



Legal Article

Personal Liability for Trust Fund Diversion

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In the late 1980s, the New York State Legislature enacted safeguards designed to protect homeowners from unscrupulous home improvement contractors and clarified the law relating to warranties applicable to new homes. Long before that legislation, New York law provided an important safeguard to protect the rights of those who provide labor and materials for the construction of homes and other improvements. Specifically, the trust fund is a tool created by New York's Lien Law, in addition to the mechanic's lien, to ensure payment for the improvement of real property. Particularly, because of the prospect of personal liability for owners and officers of corporate developers and even criminal responsibility, the trust fund provisions of Article 3-A of the Lien Law are effective and must be taken very seriously.

The trust fund provisions provide that all funds paid to an owner, contractor or subcontractor for the improvement of private or public real property constitute trust funds that must be held by the party receiving them as trustee on behalf of the parties who provided the labor and materials for the improvement of the property. Not all funds which come into the hands of a builder constitute trust funds. Only the monies specified under the Lien Law — an owner's, contractor's or subcontractor's trust — constitute trust funds.

Essentially, an owner's trust consists of loan and mortgage proceeds and other monies intended to be used to improve real property. A contractor's trust consists of proceeds paid under a contract with an owner for an improvement of public or private real property and home improvements. A subcontractor's trust consists of such monies paid by the contractor to a subcontractor. The trust is created at the moment trust funds are received by the trustee; whether a claim has been asserted by a beneficiary is irrelevant. Whether the trustee is the owner, contractor or subcontractor, the trustee has no ownership interest in the trust funds and the trust does not terminate until all trust beneficiaries who provided labor or material have been paid.

Therefore, a contractor or developer constructing a home cannot use the funds paid for

the project to pay its own expenses until it has first paid its subcontractors, laborers and material men. Also, a contractor or developer who receives trust funds for constructing one specific house cannot use those funds to pay expenses incurred in building another house. In fact, in a development involving the construction of homes on multiple sites, in the absence of proof that the work on several sites was accomplished under one agreement, each house will be deemed to be a separate project for purposes of creating a statutory trust.

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Problems arise and liability is imposed under the Lien Law when trust funds are diverted from the trust beneficiaries protected under the statute. Any payment of trust assets for a purpose not allowed by the statute is a diversion and liability will be imposed on both the trustee and the transferee (the person who improperly received the trust funds). Indeed, liability will be imposed regardless of the good faith of the trustee or transferee and even if the transferee is actually owed money by the trustee. Once a diversion is established, a beneficiary may obtain an accounting, recover the diverted trust funds, damages for breach of the trust, attorneys' fees expended in asserting a claim, and even punitive damages if it can be shown that the trustee acted in flagrant disregard of the Lien Law's trust fund provisions.

Most people assume that forming a corporation and operating in the corporate form shields them and their assets from personal liability. However, where the trustee or transferee of diverted trust funds is a corporation, the officers, directors and shareholders of the corporation will be held personally liable for the

diversion if it is shown that those individuals had knowledge that the monies transferred constituted trust funds or actively participated in the diversion. In order to establish personal liability, it is not necessary to prove actual knowledge that the monies were trust assets; proof of facts that would put a reasonable person on notice that a transfer involves trust funds will suffice. Lastly, a diversion by a trustee or a corporate trustee's officers, directors or agents constitutes the crime of larceny under the Lien Law. While prosecutions under the criminal provisions of the Lien Law are rare, the very existence of those provisions underscore the importance placed by the State of New York on the public policy of protecting beneficiaries of statutory trust funds.

EDITOR'S NOTE: For more information on Lien Law provisions in New York's Home Improvement Contract Law, you can order NYSBA's *Remodeling & Custom Home Contracts Guide*. This guide provides a general overview of home improvement contracts including: the law, specific contract requirements, checklists, financing and sample contracts.

Also available is NYSBA's *Builder's Guide to New Home Warranties in New York State*. This guide provides builders with everything they need to know about New York State's Housing Merchant Implied Warranty under GBL Article 36-B. The guide also includes relevant case law developments, tips for limited warranties, options and strategies for compliance as well as sample contract and accepted standards.

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