

**IN THE UNITED STATES DISTRICT COURT  
FOR THE DISTRICT OF PUERTO RICO**

THE GOVERNMENT DEVELOPMENT BANK  
FOR PUERTO RICO

Applicant

PROMESA  
Title VI

Civil No. 18-1561 (LTS)

**PRELIMINARY OBJECTION TO QUALIFYING MODIFICATION**

**TO THE HONORABLE COURT:**

**COME NOW**, Creditors, Fidelity and Deposit Company of Maryland and Zurich American Insurance Company, co-sureties for a certain real estate construction project (together “F&D/Zurich” or “co-sureties”), through the undersigned counsel and hereby state and pray as follows:

**INTRODUCTION**

1. On August 10, 2018, the Government Development Bank for Puerto Rico (“GDB”) and the Puerto Rico Fiscal Agency and Financial Authority (“AAFAF”) (collectively referred hereafter as “Petitioners”) filed an application (the “Application”) pursuant to section 601(m)(1)(D) of the Puerto Rico Oversight, Management, and Economic Stability Act (“PROMESA”) seeking approval of a Qualifying Modification (as this term is defined in the Application) for the GDB. (Dkt. No. 1).

2. Petitioners filed an Emergency Motion for Setting Deadline for Parties to File Notice of Intention to Object to the Qualifying Modification for the GDB and Parties to File Standing Objections (Dkt. No. 3), and also filed a Motion Requesting Order Approving Procedures (Dkt. No. 4), all of even date.

3. The Court granted Petitioners' Emergency Motion for Setting Deadline for Parties to File Notice of Intention to Object to the Qualifying Modification for the GDB and Parties to File Standing Objections and set August 20, 2018 as the deadline for parties to file notice of intention to object to the qualifying plan and August 30, 2018 as the deadline to file Standing Objections. (Dkt. No. 7). F&D/Zurich filed its Notice of Intent to Object to the Qualifying Modification ("Notice") on August 20, 2018. (Dkt. No. 18).

4. The Court granted F&D/Zurich an extension of time until today to file the instant Preliminary Objection to the Qualifying Modification. (Dkt. No. 146).

### **FACTUAL AND LEGAL BACKGROUND**

5. As explained in the Notice, the co-sureties issued certain Performance and Payment Bonds ("Bonds") on behalf of L.P.C.D., Inc. ("LPCD") as principal for the Comunidad Río Bayamon Norte-Urban Infrastructure project ("Project"). The Bonds name the Government Development Bank for Puerto Rico ("GDB") as the Owner/Obligee of the Project. (**Exhibit A**). Prior to the issuance of the Bonds for the Project, LPCD executed a certain Agreement of Indemnity ("Agreement") in favor of F&D/Zurich. (**Exhibit B**). The Agreement contains a provision which assigns the contract proceeds, including all percentages retained, for the Project to F&D/Zurich as collateral for losses and expenses in the event of any abandonment or breach by LPCD of any other contract bonded by the co-surety.

6. Numerous subcontractors and suppliers of LPCD made demands upon F&D/Zurich for payment on the Bonds in connection with the Project and another project of LPCD.

7. On numerous occasions, F&D/Zurich gave notice to GDB of claims for a substantial portion of LPCD's unpaid contract balances from GDB, including retainage, for the Project. F&D/Zurich gave notice to GDB of its rights to subrogation under the Agreement before any funds were paid to LPCD by GDB, F&D/Zurich.

8. LPCD is a corporation organized under the laws of the Commonwealth of Puerto Rico, with its principal place of business located in Las Piedras, Puerto Rico.

9. F&D is a corporation organized under the laws of the State of Maryland, with its principal place of business located in Schaumburg, Illinois, and is authorized to do business in the Commonwealth of Puerto Rico.

10. Zurich is a corporation organized under the laws of New York, with its principal place of business located in Schaumburg, Illinois, and is authorized to do business in the Commonwealth of Puerto Rico.

### **BASIS FOR OBJECTION**

11. On June 7, 2017, F&D/Zurich gave notice to GDB that the its Restructuring Support Agreement (“RSA”) did not clarify the proposed treatment and/or impairment of F&D/Zurich’s claims against GDB with respect to its subrogation rights against LPCD under the Agreement and/or the Bonds for any amounts due by GDB as owner of the Project. Indeed, notice was given that the RSA was silent as to how F&D/Zurich would recover amounts due by GDB as owner of the Project, including but not limited to retainage amounts. **(Exhibit C)**.

12. GDB failed to answer repeated requests for information and notices from F&D/Zurich.

13. There are various reasons that support the F&D/Zurich’s objections to the Qualifying Modification. First, the GDB failed to comply with Title VI’s information and notice requirements as no notice has been provided to F&D/Zurich regarding the Qualifying Modification or the RSA.

14. Previous attempts made by the F&D/Zurich seeking information regarding the status of the retainage regarding the Project and the status of the proposed sale of the property object of the Project went unanswered by the GDB. Furthermore, no notice was provided to these

two entities and no Solicitation Package (as this term is defined in the Application) containing the Solicitation Statement, including the Preliminary Offering Memorandum and corresponding Ballots has been distributed or notified to F&D/Zurich, as holders of claims against the GDB. Hence, the requirements of section 601 of PROMESA have not been met and the Application should be denied.

15. Contrary to the repeated representations of the Petitioners, the process followed by AAFAF and GDB to seek approval of the RSA and present their Application failed to ensure that all parties with a stake in GDB's restructuring have an opportunity to be heard in connection with the Title VI efforts.

16. Also, F&D/Zurich hold Bond Claims (as this term is defined in PROMESA) because the co-sureties are private entities entitled to moneys held and owed by the GDB to the co-sureties on the basis that the co-sureties have incurred in substantial payments to cover claims under the Bonds. The Qualifying Modification posits that "the claims of GDB's bondholders, municipal and private depositors, and certain other contingent creditors will be resolved by exchanging such claims for new bonds issued by a governmental entity created by the GDB Restructuring Act - the GDB Debt Recovery Authority (the "**Recovery Authority**")". Yet, it ignores the Bond Claims of F&D/Zurich, as they are not included in the list of private depositors of the GDB or elsewhere in the RSA.

17. The private obligations of the GDB to F&D/Zurich are ignored in the Qualifying Modification and the RSA. The Bond Claims of the F&D/Zurich will not be resolved through the Qualifying Modification.

18. Moreover, the Qualifying Modification intends to use funds held by the GDB to satisfy GDB obligations to other creditors, while at the same time, ignoring the entitlement of the F&D/Zurich to payment under the Agreement.

19. Moreover, the RSA and the Qualified Modification intend to sell the real estate portfolio owned by GDB, including the Project, while impairing the rights of F&D/Zurich against GDB and the Project.

20. Finally, the F&D/Zurich, constitute a distinct and separate class of claim holders that have been ignored by the GDB in the Qualifying Modification.

#### **SURETY LAW GIVES F&D/ZURICH A PRIORITY CLAIM OVER GDB'S FUNDS**

21. Puerto Rico law on the rights of sureties to collect from owners of projects and contractors “accords with that ‘widely applied in this country.’” Segovia Development Corp. v. Constructora Maza, Inc., 628 F.2d 724, 725 (1<sup>st</sup> Cir. 1980) (quoting Pearlman v. Reliance Ins. Co., 371 U.S. 132, 137 (1962)). “A surety who pays the debt of another is entitled to all the rights of the person he paid to enforce his right to be reimbursed.” Id. Retainages are the property of the owner of the project and “by way of subrogation, became the surety’s property to the extent necessary to reimburse it for its payment of the laborers and materialmen and their costs of contract performance.” Id. at 726.

22. As further explained below, under Puerto Rico law, a surety who pays for a debtor, is to be indemnified by the debtor. Article 1737 of the Puerto Rico Civil Code, 31 L.P.R.A. § 4911. U.S. Fid. & Guar. Co. v. New P'ship & Co., 2009 WL 2431437, at \*4–5 (D.P.R. Aug. 7, 2009) (citing 31 L.P.R.A. § 4911). See also Constructora Andrade Gutierrez, S.A. v. Am. Int'l Ins. Co. of Puerto Rico, 467 F.3d 38, 45–46 (1<sup>st</sup> Cir. 2006) (“Puerto Rico law recognizes the relationship between a surety and a debtor and requires a debtor to indemnify a surety even when the security is paid without the debtor's knowledge.”).

23. Specifically, Article 1737 of the Puerto Rico Civil Code provides that “[a] surety who pays for a debtor shall be indemnified by the latter.” 31 L.P.R.A. § 4911. The indemnity consists of: (1) the total amount of the debt; (2) legal interest; (3) the expenses incurred by the

surety; and (4) losses and damages, when proper. *See id.* Further, Article 1738 provides that “[b]y virtue of such payment the surety is subrogated in all the rights which the creditor had against the debtor.” 31 L.P.R.A. § 4912.

24. Finally, Article 1166 provides that “[s]ubrogation transfers to the subrogated the credit, with the corresponding rights, either against the debtor or against third persons, be they sureties or holders of mortgages.” 31 L.P.R.A. § 3250. Under these subrogation statutes, the surety is subrogated to all of the rights of creditors whom it paid under the payment and performance bonds and is generally subrogated to obligee’s right to have the project completed, and to all the legal and contractual rights of the principal. See Segovia Dev. Corp. v. Constructora Maza, Inc., 628 F.2d 724, 727 (1st Cir. 1980).

25. The First Circuit has further held that

Under both the general common and commercial law and under Puerto Rican law, laborers and materialmen have rights to contract retainages which are superior to those of general creditors, even where such funds have been attached by the outside creditor first. Since the surety is subrogated to these rights as a result of satisfaction of its payment and performance bonds, its rights are also superior to those of any general creditor or those who ... assume the role of such a creditor through their status under the Bankruptcy Act. Id., 688 F.2d at 729; see also U.S. Fid. & Guar. Co. v. Challenge Const. Corp., 704 F.Supp.2d 73, 78 (D.P.R. 2009).

26. A surety has a priority over any funds owed by the owner to the general contractor of a project. Goss, Inc. v. Cycrex Const. & Co., S.E., 141 D.P.R. 342, P.R. Offic. Trans., 1996 WL 499344 (P.R. July 9, 1996).

27. Moreover, Article 1738 provides that a surety who pays for a debtor is “subrogated in all the rights which the creditor had against the debtor.” P.R. Laws Ann. tit. 31, § 4912. Article 1166 states that: “Subrogation transfers to the subrogated the credit, with the corresponding rights, either against the debtor or against third persons, be they sureties or holders of mortgages.”

P.R. Laws Ann. tit. 31, § 3250; see also Segovia Dev. Corp., 628 F.2d at 727; Prestige Capital Corp. v. United Sur. & Indem. Co., 245 F. Supp. 3d 349, 354 (D.P.R. 2017)

28. In American Fire & Casualty Co. the First Circuit adhered to its holding in National Shawmut Bank this occasion concerned rights of a surety under Puerto Rico law and what a surety a recover under the theory of legal subrogation. (“The teaching of National Shawmut Bank, is that the surety has a superior claim to these payments. But for the surety's completion of the work, the obligee on the bond, be the owner or prime contractor, would have been entitled to apply the funds against the cost of completion. It is the surety's performance which frees the funds, and, in our view, the surety is entitled to them.”) American Fire & Casualty Co., 411 F.2d at 758 (citing Nat'l Shawmut Bank of Boston v. New Amsterdam Cas. Co., 411 F.2d 843 (1st Cir. 1969)).

29. Where a surety guarantees the payment and performance obligations of a principal in favor of an obligee, the surety is entitled to be indemnified by the principal for all of the losses that the surety incurs for performing the principal's bonded obligations. See Andamios de Puerto Rico, Inc. v. Oriental Eng'g, Corp., 2011 WL 6439994, at \*5 (P.R. Cir. Oct. 17, 2011) (citing 31 L.P.R.A. §§ 4871, 4910-4915) (“The contract of guarantee is one by which one party agrees to pay or perform an obligation by a third party if it is unwilling or unable to do so. . . . When the debtor breaches the principal obligation, the guarantor must comply. . . . But you can claim from the debtor what has been paid to your creditor, with the payment of interest, expenses and damages, if there is no agreement to the contrary.”). Before the surety issues any performance or payment bonds on a principal's behalf, however, it is customary for a surety to first require that the principal and other indemnitors execute an indemnity agreement. Id. (citing Professional Underwriters v. Dis. Automotive, 121 DPR 536, 540 (1988); Arzuaga v. The Hood Consts., Inc., 90 DPR 104, 124 (1964)) (“It is the custom of guarantors to require an ‘indemnity contract’ before

securing the contractors' execution and payment obligations.”). Further, “[a]s part of this agreement, the guarantor has the right to recover . . . *what the indemnity contract provides.*” Id. (emphasis added). If the principal or other indemnitors fail to comply with their obligations under an indemnity agreement, a valid breach of contract action exists in favor of the surety and against the indemnitors in default of their obligations. See id. See also Instituto de Educacion Universal, Inc. v. Great Lakes Higher Educ. Corp., 2001 WL 1636686, at \*2 (D.P.R. Sept. 28, 2001), aff'd sub nom. Instituto De Educacion Universal Corp. v. Great Lakes Higher Educ. Guar. Corp., 126 F. App'x 1 (1st Cir. 2005). “The elements of a cause of action for breach of contract are (1) a valid contract and (2) a breach by one of the parties to the contract.” Great Lakes Higher Educ. Corp., 2001 WL 1636686, at \*2. As to the first element, “[p]ursuant to Puerto Rico law, a contract has three elements: a definite and legal object, consideration, and consent. Rojas-Buscaglia v. Taburno-Vasarhelyi, 2016 WL 4183125, at \*13 (D.P.R. Aug. 5, 2016) (citing 31 L.P.R.A. § 3391); U.S. Fid. & Guar. Co. v. Hato Tejas Const., S.E., 2010 WL 2900372, at \*3 (D.P.R. July 21, 2010). As to the second element, a breach by one of the parties to the contract exists when that party “in any manner whatsoever” acts “in contravention of the stipulations” of the contract. See 31 L.P.R.A. § 3018. “[W]hen the breach of a contractual obligation causes harm to any of the contracting parties, an action for damages for breach of contract lies.” U.S. Fid. & Guar. Co. v. Hato Tejas Const., S.E., 2010 WL 2900372, at \*3 (D.P.R. July 21, 2010) (citing Soc. de Gananciales v. Velez & Asoc., 98 TSPR 54 (P.R. May 7, 1998)). Accordingly, the party in breach of the contract, “shall be subject to indemnify for the losses and damages caused thereby.” 31 L.P.R.A. § 3018.

## CONCLUSION

30. F&D/Zurich issued payments and performance bonds on behalf of LPCD for the benefit of GDB. GDB owes funds to LPCD for retainage for construction work in the Project.



F&D/Zurich also holds an indemnity from LPCD for funds advanced to laborers, materialmen and subcontractors under Bonds issued for the Project and for payments made for another project of LPCD. F&D/Zurich has repeatedly requested from GDB for it to pay F&D/Zurich any amounts payable to LPCD. GDB has ignored all of F&D/Zurich's requests and has opted to ignore any claim from LPCD for which F&D/Zurich are subrogated. Inasmuch as the Qualifying Modification and the RSA fail to offer a treatment for F&D/Zurich's claims, the Application should be denied.

### **RESERVATION OF RIGHTS**

31. Nothing contained in this Notice constitutes an admission of the validity of the Qualifying Modification or a waiver of F&D/Zurich's rights.

32. F&D/Zurich expressly reserve the right to raise objections not described herein including but not limited to takings and illegal discrimination of equally situated creditors.

33. The F&D/Zurich reserve the right to amend this preliminary objection.

**WHEREFORE**, for the reasons stated in this Preliminary Objection, F&D/Zurich request that the Qualifying Modification be denied as it does not satisfy the applicable requirements of PROMESA section 601.

RESPECTFULLY SUBMITTED.

In San Juan, Puerto Rico, this 21<sup>st</sup> day of September 2018.

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**CERTIFICATE OF SERVICE**

I certify that on September 21, 2018 I electronically filed the foregoing with the Clerk of the Court using the CM/ECF system which will automatically send notice of such filing to all attorneys of record.

In San Juan, Puerto Rico, this 21<sup>st</sup> day of September 2018.

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