

Matter of New York Sur. Co.

2009 NY Slip Op 31035(U)

April 28, 2009

Supreme Court, Nassau County

Docket Number: 017005/98

Judge: Thomas P. Phelan

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SHORT FORM ORDER

SUPREME COURT - STATE OF NEW YORK

Present:

HON. THOMAS P. PHELAN,

Justice

TRIAL/IAS PART 4
NASSAU COUNTY

In the Matter of

the Liquidation of

NEW YORK SURETY COMPANY

ORIGINAL RETURN DATE: 02/27/09
SUBMISSION DATE: 03/27/09
INDEX No.: 017005/98

Claimant: CLASSIC STONE
Claim Nos: 93060055-003
 93060054-000

MOTION SEQUENCE #13,14

The following papers read on this motion:

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Motion by New York State Insurance Department to confirm the report of the referee is denied. Cross-motion by claimant Classic Stone, Inc. to reject the referee's report is granted.

C. Pavlou & Sons ("Pavlou") was the general contractor on two construction projects for the City of New York (the "City"). The projects were located in housing developments in Manhattan and involved the conversion of two residential buildings to medical clinics. In June 1993, Pavlou obtained performance and payment bonds from New York Surety Company ("New York Surety") covering its work on the projects. Each payment bond provided that "[T]he Surety...hereby stipulates and agrees that the obligation of said Surety...and its bonds shall be in no way impaired or affected by any extension of time, modification,...or change in or of the said contract...or by any assignment, subletting, or other transfer thereof...." In 1994, Pavlou hired claimant Classic Stone, Inc. ("Classic Stone"), a stone and marble contractor, to perform stone work on the projects.

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In March 1996, Pavlou defaulted on both of its contracts and was removed as the general contractor. Pursuant to the performance bonds, the City called upon New York Surety to complete the projects. New York Surety hired Bat-Jac Contracting Corp. ("Bat-Jac") to be its "completion contractor" and requested Classic Stone to continue working on the projects. Although Classic Stone entered into subcontracts with Bat-Jac, covering the same stone work, no performance or payment bonds were obtained by the completion contractor. In mid-August of 1996, Classic Stone, which had not been paid for its work, refused to perform further work on the projects. Bat-Jac ultimately defaulted on the construction contract, and New York Surety defaulted on its undertakings.

In December 1997, Classic Stone commenced an action against Bat-Jac and New York Surety in Supreme Court, Nassau County, to recover for its work on the projects (Index No. 35613/97). In May 1998, Bat-Jac was dissolved by the New York Secretary of State for failure to pay franchise taxes. In September 1998, an order of rehabilitation was issued for New York Surety, and all other proceedings against the insurer were stayed by this court.* The order of rehabilitation was subsequently replaced by an order of liquidation.

In February 1999, Classic Stone submitted claims to the Liquidation Bureau (the "Bureau") of the New York State Insurance Department based upon its work on the projects. In essence, Classic Stone's position was that it was entitled to recover on Pavlou's payment bond even though its work had been performed for a replacement contractor. By letter dated February 22, 2000, Maureen Hardy, a senior claims examiner for the Bureau, notified Classic Stone that the Bureau intended to await a decision in the Supreme Court action before adjudicating the claims. Ms. Hardy noted that the stay of all proceedings against New York Surety did not prevent the action against Bat-Jac from going forward.

In response, Classic Stone commenced an Article 78 proceeding against the Superintendent of Insurance, seeking to compel a determination upon its claims (Index No. 7915/00). By order dated November 8, 2000, this court dismissed the Article 78 petition on the ground that the Bureau's decision to await a ruling in the action against Bat-Jac was not irrational. On November 14, 2002, Classic Stone was awarded a judgment of \$160,122.15 against Bat-Jac, after the contractor defaulted at trial. Nevertheless, on August 20, 2003, the Superintendent of Insurance issued a notice of determination, recommending the disallowance of the claims (Classic Stone Ex. C).

* The rationale for staying other litigation against an insolvent insurer is that the provisions of the Insurance Law concerning rehabilitation and liquidation are exclusive in their operation (*In re United Community Ins. Co.*, 226 AD2d 948, 950 [3d Dept 1996]).

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Meanwhile, by order dated December 6, 1999, this court had appointed Louis J. Milone, Jr. as a referee to hear and report as to all claims against New York Surety which had not been settled or compromised (Classic Stone Ex. B). On June 25, 2004, Mr. Milone held a hearing with respect to Classic Stone's claims (Movant Ex. D). However, no report by Mr. Milone was ever issued. By order dated October 24, 2007, this court relieved Louis J. Milone, Jr. and appointed Owen B. Walsh as referee in his place (Classic Stone Ex. D). While referee Walsh was not directed to conduct a de novo hearing, he was authorized to take additional testimony in his discretion. Referee Walsh conducted a continued hearing on Classic Stone's claims on August 1, 2008 (Movant Ex. E).

By decision dated December 3, 2008, referee Walsh recommended that the determination of the Superintendent of Insurance be upheld and the claims be denied (Movant Ex. A). Referee Walsh reasoned that there had been no assignment or transfer of the "bonded original contract" to Bat-Jac, but rather a "novation," and "new contracts entered into by a new contractor." The referee also rejected Classic Stone's argument that the Superintendent of Insurance was estopped from denying liability on the bonds by the fraudulent conduct of Maureen Hardy, the claims examiner. Classic Stone asserted that it was induced to continue work on the project by Ms. Hardy's false representation that, if Bat-Jac defaulted, New York Surety would pay Classic Stone's claims. Classic Stone further alleged that Ms. Hardy failed to disclose that she had a conflict of interest in that she was married to Bat-Jac's project manager.

The Bureau moves pursuant to CPLR 4403 to confirm the referee's report. In support of confirmation, the Bureau argues that the referee's report is entitled to "substantial deference" by the court. Classic Stone cross-moves to reject the referee's report and for a direction that its claims be allowed and paid. Stressing that the referee was appointed to hear and report, Classic Stone asserts that the report is in "no way binding on the court."

The Superintendent of Insurance serves as supervisor of the state's insurance industry as a whole, and also as a "court appointed receiver on behalf of distressed insurers" (*Dinallo v Ins. Dept Liquidation Bureau*, 9 NY3d 94, 97 [2007]). In the latter role, the Superintendent of Insurance possesses "broad fiduciary powers to manage the affairs of distressed domestic insurers and to marshal and disburse their assets" (Id.). To protect creditors, policyholders and the general public, the statutory scheme furnishes a comprehensive mechanism for collecting the assets of a distressed insurer and paying its creditors (Id.).

If the Superintendent of Insurance determines that attempts to rehabilitate a distressed insurer would be futile, he may apply to Supreme Court for an order of liquidation (Insurance Law § 7403(a)). Such an order directs the Superintendent of Insurance "to take possession of the property of such insurer," liquidate its assets, "deal with such property and business of such insurer," and "give notice to all creditors to present their claims" (Insurance Law § 7405(a)). "The Supreme Court, in turn, is charged with directing the manner in which payments and dividends to creditors shall be made" (*Dinallo v Ins. Dept Liquidation Bureau*, 9 NY3d at 98).

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The Superintendent of Insurance enforces orders of rehabilitation and liquidation through the New York State Insurance Department Liquidation Bureau, which conducts the day-to-day operations of the distressed insurer (Id.). Pursuant to Insurance Law § 7422, the Bureau routinely retains personnel from the distressed insurer to assist it in the liquidation process. Such individuals are compensated out of the funds or assets of the insurer and are not employees of the State (Id.).

Allowed claims which remain unpaid by reason of the insurer's insolvency are to be paid from the Property and Liability Insurance Security Fund (Insurance Law § 7603(a)(1); *Paramount Communications, Inc. v Gibraltar Cas. Co.*, 90 NY2d 507, 514 [1997]). An "allowed claim" means a claim "which has been allowed by the court in a proceeding under Article 74 of [the Insurance Law]" (Insurance Law § 7602(g)). While it is up to the court to allow or disallow a claim, the court must determine the degree of deference to be accorded to the Superintendent's recommendation.

"When the Superintendent's interpretation of a statute or its application involves knowledge and understanding of underlying operational practices or entails an evaluation of factual data and inferences to be drawn therefrom," the court will defer to that interpretation unless it is irrational (*In re Union Indemnity Ins. Co.*, 92 NY2d 107, 114 [1998]). However, where "the question is one of pure statutory reading and analysis, dependent only on accurate apprehension of legislative intent, there is little basis to rely on any special competence or expertise of the administrative agency" (Id.). As the referee recognized, the present dispute turns on a question of contract law. Thus, the court need not give deference to the recommendation of the Superintendent. The report of a referee to hear and report is similarly not binding upon the court (CPLR 4403; *Matter of Broome*, 13 AD2d 657 [2d Dept 1961]). The court will proceed to determine de novo the issue of whether Classic Stone's claims are covered by the payment bonds.

In the event of a contractor's default, the surety's obligation is to either complete the work or to pay the obligee the amount necessary for it to have the contract completed (*U.W. Marx, Inc. v Mountbatten Sur. Co.*, 3 AD3d 688, 691 [3d Dept 2004]). A completing surety succeeds under equitable subrogation principles to all rights that the obligee/owner has against the contractor, including the right to use the unpaid contract balance to complete the project or satisfy outstanding claims for labor and materials furnished (*RLI Ins. Co. v Department of Labor*, 97 NY2d 256, 265 [2002]).

The court agrees with the referee's conclusion that Classic Stone may not recover on the theory that Pavlou, the defaulting contractor, assigned the construction contract. However, the court rejects the referee's conclusion that there was a material alteration of the risk assumed by the surety. "As a general rule, any material or substantial alteration of the terms of a contract, for whose performance a surety is bound, when made without the surety's consent, releases the surety from [its] obligations" (*Midland Steel Warehouse Corp. v Godinger Silver Art Ltd*, 276 AD2d 341, 343 [1st Dept 2000]). The rationale is that the

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creditor and the principal debtor may not alter the surety's undertaking to cover a different obligation (Id.). The referee determined that New York Surety's entering into a new contract with Bat-Jac constituted a "novation," which somehow materially altered the surety's risk and released Pavlou, its principal.

Where a subcontractor defaults and the prime contractor enters into an "assumption agreement" with a new subcontractor, the original subcontractor's surety will be discharged if the prime contractor intended to release the original subcontractor (*In re Union Indemnity Co.*, 234 AD2d 120 [1st Dept 1996]). The surety may also be discharged pursuant to the terms of the performance bond, if the prime contractor fails to give the surety reasonable notice of the default by the subcontractor (Id. at 122).

Had the City entered into a new contract with Bat-Jac, upon Pavlou's default, questions as the release of Pavlou, or inadequate notice to the surety, might have been presented. However, because the City called upon New York Surety to perform pursuant to its bond, as a matter of law, there was no material alteration of the surety's obligation. Nor, by definition, is there any question as to whether the surety received adequate notice. The court also notes that the subcontracts between Bat-Jac and Classic Stone made reference to the contract between Bat-Jac and New York Surety, confirming that Classic Stone's performance was intended to benefit the surety in fulfilling its performance bond obligation. In these circumstances, Classic Stone was clearly justified in relying upon the payment bond to secure payment for its work on the projects.

Accordingly, New York State Insurance Department Liquidation Bureau's motion to confirm the report of the referee is denied. Cross-motion by claimant Classic Stone, Inc. to reject the referee's report is granted. Claims 93060055-003 and 93060054-000 are allowed, and the matter is remanded to the Liquidation Bureau for further proceedings consistent with this order.

This decision constitutes the order of the court.

Dated: 4-28-09

HON THOMAS P. PHELAN
[Signature]
J.S.C.

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