

CONDITIONAL PAYMENT BONDS -- PANACEA OR PANDORA?

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Introduction

In 1991, §713.245 Fla. Stat. ("Conditional Payment Bond Statute") became effective.¹ North American Specialty Insurance Company v. Hughes Supply, Inc., 705 So.2d. 616, (Fla. 4th DCA 1998) is the first and, thus far, only, reported appellate decision construing the statute. In North American, the Fourth District held that a payment bond containing the conditional payment language and legend required by the statute would, nevertheless, be considered as an unconditional payment bond, to be construed pursuant to §713.23 Fla.Stat., where the underlying subcontract did not have conditional payment language. The purpose of this article is to explore the events leading to the enactment of the Conditional Payment Bond Statute, the manner in which the protection of the statute is invoked, and the effect of practical construction industry circumstances on the value of the statutory scheme.

Creating the Need for a Conditional Payment Bond

In February, 1990, the Florida Supreme Court decided OBS Company, Inc. vs. Pace Construction Corp., 558 So.2d 404 (Fla. 1990) ("OBS"). OBS was a subcontractor who sued a general contractor, Pace, and the surety on a §713.23 Fla.Stat. Labor and Material Payment Bond ("Bond"). The subcontract between OBS and Pace contained conditional payment language, which conditioned Pace's obligation to pay OBS upon Pace's prior receipt of payment from the project owner.² The Supreme Court held the particular conditional payment language to be ambiguous and, therefore, unavailing as a defense to OBS' claim against Pace. Under the plain language of the bond, therefore, the surety was liable to OBS, as well.

Nevertheless, the Court went further, and considered the surety's liability under the *assumption* that the conditional payment language was enforceable to validly insulate the contractor from liability to the subcontractor's claim:

Furthermore, even if we found the subcontract unambiguously shifted the risk of the owner's nonpayment to OBS, we would still hold the sureties liable under the terms of the payment bond.³

Basing its ruling on considerations of public policy, the Supreme Court found that a surety on a payment bond could not avoid liability to a subcontractor by resort to conditional payment language in the subcontract between the contractor and subcontractor:

The payment bond is a separate agreement, and any inability to proceed against the general contractor does not necessarily prevent recovery against the sureties under the

bond. In this case, recovery under the bond is in no way conditioned on the owner making final payment to [the contractor].⁴

Addressing the Need

The practical effect of the Court's ruling in OBS was to sanction an "end around" conditional payment language in subcontracts on bonded jobs: Although a subcontractor could not recover against the contractor directly, the subcontractor *could* recover against the surety on the bond. Thus, the contractor, likely having guaranteed the payment obligation to the surety, would ultimately be answerable to indemnify the surety, despite an otherwise enforceable "Pay When Paid" defense.

The Supreme Court could not have held otherwise. Had the Court exempted the surety from liability when a subcontract contained conditional payment language, the public policy against prospective lien waivers would have been violated.⁵ The subcontractor would have no lien rights against the owner because of the payment bond exempting the owner's property from liens,⁶ and no rights against the surety. To avoid this inadvertent and repugnant prospective lien waiver, the Court held the surety liable, despite enforceable conditional payment language.

The ruling in OBS carried the potential of undermining the viability of conditional payment clauses. These clauses have become popular with general contractors in protecting themselves from exposure to their subcontractors when they are not paid by the owner. Without protection for a surety, the protection the conditional payment language afforded the general contractor was ineffective. In response to the perceived anomaly created by the February, 1990 decision in OBS,⁷ in July, 1990, the Florida Legislature adopted §713.245, Fla. Stat., which became effective on January 1, 1991. The statute allows for a new type of payment bond which expressly exempts sureties from liability to subcontractors where there is enforceable conditional payment language in the subcontract. This Conditional Payment Bond allows a surety to condition its obligation to a subcontractor upon the owner's making payment to the contractor, so long as the subcontract contains express, unequivocal, conditional payment language.⁸

The Limited Applicability of the Conditional Payment Bond

For a payment bond to be considered conditional under §713.245, "the contractor's written contractual obligation to pay lienors must be expressly conditioned upon and limited to the payments made by the owner to the contractor..."⁹ Where there is no such conditional payment language, the bond is construed as a §713.23 unconditional payment bond. This result follows from the recognition that a §713.245 bond is merely a §713.23 bond with conditional language engrafted thereon. If the conditional payment language is ineffective due to the absence of supporting language in the underlying subcontract, the bond is still enforceable under 713.23.¹⁰

Construing the Conditional Payment Bond in the Real World

A Conditional Payment Bond may be construed as conditional in some instances and unconditional in others on the very same job. Since there is, by definition, no contract between the Contractor and lower tiered subsubcontractors or suppliers to

subsubcontractors with whom the Contractor is not in privity, the threshold requirement of written conditional payment language will not be met. Therefore, in those instances, the bond will be unconditional as to such lower tiered players. On the other hand, where the subcontracts between the general and subcontractors in privity with the general contain enforceable conditional payment language, the bond would be considered conditional.¹¹ As a result, all potential claimants should exercise care to determine whether the particular payment bond in place on a job is conditional, under §713.245, or unconditional, under §713.23. If the bond is conditional, further care must be taken to determine whether the particular subcontract contains enforceable conditional payment language. Where there is doubt, the claimant must not only perfect its claim against the bond, under both §713.23 and §713.245, but also must perfect its lien against owner's property.

Perfecting Claims Against a Conditional Payment Bond

If one is not already sufficiently confused, the statute provides that a subcontractor must perfect both a claim of lien against the owner's property and a claim against the Conditional Payment Bond.¹² Presuming the presence of conditional payment language in a written subcontract, the surety is only responsible to pay lienors for whom the contractor has received payment from the owner. In such event, the owner's property is exempt from liens and the remedy is a claim against the bond. Where, on the other hand, the owner does not pay the Contractor for this particular lienor's work, the surety on a Conditional Payment Bond is under no obligation to pay the lienor and the owner's property would not be exempt from liens. The lienor would have to proceed to foreclose a lien against the property, having no recourse against the bond.¹³

The procedure for perfecting a claim against a §713.245 bond differs from the notice requirements incidental to perfecting a claim against a §713.23 bond. Because it may not be clear at the outset whether the bond will ultimately be construed pursuant to §713.23 or §713.245, care must be taken to perfect claims under both sections. Failure to properly perfect a claim against the bond pursuant to §713.23, on the mistaken belief that the bond will be construed pursuant to §713.245, may result in an otherwise valid claim being defeated.¹⁴

A claim against a §713.245 bond is perfected, in the first instance by the recording and service of an ordinary claim of lien. Thereafter, the statute designates a precise procedure to be timely followed:¹⁵ First, the claimant must file and serve its Claim of Lien against owner's property. Owner, in response, records a Notice of Bond and, if she has, in fact, paid the Contractor, a sworn Certificate of Payment, which sets forth the amount that she has paid the Contractor for the labor, materials and services described in the Claim of Lien.¹⁶ The clerk serves the Certificate of Payment upon the Contractor, Surety and lienor. Thereafter, the Contractor can either join in the certificate of payment, in which case the bond stands for the obligation, or contest the fact of payment, by filing a Notice of Contest.¹⁷ Although there are statutory penalties for false statements in the Certificate of Payment and Notice of Contest, to the extent that payment is contested, the claimant retains its lien, and does not have a claim against the bond. It is likely, then, that many situations will arise where a claimant would have claims against both the bond and the property.

Conclusion

While the limitation on the surety's undertaking may suit the insurance industry, the §713.245 statutory scheme creates uncertainty, difficulty in application, multiplicity of claims and varying levels of protection. Given the "fundamental purpose" of "protecting those whose labor and skills improve land of others by providing a plan by which they may receive fair share of monies payable by the owner to the general contractor,"¹⁸ one might wonder whether the Conditional Payment Bond Statute has created more problems than it solved.

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¹ The statute was amended in 1992 and in 1995.

² A "pay-when-paid" or "conditional payment" clause shifts the risk of the owner's non-payment from the general contractor to its subcontractors. The sub is only entitled to payment from the general when, and only when, the general receives payment from the owner. Although disfavored, these provisions are enforceable in Florida. However, they are strictly construed. For a discussion of "Pay When Paid" clauses, see: Peacock Construction Company v. Modern Air Conditioning, Inc., 343 So.2d 840 (Fla. 1977) and DEC Electric, Inc. v. Raphael Construction Corp., 558 So.2d 427 (Fla. 1990).

³ 558 So.2d at 407.

⁴ Id. at 408.

⁵ See, i.e. §713.20(2), Florida Statutes, 1988, which prohibits prospective waivers of lien.

⁶ §713.02(6), Florida Statutes (1988).

⁷ See, House of Representatives Committee on Judiciary, Final Staff Analysis and Economic Impact Statement pertaining to CS/SB 1330.

⁸ A Conditional Payment Bond limits a surety's liability to only those amounts which a Contractor receives from an owner for a subcontractor's work but does not pay over to that subcontractor. A query that is beyond the scope of this article is whether such construction renders the Conditional Payment Bond more a fidelity than a payment bond.

⁹ North American Specialty Insurance, 705 So.2d at 61.

¹⁰ Id.

¹¹ Of course, if the lower tiered subsubcontractors have enforceable conditional payment language in a written subsubcontract, the conditional nature of the bond will "flow down" and be applicable to the claims of such subsubcontractors.

¹² §713.245(3), Fla.Stat.

¹³ §713.245(11), Fla.Stat.

¹⁴ North American Specialty, 705 So.2d at 616.

¹⁵ 713.245(4)-(13), Fla.Stat.

¹⁶ If owner has not paid the general contractor, owner will not record the Certificate of Payment and the lien operates unaffected by the existence of the Conditional Payment Bond.

¹⁷ The Notice of Contest may admit to some, but not all of the payment, or may deny receipt of payment altogether.

¹⁸ Crane Co. v. Fine, 221 So.2d 145, 152 (Fla. 1969).