courts have treated labor department claims differently and have held that such claims have priority over a completing surety's claim to contract funds.

The Titan Indemnity Decision

Consider the recent case of Titan Indemnity Co. v. Triborough Bridge and Tunnel Authority, Inc., 135 F.3d 831 (2nd Cir. 1998). In this case, D.H. Farney Contractors, Inc. ("Farney") entered into a contract with the Triborough Bridge and Tunnel Authority ("TBTA") for certain repairs to the Triborough Bridge and Verrazano Narrows Bridge (the "Project"). In connection with the Project, Titan Indemnity Company ("Titan"), as surety, issued a performance and payment bond on behalf of Farney, as principal, and in favor of the TBTA, as obligee. Approximately ten months after commencing work, Farney breached the contract and the TBTA declared Farney in default and made demand upon Titan to complete the Project. At that time, the TBTA was holding $97,601.88 which was purportedly earned by Farney but not paid as a result of various liens, levies and restraining orders. After Titan completed the Project, it brought an action seeking turnover of the entire $97,601.88 which the TBTA continued to withhold. In addition to Titan, five other entities were brought in to the litigation and sought part of the withheld funds. They were as follows:

The New York City Department of Labor ("DOL"), which had issued a "notice to withhold" $48,450 pursuant to New York Labor Law §220-b. That amount represented the DOL's estimate of Farney's liability (including interest and penalties) for failure to pay prevailing wages to two its employees;[2]

1. The IRS, which asserted a tax lien claim of $16,721.39 for income taxes due for Farney employees who worked on the Project;
2. Quadrozzi Concrete Corp. ("Quadrozzi"), which claimed $3,458.30 for concrete supplied to the Project;
3. Stapleton, a laborer who asserted a claim for unpaid wages pursuant to the prevailing wage law; and
4. Helen Carr Construction Corp. ("Carr"), which asserted a claim based upon a judgment against Farney on an unrelated project.

The District Court's Decision

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[2] Although the DOL's notice to withhold was for $48,450, the TBTA actually allocated only $21,495.65 of the withheld contract balance pursuant to such notice.

After all parties moved for summary judgment, the district court made the pivotal ruling that the withheld funds were trust funds under §70 of Article 3-A of the New York Lien Law, which provides, in pertinent part, that all funds "received by a contractor under or in connection with a contract for . . . a public improvement in this state, . . . and any right of action for any such funds due or earned or to become due or earned, shall constitute assets of a trust." Finding that the withheld funds were Article 3-A trust funds, the district court ruled that the priority of the various claimants was governed by §77(8) of Article 3-A, which is paraphrased below:

> (I)n any distribution of trust assets pursuant to order or judgment in any action to enforce a trust, the following classes of trust claims shall have preference, in the order named:
>
> (a) trust claims for taxes and for unemployment insurance and other contributions, due by reason of employments, and for amounts of taxes withheld or required to be withheld;
>
> (b) trust claims of laborers for daily or weekly wages;
>
> (c) trust claims (of laborers) for benefits or wage supplements;
>
> (d) claims to a laborer's wages (other than claims for amounts of taxes deducted from payments thereof), pursuant to law or agreement, made by third parties on behalf of the laborer, to the extent that such third party is entitled to assert, as a trust claim, the claim the laborer would otherwise have for such amount.

§77(8) goes on to say that:

> "Except as provided in this subdivision, trust claims entitled to share in any distribution of trust assets pursuant to order of the court shall share pro rata."

Notwithstanding the foregoing, the district court held that there are certain claims which are entitled to "super-priority" status, and that they are to be satisfied before the priority of the other trust fund claims is even evaluated. Among such special claims are those of subcontractors and suppliers who have properly filed and perfected valid mechanics' liens. Since neither Quadrozzi nor Stapleton ever filed or perfected a valid mechanics' lien, however, the district court held that they were not entitled to super-priority status. The district court also rejected Titan's arguments that it was entitled to super-priority status, ruling that, as a trustee of an Article 3-A trust, it was first obligated to pay claims of statutory trust beneficiaries before taking any contract proceeds for its own benefit.

The district court did, however, grant super-priority status to the DOL, at least with respect to the $21,495.65 which the TBTA had actually withheld and allocated pursuant to the DOL's notice. Therefore, the district court ordered that, of the $97,608.81 "trust fund"

which the TBTA was holding, $21,495.65 was to be paid first to the DOL, leaving a balance of $76,106.23.

The district court then ordered payment to the Article 3-A beneficiaries in accordance with New York Lien law §77(8) which determines priorities among trust beneficiaries. The district court directed that the IRS, which receives first priority under §77(8), was to be paid its tax claim of $16,721.39. As the next priority under §77(8) goes to "trust claims of laborers for daily or weekly wages," the court ordered that the DOL be paid $10,610.07 on behalf of Stapleton, the only laborer who was still owed wages. The trust claim of Quadrozzi, which fell into the "residual" trust category, came next, and so the district court ordered that it be paid its claim of $3,458.30. After the super-priority claims and trust claims were satisfied, the district court ruled that the remaining balance of $48,774.77 belonged to Titan as completing surety. (The court held that judgment-creditor Carr had no right to any of the withheld funds as it was not entitled to either super-priority or trust claim status).

Titan's Appeal to the Second Circuit

Titan appealed, arguing that the district court erred, among other things, (1) by according priority to the trust fund beneficiaries over Titan's claim, and (2) by ruling that the DOL's claim had super-priority status and thus had priority over Titan's claim. With respect to the first alleged error, Titan argued that, pursuant to its subrogation rights which attached when it issued its bonds, Titan's claim to the withheld funds is superior to the trust claims. The Second Circuit rejected this argument, noting that it was "undisputed" that the withheld funds were Article 3-A trust funds, and therefore that the district court properly determined priority in accordance with §77(8) of the statute.

In so ruling, the Second Circuit distinguished the case of Scarsdale Nat'l Bank & Trust Co. v. United States Fidelity & Guaranty Co., 264 N.Y. 159, 190 N.E. 330 (1934), upon which Titan had relied. The Scarsdale Court had held that a completing surety had priority to contract funds over an assignee of a defaulting principal, since the surety was subrogated to the owner's rights, while the assignee-bank was entitled only to whatever rights the assignor (principal) had. Since the Scarsdale case did not involve any Article 3-A trust fund beneficiaries, however, the Second Circuit deemed it inapposite.

With respect to the district court's finding that Titan's claim was also inferior to the DOL's, Titan countered with the argument that Farney had already been in default at the time the TBTA received the DOL's notice. According to this argument, once Farney was in default, no further funds became due and owing to it, and thus there were no funds to which the DOL's §220-b notice could attach.

The appellate court rejected this argument on a rather technical, estoppel-based theory. During the litigation, the IRS had submitted a Rule 3(g) Statement [a statement of facts as to which a party asserts there is no genuine issue]. One of the factual assertions in the IRS's 3(g) Statement was that "[a]t the time of Farney's default, the TBTA was holding $97,601.88 . . . which Farney had earned, but had not been paid under the Contract."

Because Titan did not object to this statement, the court concluded that Titan implicitly conceded that the TBTA received the DOL's notice to withhold prior to Farney's default. The court therefore refused to entertain the surety's argument (raised for the first time on appeal) that Farney was already in default at the time the TBTA received the DOL's notice.

More Effective Future Strategies

While the Titan Indemnity case is an unfortunate decision, all hope is not lost, for sureties may be able to overcome the court's holding by making certain arguments which Titan failed to make.

First, the court repeatedly noted that it was "undisputed" that the withheld funds constituted trust funds pursuant to Article 3-A of the New York Lien Law. If Titan had disputed that fact and argued that the withheld funds were NOT trust funds, the outcome might have been different. Indeed, had the court determined that the withheld funds were not Article 3-A trust funds, the basis for its analysis would have been different.

There certainly appears to be a solid legal basis for the position that the withheld funds were not statutory trust funds. First, the withheld funds clearly were not "received by a contractor" within the meaning of New York's trust fund statute, since they were never paid to Farney. Second, the funds were not "due or earned or to become due or earned" within the meaning of the statute because, once Farney had breached its contractual obligations to the TBTA, it forfeited its right to receive any contract funds, at least until all completion costs were paid, and labor and material claims satisfied. Because of Farney's default, the withheld funds arguably were never earned, due or to become due to Farney, and therefore never became Article 3-A trust funds. Titan apparently failed to make this argument.

In addition, Titan failed to object to the IRS' factual assertion in its Rule 3(g) Statement that "[a]t the time of Farney's default, the TBTA was holding $97,601.88 … which Farney had earned, but had not paid under the Contract." According to the court, Titan's failure to deny this statement constituted an admission that the DOL's notice to withhold had been received prior to Farney's default. In truth, it appears that Farney was in default prior to the date of the DOL's notice. Titan obviously should have objected to the IRS' 3(g) Statement. The Second Circuit then may have been forced to agree that, upon Farney's default, no further funds were due or earned or to become due to Farney, and that there were no funds to which the DOL's notice could have attached.

It should be noted that, because the court essentially held that Titan had waived its ability to argue that Farney's default preceded the DOL's notice, it is doubtful that the Second Circuit would have allowed Titan to argue that the withheld funds were not Article 3-A trust funds since that argument is based on the same premise. That is, both arguments are based upon the assertion that, upon Farney's default, the withheld funds were no longer due to the contractor.

More Thoughts on the Titan Indemnity Decisions

Both the district and appellate courts in Titan Indemnity reached adverse

conclusions which quite possibly could have been avoided. With the advantage of hindsight, it is clear that the surety should not only have challenged the IRS' 3(g) Statement, but should also have argued (1) that the principal was in default long before the declaration of default by the TBTA, and (2) that the question of whether the DOL's notice to withhold preceded the date of default is actually unimportant to a determination of the relative rights of the completing surety and the labor department, since the surety's subrogation rights arose at the time that its bonds were issued. The Second Circuit also lost sight of the fact that the surety became subrogated to the rights of the owner (not just the terminated principal) to use unpaid contract funds for contract purposes such as payment of completion costs, subcontractors and suppliers. Apparently, Titan did not effectively argue that virtually all of the withheld contract funds never became "trust funds" because those funds were needed to reimburse the completing surety, which was subrogated to the TBTA's rights. The Second Circuit states, at 135 F.3d 834, that "the rights of a surety in the trust proceeds do not trump those of the Article 3-A trust fund beneficiaries;" this ignores the fact that, under the better analysis, funds needed to complete the work or to pay laborers and materialmen do not become trust proceeds at all. Obviously, the mere existence of trust fund beneficiaries does not create a trust fund.

The Titan decision is prejudicial to sureties for a variety of reasons. The appellate court awarded the DOL a "super-priority" as to the $21,495.65 actually withheld by the TBTA pursuant to the DOL's withholding notice. There appears to have been no serious effort to investigate or substantiate the actual amount of Farney's prevailing wage underpayment. In the usual case, however, the amount which the DOL directs an owner to withhold pursuant to §220-b is only an estimate of the principal's actual liability for prevailing wage violations. The funds are supposed to be withheld pending a final determination of the principal's actual liability. If a laborer instead asserted a payment bond claim for the unpaid wages, the surety would require substantiation for the claim. In Titan, the surety was deprived of its opportunity to challenge the claim, or resolve it for some lesser amount.

In addition, the amount which the owner is directed by the DOL to withhold may also include (as it did in Titan) penalties which, under normal circumstances, are not recoverable under the surety's payment bond, as the same is not part of the "labor or material" incorporated into the project. See e.g., Lite-Air Products, Inc. v. Fidelity & Deposit Co. of Maryland, 437 F. Supp. 801 (E.D. Pa. 1977); J.C. Snavely & Sons, Inc. v. Web M & E, Inc., 594 A.2d 333 (Pa. Super.), appeal denied, 602 A.2d 860 (Pa. 1991); Ragan v. Tri-County Excavating, Inc., 62 F.3d 501 (3rd Cir. 1995); Reliance Universal, Inc. v. Ernest Renda Contracting Co., Inc., 454 A.2d 39 (Pa. Super. 1982); Can-Tex Industries v. Safeco Ins. Co. of America, 460 F. Supp. 1022 (W.D. Pa. 1978). Indeed, in denying recovery of "finance charges" under a payment bond, the court in Lite-Air Products, supra, stated:

> [T]his claim must also be dismissed for not being a properly included item under "labor and materials." First, this claim is not an indispensable cost for labor or materials which added value to the building project. Rather, the claim for finance charges is in the nature of a penalty, and therefore would more appropriately be classified as damages than as part of the value of the materials. [437 F. Supp. At 804.]

It is also possible that a payment bond claim by a laborer or by the DOL for unpaid wages may be time-barred under either the bond or the relevant public works statute (in New York, State Finance Law §137).

The Cross Bay Decision

Another recent New York decision with a questionable result (although better for the surety) is City of New York v. Cross Bay Contracting Corp., 662 N.Y.S.2d 462, 235 A.D.2d 10 (App. Div. 1997). In that case, Cross Bay Contracting Corp. ("Cross Bay") had entered into a contract with the New York City Department of Sanitation (the "City") for construction work at the Fresh Kills Landfill in Staten Island (the "Project"). In connection with the Project, Colonia Insurance Company ("Colonial"), as surety, had issued a performance and payment bond on behalf of Cross Bay, as principal, and in favor of the City, as obligee. Shortly after work commenced on the Project, the City terminated the contract "for convenience." By that time, Colonia had made payments to several claimants under its payment bond. In addition, there were several liens filed by subcontractors who had furnished labor and material to the Project for which they had not been paid. There was also a "restraining notice" filed by the New York State Commissioner of Labor for unemployment insurance contributions allegedly owed by Cross Bay pursuant to New York Labor Law §573(2), as well as a "notice of levy" issued by the IRS with respect to taxes owed by Cross Bay. Finally, the Office of the City Comptroller had issued a "stop payment order" directing that the City withhold $100,000 from Cross Bay for its alleged failure to pay prevailing wages pursuant to Labor Law §220-b.

The City, as stakeholder, commenced the action seeking a determination of the priority of the competing claims to the remaining contract funds, which totaled $171,917.38. The City then moved to reduce the amount of the funds available for distribution by $100,000 (the statutory maximum amount that may be withheld), while Colonia moved for summary judgment seeking the entire $171,917.28 based upon its equitable subrogation rights. The lower court ruled that the City had established a "prima facie right" to withhold the $100,000 pursuant to Labor Law §220-b, and denied Colonia's motion, concluding that it failed to establish any entitlement at all to the withheld funds.

The Appellate Division affirmed the lower court's ruling that the City had established a legitimate right to withhold $100,000, in accordance with the Comptroller's stop payment order and pursuant to Labor Law §220-b. However, the appellate court reversed the lower court's denial of Colonia's summary judgment motion and held that Colonia was entitled to the balance of $71,917.38 (the remaining contract funds less the $100,000 withheld because of the stop payment order).

In granting summary judgment to Colonia for the $71,917.38, the appellate court held that Colonia's rights to those contract funds were superior to the rights of all competing claimants, relying on the surety's old friend – subrogation – and citing the case of U.S. Fidelity & Guaranty Co. v. Triborough Bridge Auth., 297 N.Y. 31, 74 N.E.2d 226 (1947). In that case, the New York State Court of Appeals held that a surety had priority to contract funds over an IRS tax lien since the surety's subrogation rights arose at the time it executed its bond, which was before the tax lien was filed.

The Appellate Division in Cross Bay further reasoned as follows:

> Colonia is subrogated to the City's rights and may use the contract funds to apply the funds to payments made and to be made under

> the payment bond. It is clear that Colonia's right to the interpleaded fund is superior to that of the other claimants, who are entitled only to funds "due or to become due" to the debtor, Cross Bay. No monies, however, are or will be due Cross Bay, since its rights are subordinate to those of the City and, by subrogation, subordinate to those of Colonia. [662 N.Y.S.2d at 465].

The Cross Bay decision reaffirms the surety's equitable subrogation rights with respect to reimbursement for both performance and payment bond losses, and should be extremely helpful to the surety which seeks to obtain contract balances over the claims of creditors such as the IRS and unpaid subcontractors. Of extreme import is the fact that the Appellate Division did not rule that the contract funds were Article 3-A trust funds (as did the Second Circuit in Titan Indemnity), nor was there any discussion regarding whether Cross Bay's termination came before or after the Commissioner of Labor's restraining notices, or the City Comptroller's "stop payment order."

Unfortunately, the Appellate Division failed to rule that the surety is also entitled to the $100,000 which, according to the court, the City properly withheld pursuant to the stop payment order. While it is also true that the court did not hold that these funds should be paid to the Comptroller (and therefore did not go as far as the Second Circuit did in Titan), its analytical distinction of prevailing wage claims from the other claims is unexplained. In fact, since the Cross Bay court did not regard these withheld funds as Article 3-A trust funds, its failure to unequivocally include them within the "reach" of the surety's subrogation rights makes the decision a somewhat disappointing one – at least with respect to the surety's contest with the Department of Labor. The case is currently on appeal to the New York State Court of Appeals on the limited issue regarding priority in the $100,000 in withheld funds. Until a decision is reached on the appeal in the Cross Bay case, the law in New York will remain less than favorable concerning the surety's rights to contract funds as against prevailing wage claims asserted by New York's Department of Labor.

Perhaps the best New York case for the surety with respect to its priority subrogation rights vis-a-vis the Department of Labor is Firemen's Insurance Company of Newark v. State of New York, 412 N.Y.S.2d 206, 65 A.D.2d 241 (App. Div. 1979). In that case, Jo-Gar Construction, Inc. ("Jo-Gar") had entered into a contract with the New York State Department of Environmental Conservation (the "State") for construction work at the Lewey Lake Campsite in Hamilton County (the "Project"). In connection with the Project, Firemen's Insurance Company ("Firemen's"), as surety, had issued a performance and payment bond on behalf of Joe-Gar, as principal, and in favor of the State, as obligee. When Jo-Gar failed to complete the contract work, the State terminated Jo-Gar and demanded that Firemen's complete the Project in accordance with the performance bond. At that time, there was a contract balance of $11,241.27, of which $5,292.50 was retainage. Firemen's completed the work and requested that the State pay it the entire contract balance of $11,241.27, since it cost Firemen's more than that to complete the job. The State paid Firemen's $9,541.68, but withheld $1,699.59 pursuant to a claim in that amount filed by the DOL for unpaid unemployment insurance contributions owed by Jo-Gar.

Firemen's brought an action seeking turnover of the $1,699.59. In affirming the lower court's order granting summary judgment to Firemen's, the Appellate Division reasoned that, since "the demanded retainage was kept by the State to insure that the work was completed on time and not to insure that workers and materialmen were paid", the surety's equitable subrogation rights "cannot be defeated by any attempt by the State to offset by counterclaim a debt related to payment for work or materials and not to performance." 412 N.Y.S.2d at 208. The court also relied on the fact that the contractor's default occurred prior to any default in payment of unemployment insurance contributions. (The court noted, in dicta, however, that the DOL could have asserted a claim under Firemen's payment bond for the unpaid unemployment insurance contributions).

Neither the Titan decision nor the Cross Bay court cited the Firemen's case. It is unknown whether the sureties' attorneys in those cases cited or relied upon Firemen's at all.

Conclusion

Thanks to a handful of well-reasoned (and often-cited) reported decisions, sureties have long assumed that they are entitled to receive the unexpended contract funds whenever they incur performance or payment bond losses. Two recent appellate court decisions in New York seem to suggest that prevailing wage claims – usually asserted by a department of labor or its commissioner – are entitled to a priority, defeating even the subrogated surety. It is hoped that the foregoing analysis will provide sureties with useful arguments and ammunition for the fray.

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In the surety field, he has successfully argued at the trial and appellate levels, resulting in reported decisions in favor of surety clients, including Hutton Construction Co., Inc. v. County of Rockland, et al., 52 F.3d 1191 (2nd Cir. 1995), and Allied Mechanical and Plumbing Corp. v. Dynamic Hostels Housing Development Fund Co., Inc., Mundo Developers, Ltd. and St. Paul Fire and Marine Insurance Co., 62 B.R. 873 (Bkrtcy. S.D.N.Y. 1986).

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