

NEW YORK CONSTRUCTION LAW UPDATE

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MAINTAINING PROPER LIEN LAW TRUST RECORDS TO AVOID POTENTIAL PERSONAL LIABILITY

The Lien Law trust laws are something that most contractors have heard of but very few understand. This is unfortunate since the Lien Law trust laws are one of the few areas of the law that are, arguably, intended to protect contractors (as opposed to owners). In a nutshell, Article 3A of the Lien Law requires every "trustee" to keep all funds that he receives on a construction project in a "trust account" for the benefit of the trust beneficiaries. Just who is a trustee is not always clear but the following general guidelines may be helpful: 1) if an owner receives a construction loan the owner is a trustee; 2) a general contractor is always a trustee; 3) a subcontractor can be a trustee if he, she or it owes money to a sub-subcontractors, materialman, vendor or supplier; or 4) a sub-subcontractor and beyond can be a trustee under the same circumstances as a subcontractor. A simple rule of thumb is that if you are receiving money on a construction project in the State of New York and you owe money to someone else for labor or materials that they supplied to you on that same project then you are a Lien Law trustee and all monies that you receive are "trust funds."

If you are a trustee you must pay all beneficiaries of the trust before you can use the funds for non-trust purposes. Most importantly, you cannot use the funds for another project and you cannot use the funds to take your profit until you have satisfied all trust claims. While the Lien Law does require you to maintain these funds in a trust account, it is generally accepted that you do not need a separate account for each project. Rather, you must keep separate books and records for each project. But keeping the funds in one account is not in and of itself a trust violation. Your books and records for the project should show the name of the project, the date and amount of payments received and the date, amount and payee of each payment made from the trust funds. For example, if the general contractor (GC) receives a \$100,000 payment from Owner (O) on Project X and then pays \$25,000 to Subcontractor A, \$25,000 to subcontractor B and \$25,000 to supplier C, each of those transactions must show up on GC's books and records. Each would be a proper use of the Lien Law trust funds. The remaining \$25,000 from O on Project X, assuming no other beneficiaries have trust claims, can be used by the GC as it sees fit whether that be to take profit, use on another project or something else.

In the above example, GC gets into trouble when Subcontractor D is still owed money but rather than pay Subcontractor D, GC takes \$25,000 to order materials for Project Z. This scenario results in a Lien Law trust violation. The consequences can be disastrous. First, the court has the ability to order the trust funds repaid if possible. Second, diversion of trust funds is a crime that you can be prosecuted for. Third, diversion of trust funds exposes corporate principals to personal liability. Fourth, diversion of trust funds exposes the trustee to potential punitive damages and attorneys' fees awards. In summary, diverting trust funds can put you in a whole heap of trouble. While troublesome for the trustee, everyone below him that was owed money and was not paid is offered the additional leverage of the trust claim in their pursuit of the money they are due on the project.

Lien Law Section 75 requires all trustees to maintain careful and accurate books and records of all of these trust transactions. Failure to maintain proper books and records creates a legal presumption that the trust laws have been violated. While not a final determination, overcoming this presumption in litigation can be very difficult and in most cases impossible. As a beneficiary of the trust, you are allowed, under Lien Law Section 76, to demand that the trustee provide you with a verified statement, in writing, showing each of the entries on the books and records of the trust account. In other words, if a general contractor tells you he hasn't paid you because the owner hasn't paid him you can demand to see his books and records for the project and the general contractor is legally required to disclose them to you.

One very important caveat: a Lien Law trust fund claim has a very short statute of limitations. It must be brought within 1 year of the time the diversion occurred. Therefore, you must stay on top of anyone that owes you money and keep careful track of the money. Don't be afraid to exercise your rights under Lien Law Section 76 if you have not been paid and you think someone may have diverted money on the project. When in doubt, contact your attorney to find out what rights you have and to make sure you preserve any potential claims you may have.