

certain types of owners to a contractor for work by a subcontractor are deemed to be held "in trust" by the contractor for the benefit of the subcontractor:

A.R.S. 33-1005. Payments made in trust

Monies paid by or for an owner-occupant * * * to a contractor * * * as payment for labor, professional services, materials, machinery, fixtures or tools for which a lien is not provided in this article shall be deemed for all purposes to be paid in trust and shall be held by the contractor for the benefit of the person or persons furnishing such labor, professional services, materials, machinery, fixtures or tools. Such monies shall neither be diverted nor used for any purpose other than to satisfy the claims of those for whom the trust is created and shall be paid when due to the person or persons entitled thereto. The provisions of this section shall not affect other remedies available at law or in equity.

In the *In re Baird*, 114 B.R. 198 (B.A.P. 9th Cir. 1990) case, the Bankruptcy Appellate Panel concluded that the misuse of funds in violation of the Arizona "trust fund" statute stated a claim that the "debt" owed to the creditor is a non-dischargeable debt in bankruptcy. *Baird*, 114 B.R. at 206. In other words, the debtor who filed bankruptcy in *Baird* had substantial incentive to resolve the subcontractor's claim because the debt may remain collectable by the subcontractor despite the bankruptcy filing (which is generally the exception, not the rule, for most debtors who fully complete the bankruptcy process).

Creating New Potential Rights by Creating a Trust by Contract.

Absent an action by the Oregon Legislature to pass a "trust fund" statute similar to the Arizona statute, construction creditors may be able to create new potential bankruptcy rights by creating a trust by agreement.

A trust is nothing more than a special relationship where a trustee holds legal title to a "res," or property, for the benefit of the trust beneficiary. The Uniform Trust Code ("UTC"),

TRUST ME:

ENHANCING CONSTRUCTION CREDITOR RIGHTS IN BANKRUPTCY THROUGH TRUST LAW

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The beneficiary of a trust enjoys a number of special benefits and rights as a creditor in a bankruptcy filed by the trustee (the custodian of the trust as the debtor in bankruptcy, not the trustee appointed to administrate or oversee the bankruptcy process). This article suggests that a construction creditor may also be able to enhance its collection rights in bankruptcy by contractually creating a trustee-beneficiary relationship with the contractors the creditor supplies for construction projects.

Statutory Trusts in Other States.

The use of trust law concepts to enhance construction creditor's rights in bankruptcy is not new. For example, in Arizona, funds paid by

adopted in Oregon, provides the following minimum requirements for creating a trust:

- (a) The settlor has capacity to create a trust.
- (b) The settlor indicates an intention to create the trust.
- (c) The trust has a definite beneficiary * * *
- (d) The trustee has duties to perform.
- (e) The same person is not the sole trustee and sole beneficiary. See ORS 130.155(1).

Absent language to the contrary in the terms of the trust, the UTC provides the default rules for trusts, subject only to certain non-waivable rules. See ORS 130.020(1) and (2). Note that a “settlor” means “a person * * * who creates a trust or contributes property to a trust” – so the settlor need not be the person who contributes the property to be held in trust. ORS 130.010(16).

One important default rule under the UTC is that a trustee must hold trust property separate and apart from the trustee’s own property. ORS 130.695(2). Therefore, any agreement attempting to create a trust established over “funds” should provide that the trustee (i.e. the person who owes the money for the purposes of this article) may commingle the trust beneficiary’s funds with its own funds. See ORS 130.020 generally and 130.720(1) (permitting the trust agreement to vary the trustee’s duties). Using the example of a contractor holding funds in trust for its subcontractor, the failure to modify this default rule under the UTC would require the contractor to deposit the subcontractor’s funds in a separate account, which is not practicable, and may cast doubt on whether the arrangement truly is a trust.

Construction Law Relationships Potentially May Include a Trustee and Beneficiary.

A joint check agreement creates a three party relationship for the express purpose of benefiting a remote payee – typically a contractor who makes payment on a subcontract jointly with the subcontractor and the subcontractor’s supplier. Using the above-example, it may not be a

significant additional step for a material supplier with sufficient negotiating power to include language in the joint check agreement creating an express trust whereby the contractor (as the “settlor”) requires the subcontractor (as the “trustee”) to hold funds intended to be paid to the supplier (the beneficiary) in trust. Language to use as a starting point might be:

All parties agree that all funds owed to Customer, to the extent those funds result from materials or equipment supplied by Supplier, shall be and are held in trust for the sole benefit of Supplier for the express purpose of insuring Supplier realizes payment for past and future materials and equipment supplied to the Project (hereinafter “Trust Funds”). Customer may commingle Trust Funds, but agree they have no interest in Trust Funds held by anyone, that Customer has no interest in the joint checks to be issued pursuant to this Agreement, and to promptly account for and pay to Supplier all such Trust Funds.

Similarly, a construction contract that requires retention is analogous to a trust relationship insofar as there is a “res” – the retained percentage of the contract funds earned – held by the contractor (or owner) to secure completion of performance by the ultimate intended beneficiary of the retainage. Or for that matter, all funds earned under the construction agreement. For example, the following case excerpt recites contract language used by a general contractor to insure the subcontractor paid its suppliers:

Each subcontract provided that all money received by the subcontractor from Raiser [the general contractor] immediately became and constituted a trust fund for the benefit of “persons and firms supplying labor and materials . . . for the benefit of said persons and firms, and shall not in any instance be diverted by Subcontractor to any other purpose until all obligations arising hereunder have been fully discharged and all claims arising therefrom have been fully paid.”

In re Gonzales, 22 B.R. 58, 59 (B.A.P. 9th Cir. 1982). Note, however, that due to the adoption of the UTC since this case decision, a drafter must include language expressly permitting the trustee to commingle funds with the trustee's own funds.

Using Trust Concepts in Bankruptcy to Protect Construction Creditors.

If parties to construction contracts can be elevated to the level of a trustee and beneficiary in relation to the sums to be paid, a creditor can potentially enjoy additional rights and remedies in bankruptcy court.

1. Misuse of Trust Funds May Be a Non-Dischargeable Debt of a Contractor *or* a Responsible Corporate Officer of Contractor.

Most bankruptcy debtors file bankruptcy to discharge debts and to obtain a financial "fresh start" – meaning most debts arising before the bankruptcy filing are no longer collectable against the debtor. However, a bankruptcy debtor may not discharge certain types of debts determined by the bankruptcy court to be "non-dischargeable." Case law provides that even a potentially innocent misuse of funds by a fiduciary can give rise to a claim the debt is non-dischargeable under 11 USC §523(a)(4). *In re Gonzales*, 22 B.R. at 59 ("defalcation" under Section 523(a)(4) does not require proof of an intentional wrong by a debtor with respect to funds held in trust).

Potentially, this theory could apply to both a subcontractor seeking to recover payment affirmatively from the upstream contractor (as is the case in *Baird*), or a general contractor seeking to recover damages caused by a downstream subcontractor's non-payment of "trust funds" to his supplier who filed mechanics liens (as is the case in *Gonzales*).

Furthermore, it seems possible to create liability on the part of the "trustee" that may even attach to officers of the debtor corporation. For example, the debtor in the *Baird* case was a *corporate officer* of what presumably was an insolvent corporate entity that owed the debt for the work performed. While *Baird* is obviously of

only limited utility as it is based upon a "statutory" trust, perhaps the same result could be obtained contractually if the "trust" provision of the contract identified the contractor's specific corporate officers as trustees over the funds and recited their specific fiduciary duties in relation to the funds.

2. Trust Funds May not be Part of Debtor's Bankruptcy Estate (and Should be Paid to Creditor).

A voluntary bankruptcy filing immediately creates a bankruptcy "estate" in all legal and equitable interests of the debtor in any property, wherever located. The concept of an estate is critical to bankruptcy law. Generally, the purpose of most bankruptcies is to either liquidate the debtor's non-exempt assets to pay creditors or to use the debtor's assets as part of a plan to reorganize. The bankruptcy "estate" generally describes all of the debtor's property to be protected from unauthorized creditor collection action and unauthorized transfers by the debtor, both of which disrupt or render impossible an orderly administration of the bankruptcy.

Under the statute creating the bankruptcy estate, however, the trustee (i.e. the debtor who is the custodian of a trust) owns only "legal title" to trust assets - equitable title is held by the beneficiary for whom the assets are held in trust. 11 U.S.C. §541(d). Therefore, if the trustee files bankruptcy as a debtor, the trust assets never become part of the debtor's bankruptcy "estate" and the debtor should not be able to "use" or liquidate those trust assets in a bankruptcy. *See In re LAN Tamers, Inc.*, 329 F.3d 204 (1st Cir.2003) (Holding that the debtor did not have any property rights in funds that the court declared to be held in a resulting or constructive trust); and *In re Edison Bros., Inc.*, 243 B.R. 231 (Bankr.D.Del.2000) (Same result regarding a constructive trust). Accordingly, a creditor who is a beneficiary of trust funds traceable to trust funds held by the debtor may file an adversary proceeding for the return of those funds. Similarly, the creditor can and often should object to any motion to use cash collateral in the context of a Chapter 11 bankruptcy to the extent the trust funds are

traceable to the cash collateral that the debtor proposes to use.

3. Trust Funds Used to Pay Debts May Not be Subject to Preferential Transfer Claims In Bankruptcy. Many trade creditors are familiar with preferential transfer claims under 11 U.S.C. §547. A common scenario is a trade creditor receives a payment from a customer on a pre-existing debt only after threatening collection. The customer then files bankruptcy less than ninety (90) days after the check clears the bank. Sometime later, the creditor receives a letter from the bankruptcy trustee demanding the creditor return the payment to the bankruptcy court as a "preferential payment."

If the trade creditor can claim the funds paid were "trust funds" (such as the scenario with a trade creditor who uses a joint check agreement that creates a trust), the trade creditor may have a potential defense to disgorging the funds. A central element of a preferential transfer claim under Section 547 is that there was a transfer of "*an interest of the debtor in property*" – in other words, the debtor "owned" the property or funds transferred. As noted in the discussion above, a trustee (again, custodian of a trust as a bankruptcy debtor) only holds legal title, not equitable title, to the trust property. Accordingly, case law provides that a transfer of "trust property" may not be subject to a preference claim. *Begier v. Internal Revenue Service*, 496 U.S. 53, 110 S.Ct. 2258, 110 L.Ed.2d 46 (1990) (Debtor's payments of employee FICA taxes and certain excise taxes deemed by statute to be held in trust by the Internal Revenue Service were not preferential transfers of an interest held by the debtor in the funds to the IRS).

Summary. Given the fragile condition of the construction industry, bankruptcy is a potential risk for virtually any given project. While none of the above-strategies may be fool proof, use of these techniques by creditors may provide significant value should a bankruptcy occur. Trust me.