NEW YORK CONSTRUCTION LAW UPDATE

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WHAT EXACTLY IS A LIEN LAW TRUST DIVERSION?

As contractors and attorneys become more aware of the requirements and obligations of Article 3-A of the Lien Law, otherwise known as the trust fund provisions, more and more questions arise about just what a contractor can, and cannot, do. A simple answer can be found in Article 3-A of the Lien Law itself. Particularly, Lien Law Section 72 says that: "Any transaction by which any trust asset is paid, transferred or applied for any purpose other than a purpose of the trust as stated in subdivision one or subdivision two of section seventy-one, before payment or discharge of all trust claims with respect to the trust, is a diversion of trust assets, whether or not there are trust claims in existence at the time of the transaction, and if the diversion occurs by the voluntary act of the trustee or by his consent such act or consent is a breach of trust." Not exactly clear and simple language but it is a good starting point for figuring out what a trust fund diversion is.

Let's look at the first thing that has to happen for a Lien Law trust fund diversion to take place: there must be a "transaction by which any trust asset is paid, transferred or applied." In other words, the contractor has to take money that it received as payment for a construction project, we will call it "Project X", and use that money in some way. Of course not all uses of the trust asset are improper or illegal. So we look to the next element of the Lien Law trust fund diversion claim. That money that the contractor received on Project X must be "used for any purpose other than a trust purpose." The logical question then becomes what is a trust purpose? Lien Law Section 72 points us towards the answer in Lien Law Section 71.

There are two parts of Lien Law Section 71. Sub part 1 of Lien Law Section 71 says that the trust funds that contractor is holding on Project X can be used and applied for "payment of the cost of improvement." Quite simply that means contractor can use the trust funds for Project X to pay for costs of construction on Project X (for example he can use the trust funds to pay for supplies). Sub part 2 of Lien Law Section 71 then gives us a nice list of exactly what types of things the contractor, as trustee, can pay with the Project X trust funds. Section 72(2) says the funds can be used to pay:

(a) payment of claims of subcontractors, architects, engineers, surveyors, laborers and materialmen;

(b) payment of the amount of taxes based on payrolls including such persons and withheld or required to be withheld and taxes based on the purchase price or value of materials or equipment required to be installed or furnished in connection with the performance of the improvement;

(c) payment of taxes and unemployment insurance and other contributions due by reason of the employment out of which such claims arose;

(d) payment of any benefits or wage supplements, or the amounts necessary to provide such benefits or furnish such supplements, to the extent that the trustee, as employer, is obligated to pay or provide such benefits or furnish such supplements by any agreement to which he is a party;

(e) payment of premiums on a surety bond or bonds filed and premiums on insurance accrued during the making of the improvement, including home improvement, or public improvement;

(f) payment to which the owner is entitled pursuant to the provisions of section seventy-one-a of this chapter.

Each of the above items are fairly self explanatory. Sub paragraph (f) deals with certain owner related payments that are not the normal situation so we won't spend any time in this article reviewing that particular item. The remaining items really require no explanation.

So we are almost there in determining just how a contractor engages in the diversion of trust funds. We know the contractor must receive payment on Project X, must then use that money for a non-trust purpose and we know that the non-trust purposes are anything other than those set forth above. The final element that puts the nail in the contractor's trust diversion coffin is when he uses the trust money for a non-trust purpose "before payment or discharge of all trust claims with respect to the trust." In other words, all of the claims identified in Lien Law Section 71 as permissible ways to use trust funds must be fully satisfied before contractor uses the Project X money on any non-trust purpose. Once all trust claims have been paid, the remaining monies on Project X become the asset of the contractor and he may use them in any manner that he sees fit. The contractor can use the former trust funds to fund Project Y, give his employees bonuses, buy new computers for the company, take a trip to China or buy a new yacht. The point is it no longer matters once the trust claims have been satisfied.

What contractors must become aware of is exactly what they can and cannot use their trust funds for and they must understand their obligations to keep accurate records of those trust uses. Remember, failure to keep adequate and accurate records of the trust creates a presumption of a trust fund diversion that makes the contractor liable for a trust diversion simply because he cannot prove there was not a diversion.

When in doubt, contractors should consult with their attorney and make sure that they have the proper checks and balances in place, and that they fully understand Lien Law Article 3-A, to make sure that they are protected and not exposing themselves to criminal and civil liability for trust fund diversions.