

TRUST FUND PROTECTS THE BOTTOM OF THE CONSTRUCTION CHAIN

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A “payment” food chain exists among the construction network with the chain consisting of owners, contractors, subcontractors, supplier and laborers. Inevitably, one party will rightfully hold the money of another at one time or another. How can the subcontractors and suppliers last in line have guaranteed payment? One solution is the construction trust created when one party holds legal title to property in which another party has the right to beneficial enjoyment. A trust ensures that the contractor/trustee will handle the money with a high degree of care.

As trustee, a contractor is subject to civil and even criminal liability for the misapplication of trust funds. Therefore, it is inherent that all contractors understand when this relationship is created, what is expected of a trustee, who can be held liable, and the benefits a trust can deliver. This article outlines a trust created in the construction industry context as defined in the Texas Property Code, Chapter 162, commonly referred to as the Construction Trust Fund Act.

Creation of the Construction Trust

Construction payments are considered trust funds when made to a contractor, subcontractor or officer, director, or agent of the same under a construction contract for the improvement of real property. Similarly, funds borrowed by these parties for the improvement of such real property and secured by a lien are also considered trust funds. As a result, the contractor becomes a trustee and owes a duty of care to the beneficiaries, who consist of the suppliers and materialmen on the project. Once the owner makes payment to the general contractor a trust is created under Texas law and exists for all parties in the subcontract chain, regardless of direct contractual privity. Further, the trust does not expire when the general contractor pays a subcontractor. It continues in those funds for the benefit of all the subcontractors and suppliers in the chain below.

Chapter 162 of the Texas Property Code defines this relationship and was implemented in order to protect contractors, subcontractors, materialmen, and laborers from the fraudulent application of funds and refusal to pay for work completed. The statute offers automatic protection without the need to file a lien or initiate a law suit to collect debts. Accordingly, courts have interpreted this statute broadly to fulfill its protective purpose.

Expectation of the Trustee

Primarily, the trustee has a duty not to misapply the funds. Misapplication occurs when a trustee “intentionally, or knowingly or with intent to defraud, directly or indirectly retains, uses, disburses, or otherwise diverts trust funds without first fully paying all current or past due obligations incurred by the trustee to the beneficiaries.” (Texas Property Code, § 162.031) Courts have found misapplication even if the trustee did not intend to defraud the beneficiary and even if unauthorized payments were made in good faith. Consequently, ignorance is not an effective defense.

There are, however, effective defenses to actions brought against a contractor/trustee for alleged misapplication of trust funds. These include the following:

- (1) Payment was made for actual expenses that are directly related to the construction or repair of the improvement on the property. Courts have strictly enforced the requirement that the expenses be directly related to the property.
- (2) After notice to the beneficiary, funds are retained because the trustee reasonably believes that the beneficiary is not entitled to such funds or have been retained as authorized or required by chapter 53. (Chapter 53 of the Texas Property Code is beyond the scope of this article). Note that notice must have been given to the beneficiary before relying on this defense.
- (3) The trustee paid the beneficiary all trust funds which they were entitled to receive no later than 30 days following written notice to the trustee of the filing of a criminal complaint or other notice of a pending criminal investigation.

Accountability in the Trust

Anyone in the construction chain can be considered trustees and therefore held accountable for the misapplication of trust funds.

The Owner. Owners do not escape liability simply because they are on top of the construction food chain. Any retainage withheld from progress payments are trust funds. This means a materialman can recover from an owner when retainage is withheld despite the lack of a direct contractual relationship. This is possible even if the materialman does not perfect a statutory materialman's lien because the Construction Trust Fund Act serves as protection in addition to materialman's lien statutes. Additionally, the owner cannot credit expenses not directly related to the construction contract.

The General Contractor. Perhaps the most common trustee in this context is the general contractor who receives funds from the owner and is in turn required to pay the subcontractors on the project.

The Subcontractor. The subcontractor is also trustee when holding funds owed to a materialman, supplier or laborer.

The Individual. An officer, director or agent can be held personally liable for the misapplication of funds. These individuals must have control or direction of trust funds to be considered trustees. A designation of title alone will not suffice to hold an individual accountable. For example, a stockholder/officer who has a passive role within a company and makes no managerial decisions nor participates in decisions to pay creditors is not a trustee under Texas law. Beware that individuals cannot hide under the guise of company bankruptcy.

Exceptions to liability under the Construction Trust Fund Act apply to banks, savings and

loan associations, lenders, title companies, and corporate sureties.

An Example: The Trust in Action

Consider when there are competing interest to the trust fund. Owner pays general contractor (GC) who retains funds from subcontractor one (S1) to ensure that other subcontractors and materialmen will be paid. A federal tax lien is filed against S1 and the federal government wants to assert a superior right to the retainage held by the GC. Enter unpaid materialman. Although he does not have a perfected lien on the funds, he asserts a superior right to the funds as beneficiary of a trust. S1 has no right to the funds absent a showing that all obligations owed to the materialman were completed. The vulnerable, last in line, materialman wins and the statute has served its purpose.

The duty created by the trustee/beneficiary relationship establishes a high standard of care in which honesty alone is not sufficient, but a standard of actual behavior is upheld to maintain the integrity of the relationship. This gives assurance to those at the bottom of the construction chain that their paycheck will not end up in the pockets of someone else.