

# Trust Fund Diversion Presumed

By: Michael J. Rosenthal, Esq.

In upholding a Supreme Court decision that awarded a subcontractor summary judgment on liability, the Appellate Division has recently reaffirmed the importance of Lien Law Article 3-A and the requirement that all owners, contractors and subcontractors maintain funds in trust in order to provide protection for those parties involved in the improvement of real property, ensuring that they will be properly compensated for their services.

After filing a mechanic's lien and commencing a lawsuit to, among other things, foreclose upon a mechanic's lien, a subcontractor on a public improvement project demanded that the site contractor (upper tier contractor) furnish the subcontractor with a Lien Law §76 verified statement of all monies received on the project and detail how those monies were paid and/or applied on the project. When the site contractor failed to provide the Lien Law §76 verified statement, the subcontractor moved the court to compel its production. The Supreme Court directed the site contractor to provide a verified statement within 10 days. The site contractor furnished the Lien Law §76 verified statement, however, the subcontractor deemed it to be deficient and, again, moved the court to compel the site contractor to properly respond to the demand with the specificity required by the statute. The Supreme Court held that the verified statement failed to comply with the provisions of Lien Law §76 and awarded the subcontractor summary judgment on the issue of liability.

The Appellate Division, in reviewing the Supreme Court's award of summary judgment, affirmed the Supreme Court's findings that the verified statement provided by the site contractor was deficient in a number of respects. The verified statement failed to set forth the dates and amounts of the trust assets receivable, trust accounts payable and trust funds received as required by Lien Law §75(3)(A)-(C). The Appellate Division also found that the verified statement did not set forth the exact date each payment was made and did not provide a sufficiently detailed breakdown of the total payments made with trust funds. Importantly, the Court found that there was a \$4 million gap of unaccounted funds based upon the amounts the site contractor received and paid out. While the Appellate Division surmised that the gap may be attributable to the direct labor and equipment costs paid by the site contractor, the site contractor failed to provide an explanation for this gap and failed to provide a complete accounting of its trust assets receivable as required by Lien Law §75(3)(A).

Ultimately, the Appellate Division held that in light of the documented deficiencies in the site contractor's verified statement, deficiencies that the site contractor failed to remedy despite ample opportunities to do so, and absent any reasonable explanation for the shortcomings, the site contractor failed to overcome the statutory presumption of an improper diversion of trust assets and affirmed the Supreme Court's award of summary judgment on the issue of liability.

## Commentary

This recent Appellate Division decision reiterates the importance of the statutory mandate upon owners, contractors and subcontractors, acting as trustees on construction projects, to adequately maintain books and records. The failure of the trustee to keep the statutorily required books and records is presumptive evidence that the trustee applied or consented to the applications of the trust funds for purposes other than a purpose of the trust.

As this case shows, a contractor (and any other statutory trustee) will be severely penalized by the courts for failing to fulfill its obligations as a trustee. In this instance, the Court punished the site contractor by granting the subcontractor summary judgment on the issue of liability. When a trust diversion is found, a court can sanction a contractor by imposing personal liability and a trust fund diversion is punishable as a crime.

Owners, contractors and subcontractors acting as trustees on a construction project should not take that role lightly. The Lien Law was enacted to protect the individuals actually performing the work on a project, and there is a presumption that funds have been diverted. Protecting oneself, however, is not too daunting a task. With adequate planning and a good team to support the contractor, a contractor can adequately protect itself and comply with the law.