

DEFENDING AGAINST A MISAPPLICATION OF TRUST FUNDS CLAIM

By R. Carson Fisk (as seen in *Texas Construction* August 2009)

When non-compliant or defective work issues arise on a project, payment is often disrupted. If only partial payments are made to a contractor, some subcontractors may not be fully paid and litigation results. Savvy legal counsel may pursue a misapplication of trust funds claim as a means of recovering unpaid amounts. If one is pursuing the claim or defending against it, a claim for misapplication of trust funds can be a powerful weapon or an aggravating, although serious, nuisance.

Under Chapter 162 of the Texas Property Code, payments made under a construction contract are generally considered trust funds. The contractor, subcontractor or owner who receives the funds is considered a trustee. Laborers, subcontractors, material providers, et al, are beneficiaries of trust funds

An individual officer, director or agent of a contractor, subcontractor or owner who receives trust funds or who has control or direction of trust funds is also a trustee. Thus, an individual involved in receiving, controlling or directing payments can be sued along with—or even instead of—the entity. This is often the most effective or frustrating aspect of such claims as an individual merely acting on behalf of a business may wind up personally involved in costly litigation. Unless counsel on the opposing side listens to valid reasons that individual is not a proper party or otherwise dismisses the individual, the person is left only with disproving the claim or proving the existence of an affirmative defense.

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Pursuant to the statute, a trustee who intentionally, 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 of the trust funds, has misapplied the trust funds. A trustee acts with “intent to defraud” when the trustee retains, uses, disburses or diverts trust funds with the intent to deprive the beneficiaries of the trust funds. Intent is a subjective matter, and such claims are more difficult to address early on as discovery generally is conducted before a court is typically willing to dismiss a claim.

If a trustee has received an amount of money yet to be paid to those performing work or providing materials, the beneficiaries can assert a misapplication of trust funds claim that will initially be difficult to defeat. A trustee acts with “intent to defraud” when the trustee uses, disburses or diverts trust funds paid to the trustee in reliance on false information contained in an affidavit.

Chapter 162 does provide for various affirmative defenses to a misapplication of trust funds claim that can defeat a claim early on. First, it is an affirmative defense that the trust funds not paid to the beneficiaries were used by the trustee to pay the trustee’s actual expenses directly related to the construction or repair of the project. Generally, amounts can be safely used for directly related expenses that, while not readily traceable to a particular project, are necessary to obtain or complete the project—as long as the expenses are incurred—including overhead. As to this defense, quality record keeping can be of assistance and may allow for early resolution.

Second, it is an affirmative defense that the trust funds not paid to the beneficiaries have been retained by the trustee, after notice to the beneficiary who has made a request for payment, as a result of the trustee’s reasonable belief that the beneficiary is not entitled to such funds or the funds constitute retainage. After a beneficiary requests payment in the form of an application for payment or otherwise and the trustee has not yet been paid and payment does not appear to be forthcoming, the trustee should provide formal notice informing the beneficiary as to why the trustee believes the funds are not owed. The notice should rely on provisions in contract, such as a contingent payment clause or provisions pertaining to the quality of the work. As reasonableness is also a subjective matter, care should be taken to draft a comprehensive and detailed notice.

Third, it is an affirmative defense that the trustee paid the beneficiaries all trust funds they are 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.