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TRANSFER BONDS: ISSUES, DEFENSES AND DANGERS

PRESENTED BY:

**WILLIAM C. GUERRANT, JR.
HILL, WARD & HENDERSON, P.A.
Suite 3700 - Barnett Plaza
101 East Kennedy Boulevard
Post Office Box 2231
Tampa, Florida 33601**

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Transfer bonds are a recognized and commonly used method for transferring a mechanic's lien to substitute security. These bonds, however, have not been the subject of much commentary, and there are relatively few reported cases discussing them or the statutes which permit them. This paper will address the practical considerations, risks and defenses, of which sureties should be aware, when issuing such bonds.

A. The Lien Transfer Bond.

Mechanic's lien statutes provide a mechanism whereby an unpaid contractor may place a lien on the owner's property, and, ultimately foreclose that lien to enforce the contractual obligation to it. While such statutes serve the purpose of giving additional protection to contractors and suppliers, they obviously can be the source of a great deal of heartburn for owners and construction lenders.

A mechanic's lien foreclosure action will encumber the owner's property for however long it takes to resolve the dispute. Moreover, it subjects the entire lien property, which is typically of significantly greater value than the amount of the lien itself, to potential foreclosure. Frequently, mechanic's liens will be recorded by subcontractors as a result of disagreements with general contractors, to which the owner was not a party. The subcontractor can essentially hold the owner's property hostage pending resolution of its dispute with the general contractor. So long as the general contractor retains the leverage of non-payment to the sub, the owner's property will remain encumbered. This situation is obviously one which may become unacceptable to owners and construction lenders.

Transfer bonds provide a way out of such problems. Transfer bonds are creatures of the mechanic's lien statutes themselves. The transfer bond substitutes for the owner's property, as security for the lienor's claim. Thus, in a perfect world, the owner's property is freed from the encumbrance of the mechanic's lien, yet the liening contractor retains security for payment of its claim. When considering the issuance of transfer bonds, there are a number of underwriting considerations which are significantly different than those inherent in determinations to issue payment bonds. Similarly, from a claims perspective, issues exist which are significantly different from those ordinarily faced in dealing with payment bond claims.

B. Characteristics of the Transfer Bond.

The transfer bond is a creature of statute. For reasons which are discussed below, the transfer bond should ideally contain no conditions beyond those required by the statute. Obviously, particular attention should be paid to the exact language of the relevant statute, and the surety should be particularly concerned with the penal sum of the bond. The penal sum should be strictly limited to the minimum necessary to effect transfer of the lien. This will vary from state to state. In Tennessee, for example, the bond "shall be in the amount of the lien," while in Georgia the bond "shall be in double the amount claimed under the lien."

Compare Tenn. Code Ann. §66-11-142 and Ga. Code Ann. §44-14-364. The Florida statute requires a bond equal to the amount demanded in the claim of lien, plus the legal rate of interest per year for a period of three years, plus \$500.00 to cover court costs, which may be taxed in any proceeding to enforce the lien. § 713.24(1), Fla. Stat. (1995).

The surety's liability is strictly limited to the penal sum of the bond. Thus, at least in Florida, the penal sum caps the surety's liability even as to attorneys' fees and costs incurred by the obligee in enforcing its claim. DiStefano Construction, Inc. v. Fidelity & Deposit Company of Maryland, 597 So. 2d 248, 250 (Fla. 1992). It is obviously important that the surety assure that the language of its bond does not expand its liability beyond the minimum required by statute.

C. Underwriting Considerations.

The determination to issue a transfer bond should not be made in the same manner as determination to issue a payment bond. Since a transfer bond is not necessary unless nonpayment has already become an issue, greater scrutiny should be given to the principal's job status. The fact that a claim of nonpayment has already been made, resulting in the filing of a mechanic's lien, and the necessity of a transfer bond, obviously means the subject project is one which will involve payment disputes. While there is a risk that disputes over payment will arise whenever a payment bond is issued, when a transfer bond is issued, the dispute is a certainty.

The decision to issue a payment bond requires that underwriters look into their crystal balls and determine the likelihood of claims and exposure on the project. In the case of a transfer bond, however, the claim has already come into existence. Obviously, therefore, there is an opportunity to investigate, analyze, and evaluate the claim in advance of issuing the bond. The principal's defenses to the claim, and its intentions with respect to defending it, should be carefully examined.

To transfer a lien to security, it is not necessary that a bond be posted. Indeed, the owner or general contractor, as the case may be, could post cash to secure the lien instead of a bond. The fact that the principal prefers to pay a premium to the surety, rather than post cash, is something which warrants the surety's attention. As part of the underwriting process, the surety should determine why the principal has elected to post a bond, rather than cash security.

In evaluating the request for a transfer bond, the surety should consider the status of the dispute itself. It is important for the surety to recognize that the transfer bond may be used to transfer a claim to security even after a lien foreclosure action has begun. See e.g., American Fire and Casualty Co. v. Davis Water & Waste Industries, 358 So. 2d 255 (Fla. 4th DCA, 1979) aff'd, 377 So. 2d 164 (Fla. 1979). Thus, it is possible that the surety might step not only into a payment dispute, but active litigation as well. Clearly, the surety should determine the status of the dispute in evaluating the decision to issue the bond. The duration of the surety's obligation is also something which should be considered. If the transfer bond is to be provided prior to the institution of any lien foreclosure action, the surety should

determine the latest date by which the lienor must initiate its foreclosure action. Under Florida law, the foreclosure must be initiated within one year of recordation of the lien, or sixty days from service of a notice of contest of lien. § 713.22, Fla. Stat. (1995). The surety should promptly act to have its bond released by the clerk of the court where it is posted, at the first available opportunity. Thus, if a bond is posted prior to the institution of an action, the surety should diary the date upon which its release can be requested and act promptly to do so.

When issuing the bond, the surety should keep in mind that the payment dispute could take a long time to resolve itself. During that time, the principal's ability to respond to the claim may change. It generally will be in the surety's best interest to carefully monitor any litigation involving the transfer bond, and where it appears that the principal is being dilatory in bringing the matter to a conclusion, the surety should be prepared to step in to protect its rights, rather than find itself holding the bag for an insolvent principal at some later point.

If the bond is one which will require the periodic payment of premiums, as opposed to a single premium, the surety must understand that the nonpayment of the premium will not affect the rights of the obligee. Thus, where the principal is unable or unwilling to pay a premium which may come due after the posting of the transfer bond, the surety will nevertheless remain obligated to the obligee.

The surety should make certain that it undertakes no obligation to increase the penal sum of the bond. The statutes provide that upon motion, the penal sum of the bond can be increased. § 713.24(3), Fla. Stat. (1995). However, the surety cannot be compelled to increase the penal sum of the bond. *Aetna Casualty and Surety Co. v. Buck*, 594 So. 2d 280 (Fla. 1992) ("the statute does not permit the trial court to increase the liability of the surety beyond the amount of the bond.") In appropriate circumstances, the principal will have to supplement the bond, or obtain a substitute bond. The surety should monitor any litigation to assure that its rights are represented and protected in any proceeding seeking to compel an increase in the penal sum of the bond.

D. Claims Issues.

The transfer bond merely substitutes security for a mechanic's lien. A claimant can only recover against a transfer bond if he is entitled to enforcement of his mechanic's lien. This is the most significant distinction between a transfer bond claim and a payment bond claim, and one which has important ramifications to the defense of a transfer bond action.

The transfer of a mechanic's lien to a bond:

does not obviate the necessity of the lien claimant proving all the prerequisites necessary for him to enforce his lien. On the contrary, even though the real property is no longer encumbered by the lien, the claimant must prove all of the conditions precedent to the perfection and enforcement of that lien.

Fidelity and Deposit Company of Maryland v. Accel, Inc., 354 So. 2d 424, 425 (Fla. 4th DCA 1978). See also Gesco, Inc. v. Edward L. Nezelek, Inc., 414 So. 2d 535 (Fla. 4th DCA 1982); Roberts v. Porter, Davis, Saunders & Churchill, 389 S.E.2d 361 (Ga. App. 1989); Hardin Construction Group, Inc. v. Carlisle Construction Co., 388 S.E.2d 794 (S.C. 1990); Andrews Distributing Co. v. Oak Square at Gatlinburg, Inc., 757 S.W.2d 663 (Tenn. 1988).

In order to obtain payment under a transfer bond, a lienor/ claimant must prove entitlement to payment under the mechanic's lien law. As one court has noted:

strict compliance with the mechanic's lien laws is an indispensable prerequisite to obtaining relief under the statute, and if the claimant could not recover against the owner because he failed to comply with the lien laws, he is equally prevented from recovering on the bond or receiving payment out of the funds placed in the registry.

In re: Listle/Shreeves Corp., 20 B.R. 421, 423 (M.D. Fla. 1982); see North v. Waffle House, Inc., 338 S.E.2d 750 (Ga. App. 1985) (incumbent upon the lien claimant who brings suit against the principal and surety on the bond to prove entitlement to the underlying lien).

All defenses which would be available to enforcement of the mechanic's lien are available to the surety in defending payment against the transfer bond. Mechanic's lien laws can be procedurally tricky, and are likely to provide numerous and substantial potential defenses to an action against the transfer bond. Because claims attorneys may not be generally familiar with the procedural requirements for enforcing a mechanic's lien, there is a risk that defense opportunities will be missed. If the claim's attorney is unfamiliar with the mechanic's lien laws of the relevant jurisdiction, he should certainly obtain the counsel of someone who is familiar with those statutes.

Some significant defenses are available to sureties in transfer bond actions, which arise out of the mechanic's lien statutes, as opposed to the law of suretyship. For example, where the lienor/claimant fails to file an action to foreclose his lien or to join the surety in the action within the time permitted by the mechanic's lien statute, the obligation of the surety under the transfer bond will be discharged. General Guaranty Insurance Company v. Sunrise Nursing Homes, Inc., 326 So. 2d 446 (Fla. 2d DCA 1976); Regal Wood Products, Inc. v. First Wisconsin National Bank of Milwaukee, 347 So. 2d 643 (Fla. 4th DCA 1977). This is true even though the transfer bond has been substituted for the lien on real property. See also Hoffman Elec. Co. v. Chiyoda Int'l Corp., 417 S.E.2d 371 (Ga. App. 1992)(in defending an action to collect on a transfer bond, any of the defenses available to a foreclosure of the lien for which the bond was substituted are available); Maddux Supply Co. v. Safhi, 450 S.E.2d

101 (S.C. App. 1994).

Likewise, if the notices to owner required by the mechanic's lien statutes are not properly provided by the lienor, such will generally provide a defense to the surety under the transfer bond. Fidelity and Deposit Company of Maryland v. Accel, Inc., 354 So. 2d 424 (Fla. 4th DCA 1978). This is the case even though the surety's obligation has been substituted for the owner's. It has been held that the failure to provide a contractor's affidavit, a prerequisite to enforcing a mechanic's lien, is an absolute defense to a claim against a transfer bond. AAA Sod. Inc. v. Weitzer Corporation, 513 So. 2d 750 (Fla. 4th DCA 1987). Similarly, where a claimant would have no standing to foreclose a mechanic's lien, he cannot successfully assert a claim against a transfer bond. Thus, in O'Kon & Company, Inc. v. Ridel, 540 So. 2d 336 (Fla. 1st DCA 1989), the court ordered the release of a transfer bond where the claimant was an architect unlicensed in the State of Florida. Since the architect lacked standing to enforce a mechanic's lien, the court discharged the transfer bond, despite concluding that the architect's contract was otherwise enforceable.

The bottom line is that a claim against a transfer bond must be examined and defended as if it were a mechanic's lien against real estate. Obviously, this presents the surety with a variety of defenses which might not otherwise be available to it.

E. Additional Potential Defenses.

Certain other defenses, unique to transfer bonds, may be available to the surety. For example, the Florida statute requires that a transfer bond action must be brought in the county where the lien property is located. § 713.24(3), Fla. Stat. (1995). This is so even though the transfer bond action does not involve the foreclosure of any real property. There is authority for the proposition that this requirement does not merely dictate venue, but rather is jurisdictional. Stel-Den of America, Inc. v. Roof Structures, Inc., 438 So. 2d 882 (Fla. 4th DCA 1983), pet. for rev. denied, 450 So. 2d 488 (Fla. 1984); Monganti South, Inc. v. Hardy Contractors, 397 So. 2d 378 (Fla. 4th DCA 1981); Publix Supermarkets, Inc. v. Cheesbro Roofing, Inc., 502 So. 2d 484 (Fla. 5th DCA 1987). If indeed the requirement is jurisdictional, should the claimant initiate the action in the wrong county, the surety should object that the court lacks subject matter jurisdiction. If the statute of limitations has run in the interim, the lienor/ claimant will lose its claim.

F. Conclusion.

Because a surety is necessarily stepping into a dispute when it issues a transfer bond, the claims department should be involved in the underwriting process. If the surety is defended in the foreclosure action by the principal's attorneys, the matter should be monitored carefully to assure that the surety's interests are protected, particularly if the principal's financial condition is deteriorating. Finally, the surety has available to it defenses not available to a payment bond claim. The opportunities presented by them should not be overlooked.