LITIGATION ALERT

INSURERS BEWARE!

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Insurers writing surety bonds beware! It is critical that insurers understand their principals' construction contracts before they execute and deliver performance and payment bonds for public works projects. A recent decision by the U.S. District Court for the Southern District of New York has held that though an insurer is not a party to the principal's construction contract with the owner, the insurer's sole dispute resolution procedure against the owner is arbitration, where the insurer's bond expressly incorporates the terms of a construction contract containing a sufficiently broad arbitration provision.

This ruling arose out of a public improvement project in Brooklyn, New York. Defendants Metropolitan Transportation Authority ("MTA"), and the New York City Transit Authority ("NYCTA") entered into a construction contract with Lanmark Group, Inc. ("Lanmark") whereby Lanmark was to perform rehabilitation and upgrades to 130 Livingstone Place, which houses NYCTA's headquarters (the "Contract"). Article 8.03 of the Contract set forth the alternative dispute resolution procedures under which either NYCTA's Chief Engineer or its Contractual Disputes Review Board ("CDRB") was to render final and binding decisions in contractual disputes. Before the Contract was executed, plaintiff Federal Insurance Company ("Federal") and Lanmark executed a performance bond (the "Bond") obligating Federal to complete the Contract in the event Lanmark failed to complete its work. Federal's Bond attached a copy of the Contract, and incorporated the Contract "as though herein set forth in full."

In November 2016, NYCTA advised Lanmark and Federal of 10 separate Contract breaches, most concerning work on the building's façade. In April 2017, NYCTA terminated the Contract due to Landmark's breach and demanded that Federal complete the work pursuant to its Bond. Federal responded by advising NYCTA that neither Federal nor any other party would be able to complete the work since the Contract failed to comply with applicable New York City and New York State Building Code requirements. In May of 2017, Federal filed an action which included a single cause of action against the MTA and NYCTA for a declaration that Federal had no obligation to complete the Contract under the Bond and an injunction enjoining the MTA and NYCTA from compelling Federal to complete the Contract.

The agencies moved to dismiss Federal's sole cause of action on the basis that Federal's claim was subject to the Contract's alternative dispute resolution procedure. The Court agreed with the MTA and NYCTA and dismissed Federal's cause of action. First, the Court determined that Article 8.03 of the Contract was in fact an arbitration clause. The Court then held that Article 8.03 was incorporated into the Bond. The Court noted that although Federal was not a party to the Contract, the Bond to which Federal was a party attached the Contract and incorporated it "as though herein set forth in full" and contained no language limiting incorporation. The Court's final inquiry was whether Article 8.03 contained language broad enough to allow a non-signatory dispute to be brought within its terms. The Court analyzed the Article's language, which stated that the "parties to the Contract hereby authorize and agree to the resolution of all Disputes arising out of, under, or in connection with, the Contract." The Court concluded that although the language did not precisely mirror the standard broad arbitration clause, it did make arbitration the only means for the contracting parties to resolve any dispute in connection with the Contract. The Court found this language sufficiently broad to bind Federal to the arbitration procedures.

With the foregoing decision in mind, insurance companies providing performance and payment bonds on construction projects should review their principal's contract with the owner prior to execution and delivery of the bond(s) to determine whether or not the contract contains a broad arbitration provision. Insurers wishing to avoid even the specter of arbitration should explicitly limit and exclude from the terms of the bond any alternative dispute resolution procedures set forth in the construction contract.

Insurers providing performance and payment bonds for construction projects in New York should consult with knowledgeable construction counsel who can advise them concerning potential exposure under their bonds and their principals' contracts.

1. Federal Insurance Company v. Metropolitan Transportation Authority, New York City Transit Authority, and Landmarl Group, Inc., 2018 WL5298387 (S.D.NY 2018).

For more information, please contact:

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