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ALERT

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NEW YORK'S APPELLATE DIVISION REVERSES COLLATERAL ESTOPPEL RULING AGAINST PAYMENT BOND SURETIES IN SUIT TO ENFORCE ARBITRATION AWARD

By Thomas F. Giordano

A recent decision by the First Department of the Supreme Court, Appellate Division, addresses the preclusive effect of arbitration awards in subsequent judgment enforcement suits against payment bond sureties. In *Five Star Electric Corp. v. Federal Insurance Co.*, 127 A.D.3d 569, 8 N.Y.S.3d 98 (1st Dep't 2015), the First Department unanimously reversed an order of the New York County Supreme Court (*Five Star Elec. Corp. v. Federal Ins. Co.*, 2014 NY Slip Op 31221 (Sup. Ct. N.Y. Co., May 6, 2014) which had granted partial summary judgment against defendant construction sureties Federal Insurance Company ("Federal") and St. Paul Fire and Marine Insurance Company ("St. Paul") based on the collateral estoppel effect of an arbitration award previously rendered in favor of plaintiff Five Star Electrical Corp. ("Five Star"). The lawsuit arose out of a construction contract for the installation of a signage and public address system in various New York City subway stations. Schnader represented Federal on the appeal, and on the underlying summary judgment motion.

The Appellate Division's decision, though brief, is a notable addition to the law of collateral estoppel in the suretyship context. The decision undercuts the implication, raised by two prior Second Department decisions, that a surety is necessarily bound by an arbitration award against its principal, whether or not the surety was a party to the arbitration proceeding, or otherwise consented to the arbitral process. Here, the appeals court found that the sureties were not precluded from challenging their liability for the award, based on an unusual factual predicate that called the sureties' consent to the arbitration into question.

Facts

In 2003, the Metropolitan Transportation Authority ("MTA") entered into a contract with a "consortium," named Siemens Transit Technologies, for the installation of a public address and customer information screen system in portions of New York City's subway system (the "Project"). The consortium had been formed the previous year for the sole purpose of bidding on, and if successful, performing, that contract. Its two members were Siemens Transportations Systems, Inc. ("Siemens") and Transit Technologies, LLC ("Transit Tech"). Federal and St. Paul jointly issued payment and performance bonds for the Project, as sureties for the consortium.

The relationship between Siemens and Transit Tech was described in a contract that defined the scope of each party's work in connection with the Project: Siemens was to design the system and its software, and furnish equipment, while Transit Tech was to perform all electrical installation work. The consortium contract provided, among other things, that each consortium member would be solely responsible for its own work scope, and for any liabilities that might arise in connection with that scope. It also stated that the parties were not partners, and that neither party could unilaterally bind the consortium to any obligation.

Transit Tech independently entered into a $36 million subcontract with Five Star, which covered most of the actual electrical installation work in the subways. Although the consortium's contract with the MTA called for completion of the work within 24 months, Five Star's work on the Project was impacted by numerous alleged delays and interferences. The Project was well into its sixth year by the time Five Star terminated its subcontract, alleging various defaults by Transit Tech, including delays and non-payment of Five Star's invoices.

In 2007, Five Star commenced an arbitration proceeding against Transit Tech, in accordance with a mandatory arbitration provision in the subcontract, seeking damages for Transit Tech's defaults. Shortly thereafter, Five Star commenced a separate action in New York State Supreme Court, seeking compensation for its losses from Federal and St. Paul, under their payment bond. The action against the sureties was immediately stayed pending the outcome of the arbitration.

Although Siemens was not named as a respondent in the arbitration, it attempted to secure the consent of Five Star and Transit Tech to participate in it as a party and be bound by its outcome. Five Star refused to allow Siemens to intervene in the arbitration unless Siemens agreed to pay it a non-refundable deposit of $6 million, in advance, on account of its claims. Siemens declined to participate on these onerous terms. Neither surety was a party to, or involved in, the arbitration.

The Five Star arbitration continued for nearly five years, ultimately resulting in a $12 million award against Transit Tech as compensation for Five Star's cost overruns due to delay, disruption and inefficiency. Five Star converted the award into a judgment, but was not able to collect any portion of that judgment from Transit Tech, which, by that time, had no assets.

Five Star's Motion for Summary Judgment

In May 2013, Five Star resumed prosecution of its Supreme Court action against the sureties by filing a motion for summary judgment. In that motion, Five Star argued, among other things, that the sureties were collaterally estopped from contesting their liability for the award that had been issued against Transit Tech in the arbitration. Five Star's collateral estoppel arguments were largely based on two Second Department decisions: *QDR Consultants and Development Corp. v. Colonia Insurance Co.*, 251 A.D.2d 641 (2d Dep't 1998), and *Azevedo & Boyle Contracting v. J. Greaney Construction Corp.*, 285 A.D.2d 571 (2d Dep't 2001). Both decisions had held payment bond sureties bound by arbitration awards against their bond principals despite the fact that the sureties had not been parties to the arbitration proceedings. In both cases, the only rationale advanced for this result was that sureties "stand in the shoes of their principals" for purposes of collateral estoppel.

In response to Five Star's motion, the sureties argued that collateral estoppel could not be applied to preclude them from challenging liability, because they had not been afforded the requisite "full and fair opportunity" to litigate Five Star's claims. First, the sureties argued that neither they, nor their bond principal (*i.e.*, the consortium), had been parties to the arbitration. Second, the sureties argued that their interests were not effectively represented at the arbitration by Transit Tech, which (i) had no assets to pay any potential award or judgment, and therefore had little incentive to aggressively defend against Five Star's claims, and (ii) actually blamed its consortium partner, Siemens, at the arbitration for causing the delays that impacted Five Star. Finally, the sureties argued that Five Star's interpretation of the *QDR* and *Azevedo* decisions by the Second Department, as supporting the automatic imposition of collateral estoppel against sureties based on arbitral awards against their principals, was fundamentally inconsistent with the decision of the Court of Appeals in *Fidelity & Deposit Co. of Maryland. v. Parsons & Whittemore Contractors Corp.*, 48 N.Y.2d 127 (1979), in which a performance bond surety's request for a stay of arbitration as to its principal's liability was denied on the ground that the bond incorporated the terms of a subcontract that contained an arbitration provision. That incorporation, said the court, constituted an agreement that the surety would accept and be bound by the outcome of any arbitration as to disputes under the subcontract. In contrast, the Federal / St. Paul payment bond did not incorporate the Five Star subcontract, negating any inference that they had agreed to be bound by the arbitration award in Five Star's favor.

The motion court held that the sureties were precluded from challenging liability to Five Star, citing to *QDR* and *Azevedo* for what it characterized as a "rule" that "a surety is in privity with its principal such that an arbitration award against a principal has collateral estoppel effect against that principal's surety in subsequent litigation concerning the same issue." 2014 NY Slip Op 31221, at 8. The court made no effort to explain why the principal-surety relationship, *per se*, sufficed to deprive the sureties of their day in court, and gave short shrift to the sureties' argument that their interests had not been effectively represented at the arbitration by Transit Tech, which the court characterized as a "joint principal" on the bond. The court completely ignored the sureties' argument that they had not agreed to be bound by the arbitration award, either by incorporation of the Five Star subcontract into the bond or otherwise. Accordingly, the sureties appealed the motion court's decision and order.

<u>The Sureties' Appeal</u>

On appeal, the First Department reversed the motion court's determination that the sureties were collaterally estopped from challenging the arbitration award against Transit Tech, finding that they had been deprived of a full opportunity to contest that determination. The appeals court noted (i) that the principal on the surety's bond was the two-company consortium formed by Siemens and Transit Tech, (ii) that although Siemens was not a party to Five Star's subcontract, it had offered to participate in the arbitration and be bound by its result, and (iii) that Siemens could not rationally accept Five Star's extortionate terms for participation in the arbitration. On these facts, with one of the bond principals unable to participate in the arbitration, the court held that the sureties could not be collaterally estopped from contesting its result.

However, the First Department went a step further, stating that "given the fact that Five Star was a subcontractor to Transit Tech . . . only, there is, at best, questionable privity between Five Star [sic] and the sureties,[1] creating a question of fact concerning whether the sureties could reasonably be found to have consented to arbitration with Five Star." While the court did not provide further discussion or analysis of this issue, its focus on the sureties' "consent" to the arbitration as a predicate for collateral estoppel, and its citation to the *Parsons & Whittemore* decision on that point, is a significant departure from the so-called "rule" that sureties are necessarily precluded from challenging arbitration awards against their principal.

<u>Considerations</u>

The First Department's decision in *Five Star v. Federal* should be of particular interest to the construction and surety industries for several reasons. For sureties, the decision is a welcome addition to the body of collateral estoppel law.

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[1] The court presumably intended to refer to the questionable privity between Transit Tech and the sureties.

Unlike the decisions of the Second Department in *QDR* and *Azevedo*, it implicitly rejects the notion that sufficient privity necessarily exists between principal and surety to support the imposition of collateral estoppel in favor of a more careful analysis of the facts and equities of the specific situation. This approach is in accord with the instruction of the Court of Appeals that courts must "carefully analyze whether the party sought to be bound and the party against whom the litigated issue was decided have a relationship that would justify preclusion, and whether preclusion, with its severe consequences, would be fair under the particular circumstances." *Beuchel v. Bain*, 97 N.Y.2d 295, 304-305 (2001), *cert denied*, 535 U.S. 1096 (2002). The First Department's decision also recognizes the relevance of the surety's consent to the arbitral process in determining whether preclusion should apply. While the precise contours of the consent issue have not been defined, the decision nevertheless provides payment bond sureties with a useful argument against collateral estoppel based on awards issued in arbitration proceedings in which they were not involved.

The decision also raises important issues for payment bond claimants. As the Five Star case demonstrates, unusual contracting arrangements can lead to additional complexity in litigation. Subcontractors and suppliers should carefully consider the risks of doing business with an upstream contractor who is not the named principal on the payment bond for the project. Bond claimants should also seek to join the bond principal and its surety as co-defendants in a single action or proceeding – particularly where the claimant's is suing an upstream contractor that is not the principal named on the bond. Where a claimant is required to arbitrate its contract claims, it may wish to invite any surety, and all members of a multi-party principal, to participate in the arbitration voluntarily, in an effort to foreclose future arguments against the preclusive effect of any resulting award. While the claimant may not be able to compel arbitration against non-signatories to the arbitration agreement, a future court may be more willing to impose collateral estoppel against a party who was given the opportunity to contest liability in a prior proceeding, but declined to take advantage of that opportunity. ◆

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