

Bulletin #79, Hey, GC, Where's My Money? Remedies for the Unpaid Subcontractor (September 7, 2004)

Introduction

An unfortunate, yet all-too-common, scenario in the construction industry occurs when a general contractor ("General") gets paid by the owner, but instead of paying the subcontractors for their contributions to the project, the general uses the funds for another purpose. What are the subcontractors' options in this predicament? A statutory remedy may be available in your state called a "trust fund" or "theft by contractor" statute. Although these statutes vary by state, many provide criminal penalties against the general and civil remedies for the subcontractor.

This *Contracts Bulletin* will provide a general overview of the remedies available to subcontractors in these "contractor theft" situations. The first section of this *Bulletin* will discuss when these situations arise. The second section will outline the penalties or actions that the subcontractor can realize under the statutes. The third section will provide information on how the subcontractor can preserve its claims under these statutes. And finally, the fourth section will provide some guidelines on how subcontractors can avoid these situations.

I. When the Situation Arises

The "contractor theft" situation generally arises when the owner of the property has already paid the General for work done by the subcontractor on a project; and instead of paying the subcontractor, the General uses the money for other reasons, possibly to fund other projects, but maybe even for personal reasons. This discussion also applies to the situation where the General pays the subcontractor and the subcontractor fails to pay the sub-subcontractors. Note that this discussion is different from a "pay when paid" situation (see *Contracts Bulletin #73*); here we are assuming the General (or subcontractor) has been paid and, for whatever reason, improperly does not pay the subcontractor (or sub-subcontractor).

It should be noted at the outset that these "trust fund" or "theft by contractor" statutes most likely will not apply where the General/subcontractor withholds payments based on a good faith dispute about the quality or quantity of the subcontractor/sub-subcontractor's work or if there is a bona fide dispute as to the amount of the invoice.

II. Subcontractor's Authority to Act

1. Four Main Types of Statutory Remedies

A variety of statutory remedies are available to subcontractors or sub-subcontractors who remain unpaid, including:

1. A right to a mechanic's lien – for those who work on private projects;
2. A labor and materials' payment bond secured by a surety – for those who work on public projects;
3. A "stop notice," which forces the owner to withhold from the General enough funds to cover the subcontractor's claim of indebtedness; and
4. Remedies under "trust fund" statutes, which impose a trust on the funds the owner pays to the General for the benefit of the subcontractor.

2. Trust Fund Remedy or Mechanic's Lien? Or Both?

In the past, when subcontractors have failed to get paid, they have usually sued the General for breach of contract and filed a mechanic's lien against the owner's property. However, for various reasons, such remedies may prove either unattainable or unsatisfactory. The General may have gone bankrupt, the mechanic's lien may be too costly, the subcontractor may have missed the required deadlines and lost its mechanic's lien rights, or even foreclosure may not be an option because the subcontractor fears being found liable for environmental contamination. Thus, to protect subcontractors from dishonest general contractors and to help subcontractors receive what they are rightfully owed, many states have adopted trust fund statutes to complement the mechanic's lien remedy. These statutes also protect owners from the danger that liens will be placed on their property when the General fails to pay its subcontractors.

1. General Trust Fund Statutes

Numerous states have statutes that require Generals to hold "in trust" any payments received from the owner for labor and materials furnished by the subcontractors or suppliers. In these "trust fund states," Generals owe the highest duty of loyalty to the subcontractors or suppliers – intentionally or knowingly failing to pay subcontractors constitutes misapplication of the trust funds and will subject the General to civil and/or criminal liability. See e.g. Wis. Stat. §779 and Minn. Stat. §514.02; Supra Bruner & O'Connor. See generally Phillip L. Bruner & Patrick J. O'Connor, Jr., 3 Bruner & O'Connor on Construction Law, §§8.40–8.44 (2004).

Most statutes expressly provide that payments made from the owner to the General are held in trust for the benefit of the subcontractors and suppliers. For example, New York's lien law provides that all funds paid either to an owner, contractor, or subcontractor for the improvement of either public or private property constitute trust funds and are held by the party receiving them for the benefit of any party who provided the materials and labor. Other trust fund statutes are more limited. New Jersey's law, for example, only applies to payments made to contractors on public projects and only those subcontractors who work directly with the contractor benefit.

Some states require the General to deposit the "trust funds" into a specific construction account in a financial institution, while others (including Minnesota) allow the funds to be commingled with other funds. The New York lien law requires the General to maintain account books and records; failure to do so constitutes a presumption that the funds were misapplied.

Given the many forms of trust fund statutes, it is important that you consult with your local attorney to determine what remedies are available in your state and what you must do to preserve such remedies. The following is a synopsis of the various types of laws.

2. Criminal Statutes

Nearly half the states make it a crime for the General to fail to pay its subcontractor after the General has received payment for the work done by the subcontractor. These provisions are sometimes part of a trust fund statute and other times are separate from the trust concept. Id.

The trigger for most of these laws is when the General fails to make timely payment upon receiving progress payments from the owner. Most states require the General to pay the subcontractor within 10 and 31 days of receiving payment from the owner. Also, most of these laws require that in order for the General to be liable, it must either have intended to not pay the subcontractor or at least know that it has failed to pay the subcontractor. Id.

For example, the Minnesota statute provides that payments received by a General must be held in trust by the General for the benefit of the subcontractor, who furnished the labor, skill, material, or machinery contributing to the improvement. General contractors who fail to pay their subcontractors, and who know that they remain unpaid, are guilty of theft. Moreover, the statute permits subcontractors to bring a civil action to recover damages and costs and disbursements, including attorney fees. Minn. Stat. §514.02.

3. Other Forms of Statutes

There are other variations of trust fund/contractor theft statutes. Some states create a statutory lien on funds payable to subcontractors. Tennessee and Utah tie their theft by contractor statutes to their Prompt Payment Acts and permit subcontractors to sue for nonpayment. Illinois has found the mechanic's lien statute itself creates a trust obligation. Finally, in some states, such as Georgia, that do not have trust fund statutes, courts have developed equitable remedies to achieve similar results. Supra Bruner & O'Connor at §8.41.

4. Contractual or Express Trusts

If your state does not have a trust fund statute, you may still be able to recover payments from the General if you negotiated an "express trust" provision in your contract with the general contractor. State laws differ on the required elements, but generally the express trust must have the following characteristics:

1. An intent to create a trust;
2. Clearly identifiable trust beneficiaries (subcontractors) and a designated trustee (General);
3. A clearly defined trust res (i.e., payment); and
4. Delivery of the res to the General/trustee. Supra Bruner & O'Connor at §8.43.

Because subcontractors are the main beneficiaries of such provisions, these clauses are often resisted by general contractors and are, thus, fairly rare in construction agreements. But subcontractors, who are able to incorporate a valid trust provision in their contracts, will be better assured that monies they are owed will be protected from the claims of competing creditors. Moreover, a valid trust provision may make it more difficult for the General/trustee to discharge its debts in the event of bankruptcy.

3. Harsh Consequences for General Contractors

The theft-by-contractor statutes can have devastating effects on general contractors who fail to make timely payments. For example, in a New York case, after receiving the seventh of eight installment payments from the owner on a \$230,000 project, the General deposited the money into his business account. Although he owed money to the subcontractors for work they had performed on the project, the General withdrew \$2,000 from the account for his own use and was charged with larceny for failing to pay construction trust funds under the New York lien law. The court found the larcenous intent element satisfied by testimony from the owner that the General admitted that he would abandon the job because his expenses were eating into his profit and all the money

coming out of the job thereafter would be owed to suppliers. Id.

In some states, such as Wisconsin, not only is the General liable for misappropriation of the funds, but if the General is a corporation, any officer, director, or agent of the corporation, who is responsible for misappropriating the funds, is also liable. See e.g. Wis. Stat. § 779.05(2). Moreover, in other states, the shareholders, officers, directors, or agents of the corporation, who are not responsible for the theft, but who knowingly receive proceeds of the payment, may be subject to civil liability.

4. Limitations on the Right to Recover

There are some important limitations under these statutes on how much subcontractors may recover. For example, in a Wisconsin case, an owner fired the General before all of the work was done. The subcontractors were still owed \$2,000 for the work they had done; but since the General had paid more to the subcontractors and suppliers than it had received from the owner, the court held that the General was not liable to the subcontractor. The court stated that the test is not whether the subcontractor gets paid the full amount of its invoice but rather whether the General used the money for the agreed upon purposes. Supra Bruner & O'Connor at §8.40.

III. How Subcontractors Can Preserve Their Claims

1. Do the Work Properly

To state the obvious, subcontractors should make sure to uphold their end of the bargain by doing the work properly. As stated above, the most useful defense for general contractors is that they are withholding the payments because of a legitimate dispute over the existence, validity, or amount of the payment, or a dispute as to whether it is due. Thus, the subcontractor should do the work according to the terms of the subcontract and in a good and professional manner.

2. Provide Notice of Nonpayment to the General

If the subcontractor finishes its work and remains unpaid, it should give "notice of nonpayment" to the General. In some states, this may be required, but even in states where it is not a requirement, giving such notice may help the subcontractor prove that the General is liable. For example, under the Minnesota law, a subcontractor may give written "notice of nonpayment" to the General, and if the General does not pay the subcontractor within 15 days after receiving such notice, this will be sufficient evidence to prove that the General is liable for using the money for purposes other than to pay the subcontractor. Note that if the General can show that all proceeds received from the owner have been applied to pay the subcontractors, he will not be found liable.

IV. How Subcontractors Can Avoid These Situations

1. Examine the Contract

As has been stated in most of these *Contracts Bulletins*, it is crucial for subcontractors to examine the contract language. Subcontractors should be sure to specify the exact work, labor, and materials, which they are required to supply, and also the amount of payment it is due. A subcontractor never wants all-encompassing language in its contract that requires it to do "everything that is necessary."

Subcontractors should also remove "pay when paid" clauses from the contract (*Contracts Bulletin #73*), obtain the right to stop performing under the contract without incurring penalties if it has not been paid (*Contracts Bulletin #76*), and make sure to not waive the right to put a lien on the property.

2. Try to Get an Express Trust Provision Written Into the Contract

Although it may be difficult, subcontractors should attempt to negotiate an express trust in their contracts with the General. To be valid, the contract provision must identify all the elements required under state law to create a trust.

Conclusion

Many states have responded to the "contractor theft" dilemma with "trust fund" or "contractor theft" statutes. Although these laws vary greatly by state, they often provide civil remedies to unpaid subcontractors and may impose criminal sanctions on those who fail to pay. It is important for subcontractors to talk to their local attorney in order to understand both the remedies they may have when the General fails to pay them and also the liabilities they may face if they fail to pay their sub-subcontractors. To be eligible for a remedy, subcontractors should always make sure to review their contracts before signing and do the work according to the terms of the contract.

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