



~ February 19, 2015 ~

AOB's – Circumventing Chapter 713

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Years ago, one of our lawyers asked a plaintiff AOB attorney, “How did you come up with this idea?” He replied, “We were thinking of ways to get around Chapter 713.” Chapter 713 is the construction lien statute. The statute was never designed to protect insurance companies. Instead, the statute is designed to protect contractors, homeowners, and mortgagees. So, why would an AOB company ever want to circumvent Chapter 713, especially if the law is designed to protect fellow contractors? Why do great whites eat each other in the womb?

Chapter 713 sets forth requirements for a contractor in order to perfect a construction lien. Generally, the contractor has to substantially perform the services and have a contract with specified terms. Contrast those legal requirements with the typical AOB scenario, where the repair company never has a contract with the insured.

In particular, Section 713.32 addresses payment of insurance proceeds. Imagine that we *already* have a statute that instructs how to pay out insurance proceeds when dealing with homeowners, banks, and contractors. 713.32 provides:

713.32 Insurance proceeds liable for demands.—The proceeds of any insurance that by the terms of the policy contract are payable to the owner of improved real property or a lienor and actually received or to be received by him or her because of the damage, destruction, or removal by fire or other casualty of an improvement on which lienors have furnished labor or services or materials shall, after the owner or lienor, as the case may be, has been reimbursed therefrom for any premiums paid by him or her, be liable to liens or demands for payment provided by this part to the same extent and in the same manner, order of priority, and conditions as the real property or payments under a direct contract would have been, if the improvement had not been so damaged,

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destroyed, or removed. The insurer may pay the proceeds of the policy of insurance to the insured named in the policy and thereupon any liability of the insurer under this part shall cease. The named insured who receives any proceeds of the policy shall be deemed a trustee of the proceeds, and the proceeds shall be deemed trust funds for the purposes designated by this section for a period of 1 year from the date of receipt of the proceeds. This section shall not apply to that part of the proceeds of any policy of insurance payable to a person, including a mortgagee, who holds a lien perfected before the recording of the notice of commencement or recommencement.

So let's examine how Section 713.32 should operate. In order to do this, we will run through a few hypotheticals.

Facts - A homeowner decides to remodel a home. A dispute arises between the homeowner and the contractor, which has substantially performed the construction services. That contractor places a \$25,000 lien on the property on February 1. On March 1, the homeowner has a water loss. A water mitigation company responds to an emergency call that day to perform emergency services for \$2,500. The homeowner signs an AOB to the water mitigation company. The insured then hires a contractor to make repairs to the house. The repairs cost \$25,000. That contractor follows the laws set forth in Chapter 713 and also places a lien on the house on April 1. Meanwhile, on May 1, the mortgagee begins foreclosure proceedings because the homeowner is in default and accelerates the mortgage so that \$100,000 is now due. The insurance company pays \$26,000 out on the claim on June 1.

Q. Who gets the money?

A. Under Chapter 713, the bank gets all the money. A mortgage company with a purchase money security interest trumps all the other lienholders.

We often hear that there is no reason to include the mortgagee as a payee for completed emergency repairs because the mortgagee's collateral has been protected. As a result, Insurance companies are then "encouraged" to leave the mortgagee off the check for a discount from the AOB company. This approach overlooks both the policy of insurance and Chapter 713. A mortgagee does not have to use insurance proceeds to protect the property from further damage or make repairs. Instead, the bank can apply the proceeds to funds in arrears. Bypassing the mortgagee, and thereby the law, ensures the AOB company can receive the payment in derogation of Chapter 713.

This scenario also raises some interesting issues. Under the statute, the insured is a "trustee" of the insurance proceeds for a period of one year to pay the proceeds out in order of priority. AOB

companies claim “they are the insured” or that they have “stepped into the shoes of the insured”. If that is true, then these AOB companies have become the “trustee” of the insurance proceeds. Have they paid the mortgagees on these claims pursuant to Chapter 713? Have they paid out all other parties with a priority lien? These AOB’s do not only impact the insurance industry. They impact fellow contractors who follow the law and perfect liens. They impact the banking industry by circumventing the legislative scheme already codified in Chapter 713.

Facts – The facts are the same as above except there is no mortgagee. We now have a contractor that performed repair services and perfected a construction lien one month before the loss. The water mitigation company took an AOB on March 1 but then the repair contractor performed services and placed a lien on the house on April 1. The insurance company pays \$26,000 out on the claim on June 1.

Q. Who gets the money, how much, and why?

A. Under Chapter 713, the contractor who performed the remodeling *before* the loss receives payment in full from the insurance proceeds. After payment of that lien, there is \$1,000 left over. Those funds go to the contractor who made insurance repairs and perfected the lien on April 1. The AOB water mitigation company takes nothing.

The reality is that the law takes the insurance claim proceeds and uses them to satisfy a lien placed by a contractor before the loss. If both the water mitigation company and then contractor which performed repair services had an AOB, is there any doubt whether they would both file suit against the insurance company in today’s environment? Well, that’s exactly why we discussed the insurable interest statute in our previous article. Only parties with an insurable interest in the thing insured at the time of loss can *enforce* the policy for their own benefit.