Payment Bonds: A Valuable Tool to Protect the Rights of Subcontractors in New York

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A payment bond secures the obligation of the general contractor to pay all parties for their work on a construction project. The purpose of a payment bond is to protect the Owner against the claims (liens) of unpaid parties[1] and to facilitate payment for labor and materials furnished to the project. Beneficiaries of a payment bond often include subcontractors, suppliers, and material men. If the general contractor defaults, the beneficiaries often have the right to sue the surety directly on the bond.

In New York, all public improvements (with the exception of Industrial Development Agency projects)[2] undertaken by the State, municipal corporations, public benefit corporations and commissions appointed by law require payments bonds (also known as "§137 bonds"). Section 137 bonds[3] are designed to supplement the Lien Law by extending additional protection to parties that improve public property by ensuring payment of money due on public improvements.[4] Other public entities and improvements such as town highway improvements,[5] sewer systems,[6] and canals,[7] also require payment bonds pursuant to statute.

Contract bid specifications generally provide details as to whether or what type of payment bond is required for the job.[8] Prior to bidding, a subcontractor should review the bid specifications, as well as the applicable statute, ordinance, or law, if any, that requires a payment bond. A subcontractor should ask the general contractor to provide a copy of any and all bonds it has provided to the Owner for the particular job being quoted.[9] In addition, copies of all bonds furnished by the general contractor in connection with publicly funded projects are required to be made available for public inspection in the office of the head of the Department or Bureau in charge of the public improvement.[10]

On public projects, compliance with the specific written notice provisions of the payment bond or statute, such as those relating to the timeliness of a claim is necessary, so that a claim will not be denied outright without consideration of its merit.[11] However, if the bond claimant is in privity with the general contractor on the bond there is often no need for a written notice to the bonding company.[12] State Finance Law §137 provides that a claimant who contracts directly with the general contractor and has not been paid in full within 90 days of the day on which the claimant last performed labor or supplied materials may sue the surety without prior notice of its claim.[13] If the claimant (such as a second tier subcontractor, for example), contracted with a subcontractor and not the general contractor, the claimant must give notice of its claim to the general contractor within 120 days of the day on which the claimant last performed labor or supplied materials.[14] In this case, the notice must be served personally on the general contractor or by registered mail, at any place where he maintains an office or conducts business or at his residence.[15] If the general contractor directly receives a notice, the manner of service is immaterial.[16] The time limitation to commence a lawsuit is one year from the date on which the public improvement has been completed and accepted by the public owner.[17]

In New York State, when a claim is made on a payment bond, interest is calculated from the date of the demand. The payment bond claim should include the name of the project, the contractual relationships (i.e., owner, general contractor and subcontractor, etc.), and with "substantial accuracy" the amount owed. Much care should be taken to properly address the demand, and to be timely in its submission, so it is wise to get a copy of the bond, that will contain the precise name of the surety, the bond number and any claim submission procedures.[18]

continued on page 9

continued from page 7

The class of items covered under most payment bonds generally is the same as the class allowed by the Mechanic's Lien Law.[19] Payment Bonds are for the cost of labor and materials. They do not cover a beneficiary's lost profits[20] or damages a beneficiary suffers due to a principle's negligence.[21] In addition, Section 137 will award attorney's fees to a defending party if the demand, or claim was "without substantial basis in fact or law."[22] On the flip side, Section 137 will also award attorney's fees to the claimant if the surety presents a defense that is "without substantial basis in fact or law". First or second tier subcontractors, material men and vendors need to be certain that they are not vulnerable to a defense by the general contractor, and/or his surety. Sureties are restricted from paying out against claims for a payment bonds if a legitimate dispute exists.

A payment bond claim provides a direct connection to the prime contract with the Owner and offers a greater possibility of success than filing a lien if it can be proven that work was performed or deliveries of materials occurred and that there is no contributory failure of performance that instigated the refusal or failure to pay by the general contractor. Many defenses exist to inhibit automatic payment of a bond claim. Such defenses might include defective work, exclusive delays caused by the subcontractor which "but for" said delays, the entire project would have been on schedule, substandard materials, and so forth. Under this scenario, the surety is under no obligation to immediately write a check, unless and until the dispute is adjudicated by a court or an Arbitration proceeding.

While payment bonds can prove to be an effective tool to ensure timely payment for work performed and a means to obtain payments that have been withheld, there are two important points to be understood. First, before a subcontractor bids a project, he should obtain a copy of the payment bond if one exists, and understand the terms and conditions under which it is enforced. Second, subcontractors must be certain that the fault is clearly not theirs, before they implement a demand/claim.

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[1] *Novak & Co., Inc. v. Travelers Indem. Co., 56 A.D.2d 4187, 392 N.Y.S.2d 901 (2d Dep't 1977).*
[2] *Davidson Pipe Supply Co., Inc. v. Wyoming County Indus. Development Agency, 85 N.Y.2d 281. 6224 N.Y.S.2d 92, 648 N.E.2d 468 (1995); however, Section 5 of the Lien Law provides that if no public funds are used for a public improvement with an estimated cost in excess of $250,000, the private entity for whom the improvement is being made must post a bond or other undertaking guaranteeing payment to the contractor, subcontractors, and others furnishing labor or materials to the contractors or subcontractors. N.Y. Lien Law §5 (effective November 17, 2004).*
[3] *N.Y. State Fin. Law §137.*
[4] *Chittenden Lumber Co. v. Silberblatt & Lasker, 288 N.Y. 396, 43 N.E.2d 459 (1942).*
[5] *N.Y. High. Law §193.*
[6] *N.Y. Village Law § 17-1718(5).*
[7] *N.Y. Canal Law §30(6).*
[8] *Id.*
[9] *Postner & Rubin, New York Const. Law Manual § 8:33, at 398 (2d ed rev, 2008).*
[10] *N.Y. State Fin. Law §137(2).*
[11] *Ferrante Equipment Co.v. Charles Simkin & Sons, Inc., 30 A.D.2d 525, 290 N.Y.S.2d 246 (1st Dep't 1968).*
[12] *Id.*
[13] *N.Y. State Fin. Law §137.*
[14] *N.Y. State Fin. Law §137(3). Federal courts construe similar language in the Miller Act, 40 U.S.C.A. §§3131 et seq., to mean that the period begins to run on the last day work was done as part of the original contract; correction of defects or repairs following inspection of work will not extend the notice period. U.S. for Use of Magna Masonry, Inc. v. R.T. Woodfield, Inc., 709 F.2d 249, 31 Cont. Cas. Fed. (CCH) P 71242 (4th Cir. 1983).*
[15] *Id.*
[16] *Id.*
[17] *N.Y. State Fin. Law §137(4)(a).*
[18] *Ulster Elec. Supply Co. v. Maryland Cas. Co., 30 N.Y.2d 712, 332 N.Y.S.2d 648, 283 N.E.2d 622 (1972); N.Y. State Fin. Law §137.*
[19] *Hub Oil Co. v. Jodomar, Inc., 176 Misc. 320, supra.*
[20] *Concrete Const. Corp. v. Commercial Union Ins. Co. of New York, 68 A.D.2d 866, 414 N.Y.S.2d 703 (1st Dep't 1979) (the claimant can recover from the surety increased costs incurred due to the delay; it cannot recover its lost profits); QDR Consultants & Development Corp. v. Colonia Ins. Co., 251 A.D.2d 641, 675 N.Y.S.2d 117 (2d Dep't 1998).*
[21] *Gerosa Crane Service, Inc. v. International Products, Limited, 70 Misc. 2d 176, 332 N.Y.S.2d 536 (N.Y. City Civ. Ct. 1972).*
[22] *N.Y. State Fin. Law §137(4) (c).*