CHAPTER 16

Equitable Remedies

CONSTRUCTIVE TRUSTS

Trust fund statutes or laws are created by state legislature for public policy reasons, imposing trust relationships on certain participants in the construction process. Whether or not a trust fund law applies, trust fund relationships can exist by express agreement.[1] It is possible for a trust relationship to occur, however, even without a statute or an express agreement. This is referred to as a "constructive trust."

A constructive trust is an "equitable" concept. In other words, it is not based on a specific law or agreement. Rather, it is based on a sense of fairness by the court. Accordingly, it is a malleable concept that can appear somewhat unpredictably in a variety of forms in a variety of circumstances.

A constructive trust is a tool of equity to prevent unjust enrichment. It requires some wrongdoing either in obtaining the funds or in retaining them, if they were properly obtained.[2] The degree of actual fraud or wrongdoing required appears to change at state boundaries and with the passage of time.[3]

Accordingly, a claimant would normally prefer to have a trust fund statute or agreement to enforce rights. In the absence of such a clear-cut remedy, however, a constructive trust theory remains a possibility.

If a constructive trust is established, most or all of the benefits of trust fund laws or agreements will follow. Property held in a constructive trust belongs to the beneficiary and never becomes part of a bankruptcy estate.[4] Indeed, it is often bankruptcy that creates the need to establish a constructive trust. If a bankruptcy court finds a constructive trust, this creditor is entitled to priority in payment as to all the assets of the bankruptcy, ahead of the claims of creditors who have valid security interests, ahead of the administrative costs and expenses incurred in the bankruptcy court, and ahead of all other priority and general creditors.[5]

Where constructive trusts are found to exist, courts have held the result to be analogous to an express trust in that a bifurcation of title occurs. Legal title remains with the party in possession of the fund (trustee), while the equitable title vests with the beneficiary.[6] If the debtor's fraud or other wrongful conduct gives rise to a constructive trust, the bankruptcy trustee's sole permissible administrative act would be to pay over the sums due to the beneficial owners of the property.[7]

In a constructive trust, however, no trust and no fiduciary relationship exist until the wrongdoing.[8] This is a difference with an express trust, which existed by statute or agreement before any wrongdoing by the trustee. As a result, a debt from a constructive trust will be dischargeable in bankruptcy, while a debt from breach of a statutory or express trust will not be dischargeable.[9]

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[1] *The St. Joe Company v. Norfolk Redevelopment and Housing Authority*, 283 Va. 403, 407-08, 722 S.E.2d 622, 625 (2012), *citing Baldwin v. Adkerson, 156 Va. 447, 463-64, 158 S.E. 864, 869 (1931)*.

[2] *Wimmer v. Wimmer*, 287 Md. 663, 414 A.2d 1254, 1258 (1980); *Falls Church v. Protestant Episcopal Church in the United States*, 285 Va. 651, 667-68, 740 S.E.2d 530, 539-40 (2013).

[3] *In re Matter of Kennedy*, 612 F.2d 963 (5th Cir. 1988).

[4] *In re Matter of Kennedy,* 612 F.2d 963 (5th Cir. 1988); *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) [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."], *citing Gray v. Gray*, 412 A.2d 1208, 1210 (D.C. App. 1980).

[5] *In re Matter of Kennedy,* 612 F.2d 963 (5th Cir. 1988).

[6] *Mid-Atlantic Supply Inc. of Virginia v. Three Rivers Aluminum Co.,* 790 F.2d 1121 (Va. 1986).

[7] *Mid-Atlantic Supply Inc. of Virginia v. Three Rivers Aluminum Co.,* 790 F.2d 1121, 1125-26 (Va. 1986); *citing Georgia Pacific Corp. v. Sigma Service Corp.,* 712 F. 2d 962, 967, n.4 (5th Cir. 1983).

[8] *Patel v. Shamrock Floorcovering Servs., (In re Patel*), 565 F.3d 963, 970 (6th Cir. Mich. 2009).

[9] *Patel v. Shamrock Floorcovering Servs., (In re Patel*), 565 F.3d 963, 970 (6th Cir. Mich. 2009).

Constructive trusts have been found where the parties intended that a "trustee" hold property for the benefit of someone else, even though there was no express agreement creating a trust. Constructive trusts also arise when property is acquired by fraud[10] or by breach of some sort of fiduciary relationship. Some courts have found constructive trust in the application of a state mechanic's lien statute or criminal statute requiring payment to subcontractors in the construction industry.

Joint Check Agreements

A federal court found a constructive trust under Virginia law arising out of a joint check agreement.[11] 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.[12] This may be accomplished by an express declaration of trust or by circumstances indicating an intention of the depositor to place the fund irrevocably beyond the trustee's control and devoted to the indicated purpose.[13]

In the joint check agreement case, there was clear evidence that the supplier had refused to sell on the debtor's credit and had required a joint check agreement through a suitable debtor on the project that would be within the control of the creditor. The supplier refused to go forward until the general contractor had agreed to be bound by the arrangement in writing.[14] These features of the relationship were important. More than just the debtor made this agreement—the supplier and general contractor also were involved. There was "reliance" by the supplier on the agreement, as well. The court found a constructive trust[15] in the joint check agreement and this creditor obtained payment in full in the bankruptcy.

Other courts have not found a constructive trust in a joint check agreement.[16] This case, for example, involved a unilateral agreement by a debtor, instructing the owner to issue joint checks to suppliers. The court found no constructive trust:

> In the absence of any evidence that actions in reliance or other consideration made this agreement binding on [the debtor], its naked wording represent merely [the debtor's] unilateral agreement to have some of the proceeds contractually due to it from [the owner] made payable to it by joint checks. It places no affirmative duties upon [the debtor] in relation to the suppliers, for instance, for [the debtor] is neither required to endorse the checks nor to transfer them immediately to the suppliers, nor is [the debtor] prohibited under the terms of the agreement from revoking its 'plan' as 'proposed' by the letter.[17]

Accordingly, it seems important to have multiple parties agree to a joint check agreement, have at least nominal consideration and be able to show reliance (i.e., that the supplier would not have extended credit without the agreement). More to the point, if a creditor is in a position to get a joint check agreement signed, it would not be difficult to add language creating an express trust. An express trust agreement would require very little additional wording and would not place any additional burden or cost on any of the parties involved, as is discussed above.[18]

Fraud

In some states, a constructive trust must be based upon "fraud, actual or constructive."[19] This is an important theory to remember, if the facts exist. This will be a difficult burden for most claimants, however, for the same reasons it is

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[10] *Wimmer v. Wimmer*, 287 Md. 663, 414 A.2d 1254, 1258 (1980); *Leonard v. Counts*, 221 Va. 582, 588-89, 272 S.E.2d 190 (1980).

[11] *Mid-Atlantic Supply Inc. of Virginia v. Three Rivers Aluminum Co.,* 790 F.2d 1121 (Va. 1986).

[12] *Broaddus v. Gresham*, 181 Va. 725, 26 S.E. 2d 33, 35 (1943).

[13] *Schloss v. Powel1*, 93 F.2d 518, 519 (4th Cir. 1938).

[14] *Mid-Atlantic Supply Inc. of Virginia v. Three Rivers Aluminum Co.,* 790 F.2d 1121, 1123 (Va. 1986).

[15] In a fascinating observation, the Federal Fourth Circuit Court of Appeals stated: "Situations occasionally arise where property ostensibly belonging to the debtor will actually not be property of the debtor but will be held in trust for another. For example, if the debtor has incurred medical bills that were covered by insurance, and the insurance company had sent the payment of the bills to the debtor before the debtor had paid the bill for which the payment was reimbursement, the payment would actually be held in a constructive trust for the person to whom the bill was owed." *Mid-Atlantic Supply Inc. of Virginia v. Three Rivers Aluminum Co.,* 790 F.2d 1121, 1124-25 (Va. 1986). The described fact scenario would arguably apply in many vendor-vendee situations in the construction industry and elsewhere.

[16] *Georgia Pacific Corp. v. Sigma Service Corp.,* 712 F. 2d 962 (5th Cir. 1983).

[17] *Georgia Pacific Corp. v. Sigma Service Corp.,* 712 F. 2d 962, 971-72 (5th Cir. 1983).

[18] *See* chapter, Trust Fund Laws and Agreements; section, Trust Fund Agreements.

[19] *In re Matter of Kennedy,* 612 F.2d 963 (5th Cir. 1988).

difficult to prove fraud in any case.[20] To prove fraud, a claimant generally must prove a misrepresentation that was relied upon by the claimant and which caused damage.

This is a difficult burden, especially since these elements must normally be shown by "clear and convincing evidence."[21] As discussed in other portions of the book, there are many dishonest statements and much damage incurred which do not amount to fraud.[22]

If a claimant can prove actual fraud, however, it may be possible to obtain punitive damages, in addition to compensation.[23]

Fiduciary Duty or Confidential Relationship

A constructive trust may also be found if parties are in a fiduciary or confidential relationship. This theory would require some unusual facts, however. General contractors and their subcontractors do not usually stand in a confidential relationship to one another.[24] There must be some sort of express statement of the parties' mutual intent to stay in such a relationship.[25]

Mechanic's Lien Statutes

Some state mechanic's lien statutes, like New York's explicitly create a trust relationship. Some courts have held that a state mechanic's lien statute creates a constructive trust, even if that statute does not explicitly discuss a trust.[26] These theories would be very state specific, however, and dependent upon the wording in the mechanic's lien statute and the historic case law in the state involved. Other courts have expressly found that mechanic's lien statutes create no constructive trusts.[27]

Criminal Statutes

Many state statutes make it a crime for a contractor to receive payment and then fail to pay subcontractors and suppliers. As discussed above, the Michigan courts have long held that such a criminal statute constituted a trust fund statute.[28] One court has found that the criminal statute in Georgia created a constructive trust in favor of subcontractors and suppliers.[29] The Virginia Supreme Court, however, has expressly held that the Virginia criminal statute does not create any "private cause of action."[30]

Tracing

If a constructive trust is found, a claimant may be required to identify a trust fund in order to make use of the trust in federal bankruptcy court.[31] Under federal law, plaintiff must be able to trace their funds to an identifiable trust in the hands of the trustee. If state law is to the contrary, then it must yield to federal policy.[32]

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[20] *See* chapter, Bankruptcy Primer for Creditors; subsection, Objection to Discharge.

[21] *ITT Hartford v. Virginia Financial Assoc.*, 258 Va.193 (1999); *Suburban Mgmt. v. Johnson*, 236 Md. 655 (1964); *See also Allied Bldg. Prod. v. Federal,* 729 F. Supp. 477, 478 (Md. 1990).

[22] *See* chapter, Bankruptcy Primer for Creditors; subsection, Objection to Discharge.

[23] *Allied Bldg. Prod. v. Federal,* 729 F. Supp. 477, 479 (Md. 1990).

[24] *Allied Bldg. Prod. v. Federal,* 729 F. Supp. 477, 478 (Md. 1990).

[25] *Allied Bldg. Prod. v. Federal,* 729 F. Supp. 477, 478 (Md. 1990).

[26] *United Parcel Service, Inc. v. Weben Industries, Inc*., 794 F.2d 1005 (5th Cir. Tex. 1986); *Bethlehem Steel Corp. v. J. Coleman,* 66 B.R. 932 (M.D. Ga. 1986).

[27] *Georgia Pacific Corp. v. Sigma Service Corp.,* 712 F. 2d 962 (5th Cir. 1983).

[28] *See* chapter, Trust Fund Laws and Agreements; subsection, Trust Fund Laws; subsection, Michigan.

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

[30] *Kayhoe v. United Virginia Bank*, 220 Va. 285 (1979).

[31] *Matter of Kennedy,* 612 F.2d 963 (5th Cir. 1988).

[32] *Matter of Kennedy,* 612 F.2d 963 (5th Cir. 1988).

EQUITABLE LIENS

Introduction

Many court cases state that a subcontractor or supplier has an "equitable lien" or "equitable interest" in funds held by an owner of a construction project. Like the constructive trusts, these are equitable concepts. In other words, the result will be based on a court's sense of fairness in a particular case, rather than a specific rule of law.

Accordingly, equitable liens are a somewhat muddled and malleable concept. Courts seem to sometimes intermingle the concepts of express trusts, constructive trusts, equitable liens and equitable interests.[33] It can be difficult to nail down the characteristics of equitable liens or interests. For example, does the creditor-beneficiary always have title to the fund, like a trust relationship? Sometimes, the concept appears more like a true "lien," where the debtor trustee has title to the fund, but the creditor-beneficiary has a security interest. The distinction does not seem to make much difference from a practical point of view.[34]

Creditor-beneficiaries would probably prefer to have mechanic's lien rights, payment bond rights or a trust relationship, partly because the "rules of the road" are clearer in these legal concepts. There seems to be some reluctance on the part of judges and lawyers to recognize the concept of an equitable lien, especially in the bankruptcy forum. An equitable lien claimant seems to fight against the general bankruptcy concept that all general unsecured creditors should share equally in a debtor's assets.[35] The court case law seems to be quite consistent, however, in recognizing the existence of equitable liens. It is also true that creditors with consensual liens have a very preferred position in bankruptcy. There is no apparent reason why an equitable lien claimant should be treated differently.

The concept seems to appear most frequently in federal cases, concerning federal construction projects in the highest federal courts in the land. Many are Miller Act bond projects, although there is no case stating that this is a requirement for an equitable lien. There are some equitable lien cases arising from state public projects and even private construction projects. Sometimes, the provisions in the general contract regarding the payment to subcontractors and suppliers seem important. Other cases discuss a general right in subcontractors and suppliers to receive a contract balance, no matter what the project or the contract terms.

General Equitable Right

The U.S. Supreme Court has "recognized the peculiarly equitable claim of those responsible for the physical completion of building contracts to be paid from available monies ahead of others."[36]

Even on private projects, courts have recognized the owner's "well established right to have the laborers and materialmen paid out of the unpaid progress payments or unpaid balance does not arise from any legal obligations to those who provide it with labor and materials." This "does not arise from any legal obligation to such suppliers but simply from its equitable obligation to those who provided with labor and materials."[37]

It is not new law that unpaid subcontractors hold an equitable interest in a contract balance owed by a building owner to a general contractor.[38]

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[33] *In re RAH Development Co. Inc.*, 184 B.R. 525 (W.D. Mich. 1995), ftn 3.

[34] *In re RAH Development Co. Inc.*, 184 B.R. 525 (W.D. Mich. 1995). The distinction may have at least procedural significance, however, in determining whether the fund is ever part of a bankruptcy estate pursuant to 11 U.S.C. §541.

[35] *Grochal v. Ocean Tech. Servs. Corp. (In re Balt. Marine Indus.),* 476 F.3d 238, 242-243 (4th Cir. Md. 2007). The 4th Circuit Court of Appeals holding in *Grochal* is sometimes misinterpreted to say that a subcontractor has no equitable lien on any unpaid contract balance owed to a general contractor by the owner. The 4th Circuit Court of Appeals in *Grochal* held that the funds were property of the bankruptcy estate and should be paid to the bankruptcy court and not directly to the claimant. The 4th Circuit remanded the case to the bankruptcy court, however, to determine whether the retained funds were to be held in an equitable trust for the benefit of the unpaid subcontractors while in the hands of the debtor, stating "On remand, the bankruptcy court will have to examine the facts of the case at hand to determine if there is any basis for finding that OTS has a similar equitable interest. The court will also have to determine how that interest is treated under the Bankruptcy Code. *See e.g.*, 11 U.S.C.A. §§506, 507, 510 (West 2006) (governing secured interests, priorities, and subordination). These questions—involving rights and equities under the Bankruptcy Code—are best determined in the first instance by the bankruptcy court."

[36] *United States v. Munsey Trust Co.*, 332 U.S. 234, 240, 67 S.Ct. 1599, 1602 (1947).

[37] *Framingham Tr. Co. v. Gould-National Batteries*, 427 F.2d 856, 858 (1st Cir. 1970), *citing Munsey Trust*, *Henningsen v. United States Fidelity & Guaranty Co.*, 208 U.S. 404, 410, 28 S.Ct. 389, 291, 52 L.Ed. 547 (1908); *National Surety Corp.* 133 F.Supp. 381, 384, 132 Ct.Cl. 724, cert. denied, 350 U.S. 902, 76 S.Ct. 181, 100 L.Ed. 793 (1955); and *Pearlman v. Reliance Insurance Co*, 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962).

[38] *Active Fire Sprinkler Corp. v. United States Postal Service*, 811 F.2d. 747 (2d Cir. 1987), *citing* Restatement of Security §141 (1941); *Id*. § comment (e); *See Henningsen v. United States Fidelity & Guaranty Co.*, 208 U.S. 404, 410, 28 S.Ct. 389, 291, 52 L.Ed. 547 (1908); *Matter of Dutcher Construction Corp.*, 298 F.2d 655, 658 (2d Cir.) (*quoting National Surety Corp. v. United States,* 133 F.Supp. 381, 384,

Federal Construction Projects

Most of the case law recognizing equitable liens is from federal courts, even the cases involving private projects. This is probably for historic reasons, arising out of a series of U.S. Supreme Court cases.[39] It is most clear in federal construction projects that subs and suppliers have an equitable lien in contract balances held by the U.S. government. This may be because the government has "sovereign immunity," which often results in unfairness. Subcontractors and suppliers are not permitted to file mechanic's liens on government projects.[40] Subs and suppliers are not allowed to sue the government for unjust enrichment or for receiving labor and materials for which the government has not paid.[41] Subs and suppliers cannot even sue the government if it fails to require Miller Act payment bonds.[42]

Sovereign immunity puts subs in a particularly vulnerable position on federal projects.[43] Although no cases say so directly, the concepts of an equitable lien may have been developed by the federal courts to partially provide relief for this problem.

Subs and suppliers have an equitable right to funds held by the government, but they have no legal ability to enforce that equitable lien.[44] The government can, however, waive sovereign immunity and agree to make payment to a subcontractor. The equitable lien gives the government the right to do this.[45] This can be very helpful to a subcontractor, if the government is willing to cooperate. This is most likely to occur if a general contractor has abandoned a project, gone out of business or gone into bankruptcy.

The equitable lien concept can be very helpful to a subcontractor, when the general contractor files a bankruptcy. The debtor in possession or the bankruptcy trustee will normally seek funds from the government. The general contractor had "privity of contract" with the government. The general contractor is allowed to sue the government to enforce its contract rights. Once the debtor in possession or bankruptcy trustee does this, however, subcontractors and suppliers have an opportunity to assert their equitable lien in the funds held by the government, the trustee or the bankruptcy court.[46]

A subcontractor on a public project should also consider putting a general contractor into involuntary bankruptcy. If successful, the debtor in possession or trustee would have an obligation to collect contract balances from the government. These funds would then be collected in a forum under the watchful eyes of the unpaid subcontractors, and the bankruptcy court.[47]

A subcontractor may be able to enforce equitable lien rights once the government has paid the contract balance to anyone. There is no doubt the subcontractor has equitable lien rights. Once the funds are held by someone other than the government, the subcontractor also has the right to sue to enforce those rights.

Once the funds leave the owner's hand on a public or private project, however, a claimant will have tracing issues. Does the equitable lien continue to exist in the hands of a third party such as a secured lender? Can a secured lender or other third party become an "involuntary trustee" as with trust relationships?[48] There is not much court case law on this subject, but it does seem that a claimant would have the right to traced funds, at least against a third party with notice of the equitable rights.[49]

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132 Ct.Cl. 724, cert. denied, 350 U.S. 902, 76 S.Ct. 181, 100 L.Ed. 793 (1955)), *aff'd sub nom. Pearlmen v. Reliance Insurance Co.*, 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962).

[39] *Prairie Bank*, *Henningsen v. United States Fidelity & Guaranty Co.*, 208 U.S. 404, 410, 28 S.Ct. 389, 291, 52 L.Ed. 547 (1908); *Munsey Trust*, 332 U.S. 234, 240, 67 S.Ct. 1599, 1602 (1947); *Pearlman v. Reliance Insurance Co*, 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962). For a good discussion of the history of these cases *See In re RAH Development Co. Inc.*, 184 B.R. 525 (W.D. Mich. 1995). Most of these cases concern the subrogation rights of performance and payment bond sureties, but the sureties in those cases could not have equitable liens in contract balances held by the government unless the subs and suppliers paid by the sureties had that same equitable lien. *See Pearlman v. Reliance Insurance Co.,* 371 U.S. 132, 137, 83 S.Ct. 232*,* 9 L.Ed. 2d 190, 197 F.Supp. 441 (W.D. NY 1961). *See also Active Fire Sprinkler Corp. v. United States Postal Service*, 811 F.2d. 747 (2d Cir. 1987). *See also* subsection below, Sureties and Subrogation Issues.

[40] *F.D. Rich v. Industrial Lumber Co. Inc.*, 417 U.S. 116 (1974); *United States for Use of JB Systems v. Federal Ins. Co.*, 8 F. Supp.2d. 1320 (M.D.Ala. 1998).

[41] *See* section below, Quantum Meruit and Unjust Enrichment.

[42] *Tradesman International Inc. v. United States Postal Services*, 234 F.Supp. 1191 (Kan. 2002).

[43] *Fifty State Construction Lien and Bond Law* §1.09 "*When Contractor Does Not Provide Bond*" (Aspen 2002).

[44] *United Electric Corp. v. United States*, 647 F2nd 1082, (Ct. Cl. 1981).

[45] *United Electric Corp. v. United States*, 647 F2nd 1082, (Ct. Cl. 1981).

[46] *In re Pyramid Industries, Inc.*, 170 B.R. 974 (N.D. Ill. 1994); *In re Pyramid Industries, Inc.*, 210 B.R. 445 (N.D. Ill. 1994); *In re RAH Development Co. Inc.*, 184 B.R. 525 (W.D. Mich. 1995).

[47] *Automatic Sprinkler v. Darla Engir. Spec.,* 53 F.3d 181 (7th Cir. 1995).

[48] *See* chapter Trust Fund Laws and Agreements; section, Trust Fund Theory; subsection, Involuntary Trustees.

[49] *Ashworth v. Hagan Estates*, 165 Va. 151 (1935).

There are court cases in which an equitable lien claimant-subcontractor established priority over the debtor's secured lender or surety. It seems fairly clear that the equitable lien claimant wins this priority battle.[50]

It is also clear that claimants to a contract balance have priority in the following order:

1. The owner's right of set-off for the costs of completing the project, costs of payment to subcontractors or other breach of contract claims against the general contractor.
2. The rights of unpaid subcontractors under an equitable lien theory.
3. Payment bond sureties who paid subcontractors pursuant to a payment bond.
4. Assignees of the general contractor, including creditors with perfected security interests and banks.[51]

It would seem that a subcontractor equitable lien claimant could enforce its rights to a fund in the hands of a surety or bank. This could happen, for example, if an owner was making direct payment to a surety under an assignment agreement or if a bank seized funds from a general contractor's bank account. The same principles with respect to involuntary trustees, discussed above, should apply. In other words, while an equitable lien claimant should be able to enforce its rights, the claimant may also need to prove that the stakeholder had notice of the equitable rights. The claimant may also have the same tracing issues, discussed above, to identify funds and show that the money in the hands of the stakeholder is the same money received from the construction project owner.[52]

Payment Bond Issues

Understandably, equitable lien cases often arise where the government fails to require a payment bond, a claimant has failed to preserve its rights under the bond, or the surety has no liability because it has already paid out the maximum amount of the bond. While many cases discuss some version of these facts, no case has held that any of these facts are essential to an equitable lien claim. In other words, subcontractors have equitable lien claims whether or not the Miller Act applies at all to the project[53] or whether the government has failed to require a Miller Act bond.[54] A claimant will still have equitable lien rights in a contract balance held by the government, even if the claimant has simply failed to preserve its Miller Act bond rights[55] or the surety is not required to pay the subcontractor because the surety had already paid the full amount of the bond.[56]

State Public Projects

Equitable lien rights have been found in state public projects as well. The reasoning in these cases is sometimes equally applicable to private and public projects.[57]

Private Projects

Equitable lien rights have also been found in private projects. Most of the language in federal court opinions would be equally applicable to any private construction project, including the general equitable obligation of the owner to pay the provider of labor and materials discussed above or the equitable liens based on general contract language discussed below.

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[50] *Matter of RAH Development Co. Inc.*, 184 B.R. 525 (W.D. Mich. 1995); *In re Pyramid Industries, Inc.*, 210 B.R. 445 (N.D. Ill. 1994); *See also United States v. TAC Construction Co.*, 760 F.Supp. 590 (S.D. Miss. 1991). These battles sometimes take the form of a subrogated surety against a secured creditor. The subrogated surety in such cases consistently has priority over the secured lender, which would indicate that unpaid subcontractors have priority over secured lenders as well. *See National Surety Corp. v. United States,* 133 F.Supp. 381 (Ct. Cl. 1955); *In re Pacific Marine Dredging & Construction v. Tri-City Service District*, 78 B.R. 924 (Or. 1987); *Framingham Tr. Co. v. Gould-National Batteries*, 427 F.2d 856 (1st Cir. 1970); *See also Home Builders, Inc. v. Red Sea Group Ltd*. 475 (Bkcy. E.D. Va. 1997).

[51] *In re Pyramid Industries, Inc.*, 170 B.R. 974 (N.D. Ill. 1994) [Case Below]; *In re Pyramid Industries, Inc.*, 210 B.R. 445 (N.D. Ill. 1994), *citing United States v. TAC Construction*; *See also Home Builders, Inc. v. Red Sea Group Ltd.,* 475 (Bkcy. E.D. Va. 1997).

[52] *Kennedy Electric Company, Inc. v. United States Postal Service*, 508 F.2d 954 (10th Cir. 1974).

[53] *Framingham Tr. Co. v. Gould-National Batteries*, 427 F.2d 856 (1st Cir. 1970).

[54] *Tradesmen International v. Lockheed Martin Corporation*, 241 F.Supp.2d 1337 (Kan. 2003).

[55] *Active Fire Sprinkler Corp. v. United States Postal Service*, 811 F.2d. 747 (2d Cir. 1987).

[56] *Active Fire Sprinkler Corp. v. United States Postal Service*, 811 F.2d. 747 (2d Cir. 1987).

[57] *In re Pacific Marine Dredging & Construction v. Tri-City Service District*, 78 B.R. 924 (Or. 1987).

Many of these private project equitable lien cases indicate that the equitable lien must be based on the state law involved.[58] It may not be a coincidence, however, that most of these cases are in federal court, in which a federal judge is required to review state law to find the equitable lien right. One case indicates that while state law applies, "U.S. Supreme Court and other federal cases define the existence of an equitable lien right."[59]

Like many equitable issues, these questions become somewhat muddled. Courts have found state law equitable lien rights based on state mechanic's lien laws or based on state statutes for criminal liability for failure to pay subcontractors.[60] The legal theories in these cases are often a mixture of equitable lien and constructive trusts.

It is also not clear whether there is an equitable lien in many states. Accordingly, the better theory for courts and claimants in many state law or private project cases may be a contractual theory discussed below.

General Contract Provisions

Many of the federal project cases, state public project cases and private construction project cases discuss general contract provisions in finding an equitable lien.[61] Most general contracts state that the general contractor is in breach of contract and/or the owner has no obligation to pay until the general contractor has paid subs in full and the general contractor provides an affidavit to this effect. Federal regulations require all fixed price construction contracts to provide the following:

> Contractor certification. Along with each request for progress payments, the Contractor shall furnish the following certifications, or payment shall not be made: I hereby certify, to the best of my knowledge and belief, that ... (2) Payments to subcontractors and suppliers have been made from previous payments received under the contract, and timely payments will be made from the proceeds of the payment covered by this certification, in accordance with subcontract agreements and the requirements of Chapter 39 of Title 31, United States Code.[62]

Any property owner, including a public owner, has the right to create contractual obligations with any general contractor to pay all subcontractors on a project. If a general contractor fails to pay the subs, it has no right to further payment.

> [T]he contractor's failure to pay for labor and materials is just as much a failure to perform and carry out the terms of the contract as an abandonment of the work. In short, [the owner] is not contractually obligated to pay the fund to [debtor]. Due to the [debtor's] breach of contract, the [debtor] does not have any legal or equitable interest in the fund. Accordingly, the fund is not the property of the estate.[63]

These contractual rights are bargained for by the government or private owner and are a significant property right, promoting the successful completion of the project. There is no provision of the bankruptcy code, nor any federal or state law, which would allow the bankruptcy trustee, a debtor's surety or a secured lender to eliminate these contract rights by the owner. The general contractor simply has no rights to a contract balance unless and until all subcontractors have been paid. It is on this theory that many bankruptcy courts determine that a contract balance held by an owner is not "property of the estate."[64]

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[58] *Bethlehem Steel Corp. v. J. Coleman,* 66 B.R. 932 (M.D. Ga. 1986); *Georgia Pacific Corp. v. Sigma Service Corp.,* 712 F. 2d 962 (5th Cir. 1983); *In re Modular Structures, Inc.,* 27 F.3D 72 (3d Cir. 1994).

[59] *In re Modular Structures, Inc.*, 27 F.3D 72 (3d Cir. 1994).

[60] *Bethlehem Steel Corp. v. J. Coleman,* 66 B.R. 932 (M.D. Ga. 1986); *Georgia Pacific Corp. v. Sigma Service Corp.,* 712 F. 2d 962 (5th Cir. 1983).

[61] *In re Pacific Marine Dredging & Construction v. Tri-City Service District*, 78 B.R. 924 (Or. 1987). *Framingham Tr. Co. v. Gould-National Batteries*, 427 F.2d 856 (1st Cir. 1970); *In re Modular Structures, Inc.,* 27 F.3D 72 (3d Cir. 1994).

[62] 48 C.F.R. 52.232-5 (2003).

[63] *In Re Pacific Marine Dredging & Construction*, 79 B.R. 924, 929 (Bankr.D.Or.1987). *See also In re Modular Structures, Inc.,* 27 F.3D 72 (3d Cir. 1994). It is on this theory that bankruptcy courts often determine that a contract balance is not "property of the estate." *See* chapter, Bankruptcy Primer for Creditors; section, Preferences.

[64] *In re Modular Structures, Inc.,* 27 F.3D 72 (3rd Cir. 1994); *Polish v. Johnson Service Company,* 333 F.2d 545 (3d Cir. 1964); *In re Pacific Marine Dredging & Construction v. Tri-City Service District*, 78 B.R. 924 (Or. 1987); *See contra In re Matter of RAH Development Co. Inc.*, 184 B.R. 525 (W.D. Mich. 1995) where the bankruptcy court found that an equitable lien existed, but that the funds had to be paid into and administered by the bankruptcy court, because the fund was property of the estate. While this reasoning is questionable and not in accordance with other cases, it may be a procedural distinction without a difference.

Other bankruptcy court cases, however, have found that an equitable lien exists and that contract funds are not property of the estate, even without discussion of contract provisions.[65]

Whether the contract balance is "property of the estate" may be a procedural distinction without a difference. A fund will have to be paid into the bankruptcy court if it is property of the estate. While this will increase the bankruptcy trustee's commission, it should not affect the final result. The equitable lien claimant would stand in the same position as any other secured creditor, with a priority right to distribution of funds out of the bankruptcy estate. It is apparent that the equitable lien claimant would have priority in this fund, even over other secured creditors with an assignment or security interest in the same funds. It is probably the correct answer, however, and is a preferable procedure for a claimant that the fund goes directly to the claimant and not through the bankruptcy estate. At a minimum, this would mean faster payment and would reduce the risk of competing claims to the fund.

Sureties and Subrogation Issues

Equitable lien theory has historically been an extremely important vehicle for a payment or performance bond surety.[66] Much of the equitable lien case law actually involves a surety making claim to a contract balance in the hands of the government.

A surety will claim a contract balance from a property owner on the theory of "subrogation." If a surety is required to pay a claimant under a payment or performance bond, the surety acquires the rights of the claimant that the surety paid. This is an equitable concept, not dependent on any contractual provision.[67]

If a surety pays a subcontractor in full, the surety can then seek reimbursement by enforcing any rights the subcontractor had, including enforcing an equitable lien against a contract balance held by an owner. As we discussed above, however, a subcontractor has no right to enforce this equitable lien against a government owner, because of sovereign immunity.[68]

The surety is also subrogated to the rights of the general contractor, however. The general contractor is in direct privity of contract with the government and does have the right to sue the government. On this theory, federal courts have allowed a surety to enforce equitable lien rights of the subcontractors, even though the subcontractors would be barred from enforcing these rights themselves because of sovereign immunity.

A surety has better rights than a subcontractor with this ability to avoid sovereign immunity problems. Otherwise, however, the surety's rights cannot be stronger than the subcontractor's rights. As discussed above,[69] the equitable rights of unpaid subcontractors in retained funds are superior to the equitable rights of a surety that had paid other subcontractors.

> [T]he sureties' claims arose because the sureties' were subrogated to the rights of the suppliers and laborers. Any rights held by the sureties were founded upon the rights of the unpaid laborers and suppliers ... We would hardly hold that a subrogee [i.e., the Sureties] may enforce a right after becoming subrogated to it, but that the original owner of the right [i.e., the subcontractors] may not enforce the right before the subrogation occurs.

In fact, as discussed above, an unpaid subcontractor will win a battle with a surety for priority over a fund held by an owner.[70] Under the settled law of suretyship, the surety is not subrogated to the subcontractor claimants' rights until those claimants have been paid in full.[71]

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[65] *Active Fire Sprinkler Corp. v. United States Postal Service*, 811 F.2d. 747 (2d Cir. 1987); *National Surety Corp. v. United States,* 133 F.Supp. 381 (Ct. Cl. 1955); *United Electric Corp. v. United States*, 647 F.2d 1082, (Ct. Cl. 1981).

[66] *Pearlman v. Reliance Insurance Co.,* 9 L.Ed. 2d 190, 197 F.Supp. 441 (W.D. NY 1961); *Henningsen v. United States Fidelity & Guaranty Co.*, 208 U.S. 404, 410, 28 S.Ct. 389, 291, 52 L.Ed. 547 (1908).

[67] *American Nat'l Bank & Trust Co. v. Weyerhaeuser Co.*, 692 F.2d 455,460 (7th Cir. 1982).

[68] *Depart. of Army v. Blue Fox, Inc.*, 525 US 255 (1999); *Blue Fox v. Small Bus. Administration*, 121 F.3d 1357 (9th Cir. 1997); *Tradesmen International, Inc. v. United States Postal Service*, 234 F.Supp.2d 1191 (Kan. 2002); *U.S. v. TAC Constr. Co., Inc.*, 760 F. Supp. 590 (S.D. Miss. 1991); *But see Kennedy Electric Company, Inc. v. United States Postal Service*, 508 F.2d 954 (10th Cir. 1974).

[69] *See* subsection above, Sureties and Subrogation Issues.

[70] *Active Fire Sprinkler Corp. v. United States Postal Service*, 811 F.2d. 747 (2d Cir. 1987).

[71] *Active Fire Sprinkler Corp. v. United States Postal Service*, 811 F.2d. 747 (2d Cir. 1987).

Providing Notice of the Equitable Lien

It may be important for an equitable lien claimant to provide notice of their equitable lien claim at an early stage. As in any construction contract case, the earlier an owner is aware of a dispute, the earlier the owner can and will began to hold funds to protect the owner's interest as well as the subcontractor's. In most cases, it will be considerably easier to amicably resolve a dispute if a fund for payment is preserved.

It also makes sense that there is a "defense of payment" feature to an equitable lien claim.[72] Once the owner has paid everything owed to a general contractor, there can be no equitable lien claim against funds in the hands of the owner. There may be an ability to trace funds and enforce rights against third parties,[73] but there will be no claim against the owner.

In at least one case, an owner was exposed to double liability and required to pay an equitable lien claimant after the owner ignored a notice of equitable lien and made payment to others.[74] Accordingly, owners and general contractors should take notice of any equitable lien seriously. By the same token any subcontractor will wish to send notice of their equitable lien at the earliest sign of trouble in a project to the project owner, general contractor and, if possible, any surety and secured lender.

QUANTUM MERUIT AND UNJUST ENRICHMENT

Quantum Meruit and unjust enrichment are also ancient equitable theories that can allow recovery to a claimant in the absence of an express contract. Like equitable liens, these are malleable and somewhat muddled concepts that have gone by many different names, including *quantum meruit*, quasi contract, implied contract, unjust enrichment and other names.[75]

This outline will not attempt to survey all of the different names and concepts that have been used over hundreds of years. This would serve no purpose and is probably impossible. Different courts have conflicting definitions and principles. It is fair to say that all of these equitable concepts are based on the idea that someone got something for nothing and it is not fair to let them keep it without paying for it.

It is important to note that these are all theories of *personal* liability, unlike equitable liens or trusts, which create an interest in property. *Quantum meruit* type theories allow the claimant to sue the person that benefited from labor or materials supplied.

> *Quantum meruit* is an equitable remedy founded upon the principle that no one who benefits from the labor ... of another should be unjustly enriched at the other's expense. The doctrine operates, in the absence of a specific contract, to infer a promise on behalf of the person to whom the benefit is conferred to pay a reasonable sum for the services or materials furnished. In other words, *quantum meruit* presupposes both the absence of an express contract and unjust enrichment of the defendant.[76]

Under Maryland and Virginia law, the essential elements of a *quantum meruit* or unjust enrichment claim are

1. A benefit conferred upon the defendant by the plaintiff.
2. An appreciation or knowledge by the defendant of the benefit.
3. Acceptance or retention by the defendant under such circumstances as to make it inequitable for defendant to retain the benefit without payment of its value.[77]

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

[73] *See* chapter, Trust Fund Laws and Agreements; section, Trust Fund Theory; subsection, Tracing and Identifying Funds in Debtor's Possession.

[74] *Active Fire Sprinkler Corp. v. United States Postal Service*, 811 F.2d. 747 (2d Cir. 1987).

[75] *In re Presidential Golf Course Claims*, 83 Va. Cir. 541, 545-546 (Va. Cir. Ct. 2010) [It is clear that many courts have struggled with the terms, unjust enrichment, *quantum meruit,* quasi contract and implied contract. They have often been used interchangeably. It is clear from a review of the authorities that there has been considerable confusion in the law regarding the various terms].

[76] *Kane Enterprises v. MacGregor (USA), Inc.*, 322 F.3d 371, 376 (5th Cir. 2003). Citations omitted.

[77] *Grubb & Ellis Co. v. Potomac Med. Bldg., LLC*, 2009 U.S. Dist. LEXIS 93471 (E.D. Va. Sept. 29, 2009); *Gutterman Iron & Metal Corp. v. Figg Bridge Developers, L.L.C.*, 82 Va. Cir. 304 (Va. Cir. Ct. 2011); *Granite Construction Company v. Mass Transit Administration*, 57 Md. App. 766, 774, 471 A.2d 1121, (Md. Ct. Spec. App. 1984), *citing Dobbs Handbook on the Law of Remedies* §4.2 (1973); *see also Paramount Brokers, Inc. v. Digital River, Inc.*, 126 F.Supp. 2d 939 (D.Md. 2000); *Brookfield Centre Ltd. Partnership v. CFS Mgt. Co.*, 135 Bankr. 23 (Bankr. E.D. Va. 1991).

Some courts have said that the modern trend is to recognize actions for quasi-contract based on a "reasonable expectation theory." Under this doctrine, one of three things must be true to recover in quasi-contract:

1. The plaintiff had a reasonable expectation of payment;[78]
2. The defendant should reasonably have expected to pay;[79] or
3. Society's reasonable expectations of security of person and property would be defeated by nonpayment.

The most obvious and important of these elements is unjust enrichment in the defendant. If the defendant has not received something for nothing, a *quantum meruit* claim will probably not succeed.[80] If the defendant had to pay someone else for the labor and materials, for example, there is no unjust enrichment.[81] Similarly, if the labor or material had no value, there would be no unjust enrichment.[82]

Where there is a valid, clear and unambiguous contract between the parties and there is no misunderstanding concerning the price to be paid, *quantum meruit* is not available.[83] This is often an issue for "extra" or "change order" work in a construction contract. A claimant cannot circumvent notice or other claims provisions in the contract by using a *quantum meruit* theory.[84]

The simplest case in the construction industry context would be someone who requested labor and materials without any express agreement, but then refused to pay, on the theory that there was no enforceable contract. The law will imply a contract and provide recovery.[85]

A more complex issue arises when a subcontractor tries to collect from an owner for labor and materials supplied. This could happen, for example, if a general contractor goes out of business or abandons a project.

The majority of states permit a subcontractor to assert a *quantum meruit* claim against an owner, despite the fact that there is no privity of contract between the owner and subcontractor, so long as the essential elements of quasi-contract are present.[86]

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[78] *Gutterman Iron & Metal Corp. v. Figg Bridge Developers, L.L.C.*, 82 Va. Cir. 304 (Va. Cir. Ct. 2011).

[79] In the District of Columbia, there are four elements of a claim in quantum meruit: (1) valuable services being rendered; (2) for the person sought to be charged; (3) which services were accepted by the person sought to be charged, used and enjoyed; and (4) under such circumstances as reasonably notified the person sought to be charged that the plaintiff, in performing such services, expected to be paid. *Waco Scaffold & Shoring Co. v. 425 Eye Street Associates*, 355 A.2d 780, 783 (D.C. 1976).

[80] *Kern v. Freed Co.*, 224 Va. 678, 299 S.E.2d 363 (1983).

[81] *Kern v. Freed Co.*, 224 Va. 678, 299 S.E.2d 363 (1983).

[82] *Grubb & Ellis Co. v. Potomac Med. Bldg., LLC*, 2009 U.S. Dist. LEXIS 93471 (E.D. Va. Sept. 29, 2009) [*Quantum meruit* claim failed because Plaintiff failed to prove that the services rendered were of value. Under *quantum meruit*, a plaintiff is only entitled to recover the reasonable value of its services performed. Recovery is not measured by the benefit conferred on the defendant, but rather by the actual value of the services performed].

[83] *Pa. Elec. Coil v. City of Danville*, 329 Fed. Appx. 399, 404 (4th Cir. Va. 2009) [Where there is an express and enforceable contract in existence which governs the rights of the parties, the law will not imply a contract in contravention thereof], *citing Royer v. Board of County Supervisors*, 176 Va. 268, 10 S.E.2d 876,881 (Va. 1940); *Artistic Stone Crafters, Inc. v. Safeco Ins. Co. of Am*., 2010 U.S. Dist. LEXIS 76698, 20-21 (E.D. Va. July 27, 2010) [Because the Subcontract specifies a process for the reimbursement of additional, unanticipated costs incurred in the project, the claimant is unable to obtain such reimbursement under a theory of *quantum meruit*].

[84] *Pa. Elec. Coil v. City of Danville*, 329 Fed. Appx. 399, 404 (4th Cir. Va. 2009) [the parties' contract forecloses any recovery under a *quantum meruit* theory because the contract contains a provision requiring written change orders for price increases*], citing Main v. Department of Highways*, 206 Va. 143, 142 S.E.2d 524 (Va. 1965) [The written contract clearly provided the method to insure the recovery of the cost of extra work. Not having followed the prescribed method, they are not entitled to such recovery an implied agreement or *quantum meruit* basis].

[85] *Mongold v. Woods*, 278 Va. 196, 203, 677 S.E.2d 288 (Va. 2009) [*Quantum meruit* recovery is based upon an implied contract to pay the reasonable value of services rendered. Where service is performed by one, at the instance and request of another, and nothing is said between the parties as to compensation for such service, the law implies a contract, that the party who performs the service shall be paid a reasonable compensation.]; *Nossen v. Hoy*, 750 F.Supp. 740 (E.D. Va. 1990); *Marine Dev. Corp. v. Rodak*, 225 Va. 137, 300 S.E.2d 763, 765 (Va. 1983) [He who gains the labor of another must make reasonable compensation. When one furnishes labor to another under a contract which is void and of no effect, he may recover the value of his services on a *quantum meruit*.]; *Hendricks v. Meredith*, 161 Va. 193 (1933).

[86] *Building and Construction Contracts: Right of Subcontractor Who Has Dealt Only with Primary Contractor to Recover Against the Property Owner in Quasi Contract*, 62 A.L.R.3d 288 (1975); 66 Am. Jr. 2d *Restitution and Implied Contracts*, §15 (1973).

Virginia Courts have followed the majority approach and recognized that a subcontractor supplying material or labor that benefits the property can sue the owner of the property directly on a theory of *quantum meruit*. Though there is no privity of contract between them, where the owner has been unjustly enriched through materials or labor supplied by the subcontractor, *quantum meruit* is appropriate as an equitable remedy.[87]

In *School Board v. Saxon Lime and Lumber*, the Virginia Supreme Court allowed a subcontractor to recover the value of materials furnished for use in a school project. Because the general contractor had gone bankrupt and the school board had benefited by use of the materials in the project, the plaintiff subcontractor was entitled to recovery against the school board. Though there was no express contract between them, the court held that there was an implied contract to pay for the materials used.[88] Again, the issue of unjust enrichment was important. If the owner has paid for the labor and materials, there is no unjust enrichment and a subcontractor will not be able to recover.[89] This may also be true if the improvements simply have no value to the owner because they are unusable or simply have not been used (i.e., has no value to this owner).[90]

Another interesting use of *quantum meruit* theories occurs in lease situations, where a tenant orders improvements to real estate, but the lease is then terminated. Recovery may be allowed in some such cases.

[87] *School Board v. Saxon Lime and Lumber Co.*, 121 Va. 594 (1917); *Gutterman Iron & Metal Corp. v. Figg Bridge Developers, L.L.C.*, 82 Va. Cir. 304 (Va. Cir. Ct. 2011); *Sherwin Williams Co. v. Buckingham Associates*, 20 Va. Cir. 83 (1990); *E.E. Lyons Construction Co. v. TRM Development Corp., and Sizzler Restaurants International, Inc.*, 25 Va. Cir. 352 (1991); *Hughes & Hughes, Inc. v. Bradley*, 25 Va. Cir 158 (1991). *See also CTI Consultants, Inc. v. Mercure Dulles Inc.*, 26 Va. Cir 257 (1992) [holding that quantum meruit is an appropriate remedy for a subcontractor, by denying the remedy given the particular facts in that case].

[88] *School Board v. Saxon Lime and Lumber Co.*, 121 Va. 594, 597 (1917).

[89] *Kern v. Freed Co.*, 224 Va. 678 (1983).

[90] For a subcontractor to recover on a quantum meruit claim, it must show that it bestowed a benefit upon the defendant. *See Filston Farm Co. v. Henderson,* 106 Md. 335 (1907).