

**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)

**SUPPLEMENTAL AND SUPERCEEDING OBJECTION TO QUALIFYING  
MODIFICATION OF CREDITORS F&D/ZURICH**

**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:

**PRELIMINARY STATEMENT**

The Government Development Bank for Puerto Rico (“GDB”) seeks to restructure its obligations with depositors and bondholders through the process established pursuant to Title VI of the Puerto Rico Oversight, Management, and Economic Stability Act (“PROMESA”). In its Restructuring Support Agreement and the Solicitation Statement Issued for the proposed Qualified Modification filed with its Application, GDB left out the claims of F&D Zurich, failed to provide any treatment, failed to expressly classify F&D/Zurich in any class of claims, and completely ignored months of notices and communications demanding payment.

As a result of the discovery in the instant action, GDB conceded that F&D/Zurich are trade vendors of GDB and are entitled to have their claims allowed and paid in full, inasmuch as they subrogated as co-sureties of a general contractor who, having provided construction services for a

project owned by GDB, is a vendor/contractor of the Petitioner. The co-sureties agree with that assessment. However, notwithstanding the correct classification (still absent from the RSA and the Qualified Modification), GDB stalled payment to F&D/Zurich because it now believes it should pay a different creditor of the contractor. GDB and that other creditor have denied repeated requests made by F&D/Zurich to obtain any evidence of the alleged priority claim of that creditor, which GDB intends to pay. Logically, F&D/Zurich demanded that monies owed to the vendor/contractor be deposited in Court so that the creditors of the contractor can argue their case outside of this PROMESA litigation. GDB unreasonably rejected the interpleader and has decided to withhold payment from F&D/Zurich.

Since the co-surety have priority over any creditor of the vendor/contractor pursuant to Puerto Rico statutory and contractual subrogation for the reasons stated below, and, because GDB continues to deny any treatment and classification of F&D/Zurich in its RSA and the Qualified Modification, the co-sureties object to the approval of the Application.

### **PROCEDURAL BACKGROUND**

1. On August 10, 2018, the 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 PROMESA seeking approval of a Qualifying Modification (as this term is defined in the Application) for the GDB. (Dkt. No. 1).

2. After several procedural incidents, the Court granted F&D/Zurich an extension of time until today to file the instant Preliminary Objection to the Qualifying Modification. (Dkt. No. 195).

### **FACTUAL BACKGROUND**

3. The co-sureties issued certain Performance and Payment Bonds (“Río Bayamón Bonds”) on behalf of L.P.C.D., Inc. (“LPCD”) as principal for the Comunidad Río Bayamon

Norte-Urban Infrastructure project (“Río Bayamón Project”). The Río Bayamón Bonds name the Government Development Bank for Puerto Rico (“GDB”) as the Owner/Obligee of the Project. **(Exhibit A)**. The co-sureties also issued certain Performance and Payment Bonds (“Manuel A. Pérez Bonds”)(the“Río Bayamón Bonds” and the “Manuel A. Pérez Bonds” are collectively referred hereinafter as the “Bonds”) on behalf of L.P.C.D., Inc. (“LPCD”) as principal for the Modernization of the Manuel A. Pérez Public Housing Project (“Manuel A. Pérez Project”). The Manuel A. Pérez Bonds name the Public Housing Administration of the Commonwealth of Puerto Rico as the Owner/Obligee of the Project. **(Exhibit B)**. 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 C)**. 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.

4. Numerous subcontractors and suppliers of LPCD made demands upon F&D/Zurich for payment on the Bonds in connection with the Río Bayamón Project. To date, the co-sureties have disbursed to LPCD’s subcontractors and suppliers in the Río Bayamón Project the sum of \$1,295,731.62 for services and materials not paid by LPCD and provided for the Río Bayamón Project. It is estimated by LPCD that there exist additional unpaid claims for this project in the amount of \$979,000.00. **Exhibit E**, infra, Deposition of Paul W. Eaves, at pp. 26, 38-41.

5. With respect to the Manuel A. Pérez Project, LPCD abandoned the project and defaulted in its obligations with the owner, a fact that was already decided by the Puerto Rico Court of Appeals in certain litigation between LPCD and the Public Housing Administration. **(Exhibit D)**. The Public Housing Administration demanded the co-sureties to meet their obligations under the Manuel A. Perez Bond, which they both satisfactorily did with the execution

of a Completion Agreement with the Public Housing Administration. As a result of LPCD's default in the Manuel A. Pérez Project, the co-sureties suffered a paid loss of \$12,809,942.51 and have a current net loss in the Manuel A. Pérez Project of \$6,392,027.31, not including surety expenses and attorneys fees. **Exhibit E**, Deposition to Paul W. Eaves, at p. 43.

6. 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 Río Bayamón 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. **Exhibit F**.

7. F&D/Zurich held a meeting with GDB to discuss the foregoing and explain the basis for their claims to no avail. **Exhibit E**, Deposition to Paul W. Eaves, at p.19.

8. The GDB currently holds retainage for the Río Bayamón project in the estimated amount of \$9,045,000.

9. 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.

10. 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.

11. 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.

12. GDB owes F&D Zurich \$7,687,758.93 as of today. This amount is estimated to increase for surety expenses. This amount is not disputed. **Exhibit E**, Deposition of Paul W. Eaves, at p. 43.

### **BASIS FOR OBJECTION**

13. On June 7, 2017, F&D/Zurich gave notice to GDB that 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 Río Bayamón 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 Río Bayamón Project, including but not limited to retainage amounts. **(Exhibit G).**

14. 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.

15. Previous attempts made by the F&D/Zurich seeking information regarding the status of the retainage regarding the Río Bayamón Project and the status of the proposed sale of the property object of the Río Bayamón 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.

16. 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.

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 Río Bayamón Project, while impairing the rights of F&D/Zurich against GDB and the Río Bayamón 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. 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 (1st 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).

**F&D/ZURICH HAVE PRIORITY OVER ANY OTHER CREDITOR OF LPCD**

26. GDB's recent position that it concedes F&D/Zurich's subrogation claims should be entitled to treatment under the RSA as a vendor claim, and thus paid in full, but that it must pay another creditor of LPCD instead is contrary to well settled surety law and a deliberate obfuscation of how interpleader works. 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. This Court recently issued an opinion presenting very similar facts that should clarify any confusion of GDB. Prestige Capital Corp. v. United Surety and Indemnity Co., 245 F. Supp. 3d 349, 354 (D.P.R. 2017). In Prestige, this Court was presented with an action by a lender to a contractor that purchased the receivables of a construction project and perfected its security interest over those receivables, including the retainage. Id. at 351-53. The surety had honored the obligations of the contractor by completing a project and had subrogated under a bond. Id. at 352-53. The surety sought payment from the owner of the project and asked to be paid from the amounts owed to the contractor. The lender to the contractor sought to intervene and obtain payment rather than allowing the payment to go to the surety on the basis of an antecedent perfected interest in the receivables of the surety. Id. This Court unequivocally held that, under Puerto Rico law, the surety has a priority subrogation right to indemnity. Id. at 355 (“[A]surety ‘has a superior claim by way of subrogation’ and therefore *could* recover progress payments *earned prior to default, but not paid.*” (emphasis in original) (quoting American Fire & Casualty Co. v. First Nat. City Bank of New York, 411 F.2d 755, 758 (1st Cir. 1969))).

28. In American Fire & Casualty Co. the First Circuit adhered to its holding in National Shawmut Bank of Boston v. New Amsterdam Casualty Company, 411 F.2d 843 (1st Cir. 1969). In American Fire & Casualty Co a surety under Puerto Rico law attempted recovery under

the theory of legal subrogation. 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)). (“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.”).

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.

**The Proposed Qualifying Modification Would Effectuate a Taking of F&D/Zurich’s Property Without Just Compensation**

Approval of any Qualifying Modification that utilizes funds of the contractor/vendor, LPCD, hence, F&D/Zurich’s property and, as such, modifies’ rights to their property would violate the Takings Clause of the Fifth Amendment to the United States Constitution. The Fifth Amendment states that “private property [shall not] be taken for public use, without just compensation” and is applicable to states and commonwealths of the United States pursuant to the Fourteenth Amendment. The Constitution of the Commonwealth of Puerto Rico contains an

equivalent provision in Article II, § 9. “The Takings Clause is ‘designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole.’” Ark. Game & Fish Comm'n v. United States, 568 U.S. 23, 31 (2012) (internal quotation omitted); see also First Eng. Evangelical Lutheran Ch. of Glendale v. Cty. of Los Angeles, 482 U.S. 304, 318-319 (1987); Penn Central Transp. Co. v. New York City, 438 U.S. 104, 123-125 (1978). A taking occurs when there is an actual taking of private property for which the person did not receive just compensation. Wash. Legal Found. v. Mass. Bar Found., 993 F.2d 962, 973 (1st Cir. 1993) (quoting Bd. of Regents v. Roth, 408 U.S. 564, 577 (1972)).

Here, the Qualified Modification and the RSA pretend to use the monies available to honor contractor/vendor claims, including LPCD, to pay the holders of the restructured Bond Claims. In doing so it would be confiscating the appearing parties’ property without just compensation. F&D/Zurich reserve and preserve all of their rights and remedies under the Takings Clause.

### CONCLUSION

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 Rio Bayamón 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**

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

31. 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.

32. The F&D/Zurich reserve the right to amend this supplemental and superseding 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 23rd day of October 2018.

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**CERTIFICATE OF SERVICE**

I certify that on October 23, 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 23rd day of October 2018.

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