CHAPTER 15

Trust Fund Laws and Agreements

INTRODUCTION TO TRUSTS

Let's suppose your last will and testament for you and your spouse creates a trust for the benefit of your children. If you and your spouse are killed in an accident, all of your money goes into a trust fund for the health, education and welfare of your children. Let's suppose your brother is set up as the trustee of that trust fund. Your brother as trustee has the discretion to use the trust fund to purchase groceries, buy clothing, take the family on vacation, pay a portion of the mortgage and pay for tuition for your children.

If your trustee brother later becomes insolvent and files bankruptcy, many of your trustee brother's creditors may try to attach the trust fund. They would argue that your trustee brother had the discretion to use trust funds whenever he thought it was appropriate for the children. Your brother wrote checks off of the trust fund account monthly for any variety of household expenses. Will your brother's creditors be able to attach this trust fund?

No, the creditor should fail in this attempt. The money does not belong to your bankrupt brother-trustee. The money still belongs to your children as "beneficiaries." Your brother has only "legal" title. Your children have "beneficial" or "equitable" title to the trust fund.

Some states have trust fund "statutes" or laws to protect owners, general contractors, subcontractors and suppliers in the construction industry, including Maryland, New York, New Jersey, Wisconsin and Michigan. Summaries of some of those state laws are provided later in this chapter. In general, however, when a general contractor receives payment from the construction project owner, the general contractor holds funds in trust for the benefit of the subcontractors and suppliers. Subcontractors then hold funds in trust for their suppliers and sub-subcontractors. The federal government has similarly created the Perishable Agricultural Commodities Act (PACA) to protect unpaid sellers of perishable agricultural products

In some states, such as Maryland, the officers and directors of a company holding trust funds are also personally liable to make sure that trust funds get to the proper subcontractor and supplier beneficiaries. This works very much like personal liability for federal 941 income withholding taxes. In addition to having special status if the trustee contractor files bankruptcy, the trust beneficiary may also have a personal guaranty from the officers and directors of the bankrupt debtor.

In the event of bankruptcy, the trust funds held for the benefit of others do not become a part of the bankruptcy estate. These funds always belong to the beneficiary. The trustee is merely "holding" the beneficiary's money. The creditor may need to get appropriate bankruptcy orders, but may be entitled to payment directly from an owner, general contractor or from the bankruptcy estate by bankruptcy court order. This concept can also be a very important defense to a preference claim in bankruptcy.

Since a debtor-trustee is never the owner of trust funds, it is also impossible for the debtor to sell or give away trust property or grant a security interest in trust property. The trustee could not give away or sell trust property, since a trustee does not have title to (does not own) trust property. The beneficiary of the trust could claim ownership of the trust property, even in the hands of third parties. By the same token, a trustee cannot grant an effective security interest in trust property.

Even in states without trust fund laws, it is possible to create a trust fund relationship by agreement. This works just like a bank trust fund or a trust fund for children. It is possible to add trust language to a contract, joint check agreement or credit agreement with just a few sentences.

Trust fund statutes were created to protect various players in the construction industry from impecunious or dishonest contractors. The beneficiaries of the trust are often lower tier subcontractors or suppliers that generate the trust fund by supplying labor and materials to a construction project. If poor management or dishonesty causes a contractor to become insolvent, receivables on construction projects will often go to the bankrupt's secured creditors or banks, or will be shared pro rata with all of the bankrupt's general unsecured creditors. In any event, the lower tiered subcontractor or supplier will receive little or nothing in the absence of mechanic's lien or payment bond rights.

The primary motivation to create many trust fund statutes, however, has been the desire to protect owners and general contractors. Many states have no "defense of payment" to their mechanic's lien.[1] In other words, an owner can be required to pay for a project twice, if a general or subcontractor fails to properly pass funds on. In Maryland, for example, the trust fund statute was in large part created to protect owners. The personal liability feature of the trust fund statute particularly would motivate contractors to protect owners from double liability and to make sure funds went to subs and suppliers.

Similarly, general contractors on public projects normally are required to provide payment bonds that can also create double liability for general contractors. Generally, there is no "defense of payment" on a payment bond.[2] On federal projects, general contractors are liable to second tier subcontractors. This means a general contractor can pay its obligations to subcontractors in full and then still be liable to pay for the same labor and materials again to a sub-subcontractor. The general contractor may not have even been aware of lower tier subs and suppliers on the project. The New Jersey Trust Fund Statute, for example, is applicable only to public projects and was created in part to protect general contractors on public projects.[3]

The Maryland Little Miller Act actually provides protection to *third* tier subcontractors.[4] This puts general contractors on Maryland public projects in a particularly risky position. It is difficult to police funds paid to direct subcontractors, much less sub-subcontractors. General contractors in Maryland can require subcontractor payment bonds, but this generates higher costs for subcontractors, general contractors and ultimately owners. Some subcontractors also have insufficient bonding capacity, taking many potential bidders out of contention. General contractors can and should carefully police lien waivers from lower tiered subcontractors and suppliers. This also generates higher administrative costs, however, and is not always practical. It may be impossible where there is exposure to *third* tier subcontractors and suppliers.

It is certainly no accident, therefore, that Maryland has a trust fund statute applicable to Little Miller Act contracts and to property subject to mechanic's lien rights.[5] While this trust fund statute certainly protects lower tier creditor-beneficiaries, protection for owners and general contractors from double liability was a primary motivation for its creation.

All of the same players will want consensual trust fund agreements, if there is no trust fund statute for protection. Material suppliers would certainly want a trust fund provision in their credit agreement or quote before supplying. Lower tier subcontractors have a similar interest.

Owners will also want trust fund provisions in their general contracts. This is particularly true in states, such as Maryland or Pennsylvania, with no defense of payment to the mechanic's lien. Trust fund provisions will help preserve and protect funds for subs and suppliers, protecting owners from dual liability. Consensual trust fund provisions can also protect owners or general contractors from completion costs in the event of contractor abandonment or insolvency. General contractors should require these trust fund provisions in all subcontracts. These documents already contractually require subcontractors to complete projects and pay for all labor and materials. There is no real additional cost to either party in modifying this language to create a trust relationship.

Who is the loser in a trust fund relationship? The trustee's liability for breach of a trust relationship duplicates contract liability.[6] If a materials supplier can sue a customer under a credit agreement, what does it add to sue the customer for breach of trust? The real difference comes in the event of insolvency and the trust beneficiary's relationship with third parties, with whom there is no contract.

As discussed at length in other chapters of this book, bankruptcy or insolvency is not a battle between the creditor and the debtor that breached a contract. The debtor is gone and is out of business. Even in a Chapter 11 reorganization, the stockholders of the corporation normally change. The "bad guy" is gone. Bankruptcy is generally a "battle between innocents." All participants deserve to be paid in full; the question becomes who will bear the cost of the debtor's insolvency?

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[1] *See* chapter, Mechanic's Lien Rights and General Principles, and the multiple chapters on Mechanic's Liens in Virginia, Maryland, Pennsylvania and D.C.; sections, Defense of Payment.

[2] *Mai Steel Service, Inc. v. Blake Constr. Co.,* 981 F.2d 414, 419 (9th Cir. Cal. 1992).

[3] *Universal Bonding Insurance Company v. Gittens and Sprinkle Enterprises, Inc.*, 960 F.2d 966 (3rd Cir. 1992); *Walters v. Atlantic Builders Group, Inc*. 951 A. 2d 94 (Md. App. 2008).

[4] Md. State Finance and Procurement Code Ann. §17-108 (1988).

[5] Maryland Real Property Code §9-204; *see also* New Jersey Statutes Annotated N.J.S.A. 2A: 44-148.

[6] Personal liability of officers and directors under trust fund laws and the potential for punitive or treble damages may add additional liability. *See* subsection below, Personal Liability of Officers and Directors.

As discussed in connection with bankruptcy, secured creditors have a preferred position in bankruptcy.[7] Article 9 of the Uniform Commercial Code allows a creditor to obtain a first priority lien on a debtor's accounts receivable. In bankruptcy, all monies still owed to the debtor will go to this secured creditor, unless there are superior security interests.[8] This result can seem very unfair. Material suppliers and lower tier subcontractors may remain unpaid. Owners and general contractors may face double liability to pay them. Labor and materials have generated this receivable, which would not otherwise exist. Why should the secured creditor have first priority to this receivable? The secured creditor is also an innocent that has lost money, but this is quite arguably different money. The secured lender is often a bank that lent money for general operations. This receivable was created by the labor and/or materials supplied by the subcontractor or supplier, a different creditor.

If secured creditors do not consume all assets in bankruptcy, any remainder goes to general unsecured creditors.[9] All these creditors are certainly innocent and in a similarly vulnerable position. At the same time, however, it is arguable that these general unsecured creditors also did not generate this particular receivable. In any event the owner, general contractors, subs, suppliers and the general unsecured creditors of the insolvent debtor are all innocents competing for limited assets.

TRUST FUND THEORY

Most of the theory behind trust fund laws and trust fund agreements is the same. As courts began to deal with new trust fund laws in the last couple of decades, the courts understandably looked for guidance in older and well-established case law regarding traditional trust arrangements. Since a trust fund law is created from scratch by a state legislature, the exact wording of a trust fund law can vary from state to state. These differences in wording can result in operational differences. Some states, for example, create personal liability for officers and directors. Accordingly, the case law on conventional trust arrangements tends to be the same from state to state but can still have differences.

Comparison with Security Interest

Security is the conventional method by which creditors establish priority, including voluntary security interests in accounts receivable, vehicles, real estate or equipment. Mechanic's lien laws can also help a creditor establish an involuntary security interest in real estate. If the creditor can establish mechanic's lien rights, the receivable from that property owner is not shared with general unsecured creditors. The mechanic's lien claimant can claim priority over that entire receivable.

Trust fund laws or agreements are theoretically different from security interests. Technically, the trust beneficiary is not a secured creditor; instead, it is something even better. If there is a trust, the receivable is simply not property of the estate. The debtor does not own this property and cannot grant a security interest in this property. The debtor is simply "holding" the beneficiary's property.

You may be familiar with a "contract for deed" or an "installment contract" in a real estate sale. In this arrangement, the debtor makes payments each month for several years. When the payments are complete, the seller then deeds the property to the buyer. The debtor does not "own" the property until he is finished making payments. This same transaction could be structured as a mortgage where the seller deeds the property now and takes back a security interest. If the debtor defaults on the loan, the creditor must foreclose on the security property. It is safer for the creditor, if the debtor never owns the property.

Comparison with Contract Rights

You could logically wonder what advantage a trust fund relationship has over a contract or credit agreement. If your debtor-buyer does not pay for labor or materials supplied, the contract provides the right to sue and obtain judgment for the balance due. What does it add to be able to sue the debtor-trustee for "breach of trust"?

A trust fund law or agreement may not give you any better remedy *against your debtor* than your contract rights. The real difference is in the quality of the remedy against third parties. First, the trust fund agreement, if properly worded, may allow a creditor to collect directly from property owners or other third parties. This would be similar to rights of collection for a perfected secured creditor with a UCC-1 Financing Statement and Security Agreement.

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[7] *See* chapter, Bankruptcy Primer for Creditors; section, Introduction; subsection, The Importance of Security.

[8] Mechanic's lien or payment bond rights can create a superior security interest, for example.

[9] *See* chapter, Bankruptcy Primer for Creditors; section, Introduction; subsection, Creditors v. Creditors.

Even more important, however, are the creditor-beneficiary's rights against third parties in the event of bankruptcy. Bankruptcy is actually a battle between creditors over the limited assets available for distribution. A creditor always wants to identify a receivable somewhere and establish an absolute right to collect the entire receivable and not share it with any other creditors. A creditor accomplishes this, for example, in a mechanic's lien proceeding. The other creditors in the bankruptcy estate will always argue that this receivable should go into the general pot to be shared by all of the general unsecured creditors.

A trust fund relationship is a mechanism to claim exclusive ownership of this one receivable from a property owner or a general contractor. This is similar to the advantage in establishing mechanic's lien right, but it is not actually a security interest. It also has no specific timeline and can be less expensive. If the debtor has agreed to a trust fund agreement, then the receivable never becomes property of the debtor-trustee. It is always the creditor's property, and there is no need to share it with any other creditor.

As between the creditor-beneficiary and the debtor-trustee, the trust fund relationship does not add anything, unless you are dealing with a trust fund law that creates personal liability for officers and directors.[10] The biggest difference in trust fund laws and agreements will be in the relationship between the creditor-beneficiary and the debtor's other creditors in an insolvency situation.

Tracing and Identifying Funds in Debtor's Possession

Some courts have held that the creditor-beneficiary has the "burden of proof" to properly trace funds.[11] Money is very "fungible." One dollar looks the same as another. In order to establish ownership over a particular fund of money, a creditor-beneficiary must be able to prove that those particular dollars are the trust fund dollars. The creditor-beneficiary not only must prove that it has a right to funds generally, but a superior right over secured creditors and other claimants to these particular funds.[12]

In tracing funds, the creditor-beneficiary does get help from a legal presumption that the debtor-trustee will spend his own money before the debtor-trustee spends trust funds. When trust funds are "commingled" or mixed with the debtor-trustee's funds in a bank account, the law will presume that the debtor-trustee is honest and will avoid misappropriating trust funds. The creditor-beneficiary will need bank records to show that a trust fund received from a certain construction project was deposited in a certain bank account. If the balance in that bank account never drops below the amount of the trust fund, then the law will assume that the trust fund is still intact in that bank account. The creditor-beneficiary has successfully traced and identified the trust fund.[13]

Once a commingled account goes into a negative balance, however, the funds lose their identity and tracing becomes impossible. This is called the lowest intermediate balance test.[14] This is a legal fiction that says that when trust funds have been traced into a general bank account, the creditor-beneficiary can successfully identify funds if the balance of the account has always equaled or exceeded the amount of the trust fund. However, if all monies are withdrawn, the trust fund is lost, even if new monies are later deposited into the account.[15] If the account balance remains positive, but the balance drops lower than the amount of the trust fund, then the trust fund is considered

[10] *See* subsection below, Personal Liability of Officers and Directors.

[11] *Old Republic Nat'l Title Ins. Co. v. Tyler (In re Dameron)*, 155 F.3d 718, 723-724 (4th Cir. Va. 1998) [tracing is an issue of federal rather than state law]; *In re Goldberg*, 932 F.2d 273, 280 (3d Cir. 1991) [claimant must show the existence of a trust and must also show that it can trace the trust funds; the tracing requirement derives solely from federal law]; *Conn. Gen. Life Ins. Co. v. Universal Ins. Co*., 838 F.2d 612, 618 (1st Cir. 1988); *In re Bullion Reserve of N. Am*., 836 F.2d 1214, 1218 (9th Cir. 1988); *In re Kennedy & Cohen, Inc.*, 612 F.2d 963, 966 (5th Cir. 1980) (*per curiam*) ["Under federal law, plaintiffs must be able to trace their funds to an identifiable trust in the hands of the trustee"]; *but see Wolff v. United States, IRS (In re FirstPay, Inc.)*, 773 F.3d 583, 595 (4th Cir. Md. 2014) [Under these principles, a court may presume that funds received, held, and conveyed by a trustee in accordance with the purpose and for the benefit of a trust, although commingled with funds not subject to that trust, are indeed funds subject to the trust. In the context of a preference avoidance claim, the burden rests with the party claiming ownership of the funds to rebut the presumption]; *In re McGee*, 258 B. R. 139 (Bankr.D.Md. 2001) [Specific trust funds need not be traced by the claimants in order to enforce the trust and to recover for its violation].

[12] *Panhandle Bank & Trust Co. v. Graybar Electric Company, Inc., et al.*, 492 SW2d 76, 78 (Tex. App.).

[13] *The St. Joe Company v. Norfolk Redevelopment and Housing Authority,* 283 Va. 403, 408-09, 722 S.E.2d 622, 626 (2012), *citing Old Republic Nat'l Title Ins. Co. v. Tyler (In re Daneron)*, 155 F.3d 718, 724 (4th Cir. 1998) [to say that "such tracing may be sufficiently accomplished under the lowest intermediate balance rule by a showing that the amount in the destination account exceeded the value of the constructive trust"]; *In re Quality Telecomm. Servs.,* 2006 Bankr. LEXIS 4512 (Bankr. D. Md. Feb. 27, 2006); *First Federal of Michigan v. Barrow*, 878 F.2d 912 (6th Cir. 1989); *See also Selby v. Ford Motor Co*., 590 F.2d 642 (6th Cir. 1979) and *Huizinga v. United States,* 68 F. 3d 139 (6th Cir. 1995).

[14] *First Federal of Michigan v. Barrow*, 878 F.2d 912 (6th Cir. 1989).

[15] *In re Quality Telecomm. Servs.,* 2006 Bankr. LEXIS 4512 (Bankr. D. Md. Feb. 27, 2006); *First Federal of Michigan v. Barrow*, 878 F.2d 912 (6th Cir. 1989).

dissipated or lost to that extent, unless the creditor-beneficiary can prove the debtor-trustee intended to replace the trust funds with the later deposits.[16]

A few courts have extended the legal fiction to assume that a debtor-trustee will always replace trust funds at the earliest opportunity. In other words, as long as there is sufficient money currently in the bank account where trust funds were originally deposited, this will be sufficient tracing for some courts.[17]

There is an interesting bankruptcy court case under the Maryland Construction Trust Fund Statute stating that a claimant does *not* need to trace funds to enforce a trust, since the Maryland law explicitly allows the commingling of trust funds.[18] In this case the claimant was attempting to establish personal liability of officers and directors, however. It is questionable whether this "no need to trace" rule would apply to a creditor-beneficiary trying to establish priority over a secured creditor.[19]

Commingling Funds, Restrictions on Use and Payment on Demand

The "commingling" of trust funds is closely related to the issue of tracing. Most trust fund laws allow a debtor-trustee to "commingle" funds.[20] This means that it is not necessary to keep the trust funds in a separate bank account. The debtor-trustee does not need to separately account for trust funds, but he must make sure that funds received on a construction project are eventually paid to all subcontractors and suppliers that helped generate the fund.[21]

Accordingly, trust funds go into the debtor-trustee's regular bank account. The trust fund is mixed with trust funds belonging to other creditor-beneficiaries and funds belonging to the debtor. While this makes banking and accounting easier for the debtor-trustee, it also creates problems for the creditor-beneficiary in identifying or tracing funds.

In any voluntary trust fund agreement, it would be possible to prohibit commingling and this would be preferable in any trust agreement.[22] Where a creditor has a strong bargaining position, a creditor could require a separate bank account for all proceeds coming from a particular construction project. This would certainly aid the creditor in collecting trust funds and eliminate the need to trace funds.

In some states, commingling of trust funds invalidates a trust fund agreement[23] or a constructive trust. It may be possible to avoid this problem in any voluntary trust fund agreement by expressly allowing the trustee to commingle funds,[24] but the safest course is to require use of a separate trust account. Some courts have held there can be no trust if the agreement expressly permits commingling[25] or even if it fails to prohibit commingling.[26] Some court case law indicates that a trust is broken as soon as the trustee commingles funds,[27] whether or not comingling is permitted,

[16] *First Federal of Michigan v. Barrow*, 878 F.2d 912 (6th Cir. 1989); *See also Distral Energy Corp. v. Michigan Boiler & Engineering Co*., 171 B.R. 565 (Bkrtcy. E.D.Mich. 1993).

[17] *Bethlehem Steel Corp. v. J. Coleman Tidwell*, 66 B.R.932 (M.D. GA 1986).

[18] *In re Robert McGee*, 258 B.R. 139, 148 (D. Md. 2001); *see also Wolff v. United States, IRS (In re FirstPay, Inc.)*, 773 F.3d 583, 595 (4th Cir. Md. 2014) [Under these principles, a court may presume that funds received, held, and conveyed by a trustee in accordance with the purpose and for the benefit of a trust, although commingled with funds not subject to that trust, are indeed funds subject to the trust. In the context of a preference avoidance claim, the burden rests with the party claiming ownership of the funds to rebut the presumption].

[19] *See e.g., In re Quality Telecomm. Servs.,* 2006 Bankr. LEXIS 4512 (Bankr. D. Md. Feb. 27, 2006).

[20] Maryland Real Property Code § 9-201(c); *Ferguson Trenching Co. v. Kiehne*, 329 MD 169, 618 A.2d 735, 1993; *Cunningham v. Brown*, 265 U.S. 1, 11, 44 S.Ct. 424, 426 (1924); *Cunningham v. T & R Demolition, Inc. (In re ML & Assocs.)*, 301 B.R. 195, 200 (Bankr. N.D. Tex. 2003).

[21] *In re Building Dynamics, Inc.*, 134 B.R. 715, 716 (Bankr. W.D.N.Y. 1992) *citing* New York Lien Law §75(a) ["Intermingling of the trust funds is permitted, but careful records must be kept"].

[22] *M&T Elec. Contrs., Inc. v. Capital Lighting & Supply, Inc. (In re M&T Elec. Contrs., Inc.),* 267 B.R. 434, 479 (Bankr. D.D.C. 2001) *citing Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp.),* 810 F.2d 270, 274 (D.C. Cir. 1987) [for a trust to be present, whether an express trust or a constructive trust, "the courts have uniformly required a contract irrevocably obligating the debtor both to segregate the "trust funds" from the debtor's own funds and to deliver the "trust funds" to the creditor"].

[23] *Harleysville Worcestor Mut. Ins. Co. v. Bank of Am. N.A. (In re Suprema Specialties, Inc.),* 370 B.R. 517 (S.D. N.Y. 2007), *aff'd In re Suprema Specialties, Inc. v. Bank of Am. N.A*., 309 Fed. Appx. 526 (2d Cir. 2009) [in order to create a trust, there must also be actual trust property at the time of creation].

[24] *Section 179, comment (f), of the Restatement of Trusts, 2nd* ["By the terms of the trust the trustee may be permitted to mingle trust property with his own property. It may be expressly so provided by the terms of the trust or the character of the trust may be such as to make this proper"].

[25] *Airlines Reporting Corp. v. Pishvaian*, 155 F. Supp. 2d 659, 664-55 (E.D. Va. 2001); *In re Penn Cent. Transp. Co.,* 328 F. Supp. 1278, 1279 (E.D. Pa. 1971), *citing* Scott on Trusts, 3rd ed. § 12.2; *In re Lord's, Inc.,* 356 F.2d 456, 458 (7th Cir. Ill. 1965); *see also Marrs-Winn Co., Inc. v. Giberson Electric Inc.,* 103 F.3d 584, 592 (7th Cir. 1996).

[26] *In re Morales Travel Agency*, 667 F.2d 1069, 1073 (1st Cir. P.R. 1981).

[27] *In re Kulzer Roofing, Inc*., 139 B.R. 132, 140 (Bankr. E.D. Pa. 1992); *In re Greenbelt Road Second L.P. v. Schlossberg*, 1994 WL 592766, App. LEXIS 30440, 9-13 (4th Cir. Md. 1994) (Unpublished Opinion). However, this case law does seem to mix up the issues of

because it makes tracing impossible. Some courts disagree, saying that commingling does not necessarily defeat a trust.[28] This would also seem contrary to the lowest intermediate balance rule. If a trust beneficiary can show that the funds went into a general bank account and the balance never went below the amount of the trust funds, the lowest intermediate balance rule would say that the funds have been adequately traced. Other case law agrees,[29] sometimes pointing out that commingling of funds is a breach of the trustee's fiduciary duty that should not operate to prejudice the beneficiary.[30] In any event, commingling can be a problem that can defeat a voluntary trust and should be avoided if possible.

Some cases discuss commingling in connection with a requirement of restrictions on the use of trust funds. There can be no trust if the trustee is allowed to use the funds in any manner that they wish.[31] The right or ability to commingle funds means there are no restrictions on the use of the trust funds.

A related issue is a requirement that the trustee pay over trust funds to the beneficiary "on demand."[32] If a trustee is required to hand over funds only at specified intervals, some courts think this is evidence of a normal creditor-debtor relationship and that no trust was intended. A "real" trustee would also be required to hand over exactly the sum of money received. An agreement requiring the trustee to pay the full purchase price, even if that full purchase price is never received, would again indicate a creditor-debtor relationship and not a trust.

It is apparent that voluntary trust fund agreements will have more difficulty in a bankruptcy court, where there is a stronger prejudice against a creditor trying to avoid general unsecured creditor status. Bankruptcy courts have stated that they are "not inclined to allow creditors to utilize a trust theory as a means of obtaining preferential treatment in a bankruptcy," since "equality of distribution among creditors is a central policy of the Bankruptcy Code.[33]

Collecting Trust Funds Directly from Project Owner or Upstream Contractor

One important difference between a simple contract relationship and a trust fund relationship may be the creditor-beneficiary's ability to collect from "third parties" (someone other than the debtor-trustee). For example, a creditor-beneficiary may be able to collect directly from a construction project owner or general contractor.

In other situations, trust funds may go through or past the debtor-trustee to other third parties. The debtor may use the trust funds to pay another creditor, may give the money away to a family member or may spend it on luxury items. A secured creditor of the debtor-trustee might actually seize or garnish the trust funds. This is discussed below under Involuntary Trustees.

The wording of a trust fund law in any particular state may control whether a creditor-beneficiary has direct collection rights against an owner or general contractor. The Maryland Trust Fund Statute, for example, states that "any moneys *paid* under a contract by an owner to a contractor ... shall be held in trust."[34] If the money has not yet been paid, it is arguable whether a trust exists.

Under the New Jersey Trust Fund Statute, there is no trust until the money is "paid" by the owner.[35] In other words, there is no trust in money held by the owner and a creditor-beneficiary has no claim against an owner. Wisconsin courts on a trust fund law with similar language have ruled that there is no trust until the fund is paid to a general

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commingling and tracing, apparently holding that tracing is impossible by definition if there has been commingling and apparently ignoring the intermediate balance test discussed in the subsection above on Tracing.

[28] *Wolff v. United States, IRS (In re FirstPay, Inc.)*, 773 F.3d 583, 592 (4th Cir. Md. 2014) [We are not persuaded that the commingling of funds that occurred in this case defeated creation of a trust].

[29] Constructive Trust: *The St. Joe Company v. Norfolk Redevelopment and Housing Authority*, 283 Va. 403, 722 S.E.2d 622 (2012); Express Trust: *Racetrac Petroleum, Inc. v. Khan (In re Khan)*, 461 B.R. 343, 350 (E.D. Va. 2011) [An agreement that allows comingling of funds in trust with other non-trust funds does not negate the existence of a fiduciary relationship]; Commingling of funds by a trustee does not of itself destroy an express trust: *Wolff v. United States, IRS (In re FirstPay, Inc.)*, 773 F.3d 583, 592 (4th Cir. Md. 2014); *In re Warner-Quinlan Co.,* 86 F.2d 103 (2d Cir. 1936); *Southern Cotton Oil Co. v. Elliotte,* 218 F. 567 (6th Cir. 1914); *In re Steele-Smith Dry Goods Co.,* 298 F. 812 (N.D.Ala.1924).

[30] *The St. Joe Company v. Norfolk Redevelopment and Housing Authority*, 283 Va. 403, 408, 722 S.E.2d 622, 605 (2012); *see also Wolff v. United States, IRS (In re FirstPay, Inc.)*, 773 F.3d 583 (4th Cir. Md. 2014); *Marrs-Winn Co., Inc. v. Giberson Electric Inc.*, 103 F.3d 584, 592-93 (7th Cir. 1996); *Federal Insurance Company v. Fifth Third Bank*, 867 F.2d. 330, 334 (6th Cir. 1989).

[31] *In re Morales Travel Agency*, 667 F.2d 1069, 1071 (1st Cir. P.R. 1981).

[32] *In re Lord's, Inc.,* 356 F.2d 456, 458 (7th Cir. Ill. 1965); *In re Morales Travel Agency*, 667 F.2d 1069, 1072 (1st Cir. P.R. 1981).

[33] *In re Kulzer Roofing, Inc.*, 139 B.R. 132, 138 (Bankr. E.D. Pa. 1992); *See also In re Morales Travel Agency*, 667 F.2d 1069, 1071 (1st Cir. P.R. 1981) [If a ritualistic incantation of trust language were deemed conclusive, it would be a simple matter for one creditor, at the expense of others, to circumvent the rules pertaining to the creation of bona fide security interests].

[34] Maryland Real Property Code §9-201(a).

[35] *Universal Bonding Insurance Co. v. Gittens*, 960 F.2d 366 (1992).

contractor.[36] A secured creditor of the debtor-trustee could win this battle over a trust fund claimant in an attempt to collect money from an owner.

Similarly, the wording of a consensual trust fund agreement could also control whether the creditor-beneficiary had collection rights from third parties. A secured creditor can include collection rights in a security agreement. Article 9 of the Uniform Commercial Code also gives a secured creditor the right to collect accounts receivable of the debtor.[37] Presumably a creditor-beneficiary could include the same type of language in a consensual trust fund agreement.

In the historic general law of trusts, a beneficiary always had the ability to collect a trust fund that could be traced and identified.[38] The wording of some state trust fund statutes also (explicitly or implicitly) allows collection rights against a project owner or upstream contractor. The Maryland Trust Fund Statute, for example, seems to provide a different status for owners or general contractors when it states:

> MD Real Property Code 9-201(a): *Moneys to be Held in Trust*. "Any moneys paid under a contract by an owner to a contractor, or by the owner or contractor to a subcontractor for work done or materials furnished, or both, for or about a building by any subcontractor shall be held in trust by the contractor or subcontractor, as trustee, for those subcontractors who did work or furnished materials..."

The language of this trust fund law seems to allow a sub-subcontractor to collect directly from a general contractor. Other courts faced with similar wording have allowed such direct collection rights.[39]

As a practical matter, a trust relationship may aid a creditor-beneficiary tremendously, even if there is technically no right to sue a stakeholder (owner or general contractor) directly. Owners and general contractors are normally supportive of getting the payment to lower tiered subcontractors and suppliers. Owners often fear mechanic's lien rights. In addition, a debtor-trustee normally will not contest the debt and may begrudgingly allow a joint check or direct payment. In addition, priority battles often occur when a debtor is insolvent or has gone out of business. The competition is often between creditors. An owner or general contractor will normally prefer to pay a subcontractor that supplied labor and materials to the project, rather than to a bank that has a security interest in the debtor-trustee's accounts receivable.

In any event, a notice or demand letter reciting a trust fund law or agreement will often help obtain direct payment from an owner or general contractor.

Involuntary Trustees

A trustee cannot convey good title to trust property, because he has no good title. The creditor-beneficiary is always the true owner of a trust fund. If a thief steals your car and then "sells" it, you still own the car and can recover it. The thief could not grant an ownership interest in the car, because the thief had no good title to convey.

What if the debtor-trustee has received the trust fund and then paid it over to another creditor, friend or family member? The creditor-beneficiary may need to collect directly from such a third party as an "involuntary trustee." This person did not agree to be a trustee but could be required to act as trustee nonetheless.

A trustee cannot give trust property away. Many of the involuntary trustee cases come down to whether the recipient was a "bona fide purchaser," that is, someone who paid good money for the property without knowledge of the breach of trust. If the recipient of the money did not pay for it, they cannot be a bona fide purchaser and must return the money to the beneficiary.

Some states will allow a trust beneficiary to force repayment from an innocent third party (involuntary) trustee who was not aware of the trust.[40] However, many states will impose involuntary trustee status only on one who

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[36] *In re Pacocha*, 9 B.R. 531 (Bkrtcy W.D. Wis. 1980).

[37] UCC §9-607.

[38] *Williams v. Dickinson County Bank*, 175 Va. 359, 7 S.E.2d 885 (1940).

[39] *Trio Forest Products v. FNF Const.*, 182 Ariz. 1 (App. 1994).

[40] *The St. Joe Company v. Norfolk Redevelopment and Housing Authority*, 283 Va. 403, 408-09, 722 S.E.2d 622, 625-26 (2012), *(2012), citing Faulknier v. Shafer,* 264 Va. 210, 215, 563 S.E.2d 755, 758, (2002) [When property is given or devised to a defendant in breach of a donor's or testator's contract with a plaintiff, equity will impose a constructive trust upon that property in the hands of the recipient even though (1) the transfer is not the result of breach of a fiduciary duty or an actual or constructive fraud practiced upon the plaintiff, and (2) the donee or devisee had no knowledge of the wrongdoing or breach of contract].

knowingly takes charge of the trust or any of its parts.[41] The beneficiary has a right that no person shall knowingly aid the trustee in committing a breach of his duties. There is no dispute on this principle, but there can be difficulties deciding whether certain conduct amounts to a participation in a breach of trust. If a third party helps or takes part with the trustee in a breach of trust, a creditor-beneficiary may be able to trace the trust property and make a claim against the involuntary trustee.[42]

There are two elements for wrongful participation in a breach of trust:

1. An act or omission which furthers or completes the breach of trust by the trustee
2. Knowledge at the time that the transaction amounted to a breach of trust.[43]

Many of the involuntary trustee cases will come down to the quality of the involuntary trustee's knowledge that their receipt of the money was a breach of trust. A third person has notice of a breach of trust not only when they have actual knowledge but also when they *should* know of the trust. An involuntary trustee knows facts that would lead a reasonable intelligent and diligent person to inquire whether they are receiving funds from a trustee committing a breach of trust.[44]

If a creditor-beneficiary cannot prove involuntary trustee status, then the trust is probably broken when the money leaves the hands of the debtor-trustee. Although there is no strict deadline in enforcing trust fund rights, this provides a practical deadline. It is important to enforce trust fund rights while the trustee still has the money. This may not be long.

Trustee Cannot Grant Security Interest in Trust Funds

Secured creditors of the debtor-trustee cannot obtain a security interest in trust funds.[45] Just as a trustee cannot convey good title by selling or giving away trust property, a trustee also cannot grant a security interest in property it does not own.[46] This is true even if the secured creditor has a "super priority" security interest in a bankruptcy proceeding.[47]

Set-Off Rights

What if the trust funds are in a bank account and the debtor-trust owes the bank money on an unrelated transaction? It would seem that if a trustee cannot grant a valid security interest in a trust fund, then a bank in this situation also could not have set-off rights. However, at least one case describes this as a "minority rule" not followed by most courts.

The United States Court of Appeals for the Sixth Circuit has stated that the majority rule is that a bank may set-off obligations to the bank against a bank account, where the bank "has no knowledge of the interest of a third party in an account."[48] This majority rule still has a "no knowledge" requirement,[49] similar to the involuntary trustee status described above. In other words, a bank still could not set-off obligations if the bank had reason to know that the funds in the bank account were trust funds.

The United States Court of Appeals for the Sixth Circuit went on to observe, however, that Ohio follows the minority rule, also termed the "equitable rule," which states that a bank, even without express or implied knowledge

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[41] *Insurance Company of North America v. Genstar Stone Products Company*, 338 Md. 161, 184, 656 A.2d 1232, 1243 (1995), *quoting from Sandpiper North Apartments, Ltd. v. American National Bank & Trust Co*., 680 P.2d 983 (Oklahoma 1984).

[42] *Phillips Way v. Presidential Financial Corp.*, 137 Md. App. 209, 219-20, 768 A.2d 94, (Md.App. 2001), *quoting from* George G. Bogert in *The Law of Trusts and Trustees*, (Rev. 2nd ed. 1983) §868, 103-104.

[43] *Phillips Way v. Presidential Financial Corp.*, 137 Md. App. 209, 219-20, 768 A.2d 94, (Md.App. 2001), *quoting from* George G. Bogert in *The Law of Trusts and Trustees*, (Rev. 2nd ed. 1983) §901, 311.

[44] *Phillips Way v. Presidential Financial Corp*., 137 Md. App. 209, 219-20, 768 A.2d 94 (Md.App. 2001), *citing* restatement (Second) of Trusts (1958) §297, Comment (a).

[45] *Marrs-Winn Co., Inc. v. Giberson Electric Inc*., 103 F.3d 584 (7th Cir. 1996).

[46] It matters not whether the creditors' claim is perfected as the monies were held in trust for the creditor and never became a part of the debtor's estate. *Cutler-Hammer, Inc. v. Wayne*, 101 F.2d 823, 825 (5th Cir. 1939), cert. denied, 307 U.S. 635, 59 S. Ct. 1031 (1939). "[I]t therefore matters not whether a creditor of the estate is secured or unsecured as neither will have a claim to that which never enters the estate." *Marrs-Winn Co., Inc. v. Giberson Electric Inc*., 103 F.3d 584 (7th Cir. 1996).

[47] *Marrs-Winn Co., Inc. v. Giberson Electric Inc*., 103 F.3d 584 (7th Cir. 1996), *see also* Bankruptcy Code, 11 USC §363.

[48] *Federal Insurance Company v. Fifth Third Bank*, 867 F.2d. 330, 334-335 (6th Cir. 1989).

[49] *Federal Insurance Company v. Fifth Third Bank*, 867 F.2d. 330, 334-335 (6th Cir. 1989).

of a trust, cannot apply trust funds against funds that the trustee owes the bank, "where such lack of knowledge has not resulted in any change in the bank's position." In other words, if the bank has relied somehow on the existence of funds in the bank account, without knowledge of the trust, the bank may still be able to set-off.

In short, a bank or other third party's ability to set-off will be based on factors very similar to those used to determine whether a third party can be an involuntary trustee. Namely, it will depend on the quality of the third party's knowledge of the existence of the trust.

If an owner or other upstream contractor wished to set-off obligations, however, the situation would be different. Suppose a general contractor received funds from an owner for labor and materials supplied. These would constitute trust funds under most state trust fund laws. If the general contractor had back charges against a subcontractor for defective work, however, that subcontractor probably could not enforce trust fund rights to rise above its contract obligations. In other words, the subcontractor-beneficiary could not force the general contractor to pay more than the subcontractor would be owed under the subcontract agreement.

What if a supplier to the subcontractor tried to assert trust fund rights? The back charges against the subcontractor had nothing to do with defects in the supplier's material. Could the supplier force the general contractor to pay more than the subcontractor could?

A review of banking industry case law discussed above would indicate that the general contractor could not offset in this situation. A general contractor doing business in a state with a trust fund statute would probably have actual knowledge of the trust fund relationships. At the same time, this situation does seem different than that of the third party secured bank.

Personal Liability of Officers and Directors

In some states, the trust fund statute makes officers, directors or managing agents personally liable for misuse of trust funds. There are specific provisions for personal liability in some state codes.[50] The possibility of personal liability is an important protection for subcontractors and suppliers, who would otherwise have no remedy when a corporation went out of business. This concept of personal liability for trust funds seems similar to the personal liability attaching to officers and directors for failure to account for Internal Revenue Service Cost Section 941 taxes. Such personal liability does make individuals take their duties seriously for withholding taxes.

New York's Lien Law establishes a trust fund for the protection of subcontractors and suppliers, as well as personal liability for the misappropriation of such trust funds. The statute provides:

> Any trustee of a trust arising under this article [Article 3-A], and any officer, director or agent of such trustee, who applies or consents to the application of trust funds received by the trust as money or an instrument of the payment of money for any purpose other than the trust purposes of that trust, as defined in section seventy-one, is guilty of larceny and punishable as provided in the penal law...[51]

Under the Maryland Trust Fund Statute, personal liability can attach to "any officer, director or managing agent of any contractor or subcontractor..."[52] A "managing agent" means an employee of a contractor or subcontractor who is responsible for the direction over, or control of, money held in trust.[53]

Under the Maryland Trust Fund Statute, any officer, director or managing agent "who knowingly retains or uses the monies held in trust... for any purpose other than to pay those subcontractors for whom the monies are held in trust, shall be personally liable to any person damaged by the action."[54]

The potential for personal liability is very helpful but does have its shortcomings. The claimant must establish that the underlying construction contracts were subject to either the Maryland Little Miller Act (Bond Statute) or the Maryland Mechanics' Lien Statute, in order to establish that the Trust Fund Statute applies at all.[55]

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[50] Maryland Real Property Code Section 9-201, *et seq*.; 42 O.S. 1981 §§152, 153 (Oklahoma); MCL 570.152 (Michigan); Wis. Stat. 779.02, *et seq*. (Wisconsin).

[51] New York State Consolidated Laws, Article 3-A §79-a.

[52] Maryland Real Property Code Section 9-202.

[53] Maryland Real Property Code Section 9-201(a).

[54] Maryland Real Property Code Section 9-202; *Argonaut Ins. Co. v. Wolverine Constr., Inc*., 976 F. Supp. 2d 646 (D. Md. 2013).

[55] *See below; C&B Constr., Inc. v. Dashiell,* 460 Md. 272, 289, 190 A.3d 271, 281 (2018).

Contractors are also allowed to "commingle" funds under the Maryland Statute.[56] In other words, it is not necessary to keep the trust funds in separate accounts. Most general contractors are working on several projects. Funds are entering and leaving the general contractor's bank account for many purposes. If a general contractor can show that all funds leaving the account were used to pay subcontractors and suppliers on *some* construction project, then it is unlikely that a court will hold any individual officer or director personally liable.[57]

The Maryland Trust Fund Statute does not impose personal liability merely upon the failure to pay subcontractors in full, absent fraud or misappropriation of funds. A creditor-claimant must show that funds paid by contractors to subcontractors were earmarked for payment to a specific payee, that payment was not made, and that those funds can be tracked in order to impose personal liability.[58] The mere insufficiency of funds to pay all down-the-chain subcontractors or suppliers is not a basis for the imposition of personal liability. Claimants must show that a person in control of the corporation "knowingly retained or used" the moneys held in trust for any purpose other than to pay the trust beneficiaries.[59]

As a practical matter, a contractor will usually be "robbing Peter to pay Paul" for a long time prior to insolvency. A claimant may not be able to establish personal liability, unless there is a blatant case where an individual officer used funds for personal reasons.

Ability to Discharge in Bankruptcy

Once a corporation goes out of business, its creditors may seek to establish personal liability on the corporate officers and directors pursuant to a trust fund statute. Those corporate officers, directors or managing agents may personally file bankruptcy soon thereafter. Can personal liability under a trust fund statute be discharged in bankruptcy? In other words, will a personal bankruptcy get rid of personal liability under a trust fund statute?

Under the Bankruptcy Code, an individual cannot get a discharge from any debt obtained by false pretenses, a false representation or actual fraud.[60] In order to avoid discharge, a creditor must prove:

1. The debtor made a representation,
2. At the time the debtor knew the representations were false,
3. The debtor made the representations with the intention and purpose of deceiving the creditor,
4. The creditor relied on such representation, and
5. The creditor sustained loss and damage as the proximate result of the representations.[61]

This standard required under the Bankruptcy Code may be more than is required by a state trust fund statute. State law would control what is necessary to obtain a personal judgment against an officer, director or managing agent. If that individual becomes insolvent and files bankruptcy, however, the Bankruptcy Code determines whether or not the debt will be discharged in bankruptcy.

Many trust fund statutes or agreements also create "fiduciary responsibility" for officers, directors or managing agents. The 1995 amendments to the Maryland Trust Fund Statute would seem to create an express trust or fiduciary relationship.[62] Debts arising from a breach of fiduciary duty can also be non-dischargeable under the Bankruptcy Code.[63] To avoid a bankruptcy discharge on this type of debt, the claimant must prove:

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[56] Maryland Real Property Code Section 9-201(c)(1).

[57] *Collins/Snoops Assocs. v. CJF, LLC*, 190 Md. App. 146, 167, 988 A.2d 49 (Md. Ct. Spec. App. 2010) [Subcontractor failed to present evidence to prove that any funds were "held in trust." Where funds paid by [an owner] to [a contractor] are earmarked for payment to a specific payee, but payment is not made, and those funds can be tracked, personal liability may be imposed. The mere insufficiency of funds to pay all down-the-chain subcontractors or suppliers is not a basis for the imposition of personal liability on the managing agent of the debtor contractor corporation].

[58] *Argonaut Ins. Co. v. Wolverine Constr., Inc*., 976 F. Supp. 2d 646, 659 (D. Md. 2013).

[59] *Selby v. Williams Constr. Servs*., 180 Md. App. 53, 63-65, 948 A.2d 132 (Md. Ct. Spec. App. 2008) [Absent segregation or earmarking of draws for payment, we cannot find a misuse or misapplication of those funds that would establish personal liability. The court noted that the individual defendant had demonstrated good faith and had made personal loans to his construction company to pay subcontractors, using a line of credit secured by his home].

[60] 11 USC §523(a)(2)(A).

[61] *In re Woodall*, 177 B.R. 517, 520 (Bankr. D. Md. 1995) [The creditor must prove these elements by a preponderance of the evidence, rather than by a clear and erroneous standard].

[62] Maryland Real Property Code 9-201(b)(2). *See also* Wisconsin "theft-by-contractor" statute, Wis. Stat. §779.02(5); *In re Coch* 197 B.R. 654 (Bankr. W.D. Wisc. 1996).

[63] 11 USC §523(a)(4).

1. The existence of a trust,
2. That the debtor was a fiduciary of that trust, and
3. Fraud or defalcation by the debtor while acting as a fiduciary of the trust.[64]

Defalcation means a willful neglect of duty.[65] Defalcation in bankruptcy requires more than negligence, though less than fraud.[66] A claimant must show more than mere negligence.[67]

Whether there would be individual liability for breach of fiduciary duty should depend on whether a trust fund statute or agreement makes the individual officer or director a trustee, as opposed to only the corporation being a trustee. For example, the Maryland Trust Fund Statute now states, "An *officer, director or managing agent* of a contractor or subcontractor who has direction over or control of money held by trust ... *is a trustee* for the purpose of paying the money to the subcontractors who are entitled to it."[68]

Punitive and Treble Damages

If a creditor can prove actual fraud by a trustee or fiduciary, then it should be possible to obtain punitive damages in addition to compensatory damages.

To prove actual fraud, a claimant would have to produce clear and convincing evidence of the five elements discussed above to avoid bankruptcy discharge. If a creditor can prove these five elements by clear and convincing evidence, the claimant should be entitled to punitive damages under either a trust fund statute or any type of voluntary or contractual trust agreement.[69]

The same should be true if a claimant can prove breach of trust or breach of fiduciary duty as discussed above. Under many state laws, punitive damages may be awarded for breach of a fiduciary duty.[70] Some states require proof of conduct that is willful or wanton and in reckless disregard of rights.

Some states also have special laws allowing for recovery of triple damages for fraudulent activity.[71] These treble damage laws may be applicable to a trust fund statute.

Insolvency Protections and Bankruptcy

A federal bankruptcy court cannot circumvent a state's legislature determination that public construction contractors and suppliers require special protection.[72] Federal bankruptcy law will recognize and enforce the property right created by state law.[73] Federal bankruptcy law does not determine whether a trust exists. State law establishes a trust relationship, either through a trust fund statute or any type of voluntary trust agreement.[74] A creditor will need to look at the state law where the transactions occurred, therefore, to determine the result once a debtor files bankruptcy.

A state law trust will have important implications in a bankruptcy. The trust fund is simply not "property of the estate." The United States Supreme Court has stated that Congress plainly excluded property of others held by the

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[64] *In re Coch* 197 B.R. 654, 656 (Bankr. W.D. Wisc. 1996).

[65] *In re Moreno* 892 F.2d 417, 421 (5th Cir. 1990); *See Carlisle Cashway, Inc. v. Johnson* (*In re Johnson*), 691 F.2d 249 (6th Cir. 1982); *Meyer v. Rigdon*, 36 F.3d 1375 (7th Cir. 1994).

[66] *Meyer v. Rigdon*, 36 F.3d 1375, 1382-85 (7th Cir. 1994).

[67] *Grogan v. Garner,* 498 U.S. 279; *Patel v. Shamrock Floorcovering Servs., (In re Patel),* 565 F.3d 963, 970 (6th Cir. Mich. 2009) *citing In re Johnson,* 691 F.2d 249 (6th Cir. Mich. 1982) [defalcation only occurs when there is more than mere negligence r a mistake of fact. There is no such thing as "defalcation per se" and instead the debtor must have been objectively reckless in failing to properly account for or allocate funds]; *but see Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510, 512 (2d Cir. 1937), where Judge Learned Hand stated that because "defalcation" ought not to be redundant with "fraud" and "embezzlement," subjective, deliberate wrongdoing was not an element required to establish defalcation. Some circuits have held that "defalcation" might include "innocent" or merely negligent conduct. *See Republic of Rwanda v. Uwimana (In re Uwimana),* 274 F.3d 806, 811 (4th Cir. 2001); *Lewis v. Scott (In re Lewis),* 97 F.3d 1182, 1186 (9th Cir. 1996)).

[68] Maryland Real Property Code 9-201(b)(2). This 1995 amendment would seem to change the result in *Ferguson Trenching v. Kiehne* and the *In re Woodall* case (177 Bankr. 517).

[69] In Maryland, an intentional breach of fiduciary duty is a tort for which punitive damages may be awarded. *Hartlove v. Maryland School for the Blind*, 111 Md. App. 310 (1996); *Campbell v. Darien Lumber Co*., 1998 unpublished WI opinion.

[70] *Loehrke v. Wanta Builders, Inc.*, 445 NW 2d 717, 151 Wis. 2d. 695 (Wis. App. 1989).

[71] *See e.g.*, Wis. Statute 895.80; *see also Tri-Tec Corp. v. Americomp Services Inc.*, 646 NW 2d 822, 254 Wis. 2d 418 (Wis. 2002).

[72] *Universal Bonding Insurance Co. v. Gittens and Sprinkle Enterprises, Inc.*, 960 F.2d 366 (3d Cir. 1992); *Huizinga v. United States*, 68 F.3d 129 (6th Cir. 1995).

[73] *Selby v. Ford Motor Co*., 590 F.2d 642, 647 (6th Cir. 1979).

[74] *Mid-Atlantic Supply Inc., v. Three Rivers Aluminum Co.*, 790 F.2d 1121 (4th Cir. 1986).

debtor in trust at the time of filing the bankruptcy petition.[75] The debtor or bankruptcy trustee has no real interest in trust funds.[76] The trustee holds only bare legal and not equitable title. Courts have consistently found that funds are not property of the bankruptcy estate, if they are covered by construction industry trust fund statutes.[77]

Without a trust relationship, this fund would be an asset of the debtor. The fund either would be property of the debtor in its bank account or in an account receivable from an owner or general contractor. The general rule is that this "property of the estate" would go into the general pot to be shared by all general unsecured creditors. As discussed at length in the bankruptcy chapter of this book,[78] insolvency or bankruptcy is no longer a battle between the debtor and creditor. It is a battle between creditors over the limited assets available for distribution.

A creditor always wants to identify a receivable somewhere and establish that the creditor has an absolute right to collect the entire receivable and does not need to share it with any other creditors. A creditor can accomplish this, for example, in a mechanic's lien proceeding. If a creditor establishes valid mechanic's lien rights, this particular receivable does not go into the general pot to be shared with other creditors. The mechanic's lien claimant can keep the entire receivable. Similarly, a bank may have a blanket security interest and UCC financing statement covering all accounts receivable of the debtor. If this security interest proves to be valid, then this secured creditor can collect these receivables and does not need to share.

A trust fund relationship is a mechanism by which a creditor can claim exclusive ownership of one receivable from a property owner or general contractor. Technically, this is not a security interest and a trust fund claimant is not a secured creditor. Instead, the trust fund creditor is something even better. The receivable is simply not property of the estate. The debtor does not own this property and is simply "holding" the beneficiary's property.

This distinction has some similarities with a "contract for deed" or "installment contract" in a real estate sale. In this arrangement, the debtor makes payments each month for several years. When the payments are complete, the seller then deeds the property to the buyer. The debtor does not "own" the property until he is finished making payments. This same transaction could be structured as a mortgage where the seller deeds the property now and takes back a mortgage. It is safer for the creditor, however, if the debtor never owns the property until the debt is paid in full. The creditor will not need to "foreclose," because the creditor still owns the property. The debtor is simply in breach of contract and loses its rights under the contract.

Similarly, a trust fund is not property of the estate, whether the money is sitting in the debtor's bank account or is being held by a property owner. A trust fund creditor-beneficiary will prevail over a secured creditor claiming priority over a trust fund receivable.[79] A trust fund creditor-beneficiary may be able to collect funds directly from an owner or a general contractor, may be able to force a debtor in bankruptcy to release funds, may be able to assert personal liability on officers or directors under a trust fund law, and may have defenses against future preference litigation.

However, it is apparent that voluntary trust fund agreements will have more difficulty in a bankruptcy court than will trust fund statutes. Bankruptcy courts have stated that they are "not inclined to allow creditors to utilize a trust theory as a means of obtaining preferential treatment in a bankruptcy," since "equality of distribution among creditors is a central policy of the Bankruptcy Code.[80] The mere use of the word "trust" in an agreement may not succeed in providing preferential treatment.[81] The issues of tracing, commingling and an identifiable trust fund, discussed above, can still be a problem in bankruptcy.

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[75] *See* §541(b); H.R.Rep. No. 95-595, p. 368 (1977); S.Rep. No. 95-989, p. 82 (1978); *United States v. Whiting Pools*, 462 U.S. 198, 205 n10, 103 S.Ct. 2309, 2314 (1983).

[76] *Beigler v. I.R.S.*, 496 U.S. 53 (1990); *Mid-Atlantic Supply Inc., v. Three Rivers Aluminum Co.*, 790 F.2d 1121 (4th Cir. 1986).

[77] *Universal Bonding Insurance Co. v. Gittens and Sprinkle Enterprises, Inc.*, 960 F.2d 366 (3rd Cir. 1992); *Huizinga v. United States*, 68 F.3d 129 (6th Cir. 1995); *In re Marrs-Winn Co. Inc.*, 103 F.3d 584 (7th Cir. 1996) ["It is a well-settled principle that debtors do not own an equitable interest in property that they hold in trust for another, and, thus, those trust funds are not 'property of the estate.'"], *citing City of Farrell v. Sharon Steel Corp.*, 41 F.3d 92, 95 (3d Cir. 1994); *See also T&B Scottdale Contractors Inc. v. United States*, 866 F.2d 1372 (11th Cir. 1989).

[78] *See* chapter, Bankruptcy Primer for Creditors; section, Introduction; subsection, Creditors v. Creditors.

[79] *Marrs-Winn Co. v. Giberson Electric, Inc.*, 103 F.3d 584 (7th Cir. 1996), *relying in part on Federal Insurance Co. v. Fifth Third Bank*, 867 F.2d 330 (6th Cir. 1989).

[80] *In re Kulzer Roofing, Inc.*, 139 B.R. 132, 138 (Bankr. E.D. Pa. 1992); *See also In re Morales Travel Agency*, 667 F.2d 1069, 1071 (1st Cir. P.R. 1981) [If a ritualistic incantation of trust language were deemed conclusive, it would be a simple matter for one creditor, at the expense of others, to circumvent the rules pertaining to the creation of bona fide security interests].

[81] *In re Kulzer Roofing, Inc.*, 139 B.R. 132, 142 (Bankr. E.D. Pa. 1992); *In re Morales Travel Agency*, 667 F.2d 1069, 1072 (1st Cir. P.R. 1981).

Collecting Trust Funds Directly from Third Parties

As discussed above, a creditor-beneficiary may be able to collect trust funds directly from a general contractor or upstream contractor. In one bankruptcy court case, a sub-subcontractor obtained payment directly from a general contractor. The bankruptcy trustee failed in an attempt to force the creditor-beneficiary to repay the money to the bankruptcy court. The bankruptcy trustee unsuccessfully argued that the sub-subcontractor was effectively collecting on the debtor's account receivable, diminishing the value of the bankruptcy estate.[82] The court dismissed that argument as purely theoretical. The pool of funds from which the unsecured creditors may recover was not diminished.

Collecting Trust Funds Directly from Bankruptcy Estate

The pool of funds available to the debtor and its reorganization or to all creditors for payment of claims is not diminished if the debtor pays the trust beneficiaries. The trust funds would have to be held and managed by the debtor-trustee for the benefit of the beneficiaries only. If trust funds were paid into the bankruptcy estate, the debtor's sole permissible administrative act would be to pay over or endorse the sums due to the beneficial owners of the trust property.[83]

Personal Liability of Officers and Directors

As discussed above, some state trust fund laws create personal liability for the officers, directors or managing agents of corporations in the construction industry.[84] This statutory personal liability is similar to having a personal guaranty from an officer or director. If the corporation is in bankruptcy, a creditor can no longer sue the corporation. The creditor is free to pursue the personal guarantor, however, unless the personal guarantor files bankruptcy.

If an individual guarantor files bankruptcy, they will normally get a discharge from contract debts arising from guaranties. As discussed above, however, individuals may *not* be able to get a discharge from trust fund obligations.[85] This ability to pursue individuals, even in bankruptcy, can be an important weapon for a creditor in bankruptcy.

Bankruptcy Preference Protections

A debtor-contractor has a property right in trust funds only if there is a balance remaining after all the trust beneficiaries have been paid.[86] In other words, a contractor receiving payment must pay the supplier on the contract first, before taking its profit. The bankruptcy trustee has no right to appropriate trust funds for the benefit of general creditors.[87] In other words, trust funds received by a creditor-beneficiary cannot be a preference and do not have to be repaid to the bankruptcy estate.[88] Bankruptcy law simply does not authorize a trustee to distribute other people's money amongst a bankrupt's creditors.[89]

Accordingly, a creditor receiving a preference repayment demand or lawsuit should investigate whether a trust fund agreement existed in a contract or credit agreement. If not, a state trust fund law may provide an effective defense to the preference action. Trust fund claims do not have short notice deadlines, as do mechanic's lien or payment bond claims. This is one advantage to trust fund claims. In other words, even if a creditor took no action to enforce trust fund rights and even if the creditor was never aware of the trust funds rights, there may still be an effective defense to a future preference action.[90]

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[82] *Universal Bonding Insurance Co. v. Gittens and Sprinkle Enterprises, Inc.*, 960 F.2d 366 (3d Cir. 1992); *Huizinga v. United States*, 68 F.3d 129 (6th Cir. 1995); *In re Marrs-Winn Co. Inc.*, 103 F.3d 584 (7th Cir. 1996).

[83] *Georgia Pacific Corps. v. Sigma*, 712 *F.2d 962* (5th Cir. 1983); *United Parcel Service v. Weber Industries, Inc.*, 794 F.2d 1005 (5th Cir. 1986).

[84] *See* subsection above, Personal Liability of Officers and Directors.

[85] *See* subsection above, Personal Liability of Officers and Directors; sub-subsection, Ability to Discharge in Bankruptcy.

[86] *Selby v. Ford Motor Co.*, 590 F.2d 642, 646 (6th Cir. 1979), *citing Aquilino v. U.S.*, 10 N.Y.2d 271, 279 (1961) (Decision on remand from the United States Supreme Court).

[87] *Selby v. Ford Motor Co.*, 590 F.2d 642, 644 (6th Cir. 1979).

[88] *See* chapter, Bankruptcy Primer for Creditors; section, Preferences; subsection, The Trustee's Burden of Proof; sub-subsection, Trust Fund Statutes and Agreements.

[89] *Universal Bonding Insurance Co. v. Gittens and Sprinkle Enterprises, Inc.*, 960 F.2d 366 (3d Cir. 1992); *Huizinga v. United States*, 68 F.3d 129 (6th Cir. 1995); *In re Marrs-Winn Co. Inc.*, 103 F.3d 584 (7th Cir. 1996).

[90] *See* chapter, Bankruptcy Primer for Creditors; section, Preferences; subsection, The Trustee's Burden of Proof; sub-subsection, Trust Fund Statutes and Agreements.

Most cases seem to put the burden on the preference defendant to trace funds and prove that the money received were trust funds.[91] This is at odds, however, with the trustee's burden to prove that the prepetition transfer was property of the estate. Other cases have put this burden on the trustee.[92]

TRUST FUND AGREEMENTS

All parties generally have freedom of contract. A supplier or subcontractor could simply refuse to supply labor or materials if some "unrelated" secured creditor would have first priority to the resulting receivable. An owner or general contractor could refuse to award a contract, if a contractor refused to hold completion costs in trust. Logically, there is no reason why a potentially insolvent contractor and their bank can decide between themselves that the bank will have first priority to all receivables. Trust fund statutes are created as a matter of public policy to protect owners and grant first priority to suppliers and subcontractors. A consensual trust fund agreement comes to the same result. Owners and general contractors, as well as lower tier subcontractors and suppliers, can simply refuse to do business unless their contracts include trust fund provisions.

Based on court case law on public trust fund statutes, consensual trust provisions in contracts enable owners, contractors and suppliers to "trump" or preserve priority over a debtor's secured lenders and avoid general unsecured creditor status in bankruptcy. Consensual trust fund provisions in commercial contracts seem to be a fairly new idea. As a result, there is little court case law providing direct guidance. There is much more case law on the workings of trust fund statutes, both in state and federal bankruptcy courts. We believe these cases provide guidance on the operation of wording in various trust fund provisions, whose language could be duplicated in contracts. This case law also describes the relationship among trustees, beneficiaries, secured lenders and other third parties.

There is also a great deal of case law regarding trust agreements historically. Trusts have existed for centuries in connection with estate planning, protection of assets, real estate development and other commercial purposes. There is no doubt that consensual trust agreements have a significant legal status. It is only their use in commercial contracts that is at all new or uncertain. It is fairly clear, for example, that no specific form or wording is required for a consensual trust agreement. It is the intent of the parties that is controlling.[93] A long document with various provisions is unnecessary. If it is clear that the creator of the trust (settlor) intended to create a trust and did not intend the trustee to take ownership of the property, then a trust exists. The language can be quite short as long as the intent is clear.[94] On the other hand, the mere use of the word "trust" alone may not succeed in providing preferential treatment.[95] The issues of tracing, commingling and an identifiable trust fund, discussed above, can still be a problem.

It seems clear that there are no public policy or fairness objections to consensual trust fund agreements. The Maryland state legislature has decided to inject involuntary trust relationships into construction contracts to promote justice and fairness. It would seem that the same relationship created by agreement also promotes justice and should be protected by the law.

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[91] *Lovett v. Homrich, Inc.(In re Philip Services Corp.)* 359 B.R. 616 (Bankr. S.D. Tex. 2006); *Cunningham v. T & R Demolition, Inc. (In re ML & Assocs.)*, 301 B.R. 195, 200 (Bankr. N.D. Tex. 2003) [Because the preference defendant could not trace project payments through commingled bank accounts, the preference defendant failed to show that the funds it received were trust funds].

[92] *In re Building Dynamics, Inc*., 134 B.R. 715, 717 (Bankr. W.D.N.Y. 1992), *citing In re Casco Electric Corp*., 28 B.R. 191, 195 (Bankr. E.D.N.Y. 1983) *aff'd* 35 Bankr. 731, 732 (D.C. 1983) [Since it is undeniable that the debtor received monies constituting trust assets, the burden lay on the trustee to prove that the money paid was not part of such trust assets. Indeed, it is arguable that by the very act of payment, the debtor identified the funds as trust assets].

[93] *From the Heart v. African Methodist*, 370 Md. 152, 803 A.2d 548 (2002).

[94] *M&T Elec. Contrs., Inc. v. Capital Lighting & Supply, Inc. (In re M&T Elec. Contrs., Inc.),* 267 B.R. 434, 479-480 (Bankr. D.D.C. 2001), *citing Old Republic Nat'l Title Ins. Co. v. Tyler (In re Dameron),* 155 F.3d 718 (4th Cir. Va. 1998) [An express trust is created when the parties affirmatively manifest an intention that certain property be held in trust for the benefit of a third party]. *See Peal v. Luther*, 199 Va. 35, 97 S.E.2d 668, 699 (1957)]; *Holmes Envtl. v. Suntrust Banks (In re Holmes Envtl., Inc.),* 287 B.R. 363, 375 (Bankr. E.D. Va. 2002) [An express trust may be created "without the use of technical words." All that is necessary are words, or circumstances "which unequivocally show an intention that the legal estate was vested in one person, to be held in some manner or for some purpose on behalf of another ...," *Broaddus v. Gresham*, 26 S.E.2d 33, 35 (Va. 1943)]; *see also Woods v. Stull*, 182 Va. 888, 30 S.E.2d 675, 682 (1944); *Schloss v. Powell*, 93 F.2d 518, 519 (4th Cir. Va. 1938); *May v. Michael*, 18 Md. 227 (1862); *Sieling v. Sieling*, 151 Md. 536 (1926).

[95] *In re Kulzer Roofing, Inc*., 139 B.R. 132, 142 (Bankr. E.D. Pa. 1992); *In re Morales Travel Agency*, 667 F.2d 1069, 1072 (1st Cir. P.R. 1981).

Protective Provisions for Owners and General Contractors

There is some significant case law in support of consensual trust agreements in commercial contracts. One case before the United States Court of Appeals involved a general contract that stated:

> All monies paid on account to any contractor for materials or labor *shall be regarded as fund [sic] in his trust for payment of any and all obligations relating to this contract* and no such amount of monies shall be permitted to accrue to the contractor until all such obligations are satisfied. Evidence satisfactory to the state may be required to show that all current obligations relating to this work are satisfied before releasing any payment due on the work. Before payment of the final estimate, each contractor shall file an affidavit with the state, stating that the monetary obligations [sic] relating to lienable items in connection with the work have been fulfilled.[96]

One party to the lawsuit asserted that the contractor agreed in this contractual provision to hold as trustee all progress payments received from the state.[97]

Notice that this contract provision is similar to provisions in many construction contracts, requiring the contractor to promptly pay for all labor and materials on receipt of payment, providing affidavits of payment and avoiding liens. The difference was in the first sentence alone, which used the word "trust." The federal Court of Appeals reviewed historic trust law, including the need to show that a trust was clearly intended. The court decided that an express trust was formed by this contract provision and decided that the subcontractors and suppliers that should have received the money had priority over the bank with a recorded security interest in the receivable. The bank, which actually already had possession of the deposit, was required to return the money. The bank was not allowed to set-off the deposit against money the bank was owed by the same debtor.

In another case, a subcontract provided:

> "All sums tentatively earned by Subcontractor by the partial or complete performance of the Subcontract Work and any balance of unearned Subcontract price if and when paid by Owner to Contractor, shall constitute a fund for the purpose of (a) full and timely completion of the Subcontract Work and fulfillment of all Subcontract requirements, (b) payment of any back charges or claims due Contractor, from Subcontractor, based upon this Subcontract or otherwise, and (c) payment to the sub-subcontractor, workers, design professionals, material and service suppliers of Subcontractor, and others who have valid and enforceable mechanic's lien claims or valid and enforceable bond claims (if project is bonded). *Such Tentative earning shall not be due or payable to Subcontractor… or anyone else claiming in Subcontractor's… place and stead, including but not limited to a Trustee in bankruptcy or receiver, until and unless such Subcontract Work is fully and satisfactorily completed, all Subcontract requirements are fulfilled, Contractor and such persons are fully paid and satisfied and the provisions… below are fully satisfied. Subcontractor agrees to promptly pay all sub-subcontractors, workers, vendors and suppliers* of Subcontractor and to provide Contractor with each application for periodic progress payments, and the final payment, such lien waivers of proof of such payment as Contractor may require. At any time, Contractor may demand additional written evidence of Subcontractor's capability to perform and of such payments to such persons by Subcontractor. Subcontractor declares that all funds received by Subcontractor from Contractor hereunder shall be deemed to be held by Subcontractor in *trust* for the benefit of those furnishing work, labor, materials, services, equipment, etc., to or through Subcontractor for the Subcontract Work."[98]

This contract provision also contains common agreements to promptly pay all sub-subcontractors, provide lien waivers and proof of payment. The Seventh Circuit Court of Appeals found that this contract provision created a trust. Notice that this subcontract provision also created a trust agreement to protect the general contractor against completion costs for failure to complete the subcontract. This subcontract provision would seem to be very beneficial for any general contractor. After the subcontractor filed for a bankruptcy, the general contractor was able to enforce

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[96] *Federal Insurance Company v. Fifth Third Bank*, 867 F.2d. 330, 332 (6th Cir. 1989).

[97] *Federal Insurance Company v. Fifth Third Bank*, 867 F.2d. 330, 332 (6th Cir. 1989). The claimant in this case was actually a bonding company that was subrogated to (had taken over the rights of) subcontractors and suppliers.

[98] *In re Marrs-Winn Co. Inc.*, 103 F.3d 584, 591 (7th Cir. 1996).

this trust fund agreement, even against a secured lender that had a bankruptcy court approved "super priority" security interest in all property of the debtor. The secured lender was forced to return to the general contractor funds it had seized from a bank account.

The language quoted above seems to provide a good model for trust language to protect an owner or general contractor in a contract. This would help protect payment to subcontractors and suppliers in the event of bankruptcy and protect the owner or general contractor from double liability under mechanic's lien law or payment bonds. In the event of insolvency, this language should also help an owner or general contractor recover the costs of completing a project.

Protections for Suppliers and Subcontractors

Lower tier subcontractors and suppliers also have opportunities to create trusts. It would be preferable to get a "three party" agreement, with the endorsement of the owner (or general contractor). This is helpful as a practical matter. If the owner (or general contractor) has approved the arrangement, they can help make sure money flows to the creditor-beneficiary. This probably will also help ensure an enforceable trust exists.[99]

Owners or general contractors may resist this arrangement, as joint check agreements are often resisted. It is respectfully suggested to owners and contractors, however, that trust fund relationships have all the advantages described above for general contractors and owners.

It is often best to create a trust relationship in the form of a "joint check agreement," because the players on the construction project are familiar and hopefully comfortable with this concept. The 'joint check" provisions also are helpful procedures to follow to make sure that trust funds get to the creditor-beneficiary. Fairly minor changes are necessary to a "standard" joint check agreement in order to create a trust agreement. Suggested language for a Trust Fund Joint Check Agreement would be:

AGREEMENT

In consideration of the sum of one dollar cash in hand paid and the supply of labor and/or materials by Seller on the Project, the receipt and sufficiency of which is hereby acknowledged ________________________ owner or general contractor ("Owner/G.C."), ________________________ (Seller) and ________________________ contractor or Seller's customer ("Contractor") and ________________________ ("Seller"), agree as follows:

1. All checks issued by Owner/G.C. to Contractor for (all labor or materials supplied) or (only for the Seller's sales price of material supplied by Seller) on the ________________________ construction project ("Project") shall be made jointly payable to Contractor and Seller and shall be promptly delivered to Seller. Owner/G.C. may rely on any written notice provided by Seller, stating the total current indebtedness of Contractor to Seller and limiting any obligation under this Agreement for any current requisition. Contractor appoints Seller its attorney in fact to sign or endorse on behalf of Contractor all checks received from Owner/G.C.
2. **Contractor agrees that all funds owed to Contractor from anyone or received by Contractor to the extent those funds result from the labor or materials supplied by Seller shall be held in trust for the benefit of Seller ("Trust Funds"). Contractor agrees it has no interest in Trust Funds held by anyone, to segregate and to make no use of, except to promptly account for and transmit to Seller all such Trust Funds no later than on demand.**
3. Seller agrees to supply labor and/or materials to the Project in accordance with Seller's contract.
4. This Agreement is not in payment of obligations of Contractor to Seller and will not affect Seller's rights to withdraw or refuse further credit, or Seller's rights to any payment bond, mechanic's lien, trust fund or other legal rights.

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[99] *Mid-Atlantic Supply Inc. v. Three Rivers Aluminum Co.*, 790 F.2d 1121 (4th Cir. 1986).

It should also be possible to create trust agreements in contracts, proposals or quotes. It is advantageous, at least as a practical matter, to get the agreement of the person that will issue payment to the debtor. This should not be legally necessary, however, to create a trust. A creditor could simply refuse to supply labor or material unless the debtor agreed to hold resultant funds in trust. The operative trust language, shown above, can be included in any contract, proposal or quote as follows:

> Contractor agrees that all funds owed to Contractor from anyone or received by Contractor to the extent those funds result from the labor or materials supplied by Seller shall be held in trust for the benefit of Seller (Trust Funds). Contractor agrees it has no interest in Trust Funds held by anyone, to segregate and to make no use of, except to promptly account for and transmit to Seller all such Trust Funds no later than on demand.

It may also be possible to include this language in a blanket credit agreement for all transactions. It would be preferable, however, to have the provision in a separate contract for each project.[100]

There is case law in *some* states stating that a failure to segregate or require segregation of funds prevents the creation of a trust.[101] Other states do not seem to have this requirement.[102] It is certainly preferable to require that the funds be put in a segregated account. This would make it easier to police the use of the trust funds and help insure that a court would recognize the existence of a trust.

There is also some case law that no trust is created until the trust is funded. However, the prevailing rule seems to be that a trust can be immediately created with just the promise to pay money to the trustee in the future.[103] Expansions of this language could include the right to collect funds directly from third parties, such as owners or general contractors. A trustee could also agree that there is no need to trace particular funds from particular projects and that whatever money is left in a bank account are trust funds. These provisions are probably enforceable against the trustee. They may not, however, be enforceable against third parties holding the money. Nonetheless, it may help convince a fund holder to voluntarily cooperate. It may be possible and is preferable to get the stakeholder (owner or general contractor) to agree to these provisions by endorsing the contract, by separate letter agreement or by joint check agreement.

It may be helpful to get a trustee to agree to act "without compensation." In some states, the trustee may otherwise have a claim to a percentage of the trust fund as compensation for acting as trustee.[104]

Trust fund agreements have significant advantages for lower tired subcontractors and suppliers. They should be easy to sell as creating no additional cost to the debtor. There is no filing fee and no deadline as compared to mechanic's lien or bond litigation.

This trust fund language creates a relationship that should work just like the trust fund laws. The debtor-trustee agrees that all funds received are held in trust, to the extent funds result from labor or materials supplied. If the debtor-trustee files bankruptcy, these funds will not be property of the bankruptcy estate. The creditor-beneficiary will not need to share with the general unsecured creditors and should be able to keep these funds as the trust beneficiary.

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[100] The rest must be identified for a trust "In order that a court of equity may carry trusts into effect, they must be certain and definite in respect to the subject matter thereof; where a trust is vague and indefinite in either of these particulars, it is void." Michie's Jurisprudence on Trusts and Trustees §8 (Lexis-Nexis 2000).

[101] *M&T Elec. Contrs., Inc. v. Capital Lighting & Supply, Inc. (In re M&T Elec. Contrs., Inc.),* 267 B.R. 434, 479 (Bankr. D.D.C. 2001), *citing Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp.),* 810 F.2d 270, 274 (D.C. Cir. 1987) [for a trust to be present, whether an express trust or a constructive trust, "the courts have uniformly required a contract irrevocably obligating the debtor both to segregate the "trust funds" from the debtor's own funds and to deliver the "trust funds" to the creditor"].

[102] *Federal Insurance Company v. Fifth Third Bank*, 867 F.2d. 330, 334 (6th Cir. 1989) [The Bank also argues that there was not a trust formed because there is no evidence in the contract that the State required Becker to hold this money in a separate account. However, this is not a determining factor of whether a trust was formed. The requirement to hold the funds in a separate account is a fiduciary obligation of Becker's, as trustee, and therefore, when a trust is formed, the trustee has this obligation regardless of the trust agreement wording]. *See* RESTATEMENT (SECOND) OF TRUSTS § 179 (1959)]; *In re Marrs-Winn Co. Inc.*, 103 F.3d 584, 591 (7th Cir. 1996) ["Missouri law requires four elements for a valid express trust: identified beneficiaries, a trustee, an identifiable trust res, and actual delivery of the trust corpus," *citing Electrical Workers, Local No. 1 Credit Union v. IBEW-NECA Holiday Trust Fund,* 583 S.W.2d 154, 161 (Mo. 1979) (en banc)].

[103] *Holmes Envtl. v. Suntrust Banks* (*In re Holmes Envtl., Inc*.), 287 B.R. 363, 378 (Bankr. E.D. Va. 2002), *citing* Restatement (Second) of Trusts, cmt § 17(a)(3) (1959).

[104] Virginia Code §26-30 (Michie 1950).

Trust fund laws or agreements are one way that a vendor can gain priority over a customer's bank that has a blanket security interest on receivables. This also makes sense. The creditor-beneficiary is essentially saying that it will not provide the value of labor and materials, if some other lender will have priority over the receivable that is generated by the labor and materials provided. A creditor can refuse to supply labor or materials unless it will have absolute first priority to the value provided. This absolute first priority is a trust fund agreement.

Trust fund agreements would seem to be a simple, cheap and unobtrusive way for a creditor to protect itself from insolvencies. Trust fund laws have now been around for a few decades. There is a growing body of case law explaining the protections of a trust fund law against blanket security interests or preference litigation. Conventional, voluntary trusts, such as a trust fund for children, have also been around for centuries. There is a great deal of court case law explaining the workings and protections of such consensual trust agreements.

By reviewing the case law on consensual trust agreements and the newer case law on trust fund laws, you can get a good picture of how a court should view trust fund arrangements in a conventional vendor-buyer relationship in the construction industry or in any other sale of goods or services. It is important to keep in mind, however, that the use of trust fund arrangements in a traditional debtor-creditor commercial transaction is an innovation that has not yet been tested in the courts.

TRUST FUND LAWS

The workings of trust fund laws under federal and different state laws can vary, just as the wording of negotiated trust fund agreements can vary. The wording of a particular statute can vary the general discussions above regarding trust fund rights. Particular differences from state to state can include whether personal liability exists for officers and directors, what type of construction project is covered by the trust fund law, and to what beneficiaries the trust may extend. Other features of trust fund law do not arise from specific statute wording but are derived from the general common law of trusts. These features will tend to be the same from state to state, unless a state legislature has enacted a specific law to the contrary. These features would generally include a claimant's need to trace funds, whether the commingling of funds will break the trust, a trustee's inability to convey good title or a security interest in trust funds and the bankruptcy implications.

State-level trust provisions can be divided into three basic categories: statutory, common law and as a supplement to pre-existing mechanic's and materialmen's liens. What follows is a summary of the Trust fund statute in Maryland, where the author is licensed to practice law. After that is a partial survey of trust fund laws in all fifty of the United States. Some of these summaries were written by licensed attorneys in those states, with contact information included. The author urges particular caution in using this summary as a starting point only. You should consult the attorneys noted or another licensed attorney in each state to evaluate any particular factual situation or state law.

The Maryland Trust Fund Statute

The Maryland Trust Fund Statute has existed since 1987, with important revisions in 1995.[105] There is still not much court case law on the Maryland trust fund law, so it is often necessary to look at the law of other states to predict how it will work. Much of the existing case law was probably changed by the 1995 amendment that made it unnecessary to prove intent to defraud in order to establish personal liability. Most of the case law on the Maryland statute involves personal liability of officers and directors in bankruptcy.

In order to establish that the Maryland Trust Fund Statute applies, the claimant must establish that the underlying construction contracts were subject to either the Maryland Little Miller Act (Bond Statute) or the Maryland Mechanics' Lien Statute.[106] This basically includes most or all state public projects while excluding any federal

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[105] Maryland Real Property Code §9-201 *et seq*.

[106] Maryland Real Property Code §9-204.

(a) This subtitle applies to contracts subject to Title 17, Subtitle 1 of the State Finance and Procurement Article, known as the "Maryland Little Miller Act", as well as property subject to § 9-102 of this title.

(b) This subtitle does not apply to: (1) A contract for the construction and sale of a single family residential dwelling; or (2) A home improvement contract by a contractor licensed under the Maryland Home Improvement Law.

(c) In this subtitle, "owner", "contractor", and "subcontractor" have the same meanings as in § 9-101 of this title.

C&B Constr., Inc. v. Dashiell, 460 Md. 272, 289, 190 A.3d 271, 281 (2018) [... the Maryland Construction Trust Statute contains a requirement that the underlying contracts be subject to either the Maryland Little Miller Act or Maryland Mechanics' Lien Statute.... To seek relief under this statute a claimant must demonstrate that the requirements of State Finance and Procurement Article § 17-108 have been satisfied. The provision states that a supplier may bring suit if: (1) the supplier provided labor or materials for a contract subject to this

project.[107] The Maryland Little Miller Act applies only to security for a construction contract.[108] Some projects are not bonded because they are maintenance or service contracts, and the Maryland Little Miller Act is not applicable. Presumably, the Maryland Trust Fund Statute would not apply to such contracts either.

A contract for the construction and sale of a single-family residential dwelling is expressly excluded from the statute, as is a home improvement contract by a contractor licensed under the Maryland Home Improvement Law.[109]

It is debatable whether all other private construction contracts in Maryland are covered by the act. There is some ambiguity in the statute that applies to "property subject to Section 9-102" of the mechanic's lien code. One interpretation would be that the trust fund law applies to *any* private property in the state. In other words, if a contractor could obtain mechanic's lien rights on that piece of real estate (it is not public land), then the trust fund statute applies.

One U.S. District Court, however, has given a more narrow application. Section 9-102 in the mechanic's lien code is titled "Property Subject to Lien," but then describes the types of buildings or structures that give rise to mechanic's lien rights. Some types of structures do not give rise to mechanic's lien rights in Maryland.[110] The U.S. District Court for Maryland held that directional drilling for the installation of power or communications cable did not give rise to mechanic's lien rights and, therefore, the trust fund statute did not apply.[111] This opinion would not be binding on a Maryland court. However, a Maryland court could come to the same decision. It is difficult to say how far this would go. Would a claimant have to establish that it had mechanic's lien rights in order to establish trust fund rights?

It is also not clear how far down the payment chain trust fund rights exist. The word "subcontractor" means a person who has a contract with anyone except the owner.[112] Maryland mechanic's lien law is fairly clear that claimants will have mechanic's lien rights no matter how far removed they are from the owner.[113] The Maryland Trust Fund Statute states that funds "shall be held in trust by the contractor or subcontractor as trustee, for those subcontractors who did work or furnished materials."[114] These words alone would indicate that trust fund rights also exist no matter how far removed from the owner. The beginning of this sentence may change this result, however, when it states:

> MD Real Property Code 9-201(a): *Moneys to be Held in Trust*. Any moneys paid under a contract by an owner to a contractor, or by the owner or contractor to a subcontractor for work done or materials furnished, or both, for or about a building by any subcontractor shall be held in trust by the contractor or subcontractor, as trustee, for those subcontractors who did work or furnished materials, or both, for or about the building, for the purposes of paying the subcontractors.

This could be interpreted as saying a trust is only created by payment from an owner to a contractor or from a contractor to a sub. It is not clear whether the trust would be broken by a subsequent payment from a first tier subcontractor to a second tier subcontractor. A second tier subcontractor could still be an involuntary trustee under Maryland law, assuming they have knowledge of the trust.[115]

Trustees are expressly allowed to commingle funds and are not required to keep trust funds in a separate account.[116] Partly because of this, one bankruptcy court has stated that "specific trust funds need not be traced by the claimant

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subtitle; and (2) have not received payment within 90 days.... Similarly, Petitioner has not demonstrated that the contracts at issue are subject to the Maryland Mechanics' Lien Statute.... [T]he establishment of a mechanics' lien can only occur where the work or materials provided increase the value of the land and where a valid petition has been filed.... Petitioner has not demonstrated that the basic requirement of the Maryland Mechanics' Lien Statute has been met, i.e., that the contracts improved the respective buildings by 15 percent of their original value.... Because the Maryland Mechanics' Lien Statute and Little Miller Act are not applicable to the disputed contracts, the Petitioner cannot invoke a claim under the Maryland Construction Trust Statute]; *See also Jaguar Technologies, Inc. v. Cable-LA, Inc.,* 229 F.Supp.2d. 453 (Md. 2002).

[107] *Allied Building Products Corp. v. Federal Insurance Co*., 729 F. Supp. 477 (D.Md. 1990).

[108] Maryland State Finance and Procurement Code Ann. §17-102(b) (1988).

[109] Maryland Real Property Code §9-204(b).

[110] *See* chapter, Mechanic's Liens in Maryland.

[111] *Jaguar Technologies, Inc. v. Cable-LA, Inc.*, 229 F.Supp.2d. 453 (Md. 2002).

[112] Maryland Real Property Code §9-101(g) and 9-204(c).

[113] *Diener v. Cubbage*, 259 Md. 555, 270 A.2d 471(1970); *See* chapter, Mechanic's Liens in Maryland.

[114] Maryland Real Property Code §9-201(b).

[115] *Phillips Way v. Presidential Financial Corp.*, 137 Md. App. 209, 219-20, 768 A.2d 94, (Md.App. 2001); *See* subsection above, Involuntary Trustees.

[116] Maryland Real Property Code §9-201(c).

in order to enforce the trust and to recover for its violation."[117] This bankruptcy case, however, actually involved the personal liability of a controlling officer and was not really a "tracing" case. Accordingly, a Maryland court or even the same bankruptcy court may find a tracing requirement under the Maryland Trust Fund Statute.[118]

It is difficult for contract terms to waive statutory trust fund rights. A clear waiver of statutory rights is necessary and it is probably necessary that the contract specifically identify the Maryland Trust Fund Statute.[119] Maryland has one of the most interesting cases in the country on the ability of a trustee to convey good title to trust funds, discussed above.[120] There is no other Maryland case law on the inability of a trustee to grant a security interest in trust funds, but there is no reason to think that Maryland courts would come to a result different than other states.[121]

Any officer, director or managing agent of any contractor or subcontractor who knowingly retains or uses the monies held in trust shall be personally liable to any person damaged by the actions.[122] It is not just unpaid subcontractors and suppliers that can make a personal claim against an officer, director or managing agent. "Any person damaged by the actions" would include the contractor's surety that had to pay subcontractors and suppliers.[123]

Before the 1995 amendment, it was not enough to "knowingly retain or use" the trust fund. The claimant had to prove the trustee retained or used the money "with intent to defraud." This amendment certainly makes it easier to establish personal liability and one Maryland court has found personal liability for breach of duty under the Trust Fund Statute.[124] Most case law, however, involves the ability of officers and directors to discharge personal liability in bankruptcy. As discussed above, a creditor in bankruptcy would still need to prove actual fraud in order to avoid discharge.[125]

Presumably, a claimant could recover punitive damages under Maryland law upon proof of actual fraud or breach of fiduciary duty.[126] There are no cases on these subjects, however, under the Maryland Trust Fund Statute.

Maryland state and bankruptcy courts probably would also follow the general rules discussed above on bankruptcy issues, including a creditor-beneficiary's ability to collect trust funds or defend against preference claims. There are actually several Maryland Bankruptcy Court opinions on the trust fund law. All of the opinions, however, concern the issue of personal liability and many predate the 1995 amendment to the law.

Partial Survey of Trust Fund Statutes in the United States

ALABAMA

***Statute*—**None.

ALASKA

***Statute*—**None.

ARIZONA

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[117] *In re Robert McGee*, 258 B.R. 139, 148 (Bankr. D.Md. 2001) [The commingling of trust funds is not a violation of the statute. It is likewise not a bar to recovery. Specific trust funds need not be traced by the claimants in order to enforce the trust and to recover for its violation]; *see also Argonaut Ins. Co. v. Wolverine Constr., Inc*., 976 F. Supp. 2d 646, 659 (D. Md. 2013).

[118] *See e.g., In re Quality Telecomm. Servs.,* 2006 Bankr. LEXIS 4512 (Bankr. D. Md. Feb. 27, 2006).

[119] *Walters v. Atlantic Builders Group, Inc.* 951 A. 2d 94, 180 Md. App. 347 (Md. Ct. Spec. App. 2008) [No waiver of the Maryland Trust Fund Statute where the contract stated: "Nothing contained herein ... shall create any fiduciary liability or tort liability," but did not purport to waive liability for breach of trust existing outside of the contract, such as the Maryland Construction Trust Statute].

[120] *Phillips Way v. Presidential Financial Corp.*, 137 Md. App. 209, 219-20, 768 A.2d 94, (Md.App. 2001); *See* subsection above, Involuntary Trustees.

[121] *See* subsection above, Trustee Cannot Grant Security Interest in Trust Funds.

[122] Maryland Real Property Code §9-202.

[123] *Argonaut Ins. Co. v. Wolverine Constr., Inc*., 976 F. Supp. 2d 646, 659 (D. Md. 2013).

[124] *Walters v. Atlantic Builders Group, Inc.* 951 A. 2d 94, 180 Md. App. 347 (Md. Ct. Spec. App. 2008).

[125] *In re Woodall*, 177 B.R. 517 (Bankr. D. Md. 1995), *See* subsection above, Personal Liability of Officers and Directors; sub-subsection, Ability to Discharge in Bankruptcy.

[126] *Hartlove v. Maryland School for the Blind*, 111 Md. App. 310 (1996).

***Statute*—**Ariz. Rev. Stat. §33-1005. In owner-occupied residential construction, monies paid by the owner to the prime contractor (typically a general contractor) must be held in trust for payment to subcontractors and suppliers. A.R.S. § 33-1005. Claims against general contractors are available only to subcontractors and suppliers who have served a 20-day preliminary notice.

Practice tip: For this reason, even if a subcontractor or supplier is not in direct contract with the owner of the residence and therefore cannot record a valid mechanics' or materialmen's lien claim, the best practice is to serve a timely preliminary notice in order to retain trust fund rights.

***Personal Liability*—**Individual corporate officers may be subject to personal liability for misappropriation of construction trust funds. These debts may not be dischargeable in bankruptcy (*Woodworking Enterprises, Inc. v. Bairs*, 114 B.R. 198 (9th Cir. 1990)).

***Commingling*—**There is no requirement that trust funds be held in a separate account.

ARKANSAS

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Statute—None.

***Criminal Statute*—**Ark. Code Ann. §18-44-132 imposes criminal liability on contractors who receive funds from an owner but fail to pay the amounts over to their subcontractors and suppliers. However, Arkansas courts have found this criminal statute did not create a trust fund (*In re Bass Mechanical Contractors, Inc*., 84 B.R. 1009 (1988) (Bank. W.D. Ark. 1988)).

CALIFORNIA

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Statute—None.

***Trust Agreements*—**The 9th Circuit Court of Appeals Bankruptcy Appellate Panel has determined that a construction subcontract which contains a trust provision establishes a fiduciary duty on the part of the contractor receiving contract proceeds (*In re Gonzales,* 22. B.R. 58 (9th Cir. B.A.P. 1982)).

COLORADO

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Statute—Colo. Rev. Stat. Ann. §§38-22-127 and 38-26-109; §§18-4-401 and 405.

***Trust Funds*—**Under the mechanic's lien statute, all funds disbursed to any contractor or subcontractor under any building, construction, remodeling contract or construction project, shall be held in trust for payment of subcontractors, material suppliers or laborers who have a lien or may claim a lien. Contractors and subcontractors are required to maintain separate records for each project, but not separate bank accounts. Any person who violates the provisions of the trust fund statute commits theft. (§38-22-127; §18-4-401, C.R.S.).

Likewise, under the Colorado bonds statute, all funds disbursed to any contractor or subcontractor shall be held in trust for payment of any person that has furnished labor, materials, sustenance, or other supplies used or consumed by the contractor in or about the performance of the work contracted to be done or that supplies laborers, rental machinery, tools, or equipment. Any person who violates the provisions of the trust fund statute commits theft. (§38-26-109; §18-4-401, C.R.S.)

***Treble Damages*—**Violation of the trust fund statute may result in a treble damages award against the party violating the statute under §18-4-405, C.R.S.

Personal Liability—Under Colorado case law, the principals of a company who have violated the trust fund statute may be found to be personally liable for the violation, including treble damages (*Flooring Design Assocs., Inc. v. Novick*, 923 P. 2d 216, 221 (Colo. App. 1995) and *Alexander Company v. Packard,* 754 P.2d 780 (Colo. App. 1988)).

CONNECTICUT

Statute—None.

DELAWARE

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Statute—Del. Code Ann. tit. 6 §§3502 to 3509. The statute applies to any contractor, subcontractor, or any other person who enters into contract to supply labor or materials. It establishes that all money or funds received by a contractor for the erection, construction, completion, alteration or repair of any building or addition thereon, are deemed trust funds in the hands of the contractor. The statute restricts a contractor from paying out, using, or appropriating trust funds until they have first been applied to the payment of all moneys due and owing by the contractor to all persons furnishing labor or material for the erection, construction, completion, alteration or repair of the building. Violation of the statute can result in interest penalties and if a payment is not withheld "in good faith for reasonable cause," then a court may also award reasonable attorneys' fees.

Dispute Procedure—Del. Code Ann. tit. 6 §3508.

Commingling—No restrictions or limitation on commingling under the statute.

Criminal Statute—Del. Code Ann. tit. 6 §3506.

Personal Liability—A violator of this criminal statute may be subject to criminal fines and possible imprisonment.

DISTRICT OF COLUMBIA

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Statute—None.

Court Ordered Constructive Trust—Under D.C. law, a constructive trust exists "where a person who holds title to property is subject to an equitable duty to convey it to another on the ground that he would be unjustly enriched if permitted to retain it." (*Patterson v. America's Voice, Inc. (In re America's Voice, Inc.)*, 2000 U.S. Dist. LEXIS 14761, 4-5 (D.D.C. Oct. 4, 2000), *citing Gray v. Gray*, 412 A.2d 1208, 1210 (D.C. App. 1980)).

FLORIDA

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Statute—None creating trust fund for all construction projects. However, Section 713.32 does contain trust language in private projects for insurance proceeds.

Section 713.32 states that any insurance proceeds payable to the owner or a lienor because of fire or other insured casualty are liable to liens or demands for payment for labor, services, or materials furnished. The named insured who receives any such insurance proceeds is considered a trustee of those proceeds and such proceeds are deemed trust funds for the purposes of this section for one year from the date of receipt of the proceeds. Chapter 713 governs only private projects. Additionally, under Section 713.246, any person or entity that fails to pay undisputed obligations for labor, services, or materials within 30 days entitles any person providing such labor, services, or materials to file a verified complaint. The section further explains the remedies available for the person providing the labor, services, or materials to the extent of the undisputed amount due. The prevailing party in any proceeding under Section 713.346 is entitled to recover costs including reasonable attorney's fees. Section 713.31 further provides legal recourse against anyone that attempts by fraud or collusion to deprive any lienor of its benefits or rights.

Criminal Statute—Even though Florida is not considered a "trust" state, there are provisions in Chapter 713 that mandate proper disbursement of payments. For example, Section 713.345 provides that any person or entity that receives any payment on account of improving real property must pay all undisputed amounts that are due for services, labor, or materials. Anyone who fails to pay the undisputed amounts due and owing is guilty of a felony.

Personal Liability—Yes, in the limited situation described above.

GEORGIA

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Statute—None.

Criminal Statute—Ga. Code Ann. §16-8-15. This Georgia criminal statute makes it a crime for a contractor paid by the owner to fail to pay for labor, services, or material.

Court Ordered Constructive Trust—Georgia has recognized a constructive trust fund in narrow circumstances: "Georgia law recognizes the constructive trust fund doctrine with respect to payments owed materialmen by their contractors for improvements made to a third party's realty," but only to the extent that payments do not exceed amounts owing to materialmen, and that payments are made to the general contractors at time when materialmen have either a valid lien on the owner's property or a right to file lien (*Bethlehem Steel Corp. v. Tidwell,* 66 B.R. 932, 939-40 (M.D. Ga. 1986)).

HAWAII

Statute—None.

IDAHO

Statute—None.

ILLINOIS

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Statute—This statute is applicable only when a contractor on any tier requires a contractor below him to sign a waiver of mechanic's lien rights. Upon the execution of such waiver, all moneys due and owing such lower tiered contractor or materialman are held in trust for their benefit (*Season Comfort Corp. v. Ben A. Borenstein, Co.,* 665 N.E.2d 1065 (Ill. 1995)).

Commingling—Permitted by statute.

INDIANA

Statute—None.

IOWA

Statute—None.

KANSAS

Statute—None.

KENTUCKY

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Statute—None. However, Ky. Rev. Stat. Ann. §376.070 requires contractors to pay all suppliers of material or labor if lien rights applied. Courts have disagreed whether this statute created a trust relationship, but the more recent cases say that it does not (*In Re D & B Electric, Inc*., 4 B.R. 263 (Bankr. W.D. Ky. 1980); *In Re Sigler,* 196 B.R. 762 (Bankr. W.D. Ky. 1996); *Kentucky v. Laurel County*, 805 F.2d 628 (6th Cir. 1986)).

LOUISIANA

Statute—None.

MAINE

Statute—None.

MARYLAND

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Statutes—MD Code Ann., Real Prop. §§9-201, 202, 204. When an owner pays money to a general contractor for construction work, those funds must be held in trust for payment to subcontractors. Similarly, when a general contractor pays money to a subcontractor for construction work, those funds must be held in trust for payment to sub-subcontractors. Some residential construction projects are not covered. The trust fund statute only applies to construction projects where the Maryland Mechanic's Lien law applies or the Maryland Little Miller Act Bond law applies. (*Jaguar Technologies, Inc. v. Cable-LA, Inc.,* 229 F.Supp.2d. 453 (Md. 2002)). If a third party helps or takes part with the trustee in a breach of trust, a creditor-beneficiary may be able to trace the trust property and make a claim against the involuntary trustee. (*Phillips Way v. Presidential Financial Corp.,* 137 Md. App. 209, 219-20, 768 A.2d 94, (Md.App. 2001), *quoting from* George G. Bogert in *The Law of Trusts and Trustees,* (Rev. 2nd ed. 1983) §868, 103-104)).

Remote Contractors and Suppliers—Trust fund statute may not apply once payment is made to a sub-subcontractor.

Commingling—§9-201(c) states that commingling is not a violation and will not destroy the trust.

Personal Liability—Under §9-202, any officer, director or managing agent who knowingly misuses trust funds will be held personally liable.

Trust Agreements—No specific form or wording is required for a consensual trust agreement. It is the intent of the parties that is controlling (From *Heart v. African Methodist*, 370 Md. 152 (2002)).

Court Ordered Constructive Trust—The remedy is applied by operation of law where property has been acquired by fraud, misrepresentation, or other improper method, or where the circumstances render it inequitable for the party holding the title to retain it (*Wimmer v. Wimmer*, 287 Md. 663, 668, 414 A.2d 1254, 1258 (1980)).

MASSACHUSETTS

Statute—None.

MICHIGAN

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Statutes—Mich. Comp. Laws §§570, 151 *et seq*. (1961). "In the building construction industry the building contract fund paid by any person to a contractor, or by such person or contractor to a subcontractor, shall be considered by this act to be a trust fund, for the benefit of the person making the payment, contractors, laborers, subcontractors or materialmen, and the contractor or subcontractor shall be considered the trustee of all funds so paid to him for building construction purposes." While the statute is criminal in nature, Michigan courts have construed the statute liberally in favor of subcontractors and materialmen and have allowed for a civil remedy (*Weathervane v. Whitelake*, 192 Mich. App. 316, 480 N.W.2d 337 (1991)). Because the Act supplements the Construction Lien Act, it does not apply in public bond cases.

Personal Liability—The act can also be used to assess personal liability to the principals of a corporate contractor.

Criminal Statute—Mich. Comp. Laws §570, 151 *et seq.* (1961).

Commingling—No restriction under the statutes.

MINNESOTA

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Statute—Minn. Stat. §82.75 (2016).

Criminal Statute—Minn. Stat. §48.39 (2016).

Personal Liability—Under this criminal statute, it is unlawful for any state bank to lend any officer, director or employee any funds held as fiduciary. Any officer, director or employee to whom such a loan is made shall be guilty of theft of the amount of such loan from the time of the making thereof.

***Commingling*—**A broker, salesperson, or closing agent shall deposit only trust funds in a trust account and shall not commingle personal funds or other funds in a trust account, except that a broker, salesperson, or closing agent may deposit and maintain a sum in a trust account from personal funds, which sum shall be specifically identified and used to pay service charges or satisfy the minimum balance requirements relating to the trust account.

MISSISSIPPI

***Statute*—**None.

MISSOURI

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***Statute*—**None.

***Trust Agreements*—**Missouri Courts have upheld Trust Fund provisions in construction contracts (*Mars-Winn Co. v. Giberson Electric, Inc.,* 103 F.3d 584 (7 Cir. 1996)).

MONTANA

***Statute*—**None.

NEBRASKA

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***Statute*—**None. Although the language of Neb. Rev. Stat. §52-123 is consistent with other state's trust fund statutes, the Supreme Court of Nebraska has held that the statute does not create a trust fund or a fiduciary duty on the part of the contractor (*State v. McConnell*, 266 N.W.2d 219, 222 (Neb. 1978)).

NEVADA

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***Statute*—**Nevada Revised Statutes, Title 53, Chapter 608, § 608.150. Every prime contractor making or taking any contract in Nevada for the erection, construction, alteration or repair of any building or structure, or other work of improvement, shall assume and is liable for the indebtedness for labor incurred by any subcontractor or any contractor acting under, by or for the prime contractor.

NEW HAMPSHIRE

***Statute*—**None.

NEW JERSEY

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***Statute*—**N.J.S.A. 2A:44-148 (the Trust Fund Act). The statute provides, in relevant part, "(A)ll money paid…to any person pursuant to the provisions of any contract for any public improvement…shall constitute a Trust Fund in the hands of such person as such contractor, until all claims for labor, materials, and other charges incurred in connection with the performance of such contract shall be fully paid."

There is no statutory trust fund provision in New Jersey with respect to private jobs.

Remote Contractors and Suppliers—The Trust Fund Act does not extend its benefits to those who have furnished labor or materials to subcontractors (*Universal Supply Co. v. Martell Construction Co.*, 156 N.J. Super. 327, 383 A.2d 1163 (App. Div. l978)).

Personal Liability—None

Criminal Statute—None

Creation and Termination of Trust—The trust is impressed upon the funds only upon the payment by the public owner to the contractor; funds remaining in the hands of the public entity owner are not trust funds (*National Surety Corp. v. Barth*, 11 N.J. 506, 95 A.2d 145 (1953)). Once the funds are paid out by the contractor and diverted, they are also outside the scope of the trust (*Universal Bonding Insurance Co. v. Gittens and Sprinkle Enterprises, Inc.*, 960 F.2d. 366 (3rd Cir. l992); *Universal Supply Co. v. Martell Construction Co.*, 156 N.J. Super. 327, 383 A.2d 1163 (App. Div. l978)).

Court Ordered Constructive Trust—The common law trust fund theory was discussed in *National Surety Corp. v. Barth*, 11 N.J. 506, 513-514 (l953) where the court recognized "the equitable principle that once moneys have been received or allocated for a certain purpose such moneys become impressed with a definite trust to be disbursed for that purpose only." The court concluded that materialmen, laborers and the surety (by virtue of its subrogation rights) had an equitable interest in funds earmarked for the purposes of construction (*D & K Landscaping Co. v. Great American Insurance Co*., 191 N.J. Super. 448, 453 (App. Div. l983)).

Bankruptcy and Preferences—In *Universal Bonding Insurance Co. v. Gittens and Sprinkle Enterprises, Inc.*, 960 F.2d. 366 (3rd Cir. l992), the Third Circuit determined that unpaid contract balances owed to a debtor-in-possession contractor from various governmental agencies would, upon payment to the debtor, be held in trust for the benefit of its subcontractors based on the Trust Fund Act. Such contract proceeds would not become part of the estate and could not be used by the debtor-in-possession for reorganization or to pay its creditors. *Id*. at 371-376. Funds paid pre-petition to those furnishing labor or materials to the contractor are not preferential. *See also* discussion in *Esteves Excavation, Inc*., 56 B.R. 800 (D.N.J. 1983), where the court found that funds due claimants for services performed or material furnished were not property of the bankruptcy estate.

NEW MEXICO

Statute—None.

NEW YORK

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Statute—N.Y. Lien Law §§70-79-a. The statute applies to both public and private projects. This statutory scheme impresses a trust for the benefit of subcontractors, materialmen and laborers upon any interests held by an owner, contractor or subcontractor which are the fruits of a subcontractor's, materialman's or laborer's labor or material. The scope of New York Construction Trust Fund scheme includes any improvements on real property (*Abjen Properties, L.P v. Crystal Run Sand & Gravel, Inc.*, 168 A.D.2D 783 (1990). *Chase Lincoln First Bk. v. N.Y. ST. Elec.*, 182 A.D.2d 906 [3d Dept 1992]. *Aspro Mechanical Contracting, Inc. v. Fleet Bank, N.A.*, 293 A.D.2d 97 [2d Dept 2002]).

Commingling—Under New York law there will be no trust if the trustee commingles trust funds with other general funds. (*Harleysville Worcester Mut. Ins. Co. v. Bank of Am. N.A. (In re Suprema Specialties, Inc.),* 370 B.R. 517 (S.D. N.Y. 2007), *aff'd In re Suprema Specialties, Inc. v. Bank of Am. N.A.,* 309 Fed. Appx. 526 (2d Cir. 2009)) (That court also found that in order to create a trust, there must also be actual trust property at the time of creation).

NORTH CAROLINA

Statute—None.

NORTH DAKOTA

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Statute—None. A trust may be created for any lawful purpose. §59-12-04. Trust terms must be for the benefit of beneficiaries. §59-12-04. In order to create a trust the settlor must have capacity to create the trust, and indicate an intention to do so. §59-12-02. The beneficiary must also be definite. §59-12-02. A trust may be terminated based on the terms of the trust, by the consent of all the beneficiaries (in a non-charitable irrevocable trust). If the trustee, Attorney General, or other interested party petitions, courts may modify the terms of the trust if it can be shown that it would fulfill the probable intent of the settlor. §§59-12-10 to 59-12-12.

OHIO

***Statute*—**None.

OKLAHOMA

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Statute—Okla. Stat. Tit. 42 §§152 and 153. The Oklahoma Trust Fund Statute provides that any and all funds received by a contractor or subcontractor pursuant to a building or remodeling contract are to be held in trust for the benefit of all persons holding a lienable claim on the improved property. The statute applies to trust funds received on private projects. It also applies to funds received pursuant to a construction mortgage. A mechanic's lien or materialmen's lien claim must be perfected for the statutes to apply (*Sandpiper North Apartments v. Am. Nat.Bank,* 680 P.2d 983 (OK 1984)).

***Commingling*—**No limitation under the statutes.

***Personal Liability*—**Both the entity and the managing officers are liable for the proper application of the trust funds.

***Criminal Statute*—**The entity and the managing officers are criminally liable for embezzlement if they misuse trust funds.

OREGON

Statute—None.

PENNSYLVANIA

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***Statute*—**None. However, Pennsylvania does have a public works prompt payment statute (62 Pa.C.S.A. §§3931-3939, codified as part of the Commonwealth Procurement Code) and the Pennsylvania Contractors and Subcontractors Payment Act, 73 P.S. §§501-516.

Court Ordered Constructive Trust*—n re Kulzer Roofing, Inc.,* 139 B.R. 132 (Bankr. E.D. Pa. 1992). Trusts for subcontractors based on the right of the owner to withhold contract balances if there are unpaid labor and material claims and based on equitable obligation of owner to see to the application of the withheld payments to discharge claims for labor and material: *All State Industries, Inc. v. H.E. Stoudt & Sons, Inc*., 9 Pa. D. & C.3d 552 (Pa. C.P. 1978) citing *Atlantic Refining Co. v. Continental Casualty Co*., 183 F. Supp. 478 (W.D. Pa. 1960).

RHODE ISLAND

***Statute*—**None.

SOUTH CAROLINA

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***Statutes*—**S.C. Code Ann. §§29-7-10 to 29-7-30. The statute grants laborers, subcontractors and materialmen a first lien on monies received by the contractor or subcontractor for the work done or materials provided. The contractor can hold funds if there is a good faith claim of a defect in the labor or material supplied. In order to claim a set-off, the contractor must provide a declaration and accounting of the amounts claimed sent by certified mail to the laborer seeking payment. The lien created in favor of laborers and materialmen under the statute is a first lien and takes precedence over mortgages and security interests.

***Criminal Statute*—**S.C. Code Ann. §§29-7-20. Subsection (1) of the statute provides for criminal penalties for one who transfers or otherwise expends the money he has received and fails to pay laborers or materialmen. The penalties are not more than $500 or less than $100, or not less than three months or more than six months. Subsection (2) states that falsely certifying that payments have been made is a misdemeanor and the wrongdoer may be fined not more than $500 and/or imprisoned for not more than 60 days. This section does not apply if the contractor making the certification has obtained a lien waiver, but such waiver is against public policy and unenforceable unless payment "substantially equal to the amount waived" has actually been made.

***Court Ordered Constructive Trust*—**The language of the statute does not use the words "constructive trust." In *Arrow Concrete Co. v. Bleam (In re Bleam)*, 356 Bankr. 642 (Bankr. D.S.C. 2006), the bankruptcy court held that the relationship created by the statute was contractual, rather than fiduciary in nature, and that the debt owed by a contractor to a supplier was consequently dischargeable. The Court discussed at length the fact that the bankruptcy courts were split with regard to the application of similar statutes, but emphasized that the failure to use the worst "trust" in the statute was relevant to its decision.

***Commingling*—**No prohibition on commingling in the statute.

SOUTH DAKOTA

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Except as otherwise prescribed by chapters 43-4 and 43-25 relating to transfers, a trust may be created for any purpose for which a contract may lawfully be made. (S.D. Codified Laws §55-1-1). Valid trusts are required to be in writing. (S.D. Codified Laws §§55-1-4, 55-1-14). There also must be an intention to create a trust with the subject, purpose and beneficiary named. (S.D. Codified Laws §55-1-4). Trustees may be held personally liable for misuse of trust property if not done on behalf of the trust beneficiaries. There seems to be a strong presumption that trustees act on behalf of the trust. Good faith officiating of the trust is required. (S.D. Codified Laws §55-2-1). Generally statutes frown upon commingling of funds between the trustee and beneficiary. (S.D. Codified Laws §55-4-16).

***Statute*—**S.D. Codified Laws §44-9-13(2004). The statute applies to any improvement of real estate, mines or purviews and to amounts held in excess of $500.

***Personal Liability*—**The individual may be guilty of theft of the proceeds of such payment.

***Commingling*—**The statute has no restrictions on commingling.

TENNESSEE

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***Statute*—**None. However, similar protection is covered in Tennessee's Prompt Pay Act, Tenn. Code Ann. §§66-34-101 *et. seq.*

TEXAS

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***Statutes*—**Texas Property Code §162.001 (Texas Construction Trust Fund Act).

***Construction Payments and Loan Receipts as Trust Funds*—**Construction payments are trust funds if the payments are made to a contractor or subcontractor, or officer or agent of a contractor or subcontractor, under a construction contract for the improvement of real property. Loan receipts are also trust funds if they are borrowed by a contractor or subcontractor, or officer or agent of a contractor or subcontractor, for the improvement of real property where the loan is secured in whole or in part by a lien on the property. *See Lively v. Carpet Servs. Inc.*, 904 S.W.2d 868 (Tex. App.- Houston [1st Dist.] 1995, writ denied); *Holley v. NL Indus./NL Acme Tool Co.*, 718 S.W.2d 813 (Tex. App.- Austin 1986, writ ref'd n.r.e.).

***Requirement of a Construction Account*—**A contractor who enters into a written contract with a property owner to construct improvements on a residential homestead for an amount exceeding $5,000 must deposit trust funds in a construction account.

***Misapplication of Trust Funds*—**A contractor or its agent who intentionally or knowingly retains, uses or otherwise diverts trust funds before fully paying all current and past due obligations to the beneficiaries has misapplied trust funds.

***Personal Liability*—**In the event that trust funds are misapplied, a director, officer or agent of a contractor who has control or direction over those funds is personally liable. *See C&G, Inc. v. Jones*, 165 S.W.3d 450 (Tex. App. - Dallas 2005, pet. denied).

***Criminal Liability*—**A trustee who misapplies trust funds of $500 or more commits a Class A misdemeanor, unless the misapplication was undertaken with an intent to defraud, in which case the trustee commits a third-degree felony. In addition, a trustee who fails to establish or maintain a construction account commits a Class A misdemeanor.

UTAH

***Statute*—**None.

VERMONT

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Statute—Vt. Stat. Ann. tit. 9, §4003. Note: The below is current through July 1, 2019, but is subject to change in 2019 legislative session.

Creation of Trust—Funds paid by an owner for improvement of real estate are held in express trust by contractor or subcontractor. A separate trust exists for each project of contractor.

Separate Accounts—Not required by statute, although owner may wish to have separate accounts to avoid priority disputes.

Priority—Express trust beneficiaries have priority over unsecured creditors of contractor with claims unrelated to project.

Exception—Express trusts not required for federal, state or municipal projects

Inter-contractor Trusts—Contractor holds funds received from owner in trust for benefit of creditors of contractor with claims due and owing or to become due and owning by contractor by reason of work on project by beneficiary. Any amount so held must be paid to beneficiary.

Liens—Trust creates no lien on real property. Trust does not preclude assertion of contractor's lien. Priority of a secured lender is not subordinate to express trust.

Trustees—Normal rules for corporations and limited liability entities apply; principal or head of any other company is trustee.

VIRGINIA

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Statute—No Trust Fund Statute.

Criminal Liability—Va. Code. Ann. §43-13 is a criminal statute and does not provide for any private right of action imposing civil liability (*Vansant & Gusler, Inc. v. Washington*, 245 Va. 356, 429 S.E. 2d 31(1993)). Va. Code. Ann. §43-13 does require that funds paid to general contractor or subcontractor must be used to pay persons performing labor or furnishing material. While funds paid to a general contractor or subcontractor are to be used to pay the subcontractors of the general contractor or subcontractor, they are not funds held in trust as the statute does not mention the creation of a legal trust (*Kayhoe Construction Corp. v. United Virginia Bank*, 220 Va. 285,257 S.E.2d 837 (1979)).

Trust Agreements—A federal court found a constructive trust under Virginia law arising out of a joint check agreement. Under Virginia law, any words "which unequivocally show an intention that the legal estate was vested in one person, to be held in some manner for some purpose on behalf of another" are sufficient to create a trust (*Mid-Atlantic Supply Inc. of Virginia v. Three Rivers Aluminum Co*., 790 F.2d 1121 (Va. 1986)).

Court Ordered Constructive Trust—*The St. Joe Company v. Norfolk Redevelopment and Housing Authority*, 283 Va. 403, 722 S.E.2d 622 (2012).

WASHINGTON

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Statute—Wash. Rev. Code §§60.28.011-60.28.040.

Types of Projects—Any contracts for public improvements or work, other than for professional services, by the state, or any county, city, town, district, board or other public body. (RCW 60.28.011(1), (12(c)-(d)). A retention of up to 5 percent of moneys earned is required "as a trust fund." (RCW 60.28.011(1)). The contractor may request that retainage be reduced to 100% of the value of the uncompleted work. (RCW 60.28.011(3)). RCW 60.28.011(1) literally imposes the trust fund requirement only on the project owner, but RCW 60.28.011(5) adds that if contractors withhold corresponding sums from their own subcontractors and suppliers, they must pay interest at the same rate that the prime contractor receives (if any).

With consent of the public body, the contractor may provide a bond (which is in addition to the bond required by RCW §39.08 *et seq*. discussed earlier) and not have retainage withheld. (RCW 60.28.011(6)).

Retained funds must be paid to the contractor within 60 days of completion of all contract work on the public improvement. (RCW 60.028.011(3)).

Labor and Material Covered—Every person performing labor or furnishing supplies toward the completion of a public improvement contract has a lien upon moneys reserved by a public body under the provisions of a public improvement contract. (RCW 60.28.011). However, the notice of the lien of the claimant must be given within 45 days of completion of the contract work, and in the manner provided in RCW 39.08.030. (RCW 60.28.011(2)).

Pre-Claim Notice Required by Suppliers—Every person, firm, or corporation furnishing materials, supplies, or equipment to be used in the construction, performance, carrying on, prosecution, or doing of any work for the state, or any county, city, town, district, municipality, or other public body, shall give to the contractor of the work a notice in writing, which notice shall cover the material, supplies, or equipment furnished or leased during the 60 days preceding the giving of such notice as well as all subsequent materials, supplies, or equipment furnished or leased, stating in substance and effect that such person, firm, or corporation is and/or has furnished materials and supplies, or equipment for use thereon, with the name of the subcontractor ordering the same, and that a lien against the retained percentage may be claimed for all materials and supplies, or equipment furnished by such person, firm, or corporation for use thereon, which notice shall be given by (1) mailing the same by registered or certified mail in an envelope addressed to the contractor, or (2) by serving the same personally upon the contractor or the contractor's representative and obtaining evidence of such service in the form of a receipt or other acknowledgment signed by the contractor or the contractor's representative, and no suit or action shall be maintained in any court against the retained percentage to recover for such material, supplies, or equipment or any part thereof unless the provisions of this section have been complied with. (RCW 60.28.015).

Filing claim—A claim must be filed with the board, council, commission trustees or officer acting for the public body at any time after the account balance is due but no later than 45 days after completion of the contract work. (RCW 60.28.011(2)). The lien claimant shall file with such public entity a claim giving the claimant's name, the amount of the claim and identifying the project. The notice of claim must be in the form and manner provided in RCW 39.08.030. (RCW 60.28.011(2)).

The notice should be sent via certified or registered mail, return receipt requested, or personally served on the public body. It is recommended that the notice also be sent to claimant's customer and the general contractor. This notice must be signed by the claimant or the claimant's agent making the claim or giving the notice and after being presented and filed, the notice becomes a public record. (RCW 39.08.030)

Time for Suit—Any claim against the retained fund may be foreclosed against the retained fund by commencing a lawsuit in the superior court in the county where the claim was filed within four months of the date of giving notice of the claim. (RCW 60.28.030). A prevailing claimant is entitled to recover reasonable attorneys' fees as determined by the court.

WEST VIRGINIA

Statute—None.

WISCONSIN

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Statute—*Private projects*, Wisconsin Statutes, §779.02(5) (2003). *Public projects*, Wisconsin Statutes §779.16 (2012). The trust attaches to funds that have been paid out (*Capital City Sheet Metal, Inc. v. Voytovich,* 217 Wis. 2d 683, 578 N.W.2d 643 (Ct. App. 1998)), or funds paid into the court (*Wis. Dairies, Corp. v. Citizens Bank,* 160 Wis. 2d 758, 467 N.W.2d 124 (1991)), or funds paid into the bank account of the contractor (*Kraemer Bros. v. Pulaski State Bank,* 138 Wis. 2d 395, 406 N.W.2d 379 (1987)). However, if the "trustee" pays out the funds, the funds no longer maintain the characteristic of trust funds. (Wis Stats. §779.02(5) and §779.16). Failure of the "trustee" to properly pay the trust funds to the trust beneficiaries is theft by contractor. If the "trustee" is a corporation, then the theft is deemed to be committed by any officers, directors or agent for the corporation who is responsible for the misappropriation. The trust fund statute provides for civil penalties. (Wis. Stat. §§779.02(5), 779.16). The statute also allows specific enforcement, interest and attorneys' fees

Remote Contractors and Suppliers—The trust fund statute is *not* limited to certain tier levels.

Personal Liability—On private projects (Wis. Stat. §779.02(5)).

Criminal Statute—Wis. Stat. §943.20 (*Tri-Tech Corp. of America v. Americomp Services, Inc.*, 254 Wis.2d 418, 646 N.W.2d 822 (2002)).

Commingling—No restriction on commingling.

WYOMING

Statute—None.

The Perishable Agricultural Commodities Act (PACA)

The Perishable Agricultural Commodities Act (PACA), 7 U.S.C.S. §§499a-499t creates a statutory trust to protect unpaid sellers of perishable agricultural products (produce).[127] This is a federal law, so it applies to all such produce sales in the United States. The trust protects the sellers against financing arrangements made by merchants, dealers or brokers who give lenders a security interest in the commodities or the receivables or proceeds from the sale of the commodities. This gives the claims of these PACA sellers priority over the secured creditors of the buyer.

The PACA statute and the federal regulations lay out the steps that a produce seller must take to come within PACA's protection.[128] Under all circumstances, the seller must give the buyer written notice of the seller's intention to preserve its trust benefits. Sellers are allowed to provide this notice on the invoices given to the buyer or the notice can be sent separately from the invoices, as long as it is sent within 30 days after the expiration of payment terms. If the seller and the buyer use the default payment terms provided in the regulations (within 10 days after the day on which the produce is accepted), this notice of intent to preserve benefits is all that is necessary. On the other hand, if the parties agree to payment terms greater than 10 days after acceptance (but it cannot be more than 30 days after acceptance) this agreement must be in writing. The seller must also disclose these non-statutory payment terms "on invoices, accountings, and other documents relating to the transaction."[129]

Thirty days is the maximum allowable payment term under PACA regulations.[130] This limitation exists because the statute is intended to protect only those produce sellers making short-term credit arrangements.[131]

Courts seem to consistently deny the benefits of the trust to sellers that do not follow these procedures strictly, including sellers that have credit agreements allowing more than 30 days time[132] or sellers that fail to accurately disclose the terms of payment on invoices.[133]

If a seller does follow the relatively simply procedures, however, there are impressive benefits. The seller can assert a superior claim to the proceeds from the sale of its produce that was acquired by a bank from the customer.[134] When a party establishes an interest in a PACA trust, the trust proceeds are separate from a PACA trustee's bankruptcy estate.[135]

[127] 7 U.S.C. §499e(c); *Endico Potatoes, Inc. v. CIT Group/Factoring, Inc*., 67 F.3d 1063, 1067 (2d Cir. 1995) ["Due to the need to sell perishable commodities quickly, sellers of perishable commodities are often placed in the position of being unsecured creditors of companies whose creditworthiness the seller is unable to verify"].

[128] 7 U.S.C. §499e(c)(3) and (4); 7 C.F.R. §§46.2(aa) and 46.46(e).

[129] 7 U.S.C. §499e(c)(3); 7 C.F.R. §46.46(e)(1).

[130] 7 C.F.R. §46.46(e)(2), which provides as follows: "The maximum time for payment for a shipment to which a seller, supplier, or agent can agree and still qualify for coverage under the trust is 30 days after receipt and acceptance of the commodities..."

[131] H.R. Rep. No. 98-543 at 7 (1983), reprinted in 1984 U.S.C.C.A.N. 405, 410 ["The committee does not intend the trust to apply to any credit transaction that extends beyond a reasonable period"].

[132] *Overton Distribs., Inc. v. Heritage Bank*, 340 F,3d 361 (6th Cir. 2003); *Wilson Mushroom Co. v. Davis Distribs., Inc.*, 861 F.2d 416 (4th Cir. 1988).

[133] *Bowlin & Son, Inc., Appellant, v. San Joaquin Food Service, Inc.*, 958 F.2d 938 (9th Cir, 1992).

[134] *Overton Distribs., Inc. v. Heritage Bank*, 340 F,3d 361 (6th Cir. 2003).

[135] *Bowlin & Son, Inc., Appellant, v. San Joaquin Food Service, Inc.*, 958 F.2d 938 (9th Cir, 1992). *Overton Distribs., Inc. v. Heritage Bank*, 340 F,3d 361 (6th Cir. 2003).