

## **Diversion Of Construction Trust Funds- Court Imposes *Summary Judgment* Against GC Based On Inadequate Recordkeeping Alone**

**by: Henry L. Goldberg & Robert J. Fryman**



**Henry L. Goldberg**



**Robert J. Fryman**

Construction project trust funds, pursuant to Article 3-A of New York's Lien Law, are all monies received by a general contractor or subcontractor on a project. Each level that receives funds is a trustee to the next level "down." They must segregate the funds from the funds of other projects, and ensure the funds are not used to pay non-project-specific expenses *prior* to paying all debts and obligations for the specific project. As we often say, money on construction projects must flow "vertically," never "horizontally."

In a rare action, a New York court recently granted "summary judgment" against a general contractor, finding that the contractor's books and records demonstrated, at the outset, that the contractor had paid over \$8 million to parties which were not beneficiaries for the specific project's trust fund.

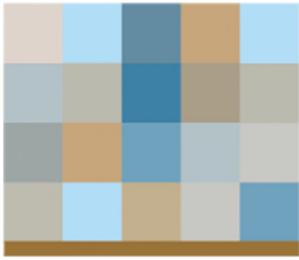
If those funds are paid or used for any other purpose outside the specific project, it would be considered a "diversion" of trust assets. This could leave the contractor/trustee who controlled the funds with significant, personal liability. The purpose of the trust is to ensure that all contractors working on any given project are paid for their work before the trustee (party holding the trust funds) pays themselves, or any other, non-project creditors.

Upon review of the general contractor's records and bank account information, the court readily found that approximately \$11,500,000 of the \$17,500,000 of trust funds held for the project was paid for expenses totally unrelated to the project. Of the money spent, approximately \$8,500,000 was paid to contractors which did not perform any work on the project and another \$1,500,000 was paid to a labor union on another unrelated project.

Significantly, although the general contractor argued that some of those payments were to subcontractors who worked on the project, the general contractor was unable to prove it. Thus, in an unusual move, the court granted summary judgment in favor of the subcontractor alleging diversion of trust funds.

Perhaps most telling was that the contractor's bank records showed that approximately \$1,200,000 was paid to the general contractor's wife and another \$300,000 to his brother, ultimately leaving only \$187.00 in the contractor's operating account to pay subs and suppliers.

Fortunately for the contractor, the court determined that there was not enough evidence (at this stage of the case) to prove that the principal of the corporate general contractor



**STRENGTH IN PARTNERSHIP®**

**CONSTRUCTION LAW  
ALERT**



*This Alert was written by Henry L. Goldberg and Robert J. Fryman.*

*Mr. Goldberg, a partner of the firm, chairs the firm's Construction Practice Group where he handles all facets of complex construction law related matters.*

*Mr. Fryman, a partner of the firm, concentrates his practice on construction law and litigation matters.*

*Nicholas Calabria, a law clerk with the firm, assisted in the preparation of this Alert.*

*Moritt Hock & Hamroff LLP is a broad based commercial law firm with more than 75 lawyers and a staff of patent agents and paralegals. The firm's practice areas include: alternative dispute resolution; commercial lending & finance; construction; copyrights, trademarks & licensing; corporate & securities; creditors' rights & bankruptcy; cybersecurity, privacy & technology; employment; equipment & transportation leasing and finance; healthcare; landlord & tenant; litigation; marketing, advertising & promotions; mergers, acquisitions & private equity; not-for-profit; patents; real estate; tax; and trusts & estates.*

knowingly diverted trust funds from the project, thus avoiding (at least temporarily, personal, and even criminal, liability). Corporate officers may be personally liable for diversion of trust funds, provided that the officer knowingly participated in or permitted the diversion of funds by the corporation. However, the court made clear in its decision that should later evidence in the litigation demonstrate that the principal of the general contractor knowingly diverted trust funds, he could still be held personally liable.

**MH&H Commentary**

This case serves as a stark reminder of the fiduciary responsibilities imposed by the Lien Law. Had the general contractor/trustee kept appropriate (and statutorily required) records of all receipts and payments on the project, the court might have been able to find the payments to be valid applications of trust funds.

The recordkeeping requirements of trust fund accounting cannot be complied with after the fact. Only with a disciplined program of tracking job-specific revenue, costs and payments, can a contractor avoid liability for trust fund diversions, whether inadvertent or not. Consultation with experienced construction accountants and/or attorneys, familiar with the record keeping requirements of the Lien Law, and the obligations of a contractor as a trustee, is essential.

Final Thoughts: Trust fund diversion is not uncommon in construction. Too many contractors are tempted to use "good" job funds to get over a cash flow crunch on a "bad" job. "What's the harm if I use revenue from a good job for temporary funding? I'll simply reconcile job-related receipts and disbursements later, when cash flow catches up on the bad job." This case is a clear reminder of the folly of not resisting the temptation of this reasoning. As with IRS audits, you don't want to be the one scrutinized and examined.

Any issues raised in this Alert may be addressed to either Mr. Goldberg or Mr. Fryman who can be reached at: (516) 873-2000 or by email at [hgoldberg@moritthock.com](mailto:hgoldberg@moritthock.com) or [rfryman@moritthock.com](mailto:rfryman@moritthock.com)



*This Alert is published solely for the interests of friends and clients of Moritt Hock & Hamroff LLP for informational purposes only and should in no way be relied upon or construed as legal advice.*

©2019 Moritt Hock & Hamroff LLP

Attorney Advertising

400 Garden City Plaza, Garden City, NY 11530 | Tel (516) 873-2000 | Fax (516) 873-2010  
1407 Broadway, 39th Floor, New York, NY 10018 | Tel (212) 239-2000 | Fax (212) 239-7277

[www.moritthock.com](http://www.moritthock.com)