

# Construction Trust Fund Statutes: Use as a Shield and Weapon

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# CONSTRUCTION TRUST FUNDS

- Several states have enacted construction trust fund statutes in an attempt to protect owners and generals as well as ensure that subcontractors, and in some cases sub-subcontractors and suppliers, are paid monies owed to them for labor and/or materials supplied to construction projects.

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## A TYPICAL TRUST FUND

- A typical construction trust fund statute may provide as follows:

“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 who did work or furnished materials, or both.”

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# WHO IS WHO AND WHAT IS WHAT

- **Trustee** - Party who receives the monies.
- **Trust Property** - Monies paid for work done or materials furnished, or both.
- **Trust Beneficiaries** - the subcontractors / laborers who did the work or suppliers who furnished the materials.
- The purpose of the trust is to pay the trust beneficiaries.

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# PERSONAL LIABILITY

- Officers, Owners and Directors or those who receive and disburse funds.
  - Non-Dischargeable in Bankruptcy
  - Civil Claims
  - Criminal Liability

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## PUBLIC OR PRIVATE

- Construction trust fund statutes attach a trust to funds paid or to be paid to contractors, and subcontractors.
- Some statutes distinguish between PUBLIC and PRIVATE contracts and only apply to a specific class of project.
- Other constructive trust fund statutes apply only to claims that would be the proper subject of a mechanic's lien. In such states, it follows that the statute would not apply on a public works project as such a project is not lienable.

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## REMEDIES

- Construction trust fund statutes vary widely by State with regard to the remedies provided under the statutes. Some states' statutes provide for civil remedies such as attorney's fees or interest if the construction trust funds are misappropriated, while other states do not.
- Instead some statutes provide solely criminal penalties in an attempt to deter misappropriation while yet other states provide for both – civil and criminal penalties.

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## MORE REMEDIES

- Construction trust fund statutes that provide criminal sanctions for misappropriation of trust funds generally only apply to funds already paid to a contractor.



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## MORE REMEDIES

- A few states provide for personal liability for officers or directors of the contractor if the trust funds are misappropriated. This personal liability is usually only imposed on the officers or directors who controlled distribution of the trust funds. The statute may require proof of the officer's or director's intent to defraud the trust beneficiary. Others are basically strict liability. Such an officer or director may be personally liable even if the construction trust fund statute does not so provide.

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# CONSTRUCTION TRUST FUND AND BANKRUPTCY

- Trust Funds are not property of a Bankruptcy estate.
- Pursuant to section 541(d) of the Bankruptcy Code, property in which a debtor holds only legal title and not equitable title becomes part of the debtor's bankruptcy estate only to the extent of debtor's legal title. If there is a valid trust in existence, "property of the debtor held in trust at the time of filing its bankruptcy petition is excluded from the bankruptcy estate." Important for preference claims by Trustee.
- To the extent that there is a valid trust in existence, construction trust funds paid to the debtor after the filing of bankruptcy are held by the debtor subject to the trust obligations.

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# CONSTRUCTION TRUST FUND AND BANKRUPTCY

- Can a violation of a construction trust fund statute support a finding of non-dischargeability?
  - For those statutes which provide solely criminal remedies, some courts have generally held that misappropriation of the trust funds does not support a finding of non-dischargeability.
  - For construction trust fund statutes that do not require segregated accounts but do create express trust requirements that arise before any wrongdoing, the courts generally hold that a misappropriation of the trust funds will support a finding of non-dischargeability.
- Likewise, statutes that require the contractor to segregate and keep detailed records of the funds find the trust to be sufficient to support a determination of non-dischargeability.

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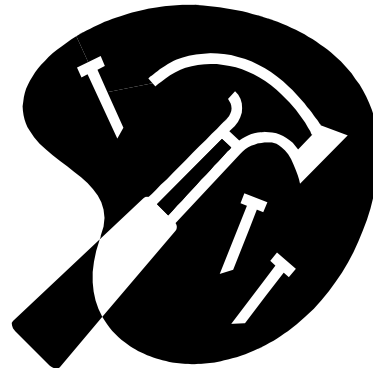
## COMMINGLING OF TRUST FUNDS

- Most construction trust fund statutes set forth little or no procedural requirements for the maintenance of the trust funds and may expressly permit commingling of trust and non-trust funds.
- Other statutes require that detailed accountings be kept for each trust. If commingling is permitted, the funds do not lose their trust nature as a result.

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# CONSTRUCTION TRUST FUND STATUTE BY STATE

Does your state have a construction trust fund statute?



Let's take a look!

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# CONSTRUCTION TRUST FUND STATUTE BY STATE

States that do not have a trust fund statute:

|             |               |                |               |
|-------------|---------------|----------------|---------------|
| Alaska      | Indiana       | Missouri       | Rhode Island  |
| Arkansas    | Iowa          | Montana        | Tennessee     |
| California  | Kansas        | Nebraska       | Utah          |
| Connecticut | Kentucky      | Nevada         | Virginia      |
| Florida     | Louisiana     | New Mexico     | West Virginia |
| Georgia     | Maine         | North Carolina | Wyoming       |
| Hawaii      | Massachusetts | Oregon         |               |
| Idaho       | Mississippi   | Pennsylvania   |               |

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## COLORADO

Colorado has a construction trust law, Colo. Rev. Stat. Ann. § 38-22-127.

It provides that all funds disbursed to a contractor or subcontractor on a project subject to Colorado's mechanics' lien law are held in trust for downstream subcontractors who may have a lien against the subject property. Colo. Rev. Stat. Ann. § 38-22-127(a). However, where the contractor or subcontractor to whom the disbursement was made has a good faith belief that the lien claim is invalid or is subject to setoff, no trust is created. Colo. Rev. Stat. Ann. § 38-22-127(b). Colorado imposes personal liability upon those officers controlling the disbursement of funds who divert trust funds to other obligations of the contractor or subcontractor. See *Flooring Design Assocs., Inc. v. Novick*, 923 P.2d 216, 221 (Colo. App. 1995).

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## DELAWARE

Delaware has a construction trust fund statute that appears to apply to all types of projects. Del Code Ann. tit. 6, § 3502.

The statute applies to any contractor, subcontractor, or any other person who enters into contract to supply labor or materials. The statute doesn't apply to owners. The statute applies to funds received. Violation of the statute can result in interest penalties, Del. Code Ann. tit. 6, § 3506, and a violator may also be subject to criminal fines and possible imprisonment, Del Code Ann. tit. 6, § 3505. If a payment is not withheld "in good faith for reasonable cause," then a court may also award reasonable attorneys' fees. There are no restrictions or limitations on commingling under the statute.



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# ILLINOIS

Illinois has a construction trust statute, but it is only applicable to projects on which lien waivers are required. 770 ILCS 60/21.02.

The statute provides that where an owner, contractor, subcontractor, or supplier of any tier requires the execution of a lien waiver from any person supplying labor or materials to a project governed by the mechanics' lien law, any earned but unpaid funds for work for which the lien was waived are held in trust for the party executing the waiver.

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# MARYLAND

Maryland has a construction trust law, Md. Code Ann., Real Prop. § § 9-201, et seq.

It requires that any funds paid under a contract by an owner to a contractor or by an owner or contractor to a subcontractor shall be held in trust for those subcontractors who did the work or furnished the materials for purposes of paying those subcontractors. Md. Code Ann., Real Prop. § 9-201. The trust nature of the funds extends to the benefit of lower tiers of subcontractors. *Id.* The law applies to private projects and to those under the Little Miller Act, but not to federal projects within the state or single home residential contracts. Md. Code Ann., Real Prop. § 9-204; *United States ex rel. Allied Bldg. Prods. Corp. v. Federal Ins. Co.*, 729 F. Supp. 477, 478 (D. Md. 1991).

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# MICHIGAN

Michigan has a construction trust fund statute, The Michigan Building Contract Fund Act, Mich. Comp. Laws Ann. § 570.151, et seq. (the “MBCFA”).

The MBCFA does not apply to public construction projects. In re Certified Question, 411 Mich 727; 311 NW.2d 731 (1981). The MBCFA is for “the benefit of the person making the payment, contractors, laborers, subcontractors or materialmen.” Mich. Comp. Laws Ann. § 570.151. The MBCFA applies to laborers, subcontractors and materialmen that contracted directly with the contractor or subcontractor who is acting as the trustee. Mich. Comp. Laws Ann. § 570.151; *KMH Equip. Co. v Chas J Rogers, Inc.*, 104 Mich. App. 563; 305 NW.2d 266 (1981). Equipment lessors are not protected under the MBCFA. *KMH Equip. Co. v Chas J Rogers, Inc.*, 104 Mich. App. 563; 305 NW.2d 266 (1981). The MBCFA provides that the contract funds paid by any person to a contractor, or by such person or contractor to a subcontractor are trust funds. Mich. Comp. Laws Ann. § 570.151. The MBCFA does not impose a trust upon funds held by the owner. *Renshaw v Samuels*, 117 Mich. App. 649; 324 NW.2d 117 (1982).

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## MICHIGAN CONTINUED

The MBCFA imposes civil and criminal liability for violation of the statute. See *People v Whipple*, 202 Mich App 428; 509 NW2d 837 (1993), *James Lumber Co., Inc. v J & S Constr., Inc.*, 107 Midi. App. 793; 309 N.W.2d 925 (1981). The MBCFA also imposes criminal liability for violation of the statute, Mich. Comp. Laws Ann. § 570.152, and personal liability where a defendant personally mis-appropriated the funds after they have been received by the corporation. *People v Brown*, 239 Mich. App. 735; 610 N.W.2d 234 (2000). Nothing in the MBCFA prohibits a trustee from commingling.

- Felony – Three years prison

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## MINNESOTA

Minnesota has a construction trust fund statute that applies to “payments received by any person contributing to an improvement to real estate within the meaning of section 514.01 shall be held in trust by that person for the benefit of those persons who furnished the labor, skill, material, or machinery contributing to the improvement.” Minn. Stat. Ann. § 514.02 (2003).

If a person uses trust funds knowing that the funds are owed to a supplier of labor or material and if the person has not provided the person making payment a valid lien waiver in accordance with Minn Stat. Ann. § 514.07, or has not furnished the person making payment with a payment bond in the basic amount of the contract price, such person is guilty of theft. If the misappropriation of trust funds is related to residential real estate, a “shareholder, officer, director, or agent of a corporation who is responsible for the theft shall be guilty of theft of the proceeds.” Minn. Stat. Ann. § 514.02 (2003). A person injured by a misappropriation of trust funds may bring a civil action for “costs, disbursements, including costs of investigation and reasonable attorney’s fees” and may receive other relief as determined by the court. Minn. Stat. Ann. § 514.02 (2003).

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## NEW JERSEY

New Jersey has two separate trust fund statutes. N.J. Stat. Ann. § 2A:44-148 is a trust fund statute for public works and N.J. Stat. Ann. §§ 2A:29A, et. seq. is a trust fund statute for private parties who have forwarded money toward the purchase of a dwelling house.

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# NEW JERSEY - PUBLIC

## Public Projects:

N.J. Stat. Ann. § 2A:44-148 applies to all money paid by a public entity to a contractor for any type of public improvement. The money is to be treated as a trust fund in the hands of the contractor until “all claims for labor, materials and other charges incurred” in connection with the improvement are fully paid. This trust fund statute only “protects those who have a direct contractual relationship with the prime or general contractor”, and does not extend its benefits to those “who have furnished labor or materials for the project through contract with any subcontractors down the ladder.” *Universal Supply Co. v. Martell Constr. Co., Inc.*, 156 N.J. Super. 327 (App. Div. 1978). The trust fund is created by any public entity in New Jersey paying any Contractor for “public improvements.” N.J. Stat. Ann. § 2A:44-148. The trust attaches whenever money is paid by a public entity to a contractor and remains until all claims for labor, materials and other charges incurred with the construction have been paid. N.J. Stat. Ann. § 2A:44-148.

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## NEW JERSEY – PUBLIC CONTINUED

A breach of this trust fund statute by a contractor may result in a charge of theft by failure to make required disposition under N.J. Stat. Ann. § 2C:20-9. The offense of “theft by failure to make required disposition of property received” is committed when a person: (1) purposely obtains or retains property upon agreement or subject to a known legal obligation to make specified payment or other disposition, (2) deals with the property obtained as his own, and (3) fails to make the required payment or disposition. *State v. Pessolano*. 343 N.J. Super. 464, 778 A.2d 1153 (App. Div. 2001). *American Lumberman’s Mut. Casualty Co. of Illinois v. Bradley Const. Co.*, 13 A.2d 783, 786 (N.J. Ch. 1940); citing N.J. Stat. Ann. § 2:60-212 (now superceded by N.J. Stat. Ann. § 2C:20-9).



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## NEW JERSEY - PRIVATE

### Private Projects:

N.J. Stat. Ann. § 2A:29A, et. seq. applies to moneys paid as a deposit or advance by a person who has contracted or agreed to purchase a dwelling house to be constructed. Applies to the person who contracts or agrees to purchase a dwelling house to be constructed and any person who receives those funds. See N.J. Stat. Ann. § 2A:29A-l. It applies only to funds deposited or advanced on a yet to be build dwelling house. N.J. Stat. Ann. § 2A:29A-l. Any misuse of the money covered by the statute constitutes an unlawful diversion of funds and the violator can be adjudged a disorderly person and subjected to a fine of not, less than \$200 or by imprisonment for not more than 30 days or both. N.J. Stat. Ann. § 2A:29A-4. See N.J. Stat. Ann. § 2C:20-9.

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## NEW YORK

New York does have a construction trust fund statute, N.Y. Lien Law § § 70-79-a (McKinney 1993 & Supp. 2004).

The statute applies to all projects for improvement to real property or construction of public improvements and to Owners, as trustees of funds received by Owner; Contractors and Subcontractors, as trustees of funds received by Contractors and Subcontractors respectively; Contractors, Subcontractors, Vendors as beneficiaries of the Owner's trust and beneficiaries of trust funds received by upper tier contractors; and Governmental entities with claims such as employment taxes.

The trust arises when trust asset comes into existence (first payment) and continues until all claimants have been paid or the trust is exhausted.

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# OKLAHOMA

The Oklahoma trust fund statutes are Okla. STAT. tit, 42, § § 152 and 153. Because they create trusts for the benefit of those with “lienable claims” the statutes apply solely to private works projects since lien claims cannot be asserted against public property.

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## OKLAHOMA CONTINUED

The amount payable under any building or remodeling contract shall, upon receipt by any contractor or a subcontractor, be held as trust funds for the payment of all “lienable claims” due and owing or to become due and owing by such contractors or subcontractors. Similarly, funds received pursuant to a mortgage executed for the purpose of constructing or remodeling any structure are deemed to be trust funds for the payment of all valid lienable claims due and owing or to become due and owing by the mortgagor. Likewise, the amount received by a seller of real property under a warranty deed must be held as trust funds for the payment of all valid lienable claims due and owing or to become due and owing by the seller or his predecessors in title which arise out of improvements made upon the real property within four months (the lien filing period in Oklahoma for a prime contractor) prior to the delivery of the warranty deed. Okla. Stat. tit. 42, § 152.

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## OKLAHOMA CONTINUED

There is no mandate that the “trust funds” be deposited to a separate or special bank account, although doing so might be the safest method of avoiding an alleged breach of trust and criminal prosecution for embezzlement by trustee under OKLA. STAT. tit. 21, § 1451. Section 153 specifically provides that such “trust funds. . . shall be applied to the payment of said valid lienable claims and no portion thereof shall be used for any other purpose until all lienable claims due and owing or to become due and owing shall have been paid.” If the party violating the trust fund law is an entity having the characteristics of limited liability pursuant to law, both the entity and the natural persons having the legally enforceable duty for the management of the entity shall be liable for the proper application of the trust funds, and are subject to punishment for criminal embezzlement by trustee in the event of misuse. For criminal prosecution purposes the “natural persons” subject to punishment include the managing officers of a corporation and the manager(s) of a limited liability company. Okla. Stat. tit. 42, § 153.

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## OKLAHOMA CONTINUED

The trust fund statutes do not prohibit the filing or enforcement of a statutory labor, mechanic or materialman's lien by a lien claimant, nor does the filing of a lien claim release the holder of the trust funds from the statutory trust obligations. Okla. Stat. tit. 42, § 153. In fact, a properly perfected mechanic's and materialman's lien claim is necessary in order to create a "lienable claim," thus invoking the constructive trust fund statutes. *In re Tefertiller*, 1989 Ok. 60, 772 P.2d 396.

If someone other than a statutorily identified recipient of trust funds is found to have actually exercised control over disbursement of the funds, knowing it to be a part of the trust res, such person may be regarded pro tanto as an involuntary trustee. *Sandpiper North Apartments, Ltd. v. American Nat. Bank and Trust Co. of Shawnee*, 1984 OK 13, 680 P.2d 983.

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## OKLAHOMA CONTINUED

One charged with knowledge of the source of trust funds is required to inquire as to the source, and thereafter make proper distribution by paying valid lienable claims, rather than applying the payment to the oldest debt due. *McGlumphy v. Jetero Const. Co., Inc.*, 1978 Ok. 154, 593 P.2d 76.

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# SOUTH CAROLINA

South Carolina has a “First Lien on Funds” statute found at Section 29-7-10 of the South Carolina Code.

- The statute applies to projects involving the “erection, alteration, or repairing of buildings in this State...”
- It applies to general contractors, subcontractors, lower tier subcontractors and materialmen. It does not apply to the owner.
- It applies to funds paid to the contractor or to any subcontractor.
- The contractor or subcontractor who fails to pay a lower tier entity from funds received is guilty of a misdemeanor and may face up to 6 months imprisonment.
- There is no prohibition against commingling.



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## SOUTH DAKOTA

The South Dakota trust fund statute is S.D. Codified Laws § 44-9-13 (2004).

- The statute applies to “any improvement of real estate, mines or purviews.”
- The statute applies to “any contractor, subcontractor or supplier.
- The statute applies to funds in excess of five hundred dollars of the proceeds from the project used for non-project-related purposes when there are still project-related outstanding costs. “It is not a violation of this section to withhold funds from a contractor, subcontractor or supplier pending the completion and approval of his final work or product.”
- The statute makes such use of the funds a criminal offense: the individual “is guilty of theft of the proceeds of such payment.”
- The statute does not mention commingling.

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# TEXAS

Texas does have a construction trust fund statute: Tex. Prop. Code Chapter 162

The statute applies to Public, private commercial, residential. Residential project: over \$5,000. must be deposited in a construction account.

The statute applies to the Owner, general contractor, subcontractor, lower-tier subcontractor vendor for all construction payments as well as loan receipts for the purpose of improving specific real property secured by a lien on the property.

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# VERMONT

Vermont's trust fund statute is Vt. Stat. Ann. tit. 9, § 4003, "Contractor's and subcontractor's payment obligations."

This statute applies to the payment of subcontractors, and requires that the due date for receipt of payments from the owner be disclosed to the subcontractor. Additionally, when a subcontractor has performed in accordance with the provisions of its contract, a contractor shall pay to the subcontractor, and each subcontractor shall in turn pay to its subcontractors, the full or proportional amount received for each such subcontractor's work and materials based on work completed or service provided under the subcontract, seven days after receipt of each progress or final payment or seven days after receipt of the subcontractor's invoice, whichever is later.

If there is a delay in payment, "the contractor or subcontractor shall pay its subcontractor interest, beginning on the next day, at an interest rate equal to that established by [12 V.S.A. § 2903\(b\)](#), on such unpaid balance as may be due." The statute does not mention commingling.

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# WASHINGTON

Washington has a “trust fund” statute codified at Wash. Rev. Code § 60.28.010.

It applies only to “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.” By its terms, the statute requires retention of up to 5% of moneys earned “as a trust fund for the protection and payment of any person or persons, mechanic, subcontractor or materialman who shall perform any labor upon such contract or the doing of said work, and all persons who shall supply such person or persons or subcontractors with provisions and supplies.” The statute also protects “the state with respect to taxes” due from the contractor. The 5% retainage is subject to reduction after 50% of the original contract work has been completed.

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# WISCONSIN

Wisconsin has a trust fund statute that applies to private projects, Wis. Stat. § 779.02(5) (2003), and public projects, Wis. Stat. § 779.16 (2003).

The trust attaches to funds that have been paid out, see *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, see *Wis. Dairies, Corp. v. Citizens Bank*, 160 Wis. 2d 758, 467 N.W.2d 124 (1991), or funds paid into the bank, see *Kraemer Bros. v. Pulaski State Bank*, 138 Wis. 2d 395, 406 N.W.2d 379 (1987).

The trust fund statute provides for civil penalties and criminal penalties. See Wis. Stat. §§ 779.02(5), 779.16 (civil penalties); Wis. Stat. § 943.20 (criminal penalties) as well as specific enforcement, interest, attorneys' fees, personal liability on private projects per Wis. Stat. § 779.02(5).

Is the trustee entitled to commingle? Yes, see *Simonson v. McInville*, 42 Wis. 2d 346, 166 N.W.2d 155 (1969).

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## CONCLUSION

Payment provisions can have significant financial consequences for any party that has assumed the risk of non-payment, and can have significant financial benefits for the party that has shifted the risk of non-payment. Parties negotiating a construction contract should closely scrutinize conditional payment provisions to determine the effect of such provisions before entering into the contract. Likewise, construction trust fund statutes can provide useful remedies to owners, contractors, subcontractors, and sureties. The party charged with maintaining a construction trust fund should be familiar with specific requirements of the statute prior to the commencement of the construction project in order to ensure compliance with any procedural requirements and to avoid liability for remedies available under the statute.

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## HOW DO WE COMPLY?

- Joint checks
- Waivers
- Direct pay
- Contract clause

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## CONTRACTUAL TRUST FUND

Any and all material, equipment, and/or services, received from Client Company, and any proceeds, funds, or payments received by the Applicant from jobs/projects/business on which the material, equipment, and/or services, were sold, used or incorporated, are expressly held in trust by Applicant, its principals and Guarantor(s) for the benefit of Client Company, until Client Company has been paid in full. Use of any proceeds, funds, or payments received by Applicant from jobs/projects/business upon on which the material, equipment, or services, were sold, used or incorporated, before Client Company has been paid in full, shall constitute a breach of the trust and fiduciary duty of the Applicant, its principals and Guarantors. Applicant and Guarantor(s) warrant that he/she/it is aware of and will comply with all State laws requiring any proceeds, funds, or payments received by Applicant from jobs/projects/business on which Client Company's material, equipment, and/or services, were incorporated, be used to first pay Client Company. Applicant and Guarantor acknowledges his/her/its fiduciary duty to use any proceeds, funds, or payments received from jobs/projects/business on which Client Company's material, equipment, and/or services, were incorporated, to first pay Client Company and that failure to do so constitutes defalcation and conversion of trust funds. Any debt that arises out of the breach of the trust and/or defalcation of the material, equipment, services, and/or any proceeds, funds, or payments received by Applicant, is non-dischargeable in bankruptcy.



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## TAKE AWAYS

- Educate
- Pre-qualification
- Know all suppliers
- Joint checks and direct pay
- Follow through on sworn statements and applications for payment and disbursements
- Contract documentation
- Notice

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# CONSTRUCTION TRUST FUNDS

Questions?



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# THANK YOU

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